Stabilisation and Structural Reforms for Sustained Growth*

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First, an overview of the world economy to provide us with the stark evidence of the deep economic and social crisis which the world still faces despite the process of far reaching economic reforms and adjustments which many countries have undertaken over the past decade and a half, Global unemployment today, as a proportion of potential employment, is higher than at any time since the Great Depression. Of a world labour force estimated at 2.8 billion people, an estimated 30 per cent are not productively employed. More than 120 million people are registered as unemployed throughout the world, in that they seek and are available for work but cannot find it. An estimated 700 million people are underemployed, the 'working poor', and they form the bulk of the estimated 1.1 billion absolute poor in the world. With new entrants joining the labour force at an increasing rate, the pressures on the employment situation and poverty problem will further intensify in the coming years.

Recent economic trends are not very encouraging. In 1993, for the fourth year in succession, average world per capita income fell. In 1992-93, the employment situation worsened in most countries, whether developed, developing or in transition. Outside East and South-East Asia, even if employment levels were sustained, it was usually at the price of falling wages. Employment conditions have also changed considerably and in many cases deteriorated – the risk of job loss persists, young people especially find it more and more difficult to get employment, and the informalisation of employment in urban areas continues as more people turn towards self-employment.

A closer look at the employment trends in most regions of the world confirms the seriousness of the employment problem. In the industrialised countries unemployment is forecast to reach 8.6 per cent in 1994, or 35 million people. In Western Europe the rate of unemployment will then be almost 12 per cent. In Eastern Europe, unemployment rates of over 15 per cent are now common. In Russia, in early 1992, real household expenditure had fallen to 40 per cent of its 1987 level. In the labour market the deep recession is reflected in the serious increases in poverty rather than in open unemployment. Most of the countries in sub-Saharan Africa reflect the deep economic recession and crisis which they have faced over the last two

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decades. Urban unemployment is now reported to be about 20 per cent and is rising. In the rural areas underemployment affects well over 50 per cent of the labour force. In Latin America, although in the 1990s economic growth has picked up, it is still insufficient to bring about a significant improvement in the overall employment situation and open urban unemployment remains at about 7 per cent. The only exception to this rather depressing scenario has been the performance of Asian economies especially the very fast growing economies of East and South-East Asia. But even for most of the Asian countries there is little room for complacency. Asia still contains the greatest concentration of poverty with almost one-half or fifty per cent of the estimated 1.1 billion of the world's poor living in South Asia and fifteen per cent in East Asia.

The root cause of this persisting crisis has been the decline in the rates of economic growth since the early 1970s. It was the first oil shock of 1973 which marked the end of the 'golden age' of high and steady growth which had prevailed in the advanced industrialised countries since the end of the Second World War. It was, however, the second oil shock in 1979, and the economic response of the industrialised countries, in the form of a sharp contraction in demand and increase in interest rates, that precipitated the deep economic recession in both the advanced and developing countries. During the 1970s, a number of countries especially in Latin America and Africa had to recourse to heavy external borrowings to finance the increase in oil prices, mainly from the surpluses of the oil producing countries deposited in the world's big commercial banks. These countries now faced a drastic decrease in demand for their exports owing to the recession in the industrial world, a sharp decline in their terms of trade, a massive increase in the debt burden due to extremely high real interest rates, and a dramatic decrease in availability of external resources. This situation led to most developing countries being faced with mounting public sector deficits and untenable balance of payments situation which needed strong measures to correct. Thus started the painful process of stabilisation and adjustment which has dominated economic policy making ever since.

It is not possible to recount in detail how different countries have tried to cope with this period of adjustment. Clearly for most countries in sub-Saharan Africa and Latin America, the 1980s is rightly referred to as the 'lost decade'. In sub-Saharan Africa, per capita GNP fell by almost a fifth between 1980 and 1989 wiping out most of the economic gains since independence. The debt/GNP ratio rose to 115 per cent. Real world prices for coffee, cocoa, cotton and tea fell by 50 per cent as did levels of investment in real per capita terms between 1980 and 1989. In Latin American countries, GDP per capita was 9.6 per cent lower in 1990 than in 1980. The rate of investment fell from 21.2 per cent during 1975-80 to

17.8 per cent in the 1980s. These developments led to a drastic decrease in employment and increases in poverty levels in most countries of Africa and Latin America.

