CHAPTER – I

INTRODUCTION

Background :

This chapter tries to explain the factors that led to the emerge of International Monetary Fund and the manner in which it functioned upto August 1971 when the USA had to give up the convertibility of dollars into gold. With this development, the system of stable foreign exchange rates also came to an end. With the substantial increase in the price of crude oil by the OPEC countries, first in 1973 and then again in 1979, the non-oil developing economies experienced severe deterioration in their balance of payments condition. At the same time, the movement of private capital flows acquired increased significance. The OPEC countries placed their deposits with the private commercial banks of Europe and America, which in turn used them to give imprudent loans to the African and Latin American countries. The IMF and the World Bank also expanded their credit lines for the developing economies. They also advised the borrowing countries to adopt economic stabilization and structural adjustment programme, requiring these economies to change their foreign trade and foreign exchange rate policies as well as fiscal and industrial policies in the management of domestic economies. These new policies were supported by the theoretical edifice that came to be known as New Political Economy of Development with its advocates and critics bringing out the strengths and weaknesses of these policies. Large number of developing economies in the world today have adopted these policies and their economies have been integrated into the World economy.

The world economy came to be integrated in a unique manner under the international gold standard that worked quite smoothly during the last quarter of the 19th Century and the first quarter of the 20th century. The Pound Sterling was at the centre of this financial system and the foreign exchange rates among the important currencies remained stable – often called rigidly stable – with narrow movements between the upper gold point and the lower gold point determined by the shipping cost of gold between the trading countries. The foreign exchange rates between the U.K. and the U.S.A. was £1 = $ 4.87 during the heydays of the working of the gold standard system and could fluctuate between £1 = $ 4.84 and £1 = $ 4.90. Another significant effect that the gold standard carried with its working was to restrict the change in the money supply in the economy on the basis of the availability of gold, which in turn was influenced by the surplus or deficit in the balance of trade of a country. A country having a surplus in the balance of trade would experience inflow of gold, its Central Bank will have to bring about monetary expansion and this in turn would lead to price rise. The opposite set of effects will be experienced by the country having a deficit in the balance of trade. The international financial system under the gold standard thus was to ensure that no country would permanently be able to accumulate gold or lose gold.

This system worked smoothly up to the beginning of the First World War but broke down during the war years and by 1918, the foreign exchange rates came to be determined by the purchasing power parity instead of gold parity. The interwar years 1919 to 1939 came to be marked by chaos in the foreign exchange rates and the great depression between 1929-1932. England decided to go back to the gold standard in 1925 at the existing price of gold i.e. without devaluing its currency. There was an interesting debate between Winston Churchill who was Chancellor of exchequer and John Maynard Keynes. Churchill was strongly opposed to the devaluation of pound sterling and desired that England remained on the gold standard with its currency pound sterling being used as the reserve currency by the rest of the world. Keynes on the other hand argued that the gold standard had outlived its historical role and that rigidly stable foreign exchange rates were not in the economic interest of the world economy and to go back to the gold standard without devaluing pound, which was already overvalued, would be disastrous for the British economy in particular and the world economy in general. The economic events since 1925 have proved Keynes right. With the overvalued pound, the British economy went on having deficit in its balance of payments year after year and the huge outflow from the pound sterling began on the presumption that it will have to be devalued. The pound reserves held by the Central Banks, other financial institutions and the firms outside England were much larger than the monetary gold stock with the Bank of England. England left the gold standard in 1931 and the pound was devalued. This was the end of the gold standard system and also of the rigidly fixed foreign exchange rates. The devaluation of the pound was followed by the devaluation of the dollar in 1933, and another major world currency Franc, was devalued in 1936. The devaluation cycle of the 30's left the foreign exchange rates among the major currencies unchanged – they came back to the level at which they were in 1931. However, all major currencies were devalued in terms of gold and as a result, the price of gold went up, increasing the value of the monetary gold stock with the Central Banks of the different countries of the world. Even after 1936, the foreign exchange rates remained highly volatile, producing harmful effects on the volume of the world trade and world prosperity. From 1939 the Second World War started and it was not possible to take any corrective action for the world as a whole. However, lot of thought came to be devoted to the economic problems that the world would face after the Second World War was over. As early as 1942, John Maynard Keynes put forth his ideas for the post war world economic order in the form of three memoranda in response to the invitation by Walter Funk, the German Economic Minister. His first proposal related to the creation of the International Clearing Union. It was a Central Bank of the Central Banks with its own currency to assist the member countries in meeting their balance of payments difficulties. This institution would impose a penalty and proceeds of a tax on such countries were to be used for the international buffer stock operations in primary goods. The second proposal related to a fund to be created for the reconstruction of the war ravaged economies of Europe. His third proposal related to a commodity buffer stock to be operated by an International Trade Organization whose responsibility would be to maintain and operate the buffer stock of primary goods with an objective of providing stability to their prices. The buffer stock operations were supposed to be anti-cyclical in nature and the International Trade Organization was expected to make purchases when the world price of the primary (agricultural) commodities fell and to resort to sale of these commodities when the prices were quite high.

By the end of the Second World War, England emerged as a debtor country, with large part of her industrial empire having been liquidated in order to be able to pay for the massive war effort. Keynes could successfully negotiate a loan for the Government of England from the USA Government and this significant event marked the beginning of medium term and long term loans given by the Government of a lending country to the Government of a borrowing country.

The Bretton Woods System :

At the Britton Woods Conference most of the points contained in the Keynes' plan were not accepted and the American plan also known as the White plan could get practically all its salient points included in the final draft. The International Monetary Fund (IMF) began its working with a resource base of \$ 8 billion as against \$ 25 billion suggested by Keynes. Each member country was to be given its quota of subscription depending upon its share in the world trade. As the USA had 25% share in the world trade, its subscription was fixed at $ 2 billion and had 25% voting power. Next to follow were the U.K. and France with their subscription fixed at 12½% of the total which came to be $ 1 billion each. Thus, these major trading countries of the world were to subscribe 50% of the total resource base and between them controlled 50% of the total voting power. A member country suffering from a temporary deficit in its balance of payments would approach the Fund and borrow (draw) a short term / medium term loan. On the other hand, a member country suffering from a persistent balance of payments deficit would be allowed to devalue its currency. A member country was required to subscribe 25% of its quota in the form of gold and remaining 75% in the form of its own currency. Thus, the IMF could benefit in the constitution of its resource base only from the subscription made by the countries like the U.S.A., the U.K., France etc., as the currencies of the large number of countries had no worthwhile use for the Fund as the deficit countries would like to borrow from the IMF only in the form of the dollar, the pound sterling and franc. Thus, the resource base of the IMF came to be crippled further. A member country could borrow (draw) from the IMF up to first 25% of its quota unconditionally. However, it would be allowed to borrow next 25% and then next 25% and the next 25% of its quota conditionally. The first part of borrowing is also sometimes known as gold tranche borrowing and the second category of borrowing has come to be known as credit tranche borrowing. The conditions stipulated by the Fund to a member country have also come to be known as conditionalities and under the impact of the dominant economic thinking of those fateful years, they were in the nature of demand management policies.[1]

In other words, a country having a deficit in the balance of payments should bring about a contraction in the total spending and bring down the rate of inflation. Other things remaining same, this would encourage exports and help the economy to restore equilibrium in its external account. That, such a policy would also lower the rate of growth of the economy and might lead to unemployment was not overlooked, but was regarded as a price that a deficit country should be ready to pay. Moreover, a deficit country would not be required to devalue its currency and the IMF would thus be able to promote its objective of keeping the foreign exchange rates stable. Since most of the economies of Europe and Japan together with number of underdeveloped countries had deficit in their balance of payments in the years succeeding the end of the war, and the USA alone had massive surplus, the IMF agreed to the devaluation of practically all major currencies vis-à-vis the dollar in 1949. The USA agreed to the inclusion of the scarce currency clause which implied that a country having a persistent surplus in its balance of payments could be declared by the IMF as a scarce currency country and as a result of this, other member countries would be free to take measures restricting imports from such a county- a measure to which the IMF would not agree under normal conditions. Moreover, it was also agreed

[1] Kennen Peter B, The International Economy, second edition, Prentice Hall of India, 1989, P. 411-412.

that the IMF would take its decisions either with unanimity and failing that with 85% majority vote which implies that any proposal before the Fund to which the USA does not agree, cannot be passed.

The USA took two major decisions from the inception of the IMF in 1946 one of which had significant implications for the working of the international financial system under the IMF. The USA declared that its currency dollar was convertible into other currencies. However, by the time the second world war ended, no other currency in the world was convertible. In view of this, convertibility of dollar remained only on paper and had no practical significance. Secondly, the USA declared that the dollar was convertible into gold at the international price of gold, i.e. 1 ounce = $ 35 (This is called Troy ounce which is equal to approximately 28 grams). Under the international gold standard, the pound sterling was convertible into gold at the price of gold prevailing then. While the pound sterling continued to function as reserve currency under the Bretton Woods System, its relative importance had become quite insignificant. On the other hand, the dollar now emerged as the dominant reserve currency which came to be held as liquid reserves by many countries of the world. The international liquid reserves were held by the member countries in the form of (a) monetary gold stock (b) currency reserves in the form of dollar and pound and a few other currencies and (c) borrowing from the IMF under gold tranche and credit tranche. In the initial years of the working of Bretton Woods System, the IMF did not give loans to the member countries as it did not have prior experience of this kind of activity. Total monetary gold stock of the world as a whole was placed at $ 40 billion, valued at the international price of gold of which 60% i.e. monetary gold stock of the value of $ 24 billion was held by the Federal Reserve System alone and the remaining stock of monetary gold was held by the other member countries. Moreover, the dollar reserves held by the Central Banks, other banks and firms outside the USA amounted to $ 3 billion. Under such conditions, it was possible for the USA to convert dollar reserves held by other countries into gold and the dollar reserves came to be regarded as a preferred reserve asset by the rest of the world for obvious reasons. It is easier to make financial transactions with dollars than with gold and the dollar reserves held by the member countries would also earn some interest. In view of this, the importance of dollar as a reserve currency went on increasing. No country approached the IMF with a proposal to declare the dollar as the scarce currency as the USA undertook massive Marshal Plan under which it gave huge loans to war devastated economies of Europe and Japan at concessional interest rate. Under such a situation, there was no need to resort to borrowing from the IMF by the member countries.

