Structural adjustment lending: early experience

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The serious payments deficits that have confronted oil importing developing countries since 1979 have highlighted the need for medium-term structural changes in their economies as well as short-term balance of payments support. To respond to these needs the Bank has adapted its assistance to include lending for structural adjustment.

Structural adjustment lending was introduced in early 1980 as one of several responses by the World Bank to alleviate the growing payments difficulties facing many developing countries. The considerations that led to this initiative were discussed by Peter Wright in an article entitled "World Bank lending for structural adjustment" (***Finance and Development***, September 1980). From the outset the Bank's management has stressed that there is no preconceived model or pattern to guide either the form or content of the adjustment programs; structural adjustment lending was to be evolved on a flexible case-by-case basis, adapting the approach to each country's situation. By mid-1981 nine structural adjustment loans or credits had been approved and a preliminary evaluation of the Bank's experience with this new lending instrument is now possible. While this experience is clearly limited, significant patterns and issues are nevertheless already emerging.

In brief, the objective of structural adjustment lending is to provide quick disbursing finance to support measures specifically designed to strengthen countries' balance of payments (BOP) within five to ten years without severely constraining demand in a manner that unnecessarily sets back economic and social development. A prerequisite for this new form of assistance is the elaboration of an appropriate set of specific actions that the government will undertake either to increase or to save foreign exchange earnings. In most cases a key ingredient will be measures to adjust the structure of production to recent changes in international prices. The structural adjustment programs may be phased over a number of years, cover several sectors—principally agriculture, industry, and energy—and may be supported by a series of loans. Any country facing a serious medium-term foreign exchange constraint and proposing a viable adjustment program is eligible.

Over the past year this type of lending by the Bank has attracted considerable controversy. Some see the loans as little different from immediate BOP support—the domain of the International Monetary Fund—and fear that the roles of the two institutions may become blurred and conflicting advice may be given. Others question the Bank's qualifications for addressing macroeconomic issues; project lending is viewed more favorably because it generally leads to the creation of tangible productive assets. At the same time it is argued that sector policy issues can and should be tackled within the context of project lending.

Representatives of some developing countries also have warned that the Bank risks intruding into the preserve of sovereign governments. They view the close links that have been developed with the Fund with suspicion and fear that together the two international institutions would exercise undesirable leverage to limit national policy options. Broader questions have been raised about the few countries that appear likely to be eligible for structural adjustment loans and about whether the funds to be used are additional to existing lending. Some believe that the Bank's insistence on a high degree of conditionality will exclude the poorer countries whose administrations lack the capacity to formulate and implement robust policy packages. Further, they argue that, unless the Bank is authorized to expand its total lending, structural adjustment loans will merely substitute for project loans. These concerns may only be dispelled or confirmed as experience is gained with the practical implementation of structural adjustment lending. However, the loans approved to date indicate that these initial reservations were not well founded.

Nature of structural adjustment

The sharp and long-term rise in energy costs, the inflationary rise in the prices of manufactured goods, high interest rates, and the drop in demand for primary products related to recession in the industrial countries have all combined to create a highly adverse international environment for the oil importing developing countries in the 1980s. The impact of these events has varied greatly among countries, depending on both the vulnerability of the different economies and the quality of economic management. Some of the recent changes in international prices must be considered permanent and, consequently, must be addressed through long-term adjustments in the economic structure of a country, in contrast to temporary measures that are an appropriate response to short-term payments disequilibria.

Countries have three basic ways to respond to these external shocks: (1) by modifying the structure of output by introducing incentives that encourage resources to be switched to the production of both exports and import substitutes; (2) by borrowing heavily abroad to maintain development momentum with the hope that rapid growth will accommodate the payments deficit; and (3) by moving toward greater autarky by reducing imports and hence accepting a slower rate of growth. While in theory these options may be pursued independently, in practice most governments have adopted programs that combine the three different approaches.

Conceptually, structural adjustment is designed to respond to permanent changes in the external environment and may be distinguished from structural reform to correct for inappropriate domestic policies. In practice these two elements become inextricably interwoven, and consequently none of the programs supported by structural adjustment lending may be regarded as solely correcting for external shocks. Many countries now adversely affected by a sharp deterioration in their terms of trade were already experiencing payments problems and slow growth as a result of domestic policies; worsening terms of trade served to heighten the crisis and gave new urgency to the implementation of remedial measures. Many of the reforms proposed under structural adjustment lending are long overdue and are not necessarily specifically related to the changed international price structure. They are all designed, however, to have a direct impact on the BOP.

