

Adjustment Experience in the 1970's(*)

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1. Adjustment and development

When examining the literature on the link between short-term adjustment policies and development needs, two rather distinct strands of thought emerge quite clearly.

The first strand is more dominant in international financial institutions, in the governments of the developed countries, and also seems to have increasing influence within some Third World governments. As it is linked to neo-classical economic thinking, it regards financial equilibrium (both of internal variables and in the current account of the Balance of Payments) as a pre-condition for healthy development. According to this view, *The restoration of balance, once it is disturbed, is considered to have priority over all other objectives.*

The second strand of thinking is more dominant in international institutions closely linked to the developing countries and among politicians, academics and public opinion in certain Third World countries. This view takes as one of its starting points a critique of the former position; it points out that excessive emphasis on rapid adjustment to financial targets often leads to unnecessary sacrifices of the broader aims which economic development implies. This line of thinking is based on the belief that, reduction of poverty, social justice and other targets (such as an increase in national autonomy or institutional change) have priority over short-term financial equilibrium. Although this position makes many important contributions (some of which will be examined below), it usually neglects or underestimates the fact that a minimum of financial equilibrium is essential, not only for sustaining economic growth, but particularly for achieving targets such as increasing national autonomy, which this position strongly advocates.⁽¹⁾

So as to analyse the link between short-term adjustment and long-term development, it seems useful first to define more precisely both the meaning of development and that of adjustment.

As became increasingly evident in the 1960s, economic growth was insufficient by itself to solve the main problems and respond to the aspirations of the great majorities in the Third World.⁽²⁾ Thus, today, development

(*) This paper was prepared for the conference on adjustment policies for senior African Officials, organized by the World Bank, IMF and Commonwealth Secretariat, and chaired by Prof. Dudley Seers in London

(1) These two approaches can be rather well illustrated by the changing nature of economic policies and development in Chile during the 1970s.

(2) For a discussion of these issues, see D. Seers «The New Meaning of Development» in *International Development Review*, Vol XIX, N.º 3. This paper reviews some of the main contributions to this discussion in the 1970s, including the well-known IBRD-IDS study *Redistribution with Growth* (Oxford, 1974).

is seen as implying not only economic growth, but also increasing satisfaction of basic needs of the majority of the population, decrease in inequality and unemployment, and growing self-reliance.

The concept of short-term adjustment to external constraints has also undergone important modifications, mainly in the late 1970s. International financial institutions (and particularly the IMF) have since Bretton Woods basically regarded equilibrium in the current account of the Balance of Payments as the main and proper goal adjustment policies for all countries.⁽³⁾ They have also considered till very recently that when a particular country deviates significantly from this position by going into deficit, it should attempt to reach current account balance very quickly (preferably within the period of one year). This definition of adjustment has been increasingly challenged,⁽⁴⁾ mainly for the following reasons. Firstly, it is pointed out that the current account deficits of Third World countries are related to their need to finance development; for this most LDCs should be net recipients of long-term capital, particularly as it is the declared policy of the government of developed countries to assist the Third World development through the provision of capital. Consequently it has been proposed that countries which are net importers of capital should reach agreement with those countries and/or institutions that will export capital to them, on a long-term target for their current deficit; the adjustment process would then aim to eliminate imbalances inconsistent with their long-term capital inflows. However, so long as such proposals are not implemented, it remains true for a particular developing country—whether it is subjected to IMF conditionality or not—that it cannot sustain in the medium-term a current account deficit in Balance of Payments unless other countries governments or international financial institutions—be they public or private—are willing to finance it.

⁽³⁾ The International Monetary Fund's position is of great importance on this issue because, as is stated in its Articles of Agreement, the Fund is the international agency with primary responsibility for shortening the duration and lessening the degree of disequilibrium in the balance of payments of its member countries. The basic concepts and models behind the Fund's approach to adjustment policies can be found for example in IMF—*The Monetary Approach to the Balance of Payments*, Washington DC, 1977.

⁽⁴⁾ For recent important critiques of the concepts of adjustment dominant in IMF thinking, see in particular (UNCTAD/UNDP *The Balance of Payments Adjustment Process in Developing Countries: Report to the Group of Twenty-Four*, Project INT/75/015, and *The International Monetary System and the New International Order*, main document for the South-North Conference, Arusha, Tanzania, July 1980. It is also important to note that Fund itself has begun to publish articles written by its staff, which themselves are fairly critical of the type of adjustment it has been implementing. (See, in particular, T. Reichmann, «The Fund's Conditional Assistance and the Problems of Adjustment, 1973-5» in *Finance and Development*, December 1978, and C.P. Blackwell, «Reflections on the Monetary Approach to the Balance of Payments», *IMF Survey*, 20 February and 6 March 1978).

Secondly it is pointed out that the time scale in which countries are obliged to adjust their current account is too short.⁽⁵⁾ Developing countries—and particularly the poorest among them—have far less flexibility than the industrialised countries to redeploy their resources quickly so as to adapt to unfavourable changes in the international environment. This problem became greatly accentuated in the 1970s; as we shall see, *in that decade an increasing number of the balance of payments problems faced were caused by largely unpredictable factors over which particular countries had no control.* In many such cases, the restoration of balance of payments equilibrium without a disruption of the development process requires long-term structural changes. A good example is adjustment to higher oil prices.

Furthermore, the severity and rapidity of the adjustment required of countries in current account deficit implies a marked asymmetry with the indefinite period for adjustment taking place in the surplus countries. Because of this, the international system of surveillance tends to impose a deflationary bias on the world economy as a whole, and on the poorest developing countries in particular. Only very rarely have industrialized countries with a deficit in their current account gone to the Fund for finance (certainly the U.S. has never done so!); they usually finance their deficits through their own «rich country» network. Semi-industrialized developing countries have been able during the seventies to obtain private finance from the multinational banks often without having to adjust within the IMF framework. Therefore, given the current characteristics of the international monetary system, the more stringent and short-term adjustment which is a condition for obtaining a stand-by or extended facility from the Fund, are accepted mainly by the weakest and poorest countries, as only they have no alternative source of finance.

