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ADJUSTMENT AND EQUITY

by

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- Adjustment does not necessarily increase poverty
- Adjusting *before* a crisis reduces social costs
- Refusal to adjust and the suspension of imports leads to *self-centred underdevelopment*, which is socially much more costly
- The choice of macroeconomic stabilisation measures is important: the same result can be obtained with *higher or lower* social costs
- Some structural adjustment measures have beneficial social effects but others, like the reorganisation of public enterprises, involve high costs
- Action by donor countries is indispensable to offset the increase in poverty linked to stabilisation measures and to the reduction of employment in public enterprises

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The word “adjustment” is by nature doomed to be unpopular because it has come to be synonymous with restrictions. Let us take the simplest example, that of a substantial fall in state revenues. The immediate response is to say that expenditure must be adjusted to income, or in more direct terms that certain types of expenditure must be slashed. On the other hand, there is never any talk of adjusting expenditure when revenues increase; this happens without any discussion and in an atmosphere of euphoria.

It is no accident that this unpopularity is concentrated on the social aspect of adjustment. In the constricting context of IMF agreements, adjustment generally results in a substantial reduction in the external deficit and the budget deficit. Since the soundness of these objectives is obvious in view of the serious external imbalances, and since these objectives are often attained, it is difficult to argue with this economic aspect of adjustment. On the other hand, the reduction in overall demand brought about by the adjustment measures results in higher unemployment and lower real wages. Since governments have to reduce excessively large budget deficits, they cut expenditure on education, health or social welfare. The removal of subsidies on food products causes a sharp increase in the prices of goods essential to the poor. Under these circumstances, criticism of adjustment understandably concentrates on the social costs. The opponents of the adjustment policy point to the rise in unemployment, the fall in wages and above all the aggravation of poverty, the poor being those most affected by unemployment, higher prices for basic necessities and reduced social expenditure. Increasing pauperisation often triggers demonstrations and even riots in the towns, and adjustment is described as the latest disaster to hit the developing countries — a disaster imposed by the international organisations and the creditor banks in total disregard of the essential needs of the people.

Initially a technical matter, adjustment becomes a key political issue. In both democratic and authoritarian countries, provided there is a certain minimum of freedom of the press and of speech, the negative social consequences of adjustment become the favourite opposition target and the government finds itself faced with a difficult choice: abandon the adjustment programme and return to uncontrollable imbalances or continue and give fresh ammunition to its opponents.

Even if we assume that the government and the coalition of interests supporting it are supremely unconcerned about the aggravation of poverty, there is no doubt that it still has a political cost, whether in the form of social unrest in poor districts or fresh ammunition for the opposition parties. Only dictatorships that prohibit any freedom of the press or of speech can avoid this cost. Because of these political reactions to adjustment policies, many governments may wish to minimise the human cost of the adjustment, even if social considerations are not normally their prime concern.

In addition, the donors, if their main aim is to improve the standard of living of the population of these countries, and in particular that of the poor, are well aware of these social costs, all the more so because they also play a role in the definition of adjustment policies thanks to their weight within the IMF.

The theme of “adjustment and equity” is therefore not just a scientific subject of the greatest interest, it is also a very important political issue, both for the governments engaged in the adjustment process and for the donor countries. This is why the OECD Development

Centre has set two objectives for the project “Adjustment Programmes and Equitable Growth”: to evaluate the real social consequences of stabilization programmes and to seek ways of reducing their costs. This evaluation appears simple enough at first sight: surely it is simply a matter of measuring the trends of certain variables such as the unemployment rate, real wages, the percentage of poor and their average income and certain social indicators such as infant mortality and school enrolment rates? This descriptive approach does not provide the answers, however, for we do not know how much of any change is imputable to the adjustment measures and how much to the imbalances and the earlier crisis.

The first objective is therefore to try to evaluate the *net* social costs of adjustment, i.e. the *gross* costs observed, less what is imputable to the preceding crisis; the second is to try to avoid, or at least minimise, any negative side effects by designing adjustment programmes better suited to the particular case.

A counterfactual analysis using a computable model has proved indispensable to achieving these objectives because this is the only method that makes it possible to study adjustment “other things being equal”. This model in fact makes it possible to estimate the net social cost of an adjustment measure, i.e. its impact when the influence of all other factors is eliminated. In addition, the model allows us to estimate the economic and social consequences of other possible adjustment programmes and thus select the most equitable. The model, in the Development Centre version or something close to it, has been applied to five countries: Côte d’Ivoire, Ecuador, Indonesia, Malaysia and Morocco. In addition, adjustment in two other countries, Chile and Ghana, has been studied in detail, though it was not possible to use a model.

Before attempting to take stock of the social consequences of adjustment, however, it is necessary to recapitulate the origins and consequences of the crisis that led to the adjustment.

Origin of the crisis

Even though we present here only a very simplified picture of the origin of the crisis, it must not be forgotten that situations vary greatly from one country to another. This means that the circumstances of the crisis have to be taken into account, because the same adjustment policies have different effects depending on these baseline situations.

To put it simply, perhaps at the risk of oversimplifying a little, we can say that the crisis resulted from the conjunction at the beginning of the 1980s of external shocks with a domestic situation that was more or less fragile as indicated already by certain imbalances. During the 1970s, the majority of the countries concerned accumulated an increasingly heavy foreign debt burden because they were financing an ever-growing share of their investments through foreign loans. After some years of domestic funding thanks to favourable terms of trade, governments maintained very high levels of investment despite the reversal of these terms. Many interest groups in these countries encouraged expanding the parapublic sector, the prime beneficiary of this investment. In addition, foreign banks offered considerable sums of money (petrodollars that they were recycling) at conditions very favourable to borrowers (very low or even negative real interest rates).

Interest payments on this debt amounted to between 6 and 18 per cent of export earnings in the countries of our sample (except for Malaysia, which borrowed only on the domestic market, and Ghana, which had no longer been able to borrow abroad since the beginning of the 1970s), and the foreign debt amounted to a year's worth or more of export earnings. Since these countries, apart from Indonesia, were not able to achieve a substantial foreign trade surplus but mostly suffered from a chronic trade deficit, they were running a sizable current account deficit (8 to 15 per cent). By 1980, therefore, many countries were already caught in the vicious circle of indebtedness, having to borrow more and more in order to pay the interest on their debt and continue to invest.

The budget deficit and inflation were also sometimes connected with this external imbalance. The deficit, to some extent due to interest payments, was substantial in Côte d'Ivoire, Morocco and Malaysia, while the inflation rate was already high in Ghana, Indonesia and the two Latin American countries.

These economies were therefore in a precarious situation — except those of Malaysia, which had few foreign debts, and Indonesia, which could pay the interest on a large debt thanks to its oil — when they were hit by two shocks at the beginning of the 1980s: on the one hand the rise in interest rates and rarefaction of international credit, and on the other a depreciation in the terms of trade. Thus the fall in copper prices in Chile, cocoa and coffee prices in Côte d'Ivoire and Ghana, rubber and other products in Malaysia meant a depreciation of about 20 per cent in the terms of trade at the beginning of the 1980s. From 1983 to 1986 Ecuador, Malaysia and Indonesia suffered the effects of the fall in oil prices. Other countries had been affected before 1980, however, such as Morocco where the price of phosphates fell as from 1978. These price falls had a more or less serious impact depending on the degree of openness of the economy. Malaysia, with exports amounting to 50 per cent of GDP, was the country most sensitive to such a shock, since a fall of 14 per cent in the terms of trade meant a reduction of 7 per cent in the foreign purchasing power of GDP and hence in the real income of this country.

Analysis of the economic situation of the sample countries at the beginning of the 1980s shows that three of them stand out from the rest: Indonesia and Malaysia, still in a healthy situation, and at the other extreme Ghana, in serious crisis ever since the mid-1970s. As Malaysia had only a modest external debt, while oil revenues made Indonesia well able to pay the interest on its debt, these two countries did not have a large current account deficit. Ghana did not have a large deficit either, but for very different reasons. Already in crisis for some ten years, this country had had to reduce its imports to the very low level of its exports as it could no longer borrow abroad, having refused to adjust. Ghana is thus a prime example of the consequences of non-adjustment: imports must be rationed increasingly in the context of a shrinking economy for the sake of a policy of self-centred “development”.