Within ten years of the end of the Second World War, the European economies and Japan recovered in a miraculous manner from the destruction of their capital assets and started growing quite rapidly. However their stock of international liquid reserves – dollar reserves – was completely exhausted and they were in need to have more dollar reserves. In fact, late forties and early fifties marked the time which experienced dollar shortage and for a while, it was widely feared that the world economy would experience dollar shortage for a long time to come. However, this kind of prognosis of the world economy was disproved. The USA went on sustaining deficit in its balance of payments and thus went on providing dollar reserves to the rest of the world. This was an interesting situation under which the USA had huge surplus on the balance of trade showing its irrefutable comparative cost advantage. In fact, while Great Britain had surplus in the balance of payments for one hundred years – 1815 to 1914 i.e. from the end of Napoleonic wars to the beginning of the first world war, the USA enjoyed an unbroken spell of surplus in the balance of payments from 1893 to 1969 and it is this one single important fact that made England the capital exporting country in the 19^{th} Century – the USA benefited from the capital imports from England during its early phase of economic development and made the USA the dominant capital exporting country in the 20^{th} Century. From the middle of the fifties, while the USA continued to have a huge surplus on the balance of trade, and also a huge surplus on the current account of its balance of payments, it lent to the rest of the world larger amount than its surplus on the current account, thus showing an overall deficit in its balance of payments. Thus, by sustaining an overall deficit in its balance of payments, the rest of the world could accumulate the dollar reserves they needed to be able to maintain the stability of their foreign exchange rates. However, this arrangement suffered from an inherent internal contradiction of a serious dimension. As the world economy would grow and the individual economies would expand, their need for international liquid reserves would also increase. As the world gold stock would not increase because the relative price of gold became less and less attractive as other prices could grow – even when the inflation rate was very moderate in the USA between 1946-1965, on the other hand, the price of gold was fixed under the Bretton Woods agreement at 1 ounce = $ 35, and as a result of this, the production of gold by the gold producing countries became less profitable. Thus, the international liquid reserves could not expand from this source. Similarly the borrowing by the member countries from the Fund did expand, but at a negligible rate. Thus, the international liquid reserves could expand only through the increase in the dollar reserves, which in turn, could increase only if the USA went on sustaining deficit in its balance of payments on an overall basis. Again, as the European economies and Japan recovered from the destruction inflicted upon them by the Second World War, some of these economies notably France and Switzerland asked for the conversion of a part of their dollar reserves into gold. Thus, the USA, that had monetary gold stock of the size of $ 24 billion in 1948, went on losing it slowly and by 1962 the world economy had reached a stage where the USA's gold stock had comedown to $ 15 billion and the dollar reserves outside the USA had risen to $ 12 billion, and by 1965 the situation had reached a point where the USA's gold stock had come down to $ 12 billion and the dollar reserves outside the USA had increased to $ 15 billion, making it clearly impossible for the USA to convert dollars into gold. As the USA's currency – the dollar – was held as the reserve currency by the rest of the world, it could not devalue its currency and with the passage of time, the dollar clearly became overvalued. As long as the USA had surplus on the balance of trade, it could resist the devaluation of the dollar. However, the US economy witnessed a deficit in its balance of trade for the first time in 1970, its resistance to devaluation of the dollar weakened and finally in August 1971, America declared that its dollar was no longer convertible into gold and it imposed 5% import duty to protect its balance of trade. Meanwhile, some countries had already moved to a system of floating foreign exchange rates. The IMF tried to keep the major currencies on stable foreign exchange rate system with wider bands than before within which the foreign exchange rates could fluctuate and the world was brought back on the system of stable exchange rates without the convertibility of dollar into gold by the USA – a significant feature of the original IMF system. Thus, in December 1971, the dollar was devalued in terms of many major currencies of the world. However, the US balance of payment situation remained weak and the pressure on the dollar continued. The dollar had to be devalued again in March 1973 – second time within a short span of 15 months, again currency realignment took place but this proved to be short lived and the dollar also started floating. With this, the system of stable or pegged foreign exchange rates was replaced by a system of floating or flexible foreign exchange rates.

Special Drawing Rights (SDRs) :

Meanwhile, another development had taken place in the second half of 1960's. On the one hand, the USA was finding it difficult to maintain the convertibility of dollar into gold and a two tier system of convertibility was established in April 1968 under which the USA agreed to convert only official dollar holdings into gold and refused to convert the privately held dollar holdings into gold. The IMF introduced a new reserve asset called the special drawing rights – SDRs – from January 1969. The dollar and the gold acted as the reserve assets so far but both of them had obvious disadvantages. The dollar holdings constituted an asset for a country that acquired them, but these holdings represented liability for the USA. Similarly, the production of gold depended on the economic policies of the gold producing countries of the world and as a result, the monetary gold stock of the world as a whole had remained more or less stagnant at $ 40 billion since the inception of the Bretton Woods System in 1946. SDRs on the other hand marked a net increase in the reserve assets of a country to whom they were allotted by the IMF, without signifying corresponding increase in the liabilities of any one country. If anything, it signifies increase in the liabilities of the world as a whole. The SDRS were allotted on the basis of the share of a country in the subscription to the resource base of the IMF and the allocation of the SDRs obviously turned out to be biased against the developing countries of the world. The IMF created and allotted $ 9 billion in 1969 over a period of three years – i.e. $ 3 billion each in 1969, 1970 and 1971. Then the further creation and allocation of the SDRs was discontinued. It was again taken up in 1979.This time the IMF created and allotted $12 billion – i.e. $4 billion each in 1979, 1980 and 1981 and since then, further creation of SDRs has been discontinued, with the IMF holding a view that there is no shortage of liquidity in the international monetary system.

Oil Price Increase :

Thus, on the one hand, the world switched over to a system of floating foreign exchange rates in March 1973, a significant development took place in the later part of the year in the form of a four fold increase in the price of crude oil by the OPEC countries. Under the initial impact of the oil price rise, the balance of payments situation in both the non oil producing developed as well as developing countries was thrown out of gear. The economic growth for the world as a whole slowed down considerably and the USA showed a deficit in its balance of payments as well as negative growth rate in 1975. The developed countries reacted to this crisis by increasing the price of the manufactured goods and consequent increase in the price of exports of their goods to the developing countries as well as to the OPEC countries. The non oil producing developing countries were not in a position to react in a similar manner and their balance of payments situation worsened year after year, raising their burden of external debt. The OPEC countries as a group benefited from this oil price with there current account surplus mounting to $ 105 billion in the year 1975. This gave rise to the phenomenon of petro dollars with huge dollar denominated deposits getting placed with the European and American banks in turn making loans to the developing countries whose dependence on the private borrowing went on increasing culminating in the banking crisis of the world as a whole in 1982 with Argentina declaring its inability to honour its external commitment. The weakness of the uncontrolled private flow of capital from the European and the American commercial banks to the borrowing countries of Asia, Africa and Latin America, already deep into balance of payments deficits, was finally exposed. The banking crisis of 1982 had the potential to throw the world economy into chaos and recession and these dangers were averted by the timely and effective intervention by the IMF which gave loans to Argentina to help it to tide over the financial crisis of its own making, while the world at large heared a sign of relief. The action taken by the IMF has been an object of criticism in some quarters holding the view that the IMF intervened to protect the financial interest of the American and European banks which were guided by narrowly conceived profit motive while lending recklessly to the countries hit by the balance of payments deficits.

Economic Stabilization and Structural Adjustment Programme :

It was in this type of economic environment characterized by balance of payments deficits in large number of non-oil producing countries, growing external debt burden of the developing economies and surcharged by economic disorder and uncertainty that the twin Bretton Woods institutions – the International Monetary Fund and the World Bank – conceived and implemented the economic stabilization and the Structural Adjustment Programme. To begin with, the economic stabilization programme aimed at correcting balance of payments deficit and high inflation rates prevailing in the countries hit by the oil price rise and other external and internal stocks. Moreover, the IMF would help countries to implement certain policies to achieve the broad objectives of the economic stabilization programme and would also extend the necessary loan facilities to bring their deficits in the balance of payments to sustainable level, if not remove them completely. This programme was expected to be completed within a period of three to five years during which the country would undertake a set of deflationary policies – essentially expenditure reducing policies – which would reduce deficits in the balance of payments as well as inflation rates but would also exert a contractionary impact on the growth rate and employment.

Once the objectives of the economic stabilization programme are realized, the country would be required to undertake the structural adjustment programme which will be quite comprehensive touching wide range of economic policies such as fiscal policy, banking policy, foreign trade policy, industrial policy, agricultural policy to mention only the leading areas. In nutshell, the overriding objective of the structural adjustment programme is "to make the state small" or in other words, to reduce the role of the state in the management of the economy and to expand correspondingly the role of the private economic agents or in the more popular language of the private sector in practically all walks of a nation's life including the social sectors like education and health. This programme obviously has a long term connotation and would need more than a decade or two and under some conditions even longer to achieve the objectives of this programme.

Writing on "Structural Adjustment Policy in Developing Economies", Bela Balassa writes, "Structural Adjustment Policies may be defined as policy responses to external shocks carried out with the objective of regaining the pre shock growth path of the national economy. Regaining the growth path, in turn, will necessiate improvements in the balance of payments following the adverse effects of external shocks, since a country's balance of payments position constrains its economic growth.

The above definition reflects the importance of external shocks which developing economies have experienced in recent years. In the first half of the seventies, these shocks included the quadrupling of oil prices in 1973-74 and the world recession of 1974-75. Over the next several years, the developing economies will have to adjust to approximately 160 percent increase in oil prices since 1978.

A broader definition will also include adjustments to internal shocks which may find their origin in inappropriate policies, such as the excessively expansionary fiscal measures taken in Mexico after 1972 or in political events, such as the April 1974 Revolution in Portugal. Just as external shocks, internal shocks adversely affect economic growth and the balance of payments, requiring the application of structural adjustment policies.

