IMF Stabilisation and Structural Adjustment Programmes

Colette Murphy – Junior Sophister

Is the IMF guilty of malpractice in treating the symptoms of its patients, rather than their underlying causes? In whose interest does it act, its member countries or the powerful multinational banks? Colette Murphy offers a critical analysis of IMF policies.

Established at the Bretton Woods Conference, one of the primary objectives of the International Monetary Fund (IMF) is to make loans available to member countries experiencing balance of payments problems. Initially involved in reconstruction projects after World War II, since the debt crises of the 1980s it has become more involved with Less Developed Countries (LDCs). Many Sub-Saharan, Latin American and more recently Asian countries have turned to the IMF for assistance in addressing their growing budget deficit and debt crises. Debt rescheduling and Structural Adjustment Programs (SAPs) have been implemented, which involve IMF loans in support of policy change and institutional reform.[1] This conditionality aspect of loans and debt relief has always been controversial, but so too has the viability of IMF SAPs as a basis for short-run stabilisation and long-run growth. Do the draconian macroeconomic stabilisation plan and SAP work as a panacea for all ailments, or should each country have a more tailored approach to assessing its fundamental economic condition?

Debt Accumulation

We first need to look at why countries need to borrow and how this debt can accumulate. Countries, both developed and LDCs, can face short-term liquidity problems when budget deficits and balance of payments deficits can no longer be funded by foreign exchange inflows or reserves. They normally approach international banks, which assess the credit risk involved, lend funds and charge an appropriate interest rate based on this risk. The government is then free to invest these funds as it sees fit. Countries with developed economies and sufficient export-oriented output will earn the foreign exchange necessary to service and repay this debt without any problems.

Many LDCs, however, have an inward looking import-substitution policy rather than an export-oriented output policy. They will also generally have an unregulated

[1] Pomfret (1997)

domestic banking system with ad-hoc lending policies, little or no risk assessment experience and severe moral hazard difficulties[2]. Therefore, even with this new injection of investment, they find it difficult to channel these funds into the traded sector, which will boost output and exports sufficiently to both redress the balance of payments deficit and service new foreign denominated loans. Their difficulty is often further compounded by speculative attacks and devaluations of their domestic currency increasing the cost of foreign denominated repayments. Such an economy is typified by the macroeconomic problems of:

- Growing current account deficits.
- A build-up of structural debt.
- A lack of foreign reserves leaving currency open to speculative attacks and devaluations.
- High or hyperinflation, increasing domestic prices and worsening trade competitiveness.
- Negative real interest rates (nominal interest rate less inflation)

And by the socio-economic problems of:

- Civil and political unrest.
- A widening of the gap between rich and poor.
- Food subsidies and price distortions.

Such a lack of macroeconomic fundamentals coupled with the burden of a large accumulation of debt leads to a solvency problem where debts exceed repayment capacity. In such circumstances international banks refuse to roll over existing loans, further credit is unavailable and many LDCs turn to the IMF for assistance.

IMF Intervention, Stabilisation and SAPs

Much of the criticism of the IMF is directed towards their motives, it is suggested that fear of spill-over and contagion effects causing a threat to world-wide capital markets is the main motivator and that "*these bailout operations if handled incorrectly, could end up helping a few dozen international banks to escape losses for risky loans by forcing Asian governments to cover the losses on private*

[2] Moral hazard: risky borrowing/lending under the assumption, real or implicit, that the government will make good any losses. The risk is therefore not part of the decision to borrow/lend.

transactions that have gone bad"[3]. However, for countries facing economic crises the IMF is often the only organisation to which they can turn, and they have no option but to accept whatever measures and policies the IMF dictate.