These cases show that the classic example of adjustment as a reaction to crisis is not the only scenario possible. Four countries (Chile, Ecuador, Côte d'Ivoire and Morocco), whose fragile economies experienced a crisis due to external shock, do indeed fit this pattern, but Ghana decided to adjust only many years *after* the crisis, while Indonesia and Malaysia adjusted in 1983-84, *before* the crisis. The last two countries certainly suffered external shocks, but they could still have postponed the adjustment and borrowed abroad.

It is precisely this room to manoeuvre that enabled them to adjust without resorting to the IMF and to choose the components of their stabilization programmes more freely than the other countries.

Adjustment as a response to crisis

The term *adjustment* evokes a simple image in the media, that of a country in a financial crisis (with a large external deficit and no longer able to borrow abroad) which has to accept the conditions laid down by the IMF in order to obtain new loans.

This image greatly simplifies a much more complex reality. First, the term covers two different categories of measures, one to reduce overall demand, the other to stimulate supply.

In order to avoid any confusion we shall use the term *stabilization* solely for measures concerning demand and the term *structural adjustment* for those concerning supply. Stabilization programmes respond directly to the financial crisis: demand is cut back in order to reduce or even eliminate the foreign current account deficit. These are emergency conjunctural measures which should have an impact in the shorter term, 6 to 18 months. Conversely, a structural adjustment programme concerns the medium to long term and consists of a set of measures intended to increase supply. When these measures have a cost, the World Bank sometimes grants loans to finance them. This is the case, for example, with the reduction of customs duties or with agricultural investment. It should be noted, however, that certain measures have stabilizing and structural effects at the same time; for example, a devaluation both reduces overall demand and restructures the productive sectors.

While a distinction can be made between stabilization and structural adjustment, they nevertheless follow a common logic. It is a matter of treating the same pathology with curative action in the one case and preventive action in the other. In effect, the imbalances that lead to the financial crisis are partly due to the inadequacy of domestic supply with respect to demand. Once equilibrium is re-established by the stabilization programme, the best way to avoid a repetition of the process is to increase production capacities. Moreover, the inadequate supply is partly due to inappropriate structures in the economy: for example, an inefficient and loss-making parapublic sector, overprotected industries oriented towards the domestic market, agricultural price systems that discourage production. As a result, structural adjustment is an in-depth reform of the economy to change the context in which enterprises operate. Such a reform has favourable impacts for certain interest groups, but unfavourable for others. It thus means a change in the socio-political balance of the country that is more easily accepted in the context of a financial crisis and a stabilization programme. This can be seen both in the developing countries and in the industrialised countries, as shown by the example of the stabilization and structural adjustment programme introduced in France in 1958. In this sense, stabilization and structural adjustment are linked for both economic and political reasons. The link is manifest when the IMF and the World Bank concert their intervention and persuade governments to accompany stabilization measures with structural reforms. Obviously, the introduction of the reforms is less urgent, and in any case it takes time to prepare them. This explains the time lag between the stabilization programme and the structural adjustment loans. In Morocco, for example, the World Bank

granted these loans in March 1984 and July 1985, whereas the IMF agreement was concluded in September 1983. In Côte d'Ivoire, the stabilization programme of January 1981 was followed by a structural adjustment loan in December 1981.

The shock treatment of a stabilization programme virtually always involves the same categories of measures, even if there are many variations within each category. On the one hand there are budgetary measures (cuts in investment, reduction or stabilization of operating expenditure), and on the other monetary and exchange rate policy.

In countries that adjust in response to crisis, public investment is drastically reduced. In Morocco it fell by almost 40 per cent between 1983 and 1986. In Côte d'Ivoire it fell from 21 per cent of GDP in 1975-78 to 7.5 per cent in 1984 and in Ecuador from 7.3 per cent to 4.4 per cent. On the other hand, in the two countries that adjusted before the crisis the fall in investment was fairly modest, about 10 per cent, so that public investment remained higher than in 1980 (up 16 per cent in Indonesia and 67 per cent in Malaysia). Lastly, in Ghana, since public investment had already collapsed, the adjustment made possible a revival (up from 1 per cent to 2 per cent of GDP), foreign loans' being essential to finance the import of capital goods.

For both political and economic reasons, investment is the first category of expenditure to be sacrificed in the classic case (adjustment in response to crisis). Public opinion is much less sensitive to these investment cuts than to reductions in the operating budget. Investment expenditure is in fact concerned with imported goods and public works. If the latter are reduced, those affected are small builders and construction workers, a dispersed population that does not react. If operating expenditure is cut, however, there are two strong reactions. First, it is necessary to cut the wages of public servants, which arouses their discontent, and second, there have to be cuts in education and health provision, study grants, food subsidies, etc., which provokes more or less violent reactions on the part of beneficiaries. A temporary cut in investment may also be justifiable for other reasons. The fact is that public investment increased very rapidly in the euphoria of the 1970s, in many cases far too rapidly, doubling or even tripling as in the case of Morocco. As a result, if the trend is evaluated over a period of about 20 years, public investment does not seem to have been sacrificed despite the stabilization programmes. It must also be pointed out that there had been serious errors in the choice of investment projects, so that the efficiency of public investment was very low in certain countries.

Programmes also affected operating expenditure, but not to the same extent. In certain countries — Indonesia, Malaysia, Ecuador and Chile (though here in 1986 only, with the second stabilization programme) — operating expenditure fell slightly, while elsewhere it ceased to grow. In view of the earlier rapid growth, however, this still amounted to a change of course that involved some difficult decisions.

Unwilling to reduce the services provided to households, and bound by public service statutes, governments generally do not reduce the number of public servants during the stabilization programme, and sometimes, as in Morocco, their numbers even continue to grow. As it is necessary to stabilize the payroll, however, the only solution is a reduction in real wages, which is usually achieved by the least painful method, i.e. a freeze on nominal wages. This was the policy applied in Côte d'Ivoire, Morocco and Indonesia.

Subsidies are the second category of operating expenditure affected by stabilization programmes, despite the high political risk involved, whether they be direct subsidies to the consumer or subsidies to parapublic enterprises (which means an increase in their rates). In Morocco, for example, the government removed subsidies from all food products of intermediate status, without touching those on basic products, and revised electricity, water and transport tariffs. These same prices were also increased in Chile and in Côte d'Ivoire, where the subsidy on rice was also reduced. Other types of subsidy may also be affected: in Ghana, charges for medical consultations and hospitalisation were increased, school-books had to be paid for and subsidies on student meals and accommodation were reduced. In Côte d'Ivoire, the second stabilization programme slashed the number of study grants.

Like the cuts in public expenditure, a more restrictive monetary policy is a vital element in any stabilization programme. This goes without saying in the case of the Latin American countries that suffer from chronic inflation, but all the other countries studied also resorted to monetary policy. The growth of domestic credit was reduced in Côte d'Ivoire in 1981 and in Morocco in 1983. In Indonesia, the monetary authorities reduced the growth of the money supply and freed interest rates to encourage households to increase their deposits. Lastly, in Malaysia the total money supply did not vary in 1984 and 1985, whereas it had previously been expanding by over 10 per cent a year.

The same applies to exchange rate policy: all the countries able to do so devalued their currencies. Chile carried out a series of devaluations that reduced the real exchange rate by 10 to 20 per cent each year, while Ecuador, after a major devaluation in March 1983, announced a series of mini-devaluations equivalent to 3 per cent a month. Indonesia devalued twice, in 1983 and 1986, after each fall in the oil price, while Malaysia allowed its currency to depreciate in 1985 and 1986 so that the real effective exchange rate fell by 30 per cent in two years.