The domestic causes of the structural BOP deficits have varied. In the case of Turkey, for example, excessive protection fostered highly inefficient manufacturing enterprises and low exports despite a reasonable growth in domestic production. In several African countries neglect of the agricultural sector (low producer prices, inefficient marketing, poor maintenance of rural roads, and inadequate research, extension, and credit) has resulted in burgeoning food imports, while the volume of export crops and export earnings has not increased sufficiently to support the investment program. In some Latin American countries ill-conceived public investments have significantly lowered the rate of economic growth and this problem has been compounded by the resort to foreign loans on hard terms to maintain investment activity. The considerable scope for domestic policy improvements thus gives added importance to structural adjustment lending.

The changed prices of traded goods call for compensating modifications in the structure of production. Specifically, measures are required to conserve imported fuel and increase the output from domestic energy sources. Also, since capital goods are now relatively more expensive, a shift toward more labor-intensive sectors is justified wherever feasible. Such adjustments will take time to be implemented and become effective. During this period of adjustment bridging finance is required to cover the continuing BOP deficits.

Structural adjustment programs

The Bank lent US$1.02 billion for structural adjustment up to June 30, 1981. In fiscal year 1981 (ending June 30) structural adjustment lending was equivalent to only 6 per cent of the total World Bank and International Development Association (IDA) lending program. Clearly this is a very small amount when compared, for example, to the $68 billion current account BOP deficit of the oil importing developing countries in 1980. However, the conclusion of a structural adjustment loan, often in conjunction with a Fund stand-by or extended facility arrangement, has encouraged additional bilateral and nonconcessionary capital flows. This has been particularly evident in the cases of Kenya, Senegal, and Turkey.

Major and permanent adjustments to the new international situation will inevitably take time; for this reason the Bank normally expects to provide not one but a series of loans to support a phased program of structural adjustment possibly over a four to five year period. So far the Bank has already financed two such operations in Turkey, and repeat loans are under advanced preparation for other countries. This phasing may be either by sector, as in the Philippines, or by dividing a comprehensive program into stages, as was done in Turkey.

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The growth of these loans has been constrained primarily by the political and technical difficulties that governments confront in presenting comprehensive structural adjustment programs. Inevitably the short-term costs of adjustment adversely affect important interest groups within a country, and in some instances may not be politically feasible. In such cases project lending directed toward strengthening the BOP may be the best way to proceed. However, the scope of policy issues addressed in project lending is inevitably limited. Moreover, the pace of policy reform is then dictated by the project lending program and the project cycle, whereas a prompt and comprehensive approach is often needed to ensure that complementary measures are taken in several key sectors. This can be achieved uniquely by means of a structural adjustment loan.

Some countries now facing BOP crises that call for urgent external assistance lack the staff to elaborate effective measures rapidly. Experienced administrative and technical staff resources are typically scarce. In any event, in-depth studies are often a prerequisite for the detailed design of specific measures. These constraints do not rule out structural adjustment lending; rather, the governments would be asked to identify a few critical measures that can be implemented almost immediately and, at the same time, to set in motion the studies needed to plan a longer term action program. This approach was adopted in Tanzania and Sudan, where structural adjustment lending has been preceded by quick disbursing credits to help rehabilitate the agricultural sector.

An important element in such a phased approach has often been the provision, where requested, of technical assistance either as a separate project or as a component of another project. At the same time the Bank has been willing to step up its own economic and sector work to provide the country's authorities with additional support. In the Philippines the Bank also used its project preparation facility to enable the Government to finance consultants to help develop its structural adjustment program; in Senegal, the Government drew on specialists who had been hired under a previously negotiated technical assistance credit.

Structural adjustment lending is not limited to countries already facing an acute BOP crisis. Where the need for structural adjustment has become evident owing to

Table 1
Key components of structural adjustment operations: February 1, 1980–June 30, 1981