The expression "Structural" in the definition reflects the need for discrete, as compared to marginal, changes in policies in response to discrete shocks. Responding to these shocks will also necessitate a re-ordering of priorities as well as reconsideration of policy instruments.[2]

What is suggested here is that among the set of policies to be undertaken to tackle the problem arising out of external as well as internal shocks, the highest priority is to be given to the growth objective and the income distribution objective will get a lower priority, because rapid economic growth is necessary to enable a developing economy to take up the poverty reduction programmes. Again, if such an economy is to find itself on the pre shock growth path, the poverty alleviation measures should place emphasis on measures that raise the productivity of the poor rather than increase consumption through the provision of public services and government subsidies. This would also imply that the developing economy will have to maintain a higher rate of investment by raising the share of investment in the national income. Further, it is often argued that the time taken by developing countries to complete the economic stabilization programme would depend on the specific case. However, a developing economy would ordinarily take four to five years to find itself back on the pre shock growth path.

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[2] Balassa Bela, Structural Adjustment Policies in Developing Countries, World Bank Staff working paper No. 464, 1981, P.1.

I. G. Patel provides an extremely lucid and comprehensive idea about the structural adjustment. According to him, "The term structural adjustment no longer refers only to a stable macro economic framework with excess demand and inflation under control and major distortions in key prices, such as the exchange rates or interest rates and prices of wage goods and labour, removed. There is now general agreement that it should embrace an appropriate set of micro economic policies as well. They should include less reliance on government control and public ownership and more on individual initiative and signals from the markets, incentives by way of moderate tax rates, a less discriminatory and more transparent set of rules and regulations to the extent required, greater integration into the world economy and above all, the creation and maintenance of a competitive environment conducive to greater efficiency and resilience.

But the Gaborone conference was also clear that, structural adjustment even so widely defined, greatly abridges the policy agenda. Economic growth or development requires going beyond this to positive steps to stimulate savings and investment, to develop human resources, as well as control population growth and to prevent the degradation and destruction of natural resources to mention just the important things. Participation of the people and concern for the poor are not luxuries but essential ingredients for the success and sustainability of any sensible set of policies. Structural adjustment, development, social justice and environmental protection have all to proceed side by side and in the real world, countries have also to reckon with uncertainty and shocks whether external (oil prices) or internal (crop failure). Adjustment to unfavourable shocks and factors is as much a part of the policy agenda as are sustainable growth or social justice or financial stability and a competitive environment. While all important objectives have to be pursued and means wielded, it is not possible to do everything at the same time. Priorities have to be set and policies and programmes have to be phased appropriately – a point made most forcefully by Mr. Boarman of the IMF. There are some sequences that one can confidently recommend. For example, it would be suicidal to liberalize imports extensively unless a substantial degree of macro economic adjustment had already taken place, excess demand had been greatly reduced and realistic exchange rates and interests rated were in place".[3]

We can observe some important shifts in the manner in which the term "Structural Adjustment" has been understood. In the early 1980s, it encompassed only economic parameters with emphasis on correcting balance of payments deficits and reducing inflation rates through reduction in total spending, thus causing an adverse impact on growth and employment in the short run. Reduction in total spending in an economy would generally be achieved through reduction in expenditure on social sectors like education and health. This central proposition of the structural adjustment programme is not stated with the same degree of bluntness in the early 1990s. Apart from the existing concern for reduction in the balance of

[3] Patel I. G. (ed) Policies for African Development (from the 1980s to the 1990s), International Monetary Fund, 1992, P.3.

payments deficits and containing inflation rates, there is a perceptible shift in favour of issues like social justice and environmental degradation. This seems to have happened because of the failure of the structural adjustment programme in many developing countries. It failed because the macro economic imbalances were quite sizeable and could not be corrected with the amount of external financing provided by the international financial institutions. Again the conditionalities attached to such financing were so rigidly interpreted that some deficiency in fulfilling them somewhere during the time taken, for the correction of macro economic imbalances led to underfunding of the programme creating wide spread cynicism that underfunding of the structural adjustment programme is worse than no funding at all. By mid-1980, the IMF's policies and programmes came under criticism for failing to encourage economic growth. In fact, it was argued that the fund policies of economic stabilization tended to cause a slow down in economic activity, increased unemployment and a general worsening of living standard among the countries that approached the Fund for financial assistance in the wake of a severe balance of payments crisis.

Mohsin S. Khan and Malcolm D. Knight undertook a comprehensive survey of the available empirical studies that directly examined the relationship between the Fund policies and economic growth. According to them, the main patterns to emerge from the survey can be summerised as under :

(a) The tighter monetary and credit policies would result in a fall in the growth rate in the first year after they were implemented.

(b) If monetary and credit restraint took the form of a reduction in the flow of credit to the private sector, the private capital formation and possibly the long-run rate of growth would be adversely affected.

(c) There is some evidence that supply side policies, particularly policies to increase producer prices and the domestic interest rates, have favourable effects on production and savings.

(d) A number of studies could find a close relationship between growth rate and capital formation.

(e) The devaluation of a domestic currency, on balance, would produce an expansionary rather than contractionary effect on domestic output, even in the short run.

According to them, "one explanation of the view that Fund programmes systematically reduce growth is perhaps the misconception that programmes are designed solely to reduce aggregate demand through the use of contractionary monetary and fiscal polices. Since some empirical evidence indicates that such policies slow growth temporarily, it is concluded that Fund programmes must therefore be deflationary. As discussed in this survey, this interpretation of the policy content of fund programme is far too narrow, and account has to be taken of the other growth – inducing measures contained in fund programmes. This aspect is brought out clearly in the results of cross country studies measuring the effects of fund packages that combine the whole range of demand management and supply side policies. These studies found that the rate of growth declined in a number of countries during a course of a programme, but this result was matched by a number of cases where the growth rate in fact rose. Once the influence of all relevant policies on the growth rate is recognized, there is no clear presumption that fund supported adjustment programme, adversely affect growth."[4]

Theory of Economic Stabilization Programme :

The economic stabilization programme of the IMF rests on the monetarist approach or monetarism developed by Milton Friedman and number of other Chicago economists. According to this view, charges in total spending and the overall level of economic activity in a modern capitalist economy are determined by the changes in the stock of money. Again demand for money is a function of total wealth and the expected future streams of money income. Another important element of monetarist approach, very similar to the quantity theory of money approach is that there exists a close relationship between nominal money income and the price level. Taking these three propositions together, changes in the quantity of money would tend to provide a dependable measure of monetary impulses and these are transmitted to the real sector of the economy via relative prices. In other words, the economic policy aiming at influencing the real

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[4] Khan Mohsin S and Knight Malcolm D, Fund Supported Adjustment Programmes and Economic Growth, International Monetary Fund, 1986. P. 24.

sector of the economy can achieve its objective by exercising control over changes in the money supply including bank credit.

In the long run, growth of output and employment are determined by the factors of production at the disposal of the society. Since the behaviour of prices overtime is determined by the charges in the quantity of money, relative to the growth of output, total spending, and the rate of inflation are uniquely dependent on the money supply. According to the monetarist perspective, what is needed for the smooth functioning of the economic system is a long term monetary policy whose most essential component is a steady and moderate growth in money supply. Extending this view to the balance of payments, it is contended that the deficit in the balance of payments can be corrected by regulating domestic money supply including bank credit.

This approach has been challenged on number of grounds. In the developing economies of the third world, the degree of monetization is quite low and large number of transactions are carried out without the use of money. The problem is essentially structural in nature and any attempt to control it by changes in money supply and consequent charges in effective demand might prove to be a difficult solution. Moreover, the postulated relationship between changes in money supply and level of output and employment is also disputed. According to Killick, the monetarist argument that credit restrictions would have few or no adverse consequences for output and employment have been decisively disproved[5]. In fact, in the quest of external balance, the IMF's policies would lead to serious worsening of the internal balance. During the difficult recession episode of 1982, IMF prescribed the policy of reduction in total spending, under which deficit in the balance of trade would be corrected, but at a heavy cost of worsening the domestic situation as recession becomes worse with the deliberate deflationary policies under the economic stabilization programme.[6]

Right from the inception of the working of the two Bretton Woods Institutions, demand management by the member countries suffering from balance of payments deficits has been an important policy instrument. We can regard this as Keynes' influence on the policy instruments to be prescribed by the fund to the member countries in need of financial support. The difficulties lie in stretching it too for when it might become self defeating. If contraction in total spending throws the economy into depression, the remedy would prove to be worse than cure as it happened to number of extremely poor countries of the sub-Saharan region.

Theory of Economic Reforms :

One of the important theoretical contributions of Keynes was that involuntary unemployment in the capitalist economies is caused by deficiency of effective demand. If the management of the economy is left

[5] Killick, Tony, Improving the Effectiveness of Financial Assistance for Policy Reforms in Development Committees 1993 b. World Bank, Washington D.C 47th Meeting September, Quoted in Dasgupta Biplab, Structural Adjustment, Global Trade and the New Political Economy of Development, Vistar Publication, New Delhi, 1999, P.91.

[6] Williamson John, The Lendeing Policies of the International Monetary Fund in Williamson John (ed) IMF conditionality Institute for International Economics, Washington DC, 1983, PP 665-54.

entirely to the private economic agents namely households and firms, the resulting consumption spending (C) plus investment spending (I) may not be adequate to keep the economy at the full employment level. This would happen as the economy would enter the phase of high level of income and employment and hence his important contention that the capitalist economy tends to become highly unstable at the high level of income and employment. This happens because of the marginal propensity to consume being less than 1 and the volatile behaviour of the investment spending resulting from the downward shift of the marginal efficiency of capital. To save capitalism from falling into deep depression like the one that the world experienced during 1929-1932, the economic policy should ensure that the effective demand is high enough to maintain the system at the full employment level of income. If there is any deficiency in the effective demand made up of C+I, then the gap should be filled in by the government expenditure (G). He became an advocate of government intervention in the management of the capitalist economy and argued that government intervention should be regarded not as necessary evil but as positive good. This gave rise to an era of expansion of effective demand among the capitalist economies, through expansion of government spending on health, education and unemployment allowances as well as number of such activities that the state undertook. The Keynesian economics was at its height of glory in the middle of 1960s, when the US economy reached full employment. However, the confidence in the Keynesian policy prescriptions was shaken by the recession in 1969 and even worse recession of 1974. The US economy and the Europe were struck by stagflation – a combination of two evils of unemployment and inflation. The basic assumption underlying the beneficial role of policy of state intervention was questioned and together with the two oil price shocks of 1970s and the serious problem of persistent balance of payments deficits in the developing countries and the persistent need for borrowing from the twin international financial institutions, welcome climate for the new policy prescription was created. The three main components of this new policy are – liberalization, privatization and globalization, also known as LPG model.