Since Ghana was in a very particular situation (considerable overvaluation of the official exchange rate with a very active parallel market on which foreign currencies were traded at over ten times the official rate), drastic devaluations were necessary: the dollar rose from 2.75 cedis at the beginning of 1983 to 90 cedis in January 1986.

The only country that did not devalue was Côte d'Ivoire, and this was because it belongs to the franc zone. This problem was partly alleviated by three devaluations of the French franc between 1981 and 1983. There was a particular constellation of circumstances here: since the French franc is tied to the German mark, countries of the franc zone have lost all hope of a devaluation of the French franc and hence of the CFA franc. What is more, these devaluations of the French franc had no impact on trade between Côte d'Ivoire and France, its biggest trading partner.

While stabilization programmes always pursue the same single objective, structural adjustment is more diversified because the measures or reforms to be implemented to increase supply vary according to the economic structure: the programme must deal with problems specific to the country concerned. For example, privatisation of part of the parapublic sector makes sense if this sector is large and inefficient, but not if it plays only a minor role.

Despite the diversity of structural adjustment policies, a comparison of the different programmes shows that they are all inspired by the same philosophy: the value of the *liberalisation of trade*, both domestic and foreign, and in some cases that of the privatisation of parapublic enterprises to increase the efficiency of the economy. This philosophy guides both programmes designed in co-operation with the IMF and the World Bank and those of countries like Indonesia which acted independently.

At home, the liberalisation of trade is intended to establish true prices and eliminate parapublic monopolies in both agriculture and the non-agricultural sector. A policy aiming at true agricultural prices would not have made any sense in countries like Indonesia, Malaysia and Chile where agriculture was already governed by the market, but it was introduced in Morocco, Côte d'Ivoire and Ghana, where there were very great price distortions. In Morocco and Côte d'Ivoire, producer prices and the prices of certain subsidised inputs (fertilizers, water), were raised simultaneously. In addition, parapublic monopolies were eliminated: in Morocco, those on fertilizer sales, seed production and sales, and agricultural exports; in Côte d'Ivoire, the processing and sale of rice. It was in Ghana that this policy caused the greatest change: the price of cocoa was multiplied by seven to bring it up to the world price level, and some of the activities of Cocobod, which had the monopoly of cocoa collection, processing, transport and export were taken away from it and privatised. In all three countries these different measures were aimed at the same objective, re-establishing true prices, as the privatisation policy is a way of liberalising prices through eliminating monopolies.

A similar policy was pursued in the non-agricultural sector. The biggest reform was in Ghana, where the state had been fixing most prices since 1972: all prices except those of eight commodities were freed in 1985. In Morocco, on the other hand, a market economy had been retained but many prices were controlled. In the context of the structural adjustment all price control was abolished for 60 categories of goods. In addition, this country embarked on a policy of financial liberalisation, as did Indonesia where credit rationing and soft loans were eliminated and a capital market was developed.

The second component of structural adjustment programmes, more important perhaps in its effects, is the liberalisation of foreign trade, which in the longer term induces a restructuring of the entire economy. All of the countries studied introduced measures to promote exports, quite apart from the devaluations which had the same aim. In addition, they opened up to imports. The two most significant examples, though for different reasons, are Ghana and Morocco. Since Ghana had cut itself off from the outside world and strictly rationed all imports, this reform of foreign trade was a decision of major importance: quotas were eliminated for most goods and customs duties were reduced to moderate levels. As for Morocco, this country is a perfect illustration of the new policy, as it received the first World Bank structural adjustment loan aimed specifically at financing the liberalisation of foreign trade. Morocco abolished all export duties and export licence requirements. In addition, it abolished import quotas and put a ceiling of 45 per cent on import duties. The other countries pursued similar policies: Côte d'Ivoire eliminated quotas and at first reduced duties (subsequently, it raised them again); Indonesia reduced duties to a maximum rate of 60 per cent instead of 225 per cent and eliminated import licence requirements for many goods.

In three countries (Morocco and above all Côte d'Ivoire and Ghana) where parapublic enterprises dominated the modern sector, privatisation policies were introduced for several reasons: to liberalise trade, reduce the budget deficit (partly caused by these enterprises) and increase the efficiency of the modern sector. In addition, the parapublic sector was reformed through the gradual elimination of subsidies, reduction of the workforce and limiting of access to bank credit. This list of measures shows that the vital issue is not privatisation as such, but management according to market economy rules.

In this sense the development of a market economy may be considered the common objective of all structural adjustment measures. In addition, certain stabilization measures follow the same logic. Devaluation may be interpreted as an operation aiming at true prices, given the earlier overvaluation of the currency: the exchange rate is adjusted to its market equilibrium value. Similarly, reducing certain categories of public expenditure to eliminate a budget deficit financed by monetary expansion or obliging parapublic enterprises to operate like other enterprises are measures that impose on the public sector the same rules observed by private enterprises in a market economy.

Incomes and poverty during adjustment: each country has its own history

This title is intended to dispel two illusions. The first is to imagine that it is easy to evaluate the impact of adjustment on incomes and poverty, that it suffices to follow the evolution of various indicators and attribute the changes to adjustment. This is impossible in practice, as three sets of factors are at work: the adjustment measures, the preceding crisis or difficulties and long-term factors such as population growth. The pedagogical role of the macro-micro model applied to five of our sample countries is precisely to help us interpret the trends by referring to these various factors simultaneously. The second illusion is to think that the same trends in incomes and poverty will be seen in all countries. The detailed study of each case shows the diversity of national experience. The first reason for this is connected with the absence of any systematic relationship between adjustment and growth, since it is the latter that largely determines the trend in the number of poor and the intensity of poverty. Although adjustment is generally thought to be associated with recession, this hypothesis is not confirmed by our sample countries. If we compare the GDP growth rate in the two years following the adjustment with that in the seven years preceding it (a longer preceding period was chosen to avoid the bias of the effects of the crisis before adjustment), we see that in three countries the growth rate was lower after adjustment, in three others it was higher and in Morocco it remained virtually the same.

a) Employment trends

Since the trend in primary incomes (i.e. the incomes of the factors of production) partly depends on the employment of these factors, we first need to review briefly the employment situation. A major risk often imputed to adjustment is that of unemployment, and in fact urban unemployment often does increase during the adjustment period. On the other hand, the employment situation in rural areas generally does not deteriorate.

The fall in employment in the formal non-agricultural sector causes both higher unemployment and an expansion in informal sector employment. As can be seen, the trend in employment is but one aspect of the problem. The fact is that unlike the developed countries, all the developing countries have a large informal sector. Since in the long term the increase in labour supply is greater than that of the formal sector's labour demand (regardless of problems of crisis and adjustment), this disequilibrium gives rise to a dual labour market in which two sectors, one formal and the other informal, pay different wages to unskilled labour. There is thus a permanent excess of job demand as compared with formal sector supply, and many of those unable to find work here turn to the informal sector since they cannot remain unemployed for long in the absence of any unemployment benefits (among the seven countries studied, Chile is the only one where such benefits exist).

In most cases, stabilization programmes, by damping demand, slow modern sector employment growth or even reduce its volume, as happened in Côte d'Ivoire. A slowing of employment growth in countries where the urban labour supply is growing very rapidly due to the combined effect of several factors (population growth, internal migration) inevitably leads to increased unemployment and the expansion of informal sector employment. In Morocco, for example, the annual increase in the labour supply exceeded 5 per cent during the adjustment period. In these circumstances a slower rate of employment growth in the formal sector (though still over 1.5 per cent) both increased by half the number of unemployed and increased informal sector employment. In Indonesia too, growth of formal sector employment fell below that of labour supply. In Ecuador the rate of growth of employment in industry (a substantial part of the modern sector) fell from 9.1 per cent (1975-80) to 1.7 per cent (1982-86), a much lower rate than that of urban labour supply (about 5 per cent), which explains the increased unemployment and greater recourse to jobs in the informal sector (a survey in Quito in 1987 showed that there were more people underemployed in this sector than there were unemployed overall).

