■ structural adjustment

Since the 1980s, the expression *structural adjustment* (SA) has been used to denote programs of policy reforms in developing countries undertaken with financial support from the World Bank. Structural adjustment programs (SAPs) would normally consist of two components: macroeconomic stabilization and microeconomic, supply-side reforms. The World Bank *Operational Manual* defines structural adjustment lending (SAL) as "non-project lending to support programs of policy and institutional change necessary to modify the structure of an economy so that it can maintain both its growth rate and the viability of its balance of payments in the medium term" (*Operational Manual*, Statement No. 3.58, Annex II, November 1982).

Through SAL the World Bank financed more than 650 reform programs. SAL represented about one-quarter of its total commitments from the mid-1980s to the late 1990s, when it increased to more than 50 percent as a response to the financial crises in East Asia and remained at about one-third thereafter. Sub-Saharan Africa accounts for 34 percent of adjustment operations and 16 percent of commitments. The Latin American and Caribbean region accounts for 24 percent of adjustment operations and, with 34 percent of lending commitments, is the largest recipient of SAL, followed by Europe and Central Asia with 24 percent; East Asia and the Pacific received 15 percent of SAL, South Asia 6 percent, and the Middle East and North Africa 5 percent. SA shaped the strategy of the World Bank for nearly two decades and dominated policymaking in the developing world. During this period, almost all major programs of policy reforms were supported by SALs from the World Bank.

The bank started SAL in 1980 following serious balance of payments difficulties experienced in some of its member countries as a result of the second oil price shock in 1979. Many of these countries also had fiscal deficits and often high inflation, and the root of the external deficits was identified as excessive aggregate demand. In these circumstances, adjustment requires macroeconomic stabilization in order to reduce domestic demand to a level that is consistent with the level of external resources available to the country.

Since restrictive monetary and fiscal policies that cut demand (such as tax increases, spending cuts, and interest rate increases) also cause unemployment, they are normally accompanied by a currency devaluation that, by lowering the relative price of domestic goods with respect to foreign goods, leads to an increase in the foreign demand for domestic goods and an increase in the supply of exportable and import-substitute goods, and minimizes the employment costs of stabilization. Measures to restrain wages complement exchange rate policy to ensure that the competitive effect of nominal devaluation is not offset by wage inflation.

Macroeconomic stabilization alone may not give rise to faster growth in the future. In order to achieve this, a second type of adjustment is required, namely SA, which consists of microeconomic and institutional reforms designed to strengthen the supply response of the economy by letting the market determine the efficient allocation of resources. A central aspect of SA was market liberalization and deregulation along several dimensions, potentially including removal of price controls, deregulation of the domestic goods market, liberalization of the trade regime, deregulation of the domestic financial market, liberalization of the capital market—especially the removal of barriers to foreign direct investment—and deregulation of the labor market. A second component involved reform of public sector management, including fiscal reform, restructuring and privatization of state-owned enterprises, and restructuring of government spending. A final component consisted of reforms to create and strengthen institutions that would support stabilization and SA, such as institutions for banking supervision and the enforcement of property rights, an independent judiciary, and an independent central bank. Many economists believed that these microeconomic reforms would shift the economy to a sustainable path of higher economic growth.

The Rise of Structural Adjustment Lending Several factors contributed to the establishment of SAL. One was the nature of the crisis that was affecting developing countries. Severe balance of payments deficits required faster and larger disbursements than were possible under the standard World Bank approach of project-based lending, in which disbursements are typically slow in the first two years. By contrast, SALs typically disburse within 18 months.

A second factor was the realization within the World Bank that project success was crucially dependent on the state of the broader economic environment. This implied, first, that the World Bank could no longer encourage the pursuit of economic growth without regard for macroeconomic stability, which thus became a priority over growth and was seen as the necessary foundation for sustainable growth. A second implication is that, as the development strategies of many developing countries were now being seen as highly distorted, the World Bank had to turn its attention to removing microeconomic distortions.