Liberalization :

At the centre of the new policy prescription lies the idea of liberalization which means that the economic management of the country should be left to the free market forces of demand and supply for commodities, labour price, capital or foreign exchange and their price should be flexible in both directions and at their market determined price, their market should be cleared. The resulting allocation of resources, commodities, labour, foreign exchange etc. would be optional and efficient. For the smooth and efficient working of the market mechanism, all regulations and controls as well as barriers to the entry should be removed. This, in turn, would imply that the state should take a back seat in the economic management of the country. Any intervention by the state in the form of controls, subsidies, high import duties for production etc. would distort prices and contribute to inefficient allocation of productive resources. Controls, by their very nature, would restrict flows of commodities or capital or foreign exchange and would distort priorities and would involve some kind of rationing. Again, controls would create conditions under which rent seeking and bribing would florish. In case of developing economies, such controls would operate in favour of better off sectors of the society such as urban dwellers as well as politicians and bureaucrats and harm the economic interests of the rural poor.

Privatization :

This new economic philosophy contends that the public sector units in operation, especially if they are loss making, should be closed down or handed over to the private sector. Public ownership of industrial units be permitted in case of natural monopolies and strategic industries such as defence and high powered research establishments. Privatization of public units – especially loss making – would reduce the burden on state finances and that of profit making units would add to the resources of the state exchequer and if correct policy is followed, would reduce the burden of the public debt as most of the public sector units in the developing economies at sometime in the past have been established by borrowing done by the government. The policy of privatization, if correctly, conceived and implemented, would help developing economies to reduce fiscal deficit and control inflation.

Globalization :

The third major objective of the new economic policy is globalization. The central idea behind globalization is that free trade in goods between countries would help all the trading partners. The snag is that some countries would benefit more and some would gain less. Globalization would therefore require developing countries to follow export oriented or outward looking foreign trade policy. The policy of import substitution and other protective measures that go with this type of foreign trade policy such as quantitative restrictions on imports with the help of quota as well as high tariffs, would increase the cost of domestic production. A policy of import substitution would also work against the exportable goods that would be traded in the global market on the basis of the comparative cost advantage enjoyed by the developing economy. Apart of number of such disadvantages, a policy of import substitution would isolate the domestic economy from the technological changes that can reduce cost, introduce variety of new items in the economy and thus contribute to the overall social welfare.

The objective of globalization would also require developing economies to open their doors for the trans-continental or multinational corporations. These corporations are vertically integrated, operate with several affiliates and subsidiaries spread over different parts of the world. It is widely observed that the multinational corporations often have tacit understanding with other oligopolies with whom they engage themselves in non price competition. Under the policy of structural adjustment, the domestic economy is required to treat them on equal footing with local industries and should not be discriminated against. According to the proponents of the policy of structural adjustment, free foreign competition would raise the level of efficiency of the domestic producers and would drive them towards production of goods and services which is warranted by the comparative cost advantage enjoyed by the developing economy. The policy of globalization and of free entry of multinational corporations would lead to higher degree of integration of the domestic economy with the world economy which is usually reflected in the foreign trade as a higher percentage of a country's national income after the implementation of the policy of structural adjustment than before.

One requirement of the export oriented foreign trade policy is that the foreign exchange rate should be determined by the market forces of demand for foreign exchange and supply of foreign exchange. While the founding fathers of the twin international financial institutions favoured the policy of free trade among the member countries, even the industrialized countries had high import tariffs which they went on reducing under various GATT rounds. The developing countries on the other hand, out of their fear that they would not be able to sell their exports in the highly competitive world market, mostly followed the policy of import substitution and import restrictions with little, if any, emphasis on the policy of export promotion. The developing countries kept their currencies overvalued in relation to the leading currencies of the industrialized countries, had for long years, balance of payments deficits and had to rely on external borrowing from international financial institutions and friendly countries. All these policies have resulted into a serious external debt problem for the countries of the developing world. Under the policy of structural adjustment, a country would be required to adopt a policy of market determined foreign exchange rate, thus removing the element of overvaluation from its foreign exchange rates and make its currency convertible on current account. Similarly its dependence on debt creating capital inflow will have to gradually give place to non-debt creating capital flows in the form of foreign institutional investment (FII) and foreign direct investment (FDI). FII is generally understood to be short term in nature and refers to the investment in the shares and debentures of the companies in the recipient country. The recipient country will be required to bring about appropriate changes in the policy regarding such inflow. However, it is to be understood that such inflow would continue as long as FIIs find this activity profitable and can as well withdraw when they find such investment less profitable in comparison to such investment in other centres of the world. The other component of the non debt creating capital inflow namely foreign direct investment is long term in nature and is made in the recipient economy with the explicit objective of controlling, managing and owning the industrial unit. The foreign investing firm would thus acquire controlling interest in the equity of the company of the domestic economy. Apart from providing much needed financial support, the foreign direct investment has an added advantage namely it brings with it the latest technology making the production of the domestic industrial unit competitive in the world market. The inflow of non debt creating capital is not entirely cost free. The FIIs would take with them interest and dividend as well as capital gain arising from their investment in shares and debentures of the private corporate sector of the recipient economy. Similarly on the foreign direct investment, the foreign company would earn dividend and in some cases even the large royalty fee for the use of patents. Around mid 1990s, the International Monetary Fund also insisted on the countries implementing the policy of structural adjustment to adopt capital account convertibility, and thus making its currency fully convertible in relation to other currencies of the world. The transactions in the capital account of the balance of payments of a country are such as the create either liabilities or assets either in the domestic economy or in the rest of the world. The foreign firm can bring in capital to buy a majority stake in the company of a domestic country and invest in the government securities and so on, thus creating external financial liabilities for the recipient country. On the other hand, a company of a domestic country can take capital out to acquire a majority stake in the company in the rest of the world and to invest in the government securities in other countries. The serious financial crisis in the four South East Asian economies namely Thailand, Indonesia, Malaysia and Philippines in 1997 and the upheaval in their foreign exchange market with substantial devaluation of their currencies have brought about a change in the thinking on this vital object and the emphasis has shifted from capital account convertibility to making the financial institutions sounder than before.

Fiscal Reforms :

An important ingredient of the policy prescription of the structural adjustment programme is related to the reduction in the size of fiscal deficits. Fiscal deficits significantly above 3% in a developing economy would have its impact in the form of high growth rate of money supply – say in excess of 15% - which would in turn, have an adverse impact in the form of high inflation rate. Again, the developing economy will have to depend on large amount of internal borrowing which, through high interest payments of public debt, will be an important factor among others, contributing to the deficit in the revenue budget. In view of this, the less developed countries or developing economies not only have the problem of unsustainable external debt, but also that of unsustainable internal public debt. In view of all these adverse consequences for the working of the developing economies, the structural adjustment programme prescribes reduction in the size of fiscal deficit to 3% or less of the economy's GDP. A reduction in the size of the fiscal deficit can be achieved either by reduction in government spending or by increasing revenue or both. If a developing economy, suffering from balance of payments deficit and high inflation rate, is not in a position to increase revenue, the burden of adjustment would fall on reduction in total spending. The difficulty in reducing government spending is that there are some components of public spending in the revenue budget of the economy such as defence spending, civil administration, payment of interest on public debt or subsidies – which can not be reduced easily. As a result, a reduction in spending in the revenue budget would generally fall on social sectors like education, health, drinking water etc. The reduction in total spending may also take the form of reduction in investment spending if the economy has large public sector investment in the manufacturing activity. If the balance of payments deficit and high inflation rate are accompanied by high interest rates, then even the private sector investment is likely to be discouraged. In any case, reduction in the size of fiscal deficit would lead to reduction in total spending in the economy, reducing the rate of growth and rate of inflation and would reduce the balance of payments deficit by reducing demand for imports.

The reduction in fiscal deficit would be accompanied by reduction in the rate of growth of the developing economy and would ordinarily carry an adverse impact on the volume of employment. The advocates of the structural adjustment programme argue that the adverse impact on income, employment and social sectors would be temporary in nature and the economy would be in a position to bounce back to the high growth rate of income and employment.

Apart from reducing the fiscal deficit, the member country adopting the structural adjustment programme would be required to make its tax system transparent, more equitable and less dependent on caprices of the authorities. The developing economy, if it follows an inward oriented trade policy with its emphasis on import substitution, would have high rate of tariff or import duty. The structural adjustment programme would recommend a big shift towards export promotion measures which would primarily insist on reduction in import duties or custom duties and would also discourage a policy of export subsidies and all cumbersome rules and regulations that usually accompany them. Under GATT, the industrialized countries went on reducing import duties on manufactured goods in each round of negotiations. Most of the developing economies were not covered under the GATT as it did not include agricultural activities among the negotiation agenda. With the adoption of the structural adjustment programme, the less developed countries were also required to reduce import duties in a significant manner. Similarly direct taxes like the income tax and the corporate tax should also be lowered to bring their rates as close to those prevailing in the developed countries as possible. This would help the less developed countries to achieve better compliance in the tax revenue, thus reducing their dependence on the internal borrowing. The fiscal reform would also require the less developed countries to reduce rates of excise duties and other indirect taxes to enable them to keep their manufacturing sector competitive with the rest of the world. Such decreases in the excise duties rates and other indirect taxes would bring about a reduction in the proportion of total tax revenues contributed by the indirect taxes making the tax structure more equitable than before.

Financial Sector Reform :

The financial sector reform is another significant ingredient of the structural adjustment programme. In the less developed countries with a socialist bias in the economic policies, the commercial banks, as providers of short term credit and by far the most dominant financial intermediaries, are ordinarily in the public sector and hence, owned, managed and controlled by the state. The long term risk capital is raised in the stock market with prevailing financial practices which are far behind those prevailent in the advanced industrialized countries. The long term loans are provided by the financial institutions, often known as "Development Banks" which are also owned, controlled and managed by the state. There is a good rationale for the state, in the initial stage of economic development, establishing financial institutions catering to varieties of requirements of the large, medium and small scale industries. The less developed country might wish to develop certain new industries where the element of risk might be considerable and the stock market might not be in a position to provide all the long term capital required by such industries. In India, as early as 1948, the Govt. of India established the Industrial Finance Corporation of India and the various State Governments established State Financial Corporations after 1952-and then the apex financial institution – namely the Industrial Development Bank of India was set up in 1964. In between a large financial corporation – Industrial Credit and Investment Corporation of India – was established in the private sector with private equity capital provided not only by the Indian investors and companies but also by the foreign financial entities.

