

## Structural Adjustment and Reform in Developing Countries

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**Montek S Ahluwalia\***

The past ten years have seen a remarkable convergence of views among all segments of the development community - policy makers, academics and the major multilateral institutions - on what policies are good for development. The convergence is reflected in the near universal trend towards trade liberalization and greater openness to foreign investment, greater reliance upon market forces in both the real and financial sectors, reduction in the role of the public sector in favour of the private sector, all underpinned by a sustained pursuit of macro-economic stability through low fiscal deficits. These are the common ingredients of programmes of structural adjustment and economic reform being implemented all over the developing world.

2. Impressive though the convergence is, it is not quite the consensus which is sometimes claimed. There are variations across countries in the intensity with which different elements are pursued, and there are unsettled issues about the optimal pace and sequencing of reforms. The experience with reforms in several countries has also created greater awareness of some of the problems that may arise in the course of implementation and these have implications for the design of reform programmes. This paper attempts to define the areas of consensus and identify some of the issues which remain unsettled and controversial.

### **I. Factors Underlying The Convergence**

3. It is useful to begin with a brief review of how the convergence on policy came about. Several factors were at work affecting each of the constituents of the development community, and these have obviously interacted with each other, making it difficult to disentangle their separate contributions.

#### **1) The Retreat From Structuralism**

4. The convergence was clearly influenced by a shift in intellectual opinion away from the earlier structuralist view of development, which emphasised structural constraints and rigidities in developing countries and therefore underplayed the role of price and market signals, towards the view that many of these rigidities are the result of policy distortions which can be overcome through policy reform. In fact much of what is today called "structural reform" is essentially a market based response at overcoming constraints which earlier structuralists thought could not be overcome except through much longer term developmental processes.<sup>1/</sup>

5. The earlier structuralist focus on the inherently unfavourable external environment, and consequent export pessimism, for developing countries had given rise to the concept of a "foreign exchange constraint" and a consequential "foreign exchange gap". This provided the early intellectual justification for official resource transfers to developing countries which were expected to have large multiplier effects by relaxing the foreign exchange constraint.

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<sup>1/</sup> *Helleiner (1994) rightly points out the "debasement" of the term structural reform which is increasingly employed "to denote whatever policy package that a Government receiving a World Bank 'structural adjustment loan' was either being asked to undertake or actually did". There is no doubt that the term has acquired the flavour of Humpty Dumpty's dictum. "When I use a word it means just what I choose it to mean - neither more nor less."*

By the end of the seventies, as a result of influential studies by Little, Scitovsky and Scott (1970), Balassa (1971), Bhagwati (1978), Kreuger (1978), the structuralist view had given way to the perception that foreign exchange scarcity was largely a consequence of the anti-export bias of protectionist policies which led to poor export performance. The multiplier effect of injecting foreign exchange through concessional resource transfers was seen to be less important than the potential multipliers from expanding exports which operated through faster absorption of technology and the impact of greater competitive pressure arising from exposure to world markets.

6. Where structuralists emphasised the need for massive domestic investment to build capacity, especially in infrastructure but also in industry generally, using the state as an entrepreneurial agent to stimulate investment, later academic work focussed much more attention on efficiency of resource use and factor productivity growth as key elements in economic dynamism. The focus on efficiency as a source of growth forced consideration of the economic environment most likely to encourage efficiency. In this context, several studies e.g. Kreuger and Tuncer (1982), Nishimizu and Robinson (1984) and Nishimizu and Page (1991) emphasised greater export orientation and lower levels of protection as key determinants of efficiency. The focus on efficiency has over the years also led to a much greater concern about human resource development which was typically neglected in the earlier capital investment oriented approach.

7. The concern with efficiency also moderated the earlier enthusiasm about public sector investment as an engine of growth since experience in most countries showed the public sector to suffer from low levels of efficiency and inadequate profitability. Individual examples of efficient public sector units could always be found, ranging from the celebrated example of the Pohang Steel Plant in Korea to individual examples in other countries such as Mexico, Indonesia and India. However, the performance of the public sector as a whole in most developing countries clearly suffered from serious weaknesses which militated against efficiency and growth.

## **2) The Fund/Bank Role**

8. The International Monetary Fund and the World Bank have been actively involved in the convergence and are often credited with its principal authorship. Williamson (1991), with embarrassing geo-centrism, has even christened the convergence as the "Washington consensus"! There is no doubt that over the past ten years, the two institutions, which had somewhat distinct approaches earlier, have unified these approaches and become influential advocates of structural reforms in developing countries.

9. The advocacy of structural reforms by the Bretton Woods twins came about in the aftermath of the second oil shock and was intensified after the debt crisis which revealed large external imbalances facing many countries. The traditional Fund approach of correcting balance of payments disequilibria through reduction in aggregate expenditure levels, supplemented by exchange rate depreciation, was increasingly seen to be ineffective in view of the size of the external adjustment needed in most debt burdened countries. It was recognised that reliance on this approach alone could produce stagflationary outcomes with a disruption in the growth process. The traditional Bank approach, focussing on providing long term project finance and thus indirectly filling critical foreign exchange gaps, was equally circumscribed in dealing with the post debt crisis situation because of the limited volume of resources which could be mobilised by the Bank and other aid donors in response to the greatly expanded need. The technical work of both the Bank and Fund Staff during the 1980s repeatedly endorsed the need for larger concessional resource flows and easier debt reschedulement for developing countries. However, political realities were such that additional resources were not made available.

10. Adjustment to the post debt crisis world without significant access to additional resources implied that growth would suffer significantly unless substantial improvements in

efficiency could be somehow triggered. It is in this context that the Fund and the Bank embarked upon a joint advocacy of stabilisation aimed at achieving macro-economic stability in the short term, combined with structural reforms aimed at accelerating growth through supply side responses. The focus on structural reforms was partly a reaction to the widespread intellectual awareness of the importance and extent of policy distortions, but it was also partly a response to the inability to restore growth through provision of additional external resources. To some extent therefore structural reform had to be invented because it had become necessary!

11. The rationale for structural reforms as advocated by the World Bank and the IMF has been spelt out in an impressive range of research studies based on experience in several countries. The World Development Report 1991 provided a summary statement of the World Bank's case for structural reforms. It has also provoked counter statements by neo-structuralist critics such as Fanelli, Frenkel and Taylor (1993) and Singh (1992). An earlier and more detailed critique of the Fund-Bank approach to macro-economic policy is presented in Taylor (1988).

### **3) Policy Makers in Developing Countries**

12. Policy makers in the developing countries were obviously influenced by the retreat from structuralism in the academic world and could hardly ignore the consensus emerging in the multilateral institutions. But they were also changing their views on the basis of their own experience in the seventies and eighties. Latin America's experience was dominated by the difficulties in adjusting to the oil shock in the seventies and the subsequent, and related, debt crisis of the eighties. The failure of the partial liberalisation experiments of the Southern Cone countries in the 1970s, and the equally disappointing results from the heterodox stabilisation packages in Brazil, Argentina and Peru in the first half of the 1980s, created conditions which forced a rethinking of earlier strategies. In this they were undoubtedly influenced by the exemplary performance of East Asian countries which were able to bring about much greater export orientation in their economies and were also able to maintain a high degree of macro-economic stability all of which led to spectacular growth rates of GDP as well as employment.

13. South Asian countries did not perform badly in the eighties but here too, the stellar performance of East Asia including the performance of China as a late reformer, led to a reorientation of strategy away from excessive Government control and high protection. A process of rethinking on economic policies began in India in the eighties when several steps were taken to reduce Government controls and liberalise foreign trade, though it was not until 1991 that India embarked on a programme of accelerated reform. Policies in Pakistan, Bangladesh and Sri Lanka were also moving in the same direction. The collapse of the centrally planned economies at the turn of the 1990s, and their wholesale adoption of market orientation and global integration, became an additional factor strengthening the push towards deregulation, greater openness and adoption of market friendly policies.