The most serious case was that of Côte d'Ivoire, where modern sector employment did not just grow less rapidly, but fell. Employment in the formal private sector fell by one-third (enterprises having made large numbers redundant instead of reducing wages), and this could not be compensated by the small increase in recruitment into the administration. The overall result was that unemployment more than doubled and informal sector employment increased by 60 per cent. Without this refuge, the number of unemployed would have tripled. This serious deterioration is partly explained by a factor quite independent of the adjustment: the 1983 drought, which made many people leave rural areas and thus accelerated the increase in urban labour supply despite the adverse economic conditions.

These situations reveal the existence of a structural problem before the adjustment: it is very difficult to achieve employment growth rates of the order of 5 per cent a year in the non-agricultural formal sector to match the increase in the urban active population. It is thus obvious that any policy that reduces overall demand puts this objective quite out of reach. In certain cases, however, the revival was not long coming. In Chile and Morocco employment started to grow again in 1986, and in Chile the unemployment rate in 1987 was below that recorded before the crisis.

In this connection we may ask whether one of the factors that made governments finance investment through foreign loans at the expense of current account equilibrium was not this strong pressure of urban labour supply. This leads to a vitally important question:

how is it possible to respect macroeconomic balances while at the same time achieving growth rates in the non-agricultural formal sector high enough to increase employment durably by 5 per cent a year? Admittedly we know of certain exceptional cases of accelerated growth, but in other countries with less rapid growth employment could not be increased at this rate, and the aggravation of unemployment during the adjustment period merely revealed an already-existing problem that had been concealed by the external financing of investment.

This depressing picture for the non-agricultural sector contrasts with a more satisfactory trend in agriculture: agricultural employment grew as fast as, or even faster than (as in Morocco), the active population. This is explained by two factors: first, the stabilization programmes had a rather favourable impact on agriculture (through the devaluations, increases in producer prices and the liberalisation of trade) so that they did not reduce labour demand; second, labour supply in rural areas increases less rapidly than in the towns.

b) Trends in incomes

The same contrast between the agricultural and non-agricultural sectors is seen in incomes: the trend was positive in the former, often negative in the latter. The analysis needs to take account of total incomes, however, whereas attention is usually concentrated on wages, which represent only a small proportion of agricultural incomes. In addition, most of the people in the low-income active population are not wage earners.

The exaggerated attention paid to wages is explained by a common bias: as in the developed countries, wages are the incomes about which we know most. In the formal sector, a distinction needs to be made between the public service and private sector employees. The stabilization programme often causes a fall in the real wages of public servants for the reasons pointed out above. This was the case in Côte d'Ivoire, Morocco and Chile, but there were exceptions: Indonesia, where the purchasing power of public servants was maintained, and Ghana, where it increased. These exceptions correspond to adjustments carried out before or after the crisis. Indonesia adjusted early enough for the budgetary restrictions to be moderate, while at the opposite extreme, the real wages of public servants in Ghana had fallen by two-thirds between the crisis and the adjustment, so that an increase was essential. These two counter-examples thus confirm that a fall in public service wages is very likely in the case of classic adjustment, i.e. adjustment following a financial crisis.

In the private sector as well, income trends varied from country to country: a drop in Morocco, sharp falls in Chile and Ecuador, but stability in Côte d'Ivoire and even rises in Indonesia and Malaysia. Here again the timing of the adjustment played a role. Since the two Asian countries adjusted before the crisis, the impact of stabilization on production and hence on formal sector labour productivity and wages was attenuated. As for Côte d'Ivoire, the downward adjustment of demand was achieved solely through reduced employment, with very many redundancies, whereas the average wage did not fall.

Little is known about trends in the incomes of formal sector enterprises. Except in Malaysia where real wages increased more than labour productivity, the wages/profits ratio seems to have evolved in favour of profit, or at least remained stable as in Chile. This would

mean a net fall in profits in Malaysia and Chile (where they probably fell as did the average wage), but not in the other countries. However, the adjustment period had very varied effects for entrepreneurs in all countries: some, often the majority, gained, while others suffered losses or went bankrupt because of the liberalisation of imports (as shown by a survey in Morocco) or, in the case of construction enterprises, because of the cuts in public investment.

Owing to the nature of the informal sector, our knowledge of incomes here is obviously very inadequate, but the expansion of employment in this sector resulting from the stabilization measures no doubt exerted strong downward pressure. The fact is that in this sector production depends on the numbers active in it because capital plays a negligible role. As a result, the increase in the number of people in the informal sector and in its production potential, at a time when overall demand was reduced by the stabilization programme, must have caused prices and incomes in the sector to fall, since the adjustment between supply and demand was made through prices in this case. This was observed in Ecuador, and it is what the model indicates for Côte d'Ivoire and Morocco. This phenomenon is important because the majority of people active in this sector are classed among the urban poor. On the other hand, once economic growth revived, as in Morocco in 1986 (GDP up 8.4 per cent), the average informal sector income probably returned to its pre-crisis level.

By contrast, the trend in agricultural incomes during the adjustment should generally be favourable, for several reasons. First, production is stimulated by certain adjustment measures, notably devaluation, which boosts agricultural exports and increases the price of tradable goods with respect to that of non-tradables. Second, the governments of some countries increased producer prices (Morocco, Côte d'Ivoire, Ghana). There was indeed a favourable trend in most of the countries studied, but this was not due entirely to the adjustment; exogenous factors also played an important role. Thus good rains in Morocco in 1985 and 1986 and the drought in Côte d'Ivoire in 1983 caused the trend to be respectively more favourable and less favourable than that due to adjustment alone. These exogenous factors in some cases preceded the adjustment: in Indonesia it was not the adjustment measures but the big rural investment programme during the 1970s that led to increased productivity of agricultural labour during the adjustment period. If we look at the overall picture, we see that in all the countries studied except Ecuador average agricultural incomes increased over the period. The only counter-example confirms this conclusion: in Ecuador the small farmers do not export and a substantial proportion of their resources comes from the non-agricultural sector. It was the fall in these resources that caused the fall in their average income. Certainly this encouraging picture was partly due to exogenous factors (good rains in Morocco, earlier investment in Indonesia and Malaysia), but even in the countries where the exogenous factors were unfavourable because of drought, average incomes still increased slightly (Côte d'Ivoire) or substantially (Ghana).

c) Trends in the standard of living

The standard of living of households depends not solely on their primary incomes, but also on the services provided free by the state and on transfers, both private (emigrant workers' remittances) and public (subsidies on goods, aid given to individuals). The situation of the poor is particularly dependent on services and transfers, which constitute

a higher share of their real incomes than is the case with other households, and these are directly affected by stabilization measures: budget cuts may reduce service provision or public transfers, while a devaluation may stimulate emigrants' remittances, as was the case in Morocco.

We therefore need to determine the trend in these secondary incomes (services and transfers) before trying to draw any final conclusions on the trend in the living standards of different categories of household, and in particular poor households, during the adjustment period.

The most delicate problem, because of its political repercussions, is that of removing subsidies. The image most generally given by the media is that of rioters' protests against stabilization programmes because the prices of essential foodstuffs or of transport, water, etc. have increased by 50 per cent or 100 per cent overnight.

A comparison of the policies of the different countries with respect to subsidies shows government caution in the face of this risk. In most cases, either the subsidies are maintained or certain cuts in them are compensated by new types of aid. Thus in Morocco only subsidies on products of intermediate rank were eliminated, with the result that per capita food subsidies, in constant dirhams, did not fall between 1982 and 1985. In addition, the state provided various forms of aid to poor families (food allowances for mothers, meals in school canteens and jobs on public works projects in rural areas). Aid was not diminished during the adjustment period and was even increased in some cases (number of free meals up 15 per cent). In Ghana, the system of subsidies in favour of the poor was completely changed. The government had established a compensation policy during the 1970s: employees in the modern sector (i.e. working for the state, and parapublic enterprises) accepted low wages because the state maintained food prices at a low level through subsidies. Since there was a shortage of goods on the official market, however, public servants (who were served first) resold part of these goods on the black market. This system of subsidies was abolished but was compensated for by several targeted food aid programmes in favour of the poorest groups. The case of Ecuador is interesting because of its contradictions: President Cordero was elected in 1984 with a neo-liberal programme which was opposed to subsidies.

