

# M5101 part 5

## **Structural Adjustment**

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## Overview of the lecture:

1. Development and structural change
2. Demand-oriented policy instruments
3. Supply-oriented policy instruments
4. Policies governing foreign trade
5. External debts and debt management
6. Structural adjustment and impact on poverty reduction
7. Lessons learned

## Reasons for a structural crisis

### external

- Economic policy in industrialized countries (falling demands)
- Increase of interest rates on the capital markets
- Fluctuations on the world market, Deterioration of the ToT for DCs (developing countries)
- Protectionism of industrialized countries

### internal

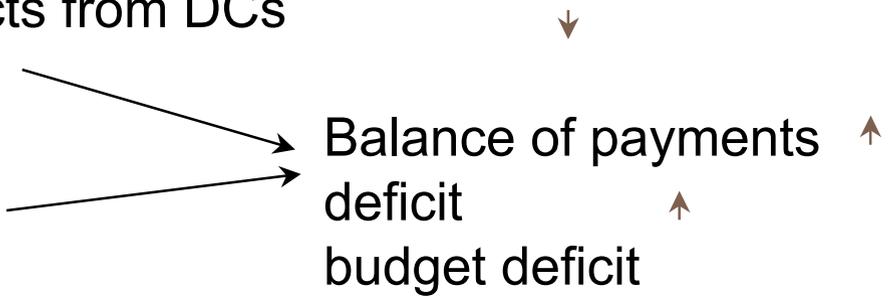
- Insufficient control of demand with consequences as inflation, budget deficit and indebtedness
- Policy, which encourages production insufficiently
- Wrong development strategies (capital-intensive industrialization by neglecting agriculture: price policy, institutions, research)
- Realization of uneconomical (prestige) projects
- Insufficient support for education and formation
- Inefficient administration

Impact chain of external factors

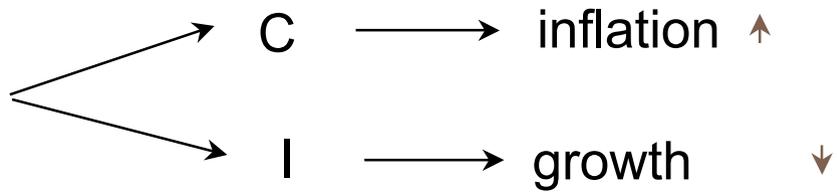
- oil price ↑
- Recession in ICs
- inflation in ICs
- export-demand for products from DCs
- export-prices ↓ (TOT) ↓

