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Jürgen Zattler*

Adjusting Adjustment

Supply Response and the Sequencing of Reform Policies

The classical approach towards adjustment has proved to have considerable shortcomings, particularly in connection with supply response issues and the conditions for re-establishing sustainable growth. The following article concludes that sustainable stabilisation and adjustment require a revised sequencing of policies, and outlines the main consequences of this for donor assistance strategies.

Most governments of least developed countries, especially in sub-Saharan Africa, started implementing structural adjustment programmes in the eighties, principally with the support of the IMF and the World Bank, together with other multilateral and bilateral donors. These reform programmes comprised in general two components: a stabilisation component designed to reduce "internal absorption", that is to say demand by both the domestic private and, especially, public sectors; and second, a structural adjustment component designed to act on the supply side of the economy by improving incentives and stimulating production and growth. Whereas the earlier programmes were largely dominated by stabilisation policies, from the second half of the 1980s the emphasis of the programmes switched initially to liberalisation and deregulation and subsequently also to social aspects.

From the very beginning, the design and implementation of adjustment programmes was highly controversial. An essential aspect of this was a misconception regarding the underlying characteristics of the problems. Those responsible for the design of programmes assumed that the macroeconomic imbalances were due to business fluctuations or other short-term factors. Thus the time needed for stabilisation measures to take effect was underestimated, it being assumed that both internal and external balance could substantially be achieved within the lifespan of short-term IMF stand-by arrangements. As a consequence, the social costs of stabilisation either were not considered or were underestimated. This view changed only towards the end of the 1980s.

The most important objective of IMF-supported

programmes is the re-establishment of a viable balance of payments position in the medium term. This objective must be attained, moreover, in conformity with IMF statutes relating to the promotion and maintenance of free trade and capital movements. In addition, such programmes aim at the re-establishment of conditions for sustainable growth, especially through supply-side policies supported by the World Bank.

The analysis underlying the formulation of structural adjustment programmes is based on the so-called absorption approach. According to this approach, a current account deficit is reflected in the fact that internal absorption (the sum of private consumption, domestic investment, and government expenditure) exceeds domestic production or income. The difference between domestic income (Y) and domestic absorption (A) is reflected in the balance on current account $CA = Y - A$. The current account shows a surplus if income exceeds absorption and vice versa. This identity implies that a current account deficit can be reduced by a relative decline in absorption or by a relative increase in income. An excess of absorption over income can be financed only through transfers from abroad and capital imports. It will be reflected in an increase in net foreign indebtedness of non-bank residents and/or in a decrease in net foreign assets of the banking system. Balance of payments adjustment refers primarily to the process by which the current account balance is made to conform with sustainable capital flows. Adjustment programmes therefore typically aim at reducing a current account deficit to fit a sustainable net inflow of capital.

The so-called monetary approach to the balance of payments¹ has been translated by the IMF into a financial programming framework,² and provides the basic theoretical foundation for its adjustment programmes. It

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aims at reducing aggregate demand to a level which is compatible with available domestic production and financing from abroad. This approach assumes that if the supply of money (the sum of the changes in international reserves and domestic credit) exceeds the demand for money, it will be spent until holdings of real money balances reach the desired level. An increase in domestic credit, therefore, which raises money supply above the desired level will thus be offset by a corresponding decrease in net foreign assets. It should be noted, however, that the model explicitly assumes "small-country" conditions, which implies that the domestic price level is determined by foreign prices through purchasing power parity. This in turn means that the demand for money is effectively independent of changes in domestic credit. In other words, domestic demand (absorption) will exceed domestic supply (income) and foreign savings (changes in net foreign indebtedness) when the growth in domestic credit exceeds the growth in money stock. Therefore, a ceiling on domestic credit will determine the change in net foreign assets, that is, the balance of payments. Hence, this ceiling constitutes the most fundamental performance criterion in IMF-programmes. Moreover, ceilings on internal and external credits to the public sector are fixed in all IMF-programmes, in order to limit the utilisation of available resources by this sector. The financial programming framework can thus be used to determine both the overall balance of payments and its components; and it can be easily linked to monetary policy and to the fiscal accounts of the government.

In countries with fundamental balance of payments disequilibria, involving serious structural impediments to growth, structural adjustment policies (supply-side and expenditure-switching measures) currently play a major role, in conjunction with stabilisation measures, with the object of reducing macroeconomic imbalances. In the short term these measures aim at an improvement in the utilisation of existing productive capacity and increased exports. Typically, they include the relaxation or removal of domestic price controls, currency devaluation, reform of the fiscal system, and liberalisation of the foreign

exchange and trade regimes. In the medium term, the objective is to increase production capacity and investment, based on the improved use of existing resources, increased savings, and a reduction in government involvement in the economy.