SA embodies the drastically new viewpoint that development is hampered not so much by capital shortage as by domestic economic policies that impede the operation of market forces. This new vision was influenced by neoliberal political economy theories that centered on the capture of the state by powerful pressure groups. The state came to be seen as the primary cause of the distortion of incentives, leading to misallocation of resources and economic failure. Free markets work well, and even where there are externalities and market failures, the state does not have the willingness or indeed the capacity to lead to a better outcome than the market would. This is a complete overturning of the view prevailing until the 1970s, according to which state intervention was necessary in order to correct distortions and facilitate structural transformation in developing countries, where free markets do not work well. In this older view, the state was a benevolent agent for development. By contrast, SA—through liberalization, deregulation, and privatization—aims to minimize state intervention in the economy and liberalize prices so that they can reach equilibrium levels.

Abandoning structuralist doctrines, which emphasize the existence of special characteristics in developing countries' economic and social structures and were the mainstream in development thinking in the 1960s and 1970s, the World Bank—through SA—presents a model for all countries to follow, irrespective of their development stage. Indeed SAPs have been characterized by a remarkable degree of uniformity.

With the outbreak of the debt crisis in the 1980s, the main objective of SAL was to prevent an international banking crisis by allowing debt restructuring and the continuation (or the resumption) of interest payments. The objective of poverty reduction—one of the bank's priorities since the late 1960s—was downgraded. Partly this was also a reflection of the negative assessment within the World Bank of the strategy pursued until then of attacking poverty directly. In addition, this critical assessment led to the view that the best way to reduce poverty is through the promotion of economic growth (the so-called trickle-down doctrine). Thus the policies of SA, which are designed to stimulate higher sustainable growth, may be justified in terms of greater equality and poverty reduction. For example, minimizing state intervention leads to higher growth and, through the trickle-down effect, to lower poverty. Moreover since poverty is particularly acute in rural areas, reducing state intervention—which typically favored industry over agriculture—lowers poverty and improves income distribution.

Empirical Assessment of the Effects of SAPs The empirical literature in this area is extensive and its findings are diverse, due to the variety of approaches used in the analyses and the methodological difficulties inherent in the evaluation of SAPs. Any short summary of the evaluation results is therefore inevitably partial. Generalizing and hence partly ignoring the diversity of individual countries' experiences, SAPs appear to have had their stronger positive effects on countries' external accounts (with increases in the rates of growth of exports and improvements in the balance of payments, though such positive results have also been found to be often temporary) rather than on the domestic economic performance (as typically investment fell and economic growth contracted or stagnated).

Indeed, growth in countries that have followed SA policies—especially in Latin America and Africa—was frequently lower than in the 1960s and 1970s, when these countries were following the highly distortionary policies that SA was meant to correct. Both in Latin America and Africa there have been instances when SA seemed to lead to economic success, but such cases were both isolated and short lived. Moreover the 1990s saw the countries that liberalized the domestic financial system and opened the capital account being hit by severe financial crises. The financial fragility of liberalized markets also seemed to make it possible for financial crises to propagate by contagion. In contrast to the experience of the countries that followed SA reforms, the countries that have managed to achieve sustained high growth are those that have significantly deviated from SA, for example by maintaining selective protection of infant industries, by maintaining controls on capital flows, or by liberalizing trade and capital movements at a slow pace.

SAPs also appear to have had negative effects on income equality and the general standards of living, as measured by health, education, and nutrition indicators. Cross-country analyses on poverty and income distribution do not provide a unified picture of worldwide trends (the different results are due to problems with the reliability and comparability of data, different country and time period samples used in the analyses, and different methodological approaches). There is evidence, however, of increases since the 1980s both in cross-country and within-country inequality as well as in poverty (once China is excluded from the sample). Such trends are attributed to many different factors but some of these factors are related to the adoption of SA policies, such as overly rapid trade and financial liberalizations, rapid and poorly designed privatization programs, and the erosion of labor institutions and of the state's redistributive role. A significant amount of empirical evidence also calls into question the effectiveness of the trickle-down mechanism: increases in average income do not appear to raise the income of the poor for prolonged periods.