The above dealt both with the magnitude and the speed of adjustment currently required mainly from developing countries with large current account deficits. Perhaps even of greater importance is the critique of the «monetarist» *type of adjustment* recommended by international financial institutions, and in particular by the IMF. When a country's imports contain a large proportion of essentials, as often happens in developing countries, payments imbalances will respond only to very large changes in total spending. Thus, while aggregate monetary tools may improve a country's payments situation, they often may do so only at great and partly unnecessary cost to the economy, both in short-term lower employment and production, and in a decline in investment, which limits future growth. A second major criticism is that the 'monetarist' type of adjustment—though claiming to be neutral as regards distribution of the burden—in fact tends to worsen

⁽⁵⁾ Some progress has been achieved in this area. For example, before 1974, countries were expected by the IMF to eliminate their current account disequilibria during one year. Since 1974, it has been recognised that many countries will require longer periods; the extended facility which operates during a period of up to three years, and allows a longer repayment period, explicitly recognised this. The desire to provide finance for more gradual and long-term adjustment has encouraged the World Bank to embark in 1980 on its new programme lending for structural adjustment, with much longer repayment period.

the distribution of income and consumption, due to measures such as reduction of state subsidies on essential foodstuffs and dismantling of price controls. This critique claims that 'monetarist-type' adjustment to balance of payments disequilibria therefore require unnecessarily large sacrifice in terms of present and future production, and that this sacrifice or cost is borne mainly by the poorest members of society.

It can therefore be concluded that adequate adjustment policies have an important role to play as an instrument to ensure long-term growth, decrease in inequality and greater national autonomy. Timely and sufficient adjustment to changing international circumstances is naturally necessary so that these objectives are not seriously threatened; however, adjustment policies must be as consistent as possible — and not contradictory as they often have been in the past — with each country's long-term development targets.

The relationship between adjustment and development was very clearly brought out by Hollis Chenery at a recent Conference.⁽⁶⁾ «The conventional separation between stabilisation and development, or short-term and long-term policies, has become increasingly inappropriate to the international economic problems of this decade, in which the adjustment policies of individual countries must be assessed over periods of five to ten years and are heavily dependent on actions by other countries.

This observation applies equally well to the design of the long-term development policies. The countries that have fared best in recent years — apart from oil producers — have been those with flexible economies that could adjust their volume and composition of trade in response to large changes in world markets... In this setting it is misleading to consider stabilisation as a primary objective in itself rather than as a means to a broader development goal».

The close link between adjustment and development is also emphasised in the UNCTAD/UNDP Report on adjustment quoted above: «This suggests the importance, at both national and international levels, of placing the adjustment process in the broader context of long-term development strategies and needs. A period of adjustment should be nothing more than an episode in a long-run process, and is therefore indispensable that the categorical imperatives of the short-run should not be allowed to dominate and perhaps even overwhelm the requirements of the long-run. A mere reduction in demand may return the economy to its previous position, but the obstacles will probably persist unless dealt with explicitly and directly, and the pressures will emerge far more as soon as the development process is resumed.

There is therefore a need for measures to tackle the basic causes of disequilibrium and the long-run obstacles to growth along with the proximate phenomena of inflation and balance of payments pressure that accompany them».

⁽⁶⁾ Comments on Krueger's paper, at Brookings Conference on Economic Stabilisation Policies in Less Developed Countries, October 25, 1979, Washington D. C.

These statements help us highlight a key aspect of the meaning of adjustment. The earlier view of adjustment stressed excessively not only the short-term but also the financial elements—both external and internal. This is clearly insufficient, as real adjustment implies changing physical patterns of investment, production, consumption and trade. It is these structural shifts which can be achieved only in the process of development. It is noteworthy that since April 1980 the IMF itself has stressed the «creation of conditions conducive to improvement in the supply of resources and broadening of the productive base», as an important part of the adjustment process⁽⁷⁾.

The idea that adjustment efforts should be placed within the framework of development planning is not new: in fact, it was expressed already in the sixties, firstly during the initial years of the Alliance for Progress. However, the link between adjustment and development has since the late seventies been expressed with increasing clarity and operational precision; furthermore, these concepts have become much more influential within the international financial institutions themselves—including the IMF. This may hopefully lead to important changes in the adjustment policies recommended to and pursued by developing countries. The large changes which have occurred in the international economy since the early 1970s, as well as the greater bargaining power of some developing countries will probably make such changes inevitable.

2. Brief review of fluctuations in the world economy in the 1970's

There is increasing consensus that the succession of drastic changes in the world economy that began with the collapse of the Bretton Woods system in 1971 subjected the developing countries during the seventies to the most severe test of their adjustment capacity of the post-war period.

Many countries faced current deficits in their balance of payments of unprecedented magnitudes. While an important proportion of these deficits reflected imbalances of domestic origin, there were major external elements of which the individual deficit countries were not responsible. Furthermore, even though these deficits were very large, they did not fully reflect the difficulties faced; in many cases, deficits were smaller than they would have been if the existence of disequilibria had not in itself caused reductions of output and employment.

The evolution of the current account deficits of all non-oil exporting less developed countries in the period 1973-80, can be seen in Table I.

(7) Source: IMF, «World Economic Outlook», May 1980, Washington D. C. The proposal to consider the supply aspects of adjustment was officially approved by the Interim Committee of the Board of Governors on the 25th of April, 1980.

TABLE I

Current account balances of non-oil exporting less developed countries
(billions of dollars)^{(1), (2)}

1973	1974	1975	1976	1977	1978	1979	1980 ⁽³⁾
-11.3	-36.9	-45.8	-32.1	-28.0	-36.2	-54.9	-68

(1) Source: IMF, *World Economic Outlook*, Washington D. C., May 1980.

(2) Refers to all less developed countries which were IMF members and were not major oil exporters.

(3) Estimated.

The main sources of increased disequilibrium in non-oil exporting developing countries that were beyond their control were two: the large changes in the price levels of internationally traded goods and the recession in OECD countries in 1975 and 1976, followed in later years by growth rates significantly below historical ones. A third factor, the impact of which is more difficult to measure, was the growth of protectionism in the industrial countries.