He did in fact reduce the subsidies on inputs and certain agricultural products, but when the economic difficulties gave rise to widespread unrest, Cordero reintroduced subsidies by financing public works in rural areas, notably in the coastal region which was his electoral base. As for Chile, the government reduced unemployment benefits, but stepped up aid to the poorest sections of the population through a programme for the distribution of food to pregnant women and children under six, and for free meals in school canteens. Côte d'Ivoire is the only example of a country that cut subsidies without any compensation: rice subsidies were reduced and transport, water and electricity prices were increased, which affected fairly poor urban families more than the very poorest or the comparatively well-off.

Since expenditure on education and health services accounts for the greater part of social expenditure, we shall limit discussion to these two fields. In both cases it is necessary to distinguish between expenditure and services, because while stabilization measures concern expenditure, a family's standard of living depends on services. A simple example suffices to illustrate this distinction: if, to obtain a 10 per cent reduction in education expenditure, a government cuts teachers' salaries by 13 per cent (assuming that salaries

make up 80 per cent of total expenditure), households receive the same services as before the adjustment. Obviously, the repetition of this measure will eventually reduce the quality of teaching and hence of the service provided, but this negative effect does not appear to any significant extent if the measure is taken only once. The history of education and health services during the adjustment leads to the conclusion that expenditure is often affected by stabilization programmes but service provision to households much less so.

Social expenditure was reduced in several countries: per capita expenditure on education and health was reduced by 11 per cent and 5 per cent respectively in Morocco, by 29 per cent and 35 per cent in Ecuador and by an average of 20 per cent in Chile. In Indonesia, expenditure remained stable during the first two years, not falling until 1986, and then only slightly. Lastly, in Malaysia this expenditure continued to increase during the adjustment period. There is a sharp contrast between the two Asian countries, where social expenditure was maintained, and the two Latin American countries, where its share was reduced in a budget that was itself shrinking.

Under the circumstances, it goes without saying that the services provided to households in Indonesia and above all Malaysia continued to develop, but other countries too were able to avoid cuts in services by reducing wages. In Morocco, for example, enrolments in secondary education increased by 22 per cent and in higher education by 29 per cent between 1983 and 1986. If primary school enrolments fell by 10 per cent, this was due not to a reduction in supply, since the number of primary teachers increased by 14 per cent, but rather to a demand effect. Similarly, the number of medical staff per capita and the number of medical examinations in public health services rapidly increased, notably in rural areas. The same policy of cutting wages enabled Côte d'Ivoire to achieve a slight increase in secondary school enrolments, compensated by a slight fall in the primary cycle, despite a sharp reduction in per capita expenditure on education. In both Côte d'Ivoire and Morocco this fall in primary enrolments was connected with the adjustment even though it was not due to a reduction in the education supply. The fact is that parents, notably in the most disadvantaged category, are less inclined to send their children to school as they see no point in it if schooling does not lead to a job in the modern sector. The long-term consequences of this reduction in primary schooling are nonetheless regrettable since the productivity and incomes of the young people concerned will be affected for several decades.

In conclusion, we can draw a general picture of the trend of living standards, including those of poor families, during adjustment. The findings of household consumption and income surveys in 1984 and 1987 for Indonesia and Malaysia, together with our data on transfers and social services, indicate a rise in living standards or at least stability (for urban households in Malaysia) during the adjustment period. On the other hand the standard of living fell considerably in Ecuador, except for the big farmers who just about managed to remain at the same level. In Chile, it would appear that the standard of living of the richest households (less than 10 per cent) and the poorest (less than 10 per cent) was maintained, while there was a significant deterioration for the rest. In Morocco and Côte d'Ivoire the situation depended on the region. In Morocco the standard of living of rural populations certainly improved during the adjustment, while it at least remained stable in Côte d'Ivoire. There was a definite fall in towns, however, notably in Côte d'Ivoire where in addition to a bigger fall in primary incomes than in Morocco, there was a fall in secondary incomes that was avoided in the North African country. Lastly, in Ghana there was a significant

improvement in the living standard of rural households, while that in the towns seems to have remained stable because the gains and losses cancelled each other out. It must be remembered, however, that this favourable outcome in Ghana is based on comparison with a pre-adjustment situation that was catastrophic.

d) The trend in poverty

The evolution of poverty is connected with that of living standards, as one would expect. In the two Asian countries poverty diminished both in quantity (i.e. the percentage of poor in the population) and in intensity (i.e. the ratio between the sum of the differences between the incomes of the poor and the poverty threshold and the sum of all incomes). In these countries the majority of the poor live in rural areas and it is above all the investment policy of the 1970s that explains this improvement in the lot of the poor farmers. The adjustment also contributed, however, through the devaluations; the liberalisation of trade, which improved the terms of trade for agriculture; and the maintenance (or even increase in the case of Malaysia) of social expenditure.

In Morocco, there was a definite improvement in rural areas, but a probable deterioration in the towns. For the poorest farmers, little involved in the market economy, it was the weather that played the major role. In the towns the deterioration is explained by the doubling of the number of unemployed and a fall in informal sector incomes. While public transfers to the poor were not reduced, neither were they increased. On the other hand, emigrants' remittances, rapidly growing thanks in part to government measures (devaluations, special high-interest accounts), were able to improve the situation for many people.

In Côte d'Ivoire, poverty was mainly concentrated in the savannah and eastern forest areas. On the basis of the price trend for products in these regions and our information on household expenditure we can assume that poverty remained stable there during the adjustment, while it significantly increased in Abidjan owing to redundancies, the fall in informal sector incomes and the cuts in subsidies on basic necessities. The situation in Ghana was somewhat different because of the catastrophic aggravation of poverty during the 1970s. In rural areas the adjustment brought an improvement, but it is difficult to judge what happened in the towns. Certain adjustment measures affected the poor while the Programme of Actions to Mitigate the Social Costs of Adjustment (PAMSCAD) improved the standard of living of the most disadvantaged.

There was a definite aggravation of poverty in the two Latin American countries. In Ecuador it involved both the rural areas (because of agrarian structures that obliged the poor to seek resources in the non-agricultural sector) and the towns. Chile is a special case because the majority of its poor live in the towns. In this case the increase in unemployment was the main reason for greater pauperisation, though targeted measures in favour of the poorest prevented any fall in the standard of living of this group.

This overall picture of poverty shows that we must be very cautious when using social indicators to evaluate the effects of adjustment. Thus in Chile and Ecuador, the infant mortality rate and life expectation continued to improve during this period. In Chile, this phenomenon is perhaps explained by the targeted measures, but it is more difficult to understand in Ecuador. In Côte d'Ivoire as well, as these two indicators improved, and

calorie consumption remained stable despite a significant aggravation of urban poverty. This leads to the conclusion that certain indicators are not very sensitive to short-term economic fluctuations and that the statistics used for other indicators are not very reliable.

The dangerous illusions of non-adjustment

The history of a number of developing countries shows that the temptation not to adjust is very strong. At the end of the 1970s these economies, like Côte d'Ivoire and Morocco, were enjoying credit-fed growth at the price of ever more serious imbalances. An increasing proportion of public and parapublic investment was financed through foreign loans. Under these circumstances, only a boom in the price of export commodities could have prevented the crisis. Why did these countries postpone adjustment while Indonesia and Malaysia took the decision as soon as serious imbalances appeared?