whereas

- import prices from ICs ↑
- oil price ↑

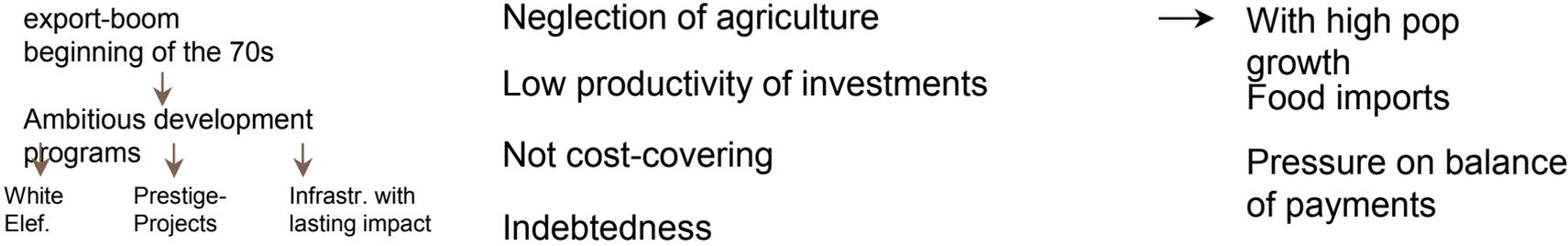


↓  
Import restrictions



# Impact chain of internal factors

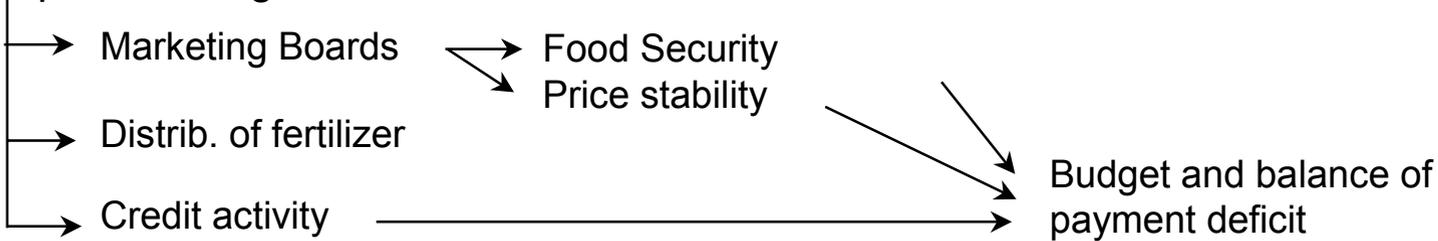
## a) Development strategy focused on industrialization



## b) Weak institutions



## c) Expansion of government activities



# What measures form a structural adjustment?

- Monetary policies, such as credit ceilings, interest rate changes and liquidity reserve requirements
- Public sector policies, particularly aimed at reducing a fiscal deficit, increasing public sector enterprise efficiency cutting public sector employment as well as subsidies
- Price policy reform, aimed at an improved resource allocation and incentive structures.
- Balance of payment policies, foremost exchange rate reform, trade liberalisation and services sector
- Foreign debt and external borrowing management aimed at controlling foreign capital flows and international indebtedness

# Instruments for macro-economic adjustment

- Primary starting point: demand side → Chapter 2
- "Demand Management Policies (monetary- and fiscal policy)
  
- Primary starting point: supply side → Chapter 3
- "Efficiency and Growth promoting Policies" (structural policy)
  
- Primary starting point: production structure → Chapter 4
- "Exchange Rate Policies" (change of tradables/  
Nontradables-structure)
  
- Primary starting point: financial flows → Chapter 5
- "External debt management"

# Instruments of Monetary Policy

## - Discount-rate policy

-  $\rightarrow \Delta i$  -  $\rightarrow \Delta$  demand of interest rate elastic components  $>$   $\Delta$  total demand

## - Open-market policy

-  $\rightarrow \Delta M$  -  $\rightarrow \Delta i$  (ahead like discount-rate policy)

$\Delta$  demand -  $\rightarrow \Delta$  goods + services

$\searrow \Delta$  demand financial instruments -  $\rightarrow \Delta P$  financial instruments  
 $\searrow \Delta i$  (cf discount policy)

## - Minimum-reserve policy

-  $\rightarrow$  MR -  $\rightarrow \Delta M$  -  $\rightarrow$  (ahead like open market policy)

## - Quality requirements

-  $\rightarrow \Delta QA$  -  $\rightarrow \Delta M$  -  $\rightarrow$  ahead like open market policy

$\searrow \Delta i$  - ahead like discount rate policy

## Factors on the supply side (production side)

### 1. Development strategy of industrialisation with neglecting agriculture

- => need for food imports ↑
- => pressure on the balance of payments ↑

### 2. Low productivity of investments in agriculture; unprofitable projects (white elephants, prestige projects)

- => insufficient cost-covering
- => indebtedness ↑
- => pressure on the balance of payments ↑

### 3. Inefficient institutions

- => Land tenure and farm tenancy legislation hindering innovations
- => Marketing- and stability institutions
- => public fertilizer distribution
- => agricultural cooperatives
- => agricultural research and extension

general: management and organisation weaknesses of institutions in these sectors

## Supply encouraging policy measures as part of structural adjustment programs

### Focus on :

1. Productivity increase (growth)
2. Amelioration of resource allocation
3. Increase of the efficiency and strengthening of institutions
4. Stimulating impact of policy measures

### include:

1. Policies ameliorating land tenure and farm tenancy rights
2. Market- and price policies
3. Institution building
  - Agricultural research and formation
  - Agricultural Extension
  - Rural financial markets
  - Cooperatives / marketing systems
  - Agricultural input markets
  - Professional associations

## What is the right exchange rate?

The right exchange rate leads to an equilibrium of the balance of payments such that the balance of the ongoing transactions (current account) is equalized by „normal“ capital flows without excessive trade restrictions, without special incentives for capital out- or inflows and without significant unemployment.

