AREC 345: Global Poverty & Economic Development

Lecture 9:

Crisis & Adjustment

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Economic Crisis & Structural Adjustment

Did Industrialization Work?

Post-independence industrial policy:

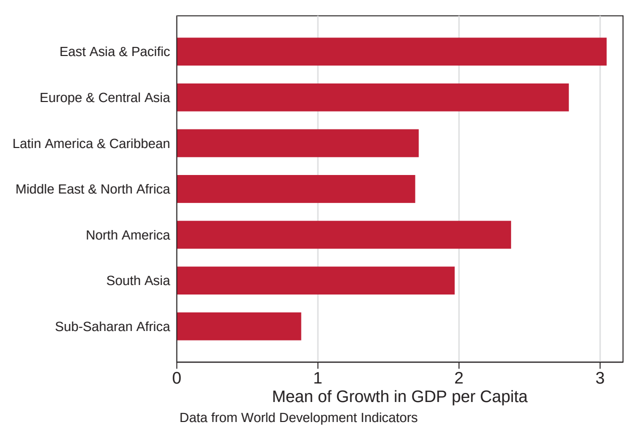
- Focused on pulling resources out of agriculture to fund industry
- Gov't subsidies, trade protection for "infant industries"
- Many firms actually owned directly by state governments
- Growing share of workforce employed by public sector

Physical capital accumulated but typically not used efficiently, most protected industries never became self-sustaining

- 1967–1968: manufacturing firms in Ghana using 35% capacity
- 1960s: 12 of 44 Kenyan industries "reasonably full" capacity

Industrial policy cost gov't in subsidies, consumers in high prices

Growth in the 1970s and 1980s

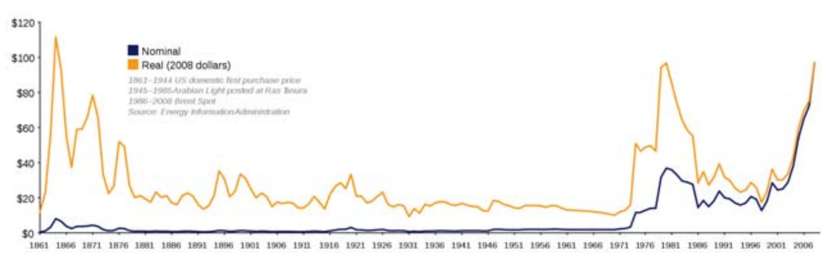


Economic Crisis: Domestic Causes

1. Failed but expensive industrial, trade policy
   - Low levels of industrial output
   - High levels of spending on public sector wages in state-owned firms
   - High prices for manufactured goods because of protectionism
2. Declining agricultural output
   - Governments use agricultural marketing boards to (implicitly) tax agricultural production and subsidize industrial sector
   - Trade, domestic regulations limit incentives to export crops
   - Lack of incentives for farmers leads to declines in food production
3. Rising debt levels as governments borrow to subsidize industry
4. Inflation (as governments print money to pay debts)

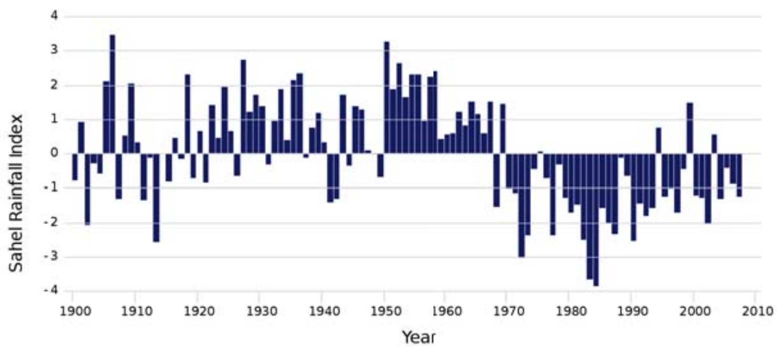
Economic Crisis: External Causes

1. Oil price shocks have direct, indirect (interest rate) effects



Economic Crisis: External Causes

2. In Africa, period of high rainfall in the Sahel comes to an end



Structural Adjustment

Washington Concensus:

- Government intervention in trade, industry not helping
- Macroeconomic policies aimed at lowering government debt burdens, increasing purchasing power discouraging saving and investment
- Governments expenditures shouldn't exceed revenues

World Bank, IMF begin promoting **structural adjustment** loans

- Loan **conditionality** expanded to deal with all aspects of gov't policy
    - Carrot: subsidized loans if gov't agrees to package of reforms
    - Stick: cut off future lending if reforms not implemented
- Policy recommendations: **stabilization** + **adjustment**

Structural Adjustment

Macro stabilization:

- Currency devaluation
- Fiscal austerity

Policy adjustment:

- Domestic liberalization
- Trade liberalization
- Selling state-owned enterprises
- Public sector layoffs

Stabilization: Devaluation

What is it?

- Allowing market forces to determine the exchange rate.

Why was it necessary?

- Fixing your country's currency at an inflated value allows you to purchase more dollar-denominated goods on the international market

Winners and losers:

- **Winners:** exporters — domestic value of foreign sales increases (or, conversely, their goods are suddenly more competitive)
- **Losers:** anyone who needs to purchase imported goods

Stabilization: Fiscal Austerity

What is it?