3. Alternative policy responses for adjustment to external shocks

In this section we shall review the types of alternative policy packages with which different countries responded to changes in the international setting during the 1970s (stressing the more critical 1974-76 period), and attempt to evaluate their effects.

Before beginning this analysis, two previous considerations seem important to make. In the first place, it seems necessary to clarify that in dealing with adjustment policies it is often difficult to establish where scientific economics ends and political preference begins. As Diaz-Alejandro points out in a recent paper⁽⁸⁾, «judgements about the speed of adjustment in different markets and evaluation of the social costs of alternative dynamic patterns are still based mostly on hunches and sketchy evidence». A certain eclecticism in economic analysis is therefore inevitable required. Undoubtedly, political preferences will have some influence in any treatment of the subject. All one can attempt to do is to make such preferences explicit.

Secondly, it seems crucial to stress the differential ability of countries to respond to external disequilibria and to use certain policy instruments. Thus, the alternative of additional external financing — particularly from the source which grew most rapidly in the seventies, private credits — was not equally accessible to different categories of countries. The higher income developing

⁽⁸⁾ Diaz-Alejandro, C. F., *Southern Cone Stabilization Plans*. Paper presented at Brookings Conference on Economic Stabilization Policies in Less Developed Countries, October 25th, 1979, Washington D. C.

countries, whose past growth record had been good, and which had accumulated relatively important foreign exchange reserves, were able to decide in the mid-seventies how much foreign borrowing they wanted to undertake; they also were able therefore to reject any idea that the deficit in the current account had to be solved through a recession which would restrict imports. As we shall see in more detail below, Brazil and South Korea both had and followed this clear option given their easy access to increased foreign private finance. However, such an option was clearly not open to the smaller, poorer, less developed economies, which often had limited foreign exchange resources, and had to rely only on limited amounts of lending and aid. Therefore, the option of postponing adjustment to the current account deficit through external finance was not feasible for them.

The capacity for adjustment itself is by no means uniform among countries. For example, there are marked differences in the ability to raise export earnings, particularly of manufactures or other non-traditional products, as well as to expand import substitution. Factors such as a country's size, its previous experience and level of industrialization, the availability of technical skills and of infrastructure, greatly condition the ability of its foreign trade sector to respond rapidly. There is now increasing consensus that since the capacity for adjustment varies from country to country due to pre-existing differences in economic structure, adjustment policies should be adapted accordingly; thus a major devaluation may yield quite different results in different countries, due to differential responsiveness of exports to such a measure in the short and medium-term.

However, a few words of caution are necessary. So-called export pessimism has certainly been exaggerated in the past and has been to a certain degree disproved by events. Thus, since 1967 the growth of exports of all non-oil LDCs in real terms has been quite remarkable (with the exception of 1974 and 1975).⁽⁹⁾ The growth of manufactured exports from LDCs has grown at a particularly rapid pace. Furthermore, several countries which in the past were commonly believed to have little export potential have disproved such views drastically; thus it is useful to remember that South Korea in the mid 1950s and Philippines in the early 1960s were almost unanimously believed to have very little export potential! The implication is obviously not that any country could have had such a successful record of export growth as South Korea or Philippines but that there were many more options open to LDCs than the export-pessimists were willing to accept. We shall return to these issues in greater detail below.

As a response to external shocks to their balance of payments in the seventies, different countries adopted one or several of the following policies:

- a) running down foreign exchange reserves and obtaining additional external financing,
- b) promotion of increased and diversified exports,
- c) import substitution and/or direct controls to restrain imports,

⁽⁹⁾ For data, see World Economic Outlook, op. cit., Table 9 p. 91

d) demand management and/or incomes policies aimed at lowering the rate of economic growth.

The first three types of policy have in common one important element, which opposes them to the fourth type: they seek adjustment without sacrificing growth.

We shall discuss these different policy responses, illustrating them with the 1970s experience of specific countries, mainly that of Brazil, Chile, India, Jamaica, Philippines and South Korea.⁽¹⁰⁾ A general point which emerges from looking at different country experiences is that specific policies may be adopted within different policy packages. Thus, export promotion (which many claim to be feasible basically only in a completely 'free trade' context with almost non-existent tariff barriers and other import restrictions, such as the Chilean model pursuits), in fact has been successfully pursued not only by countries with such 'free trade' policies, but also by countries which protect their imports substantially by both controls and tariffs; in the seventies, South Korea, Brazil, Philippines and India all provide good examples of the latter case.

We shall examine first the cases of Brazil and South Korea (with more emphasis on the former) as examples of countries which were able to sustain relatively high growth rates, even during the critical period 1974-77. As was discussed above, it is evident that the Brazilian or the South Korea experience could not have been followed by other countries, with lower levels of development and diversification of their economies, as well as much less access to external finance. However, these cases seem of general interest mainly for two reasons: firstly, they illustrate how the adjustment process to external shocks can be both postponed and its cost in terms of growth substantially moderated when there is sufficient external finance available; secondly, it seems valuable to examine the policies followed (i. e. in the field of foreign trade) by those countries which managed to maintain high growth rates, at a time when they were faced with such large external constraints, and when in fact most of the world—both developing and industrialized—was barely growing at all.

Brazil was in fact quite badly affected by the rise in the price of oil, given that it imports a very high proportion of its oil requirements. It has been estimated⁽¹¹⁾ with a rigorous methodology that, as a result of international price shifts Brazil's losses in the period between 1974-76 (comparing with 1971 as a base) were equal to 4.5% of its G. D. P.

⁽¹⁰⁾ We shall use material from different sources, drawing particularly from recent «Current Economic position and Prospects» documents on these countries, written by the World Bank and from *Studies of the experience of selected developing countries in the 1970s*, UNCTAD/MFD/TA/5, supplement to the report to the Group of Twenty-four. *The Balance of Payments Adjustment Process in Developing Countries*, INT/75/015, op. cit. above.

⁽¹¹⁾ Source: *Studies of the experience of selected developing countries in the 1970s*, op. cit. Brazil case study.

It is therefore noteworthy that Brazil was able to maintain such high growth rates during this period, even though its G. D. P. did increase less than it had previously.