14. An important feature of process of convergence is the modification of puristic or ideological positions on all sides. Among academics, including even structuralists, there is widespread recognition of the need to move away from earlier policies of excessive protection, persistent interference with market mechanisms and unquestioning belief in the efficacy of state intervention in achieving its stated and usually well meant objectives. In turn, the structuralist critique of conventional Fund-Bank programmes has created greater awareness in these institutions of possible adverse effects of reforms in certain circumstances calling for greater care in the design of the reform programme. Experience with structural reform programmes in many countries has also produced a more realistic assessment of the pace at which results can be expected. The experience of successful performers in East Asia has also influenced the convergence in important ways. While these economies have been highly successful in achieving outward orientation and high export growth, many of them are also economies where the Government has played an active role

in many aspects of the economy including especially the provision of basic education and health. Recognition of the positive role of Government and its implications for the design of a reform programme are important elements of the current convergence.

## **II. Some General Issues: Pace, Sequencing and Credibility**

15. A characteristic feature of structural adjustment and reform programmes implemented by most developing countries in the past ten years is that the agenda of reforms ranges over a number of sectors, macro-economic as well as micro- economic or sectoral issues and managing policy change in so many dimensions poses special problems. The typical reform programme includes the following elements:

- i) Macro-economic stabilisation.
- ii) Domestic deregulation of investment production and prices.
- iii) Liberalisation of foreign trade,
- iv) Privatisation of the public sector,
- v) Financial Sector Reforms,
- vi) Tax reforms,
- vii) Labour Market Reforms,
- viii) Social Safety Nets.

Managing policy changes in so many dimensions poses special problems especially when the reforms are obviously inter-related in the sense that the effectiveness of each element in the package depends upon other elements being successfully implemented. This inter-relationship raises several issues about the design of the programme.

16. The first issue relates to the pace of reform or the choice between a "big bang" approach, also known as "shock therapy" in its Eastern European incarnation, in which all the reforms are implemented in a very short time, or a more cautious "gradualist" strategy. Opinions vary on the advantages of the two approaches and a good case can be made for either depending upon particular circumstances. In the idealised frictionless world of neo-classical theory, without political and social constraints, it may be optimal to implement the entire package immediately and achieve the adjustment to the new equilibrium in the quickest possible time so that the benefits of the reforms are evident as soon as possible. In practice there are lags in adjustment which affect the speed with which the economy will respond to different initiatives. If benefits take time to surface the constituency in support of reforms will also take time to emerge. The choice of pace of reform is also influenced by political constraints arising from the fact that all structural reforms involve some distributional changes in favour of some groups and against others, and there are limits on the extent of distributional change that can be tolerated. Such changes may not be adverse in a normative sense. For example a reduction in protection and a shift in incentives towards exports may benefit labour intensive export industries and low wage labour employed in these industries at the expense of highly protected capital intensive industries with high wage organised labour, and such a shift may even represent an improvement in total employment and income distribution. However distributional changes are bound to be resisted and especially so in democracies with active and participative political purposes. Such considerations could justify a gradualist strategy in which reforms are phased over several years to limit the distributional burdens on particular groups in the initial years until the benefit of the reforms in other dimensions become fully evident and generate necessary support.

17. Earlier writers e.g. Little, Scitovsky and Scott (1970) had recommended gradualism as a logical strategy to minimise adjustment costs and ensure that the reforms are allowed to proceed at an acceptable pace. More recently, there has been greater support for a more rapid implementation of reforms on the grounds that it does not allow time for opposition to build up and also because it gives a clearer signal about future policies. Bruno (1992) has also argued for a rapid pace of implementation to counter "reform fatigue" which can otherwise build up. In practice the choice of pace is less a choice between polar opposites

and more a decision of where to locate in a spectrum of possibilities. Experience with the "big bang" approach in Eastern Europe has been far from salutary. By contrast, the much more successful performance in East Asia is typically associated with reforms implemented in a measured way over a longer period. The balance of advantage would therefore seem to lie in a phased implementation of reforms where the pace is sufficiently fast to ensure reasonable results without risking excessive disruption in the short run.

18. The second issue in managing reforms relates to optimal sequencing which is especially important if the pace of reform is gradualist. If the reforms are interdependent but their implementation is stretched out over time then certain elements of the reforms may not be successful unless accompanied by, or even preceded by, action in other areas. This raises typical second-best type problems since an otherwise sensible reform may not only be ineffective, but may actually prove counterproductive, if other elements are not in place. Trade policy reform aimed at reallocating productive resources in line with comparative advantage will not be effective if controls over production and investment prevent such reallocation from taking place. The problem of sequencing was first perceived in the context of the Southern Cone experiments in relation to the sequencing of capital account liberalisation but it is extremely relevant in all reform programmes. These issues are comprehensively reviewed in Edwards (1992) and Funke (1993). Not surprisingly, this is an area which throws up many more interesting questions than definitive answers.

19. The third issue that stares reformers in the face as they engage in the complex balancing act of gradualism combined with optimal sequencing is that the reforms must pass the test of credibility. Economic restructuring can succeed only if economic agents, especially investors believe that the reforms are enduring and will not be reversed. Investors will be willing to take long term decisions in response to new policy signals only if the new signals are seen to be permanent and irreversible. Finally, the package that emerges out of this complex balancing act of gradualism combined with optimal sequencing must also pass the test of credibility in the sense that economic agents must believe that it will not be reversed. Economic restructuring can succeed only if economic agents, especially investors, are willing to take long term decisions in response to new policy signals and this will happen only if the new signals are seen to be permanent and irreversible. To some extent the issue of credibility is linked with the choice regarding the pace of reform. A faster pace of reform could, under certain circumstances, add to credibility if the results achieved in the short term are sufficiently favourable to vindicate the reforms and ensure against reversibility. On the other hand a gradualist approach could in certain circumstances generate greater credibility if it avoids unnecessarily disruptive situations in the short run and allows time for beneficiaries of reforms to emerge with a clear vested interest in their continuation.

20. It is obviously not possible to prescribe general rules for the design of a programme of structural adjustment and reform which will ensure appropriate pace and sequencing of reforms and also ensure credibility. These are choices that have to be made in the particular context of each country, taking account not only of economic circumstances but also of political and social constraints. These issues are examined further in subsequent sections of this paper.

### **III. Macro-economic Stabilisation and the Fiscal Deficit**

21. Most countries undertaking structural adjustment have done so in the context of severe macro-economic imbalances reflected in unsustainable balance of payments deficits or high rates of inflation or both. Macro-economic stabilisation has therefore figured high on the agenda of reform in most cases. This is not only to achieve the immediate objectives of controlling inflation and managing the balance of payments, but also to create conditions conducive to sustainable growth. Macro-economic stability is also a precondition for the effectiveness of other reform initiatives. Trade liberalisation without macro-economic stability can lead to unmanageable pressures on the current account and financial liberalisation before macro-economic stabilisation can lead to unsustainable increases in

interest rates and banking crises. For all these reasons, macro-economic stabilisation is generally regarded as the centre piece of a successful reform strategy.

22. Although there is complete consensus on the need for macro-economic stability, the implementation of stabilisation programmes creates several problems. Macro-economic imbalances typically arise when the level of aggregate demand is not sustainable generating inflationary pressures and spilling over into current account deficits. The origin of the imbalance may lie in excessive expansion of domestic demand (i.e. overheating) or in an exogenous shock which worsens the current account deficit and makes the pre-existing level of aggregate demand unsustainable. In either case if the situation is not self correcting, and the increased current account deficit cannot be financed, the only way to restore macro-economic balance in the short run is to reduce aggregate demand. Stabilisation policies therefore aim at reducing aggregate demand through a combination of tight fiscal and monetary policy and this inevitably imposes a burden on some sections of society. Resentment of this burden is a common factor underlying the unpopularity of most stabilisation programmes, and this is especially so if the burden is seen to be unfairly shared among different sections. Apart from the initial and unavoidable burden of reduced demand, stabilisation programmes are also criticised because of other reasons. Two problems which are particularly important in this context are the recessionary effect of stabilisation on output levels and therefore employment in certain circumstances, and the depressive effect on investment levels, which hurts medium term growth prospects.