The main difficulty with the public sector banks is that their deposit rates and loan rates are regulated by the Central Bank and a sizable part of their total advances are directed towards certain sectors carrying an element of subsidy in the loan rates making their functioning less profitable or often loss making. Again, the commercial banks as dominant financial intermediaries and collecting savings of the community are required to support the borrowing programme of the state. This required the state owned commercial banks to invest sizable part of their deposits in the government securities. This would leave little scope for the commercial banks to give genuine advances purely guided by commercial considerations. And again, there are wide spread complaints regarding the state interfering with the decisions regarding loans given to different industries. What is true about the weak quality of advances given by the state owned commercial banks is equally true about the state owned financial institutions or development banks. Such policies could lead to only one consequence namely making the commercial banks and the development banks inefficient in their financial operations and burdening them with considerable amount of non-performing assets which would make them very vulnerable except for the fact that they were backed by a soverign state. The great disadvantage to the state was that it would not earn much, if at all, from the huge capital invested in these financial institutions.

The functioning of the capital market in the less developed countries suffered from number of deficiencies. Apart from the fact that the share value could be manipulated through some fraudulent practices by the unscrupulous operators, its working was archaic in many ways. The equities held by the individuals and the institutions were not liquid in the sense that the sales proceeds of the shares could be realized by the sellers after an inordinate delay involving a period of two months or even more and the dealing in the market in the physical form of equities – not the demat form – further compounded the problem. Again, under the earlier policy set of dominance of public sector, the flow of foreign capital into the share market of the developing economies was generally not permitted, thus insulating the domestic stock market from the favourable or unfavourable events taking place in the world economy.

If the share market does not function efficiently, it may not be in a position to help the private corporate sector to raise the requisite amount of long term capital. Again, the size of the class willing to provide risk capital may be quite small leading to the same consequence that the private corporate sector may not be able to raise sufficient amount of risk capital, making them heavily dependent on the long term borrowing from the financial institutions specially established to meet this deficiency. As the domestic rate of savings is low, the developing economy will have to depend on external loans from the friendly countries and the international financial institutions like the World Bank. In any case, the interest rate to be paid by the private corporate sector to the commercial banks on short term and medium term loans and to the financial institutions on the long term loans would be quite high – in fact much higher than the interest rate prevailing in the developed economies of the world. However, in the absence of a set of economic policies enabling foreign economic entities like the foreign mutual funds to bring in their savings into a developing economy, such a situation would persist adding to the cost of borrowing for the manufacturing industry and thus making it less competitive with the industries in the developed world.

One important objective of the structural adjustment programme is to integrate the domestic economy with the world economy by increasing the flow of capital from developed countries to the developing economies and at slightly later stage when the developing economy is ready to adopt the capital account convertibility, an outflow of capital from the developing economy to the developed counties may as well begin when the former permits its financial institutions and individuals to invest in the equity and bonds in the developed economies and when the private corporate sector in the developing economy would feel financially and technically competent to buy the manufacturing units in the developed countries. For all this to happen, the developing economy should have sufficient foreign exchange reserves – sufficiently large in relation to its import bill as well as trade deficit and its other relevant macro economic parameters should be in place – consistently high growth rate, low inflation rate and surplus on current account and in its absence, a deficit on current account of a manageable and sustainable dimension. What is equally, if not more, important is the composition of the foreign exchange reserves with the proportion of short term capital being reasonably small and the foreign exchange rate that is largely market determined.

The reforms of the institutions associated with the capital market would thus go a long way in improving their efficiency. This will be translated into reducing the lending rates of the commercial banks and of the financial institutions specializing in giving long term loans. Again the private corporate sector would be able to raise sufficient amount of risk capital from the share market. Above all, the share market would be made free from some of the most old fashioned practices of its working adding to the cost of transactions for the investors.

Agriculture :

Agricultural Sector constitutes a very significant part of a developing economy in terms of its contribution to national income and providing employment and livelihood to a predominantly large portion of its labour force and population respectively. However, large portion of this sector especially that consisting of the large number of small and marginal farmers is inefficient in terms of per unit of labour productivity and per acre productivity. The state has to make provision for subsidies on farm inputs such as seeds, water and fertilizers and also for farm support prices. Again the state has to procure food grains to be supplied, in turn, to traders involved in running the public distribution system and provide subsidies to families living below the poverty line. Looking to the sheer number of economic agents involved in the agricultural operations – millions of small and marginal farmers as well as landless agricultural labourers – the problem of improving level of efficiency is far more complex than that relating to the manufacturing sector. However, the issue of providing subsidy to farmers is far more complex in the developed industrialized economies such as the USA, the European Union, and Japan than in most of the developing economies of the world.

Under the structural adjustment programme, the state will be required to reduce subsidies to the cultivators and trim and modify its public distribution system. However, as the infrastructure facilities for the manufacturing industries would improve in the form of more efficient provision of roads and railways, electricity and water, the agricultural sector would also benefit. Again the flow of foreign capital and technology would be directed to the agricultural sector and some of its sub sectors like fruits, vegetables, flowers etc. providing incentive to the hither to non existing food processing industries. All these changes can go a long way in hastening the process of much needed diversification of the farm sector leading to improvement in farm productivity and farm incomes in course of time. While this will have a much needed benign impact on agricultural sector which is saddled with low income and poverty, it would contribute significantly in making the process of economic development faster. This is so because among the several constraints restricting the pace of economic development in the developing economy, the unsatisfactory and unstable rate of growth of the agricultural sector is quite significant.

Labour, Employment and Social Issues :

The developing economies that witnessed the predominant role of the state as an active agent of industrial development have labour laws that protect the legitimate rights of the labour – mostly organized labour without putting emphasis on the corresponding requirement of raising productivity. This has resulted into low productivity, lot of unwarranted and wasteful litigation and avoidable huge loss of working mandays. There is a wide spread view among these economies that while the organized labour takes away, a proportionately large share of the national income, the plight of the vast majority of the unorganized labour – many times more in number than the organized labour – is quite deplorable as they have to go without large number of economic benefits secured for the organized labour by the aggressive trade unions.

The structural adjustment programme would generally lead to reduction in public sector investment and hence stagnation or even reduction in public employment. At the same time, the expansion of employment opportunities in the private sector also may not take place, especially if there is increase in the capital intensity which might come to be associated with inflow of foreign capital and technology. From among those who are unemployed in the organized sector, most of them will be absorbed in the informal sector which would act as a safety net. The organized sector would take full advantage of the situation of surplus labour as a result of which a system of contract labour would come into existence. The studies made by

UNICEF and ILO have brought out this high cost of the structural adjustment programme. These studies have shown that the structural adjustment programme has destabilized many poor households in Sub-Saharan Africa which have been hurt by inflation and food security.[7]

In the early years of the adoption of the structural adjustment programme, the World Bank did not pay attention to the social issues. However, because of UNICEF's campaign in the early 1990s, a social dimention has come to be added to this programme which includes safety net and renewal programmes that would cushion the adverse impact of retrenchment in non viable industries by offering some funding and training for self employment and other jobs. However, the amount of funding for such activities has been inadequate. On this issue of social dimension, a serious difference of opinion has existed between the IMF and the World Bank on the one hand and ILO on the other, which holds the view that provision of social insurance and social protection both as a human right and as an essential element should be embodied in concepts of international labour standard. It is however interesting to note that in contrast to the liberal views of ILO on the international labour standard, WTO has attempted to use some labour standards such as prohibiting the use of child labour as a powerful instrument to thwart the exports from the developing economies to the industrial economies of the world. In the similar vein, the developing economies have demanded labour mobility and the easing of the

[7] ILO, Structural Change and Adjustment in Zimbabwe Occasional Paper, 1993, P.16.

immigration laws in the rich countries to enable poor countries to export more labour.

The adoption of the structural adjustment programme by a developing economy would lead to a reduction in total spending and as a consequence of this, to the reduction in spending on social objectives like education, health and sanitation. It might as well create more unemployment and fall in wages among the working class. This problem is further compounded if subsidies are also reduced. One World Bank study concedes, "Little is known about how people at large are affected when countrywide subsidies have to be cut back to reduce the government deficit...... but experience with adjustment programmes has already shown clearly that failure to adjust is likely to hurt the poor"[8]. Similarly another World Bank study, evaluating the performance of the structural adjustment programme in different countries during the 1980s, remarked that calorie intake had stagnated or declined during the 1980s and the poor had been hurt by the reduction in public spending, privatization of health and other services.[9]

As a concept, the social safety net has been in circulation for quite some time. However, it is not very precise in its contents and hence would create difficulties when put to practical use. Informal sectors are generally used as natural safety nets because the labourers thrown out of jobs in the organized sector of the economy, in the absence of an equally remunerative alternative, would fall back upon jobs in the informal sectors of the economy

[8] World Bank, Development Committee, <u>Problems and Issues of Structural Adjustment</u>, Washington DC, 1990, No. 23.
[9] Ibid, 44th Meeting 1992.

which may be less remunerative and less secure. The World Bank has described the range of safety net instruments as (a) targeted public delivery of basic goods and services – food, education, health, housing, water etc. either subsidized, free or in exchange for work, (b) cash transfer or payments (c) employment services and retraining, (d) consumer subsidies on basic goods (e) infrastructure development in poor areas (f) support to basic need suppliers and (g) public information and knowledge transfers. Those who could be assisted through such safety nets are classified as (a) permanently unable to earn income from market economy (old, disabled etc.), (b) temporarily unsupported namely children, students, nursing, mothers, sick, inadequately educated, (c) those who temporarily do not earn because of their specific circumstances, lack of access, discrimination, underdeveloped formal sector, (d) those with inadequate income from market economy (large family) and (e) those under temporary shock (due to recession, natural disaster). Similarly, targeting has a three way classification : (a) means tested individual assessment, (b) indicative tergetting and (c) self targetting.[10]

In those countries where the social cost associated with the adoption of the structural adjustment programme is excessively high in terms of its adverse impact on the vulnerable sectors, the programme had to be given up and policy reversal has taken place. This is what happened in Zambia in 1987 and in Madagascar in 1991.[11]

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[10] Jayarajah, Carl, William Bronson and Binayak Sen, Social Dimensions of Adjustment : World Bank Experience 1980-93, 1996.