TABLE II
Brazil's growth of G. D. P.

1967—74	1974—76	1977	1978
11.2%	7.4%	4.7%	6.3%

Source: *Studies of the experience of selected developing countries in the 1970's*, op. cit. Brazil country study.

The main mechanism used by Brazil to maintain these high growth rates in the face of foreign exchange constraints were: substantial additional net external financing, import restrictions and import substitution and, increased export promotion⁽¹²⁾.

The foreign capital supply (defined as net direct investment, loans and financing and short-term capital) grew rapidly from U.S. \$5.5 bn. in 1973 to an annual average of U.S. \$8.7 bn. in the 1974-76 period⁽¹³⁾. External borrowing was so large that net external debt as proportion of both exports and G. D. P. doubled in value between 1973 and 1977! The contribution of official external loans was small, as the Brazilian government preferred—and was able—to attract private loans instead. This had the disadvantage of higher costs, shorter maturities as well as the requirement of maintaining high foreign exchange reserves. However, the Government of Brazil seemed to feel that these higher financial costs were more than compensated by the greater freedom from outside constraints on their policy options. For example, it was felt that accomodation to Fund conditionality, particularly in the upper credit tranches would have implied high costs in terms of curtailment of economic activity and narrowing of policy choices in areas such as international trade.

Even before the 1974 balance of payments crisis occurred, the Brazilian Government had adopted a programme of more active import substitution—particularly in capital goods, petrochemicals, fertilizers, metals and energy. This programme was accelerated—particularly in the area of energy—as a result of the balance of payments crisis. Direct state invest-

⁽¹²⁾ In a recent paper, (Policy responses to external shocks in selected Latin American countries) Professor Bela Balassa estimates that a) and b) were the two main policy responses, while c) made an important, but substantially smaller contribution.

⁽¹³⁾ Source: *Studies of the experience of selected developing countries in the 1970s*, op. cit. Brazilian case study.

ment in these sectors, as well as subsidized credit lines to the private sector, were complemented by measures such as the progressive increase of the share of local inputs required of foreign firms and 'buy Brazilian' procedures in the procurement of machinery and equipment by Government and State enterprises.

As the balance of payments problems became more critical in 1974, a set of additional rather drastic import restriction measures were introduced. Amongst the most important measures taken were the prohibition of about 300 'superfluous' items, a doubling of tariff rates for approximately 1,200 items, a 30 per cent increase in the rates for another 800 items and the institution of a 100 per cent deposit—refundable after 360 days without interest—in approximately 30 per cent of the import bill.

As a result of all these measures—as well as of the somewhat reduced growth of the economy—the 1977 *real* of imports was barely higher than that of 1973 level.

In contrast to import substitution and restrictions, virtually all of the incentives to exports had been introduced before the energy crisis. Since 1965, Brazil had followed an extremely active export promotion policy, with extremely successful results. Thus, Brazilian exports which had remained stagnant in nominal terms before 1967 (reaching U.S. \$1.6 bn. in 1954 and only U.S. \$1.7 bn. in 1967) grew at a spectacular pace to U.S. \$6.2 bn. in 1973 and to U.S. \$12.1 bn. in 1977). The main elements of the export promotion policies were rebate of indirect taxes paid at all stages of the productive process, as well as other tax incentives initiated in 1965, the introduction of the crawling since 1968 and the subsidisation of manufactured exports since 1969. Some of these measures were intensified after 1974.

The South Korean experience of adjustment in the 1970's has important similarities with the Brazilian one. As can be seen in Table III, Korea was able to overcome the oil crisis with a 10 per cent average annual growth

TABLE III

Growth rates of some indicators for the South Korean economy

	1962—71 (Average)	1972	1973	1974	1975	1976 ⁽¹⁾ ⁽²⁾
G. D. P.	9.2	7.3	16.9	8.3	8.8	15.0
Exports	26.7	36.3	46.1	2.6	18.7	43.9

⁽¹⁾ Source: *Studies of the experience of selected developing countries in the 1970's*, op. cit., Korean case study.

⁽²⁾ Refers to values expressed in the 1970 Dollars.

rate of G. D. P. during 1974-76 (which even slightly above historical trends) and more than 20 per cent *real growth in exports per annum* in the same period. It is also a rather impressive achievement that South Korea's gross

investment grew more rapidly than G. D. P. during this period, the main explanation for this trend was the rapid increase in government financial capital formation.

The main reason why South Korea was able to sustain its rapid economic growth during that period was that imports in real terms continued to grow quite rapidly, even though below historical trends. The increased balance of payments deficit was financed mainly by commercial bank lending, total net annual foreign capital inflow grew from around U.S. \$300 million in 1972-73 to about U.S. \$2 billion in 1974-75, declining to about U.S. \$530 million in 1976.

In foreign trade, the main emphasis was on increased export promotion measures, which as can be seen in Table 3, yielded very successful results given that the economy's growth rate was not curbed, the level of imports was regulated through the rather sophisticated system of direct administrative import countries, which has characterized the South Korean economy since the 1960's⁽¹⁴⁾. Tariff barriers play a relatively small role in this system, which is mainly based on quantitative valuations which are intensified when the balance of payments situation becomes more restricted.

It should be stressed that even though Brazil and South Korea adjusted external shocks without sacrificing growth, their adjustment was very problematic in important aspects. Thus, although sustained economic growth in South Korea has implied a substantial reduction of absolute poverty, relative income distribution seems to have suffered a significant deterioration between the years 1970 and 1976⁽¹⁵⁾.

Furthermore, the rapid increase of both countries foreign external debt in the 1970's has decreased lenders' willingness—particularly that of the private bankers—to continue lending at the same levels to these countries. It is thus increasingly doubtful whether Brazil or South Korea will be able to «know its way out» of the second wave of external shocks which began in 1979 to the same extent as it did in 1974/1976. Furthermore, it is doubtful that these countries will be able to obtain large external loans, in the 1980's without having to accept greater external conditioning of their economic policies.