It is certainly possible to give an answer in economic terms: until the crisis, governments were hoping for a reversal in the terms of trade that would save the situation. Since Indonesia and Malaysia stand out in our sample by the quality of their economic management, we may ask whether this quality is not linked to their attitude to the future, and whether both are due to one and the same cause: the progress of economic rationality. In this sense, the reluctant adjusters' pushing on with the same policies regardless of the consequences would show little risk aversion despite the cost of failure in a relatively poor country, while the prudent behaviour associated with greater risk aversion appears more reasonable in view of the level of development.

It is also possible, however, to interpret this blind continuation in political terms. The regime of growth on credit made it possible to reconcile rapid growth (and hence an adequate supply of jobs despite the rapidly growing urban population) with the interests of influential groups. If the state wanted to finance the investment through savings it would have to tax high incomes heavily and reduce operating expenditure, and hence public service salaries, thus arousing the hostility of the middle income and rich classes. What is more, handing investment over to the private sector would bring political disadvantages by reducing the influence of public servants and of the party in power. In fact, the investments financed by foreign loans benefited above all the parapublic enterprises under government control and involving many interests (in terms of declared or undeclared incomes and influence). These political considerations combined with the responsibility of foreign banks, which, as we have seen, were offering large amounts of capital at very favourable terms for borrowers, encouraged continuation of the policy which brought the banks substantial short-term benefits.

If the first temptation is to postpone adjustment, the second is to refuse it when the crisis actually comes. This is often the reaction of opposition parties who accuse the government of bowing to IMF demands when there are other solutions that seem preferable. It is thus essential to explode this myth by demonstrating the cost of these alternative solutions.

The first solution, obtaining political aid, is possible only for a small country and is costly in terms of national independence. The aid given by the protector country has its price (access to military bases or a vote in international organisations, for example). A country

that has exhausted the normal possibilities for loans and refuses to resort to an IMF loan, often condemned in the name of nationalist sentiments, may thus bargain some aspects of its national sovereignty against external financing.

The second solution is to adjust by using a single instrument, the exchange rate, without applying a stabilization programme. This policy uses the floating exchange rate with automatic adjustment of this rate to balance the external account, but without any budgetary or monetary measures to reduce the macroeconomic imbalances. In the first place this policy is not possible unless there is a fairly developed financial market where foreign currencies are traded, which is not the case in many developing countries. Second, this option excludes other stabilization measures, which means that the overall policy is less effective, as demonstrated by the simulations for the case of Ecuador.

The third solution is that of the hard-line opposition: the country has to break off negotiations with the IMF and ration imports to preserve its independence. This measure leads to a sort of forced adjustment: imports are compressed to a point where the country has the trade surplus needed to repay its debts and stop borrowing. Another variant is to refuse to pay the debt and to adjust imports to export earnings. This strategy automatically converts the economy to the “self-centred development” model often advocated by the opposition members most hostile to any adjustment programme. This is precisely the policy adopted by Ghana and we have already seen the very heavy costs involved: fall in per capita incomes, reduced cash crop production, reduced exports and imports, sharp fall in real wages and farmers’ incomes. As a result both the number of poor and the intensity of poverty increased. The experience of Ghana, like that of other countries which followed the same path, agrees with the predictions of the macro-micro model’s simulation of non-adjustment for Morocco. The rationing of imports would have enabled Morocco to eliminate the current account deficit rapidly, but at a very high price: lower per capita incomes, a sharp fall in industrial production and investment directly linked to the rationing, and a considerable aggravation of poverty. What is more, this rationing creates rents for traders, so that inequality is also aggravated. Control of the marketing of imported goods avoids this perverse effect, but experience shows that a parallel market also develops, bringing other disadvantages and abuses. As can be seen, a better name for this strategy would be “self-centred recession”. In view of the systematic criticism aroused by any stabilization programme, we really need to refer to experiences of non-adjustment. The fact is that the history of countries that have pursued the same policies as Ghana leads to the conclusion that this strategy always has high social and economic costs. It is therefore necessary to focus the policy debate on adjustment by dispelling any dangerous illusions about a possible “self-centred development” that would make it possible to avoid adjustment. In practice the debate is generally distorted because the comparison between adjustment and this other solution is made by enumerating the costs of adjustment, mixed up with the costs of the crisis that preceded it, and totally ignoring the cost of non-adjustment. If we want to institute a more valid debate we must compare the intrinsic costs of each policy, excluding the effects of the crisis.

The advantages of anticipated adjustment

Once a country decides to stabilize, the timing of measures is a very important question since the conditions and social costs of the adjustment depend on it. While it is recognised that anticipated adjustment has undoubted economic advantages, the social advantages of this decision are generally forgotten.

The political and economic advantages are obvious. Politically, the government is not obliged to negotiate with the IMF in a context of crisis and thus admit to errors of management. By acting independently, the government probably stands a better chance of having the stabilization plan accepted by public opinion (unless it prefers to have the IMF take the blame). Certainly the costs in terms of growth and investment are only shifted in time, but they are slightly attenuated because the imbalances to be corrected are not so great.

The biggest advantage, however, is a reduction of the social costs of the adjustment, as shown by the examples of Indonesia and Malaysia and the simulation of anticipated adjustment in Morocco. The two Asian countries managed to reconcile adjustment and equity better than any of the others partly because they adjusted before the crisis. In the first place the imbalances were less serious, so that the reduction in overall demand was less drastic. This had several social consequences: as trends in job supply were more favourable, there was no sharp increase in unemployment or expansion of the informal sector (which would have meant pauperisation in this sector), and there was no fall in real wages (they actually rose by 9 per cent in Malaysia between 1983 and 1987). In addition, the budget cuts were less drastic than if these countries had waited for the crisis. This enabled Malaysia to increase per capita education and health expenditure during the adjustment and Indonesia to maintain the same level of expenditure, at least during the first stabilization plan of 1984-86. The simulation of adjustment in Morocco in 1981 rather than 1983 confirms the advantages. Of course, the social costs are transferred, with more unemployment and poverty in 1981 and 1982, but the increases are less than those actually observed in 1983 and 1984. In addition, the reduction of the budget deficit is so great that the government could have compensated for the increase in poverty by transfers while still substantially reducing this deficit. In this scenario, therefore, the poor would have been much better off in 1983-84 without having had to pay the price in 1981-82.

When we compare the history of Indonesia and Malaysia with that of the other countries, we see that a major advantage of anticipated adjustment was that it guaranteed a substantial and continuing flow of foreign capital *before and during* the adjustment period, whereas in countries that adjusted after a financial crisis this flow was interrupted for a year at least, if not several years. This capital made possible a less drastic reduction of public expenditure, maintained growth and also averted a fall in private investment. These advantages had very important social consequences: there were no sharp cuts in social expenditure and the maintenance of investment had direct effects on employment in the construction industry, which employs much unskilled labour. Conversely, where countries postponed adjustment as long as possible, the flow of foreign capital was cut off for several years before an IMF loan could be obtained, leading to very adverse social consequences.

In view of the substantial advantages of anticipated adjustment, we need to know what prevents it. There are several factors that lead to postponement of adjustment. The first is a matter of public opinion, which initially prefers the advantages of indebtedness to the

costs of adjustment, while the government goes on hoping that the tide will turn, that a sudden increase in export prices will solve all the problems. The media can play a role in changing these dangerous attitudes by making known the experience of other countries that adjusted during a crisis period — or after as in the case of Ghana — and showing the cost of this delay. It is also necessary to develop national statistical services and create economic monitoring systems independent of the government: frequent reports from these institutes would show the growth of imbalances, alerting public opinion and preparing it for stabilization measures.

Several measures are desirable from the political standpoint. The first is to guarantee government stability. Respect for democratic rules is entirely compatible with institutions that ensure the duration of a government for four or five years, whether the country has a parliamentary or presidential regime. This would remove one motive for postponing the adjustment: politicians tend to think they will no longer be in power when the financial crisis actually arrives. This is a rational calculation for a politician: he builds up a stock of popularity by pursuing expansion at the price of growing indebtedness and hopes to capitalise on this later, once his political opponents have made themselves unpopular by carrying out the adjustment. Rules such as Indonesia's requirement of budget equilibrium can also play a role. In addition, laws guaranteeing the independence of the central bank can prohibit the monetary financing of a budget deficit and make it more difficult to postpone adjustment. Admittedly, such laws can have a destabilizing effect if they are suddenly imposed, but it is possible to introduce them in stages to avoid this risk.

