

## **STRUCTURAL ADJUSTMENT PROGRAMS (SAPs)**

Structural Adjustment Programs consist of a set of policies that is identified with various names such as Washington Consensus policies, Neoliberal policies, free-market reforms, etc.

Both the World Bank and the International Monetary Fund support this type of policies, and these policies are often attached as conditions to the loans that these institutions provide to developing countries.

An excellent source of information about this set of policies—and one of the sources of this handout—can be found in Chang, Ha-Joon and Ilene Grabel. 2004. *Rethinking Development. An Alternative Economic Policy Manual*. Dhaka: The University Press, available as reserve material for this course.

### Same basic terms and abbreviations (in alphabetical order):

Debt crisis: (see class Jan 6), in the 1970s, after a decade of borrowing, Latin American countries were unable to meet their debt services after the U.S. adjusted its interest rate upwards, producing a worldwide adjustment in variable-rate loans.

IADB: Inter-American Development Bank

Import Substituting Industrialization (ISI): Set of policies directed to industrialize a country. In particular, the objective is to achieve local production of goods that were previously imported (that is, bought from producers in foreign countries) through various protective measures that restrict trade and provided incentives for industrial production.

IMF: International Monetary Fund

Monopoly: market structure in which one and only one producer supplies the good.

Quota: Trade restriction that consists in setting a maximum quantity of a good that can be brought into a country as imports. Its effect is similar to that of a tariff in that by restricting access of products to only a portion of the total supply it results in the creation of a protected market that can only be served by domestic producers.

Stabilization Policies: policies required of countries in a balance of payment crisis (see handout about financial crises for further details).

Tariff: Tax on exports or imports. Import tariffs were at the center of the ISI model. Its main objective was to make foreign goods more expensive and thus protect local producers from competition.

Technology upgrade: a rise in the technological level of industrial production (or exports) of a country. For instance, going from exports concentrated in natural resources to packaged food items, to appliances would imply an upgrade because each of the goods described has a higher level of technology involved than the former.

WB: World Bank

### The emergence and rise to prominence of Neoliberalism: the era of Structural Adjustment

The Debt crisis marked the end of a development model based on trade restrictions and state involvement in industrialization. After a series of stabilization packages (as we saw, short-term measures) had failed to stabilize countries, a new Consensus was reached in *Washington DC* (that is, where the White House, the IMF, the World Bank, and the main Think Tanks are located): what had to be done was to reform the economies in a much more structural manner.

On February, 1980, World Bank President—and former Secretary of Defense— Robert McNamara sought and received approval from the Board for a new lending instrument: the Structural Adjustment Loan (SAL) that would lend money to developing countries in exchange for the implementation of certain policies such as trade liberalization and price incentives for efficient resource use (that is, the elimination of subsidies, fixed prices, etc.). The IMF had long been making adjustment loans, but the 1980s witnessed an increased use of these, as well as the extension of their terms (Easterly 2002: 2).

The five policies or reforms generally associated with this new paradigm are the following:

1. Trade liberalization,
2. Liberalization of capital controls,
3. Reductions of all kinds of state regulation,
4. Privatization of state-owned enterprises,
5. Liberalization of labor markets.

The late 1980s and early 1990s in Latin America, then, was characterized by the re-negotiation of the external debt of countries in the region and a new lending architecture. In this new debt structure (based on government bonds, as opposed to loan agreements between countries and private banks), the *seal of approval* of the IMF became very important, and this approval (as well as any loan from either IMF, World Bank or the Inter-American Development Bank) was tied to the compliance with a set of conditions, known as *conditionality*.

The conditions consisted in the implementation of the set of policies of the Washington Consensus. In this way, a country's access to international finance depended on their compliance and advance in the implementation of this set of policies

Let's see in detail what these policies consist of.

### 1. Trade liberalization

The previous development model (ISI) was based in the premise that protecting domestic industries was a necessary condition for letting local companies grow and become competitive, and thus lead a process of development in these countries.

The new recommendations, however, state the exact opposite. According to the Washington Consensus, the removal of tariffs and quotas and thus the increased international competition faced by local industry will create strong incentives to operate more efficiently. In other words, competitiveness was to be achieved through the opening of countries to international trade and the increased competitive pressure to all domestic industries.

This advice is based on economic theories of comparative advantage. These theories state that opening trade and specializing in those activities that countries are better at is the most efficient course of action that countries can take, as they can then import the goods they are relatively less efficient at producing.