### **1. Stabilisation and Recession**

23. Conventional stabilisation programmes are often criticised on the grounds that the reduction in aggregate demand envisaged in these programmes has a recessionary impact on output and employment, which in turn means that the burden of adjustment falls more heavily on the poorer sections. This problem is perhaps less serious when stabilisation is aimed at correcting an imbalance arising from a runaway expansion in domestic demand (overheating) because demand reducing policies in these circumstances may help to contain inflation (and help the balance of payments) without depressing domestic output or employment. However a recessionary impact is more likely when stabilisation is triggered by the need to correct an externally induced deterioration in the current account deficit. In such cases the aim of reducing aggregate demand is to bring the current deficit down to sustainable levels. If export demand elasticities are infinite and if domestically produced importable are perfect substitutes for imports, it can be shown that the reduction in aggregate demand will not depress production levels in the tradable goods sectors, but will only lead to higher exports or lower imports, which improves the current account deficit. However even on these assumptions the reduction in demand will reduce output of the non-tradable goods sector. With more realistic assumptions of less than infinite export elasticities, and less than perfect substitutability between domestic goods and imports, the reduction in aggregate demand will create some slack in the tradable goods sector also.

24. The text book solution to this problem lies in exchange rate depreciation which is a critical component of stabilisation programmes. The depreciation is expected to improve the competitiveness of the tradable goods sectors and thus encourage expansion of these sectors. This expansion in response to exchange rate depreciation is expected to counter the initial deflationary impact of demand reduction. The effectiveness of exchange rate depreciation in triggering an expansion in the tradable goods sectors is therefore critical for countering the recessionary effect of demand reduction, but this process may not always work smoothly and swiftly enough.

25. One factor limiting the speed of adjustment in certain circumstances is that short run export elasticities of demand may be much smaller than elasticities in the medium run. This is especially likely if the economy is not highly diversified and export oriented to begin with. There may be many domestic products which are potentially exportable but are not immediately exportable because of quality and technology gaps which take time to bridge. In such situations it may not be possible to achieve large enough export responses in the short run except at large price reductions which imply correspondingly large depreciation.

26. An adjustment process which requires a very large depreciation poses its own problems. In the first place a large depreciation is likely to feedback into domestic prices and this can create a destabilising wage-price spiral. It can also generate negative macro-economic feedback via the fiscal deficit in situations where the Government has a large external debt or has directly or indirectly taken on the exchange risk in foreign borrowing. In such cases a depreciation designed to complement demand restraint by encouraging tradable goods expansion may actually undermine the initial demand restraining objective by worsening the fiscal deficit.

27. These considerations suggest that some loss of output and even employment in the short run may occur as part of stabilisation in certain circumstances. The extent to which this will happen depends upon the size of the initial imbalance and the effectiveness of exchange rate policy in promoting expansion in the tradable goods sector. If the initial imbalance is modest, the economy is highly diversified with a large potential export capability and world demand conditions are favourable, it may be possible to implement a stabilisation programme with a minimum recessionary impact. Under more unfavourable circumstances however the recessionary impact will be larger.

28. The key issue however is not whether there is a temporary recessionary phase as a consequence of stabilisation, but whether there is any alternative adjustment programme which will avoid it. Critics usually have in mind two types of alternatives. The first is to design alternative stabilisation programmes to handle the crisis without demand reducing policies. This is exemplified by various types of heterodox stabilisation programmes of the type that were tried unsuccessfully in Latin America in the early eighties, and also the efforts to manage balance of payments deficits through the imposition of controls as was common practice in South Asia. Experience gained so far with these approaches is not encouraging and there is little doubt that an element of demand restraint is inescapable as part of stabilisation

29. Another alternative approach is to accept the logic of adjustment programmes with demand restraint, but to argue that the adjustment should take place at a slower pace. This is a relevant issue which needs to be carefully considered. A rapid adjustment based on demand restraint is perhaps justifiable in a situation where the economy is overheated. However when the source of the imbalance is external, the pace at which the economy can adjust without precipitating recessionary conditions depends upon the pace at which resources can be redirected into the tradable sectors. Pushing the pace of adjustment beyond this point may introduce significant short term costs in terms of over deflation and unemployment. The ideal pace of adjustment is one which takes account of these considerations, but this implies an ability to finance the resulting larger current account deficit over a longer period. Unfortunately many developing countries faced with the need to make such adjustments in the eighties were also placed in circumstances in which finance was simply not available. The high external debt already incurred by many of these countries obviously added to this problem. In many cases, the pace of adjustment was effectively forced by the lack of availability of finance on suitable terms, rather than the financing requirements determined on the basis of the ideal pace of adjustment. When this happens, it is important to be realistic about the outcome of such adjustments and the short term costs involved. International agencies also need to recognise this problem and avoid underestimation of the cost of adjustment. The costs may be unavoidable if finance is not available but they should not be understated for this reason.

30. Structuralist critics of stabilisation programmes often paint extreme case scenarios where the economy may be pushed into a destabilising spiral as reductions in aggregate demand lead to a fall in output while exchange rate depreciation fuels inflation producing a stagflationary outcome with low levels of output compared to capacity and a sharp decline in real wages. In such scenarios the adjustment process operates by reducing aggregate output levels along with aggregate demand, and achieves equilibrium at low levels of capacity utilisation with the distribution of income shifting against labour through falling real

wages. The experience of many Latin American countries which experienced accelerating inflation and a decline in real wages during the eighties underlies some of these fears.

31. It is important to draw the right conclusions from these criticisms of stabilisation programmes. To begin with, it must be recognised that some of the problems described above reflect an "extreme pathology" based on some of the worst experiences of countries' in Latin America and Africa, which faced an exceptionally large adjustment after the debt crisis. These are cases where it can be argued that a more extended adjustment might have been less disruptive had adequate finance been available to permit a longer adjustment. But these outcomes should certainly not be viewed as inevitable in all cases, especially when corrective action is taken before the imbalance becomes too large. Nor should these problems be used to argue against undertaking adjustment when adjustment is necessary. Failure to adjust poses its own problems and, as the Latin America experiments with heterodoxy in the first half of the eighties amply demonstrate, there is no effective alternative method of adjustment which will yield better results. In fact postponement of adjustment in the eighties, followed by heterodox adjustment in Latin America, generated even more disastrous outcomes.

32. Perhaps the most important lesson to be learnt from accumulated experience is that it is important to act at an early stage to correct macro-economic imbalances before they become too large. Large corrections are more difficult to implement since the room for manoeuvre is limited and if the correction required goes beyond the limits which can be handled by available policy instrument the corrective action is inadequate and destabilising outcomes are more likely.

## **2. Stabilisation and Investment**

33. Stabilisation programmes are also criticised on the grounds that the reduction in aggregate demand is typically achieved at the expense of investment which jeopardises medium term growth. The experience with stabilisation in the past ten years in Latin America and Africa suggests that this is indeed a serious problem. A recent World Bank (1993) study of 57 countries undergoing structural adjustment lending reports that both public and private investment rates declined during adjustment. What is more, the process of recovery of private investment took much longer than was earlier hoped and time lags of 4 to 5 years were not unusual. It is important to consider why this and how it can be avoided.

34. Public investment has suffered in many stabilisation programmes because of the need to reduce the fiscal deficit and the manner of its reduction. The case for reducing the fiscal deficit as part of an effort to reduce aggregate demand needs little elaboration. Most developing countries have suffered from excessively expansionary fiscal policies which have produced large fiscal deficits which are simply not sustainable and a reduction in these deficits is desirable in many cases even without the compulsion of stabilisation. A reduction in fiscal deficits is also relevant when the problem arises from a deterioration on the external side. It is important to emphasise however that a reduction in the fiscal deficit does not necessarily imply a reduction in public investment. The objective of reducing the deficit can be equally achieved by increasing Government savings while maintaining investment levels. In fact a fiscal deficit reduction achieved by increased Government savings is clearly much better than the same deficit reduction achieved by reducing public investment. Unfortunately few countries have found it easy to follow the former route.

35. The scope for increasing public savings depends upon the ability to increase tax revenues (and also public sector surpluses where a consolidated view is taken of the public sector) on the one hand and reduce Government consumption on the other. Since higher tax revenues reduce aggregate demand essentially by reducing private disposable income and therefore private consumption, a combined effort at raising tax revenues and reducing Government consumption ensures that the brunt of the aggregate expenditure reduction is borne by Government and private consumption expenditure. If we can be sure that the

reduction in Government expenditure does not lead to a withdrawal of benefits to the poor, and if the incidence of additional tax revenues is not regressive, we can say that the burden of adjustment is fairly distributed. But such targeting is not always easy to achieve in practice. In practice there are severe limitations on the extent to which Government consumption can be lowered or tax revenues increased in the short run.