[11] Faroutan Faezeh, Trade Reform in Ten Sub. Saharan African Countries : Achievements and Failures, Policy Research Working Paper 1222 World Bank 1993.

The Rationale for Conditionality :

In a formal manner, the Bretton Woods Institutions began to provide several new loan facilities after the two oil shocks in 1970s, threw the balance of payments situation in many developing economies out of gear. While giving the loans, they also imposed certain conditionality – a package of policy prescriptions to help them to overcome the problem of balance of payments deficits and high rate of inflation. This was done by the IMF from its inception with its emphasis on the demand management policies. What is new is the structural adjustment programme of the World Bank is that through its policy prescriptions relating to liberalization, privatization and globalization, it attempts to change the existing economic structure of the country by recommending some very basic changes in the economic policy including fiscal and monetary policies, industrial policy and trade policy, policy regarding subsidies and public distribution and so on. Where the recipient countries are convinced about the need for such policies, these conditions are welcomed with open arms. However, where the recipient countries are not prepared, and such conditionalities are associated with the financial assistance badly needed to meet their immediate serious balance of payments crisis, these policies do not find acceptance and political will is found to be missing. The government of the recipient country tends to compare the political cost of compliance with these conditionalities with the financial cost of non-compliance – going without the package of financial assistance and the problems associated with the twin evils of balance of payments deficit and inflation [12]. Sometimes, the conditionalities are formally accepted, though the government might not intend to implement it seriously. The very high mortality rate of the economic stabilization and structural adjustment programme is partly due to such coercion. Half of the programmes broke down before the end of their intended life in 1980-90, two thirds in 1987-90. Three quarters of World Bank adjustment loans have installment tranche releases delayed because of non implementation of policy conditions in 1987-88[13].

On widely shared view on the conditionalities is that while insisting on the implementation of conditionalities, the twin world financial institutions operate like any other lending institutions, the significant difference being the replacement of conditionalities in place of collateral. However, the coditionalities go much further than loan repayment, while loan repayment with stipulated interest by the borrower to a commercial bank or any other financial institution, is exclusively a financial transaction, the conditionalities would attempt to change the whole policy paradigm of the recipient economy creating confusion in the economic, social and political realm of the economy. In other words, the conditionalities attempt to shape government policies in a particular direction which becomes a goal in itself which is significantly different from the objective of repayment of loan. The other view on the subject takes a more charitable stance namely that while the self interest of the rich countries is certainly evident in such

[12] Mosley Paul, "The Philippines" in Mosley, Paul ed al (eds.) Aid and Power – The World Bank and Policy based Lending pp 39-71. 1991

[13] Killick, Tony, "Issues in the Design of IMF Programmes" 1993.

conditionalities, they only convey to the recipient poor countries to follow the set of economic policies which they should have adopted and operated on their own and in their own self interest long ago because they landed themselves into an unsustainable economic situation caused by balance of payments deficit and high rates of inflation. The underlying assumption in this argument is that export oriented trade policy, demand management policy, control of monopoly and monopolistic policies in the management of domestic economy are policies which would help the country to attain higher rates of growth, control balance of payments deficit and inflation[14].

A widely shared criticism of the World Bank's structural adjustment programme is that it offers a standardized package of policy changes to be adopted by the developing economy receiving financial support – shortly covered under demand management policies – irrespective of the historical background, resource endowment, quality of governance, popular perception etc. As Singer puts it, "The programmes are too much inspired by a common theory or ideology and as a result, take insufficient account of country specificities and country differences"[15]. Again, the conditionalities by asking the governments in need of financial support in the face of balance of payments deficits and high rate of inflation what to do and what not to do apparently take away the initiative from the Governments and seriously reduce the capability of indigenous policy making and often adversely affect

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[14] Balassa Bela, Ibid. P.3.

[15] Singer Hans W. "Structural Adjustment Programmes : Evaluating Success" in Gunning, Jan Williem, Hank Kox, Wouter Tims and Yuto de Witt, Trade aid and development, Macmillan, London 1994.

even the legitimacy. There is a widespread belief among the developing economies which have received fund – Bank support that their economic policies are guided, if not dictated by financial institutions. Even when change in economic policy is in the right direction, there is popular resentment and most governments of the recipient economies are not in a position to show these reforms as positive good and hardly make them the agenda for election.

The New Political Economy of Development :

The structural adjustment programme of the World Bank rests on the theoretical foundation provided by The New Political Economy of Development (NPE). NPE is essentially based on the concept of rationality associated with F.A. Hayek that a rational individual makes his choice in accordance with his perceived self interest. According to Downs, a father figure of this school of thought, the type of economic reasoning applied in the neo-classical economic models based on self interest can be applied to every institution run by men[16]. Transition from individual self interest to group interest takes place when these are not in conflict. Ordinarily, a rational individual has little or no incentive to contribute to the provision of public good, if he can do without it. This is particularly so where there is no direct connection between his contribution in the form of a tax or a membership fee and the social good that gets produced. For example, he would not join a trade union and would be happy to be a free rider and

[16] Downs Anthony, An Economic Theory of Democracy, Harper and Row, New York 1957.

happy to receive higher wages resulting from the collective action, unless not being a member brings to him some serious disadvantage which on cooler consideration he thinks might bring to him larger losses than the amount of membership fee. It can be easily seen that when the group is small in size and its common objective can be easily defined, the perception of common interest becomes easy. In the absence of such conditions, a rational individual will have a strong desire to enjoy a free ride. As the number of any group increases, the homogenity of self interest will be replaced by heterogeneity of interest and it would become more difficult to bargain and negotiate among members to bring them to an agreement to a common position. A small number of oligopolists can function far more coherently and effectively in its group interest while dealing with either the government or the consumers than the large number of wheat or cotton growers.

A major issue discussed in the NPE literature is whether such pursuit of self interest by individuals and interest groups with conflicting objectives and with unequal access to decision makers can bring about a desirable optimum allocation of resources for the economy as a whole. Before the writings on NPE began to appear, the assumption underlying the neo classical economic theory was that the sum of individual welfare and utility maximization would add up to social welfare. Among the writers on NPE, Olson disagrees with this proposition. According to him, the earlier approach of the neo-classical economic theory would lead to an irrational economic outcome. The special interest groups will simply attempt to realize the self interest of their members and as a result, it would lead to reduction in the efficiency and aggregate income of the society[17].

On the other hand, coalitions, as they represent diverse interests and yet attempt to achieve a common objective, would obviously tend to have a crowded agenda and would tend to be quite slow in decision making. Moreover, once the bargain is arrived at, it would be extremely difficult to change the terms within a short period, even when it becomes necessary because of changes in the market conditions or technology. Thus while competition in the market place would lead to efficiency in resource allocation, competition in the political market based on behaviour of heterogeneous groups would generate negative outcome.

As different interest groups struggle to get a larger share of the national output, the distortions in the allocation of resources would certainly take place. The loss can be quite large as the decision making will be quite slow and the economy will not adapt quickly to the underlying conditions in the market and technology. If the group of export – import business struggles to get import control, this would involve loss to the consumers and they will be required to pay price higher than what it would have been in the absence of import control measures. However, the loss of welfare to the society can also take place from the process of lobbying for import licenses themselves. Those who succeed in securing import licenses from the

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[17] Olson Mancur, The rise and Decline of Nations : Economic Growth, Stagflation and Social Rigidities, Yale University Press 1982.

government will be in a position to earn large income as the commodities imported with the help of import licenses would be in short supply and can fatch a much higher price in the market. Thus, this kind of lobbying would involve diversion of labour and capital from other more productive activities. Such rent seeking activities for licenses and permits is bound to distort allocation of resources and make the economy less efficient.

However, we should note the difference between rent seeking and rent creation. While rent seeking results from creating artificial barriers to entry in the form of creating monopoly by granting rights to mining to owe company or by not giving manufacturing licenses to more manufacturing units even when serious shortages exist in the market. Rent creation, on the other hand, is defined as receipt in excess of opportunity cost. If the research and development department of a manufacturing unit succeeds in inventing a machine which would reduce the per unit cost of production, it is bound to earn large amount of rent in the form of high supernormal profit. Moreover, the economic reward earned by the innovator of the superior machine is a price that the society pays for progress. High economic rent earned by one businessman would provide incentive to others to follow suits and change in the resource allocation resulting from such an activity is conducive for larger production. In course of time, in absence of any barrier to entry and with increasing competition, economic rent would disappear. Thus economic rent creates added value in the economy.

On the other hand, rent seeking comes into existence when the entry is restricted under pressure from a powerful group of manufacturers lobbying for it and the rent so created continues to exist for quite some time as more resources can not be diverted to the manufacturing activity even when it is profitable. Thus a firm seeking a barrier to entry is rent seeking and its existence would induce other firms to invest time, energy and resources to influence the government in their favour.

Bhagwati has added one more dimension to rent seeking and calls them Directly Unproductive Profit-Seeking (DUP) activities. DUP activities are defined as a variation to the rent-seeking theme, emphasizing on tariff, revenue or monopoly- seeking activities as well as tariff evasion and smuggling. Bhagwati discusses three types of DUP : Policy – triggred (eg. Voluntary Export Restraints or rent seeking activities), Policy – evading (eg. Smuggling) and policy – influencing (eg. Demanding tariff on certain imports). Moreover, Bhagwati is willing to accept even wasteful activities as beneficial in certain situations i.e. in case of immiserisation[18].

However, all interest groups or coalitions are not criticized by advocates of NPE. The advocates of NPE argue for mobilizing support for structural adjustment by bringing together the potential and actual beneficiaries of such reform. "Adjustment programmes should thus be designed and presented with an awareness of the importance of political

[18] Bhagwati Jagdish (edited by Douglas A. Irwin), Political Economy and International Economics, MIT Press, Cambridge, Mass, 1991.

sustainability of building a coalition of groups benefiting from and expanding as a result of the reform process"[19].