In this framework, developing countries that are abundant in unskilled labor and natural resources should concentrate in producing and exporting agricultural goods and goods of low technological levels and import everything else. In other words, if developing countries have a comparative advantage in agricultural and low-technology goods they should specialize in those goods, and governments shouldn't try to artificially promote other sectors of the economy. On the other hand, it is argued that consumers would be better off as well, given that the elimination of trade restrictions would result in lower retail prices, and thus a higher disposable income.

Additionally, IMF economists would argue that the increased efficiency that results from this strategy will—over time—generate the conditions for a gradual increase in the technological level of industry and the economy in general. According to this view, in the long term the freeing of trade and the elimination of state intervention will result in an upgrade of the technological level of the economy and sustained growth and development.

The theory of comparative advantage—however—rests on a host of assumptions about technology, industry structure, macroeconomic conditions, access to finance, and labor and capital mobility that not always hold. Work by economists has shown that

interventionist trade and industrial policy can be beneficial, even when departing from a comparative advantage theoretical framework.

Additionally, the long-term effects of trade liberalization are highly contested. The comparative advantage theory is strictly static (that is, it compares a system with open trade with a system with trade restrictions, and claims that the former is more efficient) and thus the claims about its effects on technological upgrading have yet to be proven. Economic studies haven't found definite results on the relationship between free trade and growth.

In contrast to what the IMF and WB would claim with respect to the effects of trade liberalization and long term technology upgrading, it is often argued that opening trade without implementing policies to support industry would result in the country being locked into a path of low-technology export and production profile (for example, Chile).

Finally, the costs of—rapid—trade opening are often not seriously addressed. Trade liberalization involves the redeployment of resources from formerly protected sectors to new sectors, workers often have to be retrained and/or relocated, etc. The new jobs that are created are often of low quality and with few standards of working protection. Moreover, when the jobs created are based solely on the cheap labor costs, there is always the threat of cheaper sites (such as India and China which—compared to Latin America—have lower wages). Critics point out that the social and economic dislocation produced by the opening of trade should be incorporated into the discussion of trade liberalization.

A final issue corresponds to trade in agricultural goods. This is one of the most contentious issues in current trade negotiations and a big source of disagreement between developing and developed countries.

Most developing countries have large agricultural sectors and—as a consequence—have a large proportion of agricultural goods in their exports. As we saw, Neoliberal policies promote the removal of all kinds of subsidies and the opening of trade, but industrialized countries (such as the United States, Japan, and European countries) heavily subsidize their agricultural producers, who are able to offer the goods at prices that are lower than production costs. This generates two effects: (1) When tariffs are lifted subsidized products coming from the U.S., Europe, and Japan enter unprotected markets in the developing world and—as they are under priced—drive local producers out of business; (2) The products of developing countries cannot compete in foreign markets either, depriving these countries of one of their most important sources of foreign currency.

## 2. Liberalization of capital controls

As we saw in the handout about financial crises, since the 1970s developed countries had started lifting controls to capital flows. When developing countries emerged from the debt crisis, foreign capitals were eager to invest in assets in these countries because they

were undervalued after the crisis (and thus, prices could only go up, it was time to buy) and because they offered high returns (at least always higher than returns in developed countries).

At the same time, capital holders wanted to be able to go in and out of countries freely, without any restrictions on the time or kind of investment they were doing.

As part of neoliberal reforms, then, developing countries eased the restrictions that existed to the entry of capital. Governments also lifted various regulations that prevented foreign capital from investing in certain sectors that were deemed of particular importance, and thus were restricted to state or local capital ownership.

The argument in favor of the opening of the capital account was that it would provide an increase in the access of countries to international financing, promoting investment and thus economic growth.

Two kinds of capital flows exist: portfolio investment and foreign direct investment. The handout about financial crisis deals with the first type of inflows.

Foreign direct investment (FDI), on the other hand, is long term investment, as when a foreign firm (an investor, an investment bank or a company) buys assets such as a factory, or builds a factory from scratch in a foreign country.

In this case, the effects are supposed to be beneficial as this type of investment creates employment and thus generates economic growth. There are several caveats to this general presumption, however.

In the first place, many of the foreign direct investment that entered Latin America in the last two decades acquired existing assets (usually very undervalued after the economic recession that followed the debt crisis) and did not provide much new investment or job creation. In other words, assets moved from the hands of local capitalists to foreign hands.