36. There is no doubt that many developing countries suffer from problems of a bloated bureaucracy and most budgets contain schemes and projects of doubtful social benefit which could be drastically pruned if not entirely eliminated. In many cases Government Budgets are burdened by subsidies which are not effectively targeted to the poor and also by the direct and indirect support provided to loss making public sector units. The constraints upon how fast Governments can move in these areas are essentially political but they are no less real for that. While a period of austerity may be generally accepted at a time of crisis, and Governments may be able to take some hard decisions in such situations, some of the gains are often temporary. This is particularly so if expenditure reduction occurs in the form of "expenditure restraint" in response to the compulsions of short term economic management without any system changes which would eliminate certain types of demands entirely such as abolition of certain subsidies or elimination of certain Governmental functions, or privatisation/closure of loss making public sector units which otherwise exert claims on the Budget. Mere expenditure restraint leads to "expenditure suppression" rather than genuine "expenditure reduction" in the sense that the same expenditure demands resurface a little while later when the immediate crisis is over. The difficulty in reducing Government consumption expenditure is further increased by the emergence of new pressures to increase expenditures which may build up in the course of economic reforms. In a developing country, there are many legitimate demands upon Governments to provide basic services to the poor. These demands are likely to intensify during a period of adjustment because of the need to create social safety nets to limit the burden placed on the poor.

37. There are equally serious difficulties in increasing public savings through improved tax revenue mobilisation in the short term. A major problem here arises from systemic weaknesses in the tax systems of most developing countries. It is always possible to raise additional revenues simply by raising rates in existing tax systems, but this may be counter productive if the tax system is characterised by highly distortionary taxes. It is therefore necessary to first reform the tax structure and put in place a less distortionary tax system, and then mobilise revenue through effective enforcement of the new system.

38. The need for basic reform in the tax system as an essential component of structural adjustment is therefore one of the critical elements in any strategy of stabilisation and structural adjustment. All countries implementing structural reforms have taken important steps in this direction. Perhaps the most important initiative in this context is the introduction of VAT (or some variant thereof) in a large number of developing countries, all of whom have reported very encouraging results. However some elements of tax reforms, such as reductions in customs duties as part of trade reforms, may hurt Government revenues. It may be possible in some situations to recoup losses in customs revenues by tariffication of existing quantitative restrictions where these are important, so that the switch from quantitative restrictions to tariffs leads to higher revenues, but this may not provide large revenues in all cases. Besides a comprehensive reform of the tax system requires a system reform which cannot be implemented over night. It needs to be tailored to the particular legal and institutional circumstances of each country and involves not only the redesign of the tax structure, but even more important, a thorough overhaul and modernisation of tax administration. All this takes time to implement and in the process the growth in tax revenues in the first few years may not be as dramatic as expected.

39. The limitations on reducing Government consumption expenditures and raising tax revenues in the short run define the narrow limits of the possible in reducing fiscal deficits without hurting public investment. Where the required macro-economic adjustment is

relatively small it should be possible to restore macro-economic balance without much damage to public investment. However, where the required level of adjustment is large, as was the case with many developing countries in the 1980s because of the size of the external shock, the reduction in the fiscal deficit required for macro-economic stability forces substantial reductions in public investment. Some reduction in public investment may be acceptable in certain circumstances, as for example when public investment levels are high and the reduction reflects lower levels of low productivity public investment in non-critical sectors. However sharp reductions in public investment in critical infrastructure sectors can be very damaging to medium term growth and there is evidence of such damage in Africa and Latin America. Naim (1994) reports that real spending on new infrastructure fell in 11 of 13 countries studied with real expenditures on infrastructure in countries such as Argentina, Venezuela, Brazil, Guatemala, Panama and Mexico being less than 50% of the levels observed in the early 1980s."

40. This is not to argue against the objective of reducing fiscal deficits. The lesson to be learnt is that it is not enough to define the objective solely in terms of reducing fiscal deficits. The quality of the deficit reduction is equally important and this means that deficits should be reduced primarily by raising public savings while maintaining essential levels of public investment. This forces attention on the difficult choices which are crucial for a successful adjustment i.e. control over Government consumption expenditure including non-targeted subsidies and bold implementation of tax reforms.

41. The impact of stabilisation programmes on private investment is equally important. Unlike the case of public investment there is no immediate reason why a stabilisation effort should lead to a fall in private investment. In fact a reduction in the fiscal deficit can be expected to help private investment if it leads to lower interest rates and less crowding out of private investment. Yet as the World Bank (1993) study notes, private investment too has suffered in the course of stabilisation efforts. One explanation of this phenomenon is that public investment, especially investment in infrastructure, is complementary to private investment rather than competitive with it. Some empirical evidence for this view is given in Taylor (1993), There are also other reasons why private investment may be temporarily depressed in the course of a stabilisation programme. Where the programme quickly succeeds in restoring macro-economic stability and reducing uncertainty about the future course of action, and where there is a substantial inflow of foreign direct investment in the early stages, domestic private investment can be expected to respond favourably to the new situation if not immediately then at least in a relatively short time. However if the stabilisation programme is inadequate to the task at hand, and seen to be faltering, it can generate destabilising expectations about the medium term which may hurt investment intentions. When this coincides with trade liberalisation, which reduces protection and therefore the incentive to invest in many domestic industries, it may lead to an overall wait-and-see attitude on the part of investors both domestic and foreign which would depress private investment for a time.

42. The following lessons can perhaps be drawn for the design of stabilisation programmes with a high degree of confidence :

- i) Macro-economic stability is a precondition for successful restructuring and countries which face instability, whether induced by internal or external factors, would be well advised to take corrective steps earlier rather than later. Such adjustment will entail costs, but failure to adjust could force even higher costs on the economy.
- ii) The fiscal deficit is an important instrument in the adjustment process, but much more attention needs to be given to the quality of the deficit reduction and in particular its impact on investment if the medium term growth prospects are not to be jeopardised. A reduction in the fiscal deficit achieved through higher tax revenues generated from broad based non-distortionary taxes is the best way of reducing the deficit as it represents a permanent strengthening of the fiscal position. A pruning of non-productive Government expenditure is

perhaps equally good in the short run, though these gains are more likely to be in the nature of once for all gains. Neither route to deficit reduction is easy but the alternative is worse and the key to a well designed adjustment programme is whether it can enforce some hard decisions early to avoid worse outcomes later.

- iii) Depending upon the size of the macro-economic adjustment needed, countries may be forced to carry deficit reduction to the point where cuts in public investment may be unavoidable in the short run. Some reduction in public investment may not be damaging if it is limited to low efficiency investment in manufacturing and most Governments budgets have many such cases. However it can present serious problems if it leads to deep and prolonged cuts in public investment in key infrastructure areas where shortages will affect the productivity of capital generally in the economy. This is especially so in countries where reductions in public investment in infrastructure will not be offset by private investment for some time.
- iv) The targeting of fiscal deficit reduction, and its implications for public investment levels also has to take account of the likely level of private investment in the economy, which may also be temporarily depressed for various reasons. Structural adjustment programmes should not assume that private investment will automatically crowd in to replace public investment. There is a possibility that private investment may take time to recover in which case the pace of reduction in the fiscal deficit could be more gradual than would be otherwise justified, especially when this would help to maintain public investment in infrastructure sector at reasonable levels.
- v) Not surprisingly, these problems will be less severe the smaller the extent of macro economic correction that is required. The larger the correction the more likely that ex ante corrective steps will fall short of what is needed, leading to various types of disequilibrium behaviour.

#### **IV. Trade Policy Reform**

43. Trade Policy reform typically involves some combination of the following package of measures:

- i) Elimination of export restrictions and taxes,
- ii) Substantial depreciation of the exchange rate to increase export profitability and offset reduced protection,
- iii) Elimination of quantitative import restrictions and a shift to tariff protection.
- iv) Reduction in average tariff levels, v) Reduction in tariff variation with the ultimate objective of a uniform tariff on most if not all items.

Although trade policy is perhaps the most intensively researched area in development economics, it is only recently that trade reforms have been widely implemented in practice. Trade policies were generally restrictive in most developing countries until the early eighties and the initial reaction to the debt crisis was to tighten trade restrictions in many cases. However, there was a turn around by the mid-eighties when several countries in Latin America moved sharply in the opposite direction.