	Senegal	Turkey[1]	Guyana	Kenya	Bolivia	Philippines	Mauritius	Malawi
Trade policy								
Exchange rate policy		x			x			
Tariff reform and import liberalization	x	x		x		x		
Export incentives	x	x		x		x	x	x
Improved institutional support for exporters (export insurance and financing, export promotion institutions)		x	x	x		x	x	x
Specific programs for major export or import saving sectors	x		x	x	x	x	x	x
Sector policies								
Energy:								
Pricing policy		x	x		x		x	x
Conservation measures		x	x					
Development of indigenous sources		x	x				x	x
Agriculture:								
Pricing policy	x	x	x		x			
Improved institutional support (marketing, etc.)	x	x					x	x
Industry:								
Incentive system		x		x		x	x	
Institutional improvements and subsector programs		x	x			x	x	
Public investment program								
Revision and review of sectoral priorities	x	x	x	x	x		x	x
Strengthening of institutional capacity to formulate and implement public investment program	x		x					x
Public sector enterprises								
Financial performance	x	x	x		x			x
Institutional efficiency	x	x			x			x
Resource mobilization								
Budget policy	x	x	x	x				x
Interest rate policy		x	x	x				x
Debt management								
Strengthening of institutional capacity to manage external borrowing		x	x	x	x		x	x

Source: World Bank.
[1]Includes two structural adjustment loans to Turkey.

the changed external situation, a case may be made for structural adjustment lending before a crisis point has been reached. The Philippines is a case in point. In those instances where a country is already in a payments crisis, there will usually be a need for a structural adjustment program to be accompanied by short-term stabilization measures. A key issue in all cases has been the phasing of the adjustment program; this requires a judgment on the extent to which the income impact of the external shocks may be delayed by external borrowing. By allowing sufficient time for the adjustment process to become effective, an absolute decline in per capita consumption may be avoided.

Content of programs

While the strengthening of the BOP is the fundamental aim of structural adjustment lending, programs to date have covered a broad range of policies related to the more efficient use of resources in the key sectors (Table 1). The measures mainly fall within four areas: (1) pricing policies, to which are related tariff reforms, fiscal incentives, budget subsidies, and interest rate policy; (2) revised public investment priorities in the light of the changed international price structure and resource availabilities; (3) improved budget and debt management; and (4) strengthened institutions, particularly public enterprises. Each program is a combination of complementary and mutually reinforcing measures.

A frequent concern—especially for middle-income countries—has been to reduce the bias that has crept into the industrial incentive systems. High tariffs and import controls have often encouraged high-cost import substitution production and have, therefore, been biased against exporting. For example, the Philippine structural adjustment program aims to even out the effective rates of protection and liberalize trade in order to stimulate a radical improvement in industrial efficiency; reforms are also being introduced to reduce or simplify administrative procedures that have obstructed exports. These measures will encourage Philippine industry to become increasingly competitive in both domestic and foreign markets, benefiting local consumers as well as being a precondition for achieving sustained growth of output and employment in this sector.

For most structural adjustment programs, revised prices are crucial to foster production in the agricultural sector. Substantial empirical evidence exists to confirm that farmers respond well to price incentives. In many countries producer prices have been allowed to fall well below export or import parity prices. Improved price incentives to stimulate food production, both for the domestic market and for export, were a key feature of the programs in Bolivia, Guyana, and Senegal. To make these incentives effective, measures have also been introduced to improve marketing, access to credit, and the supply of tools, seed, fertilizer, and pesticides. In Senegal the program provided for major reforms of the agricultural parastatal enterprises, including exposing state marketing organizations to competition from the private sector to encourage efficiency. Although most structural adjustment programs give priority to reforms relating to agriculture and industry, problems in other productive sectors have been addressed. In Bolivia, for example, mining taxation was modified to provide greater incentives for investment in new mines and to encourage existing mines to exploit marginal ore bodies.

Incentives to stimulate both energy conservation and import substitution are also, at least in part, a pricing issue—to ensure that domestic fuel prices adequately reflect international prices. In Bolivia, the price of oil produced locally was raised to encourage fuel conservation and hence raise export earnings. Higher fuel prices also provide an added incentive for oil and coal exploration.

A critical review of public investment programs is an integral part of most structural adjustment programs, with greater priority being given to projects that will ease the foreign exchange constraint. The most obvious examples are investments in hydroelectric power, oil exploration, and the expansion of export crops. Many countries lack well-staffed and authoritative units within their government to undertake rigorous project evaluation. Thus, strengthening the planning capacity has also been a feature of several programs.