Two groups of beneficiaries of the structural adjustment programme are identified – the rural – agricultural masses and those producing exportables. In most of the poor developing economies of the world, government policies tend to favour the urban better off sections of the society by discriminating against the farmers and the rural population in general. This is essentially done through the policy instrument known as policy of food procurement at low, state prescribed prices and its distribution at substantial prices to the urban consumers. This is interpreted as urban bias, the influence of the urban middle class and the rich over the decision making process. Such bias against rural people is inequitable and leads to distortions in the allocation of resources. The structural adjustment programme would like such countries to withdraw such price regulations and would prescribe that the farmers should be paid agricultural prices determined by the free play of market forces of demand and supply. This does not seem to be an entirely correct view because in India, state determined price mechanism of wheat and a few other agricultural commodities continues to exist to meet the explicit demand of the farm community. The argument usually advanced by the farm community is that while the prices of agricultural inputs like fertilizers, seeds and pesticides, essentially produced by the manufacturing sector, keep on increasing year

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[19] Webb Steven B and Karim Shariff "Designing and Implementing Adjustment Programmes" in Corbo, Vittorio et al (eds.), Adjustment Lending Revisited – Policies to Restore Growth, A World Bank Symposium, World Bank, Washington D.C. p.p. 69-98, 1992.

after year. The corresponding prices of their products namely agricultural commodities do not increase in the same proportion and hence their pressure on the government to raise support prices for different crops and to discourage imports.

The second aspect of this view is that the policy of import restriction and import substitution on the one hand and of export pessimism on the other would work against the tradeables, making them costlier than what they would be under more appropriate policy mix of free import and export promotion. Such regulations and subsidies would take away large part of the advantage from those commodities which would otherwise enjoy comparative advantage. What NPE prescribes is the formation of an alliance of all these potential beneficiaries of reform – agriculturists and manufacturers of individual commodities enjoying comparative advantage so that the government in a country adopting structural adjustment programme gets the explicit support to strengthen its political base so vital for pushing forward this programme which in most cases would imply large scale policy reversals.

<u>The Theory of the State :</u>

NPE does not assume the state as a neutral or a benevolent institution. This makes a fundamental departure from the pluralistic and liberal political thinking in the west for long time. To the pluralists, the state is ordinarily understood to be neutral and it is assumed to function in a manner such that no group is systematically discriminated against. The economists in general have looked upon the state as "that agency in the division of labour which has as its proper function the maximization of social welfare"[20].

Public policy was treated as an exogenous variable and the economic system was expected to adjust to it. The development economists went a step further and regarded the state as a benevolent agent positively interested in the maximum welfare of the society.

In contrast to this, NPE assumes that for any set of economic polices to be effective, it has to be politically sustainable. In the context of the NPE, its advocates have those economic policies in mind which are prescribed by the structural adjustment programme. Thus, the question boils down to this as to what kind of political system or leadership is likely to be committed to this reform programme to vigorously attempt its adoption and implementation and to ensure its success by sustaining it for sufficiently long time to withstand attempts to slow it down or reverse it.

However, NPE analysis assumes that the elected leaders are primarily interested in remaining in power. They generally do not take principled position on any issue and would take a policy position that increases their chances of remaining in power. Earlier, governments were taken as, "Platonic guardians" of national interest but now "the government are depicted as centres of corruption, policy failures, rent seeking, ignorance etc. while the Bank has acquired a self confident position of being in possession of the Holy Grail of good policies and an ability to sort out the "good boys"

[20] Downs Anthony, Ibid.

from the "bad boys"[21]. During 1950s to 1970s, the development economists held as if the state could do no wrong, under the NPE, the state can do nothing right[22].

The advocates of NPE differ among themselves with regard to the form and contest of state power. Some hold the view that state stands to protect and promote the interest of dominant interest groups while others attribute a certain amount of autonomy to the rules in making and implementing decisions. In other words, they look upon the state as a dynamic force. In all different formulations regarding the character of the state, the common theme running is – those running the state from the political ruler at the top, through bureaucrats and technocrats only aim at promoting their own or group interest. As a result, the interest of the country and the welfare of its people hardly figure on their agenda.

Between different types of states, the authoritarian states can make things work, while those with too many interest groups with built in conflicts and each indulging in rent seeking behaviour might find decision making slow and in more conflict ridden situations, even impossible. Again, democracy would usually create demands on the state and tends to favour consumption over investment, thus weakening the conditions for high rates of growth. Again, the poor developing countries of the world are dominated by a small number of privileged groups which are more advantageously

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[21] Singer Hans W, "A Historical Perspective" in Huq Mehbub Ul ed. al (eds), The UN and Bretton Woods Institutions, New Challenges for the Twenty First Century, Macmillan, London pp. 17-25, 1995.
[22] Streeten Paul, "The Political Economy of Reform", in Schydlowsky Daniel M (eds) Structural Adjustment – Retrospect and Prospect, Praeger, Westport, Connect, London, 1995.

placed to impose their will on the decision makers. In such economies, trade unions of organized workers seeking wage rates which are much in excess of large number of unorganized workers, industrialists' group seeking import controls to keep foreign competition at a minimum, urban population groups seeking price control of food articles denying a reasonable share in GDP to the millions of small and marginal farmers are some of the well known interest groups holding sway over the decision making processes and influencing them in their favour. In such a situation, free play of interest groups would lead to rent seeking on a large scale at the cost of huge loss of welfare to the country at large.

In such a complex situation, the authoritarian regime, through its high handed methods might succeed in controlling the privileged groups and thus keeping the loss arising from rent seeking to the minimum. It has better chances of succeeding in raising resources for the structural adjustment programme and might also succeed in coping with the short term cost of adopting the reform programme.

It is now widely conceded that the adoption of the structural adjustment programme is likely to be painful to the large number of population as in the initial years, it will result in lower rate of growth and higher rates of unemployment. To sustain the reform programme under such adverse conditions, the ruling class will have to display high degree of political determination and capacity to withstand unpopularity. A democratic regime is likely to fail as the existing government is likely to lose the elections. The authoritarian regime might score a point over the democratic regime in this regard.

We can easily see the close relationship between NPE and the set of conditionalities contained in standard structural adjustment programme adopted by many countries when they were hit by the oil crisis or any other internal or external factor causing serious balance of payments deficits and high rates of inflation. One major objective of these conditionalities is to reduce, if not completely eliminate, rent seeking. As, rent seeking is the consequence of the state policy of controls, licenses and other restrictive measures, the policy of liberalization will carry a considerable impact in reducing rent seeking. The export promotion measures such as devaluation of the domestic currency would help it to be integrated with the world economy. This would facilitate the entry of the foreign firms, would establish parity between internal and external prices for different commodities and would swiftly encourage domestic manufacturing firms to specialize in the production of those commodities in which they enjoy comparative cost advantage. At the same time, the industries not having comparative cost advantage but enjoying protection under the import substitution measures will have to close down, sustaining losses in the short period but releasing productive resources at the same time which could be profitability diverted to more efficient productive activity.

Again, rent seeking is associated with the vast public sector which has grown enormously in the developing economies of the world. While it is true that all public sector units are not loss making, the element of rent seeking exists because of the management, ownership and control which are vested in the government. Again, even the profit making public sector units, under the overall impact of external competition, will be quick to sharpen the edge of competition by reducing rent seeking much to the advantage of the developing economy. The policy of privatization of the loss making and sometimes even profit making public sector units would further reduce rent seeking. To reduce fiscal deficit below a certain percentage of GNP to control inflation will force the government to reduce wasteful spending. Coming to the distributional coalitions like the trade unions which often encourage inefficiency and disturb the productive activity by resorting to unlawful strikes – another form of rent seeking – the conditionalities would want the governments to opt for labour laws which would prohibit such activities, without at the same time, harming the legitimate interests of the working class. In the developing economies, rent seeking can also take the form or providing jobs to large number of people in government offices which hardly do any productive work and are sometimes found engaged in moonlighting activities, making earning at the cost of the performance in the regular employment which is a source of livelihood. Prices should be flexible in both directions depending on the working of the market forces of demand and supply – whether commodities, labour, land, bank credit, foreign exchange etc. In nutshell, the overriding objective of the conditionalities under NPE can be summed up as – Market and not the state, should rule in order to go as close to pareto optimum in the resource allocation process as possible.

Critical Evaluation of NPE :

The basic assumption on which NPE is based is that human behaviour is solely guided by self interest and this is also understood as rational human behaviour. While self interest is an important factor explaining individual or group behaviour, it is difficult to agree with a proposition that it is the sole determinant of human behaviour even in a highly selfish society. We come across many illuminating examples in a long history of human societies when individuals rose above their narrowly conceived self interest and made the highest sacrifices including their high positions or even lives while serving some noble causes affecting the entire society. Again, NPE and self interest would explain noble qualities like philanthropy or unpleasant act of killing others in ugly communal riots. It is thus widely believed that if we define rationality only in terms of self interest, the most rational behaviour would turn out to be irrational. Similarly, in most democratic countries, half the voters do not vote, while the remaining half invariably vote, fully knowing that their vote is not going to make any significant impact on the outcome of the election.

However, NPE's assertion that most, if not all, politicians are corrupt and rent seeking and their behaviour is aimed at promoting self aggrandisement would be even less acceptable. There are politicians in very large number who are greedy and selfish. However, there are others, even though in small proportion, who are honest in financial dealings and steadfast in the pursuit of political and economic ideology. Again, if majority of the politicians are selfish and corrupt under the existing economic regime, how are they going to carryout the structural adjustment programme ? The structural adjustment programme desired by the NPE would require these very politicians to make a significant turn in the existing economic policies which would require many capabilities among them to steer the country through difficult times associated with the adoption and implementation of the economic policies associated with the structural adjustment programme. According to Nelson, "Either the government has sufficient political will or it does not. If it does, political analysis is unnecessary, if it does not, there is not much to be done about it"[23].