44. The pace of trade liberalisation since the mid-eighties has been remarkable by any standards. Between 1985 and 1991 the average tariff rate (unweighted) was reduced from 80% to 21 % for Brazil, from 83% to 7% for Colombia, from 92% to 16% for Costa Rica, from 34% to 4% for Mexico and from 64% to 15% for Peru. In many cases the reduction was brought about in one year! The coverage of non-tariff barriers has also been dramatically reduced. A similar process of trade liberalisation has been initiated more recently in South Asia, though at a much more gradual pace. East Asian countries, whose tariff levels were low even earlier, have lowered tariff rates further in this period.

45. The shift to more outward oriented and liberal trade policies has certainly proved successful if we look at the export performance of reforming countries. Chile and Turkey both became highly successful exporters in the eighties. The experience of other countries

implementing structural reforms, surveyed in World Bank (1992) and (1993), also shows that export growth rates for most countries were markedly higher in the period 1987-91 compared with the period 1982-87. These results clearly indicate that the pessimism about export possibilities, which characterised much of the earlier structuralist thinking, is not warranted by experience and this has produced a general consensus on the importance of providing an environment supportive for exports. This includes at a minimum a realistic exchange rate, which ensures export profitability and also an import policy providing exporters with an effective "free trade regime" for their inputs so that inputs can be easily obtained at world prices.

46. While there is general consensus on the importance of export orientation there is less agreement on whether the full package of import liberalisation, with elimination of quantitative import restrictions, reduction in the average level of tariff and a narrowing of tariff rates is an equally compelling necessity. Rodrik (1992) points out that high export growth achieved by many developing countries owes more to aggressive exchange rate policy than to any package of full fledged import liberalisation as recommended by trade reformers. Helleiner (1994) also expresses reservations on the pace at which full import liberalisation needs to be introduced in Africa. The experience of East Asian countries is also often cited to question the importance of import liberalisation. These countries, it is argued, certainly gave top priority to export performance and tailored their policies to support exports, but except for Hongkong they did not follow liberal import policies, especially exchange rates in the conventional sense.<sup>2/</sup>

47. Because of these doubts, it is important to define the area of consensus on the role of import liberalisation in trade policy reform. The theoretical case for reducing protection and liberalising imports on efficiency grounds is well known, as is the usual qualification in terms of the infant industry argument, which is undoubtedly relevant in developing countries. The case for some protection for domestic industry can be readily conceded but this should not be used to justify very high levels of protection such as prevailed until recently in many developing countries, especially the larger countries such as Brazil and India. To some extent the smaller economies avoided the worst excesses of high cost import substitution simply because the size of their domestic markets limited the extent to which import substitution could be pursued. In the larger economies the range of import substitution possibilities was wider and this led to a more pervasive structure of protection. It was not adequately recognised that such protection ultimately benefits protected sectors at the cost of other sectors including especially exports. High rates of protection over wide range of industries created a situation where the effective exchange rate facing these industries was much more favourable than the exchange rate facing exporters. This created a powerful bias against exports which could only be offset through special export incentives and subsidies but these are no substitute for a more favourable exchange rate since they are typically inadequate to offset the anti-export bias, are complex to administer and are a burden on the budget.

48. While few would disagree that high levels of protection are undesirable, opinions vary much more on what is the appropriate level of protection, and in particular on the extent of variation in tariffs that can be tolerated. Committed advocates of trade policy reforms typically recommend duty rates around 10% to 15%, with near uniformity of the tariff if possible. While some countries in Latin America have moved quickly to this situation others are making the transition more gradually. India for example, until very recently had tariff levels which were high on average and also highly variable, and customs duties also contributed as much as 40 percent of Government revenue. In these circumstances it is

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<sup>2/</sup> As documented by Amsden (1989) in the case of Korea and Wade (1990) for Taiwan, both countries became successful exporters by (a) ensuring that exporters had easy availability of importable inputs at world prices (b) ensuring a highly supportive exchange rate, (c) offering their firms a protected home market, and (d) combining all these with a complex system of Government administered rewards and penalties especially through directed credit arrangements which targeted individual firms and pushed them to compete internationally.

difficult to move quickly to low and uniform tariff rates without imparting too large a shock to many highly protected industries and also creating serious budgetary problems. India's approach towards tariff reductions has therefore been more gradual, with steady but substantial annual reductions in tariff levels combined with a more rapid reduction of peak rates to reduce tariff dispersion. It is expected that this process will achieve a phased transition to a more reasonable structure of protection over a 5 year period. One of the problems with such a phased transition is the uncertainty about future levels of tariffs which can delay investment decisions. It is obviously important to give clear signals to investors on the tariff regime they should expect in future. Some countries have followed the practice of pre-announced tariff reductions which helps to reduce uncertainty and encourage early restructuring of industry in line with future levels of protection.

49. One issue on which there should be no misgivings is that quantitative restrictions on imports should be substituted as soon as possible by tariffs. Accumulated experience in many developing countries establishes that quantitative restrictions, operated through discretionary import licensing, invariably create delays and inefficiency at best and corruption at worst. There is also no justification for the rents which QRs imply, least of all in a period of structural reform. Actual experience also suggests that this switch can be effected with little difficulty. In three years, India which had one of the most complex systems of import licensing has successfully dismantled licensing of imports for raw materials, components and other inputs into production and capital goods. Finished consumer goods are still subject to QRs but these too are being liberalised. The switch has been achieved with progressive reductions in tariff rates offset by exchange rate depreciation, and has presented no problems for the balance of payments.

50. Finally, it is important to consider the relevance of the East Asian example of combining export promotion with protection of domestic markets. There are several reasons why an uncritical acceptance of this approach may be inappropriate today. A general point which should be noted is that effective protection rates in East Asian countries, even during their earlier protectionist phase, were on the whole much lower than in Latin America, or South Asia, because exchange rates were never allowed to become overvalued. Besides, replication of the East Asian approach with its reliance upon interventionist regimes which often targeted individual firms depends critically upon the ability to design and operate such regimes in a manner in which ensures that individual firms benefiting from the system are under pressure to perform in world markets and actually do achieve international competitiveness at the end of the process. The line between targeted strategic support for good performers and unabashed favouritism is thin at best, and it is particularly difficult to draw in situations where transparency in Government dealings with individual companies can become an issue of public accountability. Changes in the global economy since the earlier years of the East Asian miracle also makes strict replication of the East Asian strategy more difficult today. The phenomenon of globalisation of production and the role of multinational firms in determining the ability of countries to access global production and marketing networks makes it much more difficult for countries to achieve outward orientation behind high protective barriers. Finally, the compulsions of the post-Uruguay Round world for moving towards greater openness and reduced reliance upon subsidies cannot be ignored by developing countries.

51. For all these reasons, trade policy reforms should aim not only at promoting exports but also at liberalising imports though the latter process could be accomplished in a phased manner. Some of the preconditions for the success of such policies are the following :

- i) Since trade liberalisation is designed to reallocate resources among sectors on the basis of undistorted relative profitability, it is important that domestic impediments to such reallocation be removed. This implies elimination of domestic regulatory restrictions on production and investment and also of price control as a prior condition. Trade liberalisation cannot play a useful signalling role if domestic prices are not free to adjust, or domestic resources to move.

- ii) The issue of sequencing of trade liberalisation in relation to macro-economic stabilisation can also present problems. Opinions vary between the view advocated by McKinnon (1982) and Edwards (1990) that macro-economic stabilisation should precede trade liberalisation and the view of Corden (1987) and Schweikert (1993) that it should be implemented simultaneously. The two views can be reconciled by distinguishing situations of severe macro-economic imbalances from those of relatively mild imbalance. In the former case it may be necessary to restore a substantial measure of macro-economic stability before undertaking significant liberalisation on the external front so as to avoid destabilising movements of the current account deficit and/or the exchange rate. However, in situations of milder imbalance, where corrective macro policies are being put in place, there may be no harm in proceeding with trade liberalisation simultaneously. This is especially so if there is a substantial upfront exchange rate adjustment which removes the initial over-valuation and perhaps even overshoots a little to provide a cushion of credibility.
- iii) On the related issue of capital account liberalisation there is virtual unanimity that it should be attempted last. This is the main lesson drawn from the Southern Cone failures of the 1970s. It also follows from the proposition advanced by Frenkel (1982) that since goods markets and financial assets markets clear at different speeds the goods market, which takes much longer, should be liberalised first. Too early a liberalisation of the capital account can also lead to large inflows of capital which have the immediate effect of appreciating the exchange rate thus moving in the opposite direction from the depreciation which is necessary to sustain trade liberalisation. While long term inflows of private capital are highly desirable and need to be encouraged, volatile capital flows of the portfolio type can present a problem and the size of these flows needs to be carefully watched, and if necessary may need to be regulated. The last thing developing countries need in the midst of trade liberalisation is a dose of "Dutch disease" with sharp exchange rate appreciation induced by capital inflows which may be equally quickly reversed.
- iv) In the longer term, the success of trade liberalisation depends upon its effectiveness in promoting new investment in sectors which are internationally competitive and this depends upon the interaction between trade policy reform and other factors affecting investment. Investors will only respond if the future direction of trade policies is clear and the policies are also seen to be non-reversible. Where the bulk of the trade reform is undertaken upfront, as in many Latin American countries, there is less uncertainty about the future. Where the pace of trade reform is more gradual, as for example in South Asia, it is important that the pace of implementation over the future is clearly spelt out and the transition is seen to occur in a reasonably short time so that investors can plan with confidence. Uncertainty about the future will only promote a wait and see attitude which will delay the expected benefits from trade reform.