Theoretical Shortcomings

The theoretical foundations of adjustment programmes are largely influenced by neoclassical thinking. This holds true in regard to both the stabilisation component of the programmes as well as their structural adjustment component. In substance, neoclassical theory denies that money has any impact on the equilibrium conditions of the economy ("neutrality of money"). As a consequence, the main objective of monetary policy consists in avoiding policies which aim at manipulating equilibrium conditions.

In fact, this understanding stems partly from the neoclassical view of money functions. According to this concept, money is held by individuals to satisfy their transaction needs, thus constituting a kind of mirror relationship between the real economy and the monetary sphere. However, as was already stressed by Keynes, individuals also hold money for speculative needs. This refers to the fact that money economies are associated with insecurity owing to the potential change in the value of money. These economies function essentially through time-contracts between money-holders and borrowers. Therefore, as Riese³ underlines, the theory of a money economy is essentially a theory of interaction between lenders and borrowers. The readiness of money-holders to give up liquidity and to lend, as well as the rate of interest, depends on their appreciation of the risk linked with lending. An important function of money in a money economy is therefore to permit contracts between money-holders and borrowers over a certain time-frame.

Taking this into account, the expectations of money-holders become a crucial variable. This is true both for commercial banks and for households. Consequently, the central bank does not have sole control over the credit volume, or as Riese put it, in a decentralized, monetary economy, money-holders are not in the services of the central bank.⁴ It lies within the competence of the commercial banks to decide on credit approvals and within that of other money-holders to give up liquidity. These decisions depend on their appreciation of the overall economic and political environment and in particular on their appreciation of the risk linked with lending.

Therefore, both the money supply and the demand for money are largely endogenous variables, dependent on the expectations of money-holders. On the one hand, their expectations have an impact on the money supply.

¹ J. J. Polak and V. Argy: *Credit Policy and the Balance of Payments*, Staff Papers, Vol. 18 (1971), No. 1, reprinted in *International Monetary Fund: The Monetary Approach to the Balance of Payments*, Washington D.C. 1977; M. S. Khan and M. D. Knight: *Stabilisation Programs in Developing Countries: A Formal Framework*, IMF Staff Papers, Vol. 28, No. 1, Washington D.C. 1981.

² International Monetary Fund: *Theoretical Aspects of Fund-Supported Adjustment Programs*, IMF Occasional Paper No. 55, Washington D.C. 1987.

³ H. Riese: *Geldökonomie, Keynes und die Anderen – Kritik der monetären Grundlagen der Orthodoxie*, in: E. Hödl and G. Müller (eds.): *Ökonomie und Gesellschaft*, Jahrbuch 1, Frankfurt/New York 1983, pp. 102-160, here p. 107.

⁴ *Ibid.*, p. 111.

Whereas the central bank is in a position to reduce the supply of money over the medium term, credit expansion to the private economy depends largely on commercial banks' appreciation of the risk linked with lending and on other money-holders' appreciation of the risk linked with giving up liquidity.

In turn, the change in domestic credit has an impact on the *demand* for money. As seen above, this is in contrast to the basic financial programming model of the IMF, which assumes that the variables determining the demand for money are independent of the change in domestic credit. But certainly empirically more important than the impact of the change in overall credit on the demand for money, is the composition of credit. The composition of credit (consumption, working capital, investment etc.) can influence considerably the level of income and production. Again the commercial banks' appreciation of the risk linked with lending and other money-holders' appreciation of the risk linked with giving up liquidity can be seen as crucial variables here.

The reduction in overall credit can be regarded as the main vehicle within structural adjustment programmes for decreasing inflation and macroeconomic disequilibrium. However, as the various utilizations of credit might have different impacts on supply, the effect of credit restriction on inflation also depends largely on the structure of credit.

It is argued here that the conventional approach neglects production and supply aspects. This is also shown by the fact that savings are usually considered as the central bottleneck for increasing growth. It is assumed that savings are a precondition for investment, as the latter have to be financed by these resources. Following a production-oriented view, investment, induced by the positive profit expectations of money-holders, stands at the origin of the income-creation process. Consequently, the savings rate is a largely dependent variable in the income-creation process, whereby imports have to play a contributing role.⁵ This relationship is evidenced by the equation $S = I + Ex - Im$. It can be concluded that profit

expectations for productive investment, and the competitiveness of the economy in export production and import substitution, have to be considered as the important variables for long-term and sustainable stabilisation and growth, strategic variables which are neglected in the neoclassical view.

It is important to note that the negligence of supply-side factors also concerns the utilisation of additional resources provided through external financing for adjusting economies, thus increasing the import capacity of the respective countries. This additional import capacity may be used for different purposes, e.g. for the import of consumer luxuries, other consumer goods, investment goods or other inputs for productive use. The level of income may depend largely on how externally sourced domestic credit is used. This underlines again that real income cannot be treated as an exogenous variable, as is the case in the basic financial programming model.