# Exchange Rate policy

Exchange rate change has two effects

## 1. Demand effect

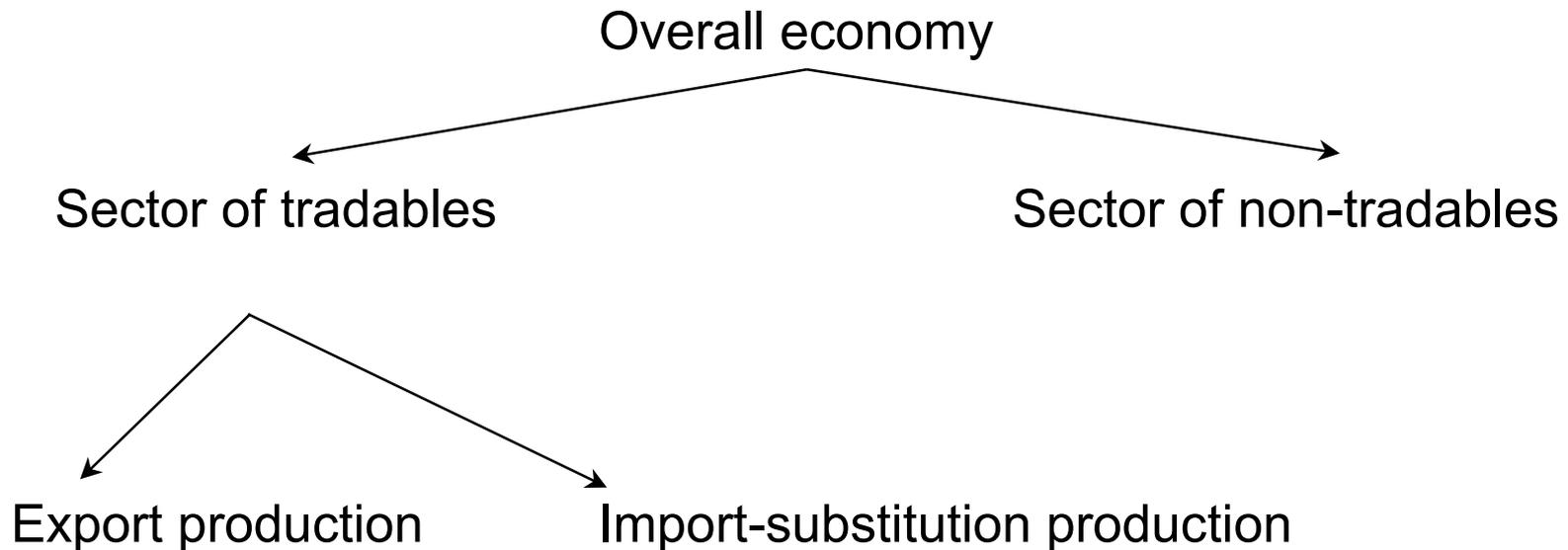
Price  $\uparrow$   $\implies$  real income  $\downarrow$   $\implies$  demand  $\downarrow$

(Differentiate between imported and locally produced products)