Table 2
Indicators relating to structural adjustment lending operations: February 1, 1980–June 30, 1981

	Amount of loan (In millions of U.S. dollars)	1980 Per capita GNP (In U.S. dollars)	1980 Ratio of BOP current account deficit to GDP (In per cent)	Debt service ratio (December 1980)	Net international reserves (In months of import coverage as of December 1980)
Turkey[1]	575	1,116	5.0	12.0	2.0
Mauritius	15	1,054	11.6	8.0	0.9
Philippines	200	760	5.4	16.6	−3.6
Guyana	22	700	10.6	24.3	0.7
Bolivia	50	592	−0.15[2]	29.6[3]	−2.4
Senegal	60	430[3]	17.1	16.5	−0.3
Kenya	55	420	16.5	12.6	1.3
Malawi	45	212	11.6	18.7	−2.6

Sources: IMF data and World Bank estimates.
[1]Includes first and second structural adjustment loans to Turkey.
[2]Minus sign (−) indicates surplus.
[3]1979 figure.

While it has been important to reduce budget deficits with the minimum adverse effect on productive activities, inadequate maintenance of infrastructure has often created production bottlenecks. In other cases, such as Kenya, expanded agricultural production will depend on improved agricultural services. To achieve these objectives, while containing or reducing the budget deficit, has required selective cutbacks to shift expenditure away from nondevelopmental activities. One approach is to target welfare programs and consumer subsidies more sharply on the needy.

Greater resource mobilization is also central to structural adjustment. Thus the programs commonly include measures to improve the profitability of parastatal organizations and strengthen tax administration. Turkey's program also incorporates new taxes. In this context the maintenance of positive real interest rates is also an important policy objective—explicitly specified in the Kenya and Guyana programs—not only to mobilize private savings but, perhaps more importantly, to encourage better resource allocation.

Since the parastatal organizations often enjoy a monopoly, their mismanagement can constitute a major bottleneck to production, as was the case in Senegal. An important component of Turkey's program involves the progressive reform of state economic enterprises introducing tighter financial discipline and more self-reliance. Other examples of institutional reforms include measures to improve agricultural extension services in Turkey and to provide better credit and insurance facilities for exporters in Kenya and the Philippines. Lastly, establishing better systems for maintaining external debt records—for example in Kenya and Turkey—was also considered essential for sound financial management.

Interaction with the Fund

The Bank's structural adjustment lending interfaces with the Fund's extended facility arrangements. Both provide funds that are available to finance a broad range of imports. Further, both emphasize the development of broad action programs rather than the organization of specific new projects. The Fund is increasingly taking into account supply as well as demand management considerations and its programs now have a longer term perspective. Similarly, Bank officials are more keenly aware than ever that effective long-term development programs can not be undertaken by a country facing an immediate financial crisis; in these circumstances, priority must be given to stabilization measures. Experience over the past year has shown that the Bank and Fund programs can, in practice, be complementary and mutually reinforcing in their effects on national developmental and stabilization efforts.

The two institutions, of course, pursue distinct objectives. The Fund's immediate aim is to help members strengthen their BOP positions, while the Bank's central preoccupation is to improve efficiency in the use of resources. In both cases the ultimate objective is to foster broad-based growth in employment and incomes. In practice both institutions are concerned about the appropriateness of key elements of national policy, though often from different points of view. For example, the Fund often raises the question of reducing subsidies to state enterprises in order to limit the budget deficit while the Bank's complementary objective is to encourage the enterprises to operate more efficiently. Each institution needs to pursue a distinct line of analysis but their policy advice needs to be harmonized if it is to be helpful to member countries. Thus, in these efforts the Bank and Fund staff need to work collaboratively with governments on defining actions required to promote economic growth within the context of a viable BOP.

Where next

So far the volume of structural adjustment lending has been very modest in terms of total Bank lending, and it is even less significant in relation to the current size of BOP deficits. Unquestionably the impact of the policy reforms is far more important than the benefits from direct resource transfer. Proposals have been made to increase the approved level of global Bank lending so that structural adjustment loans could be additional to the currently authorized lending programs. A decision on this must inevitably await a resolution of the broader issues related to the Bank's long-term lending program.

A major concern of the Bank has been to assist the poorer countries. Four of the eight countries so far benefiting from structural adjustment loans have per capita incomes below $600. However, assistance to countries only eligible for IDA loans is severely constrained by the limited availability of IDA funds. Moreover, low-income countries typically require much more staff work, and Bank staff resources are also very constrained.

As confidence grows that structural adjustment lending is an effective way to employ Bank resources, the number of operations each year may be expected to increase. Structural adjustment lending is, however, only one of a spectrum of lending instruments available to the Bank. For many countries for a variety of reasons—political, administrative, or financial—it may not be the most appropriate or effective form of assistance. Yet experience to date has confirmed that in a number of cases, structural adjustment lending does provide a very useful vehicle for the Bank to assist in the identification and implementation of important policy reforms. F&D

Related reading

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