Secondly, much of this investment came from multinational corporations (MNCs), which are usually tightly linked to their headquarters and usually import most of their inputs. As a general rule, foreign owned firms import a higher proportion of inputs than domestic firms or—in other words—create less backward linkages. Given what we saw about the balance of payment vulnerability of Latin American countries, this type of FDI can be a double-edged sword.

Thirdly, many investments of this type are market-seeking, that is, they enter a country seeking to supply the domestic market, and thus have a low export propensity, again a downside if we consider the importance that the external account has had in explaining recent crises in the region.

### 3. Reduction of all kinds of state regulation

This recommendation is based on the neoclassical<sup>1</sup> belief that the market is better at allocating resources than the state is.

In this framework, government policies such as subsidies, price controls for basic foods or transportation, etc. provoke a distortion and thus generate less efficient economic transactions.

The elimination of this type of regulations, then, is expected to make the economy function more efficiently, and thus become more productive. There are no substantiated claims about the distributional effects of these reforms, and they have often been found to be negative for the less well-off groups of society.

### 4. Privatization of state-owned enterprises

Neoliberal economists consider that state-operated enterprises, including public utilities, are a less efficient form of conducting business. This is because in conditions of public ownership prices are not set by the market and the incentive to maximize profits is often confounded with political objectives.

In this framework, the private ownership and operation of public utilities and other enterprises formerly owned by the state would generate efficiency improvements.

There are a few problems with this premise. On the one hand, many public utilities are natural monopolies, that is, services that can only be provided under a monopolistic structure<sup>2</sup>. This is relevant because economic theory would say that monopolies are inefficient *per se*, irrespective of them being under private or public ownership.

Additionally, usually privatization processes are accompanied by the creation of regulatory institutions to assure that the quality of service is acceptable and the prices charged are safe. However, if the whole process of privatization started with an indictment of state capacities, it is unclear how the state that could not operate a company

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<sup>1</sup> Neoclassical economics get their name from being the successors of classical liberalism (represented by Adam Smith, David Ricardo, and the like). The main innovation of the neoclassical school is that they base their claims on the analysis of marginal utility and marginal productivity, that is, on the increase in satisfaction, efficiency or productivity that results from the addition of a new unit of consumption, a new unit of work, or a new unit of production, etc (that new unit is the *marginal* unit).

<sup>2</sup> Two clear examples of this are natural gas and electricity. It would be inefficient that two natural gas companies build parallel gas networks to compete for the same customer. In other words, the *natural* thing to do is to allow only one company to build the networks, and thus operate as the only provider of the service of natural gas distribution.

is going to be able to regulate a private one, usually in hands of multinational corporations after privatization.

Finally, there are some non-market considerations that are important for the operation of public utilities and that are often overlooked by private providers. For example, it is very probable that providing train transportation or phone service to a small and isolated town will not be profitable, but the integration of the population of isolated areas cannot be left to be decided by market forces and profit motive alone.

#### 5. Liberalization of labor markets

Regulations of labor markets include—among others—union rights, severance payments, and mandatory employer contributions for covering employees' health insurance or social security.

According to neoliberal thinking, these regulations generate rigid labor markets that prevent an efficient allocation of resources. In plain English, if it is costly to hire a person (because of the mandatory contributions that the employer has to do) and is costly to lay off a person (because of the severance payment) then less businesses will establish even when there are unexplored markets or possibilities for innovation. Moreover, when new and more profitable opportunities emerge, existing business would not be able to switch resources to these new areas given the rigidities of labor markets.

The recommendation, then, consists in eliminating as many of these regulations as possible in order to make labor markets flexible and open opportunities for business to thrive. Among the policies that are enacted under this heading are: the creation of short term contract with less obligations for employers, the reduction or flexibilization of vacation for employees, and the restriction of the influence of unions in the workplace.

The social costs of this policy reforms are quite obvious, as employees may lose access to health care, job security, and even retirement contributions. These policies, on the other hand, have been fiercely—if not always successfully—resisted in Latin American countries.

Additionally, the effects of these reforms on economic efficiency are still contested. Several countries in Europe have highly regulated job markets, and yet their businesses are competitive at the world level (prominent examples are Finland and Sweden, home of some of the most innovative high technology companies). Some of these countries have relatively high levels of unemployment (Germany, for example), which they address through generous unemployment insurance schemes.