## 2. Structural change

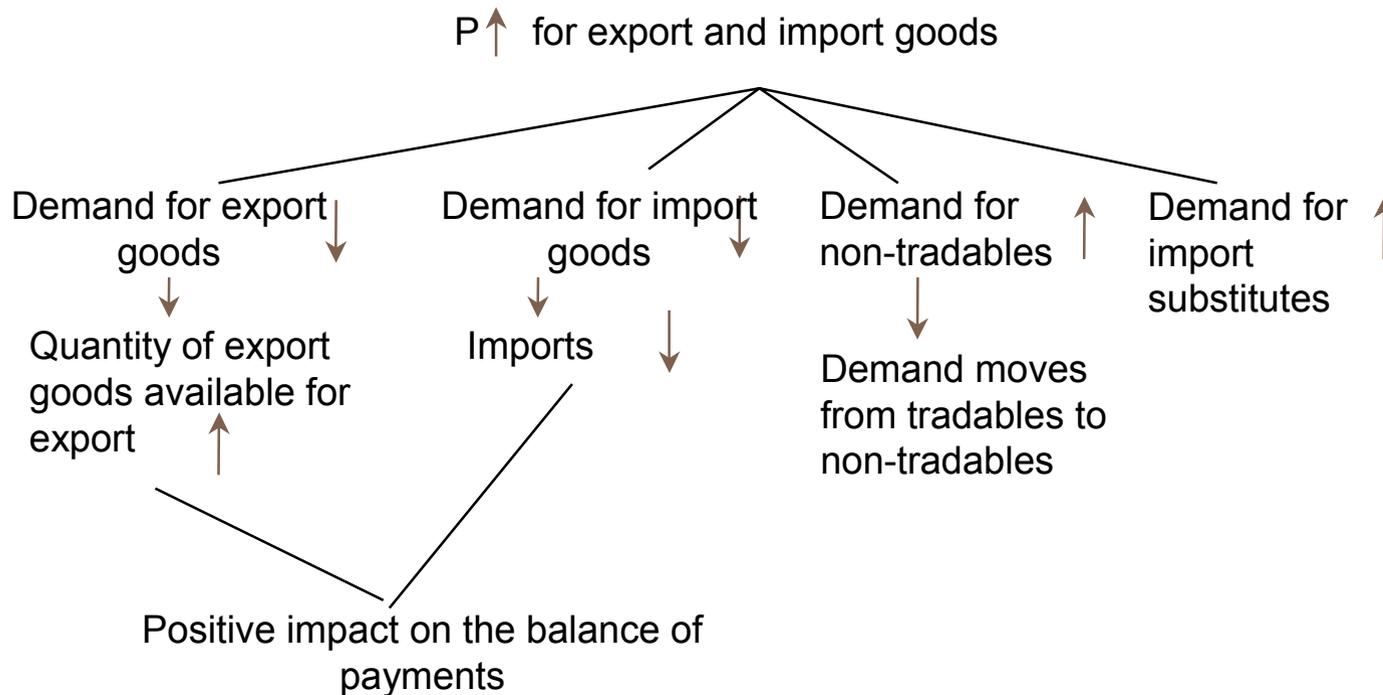
Devaluation  $\implies$  change in the price relation  $\implies$  change in resource allocation between sectors  $\implies$  structural effect (change of supply)

## Impact of exchange rate changes



# Substitution effect

The substitution effect describes the change in demand caused by the relative price change. Thus, a devaluation has the following impact .....



# The impact of a devaluation depends upon...

1. Extent of the devaluation
2. Share of the tradable and non-tradable sector
3. Flexibility of production in both sectors (supply elasticity)
4. Extent of price transmission effects to the non-tradable sector  
(cf next overhead)
5. Effectiveness of accompanying measures (fiscal and monetary policies)

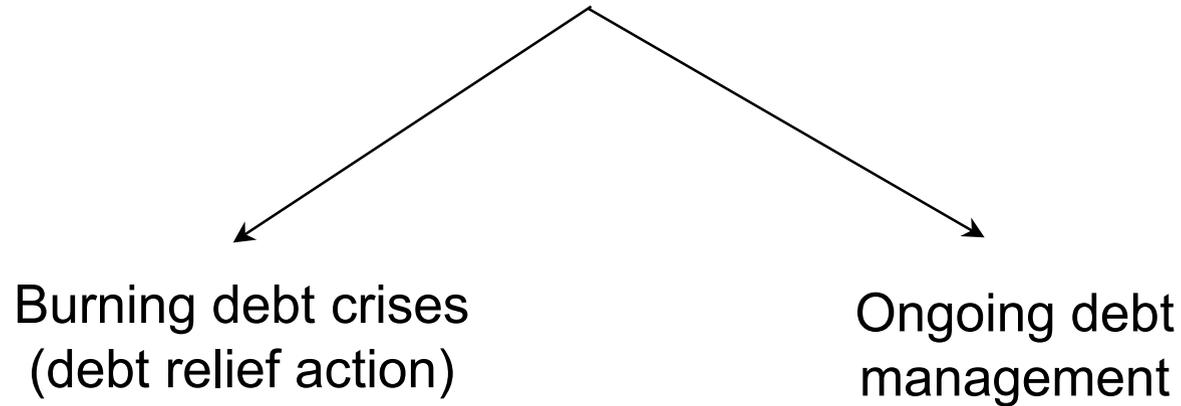
## Further aspects :