It can be concluded that the overall credit ceilings, usually fixed as performance criteria in the structural adjustment programmes, might for several reasons have negative consequences for the level of production. First, the credit ceiling for the public sector might be realised through cuts in the investment budget as well as in operation and maintenance outlays, thus affecting the use of existing investment and infrastructure. Secondly, the composition of credit to the private sector might for some reason (to be discussed below) change at the expense of credit for production. This might in turn impede not only structural adjustment but also stabilisation objectives.

In the following it is argued that this is not only an abstract possibility but a main factor explaining the, to some extent, disappointing results of structural adjustment programmes, which will be resumed below. This issue will then be looked at separately, first for the sequencing of stabilisation and structural adjustment measures, and then for the sequencing of external liberalisation policies.

Evaluation Results of SAPs

This seems to be an opportune moment to review past experience with structural adjustment in the light of recently conducted evaluations.⁶ These evaluations do not indicate a reversal in the trends in growth and investment for most of the least developed countries undergoing structural adjustment. On the contrary, these programmes were associated with significantly lower investment rates and lower savings rates.

The World Bank⁷ emphasizes that average fiscal deficits declined in "intensive adjusting countries". However, for several reasons serious doubts can be expressed with regard to the sustainability of fiscal

⁵ H. Riese: Entwicklungsstrategie und ökonomische Theorie – Anmerkungen zu einem vernachlässigten Thema, in: Thomas Schmid-Schönbein u. a. (eds.): Ökonomie und Gesellschaft, Jahrbuch 4: Entwicklungsländer und Weltmarkt, Frankfurt/New York 1986, pp. 157-196, here p. 172.

⁶ World Bank: The Third Report on Adjustment Lending: Private and Public Resources for Growth, Country Economics Department, Washington D.C. 1992; Paul Mosley, Jane Harrington and John Toye: Aid and power: the World Bank and policy-based lending, 2 volumes, London 1991; Ibrahim A. Elbadawi: Have World Bank-Supported Adjustment Programs Improved Economic Performance in Sub-Saharan Africa?, World Bank Policy Research, Working Papers, Transition and Macro-Adjustment, WPS 1001, Country Economics Department, Washington D.C. 1992.

⁷ World Bank: The Third Report on Adjustment Lending: Private and Public Resources for Growth, Country Economics Department, Washington D.C. 1992.

consolidation. First, according to the same report, investment in social and physical infrastructure has declined. Secondly, even when recurrent expenditures were maintained in "intensive adjusting countries", due to an increase in interest payments and roughly unchanged wage bills, government outlays for operation and maintenance decreased.

The decline in investment was found in both the public and the private sectors.⁸ The decline in the public investment/GDP ratio is certainly partly due to programme conditionality, setting a limit on the overall budget deficit.

The reasons for the still unsatisfactory investment rate of the private sector, which can be considered as a key indicator for the sustainable restoration of growth, are certainly more complicated. First, there is some evidence that the cut in public investment in sub-Saharan Africa may actually have exerted a significant negative impact on private investment.⁹ Especially investments in infrastructure such as roads and communications may be complementary to private investment. Secondly, the persisting high foreign debt service negatively affects private investment as it constrains resources available for investment and may impede improvements in the macroeconomic environment, thus equally discouraging private investors. This brings us to the final factor for explaining the lack of investment response by the private sector, which is the overall credibility of the sustainability of the reform process. A lack of credibility affects business confidence and may encourage private businessmen to use resources mainly for non-productive quick-turnover activities. Indeed, according to some analyses, the counterpart of the decline in the investment ratio was that adjusting countries were able to boost private consumption more than they might otherwise have done.¹⁰

Conclusions for a Coherent Approach

As a consequence of the above analysis, there is a need for redesigning reforms in particular in the following two policy areas:

☐ *Relationship between Stabilisation and Structural Adjustment*

For several reasons there can be a conflict between stabilisation policies and long-term development. It can be assumed that expectations for productive investment are rather depressed when a country embarks on adjustment. Whereas restrictive credit policy is necessary to contain inflation and to re-establish confidence in the domestic money, both internally and externally, in the medium term nevertheless aggregate demand-reducing measures might result in declines in income and output and might thus depress the private sector's expectations and its response to government policies.

In particular, to the extent that the reduction in overall credit is at least partially achieved by curtailing spending on non-traded goods, the level of real output and thus the demand for money will decrease. In this case, the balance of payments target would also not be achieved.¹¹ This may be especially true for cuts in government expenditures, as these outlays are usually more directed towards domestic supply. The supply reduction can ask for further demand reductions and there is the risk of a vicious circle of decline in production and cuts in demand. In this way, the economy could get stuck in a low investment equilibrium because of insufficient investment as a result of a self-fulfilling pessimism.