In sharp contrast the economies of South-East and East Asia continued to grow at very high rates which had not been registered elsewhere – at least not for such sustained periods of time. These economies managed to restructure mainly by taking advantage of a 'virtuous circle' of export-led and investment-led growth. Some Asian economies adopted inherently unsustainable growth strategies in the 1980, notable examples being India and the Philippines which borrowed substantially to sustain consumption-led growth. However, both India and the Philippines have managed to regain macro control and by introducing significant economic reforms, show much greater promise for sustained growth in the 1990s.

In drawing lessons from the adjustment process experience of different countries, it is important to differentiate between stabilisation and structural adjustment. Stabilisation refers to the policy measures adopted to restore macro-economic equilibrium through an orderly reduction in demand to correct the fiscal deficit and the balance of payments to sustainable levels. Structural adjustment, on the other hand, emphasises reforms in microeconomic and macroeconomic policies and institutions of the economy to enhance the efficiency of resource use as a major element of the strategy for dealing with imbalance. Stabilisation measures comprise devaluation and complementary monetary and fiscal policies, while structural adjustment places emphasis on resource mobilisation, resource allocation within the public sector, institutional reforms and the liberalisation of a wide range of markets including the capital and labour markets. It also includes deliberate steps to limit the role of the government and promotion of private sector operations including the privatisation of public owned companies and operations. This elaborate package of policies is also varied in both space and time. No two countries have exactly the same design of structural adjustment. Within any one country, the content of the package also varies over time. The 'big bang' approach to implement all the policies simultaneously is rather rare, although it was used in the Chilean case, and is being used rather unsuccessfully in economies in transition of the former Soviet Union.

The important point to note is that structural adjustment is increasingly viewed as a statement by the government for moving the economy from a less efficient to a more efficient path and from a high cost to a low cost economy. The need to emphasise the efficiency aspect has also become all the more imperative in the new context of globalisation and increasingly competitive world markets. The internalisation of production, economic liberalisation, interconnection of financial markets, freer flow of capital, technology and services across national borders are all evidence of this increasing trend towards closer integration of the world economy. Corporate strategies of multinational enterprises are being increasingly based on the premise of a homogenous world market rather than segmented national markets. Thus multinational enterprises may undertake R & D in one country, product design in another, actual production in yet another, and marketing in a fourth country. Global information networks have made it possible for different processes in the production chain to be linked worldwide and to cut down on transaction costs. Greater globalisation of the world economy has also far-reaching implications not only for the quantum but also the quality and distribution of jobs. With increasing decentralisation of operations and subcontracting across national boundaries, there is considerable dispersion of the production process. This also raises new and complex sets of issues on labour market and industrial relations.

In evaluating the experience of countries undertaking structural adjustment, we may discuss separately three critical problems that countries have had to face, namely, how they have managed demand, the kind of incentive structure that needs to be put in place to ensure efficient and equitable growth and how the social costs of transition are mitigated.

The important conclusion drawn by a recent World Bank study based on the experience of 18 developing countries during the turbulent period 1973 to 1989 is that macroeconomic stability is good for long run growth and therefore macro economic policies should be designed to stabilise real output in the face of exogenous disturbances, and to avoid the creation of unsustainable booms. Of the 18 countries studies, only Brazil and the Republic of Korea systematically followed macroeconomic policies that tended to stabilise output growth around its trend. The important message is that the Ministry of Finance should maintain control: it should know how much the public sector as a whole is borrowing, which some governments in the 1979-82 period for example, Brazil or Mexico, did not know, and what contingent obligations are being incurred through private sector borrowing. The study comes up with five basic conclusions, although it admits that these may be difficult to put into practice.

First, the Finance Ministry should cut back on spending if a crisis develops. Countries should constantly be aware that unexpected and unfavourable events will sometimes happen. Second, <u>policies</u> need to be flexible as governments need to shift gears rapidly when circumstances change. Third, <u>economies</u> need to be flexible and the more flexible they are, the less adverse the impact of the shock will be. Rigid real wages, sectorally immobile labour, and strong dependence on imported intermediate goods for domestic production all make economies less flexible and the more flexible the economy, the greater the recession when a compression of imports is required. Fourth, rapid export growth is crucial to a successful recovery. Countries should follow outward oriented policies and develop a strong and preferably diversified export base. Finally, the ability to obtain foreign aid, concessional loans or debt relief at a time of crisis – provided this is combined with strong adjustment policies, is helpful. This has certainly been true in a number of countries, notably Indonesia 1966-70, and Turkey after 1980. In contrast, the severe decline in Mexico's growth rate after 1982, is at least partly explained by the lack of such relief.