6. Devaluation and division / control and protection
7. Devaluation and resource allocation (Promotion of labour-intensive production technologies)
8. Devaluation, income distribution and impact on poverty groups

## Total Foreign Debts in Mrd. US\$

	1970	1988	1990	1993	1995
All developing countries	300	1365	1510	1776	2068
Brasil	4		117		105
Mexico	5		97		86
Argentina	2		62		61
Korea	2		34		35
Long-run	u.a.	1118	1206	1391	1622
official	u.a.	507	607	726	837
private	u.a.	611	599	665	786
Short-run	u.a.	212	269	345	385

## Debt management



	Number of debt relief actions - on average-
1975 - 1978	2 - 3 p.a.
1983	30
1984	34
1990	27

# Indebtedness and debt management

## 1. When and how becomes indebtedness a problem?

### a. Credit financing of profitable projects...

...with export component

Direct repayment and transfer problem (has to be solved by the project beneficiary)

...with domestic production component

Repayment problem is different to transfer problem.  
Transfer problem is an economywide task.

...with not directly income influencing components

Repayment and transfer problem is an economywide task.

### b. Credit financing of non-profitable projects...

-> Repayment and transfer problems occur and can lead to indebtedness problem

# Indebtedness and debt management

## 2. What are the origins of non-profitable projects and their financing?

### a. External factors

- world market
- political economy
- change on the world capital markets

### b. Internal factors

- economic policy
- chosen projects
- financing conditions
- force majeure

# Indebtedness and debt management

## 3. Solution to burning debt crises

a. Participants and their coordination

b. Distribution of the burden

c. Solution models

c1. Case-specific debt rescheduling

- information problem about indebtedness
- coordination problem
- problem of a common approach
- problem of specific conditions

c2. General debt relief

- simplicity
- equal reaction to different action
- problem of specific conditions

d. Swaps

- "debt for equity swaps"
- "debt for nature swaps"
- Repurchase of own debt bonds