The Chilean experience since 1973 provides a sharp contrast with those of Brazil and South Korea, which we have just examined. The Chilean Government attached first priority to adjusting the economy in the shortest period possible, both to internal and external disequilibria. Furthermore, the short-term policy measures it has used to archive this adjustment were extremely orthodox⁽¹⁶⁾; these short-term policies were linked to a process of fundamental long-term changes in the Chilean economy. The model has

⁽¹⁴⁾ In 1978, the South Korean government started a program of import liberalization.

⁽¹⁵⁾ For more details, see Choo, Hakchung and Kim, Daemo, *Probable Size Distribution of Income in Korea: Over Time and by Sectors*. Korea Development Institute, 1978.

⁽¹⁶⁾ In several cases, the Chilean Government had adopted more orthodox measures than those suggested to it by the I. M. F. or World Bank. For example, it has reduced both government expenditure and investment at a rate which is further than that recommended by the Fund and Bank.

been geared towards «opening up» the economy to international competition; thus, tariffs were reduced drastically from a relatively high 94% average in 1973 to a level of 10% in 1979, the lowest in the Third World'. At the same time, the role of the State in the economy is being sharply decreased, as the private capitalist—both national and international—is expected to provide the impulse for development.

Before describing the policy measures taken by the Chilean Government since 1973 to adjust and stabilize the economy, it should be stressed that it faced rather serious internal and external financial problem.

When the present Government took over power, in September 1973, the annual inflation rate (measured by the retail price index) reached 360 per cent; gross international reserves were at a very low level, even though the country had not played an important part of its foreign debt service in 1973. Several external and internal factors of great complexity explained these large disequilibria⁽¹⁷⁾. However, within this context, it seems worthwhile to point out that attitudes to economic management played an important—though not crucial—role in the creation of large financial disequilibria during the 1970-73 period. Diaz-Alejandro's⁽¹⁸⁾ comments on Latin American populist governments seem particularly relevant for Chile's Popular Unity experience: «Even sympathetic observers warning of future dangers, due to excesses in fiscal, monetary, exchange rate and income policies will be discussed by the remark that «now the economy works differently». Under those euphoric circumstances concern for economic efficiency, export-promotion and a minimum of concern for fiscal and monetary prudence will be regarded as *prima facie* evidence of «reactionary positions» not only by most Populist politicians, but also by government economists giving top priority to achieving structural reforms, or seeking a rapid transition to a centrally planned economy, or simply believing that economic efficiency, export-promotion and prudent fiscal and monetary policies are of little consequence for the welfare of most people in the country».

Furthermore, the Chilean economy also faced rather difficult external circumstances, particularly since the end of 1974, when the price of its main export product, copper, fell rapidly; Chile also had been badly hit by the leap in oil prices, as it imports three-quarters of its oil needs.

Faced with a rather serious situation of both internal and external disequilibria, the Chilean Government since 1973 attached first priority to adjust the economy in the shortest period possible, justifying the immense costs required as necessary and unavoidable sacrifices.

The main mechanism used to improve the Balance of Payments and reduce inflation since September 1973 was deflation, which not only reduced growth of output, but actually led to a *sharp fall in the level of National Income and Gross Domestic Product*.

(17) For detailed discussions, see for example, de Vylder, Stefan 1976, *Allende's Chile, the Political Economy of the Rise and Fall and the Unidad Popular*, and Griffith-Jones, S. «A Critical evaluation of Popular Unity's short-term and financial policy». *World Development*, Vol. 6, N.º 7/8, July/August.

(18) Paper «Southern Cone Stabilization» plans, op. cit. above.

TABLE IV

Selected indicators for the Chilean economy

	1973	1974	1975	1976
% Change in Expenditure on Gross Domestic Product	-1.1	4.2	-16.6	5.0
% Change in Real G. D. P.	-3.6	5.7	-11.3	4.1
Change in manufacturing production	-6.5	-0.9	-27.4	6.8
Average Unemployment Rate	7.0	9.7	16.2	16.8

Sources: World Bank Country Study, *Chile, an economy in transition*, Washington, January 1980 and Odeplan *Cuentas Nacionales*.

Chilean Expenditure on Gross Domestic Product had been growing during the period 1940-73 at an average annual rate of over 3.5%. As can be seen in Table 4, the adjustment policy implied a *fall* in Real Expenditure of G. D. P. of 16.6% during 1975, and an average decline of 3.0% for the 1974-76 period. Industrial production fell at an even more rapid rate during this period.

Unemployment, which had averaged 5 per cent in the sixties, and had fallen to 3.8% in 1972, grew drastically, peaking at 16.8% in 1976. The rate of investment (as proportion of G. D. P.) fell substantially below historical trends, as the decline in the traditionally larger role of the State in capital promotion was not compensated by an increase in private investment.

The two main policy instruments used to induce this deflation were those most strongly advocated by the supporters of monetarist orthodoxy: sharp curtailment of government expenditure and drastic reduction in real wages. Thus fiscal expenditure fell by 40% in real terms in 1975, and real wages during that year were *at least 30% below their 1969 level* (and even more below their 1972 level). The sharp fall in real wages, as well as the increase in unemployment implied a dramatic worsening of income distribution⁽¹⁹⁾.

In sharp contrast with the Brazilian and South Korean experience outlined above, the Chilean Government relied basically on the reduction of aggregate demand to curb imports; completely unwilling to use unorthodox pressures to reduce imports such as direct administrative controls, prohibition of luxury goods imports and/or increase of tariffs, which were so widely used during this same period in many countries. On the contrary, it acted in the opposite direction! *In spite of the extremely critical Balance of Payments Situation*, tariff barriers were substantially reduced (average tariffs

⁽¹⁹⁾ For a more detailed discussion of the policies and figures, see for example, Foxley A. «Stabilization policies and stagflation: the cases of Brazil and Chile» 1979 in *ILO World employment programme: income distribution and employment programme working papers*, and World Bank, Country Study, *Chile, an economy in transition*, op. cit.

fell from 67% in June 1974 to 38% in February 1976!) and other administrative import controls dismantled during this period. It is noteworthy that such a sharp reversal of the policies which had been pursued in Chile for the last three decades was made at a time of serious Balance of Payments aims⁽²⁰⁾.