It could be argued that these shortcomings are taken into account by the fact that stabilisation measures are supplemented by adjustment measures which aim at stimulating supply response and expenditure switching, thus improving the allocation of resources. However, this position is difficult to defend. As it is generally considered easier to reduce absorption than to increase production, and as a rapid decline in a current account deficit is usually regarded as mandatory, policies affecting absorption are often first put in place. Moreover, supply-side measures and expenditure-switching measures are considered to take slower effect than aggregate demand policies. The problem is therefore, that supply-side measures are usually taking effect at a time when demand-reducing policies have already negatively affected profit expectations, investment and production.

☐ *External Liberalisation*

The interactions between supply-side policies and expenditure-switching policies, as well as between the different supply-side measures themselves, notably those that are aimed at increasing current output and those designed to raise the growth rate of productive capacity, pose major problems in designing a production-oriented adjustment strategy. In particular, the effect of different sequences of external liberalisation of various markets in the economy is a subject that has been unduly neglected in the past, especially concerning least developed and sub-Saharan African countries.

⁸ V. Corbo and S. Fischer: World Bank-Supported Adjustment Programs: Country Performance and Effectiveness, in: Vittorio Corbo et al. (eds.): *Adjustment Lending Revisited*, World Bank, Washington D.C. 1992, p. 14; World Bank and United Nations Development Programme: *Africa's Adjustment and Growth in the 1980's*, World Bank, Washington D.C. 1989.

⁹ L. Servén and A. Solimano: Economic Adjustment and Investment Performance in Developing Countries: The Experience of the 1980's, in: Vittorio Corbo et al. (eds.), op.cit., pp. 117-138, here p. 131.

¹⁰ See e.g. V. Corbo and S. Fischer, op.cit.

¹¹ P. Montiel: A Monetary Analysis of a Small Open Economy with a Keynesian Structure, International Monetary Fund, Staff Papers, Washington D.C. 1985, Vol. 32 (June), pp. 204-205.

The sequencing of trade liberalisation has been subject to several studies, all of them concentrating on Asian, Latin American and European countries. Chenery et al.¹² seek to demonstrate the positive growth impact of opening-up strategies. A similar conclusion is drawn by the World Bank.¹³ Recently, a comprehensive study has been published¹⁴ examining the timing, phasing and sequencing involved in the design and implementation of a trade liberalisation policy. The authors conclude that, right from the beginning, liberalisation clearly tends to accelerate growth (p. 85). However, again, no African country was in the selected sample. Furthermore, as Greenaway¹⁵ stresses, the general results of the study are "extravagant" in the sense that the synthesis is not sufficiently justified by the individual country studies, notwithstanding the clear methodological deficiencies of the study.¹⁶

The successful sequencing of the liberalisation of different markets depends to a large degree on the national specificities of the various countries such as, especially, the adaptability of the domestic economy to changes in prices, the nature of the external payments imbalance (degree of long-term debt service obligations) and the structure of exports. These factors influence the demand-for-money function, the reaction of imports to exchange-rate changes and the impact of changes in relative prices on output in agriculture and other sectors. There is some evidence that these factors play a prominent role explaining the lack of a satisfactory supply response in least developed countries.

Therefore, neither a decrease in inflation through global reduction of demand, nor liberalisation, necessarily leads to the envisaged stimulation of investment and production. It might even further exacerbate business confidence and thus have a negative effect on private investment. In order to take these constraints into account, the sequencing of stabilisation and liberalisation policies needs to be adapted to the peculiarities of the respective countries.

The Need for Structural Reform

Consequently, the structural impediments to a vigorous supply response by the respective economies have to be addressed at an early stage of the adjustment process. This seems to be in partial contrast to conventional thinking. The classical approach assumes that structural reforms should be initiated only when sufficient progress has been made in reducing the macroeconomic imbalances. After re-establishing macroeconomic stabilisation, liberalisation policies are usually introduced, removing price distortions and the impediments to factor mobility and reducing government intervention in the private sector. Only at a later stage are the crucial areas for

improving the supply responsiveness of the private sector addressed: financial restructuring, regulatory policies, the business environment, institutional strengthening and human resources development. This thinking is also usually reflected in the relative weight given to the tranche release conditions of structural adjustment programmes. Currently, structural policies for the real and financial sectors rank only third in importance after conditions related to stabilisation and liberalisation.

Instead of the classical sequencing – relatively undifferentiated expenditure reduction, then liberalisation and lastly structural reforms and institution building – another sequence is suggested, namely:

1. *The introduction of selective expenditure cuts by suppressing commitment-based privileges, thus reducing macroeconomic imbalances in a credible and permanent way.*

It can be concluded from the above that a restrictive credit policy and demand cuts are necessary in order to re-establish confidence, both external and internal, in domestic money. However, aggregate demand policies should as far as possible be introduced in combination with selective policies. Otherwise, the risk of a breakdown in production and investment is likely to lead to policy reversals. In particular, it has to be ascertained that credit and liquidity are primarily used for production and investment, especially in the export and import substitution sector. Also, in order to attain the envisaged impact on inflation, it is necessary to distinguish between the various types of credit, excluding for example loans for investment and some credit for working capital from the overall credit ceiling.