## **V. Financial Sector Reform**

52. Most countries undertaking structural adjustment have emphasised financial sector reforms as an integral component of the adjustment programme and major overhauls of the financial sector are underway all over Latin America, South Asia and East Asia. The reforms focus mainly on the banking system, but also cover stock markets where these are important.

53. The impulse behind these reforms comes from three different sources. First, there is the literature on financial repression developed by McKinnon (1973) and Shaw (1973) which holds that excessive interest rate regulation and high reserve requirements combined with directed lending has burdened the banking system in developing countries reducing the

efficiency of banks both in mobilising domestic savings and in allocating them to different uses. Liberalisation of these restrictions is therefore recommended to reduce if not remove these distortions. A second impulse, which may appear to run counter to liberalisation, but is in fact an essential accompaniment, comes from the recognition that banking systems in most developing countries have suffered from inadequate prudential regulation weak external supervision, which has reduced the allocative efficiency of banks and also weakened them financially. Finally, there is a perceived need for financial sector reforms to enable the financial sector to support the restructuring of the real economy, which is the basic objective of structural reforms. Each of these considerations provides compelling reasons for reform in the financial sector.

54. The need for financial liberalisation as a corrective for financial repression is self-evident. The complex regulations imposed on banking systems in developing countries, including multiple regulated interest rates on both deposits and lending, high levels of reserve requirements and Government direction of credit to particular sectors, constitute a substantial tax on financial intermediation. The burden of this tax is borne by depositors who would otherwise have received higher interest rates on their deposits, and by the non-preferred borrowers who are charged high interest rates to cover the cost of subsidisation elsewhere. The beneficiaries are the preferred borrowers who are charged lower rates or whose defaults are tolerated, and the Government which benefits from pre-emption of resources at below market rates because of high reserve requirements. Developing countries would be well advised to reduce if not eliminate the economic costs of these distortions and this justifies a substantial measure of liberalisation. A case can always be made for subsidy for certain classes of borrowers, but the multiplicity of controls and administered rates prevailing in many developing countries are difficult to justify. There should at most be a single subsidised rate applicable to a limited class of borrowers, leaving other rates to be determined essentially by market conditions. Reserve requirements imposed on banks should also be reduced so that the implicit tax on financial intermediation is modest at best. Such changes would enable banks to pay somewhat higher interest rates on deposits, which would improve the banks ability to mobilise savings. On the lending side it would enable banks to charge a lower interest rate for non-subsidised borrowers more in keeping with the cost of capital. If banks are not able to reduce the burden of cross subsidy borne by non-subsidised borrowers they run the risk of disintermediation as commercially attractive borrowers turn to non-bank sources of finance, a process which hurts the banks by depriving them of their best corporate clients. This problem becomes more acute as the financial sector becomes more developed.

55. These arguments for liberalisation have been criticised on various grounds which are well summarised in Akyuz (1992). The argument that freeing interest rates will promote domestic savings and thus support a higher level of investment has its limits. Promotion of domestic savings is undoubtedly important but there is a view that domestic savings are not significantly affected by interest rates. Recent reviews of the Asian experience by Yoon-Je Cho and Khatkhate (1989) and of African experience by Nissanke (1990), suggest that the level of savings appears to be determined more by institutional factors, including especially the scope for contractual savings, rather than by high real interest rates. Large negative real rates of interest on deposits, such as are witnessed in times of severe macro-economic instability and hyper-inflation, are associated with declines in savings rates and a shift away from financial savings, but the dominant factor in such situations is the macro-economic instability and high rates of inflation. Small variations in real rates of interest in conditions of relative macro stability, may not have much impact on domestic savings or even on the ability of the banking system to mobilise savings.

56. Interest rate liberalisation on the lending side may create serious problems in situations where macro-economic stability has yet to be established. Where the Government's domestic debt is high and its fiscal manoeuvrability is limited, an increase in interest rates consequent on financial liberalisation can add to the interest burden on the budget at a time when Government is trying to reduce the fiscal deficit as part of structural adjustment. This

could undermine the fiscal effort and lead either to excessive monetisation of the deficit with inflationary consequences or to expanded Government borrowing. The latter could put further pressure on interest rates especially in situations where the market for Government debt is not well developed. Interest rate liberalisation in circumstances where the fiscal deficit is not in control could therefore lead to an "overshooting" of domestic interest rates, which could impose a severe strain on firms already under pressure as they restructure to face a more competitive environment. Financial distress in the corporate sector could in turn feed back on to the balance sheets of banks and force a contraction in bank credit. It can be argued that such a process, if it gets out of control, could have adverse effects upon investment. However the key issue here is not financial liberalisation as such but the macro-economic environment in which financial markets are liberalised. The policy conclusion to be drawn is not that financial liberalisation and the efficiency gains which it promises are not important but that these gains can only be achieved if liberalisation is undertaken in an environment of macro-economic stability. Once again sequencing becomes critical.

57. The second impulse behind financial reforms is the need for effective regulation. It is important to recognise that financial markets are fundamentally different from commodity markets in the sense that prices (in this case interest rates) are not set to clear the market. Many borrowers may be willing to offer high interest rates but they may be unacceptable credit risks either because their projects are inherently risky or because they are individually unreliable. Bankers need to screen out such borrowers and this implies that interest rates are not set to clear the market but are typically set in a zone in which there will be substantial excess demand for credit with bankers rationing credit by screening out risky borrowers. In principle this process of screening can take place in a liberalised system through good banking practices in the form of prudential norms, effective internal management controls, and strong external supervision. Unfortunately, these features have been lacking in most developing countries. Financial liberalisation therefore has to be implemented mindful of the danger that premature liberalisation may lead to irresponsible competition, with banks chasing "high return" but high risk assets, resulting in familiar problem of adverse selection and deterioration in portfolio quality. This is not to deny the need for financial liberalisation to clean up over-regulated systems. It is clear that excessive regulation leads to gross inefficiencies and very poor banking, especially if the banks are also controlled by the Government. It is only to argue that the pace of financial liberalisation needs to be calibrated to be in phase with the introduction of appropriate regulation.

58. The time needed to introduce appropriate regulation should not be underestimated as this is not simply a matter of prescribing international norms for income recognition, asset classification, provisioning and capital adequacy. New prudential norms and capital adequacy requirements cannot be implemented suddenly in banking systems which have existed without them for many years without subjecting banks to large balance sheets shocks which would either seriously destabilise the system, or impose large burdens on the budget for recapitalisation and restructuring of the banks. Banks will also take time to adjust to the requirements of the new situation as their whole approach to lending has to change to give much greater importance to portfolio quality. Nor is this simply a matter of shifting from public sector banks to private sector banks. The introduction of new private sector banks in banking systems which have been dominated by public sector banks can be extremely important for increasing competition and setting a faster pace of change, but privatisation by itself does not solve the problem. Experience with banking crises in many countries shows that private sector banks are also vulnerable if regulation is inadequate.

59. The learning process is a problem not only for the banks but for supervisors also. Regulatory and supervisory authorities, hitherto used to lax supervision, face formidable challenges in upgrading their skills to the requirements of the new situation. For all these reasons financial sector reform takes time to implement.