The Chilean experience illustrates well the very high—and to an important extent unnecessary—costs of an adjustment policy which places excessive relevance on rapid deflation implemented mainly through orthodox policies. The drastic and costly nature of the adjustment policies applied in Chile—as well as to a somewhat lesser extent in other Southern Latin American countries—have implied that they have been commonly known as «shock treatment».

Chilean economic policy since 1973 has however been very successful in export promotion and diversification; thus, noncopper exports are estimated to have grown in real terms by 150% between 1973 and 1978⁽²¹⁾. The main mechanisms used were large devaluations since September 1973 (which resulted in a substantial real devaluation of the peso relative even to the pre-Allende period) and reduction of tariffs, particularly those paid on inputs for export products.

Furthermore, Chile has obtained favourable Balance of Payments results since 1976. This has occurred not so much because of an improvement in the trade balance (the latter was very favourable in 1976, as imports fell drastically because of the recession; after 1976, as the economy slowly recovered past production levels and was «opened up», the propensity to increase imports surpassed even the rapid growth of exports). The main reason for the improvement in the Balance of Payments, particularly since 1977, has been the massive net inflow of private credits. Again, in this respect Chile differs from Brazil and South Korea, the latter used private external finance in the period 1974-76 to avoid a recession; Chile which obtained massive external finance at a later stage, was able to use it more to recover from the large recession provoked in the 1974-76 period.

The most impressive success of the Chilean model is in export promotion. The reversal of the excessive bias against exports which had characterized the Chilean economy for the last forty years had obviously been long overdue. However, as the experiences of many other countries including those of Brazil and South Korea show, it is not a necessary precondition for rapid growth of exports that all imports be liberalized at the same time⁽²²⁾.

(20) Even though the international financial institutions clearly approved of the import liberalization, it is interesting to point out that they expressed reservations to the Chilean Government about their timing. However, this Government's extreme commitment to free trade orthodoxy led it to insist on its drastic trade liberalization.

(21) Source: World Bank Country Study, Chile, an economy in transition, op. cit.

(22) For a thorough discussion of some of these cases, see Diaz-Alejandro, A. «Trade policies and Economic Development» in P. B. Kenen ed. *International Trade and Finance: Frontiers for Research*. Cambridge University Press. 1975.

Furthermore, the Chilean experience illustrates well the fact that the worst time to achieve a transition to import liberalisation is that of acute financial crisis, as the costs of such liberalisation will add to the disruption caused by adjustments to the crisis⁽²³⁾. In such a situation of crisis, if it is though desirable to achieve trade liberalisation, it seems best to apply measures which increase the profitability of exports without a direct squeeze on import substitutes. Measures such as selective export incentives or reduction of tariffs on imported inputs for exports provide a good example. Once, and if, these measures are successful, the country will find its exports growing and experience rapid economic growth; then it will be in a far better position to liberalise imports, particularly if it has an easier foreign exchange position.

Several countries have in fact applied the latter type of strategy for staged liberalisation; one of the interesting experiences being carried out at present is that of the Philippines. This country reacted to the deterioration in its terms of trade in the period 1974-76, mainly by a substantial increase in private external finance. It also intensified the export promotion policies, which had begun in 1970; the main measures adopted were a *de facto* devaluation and a very comprehensive system of incentives for exports — which included tax exemptions and deductions for exports, infrastructure and other Government support for exports and reduced tariffs for imported inputs of exported goods. (The tariffs system for other imports was barely changed in the Seventies.)

As a result of export promotion policies, the level of non-traditional exports increased at a spectacular pace (from U.S. \$41.6 million in 1970 to U.S. \$304.7 million in 1976).

Now that substantial progress has already been achieved in export promotion, the Philippines Government has designed a programme beginning in 1981 which will not only strengthen export incentives, but also liberalise trade and realign tariffs. The Philippines programme of tariffs reduction will differ in several aspects from that adopted in Chile in the 1974-1979 period: it will follow — and not be simultaneous with — a successful export promotion drive; it will be phased over a period of 5-10 years; it has resulted from a series of careful previous studies carried out by the Government, and the impact of liberalisation on «sensitive» imports will be monitored to watch for major disruptive effects on the balance of payments or on local industries. Finally, the Philippines programme of export promotion and trade liberalisation will be supported by a programme of structural adjustment loans granted by the World Bank; this will have the advantage of additional external finance to compensate for any resulting increase in imports; it may imply a disadvantage in that the additional finance is provided by the World Bank on the condition that certain changes in industrial policy are being carried out.

Until now we have concentrated on the broader macro-economic options taken by different countries to adjust to the external shocks to their econo-

(23) An interesting discussion of this issue can be found in Wolf M. «LDC policy and export performance — some lessons of experience» Mimeo World Bank, Jan 1978.

mies. However, it seems also very important to discuss the emphasis laid on different sectors. Especially in countries with very low average income per capita, and where a large proportion of the population is near the poverty line, the evolution of agriculture is of great significance. The experience of India in the Seventies seems of great interest in this aspect.

As is discussed in detail elsewhere⁽²⁴⁾, India's growth performance during the seventies was rather poor, as the increase in real per capita national income averaged no more than 0.5% during this period; undoubtedly, the negative evolution of external developments—such as sharp deterioration of terms of trade—had a very unfavourable effect on the Indian economy, contributing to this low growth record.

It is noteworthy that in spite of its overall poor growth performance, India has achieved very favourable results in agriculture during the second half of the seventies. This has made the Indian economy—as well as the poorest among its people—less vulnerable both to the external shocks from the international environment as well as to unfavourable weather conditions.