Lastly, it is necessary to prevent certain groups from having a kind of veto that allows them to prevent adjustment. The unlimited right to strike granted to public servants and workers in certain key sectors (energy, transport, mining in a country where foreign currency earnings come mainly from minerals) enables these interest groups to block certain adjustment measures. If a democratically elected government embarks upon anticipated adjustment and reduces the real wages of public servants, the blocking of this policy means that, in order to protect the incomes of wage-earners in the modern sector, the adjustment is postponed at the price of greater social hardship and measures that will affect the poor.

How to stabilize at minimum social cost

Whether the decision to stabilize is taken before or after the crisis, it is always desirable to stabilize at the lowest social cost. Stabilization measures are not neutral; this is obvious in the case of budget cuts that affect subsidies or social services, but it is also true of other measures, including purely macroeconomic ones such as monetary or foreign exchange policies.

We have applied very similar macro-micro models to five countries with different structures, and certain constants can be seen despite this diversity: certain measures are always preferable to others in terms of equity. This does not mean, however, that it is possible to stabilize using just one measure, the best. There are in fact various threshold effects: while a limited reduction in public service wages may have more favourable effects than some other measure, a cut of 50 per cent would reduce many public servants to poverty, make people refuse to work and seriously affect the quality of public services. The

comparison of measures is intended not to single out the best one but to guide selection of the optimal mix of measures such that, for the same stabilization effect, any other combination would entail higher social cost.

Despite these reservations, it appears that certain measures should be avoided. Increased indirect taxes and the dismissal of public servants, for example, have negative effects: reduction of GDP, increase in the number of unemployed and of people in the informal sector (which reduces average incomes in this sector) and immediate cuts in health and education services.

In contrast, two measures have a social impact more favourable, or at least less unfavourable, than the others: devaluation and a moderate reduction in public service wages. Devaluation favours labour-intensive industries and agriculture. It reduces inequality because the price of agricultural exports increases while real wages in the modern sector fall if they are only partially indexed to the cost of living. Since farmers are better off, they buy more from the informal sector (moreover, they devote a greater share of their resources than other categories to informal sector goods), so that average incomes in this sector increase. In addition, since the share of imported goods in household consumption increases with income and urbanisation, devaluation has very little effect on poor rural households. This optimistic evaluation needs to be qualified: devaluation is desirable only if small and medium farmers produce for export and if monetary policy prevents the economy from being caught in an inflationary spiral.

In many countries a moderate reduction in public service salaries is also desirable in view of the place occupied by public servants in the income hierarchy. This measure reduces inequality, has no significant effect on poverty and costs less in terms of growth than do other budget cuts. The advantage is particularly clear if we compare it with a reduction in rural investment. The latter measure immediately affects workers and entrepreneurs in the construction industry in rural areas, who are often poor, and in the longer term it reduces the productivity and hence the incomes of farmers. However, it is much easier for a government to reduce these investments than to reduce public service wages, so that there is a contradiction between the objective of equity and that of political feasibility.

When the number of unemployed young people in the towns is very high and likely to increase with the stabilization plan, it is desirable to combine this reduction in public service wages with the recruitment of young unemployed people at very low wages. This labour can be used for work that has a direct impact on the standard of living of the poor (the installation of proper drainage, transformation of shanty towns, etc.). This measure thus makes it possible to reduce poverty while both combatting unemployment and improving the living conditions of the urban poor.

On the other hand, a cut in public investment (the measure preferred by governments, as we have seen) has both immediate and long-term costs. It immediately reduces the activity of the construction industry, which employs low-income labour. In the longer term it reduces the productivity of private investment and hence growth, thus affecting the entire population. Cutting rural investment has negative consequences for small farmers, as demonstrated by the counter-examples of Indonesia and Malaysia. This assessment does not condemn the policies pursued by many countries. When public investment has doubled or tripled, cuts are inevitable, but they should not apply to rural investment, which can reduce inequality and poverty.

In view of the immediate effects on the construction industry and the longer term effects on growth if investment is reduced too sharply, it is preferable to make only a moderate reduction in investment combined with a reduction in operating expenditure, though it is necessary to take care if negative social consequences are to be avoided. The fact is that certain *ad hoc* measures produce only moderate savings at very high social cost. For example, the poor can no longer receive hospital treatment if they have to pay for medicines, even if the hospital does not charge them for care and equipment.

Having thus assessed the effects of budgetary policy and exchange rate policy, we now turn to monetary policy. According to the simulations, a more rigorous monetary policy is relatively neutral in its effects. For example, a more restrictive policy reduces the average income of each group in roughly the same proportion. Although this neutrality means an aggravation of poverty that is avoided with devaluation it is still preferable to the negative bias of other measures such as increased indirect taxes or the dismissal of public servants. What is more, a restrictive monetary policy has a favourable effect on the distribution of wealth. The fact is that the majority of the urban poor have only cash while rich households possess mainly real assets and often invest part of their money either in foreign currency or abroad. As a result, poor households are much more affected by the erosion of the value of money through inflation. By accelerating inflation, devaluation increases the inequality of wealth, while a restrictive monetary policy reduces it.

This summary of the advantages and disadvantages of each type of measure leads us to conclude that the best programmes combine devaluation, a restrictive monetary policy and a moderate reduction in public service wages (if these have not already been slashed, as was the case in Ghana). Certain types of investment can also be cut, in particular if, before the adjustment, investment was badly managed and expanding very rapidly. However, investment projects that increase the productivity of small farmers should be maintained. Similarly, cuts in operating expenditure should not be made in bureaucratic fashion but should take account of the social impact of each measure. Lastly, if a government wants to minimise the social costs of adjustment there is a direct and efficient method: pay compensation to the poor affected by the stabilization measures. We estimated that the amount of such transfers required to avoid any aggravation of poverty in Morocco and Ecuador would have been 1.5 per cent and 4 per cent respectively of total household incomes. This sum is not negligible in view of the budgetary crisis in these countries at the time of adjustment. It would therefore justify foreign aid, which could be envisaged by donor countries since it would only last two or three years (in Morocco, compensation was no longer needed as from 1986 because poverty had by then returned to the pre-adjustment level).

Advantages and social costs of structural adjustment

It would appear that structural adjustment is easier to implement than a stabilization programme: the effects often appear only after several years and certain measures such as financial liberalisation or administrative reform seem to be neutral. There is no denying, however, that other measures may give rise to serious conflict and have an immediate impact. The liberalisation of agricultural prices immediately increases farmers' incomes,

whereas a reform of the parapublic sector may cause thousands of redundancies. It is therefore necessary to evaluate the social consequences of the usual measures and see how a structural adjustment programme needs to be tailored to meet the requirements of equity.

In agriculture, the introduction of true prices is often favourable to farmers, in particular small farmers who use proportionally fewer inputs. It eliminates producer price control, which is a way of creating an agricultural surplus to finance investment in the non-agricultural sector. Price liberalisation may be disadvantageous to small farmers, however, if they are buyers because their holdings are very small or if export crops are grown exclusively by the big landowners. In this case, a change in agrarian structures should accompany this policy of liberalising prices and developing exports in order to rebalance agricultural commerce to the benefit of small farmers. In addition, stabilizing mechanisms are desirable in the case of wide price fluctuations on international markets.

In the non-agricultural sector price liberalisation has quite opposite effects: higher prices for the consumer, but greater availability of goods. Where official prices are very much lower than free prices, many goods are rationed and consumers have to buy on the parallel market at very high prices, higher than those charged after liberalisation. The effect of liberalisation on the standard of living of households thus depends on the proportion of goods they buy on the official and parallel markets. The impacts of other measures such as financial liberalisation are always favourable, however, since the cost of capital increases with respect to the cost of labour, thus stimulating labour-intensive activities.