As for public expenditure, global demand reduction bears the risk that demand and expenditure cuts will be undertaken in priority economic and social areas, but not in fields where cuts are needed. Indeed, the track record in decreasing non-priority public expenditure is very weak (concerning hitherto privileged groups, military spending, "white elephants", etc.).

¹² H. Chenery, S. Robinson and M. Syrquin (eds.): *Industrialisation and Growth: A comparative study*, Oxford 1986.

¹³ World Bank: *World Development Report: Industrialisation and Foreign Trade*, Oxford University Press, New York 1987.

¹⁴ D. Papageorgiou, M. Michaely and A. Choksi (eds.): *Liberalizing Foreign Trade* (7 Vol.), Oxford 1991.

¹⁵ D. Greenaway: *Liberalising Foreign Trade Through Rose-Tinted Glasses*, in: *The Economic Journal*, June 1993, pp. 208-222.

¹⁶ For the impact of alternative opening-up strategies, see also M. Kahn and Roberto Zahler: *The Macroeconomic Effects of Changes in Barriers to Trade and Capital Flows: A Simulation Analysis*, IMF Staff Papers, Washington D.C. 1982, Vol. 30 (June), pp. 223-282. For a summary of the discussion on these issues, which is too complex and extensive to be outlined in this context, see G. K. Helleiner: *Trade Strategy in Medium-term Adjustment*, in: *World Development*, June 1990, pp. 879-897.

Evaluation results show that in many adjustment countries first improvements in the fiscal deficit could not be maintained. The reason could be that expenditure cuts often concerned non-wage expenditure and public investment,¹⁷ which had to be increased later to a certain minimum level. A more selective cut in government outlays is therefore needed. Public expenditure reviews, looking at budgetary allocations, sectoral policies and budgetary procedures are the main instrument to improve the quality of the budget. These reviews should be linked, at an early stage, with the reform of the public sector.

2. The parallel reinforcement of structural reforms, the regulatory framework and institution building, thus stimulating private investment. Whenever minimum conditions for the functioning of markets are given, liberalisation policies should be introduced (first internal, then external; first goods, then financial markets).¹⁸

Particular importance should be given to assuring that external liberalisation is only introduced in parallel with accompanying structural measures. It is thankfully now widely accepted that price policy can only succeed with complementary structural policies to reform the real sectors. Similarly, external liberalisation has to be introduced in tandem with structural reforms of the real and financial sectors, flexible and active fiscal and monetary policies, and structural measures to promote the rationalisation of import and foreign exchange use.

The importance of a sequenced approach towards external liberalisation can best be demonstrated by the example of the liberalisation of the foreign exchange market. The liberalisation of the foreign exchange system

constitutes an important cornerstone in adjustment programmes for countries with non-convertible currencies. In general these reforms comprise the devaluation of the official exchange rate as well as enlarged access to foreign currencies by the introduction of more liberal foreign exchange allocation systems, such as auctioning or open general licensing systems.

These reforms are usually implemented at a relatively early stage of the adjustment process, after the trade regime has been liberalized. The objective of these reforms is to improve efficiency in resource allocation and an amelioration of the current account and balance of payments.¹⁹

Preconditions

The introduction of a liberal foreign exchange system puts the constraint for the provision of foreign exchange on the availability of local money and credit. To prevent unsatisfactory supply response, the following key preconditions have to be fulfilled, notably:²⁰

□ A major imbalance in current adjustment design is between external sector liberalisation and financial sector reform. The early implementation of financial sector reform is of paramount importance for assuring that the domestic commercial banks provide credit to profitable activities on the basis of sound examinations of creditworthiness. The establishment of a market-based mechanism for allocating foreign exchange should therefore be avoided before a reform of the financial sector is undertaken. The development of financial sector markets is a prerequisite for ensuring the transmission of monetary and credit policy with respect to investment.

□ The availability of new funds for private sector borrowing, especially longer term and often more risky lending for production activities, depends partly upon the quality of the loan portfolios of commercial banks and their ability to meet the required liquidity ratios. In order to strengthen the supply response of the economy, as a matter of some urgency, it is recommended that state-owned bank loan portfolios should be carefully audited and procedures strengthened along with the management team so as to ensure the continued commercial profitability of the recapitalised banks. The problem of non-performing loans to the parastatal sector and of cross-debts with the government has to be addressed at an early stage of adjustment in order to prevent liberalisation from destroying potentially profitable manufacturing capacities.