During the three years after 1972/73, India had to adjust not only to the sharp rise in oil prices, but also to increased foodgrain import requirements resulting from the crop failure of 1972/73 and 1974/75. However, following the succession of four good crop years from 1975/76, the requirement of foodgrain imports fell to negligible levels. Furthermore, the very bad weather in 1979/80 revealed the strength of progress in agriculture⁽²⁵⁾. Despite one of India's worst monsoon failures, agricultural production fell little compared with previous bad weather years, being maintained at a level which would have been a record only a few years ago. In spite of the drought-induced shortfall in production of foodgrains during that year, India ended the season with very large grain stocks, without any imports of foodgrains. The relatively small fall in output of foodgrain in 1979/80, as well as the large foodgrain stocks built over the former past four years of good harvest, implied that in 1980 low income groups in urban areas were assured adequate supplies of grain at relatively stable prices. The greater availability of grain and greater administrative capacity in the countryside allowed a large-scale drought relief and employment programme that successfully contained the worse aspects of a drought in India—the sharp fall in income among the poorest groups in rural areas.

Furthermore, available projections suggest the real possibility of India moving into a period of sustainable foodgrain self-sufficiency or surplus. If this comes about as a permanent feature, it would be an impressive achievement of a long-standing goal of Indian economic development.

The recent favourable results and projections in foodgrain production and distribution have been achieved in India thanks to large investments in areas such as irrigation, extension, fertilisation and storage capacity as well

⁽²⁴⁾ See, in particular, *Studies of the experience of selected developing countries in the 1970s*, op. cit. Indian case study.

⁽²⁵⁾ The following analysis is based on World Bank. *Economic Situation and Prospects of India*. 1 May, 1980.

as appropriate policies over the past four years. Foodgrain pricing policies have supported the investment efforts, achieving a number of objectives: price stability, protection of farmers' incomes and foodgrain self-sufficiency. Real prices of foodgrains and particularly rice and wheat have been fairly stable, except in years of unusual scarcity. The procurement system, while operating primarily for rice and wheat, has placed a floor on other cereal prices as well. Relative prices of foodgrains, fertilisers and other commodities have been such as to make foodgrain production and increased fertiliser consumption very profitable.

The recent favourable Indian experience in agriculture seems particularly relevant for very poor countries, in the context of possible large unexpected changes in the international environment, as self-sufficiency in basic foodstuffs makes the satisfaction of the basic needs of the majority of its population less vulnerable to those external changes.

Finally, we shall look briefly at the Jamaican experience, as an example of a country which in the period 1974-76 responded to the severe external shocks it received mainly by running down reserves, accumulating debts and restricting imports via a comprehensive system of administrative controls; thus, net foreign exchange reserves fell from +U.S. \$130.3 million in 1974 to -U.S. \$183.7 million in 1976, while the total outstanding external public debt more than doubled during that period, going from U.S. \$308.9 million in 1974 to U.S. \$831.8 million in 1976. Measures of adjustment via monetary and fiscal policy were clearly avoided during these years⁽²⁶⁾.

The Jamaican Government elected in 1972 had as its main targets redistribution of income, reduction of unemployment and securing greater national control over the economy. The latter target implied a process of important structural reforms reflected in a substantially increased state control over the economy, including the requisition of public utilities, greater participation in the bauxite, sugar and tourist sectors, and increased control over foreign transactions.

The Jamaican economy is characterised by a very high degree of openness, as measured by the ratio of foreign trade to GDP, which leads to a high sensitivity to disturbances in the international environment. For this reason, Jamaica was badly hit by external shocks in the period 1973-76 (the increase in the prices of oil and non-oil imports was particularly important). The effects of the adverse evolution of the international environment were compounded by the effects on the private sector's behaviour of the Government's political position. Thus, the rapid decline of foreign direct investment and the flight of capital was mainly the result of domestic political developments; income from tourism fell due to violence and bad press; bauxite production declined largely as the trans-national companies retaliated to the Government's radical policies towards them. In these circumstances, the

⁽²⁶⁾ Detailed accounts by Jamaicans of this period can be found in *Studies of the Experience of Selected Developing Countries in the 1970s, op. cit.*, Jamaica case study, and N. Girvan, R Bernal and W Hughes «The IMF and the Third World: the Case of Jamaica, 1974-80» in *Development Dialogue*, 1980: 2. Accounts from the point of view of international financial institutions can be found in the World Bank and IMF reports.

Jamaican Government's lack of emphasis and postponement of adjustment to external disequilibria worsened the situation even further. For example, during this period, Government expenditure growth was far quicker than that of Government revenue, which led to a rapidly rising Government deficit; in 1976, the overall financing deficit of Central Government reached 18.4% of GDP. Although an important part of this deficit was the result of largely unavoidable political and economic pressures on the Government, undoubtedly lack of emphasis on fiscal and monetary management made the Government deficit larger; this had a further negative impact on the current account of the Balance of Payments.

As a result of these trends, by the end of 1976, Jamaica faced a severe economic crisis, as its foreign exchange reserves were depleted, its borrowing capacity from private foreign banks and foreign governments was seriously eroded and it had used fully all the unconditional financing available to it from the Fund. In this situation, Jamaica was forced to seek first a stand-by and then an extended facility loan from the Fund, which implied accepting drastic adjustment policies.

As is well known, in March 1980, Jamaica decided to discontinue negotiations with the Fund.

It exceeds the scope of this paper to analyse or evaluate relations between the Fund and Jamaica. What needs to be stressed in this context is that Jamaica's inability and unwillingness to adjust to external and internal shocks, which led to the sharp deterioration of the foreign exchange situation, restricted its margin of manoeuvre and its bargaining position *vis-à-vis* the Fund; this implied, particularly in 1978, very drastic adjustment policies being required by the Fund from Jamaica as condition for its loans.

The Jamaican experience has implications for any small, open, dependent developing country which attempts to carry out a process of radical structural changes. In the present international context, such a country will find it extremely difficult to sustain for a long period a current account deficit by relying on external finance; in any case, such a large level of external financial inflows may be undesirable, as it will make the country too vulnerable to foreign pressures. Furthermore, the country may face large private capital outflows from it. For this, even though it is extremely difficult, such countries must necessarily put more — and not less — emphasis on adjusting their economies to external shocks. Both orthodox adjustment policies — such as control of real wage increases — and less orthodox ones — such as export promotion or import controls — inevitably have to play a very large role. Such countries should avoid as much as possible depletion of net foreign exchange reserves as an adjustment mechanism; in fact, if feasible, the maintenance of relatively high foreign exchange reserves will act as a protective cushion against probable net capital outflows resulting from the structural reforms and/or unexpected changes in the international environment.