The importance of maintaining macro-economic stability cannot be denied. It is also true that stabilisation and adjustment programmes may entail social costs for the most vulnerable groups, the same costs would be much bigger in the long run if necessary adjustments are not made. The major problem however, with orthodox stabilisation measures undertaken especially in the first half of the 1980s, has been that the time frame adopted for their implementation was far too short and a more gradual approach was possible. It is now generally accepted that the major international financial institutions placed excessive emphasis on short term deflationary measures even in cases where the existing imbalances were not solely the consequences of over-expansionary fiscal and monetary policies or overvalued exchange, but as in the case of many African countries, were the result of a dramatic decline in the terms of trade.

As regards demand management, the critical problem revolves around the balance of payments. In trying to restore equilibrium, the government tries to exercise control on both demand and supply, i.e., through cutting down aggregate demand and introducing measures to make supply more efficient. The real difficulty, as the experience of most developing countries including the Philippines shows, in achieving this is that contraction of demand and increase in supply move at different rates. Sectors which need to contract often do so rapidly, while those stimulated to expand often do so only after a significant time lag. Since expenditure-reducing and expenditure switching policies are usually promoted simultaneously, these tend to reinforce output losses and generate unemployment in the short run. The way to overcome this problem, even if partially is through a balanced combination of short term and long term policies, giving a clear horizon to where policies should lead as well as the possibilities of reform in a balanced way. We have seen that in Asia the successful adjusters have been those which have framed policies in the light of their long term economic transformations.

A study by the ILO of the experience of 55 countries which received structural adjustment loans from the World Bank showed that concerning success criteria in terms of bringing down the level of external balance to more sustainable levels, restoring growth and avoiding increases in the incidence of absolute poverty, only seven countries fulfilled the absolute standard of successful adjustment. Of these seven countries, the Republic of Korea is the only unambiguous case of successful adjustment, successful management of external imbalance with continued high growth and improved social indicators. Indonesia too has achieved successful adjustment in terms of restoring growth and reduction in poverty, but real wages have stagnated at very low levels throughout the 1980s. Thailand maintained high growth and avoided increase in the incidence of poverty, but the task was made much easier in Thailand's case by a large inflow of foreign resources. China and Pakistan adjusted with undiminished growth but only with increasing inequality. Turkey and Tunisia are the only other countries which combined significant adjustment with growth, but too little is known about the effect of adjustment on the incidence of poverty and income distribution in these two countries.

An important conclusion that emerges from the ILO study is that initial conditions have important implications for the composition of the instruments in the adjustment package. Combining structural reforms with too high a level of stabilisation will not only make the task of preserving growth and protecting the poor very difficult, but also damage the prospects of structural reforms by making it hard to create public support for the reform programme.

While growth with macroeconomic stability is a necessary condition for solving the problem of high unemployment and poverty, it may not be sufficient in ensuring optimal labour absorption. To ensure that this does take place, the system of incentives must be right to uphold employment-intensive growth in the economy. Overpricing of labour relative to competing factors of production, or subsidising the use of capital through tax incentives, or overvalued exchange rates and trade policies that discriminate against labour intensive exports, must be avoided. In many developing countries, these principles have been routinely and extensively violated. The result is inadequate labour absorbing growth of the economy.

The successful experience of East and South-East Asia confirms that it is possible to undertake economic reforms in microeconomic and macroeconomic policies and put in place an incentive structure that is conducive to employment growth and poverty alleviation. A remarkable feature of the experience of the Republic of Korea was that it was able to generate significant employment growth in the manufacturing sector, an increase in real wages before agriculture shed its vast share of the labour force, and a continued improvement in the distribution of income during the period of dramatic stabilisation of macroeconomic imbalance in the 1980s.

An appropriate system of economic incentives and relative factor prices can only have the desired impact if the labour market is able to effectively respond to incentives and prices. Rigidities in the labour market can also aggravate macroeconomic imbalances and be a serious obstacle to successful adjustment. It is important therefore that interventions in the labour market be designed with care and that the structure of labour remuneration not be in gross violation of market forces. Thus, the proper role of minimum wages should be to protect the weak and vulnerable workers who are without bargaining power and this should not be used to raise the price of labour far above its social cost or to distort the structure of wages. At the same time, given the many obstacles that exist in the structure of a developing economy, systematic public intervention is required, especially investment in human capital formation, promotion of equal access to human capital and productive resources and improvements in labour market information to overcome these obstacles so that there an take place a rapid expansion of productive and remunerative employment.