- Government expenditures cannot exceed government revenues

Why was it necessary?

- A country can only borrow if someone is willing to lend to them
- Not actually possible for a gov't to "print money" without inflation

Winners and losers:

- **Winners:** in the long term, everyone benefits from stable macro policies; financial crises usually hurt poor households the most
- **Losers:** in the short term, those impacted by government spending cuts (e.g. public sector workers, recipients of gov't subsidies)

Adjustment: Domestic Liberalization

What is it?

- Elimination of (some) government regulations, red tape

Why was it necessary?

- Some regulation (e.g. health and safety) is desirable
- In many cases, developing country industrial policy sought to direct firms toward specific sectors, limit trade by regulating market entry

Winners and losers:

- **Winners:** allowing free entry should increase competition, meaning that consumers will pay lower prices and have more product choices
- **Losers:** restrictions on market entry often generated rents (i.e. above-market profits) for firms in restricted industrial sectors

Adjustment: Trade Liberalization

What is it?

- Removal of trade barriers (specifically, tariffs and quotas)

Why was it necessary?

- In the post-WWII period, many developing countries increased trade barriers to protect infant industries; few countries phased them out

Winners and losers:

- **Winners:** consumers win when they are able to access cheaper, more diverse products on the global market; workers sometimes win when liberalization leads to job opportunities in the export sector
- **Losers:** firms and producers in protected sectors

Adjustment: State-Owned Enterprises

What is it?

- Privatization of firms owned or subsidized by the gov't

Why was it necessary?

- Most state-owned enterprises were being run at a loss

Winners and losers:

- **Winners:** taxpayers, people who don't like budget crises
- **Losers:** employees (and sometimes customers) of privatized firms

Adjustment: Public Sector Layoffs

What is it?

- Layoffs of gov't employees, including bureaucrats, teachers, etc.

Why was it necessary?

- Gov't jobs typically paid above-market wages; many were awarded to friends, relatives, and political constituents of government officials

Winners and losers:

- **Winners:** taxpayers, though some layoffs meant cuts to services
- **Losers:** laid off workers

Did Structural Adjustment Lending ⇒ Growth?

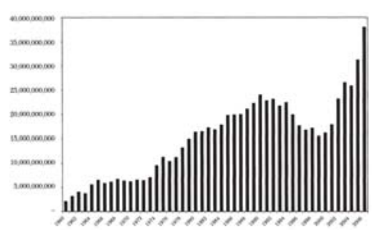


Figure 3. Total Flows of Aid to Africa (Constant 2006 Dollars)

WB, IMF awarded 241 SALs to 36 African countries in 1980s

- Did structural adjustment (the aid or the policies) cause growth?
- How would we know?
  - Adjustment didn't work because poor countries are still poor?
  - No, we need to know the **counterfactual**

Did Structural Adjustment Lending ⇒ Growth?

Can we examine the association between **aid** and **growth**?

$$E[\text{GROWTH}_{it}] = a + b \cdot \text{AID}_{it} + c \cdot \text{CONTROLS}_{it}$$

where:

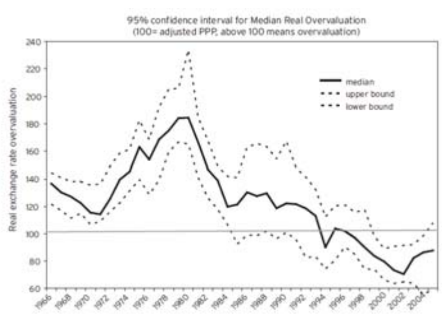
- GROWTH_{it} is GDP growth in country i in year t
- AID_{it} is measures the amount of aid received by country i in year t (or in some number of years leading up to year t)

Q: What is wrong with this regression?

- **A:**

There's almost no evidence that aid is associated with growth,
but this non-evidence is hard to interpret because of omitted variables

Did Countries Actually Adjust?



Some evidence that macroeconomic stabilization took place:

- Successful currency devaluations
- Some deficit reduction — explained by ↑ aid inflows?

Did Countries Actually Adjust?

Less evidence of progress on structural adjustment policies:

- Zambia produced four different plans to lay off public sector workers between 1979 and 1993, each supported with IMF/WB aid funding
  - Public sector employment $\uparrow$ during the same period
- Kenya wrote the same agricultural policy adjustment into five successive WB/IMF structural adjustment loan contracts
  - Also made repeated promises to privatize the train service
- This process termed

Why did the WB, IMF keep lending when adjustment didn't happen?

Evaluating Structural Adjustment

Unintended (?) consequences of too much aid, too little adjustment

$\rightarrow$ Increased debt burdens

$\rightarrow$ Aid inflows propped up weak, ineffective states

$\rightarrow$ Shifted developmental responsibilities away from state gov't

$\rightarrow$ Wasted money?

By 1990s, WB moved to "adjustment with a human face"

- Recognition that structural adjustment not working
- Some countries (eg. Senegal, Zambia, Uganda) eventually implemented many adjustment policies, many did not
- Shift to focus on "governance"

Study Guide: Key Terms

- structural adjustment (and the 6 components of)
- loan conditionality
- stabilization vs. adjustment
- partial reform syndrome