What policy implications can be drawn from such empirical findings is a highly controversial matter for two related reasons: first, these findings may be the results of flawed evaluation methodologies, and second, the empirical results may be interpreted and explained in many different ways. Let us consider, for example, the findings concerning the effects of SAPs on economic growth. The expectation is that SAPs would result first in an economic contraction in the short run (as a result of the macroeconomic stabilization), which would then be followed by a recovery (led by the supply-side reforms) that shifts the economy onto a path of sustainable growth. It is clear therefore that SAPs cannot be criticized for causing a contraction, since this is inevitable if the cause of the crisis is an excess of demand over supply. Thus the relevant question to investigate is not whether SAPs caused a contraction but whether the contraction was deeper and/or lasted longer than necessary. Actual program effects should then be compared with what the economy could have done without an SAP (such a hypothetical outcome is called a counterfactual in the literature). Methodologically, the difficulty is that the counterfactual is not observable and can only be estimated.

The different evaluation methodologies can be seen as different approaches for the estimation of the counterfactual. Intuitively, such estimation is based on the economic situation in program countries during the period preceding the start of the SAP or on the economic situation in countries that did not enter a SAP. More sophisticated methodologies would account for the fact that program and nonprogram countries may be systematically different. For example, program countries are more likely to have been hit by a negative shock in the preprogram period and, consequently, there may be systematic differences in the policies pursued by the two groups of countries during the adjustment period. Alternately, program and nonprogram countries may differ in the extent of their relative policymakers' commitment to good policies. None of these different approaches is fully satisfactory as they all have important shortcomings. Moreover since in any selected sample period not all of the observed growth rates may be sustainable in the long run, ascertaining the true influence of policies on economic growth becomes very difficult. By implication, whatever empirical evidence is found cannot be clear-cut, because it is not possible to know whether it represents the true program effects or is the result of a wrong estimation of the counterfactual.

Inevitably, however, the effects of SAPs have raised concerns about poor economic performance, growing inequality, and increasing social problems, as a result of which the development agenda has been significantly broadened, with greater attention being given to the role of institutions and institutional reforms (particularly with respect to the quality of governance) and with poverty reduction becoming a top priority in World Bank operations. In short, in accordance with much of the empirical evidence, there is consensus—both within the World Bank and among its critics—that SAPs have produced disappointing results. This empirical fact has received different explanations. World Bank critics would argue that SA policies are fundamentally flawed and inappropriate to developing countries' circumstances. Others, including the World Bank, would instead point to the lack of government commitment to policy reform and the ineffectiveness of conditionality (i.e., the set of policy reforms that are required for loan disbursement) as policy leverage. The implication of this view is that policy reform programs can be made more effective by allocating financial resources more selectively to countries with good policies and good institutions.

The End of Structural Adjustment As a response to the perceived shortcomings of SAL, the World Bank formally announced its replacement with Development Policy Lending in August 2004. The latter sees reform ownership—which could be defined as the commitment by a recipient country to undertake reforms independently of the incentives provided by lenders—as essential for the success of reform programs. By implication, the promotion of ownership breaks with the idea, typical of the SA era, that there are universal policy prescriptions. Another major difference from SA concerns the characteristics of conditionality: under Development Policy Lending conditionality must be streamlined, so that the conditions focus only on the reforms that are regarded as essential for program success. In addition, conditionality is ex ante in that loan disbursement is made conditional on a country implementing key reforms, rather than promising to do so in the future, as was the case under SA. This new approach clearly implies much greater selectivity in the allocation of World Bank's financial resources. Criticisms center on the feasibility of the principle of selectivity (particularly its lack of credibility, since withholding finance from a country with weak policies and institutions would deteriorate that country's economic and social situation further) and the conflict between ownership and selectivity (since ownership must be more than the freedom to accept the bank's preferred policies).

See also aid, international; aid, international, and political economy; International Monetary Fund (IMF); International Monetary Fund conditionality; trade-related capacity building; Washington consensus

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