□ Far greater attention and support should be given to strengthening fiscal management and control over revenue and public expenditure along with the

¹⁷ This is confirmed by the results of the Third Report on Adjustment Lending (World Bank: World Bank and Sectoral Adjustment Operations: The Second OED Overview, Operations Evaluations Department, Washington D.C. 1992). The so-called "intensive adjusting lending countries" cut the share of central government capital spending in GDP. While capital expenditures were reduced, current expenditures in these countries have not changed significantly. However, within current expenditures, interest payments grew sharply, wages and salaries were roughly maintained, and transfers and subsidies and non-wage operations and maintenance were reduced.

¹⁸ This was often not respected in the past when, especially in Latin American countries, liberalisation reforms were introduced before budget consolidation was attained. For an assessment of the short-run and medium-run effects that an expansionary fiscal policy can have on key macroeconomic variables while the economy is being opened up, see M. Kahn and R. Zahler: Trade and Financial Liberalization Given External Shocks and Inconsistent Domestic Policies, IMF Staff Papers, Washington D.C. 1985, Vol. 32 (March), pp. 22-55.

¹⁹ The same problem exists in respect to non-market induced capital inflows such as donor-financed import support.

²⁰ The following conclusions are partly based on two empirical country studies: J. Sharpley: Supply Oriented Sequencing of Adjustment Policies: Study of Mozambique, Sierra Leone, Uganda and Kenya, Commission of the European Communities, Brussels 1993; and M. Martin: Macroeconomic Evaluation of Import Support Programmes to Mozambique, Commission of the European Communities, Brussels 1993.

development of monetary policy instruments and the financial sector, right from the earliest stages of the adjustment programme, and especially before the introduction of market-determined exchange rates and market-determined interest rates.

□ In the field of credit policies, there is a clear need to permit expansion of credit to productive sectors while containing overall monetary growth. This will imply a more flexible attitude to overall credit ceilings, with the establishment of credit facilities outside the overall ceilings (investment in agriculture and industry, low-cost housing etc.), and the maintenance of sub-ceilings, distinguishing short-term from long-term lending.

□ Furthermore, the successful operation of a liberalised foreign exchange system assumes a relatively strong foreign exchange position with a relatively low dependence on fluctuating donor-financed, external resources. Otherwise, the shifts on the demand and the supply sides for foreign exchange would result in large-scale exchange-rate fluctuations; and a volatile exchange rate is likely to have a major impact on domestic production incentives and inflation. Therefore, much more attention and support should be given to export promotion and effective import substitution measures at an early stage of the adjustment process, which will build up international reserves so as to finance the liberalisation and expansion of imports, thus linking liberalisation of imports more closely to export performance and domestic production in efficient import-saving activities.²¹

If these aspects are not taken into account, the liberalisation of the foreign exchange system risks resulting in a negative supply response, with a large part of bank lending going for quick turnover business, especially in trade activities, with relatively small risk.

Long-term Development Strategy

It goes without saying that the adaptation of the suggested sequence of reforms might have a bearing on the pace of liberalisation, as the structural reforms to improve supply responsiveness will have a long time-horizon for implementation. The phasing and sequencing of the adjustment process has in this way to be integrated into a long-term strategy of development and integration into the world markets. Therefore, a development strategy is needed that emphasizes longer-term horizon-fostering stability and sustainability.

The role of the government attains a new importance in defining and implementing this strategy for long-term development and for increasing the competitiveness of the domestic economy. The major role of the government should consist in providing basic social services and

promoting productive private sector activities, thus transforming the way the government interacts with private economic agents. Public sector reform is therefore crucial to enable the state to take on this new role. The withdrawal of the state from the economy is not a goal in itself. Economic efficiency depends on the ways and means of interaction between government and the private sector rather than on the question of "more or less state".

The commitment of the government to cutting expenditures linked with privileges in a sustainable way is crucial. As stressed by Webb and Shariff,²² the strongest political asset of new teams and governments is often people's dissatisfaction with previous policies and their willingness to try something fresh (the honeymoon effect). This situation should be used to introduce irreversible structural reforms, thus ensuring the sustainability of stabilisation. Such a change in the policy regime should give a clear sign to economic agents concerning the government's commitment to carrying on the reform process.

The question arises, given the deep-rooted structural impediments to a more vigorous supply response, how such a long-term development strategy should be designed in order to attain international competitiveness and to improve the balance of payments position on a sustainable basis. It is argued here that these structural impediments, as well as the prevailing insecurity with regard to the overall macroeconomic framework, constitute a negative externality for investment. It therefore appears necessary to maintain over a longer period a policy bias encouraging investment. This policy bias should be combined with a bias towards export production and import substitution, thus encouraging the evolution from a consumption-oriented to a production-oriented development model.