The liberalisation of foreign trade is the most important aspect of structural adjustment. What are the social consequences of this opening up of the economy? On the import side, the elimination of quotas and the reduction of customs duties affects owners of over-protected and inefficient businesses and their employees, who are in the medium or upper income brackets. The liberalisation exerts downward pressure on the price of manufactured goods, which improves the terms of trade between the agricultural and non-agricultural sectors to the benefit of farmers, reducing poverty in all countries where the majority of poor are small farmers. On balance, liberalisation is thus rather favourable. This assessment is confirmed by the findings of a study of protectionism in some 20 countries, which shows that protectionism significantly increases inequality and reduces by 20 per cent the average income of the poorest 60 per cent of the population by 20 per cent.

The development of exports, which is the complement to this policy of openness to the outside world, also has favourable social consequences, at least under certain conditions. The increase of agricultural exports by small and medium farmers has immediate and long-term effects on income distribution and poverty: it gradually eliminates the reserve of very low-productivity labour in rural areas, and when the process is completed, as was the case in Taiwan in the 1970s, the non-agricultural sector has to grant big wage rises to unskilled labour, which diminishes both inequality and poverty. This mechanism does not work if exports come only from the big farms, so in this case a change of agrarian structures is justified, as we have seen. The growth of export industries also has a favourable impact because these industries are labour-intensive.

Another structural adjustment measure has a high social cost: restructuring the parapublic sector through privatisation or reforms that bring this sector into line with the private sector entails mass redundancies. The larger the parapublic sector and the worse it is managed, the greater the social cost of structural adjustment. These new unemployed

will probably not find jobs immediately because the export industries need time to develop and frequently do not use the same type of labour as the parapublic sector. This justifies compensation programmes financed by the World Bank, as for example in Ghana, to help these people become self-employed or set up as planters.

Lastly, structural adjustment has two favourable effects. First, certain liberalisation measures bring a net social gain, benefiting some individuals without causing losses to any. Second, structural adjustment in some cases increases the flexibility of the economy. The costs of a stabilization plan in terms of unemployment and poverty are lower in a flexible price regime than when modern sector prices are fixed. Thus structural adjustment, if it contributes to price flexibility, reduces the possible social cost of stabilization resulting from new imbalances. It therefore appears to be on the whole more equitable than the preceding structural framework. In some cases, however, certain supporting measures are indispensable: to develop the agricultural exports of small and medium farmers, for example, or to compensate those made redundant in the parapublic sector.

What donor countries can do

Donor countries can play an important role in diminishing the social costs of adjustment, whether it takes place before or during the crisis.

In view of the advantages of adjusting before the financial crisis, donor countries should first of all do their utmost to persuade governments to take immediate action. If governments postpone adjustment, they do so because the balance of the political costs and benefits seems to favour postponement rather than anticipated adjustment. The aim of the donor countries should therefore be to modify the political balance, and hence government preference, in favour of anticipated adjustment. For example, the temporary offer of substantial aid to compensate certain groups' losses due to the adjustment would be an effective means of persuasion. Second, donor countries could offer free insurance against exogenous shocks (deterioration of the terms of trade or drought, for example) during the adjustment. This insurance would finance the compensation for the cost of these shocks if they should appear. The offer, valid for only a few months, would stimulate action by providing security for any country adjusting before the crisis.

In the case of crisis, donor countries have two ways of reducing the social costs of a stabilization programme. The first, available to the IMF when it prepares the programme with the authorities of the country concerned, is to seek the optimal combination of measures to minimise social costs. This is surely preferable to applying standard programmes to different countries. The fact is that since each country has its own specific characteristics, a special study needs to be made in each case to determine this best mix. This requires statistical information that is often lacking and possibly the use of instruments such as macro-micro models to evaluate the effects of alternative policies.

The second way of reducing social costs involves the donors directly. Seeking the optimal programme in terms of equity in no way guarantees its political feasibility. In fact, the optimal programme and the politically feasible one are often contradictory. It is here that the role of bilateral donors may be decisive: by financing certain compensation transfers, they can make the most equitable programme politically feasible.

Donor countries are thus called upon to finance two types of transfer, one to compensate for the aggravation of poverty that may be associated even with an equitable programme, and the other to compensate for income losses suffered by other households (classified as being above the poverty level) that form a political obstacle to the programme. It should be noted that certain deliberately non-targeted transfers may achieve both objectives. One example is that of free meals in primary and secondary schools. If the aim were to aid only the poor, free meals would be limited to primary schools in poor districts, but by extending the measure to other districts and to secondary schools, the government aids the middle classes and in particular public servants. If the latter have suffered wage cuts because of the stabilization programme, their opposition will be reduced by the provision of free meals for their children.

As we have seen, transfers to compensate for the increased poverty amount to 1.5 per cent to 4 per cent of GDP. If we add transfers of a political nature in favour of other groups, the total may reach 2.5 per cent to 5 per cent of GDP. Given the crisis situation, the state cannot finance such sums. Only donor countries can resolve this problem, which means a real effort on their part. It would thus be perfectly justified if they made the objective of equity one of the conditions for the provision of loans or grants, in order to be sure that the recipient country does everything possible to minimise the social costs of the adjustment. Since it is contradictory to increase debt through social intervention in the case of financial crisis, grants are preferable to loans. What is more, this is the formula that allows the best control over the funds. If the stabilization programme succeeds, the burden of these grants should not last more than three or four years. In this respect, substantial but temporary aid appears preferable to permanent flows of limited aid. These grants to avoid the aggravation of poverty are all the more justified since there are threshold effects. Beyond a certain point, poverty has irreversible effects even if the situation of poor families subsequently improves. This is the case with the malnutrition of young children, which affects their physical and mental development and hence their productivity as adults. Thus temporary aid may prevent the most hard-hit groups' being condemned to poverty for decades.

As regards structural adjustment, donor countries have two responsibilities. The first is to control the social consequences of opening up the economy. As we have seen, stepping up agricultural exports has different effects depending on whether small and medium farmers are involved. If donors grant loans for export crops, they should make this conditional upon the use of part of the loan to open up new land to small and medium farmers, because the reduction of inequality and poverty in rural areas depends on the development of this group.

The second responsibility concerns certain countries only: those where there is a large parapublic sector. The combination of mass redundancies with stabilization measures threatens to create an explosive situation in the towns. It is therefore necessary to finance a kind of safety net for the urban populations affected by these measures during a more or less long period of structural transition. This particular restructuring operation has a high social cost, and if donor countries do not provide the required aid, there is a risk of serious unrest and the abandonment of adjustment where there is no policy alternative. The development of programmes like PAMSCAD in Ghana, which combined emergency measures (food aid) with redeployment measures (installation as a craftsman or planter, acquisition of a qualification), is a challenge for the donors because of the cost and above all the technical difficulties involved in developing and implementing such programmes.

This means that donor countries have to resolve a serious problem for which they are not historically responsible, but if they fail, the future of these developing countries will be compromised for many years.

After our analysis of adjustment it is clear that, contrary to what many people think, adjustment is not an inevitable social disaster. If there is a real political will to adjust without making the poor suffer the consequences, then concerted action by the government, the international organisations and donor countries can reconcile adjustment with the stabilization of poverty and a reduction in inequality. This requires determined action as soon as the threat of financial crisis appears: action to introduce adjustment early rather than postponing it as long as possible, action to choose the optimal mix of stabilization measures, action to accompany the structural adjustment by corrective measures, and finally action by donor countries to compensate for the effects of increased urban unemployment and a fall in informal sector incomes.

Adjustment policies compatible with equity do exist, while others entail very high social costs. This lack of determinism raises the problem of the social conditionality of aid. Donor countries have two reasons for imposing such conditionality on governments: to avoid the aggravation of poverty and to ensure the lasting success of an adjustment which is essential, but which could be compromised by social explosions caused by increased poverty.

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