## Secondary Market Values (Example)

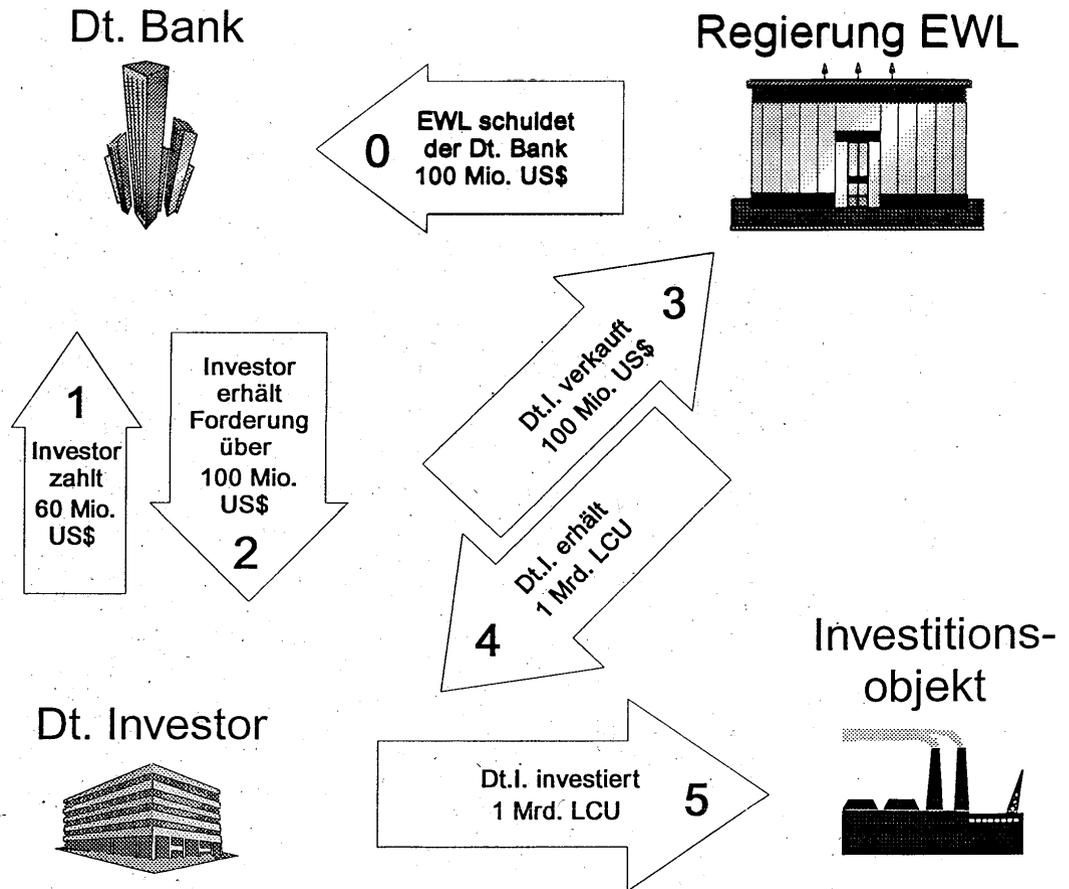
<b>Country</b>	<b>% of Nominal Value</b>
Argentina	54,1 - 78,1
Brazil	53,7 - 99,5
Bulgaria	33,2 - 52,3
Ecuador	36,2 - 74,8
Mexico	65,0 - 96,5
Nigeria	44,9 - 53,0
Panama	56,3 - 62,3
Philippines	80,5 - 96,7
Poland	50,5 - 93,6
Russia	31,7 - 70,9
Venezuela	60,8 - 72,7

source: Merrill Lynch, Emerging Markets Daily

# Debt for Equity Swap - Example

Price of the debt bond on the secondary market: 60 % of the nominal value in US\$

Official exchange rate US\$: 1 US\$ = 10 LCU



## 6. Structural adjustment and impact on poverty reduction

### \* Reduction of public expenditures in priority sectors

- health care
- schools and education
- food subsidies
- agricultural research and extension
- rural infrastructure, storing capacities, marketing systems

### \* Employment in the public sector

- reduction of employees in public administration
- wage reductions
- restructuring of public enterprises
- discrimination of the private/informal sectors
- discrimination of women

### \* Devaluation

- price effects on exports
- price effects on imports
- consumption goods (luxury goods vs. vital food)

### \* Elimination of subsidies, distortions (price policy, interest rate policy)

- agricultural producers
- consumers
- net-buyers of food
- employment effects through preferential treatment of labour-intensive technologies/sectors

## 7. Lessons learned

1. Priorities for governmental expenditures are crucial (like discussed above under reductions of government expenditures): practical education, health care, primary schools, agricultural innovations, rural infrastructure.
2. Structural adjustment means change and thus insecurity. Therefore it is important that the state creates a fair and reliable juridical framework which is defensible before court.
3. Poverty reduction needs growth. "Nowhere where growth was negative did poverty decrease.  
On the contrary, the high rates of growth in East Asia have clearly trickled down particularly if it was concentrated in labour-intensive agricultural, industry and service sectors."
4. Structural adjustment is a long-lasting process, which needs staying power from the stabilisation period to the growth period. Long-lasting staying power requires that the country itself takes over „local ownership“ (conditionality alone is not sufficient!).
5. Debt relief has to lead to a relief for the balance of payments and it has to make possible the financing of growth.