It is noteworthy that the particular importance of adjustment and economic management in countries undergoing international change is being increasingly recognised, even by very non-orthodox social scientists and politicians. Thus, among the conclusions of the recent North-South Confe-

rence on «The International Monetary System and the New International Order», held at Arusha, it is stated: «Structural change generates imbalances and new policies may produce understandable mistakes as part of the development process. Under such conditions, self-discipline and coherent economic management, including efficient planning and tight administrative controls, become particularly crucial for the survival of the policies of change». (27)

The Jamaican experience of the seventies, however, also highlights another crucial aspect: the inadequacy of the present international financial system to help relatively poorer, small, open economies to adjust to changes in the international environment, particularly if that country is undergoing important structural changes. The need for changes in the international financial system and flows will be discussed in the following section.

4. Implications for the future of the adjustment experience during the seventies.

Certain implications for the future can be extracted from the adjustment experience in the seventies, both as regards the international environment and the country responses to it. This is particularly true because many of the phenomena that occurred in the early and mid-seventies are being repeated now.

The importance of a more satisfactory international environment to facilitate national adjustment, and avoid putting obstacles in its way, cannot be stressed enough. Of particular importance within the present circumstances is sufficient availability of external finance to attenuate the cost of adjustment for developing countries. Again, recent changes in the international economic system—such as the rapid rise in the price of oil and recessionary tendencies in many industrialised countries—have led to a further sharp increase in the current accounts of oil-importing developing countries. (28) There are increasing doubts about the capacity and willingness of *existing* private and official institutions and mechanisms to provide external finance to the same extent as in the last decade so that these deficits can be covered. If these deficits are not financed externally, adjustment will have to occur mainly through a serious cutback in the already low growth rates of net oil-importing developing countries. To avoid this, expanded financial facilities for longer term lending will be required. As the role of private commercial bank lending to the Third World can be expected to grow less than during the seventies, and continue to be oriented mainly to the higher-income Third World countries, greater emphasis must be placed on increased official flows—*both from industrialised and OPEC countries*. Many important technical proposals have been made in this direction, for example

(27) «The Arusha Initiative», published in *Development Dialogue*, *op. cit.*

(28) For 1980, projections, see, for example, IMF World Economic Outlook, *op. cit.*

in the Brandt Report.⁽²⁹⁾ These proposals include both calls for a «massive net transfer of resources» from developed to developing countries, as well as channelling resources from capital-surplus Third World (mainly OPEC) countries directly to other Third World countries. Given the urgency of the situation, it is essential that the political will be found to transform quickly these proposals into realities.

Whether these new funds are being channelled through existing mechanisms and institutions or new ones, the issue of the conditionality of lending may probably have to be reviewed. Undoubtedly, any lending will have to imply certain conditionality, but it must be hoped that international financial institutions — including the Fund — stress less the traditional macro-economic indicators and more new indicators consistent with adjustment in the broader context of a country's long-term development. Criteria on growth and income distribution would be very relevant in this respect; criteria which defend or increase the level of consumption of the poorest during adjustment processes would be of particular significance. The philosophy behind the structural adjustment loans by the World Bank seems to be oriented in such a direction.

Greater availability of external finance will allow more gradual adjustment policies; this will avoid such drastic costs as the Chilean economy and people suffered under its «shock adjustment» during 1974-6.

As was stressed in section 2 and illustrated by the country experience, adjustment will have to be more closely linked to long-term structural changes and development needs. This will require actions in sectors such as energy to which insufficient attention was paid during the seventies. Important initiatives need to be taken in the future to expand developing countries' production and conservation of energy.⁽³⁰⁾

Adequate policies toward agriculture will continue to have great importance, particularly for the poorer among developing countries. The Indian experience in the seventies provides a useful example of successful policies in this sector, which seem to have assured self-reliance in foodgrains. This was achieved mainly through an important investment effort and adequate pricing policies.

As we saw above, adjustment is linked to foreign trade policies. Undoubtedly, the optimal policy which a particular developing country should follow cannot be defined in general terms; it depends fundamentally on the general level of protectionism prevailing, particularly in the industrialised countries. However, experience (here particularly illustrated by the cases of Brazil, South Korea, Chile and the Philippines) seems to show that, at least in the seventies, it was the export-optimists who were correct. Many countries which followed policies geared towards export promotion and diversifi-

⁽²⁹⁾ Independent Commission on International Development Issues: *North-South: A Programme for Survival*, Pan Books, London, 1980. Detailed concrete proposals on finance are developed in a recent Commonwealth Secretariat Report: *The World Economic Crisis*, London, 1980.

⁽³⁰⁾ See the recent World Bank document, *Energy in the Developing Countries*, August 1980.

cation achieved rather spectacular results. Furthermore, it would seem that countries, like Jamaica, which did not stress enough export promotion missed some opportunities to improve their Balance of Payments; however, it should also be recognised that possibilities for rapid export growth and diversification appear to be far greater in the higher income developing countries.⁽³¹⁾

The experience of the seventies analysed above also illustrates that liberalisation of imports is not a necessary requisite for expanding exports, particularly during the first stages of export promotion. In fact, several of the more successful export promotion cases (i. e. South Korea, Brazil and the Philippines) maintained quite levels of protection and/or administrative controls. Furthermore, when they were faced with the major external shocks of 1974-6, they increased temporarily protection through tariff and non-tariff barriers; this reduced their reliance on monetary and fiscal policy to cut imports, thus attenuating the sacrifice in output required.

Policies which redress the balance of incentives between exports and import-substitution may be required in some countries. As becomes clear when comparing the Chilean and Philippines' experience a gradual liberalisation which occurs after substantial progress has been achieved in export promotion is preferable to rapid import liberalisation during the initial stages of export promotion. The Chilean experience also clearly illustrates the undesirability of liberalising imports during a time of acute Balance of Payments crisis.

⁽³¹⁾ Thus, in the period 1967-79, the real growth of exports was much lower for the low income countries than for the rest of the non-oil developing countries. For data, see Table 9, *World Economic Outlook, op. cit.*