Before assessing a typical IMF stabilisation package, we must first look at the theory behind macroeconomic stabilisation. The need for a stabilisation program arises when a country experiences a persisting imbalance between aggregate domestic demand and aggregate supply, which is reflected in a worsening of its external payments position.[4]

There are two opposing schools of thought regarding stabilisation programs. The orthodox approach to stabilisation concentrates on restrictive monetary and fiscal discipline. In contrast, heterodox programs include wage and price freezes, exchange rate pegging and deindexation measures. IMF stabilisation policies are aimed at short-term macroeconomic stability and are oriented towards the demand side of the economy. They reflect the monetarist view that inflation is caused when the supply of money increases faster than the demand for it. They combine elements of orthodox approaches, concentrating on monetary policy and fiscal discipline, with heterodox wage and price freezes. A typical IMF stabilisation package will involve quite extensive, possibly even excessive, use of the following:

- Reduction in the budget deficit through tax increases and reduced expenditure.
- Controlling growth and money supply: restrictive targets are set for central bank credit to the government and commercial banks.
- Devaluation, stimulating exports and restraining imports.
- Removal of price controls (including interest rates) and subsidies.
- Wage restraint.[5]

The policies that the IMF recommend to reduce the degree and duration of external and internal imbalances that give rise to balance of payments difficulties must, however, be set within the context of achieving and maintaining price stability and satisfactory rates of economic growth.[6] These measures have proven to work in stabilising economies in the short-run,[7] but do countries recover in the long run

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[3] Sachs (1997)
[4] Frenkel & Khan (1990)
[5] Gillis *et al* (1992)
[6] Frenkel & Khan (1990)
[7] Lenisk (1996)

because of, or in spite of IMF intervention? Structural reforms are certainly needed to redress the fundamentals that caused the crisis in the first place, but can a package of measures that are right for Sub-Saharan or Latin American economies have any relevance in East Asia? The IMF imposes the same mix of remedies for all, irrespective of the underlying economic situation. The problems of most LDCs are those associated with transition to a market based economy, as outlined previously, and the inability to trade out of this situation leading to a build-up of a structural debt crisis. Whereas the crisis experienced in Asia stemmed from the unsustainability of current account deficits, given the nature of investments, financial sector weaknesses, bad lending practices driven by issues of moral hazard, overexposure to the property sector and fixed exchange rates, it was essentially a financial crisis. The impact on the current account and balance of payment deficits in the two economies look similar on the surface, but the causes and the underlying economic structures in each are vastly different.

Asia’s need for significant financial sector reform was real, but not a sufficient cause for the panic, nor a justification for harsh macroeconomic policy adjustments. Asia’s fundamentals were adequate to forestall an economic contraction: budgets were in balance or surplus, inflation low, private savings rate high and economies poised for export growth[8]. But bailouts of the financial sector to cover both implicit and explicit guarantees, led to governments running huge budget deficits, which quickly led to crisis point. In 1998 Korea approached the IMF for assistance. The IMF immediately imposed its standard package of stability and structural reform measures. This severe macroeconomic contraction fuelled the by now growing panic.[9] There followed a plunge in domestic demand and unemployment rose from 2% pre-crisis to 8.5%, a reduction in nominal wages and employment alone caused a 12% drop in personal consumption. The restructuring of the financial services sector and the increased unemployment led to a significant increase in government expenditures. Outlays to assist the unemployed and support small and medium sized enterprises and exporters hurt by the credit crunch amounted to 2% of GDP in 1998.[10] This quite brutal monetary squeeze appears to have thrown the baby out with the bathwater. Korea could probably have got by with a modest slowdown in growth, no credit crunch, and a realistic time horizon of a few years to complete its financial reforms.[11]

[8] Sachs (1997)
[9] ibid
[10] OECD (1998)
[11] Sachs (1997)

Conclusion

Theory suggests that IMF programs are conducive to macroeconomic stability in the short-run.[12] However the evidence to date of their application within economies as diverse as Tanzania, Brazil, Indonesia and Korea, shows that there is a need for wider economic debate regarding the viability of a single solution to fundamentally different problems. The people most affected by these problems have little knowledge or input and, while the instincts of the IMF are often correct, they can sometimes be wrong, with serious consequences.[13] These countries may be showing the same symptoms but are hardly suffering from the same ailment.

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[12] Lensink (1996)
[13] Sachs (1997)