60. The experience of East Asia in financial sector reforms is instructive. Korea and Taiwan are exemplary in their long run record of maintaining macro-economic stability, achieving

high rates of savings and investment, and ensuring allocation of resources in pursuit of economic efficiency. Yet in both countries the financial system during most of the period of rapid and highly efficient growth was far from being a liberalised system. In both countries the banks for many years were subjected to extensive interest rate controls and programmes of directed credit were common, especially in support of export industries. In fact the degree of direction went down to micro-level, with targeting directed at individual firms. These countries have also undertaken financial sector reforms in recent years, but the pace of reform has been gradual rather than rapid. It has also been undertaken in a framework of macro-economic stability.

61. An aspect of financial sector reform which has received less attention than it deserves is the appropriateness of the Anglo-Saxon model of the financial sector in which banks provide short term capital while maintaining an arms length distance from firms, and long term capital is obtained from the capital market. The alternative is the German or Japanese model in which capital markets are less important and banks not only provide long term capital but are also closely involved with corporate borrowers through interlocking ownership. Singh (1992) has argued that the Anglo Saxon Model, which has influenced most financial sector reforms, is not necessarily the best model for developing countries to follow.

62. The reliance on capital markets as a source of long term funds can be a disadvantage because stock markets are imperfect instruments of resource allocation even in developed countries. They are overly influenced by short term factors and speculative movements rather than by longer term fundamentals, and especially so where trading is dominated and driven by institutional funds under the control of fund managers who are judged increasingly on the basis of short term performance. The decline of individual investors with longer term commitments (rational or otherwise) to individual companies and their replacement by institutional fund managers oriented towards more frequent shifting of the portfolio can create conditions which are not conducive to allocating resources on the basis of long term fundamentals. It has also been argued that this adds to volatility in the stock markets. Corporate managements may begin to fear threats of takeover in situations where stock markets are volatile. Though such takeover threats have a role as a potential disciplining device, in practice they can also prove to be a distraction, preventing managements from taking a long term view. These problems are even more serious in developing countries, where stock markets are immature, the number of players is limited, and stock prices can be easily manipulated.

63. Since structural adjustment typically involves short term costs and uncertainty, a financial system which emphasises short term performance indicators may not be the most suitable for encouraging long term restructuring. By contrast, financial systems in which long term capital is provided by banks which have a much greater involvement in individual companies are more likely to create an environment in which managements can count on sustained support of a long term corporate strategy. The choice between these models is not easy to make and this is an area where issues are unresolved even in the developed countries. However the weaknesses of capital market should not blind one to their strength. Active capital markets have certainly helped the corporate sector in many developing countries to mobilise substantial resources from the public, and more recently also to attract funds from abroad. The limitations of capital markets elaborated by critics of the Anglo-Saxon model need to be kept in mind, and corrected as far as possible, on the basis of country specific circumstances. This calls for extensive reform of the capital markets as part of financial sector reform. These reforms should aim at establishing independent regulation with a view to developing transparent trading practices, appropriate disclosure norms and effective regulation of insider trading, takeover bids etc.

64. The lessons to be learnt from the experience with financial sector reform can be summarised as follows :

- i) Reform is definitely necessary in the kind of situations which existed in many countries where the banking system was burdened with excessive and multiple

regulation and a deterioration in banking culture leading to a large proportion of non-performing assets.

- ii) Rapid financial liberalisation may not be the best way of moving away from a highly regulated banking system. The pace of reform needs to be carefully calibrated, with financial liberalisation being undertaken only after appropriate prudential norms and supervisory systems have been established. This can be a time consuming process as new institutions take time to develop strength.
- iii) While the complex controls existing in most countries needed to be greatly reduced and simplified, a case can be made for retaining some key interventions in terms of a concessional rate and some directed credit. The experience of East Asia indicates that such policies are not inconsistent with economic success.
- iv) Financial sector reform is easiest to implement if macro-economic stability is not in doubt and the Government's fiscal position is not too weak. Otherwise the shift to market related interest rates for Government borrowing could worsen the fiscal situation.
- v) Privatisation alone is no guarantee of achieving good banking practices. However the entry of private sector banks could add a welcome element of competition in situations where the banking system is largely in the public sector. Entry of private capital can also help in recapitalising banks which is important in the course of financial sector reform.
- vi) Since financial sector reform imposes new prudential and capital adequacy norms on the banks it is essential to implement programmes for capital restructuring and cleaning up the banks' balance sheets as quickly as possible. Failure to do this quickly enough can introduce an unnecessary contractionary element in bank lending which could hold back economic recovery.

## **VI. Privatisation and Structural Reforms**

65. Privatisation is a relatively recent addition to the agenda of policy reform in developing countries but it has gained remarkable momentum in a very short while. Ignoring the early but ill-considered privatisation experiment in Chile in the mid- 1970s, it is only in 1984 that Mexico and Chile embarked on programmes of privatisation as part of structural reform. This was followed by a bold push in Argentina a little later, and similar action by several other Latin American countries. More recently several countries in Asia, such as India, Pakistan, the Philippines, Malaysia and Thailand have also embarked on privatisation to varying degrees.

66. Most privatisation programmes have been characterised by multiple objectives with the relative emphasis varying from country to country. Mobilising non-inflationary financial resources was clearly a very important motivation behind the sale of public sector assets in the case of many countries facing severe fiscal pressures especially in Latin America after the debt crisis but also in India, Pakistan and Bangladesh. A second important objective behind privatisation is the improvement of operational efficiency in the public sector. In fact it is only if operational efficiency increases following privatisation that there is any real efficiency gain to the economy as a whole. A mere sale of public sector assets, with no expectation of improved performance after privatisation, is of limited value. The revenue gain to the Government from the sale of assets may have the same effect on the rest of the economy as additional Government borrowing. If the funds used to purchase public sector assets are withdrawn from other assets in the system they generate the same "crowding out" problems that arise with additional Government borrowing. The only advantage is that it does not burden the budget with future debt service.<sup>3/</sup>

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<sup>3/</sup> By the same token it deprives the Budget of future income streams from assets sold. Since these income streams are in any case too low, or even negative, the fiscal position can be said to improve compared with a situation where the same resources were obtained through borrowing. However if

67. The view that privatisation will improve performance in a way which cannot be achieved through public sector reform is a key element of the new consensus. The problems arising from inefficiency of public sector enterprises have been recognised for quite some time in developing countries but the earlier perception was that public sector corporations could be made to behave exactly as private sector corporations provided the incentives and management structures were comparable. Reform of the public sector therefore focussed on management reform with particular emphasis on managerial autonomy. While there is undoubtedly scope for improving performance through such reforms there is today much greater awareness of constraints on public sector companies arising from the fact that Governments, however well intentioned, cannot insulate them from several pressures to which Governments have to respond. The very need to ensure accountability in political fora can limit the managerial flexibility available to public sector organisations making it difficult for such organisations to act in a purely commercial manner in the interest of the corporation alone. The result is a combination of problems such as a culture of excessive bureaucratic control and "oversight", politicisation of appointments, imposition of multiple non-economic objectives, and toleration of pervasive over manning all of which lead to low efficiency. As noted earlier, there are many individual examples of good performance, but equally there are far too many poor performers.

68. Privatisation, whether total or partial, is seen as a way of overcoming these problems. It is interesting to note that whereas some countries have opted for full privatisation other such as India, Malaysia, Thailand have pursued a path of partial privatisation in the expectation that even partial privatisation will help to achieve greater efficiency. Wider ownership with involvement of private sector shareholders is likely to generate greater pressure for efficient and commercially viable operations, even in situations where the Government retains majority control. If combined with a credible signal of withdrawal of budgetary support, which is the logical corollary of even partial privatisation, it can help to send signals which will push both management and labour in these organisations to higher levels of efficiency.

69. The results obtained in terms of both revenue mobilisation and improvements in efficiency are encouraging. Mexico, Chile and Argentina were all able to mobilise substantial volumes of resources from sale of assets which helped to manage the fiscal situation. Other countries have been less bold in the scale of privatisation, but even so have mobilised significant volumes of resources. India's programme of divestment of Government equity in public sector enterprises pursued since 1991, although constrained by the requirement that the Government retains a majority shareholding, is expected to contribute about 0.4 percentage points of GDP in terms of additional revenues in 1994-95. As far as the impact of privatisation on efficiency is concerned, it is perhaps too early to pronounce definitively. However, a number of studies have examined the impact of privatisation on labour productivity, total factor productivity and also aggregate welfare which includes benefits to consumers. The consensus view reflected in Glade (1991) and Kiveri, Nellis and Shirley (1992) is that privatisation has led to significant improvements on all these counts.