For an economic incentive structure to work and lead to optimal labour utilisation in the economy it is equally important to emphasise the need for a more equitable distribution of assets. In the case of the Republic of Korea (and earlier Japan), the importance of effective land reforms clearly played an important part in increasing labour absorption in agriculture in the earlier stages of economic development. Indeed, the quest for economic efficiency and to be able to successfully compete in global markets can only be fulfilled if steps are initiated to reduce and gradually remove distortions which result in 'economic rents' above their true opportunity costs to certain sectors or certain sections of the community, whether they be in the form of monopolies or bureaucratic control, or excessively big agricultural holdings.

The East Asia experience has underscored the importance of good quality general education, availability of skilled labour and entrepreneurial talent to efficiently organise and market products. The importance of high quality education is being increasingly realised and it is felt that the problem of the educated and graduate unemployed is not only a problem of mismatch in the labour market, but the fact that they do not possess basic problem-solving skills which are an essential ingredient of good, sound education. As regards vocational training, the experience of most developing countries is not very encouraging as is seen by the high levels of unemployment amongst vocational school graduates and the low esteem which they enjoy amongst private employers. Developing countries are fast realising that for investment in vocational training to be effective it must be closely linked with real demand and in order to ensure this the private sector, the users of these skills must be closely associated with the skill training process. New strategies therefore are based on increasing industry involvement in training, through apprenticeship models, training partnership (dual schemes) with industry, levy/grant schemes, industry determination of skills standards and private sector based training.

The process of stabilisation and structural reform by its very nature entails economic and social costs. It is essential for credible structural adjustment to design a policy which will have the least harmful impact on employment, on income distribution and on the well-being of the poorest sections of society and provide 'safety nets' for those who are most adversely affected by the reform process. In Latin America, Africa and Asia, a number of social fund programmes were introduced to ease the costs of adjustment. In part, the intention was to secure political support for the adjustment programme, in part to provide direct compensation to those who had lost their jobs through retrenchment, and in part to reach the poor more generally both by creating employment and by contributing to the development of social and economic infrastructure. These interventions took a variety of forms and have been referred to as 'emergency social funds' or 'social investment funds' in Bolivia and Honduras, as a 'social recovery fund' in Zambia and elsewhere, as 'special employment schemes' for example in Chile or South Asia. A recent study carried out by the ILO to analyse the experience and effectiveness of these schemes across developing countries in Latin America, sub-Saharan Africa and rural South Asia concludes that the 'new' social funds programmes (namely Bolivia's ESF, Honduras's FHIS, Madagascar's FID, Senegals' DIRE and AGETIP, Zimbabwe's SDF and Zambia's SRP), which were largely foreign driven and financed, have in general reached only a small fraction of the poor, partly because their total size is limited and partly because of poor targeting. The study is of the view that quick disbursing, poorly targeted, add-on temporary institutions are unlikely to be able to provide effective poverty reduction in the face of structural poverty. The need to design cost-effective and well targeted 'safety nets' is therefore an important challenge in minimising the social costs of adjustment.

The ILO supports in principle structural adjustment linked to the promotion of dynamic and sustainable growth, but has consistently taken the view that whenever structural adjustment programmes are implemented, they should be approached from a broad perspective that fully incorporates the social dimension and employment promotion and lays the basis for sustainable and equitable growth and development.

From the ILO standpoint, this implies that structural adjustment efforts must emphasise the following elements:

1. Incorporating social dimensions, including social protection and strengthened institutional capacity, in the design stages of structural adjustment programmes with a view to ensuring that structural adjustment is socially, as well as economically sound.

2. Mitigating the social costs of adjustment through poverty reduction measures, most notably by designing and broadening the coverage of social safety nets, while ensuring that such measures are consistent with long term development objectives.

3. Encouraging the creation of the highest possible level of productive and freely-chosen employment in conformity with the objectives of Convention No. 122, through enterprise development, improved labour market functioning and skill development.

4. Ensuring that structural adjustment programmes are consistent with the provisions of basic ILO standards, particularly the Human Rights Conventions.