The achievement and maintenance of a reasonably low real exchange rate, through a restrictive monetary policy and/or a nominal devaluation, can be an effective policy instrument towards increasing competitiveness and investment in export production and import substitution. A strategy of under-valuation was pursued very successfully by Germany in the fifties (facilitated by a fixed exchange-rate regime), by Japan in the seventies, and partially by some developing countries like South Korea.²³

²¹ Several authors emphasize the necessity to introduce export promotion before liberalising imports, as for example Donald Keating: *Trade Policy for Developing Countries*, World Bank Staff Working Papers No. 353, Washington 1979; and David Evans: *Institutions, Sequencing and Trade Policy Reform*, Report prepared for the International Monetary Issues Programme, Money, Finance and Development Division, Geneva 1991.

²² S. B. Webb and K. Shariff: *Designing and Implementing Adjustment Programs*, in: Vittorio Corbo et al. (eds.): *Adjustment Lending Revisited*, op. cit., pp. 69-96, here p. 84.

However, this policy instrument might be more important for countries which already have a relatively diversified manufacturing sector, able to respond quickly to price incentives. Furthermore, given high export dependence on one or a few commodities, especially in sub-Saharan African countries²⁴ and the low income elasticity of demand for these products,²⁵ a strategy of global export promotion conducted in parallel by several countries competing in the same area, or by one big producer country, is self-defeating. An increase in the supply of these commodities on the international market, unaccompanied by an adequate increase in demand, will lead to price reductions. The price effect thus partly or entirely offsets the effect of higher exported quantities ("fallacy of composition"). The situation becomes even more complicated due to the fact that the income elasticity of demand for the commodities imported by developing countries from the industrialized countries is relatively high.²⁶ Therefore, it seems that in most developing countries a strategy of export promotion and import substitution cannot only rely on exchange-rate devaluation but has to include more targeted and selective policies.

Indeed, there is a series of additional arguments for a non-uniform incentive structure and more active trade strategies, like the prevalence of externalities, potential for learning-by-doing, oligopolies, scale economies or institutional constraints.²⁷ In particular, it has been stressed that some of these phenomena might be more relevant to developing countries with small and imperfect markets, underdeveloped institutions and little experience regarding world market requirements.

There are also counter-arguments, in particular that the experience of selective intervention does not encourage the belief that policymakers are likely to be very good at picking goods with the greatest export and import substitution potential and "the consumer would merely continue to pay for this selective approach to export promotion in the form of higher prices".²⁸ But this position is not convincing, as many successful exporters undoubtedly

have pursued such strategies (Korea might be the most prominent example and Hong Kong is perhaps the only exception amongst the successful South-east Asian exporters). The deviation from efficiency pricing, which might be associated with a more sequenced external liberalisation and a more selective external strategy, can be compensated by efficiency gains in the medium and long terms and by a gain in stability in the incentive structure.²⁹

This strategy of selective export promotion and import discrimination has to be embedded in a coherent development strategy and supplemented by selective foreign exchange, trade and industrial policies. In particular, the importance of policies favouring investment has to be emphasized.

Consequences for External Assistance Strategies

The required changes in development policies described above have implications for donors' development assistance strategies referring both to the allocation of the available structural adjustment resources to the different countries, and to the conception of the various development assistance instruments.

The stabilisation phase aims at reducing aggregate demand to a level which is compatible with available domestic production and financing from abroad. It is obvious that a reduction in domestic spending can only work if these cuts do not in turn negatively affect the level of production itself. Therefore, during stabilisation it has to be ensured that sufficient additional resources are available for maintaining priority expenditures and especially investment for productive activities. The accommodation of stabilisation with long-term development objectives may thus, in the short term, be associated with higher external financing needs.³⁰ Moreover, the closer integration of liberalisation with institution-building and other structural reforms might also increase external financing needs in the short term. Donors therefore should

²³ A. Hannig: Südkorea nach 1980 – Modellfall der IWF-Anpassungspolitik, in: Hajo Riese et al. (eds.): Internationale Geldwirtschaft, Regensburg 1989, pp. 266-279, here pp. 274-276.

²⁴ UNCTAD: Commodity Yearbook, New York 1990, Table 17.

²⁵ Overseas Development Institute: Commodity Prices: Investing in Decline?, ODI Briefing Paper (March 1988), cited according to E. Schmiegel: Factors Influencing Price Developments of Commodities, in: INTERECONOMICS, Vol. 28, No. 3, pp. 138-143.

²⁶ Similar arguments were first formulated by R. Prebisch: The Economic Development of Latin America and its Principal Problems, New York 1950, in which he stresses the secular downward trend in the terms of trade for primary exporting countries.

²⁷ For a summary of the relevant literature, see G. K. Helleiner (ed.): Trade Policy, Industrialization and Development: New Perspectives, Oxford 1992.