70. Privatisation poses special problems in sectors which are not characterised by competitive markets in the normal sense, such as generation of electric power, telecommunications services, ports and even toll roads. Induction of the private sector into these areas both by encouraging new utility companies to come in and also by allowing private sector companies to take over the whole or part of existing utilities provides an attractive means of inducing new capacity and improving efficiency in these critical areas. However, private investors can only be attracted into these sectors if they can be assured that tariffs will be fixed on principles which ensure a fair return to investors. Since these are long term investments the assurance must hold not only for initial tariffs but for future tariff levels through mechanisms for adjusting tariffs automatically in line with rising costs. If the

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these low or even negative income streams are simply transferred to other agents in the economy there is no gain for the economy as a whole. It is only when privatisation is seen as a means of improving the income stream from public assets that there is a real gain for the economy.

sectors have previously been run as public sector monopolies, there is typically no independent regulatory body which fixes tariffs and adjusts them regularly in a manner which is transparent and fair to both producer and consumer. In such circumstances Governments may not get the best value for the assets being privatised. Spiller (1992) points to the Argentine experience in which the telephone company was privatised before a modern transparent regulatory system had been established. The result was that bids were disappointingly low and the foreign companies which won the bids subsequently reaped capital gains when a modern regulatory framework was put in place. By contrast, World Bank (1993) reports that in Venezuela, the telephone company was privatised after a modern regulatory system was established, and the privatisation was more successful.

71. A problem that has plagued privatisation in all countries is the difficulty in establishing the best modality for sale. Experience varies enormously ranging from (a) sale of a controlling shareholding in the public sector enterprise to a single company or a consortium either by inviting bids or negotiation, (b) sale to the public at a fixed price, (c) sale by "dutch auction" subject to a reserve price, (d) sale in the stock exchange, and (e) sale to workers. Each of these methods has associated problems and wherever privatisation has occurred, there has been criticism that the method of sale could have been better. In general, sale to the public resulting in wider dispersion of holdings may generate less opposition than sale of large controlling blocks to individuals or a few groups.

72. An issue which is sometimes raised in the context of privatisation is whether it would not be better to restructure enterprises and make them profit making first and then sell them, so as to obtain the best price instead of selling them as they stand and letting the new owners undertake the restructuring. This issue cannot be resolved without taking into account the feasibility and cost of restructuring if it is undertaken within the public sector. To some extent, the poor performance of public sector enterprises, which provides the rationale for sale in the first place, suggests that it would not be easy to restructure the enterprises within the public sector except at high cost and this cost must be compared with the expected additional realisation at the end of the process. Where, however, the controlling interest and management is expected to remain with Government, it is better to undertake whatever improvements are feasible before selling shares to the public so as to get the best possible price for a public sector managed unit.

73. The important lessons learnt from the privatisation experience thus far can be summarised as follows :

- i) Privatisation offers a useful opportunity to restructure Government budgets temporarily by taking advantage of the sale of public sector assets to avoid large increases in taxation or public borrowing in the early stages of an adjustment programme. The success achieved by those who have followed a bold strategy of privatisation, and the continuing resource constraints being faced by most Governments, justify a much bolder approach.
- ii) Privatisation as a mere sale of assets may help the Budget but it does not represent any real gain to the economy as a whole. A real gain to the economy arises only if privatisation is accompanied by an improvement in economic performance at the enterprise level. There are good reasons to believe that such improvements will take place even in cases of partial privatisation. In the case of partial privatisation it is important that a clear signal should be given of cutting of budgetary support in future.
- iii) While the best value may well be realised in an outright sale of a controlling block of shares to a single party, this should be accompanied wherever possible by sale to the public and the workers. Wider diffusion of ownership will allay some of the suspicion which sometimes attaches to public sector sales.
- iv) It is essential to establish a modern regulatory mechanism under which they will function before undertaking privatisation.

## **VII. Conclusion**

74. The review of structural reform experience presented in this paper indicates that the range of reforms currently underway in developing countries is impressive and is underpinned by a very substantial convergence of thinking on policy issues. It also indicates that there are problem areas in the design of structural reform programmes, especially regarding the pace and sequencing of different elements. However this should not cloud the fact that the area of consensus is very substantial. In any case consensus on broad policy direction does not imply an identity of programme design. Countries vary in initial conditions, including not only institutional and structural characteristics, but also in the extent of imbalance from which they may suffer and these differences can be expected to produce differences in the design of reform programmes. Some of the differences observed across countries are due to these considerations rather than any basic differences on policy.

75. An important theme running through the review is the need for macro- economic stability as an essential requirement for the resumption of growth and also for the success of other reforms in trade policy and in the financial sector. Both types of reforms need a stable macro-economic environment for the efficiency gains of the reforms to be realised. The reforms also impose additional strains on the fiscal situation, which need to be managed. Tariff reductions and exchange rate depreciation in the case of trade policy reforms and interest rate liberalisation in the case of financial sector reforms can have negative feedback effects on the fiscal situation. If this happens when the overall macro-economic situation is relatively stable, and the extent of the distortions in the trade and financial sectors are modest, the negative feedback can be managed relatively easily but if it occurs at a time when the macro-economic situation is itself unstable the negative feedback may make it unmanageable. This implies that the pace at which trade policy reforms and financial sector reforms can be implemented depends critically upon the pre- existing macro-economic situation and the extent to which credible fiscal correctives can be put in place.

76. A cautionary note emerging from the review is that the time required for reforms to achieve the transition to high and sustainable growth rates should not be under estimated. This is primarily because high growth requires high levels of investment and there is a lag between the implementation of structural reforms and the generation of an adequate investment response to the new signals. Many countries have experienced a slow down in investment in the early stages of an adjustment programme because fiscal problems constrain the levels of public investment and private investment takes time to re-orient to new signals. The slow down in investment can in turn lead to low levels of output. These short term output losses may be avoided where the initial adjustment required is not too large, and a strong export growth can be engineered to take up slack demand. Similarly, where foreign investment can be stimulated in a short time, an early revival of domestic investment as a whole may be more likely. These considerations underscore the importance of export policies, as also measures to attract foreign investment, in the early stages of adjustment. In the longer run, revival in investment and business confidence is crucial and these should be the central focus in designing reform programmes.

77. There are some important issues that have not been addressed in this paper but which deserve explicit recognition. An obvious omission is the lack of attention to the problems of deregulation of individual sectors. Very often developing countries suffer from excessive regulation of individual sectors which are of special importance for economic performance such as primary export sectors in some countries and infrastructure sectors such as telecommunications, roads, ports and power generation in most countries. It is important to implement sector specific deregulation of such sectors to maximise efficiency gains and also to attract private investment to ensure rapid expansion in future. These sectoral issues are not examined in this paper since the situation varies from country to country and it is difficult to generalise for all countries. Another important issue that has not been addressed in this paper is the need to create social safety nets in the course of structural reforms. Distributional changes are extremely difficult to absorb in any society and where these changes affect the poor they naturally lead to a legitimate demand for compensation of one form or another. Governments may respond by intensifying certain types of development programmes which support income levels of particular groups or by providing targeted

subsidies specifically aimed at those adversely affected by reforms. A major challenge in this context is how to design safety nets which do not impose an unsustainable burden on the budget at a time when the fiscal situation is also under strain. It is essential to design safety nets which are effectively targeted so that benefits are limited to lower income groups actually affected by the reforms and not to a much larger category.

78. In the final analysis the assessment of structural reforms in developing countries must depend upon the actual experience of countries undertaking reforms. Successful performance will strengthen conviction about reforms just as failures will lead to pre-examination. However these assessments are not a simple matter as is evident from different lessons drawn by different authors from the unambiguously successful performance of East Asian economies. The lessons of East Asia obviously differ depending on who is teaching them. It is important to subject the performance of different countries to close investigation to draw the right lesson from each experience. The research sponsored by the Bank and the Fund has made a major contribution to our understanding of reforms in developing countries but as participants in the process their research is sometimes viewed as conditioned by their policy stances. It needs to be supplemented by independent research on the same subject.

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