²⁸ C. Milner: The role of import liberalisation in export promotion, in: C. Milner: Export Promotion Strategies, Hemel Hempstead 1990, pp. 81-98, here p. 94.

²⁹ The resulting current account surplus in the case of a successful implementation of this strategy will be reflected in an inflow of foreign exchange, which can serve for strategic capital exports (to be distinguished from market-induced capital exports, for example capital flight) keeping the currency undervalued. At the same time this market constellation contributes to market-induced capital imports to build up export production. In this way, strategic capital exports assure the competitiveness of export production (through the maintenance of the undervalued currency), whereas capital imports assure a high investment rate and are reflected by a high ratio of investment goods within the overall imports (see H. Riese: Theorie der Inflation, Tübingen 1986).

³⁰ The suggested reduction in non-priority expenditure at the beginning of the structural adjustment process may be overcompensated by additional resources, necessary to improve social and economic services.

concentrate the available funds on the most promising countries.³¹

The question of the criteria for allocating the limited funds arises here. The IMF performance criteria concentrate on global demand reduction by introducing ceilings for overall credit and for government borrowing with the central bank. This policy bears the risk of favouring governments which cut expenditures in development-relevant fields (basic economic and social services) for the sake of the short-term reduction of macroeconomic imbalances. It is therefore suggested that higher external financing should be allocated to those countries which are ready to cut expenditures in non-priority areas and to undertake key structural reforms in the areas summarized above.

The political will of the respective governments to implement these reforms is therefore of central importance. This is in line with evaluation results showing that the internalisation of the reform programme can be considered as a crucial factor for its successful implementation.

Apart from the allocation of structural adjustment funds to the various countries, the way in which these funds are made available should be reconsidered. First, structural adjustment resources should contribute more to ensuring priority expenditures, in terms of both imports and budget outlays. Whereas more importance has been given recently to improving the quality of budget expenditure by maintaining or increasing the outlays for basic social and economic services during adjustment, this is not the case with regard to the composition of imports. Given the shortage of foreign exchange and the opportunity costs of scarce resources, there is a need to implement policies which enable genuine import rationalisation and reduce import and aid dependence during periods when markets are highly imperfect. In particular, the liberalisation of imports of luxury consumer goods should not be at the expense of imports for domestic production and export activities. Therefore, it is necessary to restrict imports of such luxury consumer goods.

This has implications for donors' development assistance instruments, and in particular for the design of import support programmes. Import support funds should contribute more towards ensuring priority imports. A large inflow of foreign assistance can lead to a real appreciation or revaluation of the local currency, which impairs the competitive position of local export sectors. As long as minimum requirements for the proper functioning of foreign exchange markets (financial sector reform) are not in place, appropriate instruments should be set up to ensure that both foreign and domestic resources are used essentially for financing import requirements for productive activities and basic social services. For

example, the definition of precise and broad negative lists, complemented by improved monitoring and the collection of import duties and taxes, can be an appropriate instrument towards this end.

If the respective governments are committed to this policy, there is obviously neither a need for the earmarking of counterpart funds, nor for formulating conditionalities. A kind of "ex-post conditionality"³² would apply, as described above. For these countries, the most untied form of increasing official transfers from abroad should be undertaken in the first place, which is the reduction of the debt service. Experience shows that in many cases the recovery of private investment was slowed by the persistence of a high level of uncertainty about the future macroeconomic environment caused by the burden of the external debt service, threatening the success of stabilization.³³ Therefore, a reduction of the debt service seems to be indispensable in most countries in sub-Saharan Africa not only in order directly to liberate national resources currently committed to the debt service, but also to raise the private sector's confidence in the viability of the adjustment effort.

Secondly, the suggested adaptation of the sequencing of reforms gives more importance to structural reforms and institution-building at the beginning of the adjustment process as these measures are considered a prerequisite for successful stabilisation and liberalisation. This is the main argument why project and targeted programme assistance will attain renewed importance in the future. However, it is not the "good old" project assistance which is required, but rather technical and financial assistance, which is integrated into the sectoral and macroeconomic framework, thus supporting structural adjustment objectives. Most of this kind of assistance should be introduced as early as possible, and even before a formal adjustment programme is launched.

The coherent implementation of structural adjustment support with other instruments of development assistance in order to attain a maximum of supply response by the economies is therefore of central importance. The different instruments should be complementary, reinforcing each other and pursuing, on different levels, the same objectives. Accordingly, counterpart funds generated e.g. through food aid or sectoral programmes should also be used for on-budget expenditure and contribute to improving the efficiency and equity orientation of the budget.

³¹ It is assumed that no considerable increase in overall ODA transfers can be expected in the forthcoming years.

³² World Bank: Sustainable Growth with Equity, Technical Department/Africa Region, Washington D.C. 1989.

³³ L. Servén and A. Solimano, *op.cit.*, p.117.