Assuming that the economic policies associated with the structural adjustment programme are beneficial for the country, why should the existing political regime adopt them if they are not likely to promote their self interest? Why should the existing political regime so far engaged in rent seeking groups of urban population, industrialists happy with the existing import substituting trade policy, wage protecting trade unions and other such groups suddenly agree to adopt a set of new economic policies ? Why should people at large accept new economic policies which are, at least in the short run, going to create hardships in the form of rising rate of unemployment ? The only plausible explanation for adopting a fundamental

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[23] Nelson John, "The Political Economy of Stabilization – Commitment, Capacity and Public Response" in Bates Robert H (ed) Towards a Political Economy of Development – A Rational Choice Perspective, University of California Press, 1988.

change in economic policies on the part of the politicians is that faced by the serious economic crisis on the foreign exchange reserves front, they become aware of the fact that the existing economic policies are no longer tenable and rather than inflicting dishonour in the form of default in the repayment of external debt, they agree to adopt new policies, making a sharp departure with the existing policies. Moreover, any serious economic crisis is in the making for quite sometime and political leaders in some faint manner, if not explicitly, are aware of the weakness of the existing economic regime. The emergence of a crisis often takes the form of a proverbial last straw that breaks the camel's back. The same political regime would adopt the structural adjustment programme and would implement the new economic policies as it happened in India in mid 1991.

Similarly it is not true to say that the authoritarian system can keep itself free from the rent seeking activities of some special interest groups. The authoritarian regime also has to secure political support for its survival from distributional coalitions. As is widely practiced, such a regime will take explicit economic measures which would favour some and harm some other interest groups. Again, the authoritarian regime will require to secure support from powerful countries and from the external agency like the World Bank as such a regime does not get any support from the domestic civil society groups. In fact, the authoritarian regime can be as much corrupt and rent seeking, if not more, as any other regime.

The other relevant issue is whether the bureaucracy and the state should be neutral among different interest groups or should implicitly, if not explicitly, seek support from the interest groups which are very likely to benefit from the economic policies. Such a support would be necessary to keep the reform programme politically sustainable. If such a support base is to be created, then such groups would only replace the old distributional coalitions and then the new set of interest groups would behave in the same manner – rent seeking and corrupt like those whom they have replaced. As Taylor remarks, "Generals ousting corrupt politicians in a coup, and making trains run in time at the beginning, usually end up being worse than those they replace, as the experience of many countries – from Pakistan and Bangla Desh in Asia to Central American republics through Africa South of the Saharan – confirms"[24].

In contrast to the rent seeking by different interest group by persuading the state to create monopoly through diverse restrictive measures, Amsden has introduced the concept of private rent seeking which in simple terms means buying cheap and selling dear, or realizing profit upon alienation, rather than through making investment in new plant, equipment and human resources. It implies specialization and arbitrage in stocks or existing assets. "The private rent seeking stands in the way of the most socially efficient use of resources and is not less serious than rent seeking associated with public political patronage. Further, private rent

[24] Taylor Lance, "Policy Reform in the 1980s" in Schydlowsky, Daniel M (ed), Structural Adjustment – Retrospect and Prospect, Praeger, Westport, Connecticut, London, 1995.

seeking behaviour forces the governments to offer concessions, subsidies and support in various other forms in order to induce private entrepreneurs to invest in manufacturing. Once the existence of private rent seeking is recognized, privatization can no longer be taken as synonymous with efficiency"[25].

Some of the leading protagomists of NPE admit that the neo-classical attack on the state has been carried too far. It is now widely recognized that the state alone can provide a set of conditions so badly required for economic development such as law and order, sound judiciary, effective macro economic policy framework, infrastructure, investment in human capital and so on "Further, the policy elite is not merely interested in staying in power and in adopting whatever policy would make it cling to power it does have some explicit norms of what constitutes good policy. Still further, the coalition partners it seeks for staying in power are usually historically and ideologically given, while it will not seek support from some forces even for the sake of staying in power. Power is a means to an end, and not the end itself"[26].

NPE and the Role of World Bank and International Monetary Fund :

While there is no explicit mention of the twin financial institutions in the vast literature on NPE, their pivotal role is implicit in the formulation of the structural adjustment programme to be adopted and implemented by the

[25] Amsden, Alice H, "Comments" in Meier, Gerald M (ed) Politics and Policy Making in Developing Countries : Perspective on the New Political Economy, ICS Press, San Francisco 1991.
[26] Grindle, Merilee S and John W Thomas, Public choices and Policy Change. The Political Economy of Reform in Developing countries, John Hopkins University, Press, 1991.

less developed economies. Often their presence is not clearly visible as that kind of perception in the developing economies is likely to generate hostile reaction and this would become politically a sensitive issue. A perception that the government has adopted structural adjustment programme under the pressure from the twin financial institutions would considerably erode its credibility and the government would be subjected to the criticism that it has become subservient to the industrialized countries of the West. Their role to a certain extent is fulfilled by the bureaucrats and technocrats of the developing economies, who have earlier worked in these twin financial institutions and are now in charge of implementing the reform programme. The conditionalities accompanying it would make the government to be withdrawn from what they perceive to be the market distorting activities.

Within these twin financial institutions, two approaches towards the developing economies are visible regarding their role in the implementation of the reform programmes. The harsh approach recommends release of the loan amount in tranches subject to the fulfillment of a set of performance criteria and withdrawal or postponement for funding in the event of non compliance. This view prevailed in the early years of the implementation of the structural adjustment programme. This approach has been largely given up after gaining some experience and has been replaced by the lenient approach which consists of discarding such harsh conditionalities and recommends continuation of the financial assistance even when some conditionalities could not be complied with by the recipient countries. While some pressure should be exerted by the financial institutions so that the reform programme is implemented in large part otherwise the government of the recipient country would not be left with enough room to negotiable with the internal pressure groups which are likely to mount political opposition to the reform programme itself.

Both these approaches on the whole have one thing in common – both are in favour of adoption and implementation of the reform programme by the developing economies and both of them clearly hint at the overriding role of the twin financial institutions. In a way, their role can be compared with the invisible hand which in this case is sufficiently visible. They will try seriously to secure political commitment for the structural adjustment programme from leaders who might be initially reluctant to embrace the reform programme as it would involve bitter confrontation with the well entranched rent seeking classes but will have to be persuaded if not coerced, to adopt it as their own programme, adopted after lot of thought in the larger interest of the country.

This discussion regarding the New Political Economy of Development shows that it "is internally inconsistent, ahistorical, is oriented towards justifying market centred economic policies under authoritarian regimes, is dependent on the rich world institutions for its success and ignores the importance of institutional factors in the development process. While self interest is a powerful motive, its attempt to explain all types of behaviour solely in terms of selfishness is not only wrong but has led to serious inconsistencies in the NPE theoretical structure. Its poor opinion of political leaders, for helping rent seeking behaviour and for other failings has raised the question of whether, if that premise holds, there is any basis for hoping that the same leaders would implement the structural adjustment programme that runs counter to their own self interest. Its high opinion of the "Impartial" bureaucrats with national interests at heart and ability to rise above interest groups and their conflicts, similarly, leaves the question of where this particular breed would come from and whether their presence would qualify the Olsonian premises of self interest as the role motivating factor in human behaviour unanswered. More important, why should these nationally interested bureaucrats be allowed to implement structural adjustment by self interested politicians if that is not in their self interest?

"Perhaps the only redeeming feature of this theory is its analysis of 'rent seeking behaviour, that has a certain relevance to the contemporary LDCS' political economy. This explains in formalized form what had been known in India for the last five decades as 'licence – permit raj', and perhaps with similar expressions, in the vocabulary of many other LDCS. Apart from the economic costs involved in rent seeking, what is can do to the political environment of a country is amply illustrated by the voluminous documentation of corruption at high places. Over the past decade or two in a large number of countries, including India, South Korea, Japan and Italy. While open and competitive economy is a myth, unbridled state control also can not be recipe for success, human material being what it is in a class society. There is a serious need to critically examine the overwhelming system of controls and regulations that breed inefficiency and corruption and strifle individual initiative, but at the same time, it would be nothing short of wishful thinking to assume that a no control regime can deliver development to a poor country. While excessive controls should be done away with, it would be equally wrong, as the saying goes, to throw the baby out along with the bath water. Paradoxically, however, the highly negative experience with corruption at high places also contradicts the NPE claim that an open economy is more capable of handling corruption. In India's case, the era of sleaze and scam largely coincides with increasing liberalization since the mid 1980s and the introduction of structural adjustment, dismantling of controls, privatization, integration with the global economy and the entry of the MNCs in the economy"[27].

The oil price rise of 1973 and 1979 adversely affected the balance of payments situation of large number of non-oil producing developing countries. At the same time, the private commercial banks started withdrawing their loans from these countries after the Argentinean crisis of 1982. IMF and the World Bank had to enter this area of providing financial assistance in a big way, asking the borrowing countries to implement economic stabilization and the structural adjustment programme.

By 2000, these new economic policies completed twenty years and it is worthwhile to undertake a study of the impact of these reform measures

[27] Dasgupta, Biplab, Structural Adjustment, Global Trade and the New Political Economy of Development, Vistar Publications, New Delhi, 1999.

on different countries of the world. This study has selected Indonesia, Thailand, Sub-Saharan Africa and India. Sub-Saharan Africa represents the weakest group which could not assimilate the new economic policies adequately. At the other end, India, which grew very slowly in the pre reform period could achieve spectacular success under economic stabilization programme and could take the reforms further under the structural adjustment programme. Thailand and Indonesia fall in the third category in the sense that they had done quite well even in the pre reform period. Somehow they developed serious balance of payments problems for different reasons in early years of 1980s and adopted reform measures from 1985-86. While they did remarkably well, the great weakness lay in having high and unsustainable balance of payments deficits, in receiving large flow of short term capital and in not making their financial institutions sound from within. They were struck by the crisis, their growth rate was considerably slowed down for the next five years but they imparted soundness to their financial institutions.

Above Literature survey has highlighted many development in the world economy. Thus, this study raises the following questions and attempts to provide some answers to them. (a) Can the Fund-Bank economic reforms have the same content for different countries facing balance of payments problem ? (b) Why did Sub-Saharan African countries fail to benefit from the economic stabilization programmes ? (c) Should countries accept convertibility of the currency before putting their financial institutions in sound health ? (d) What role can fiscal consolidation can play in proper implementation in economic reform measures ? (e) What should be the foreign exchange rate policy in the face of free movement of capital across the world ? (f) What is the degree of success and failure of structural adjustment programme ?

Chapter Scheme :

Chapter II brings out the identification of the main issue which is studied in this research work and it spells out the objectives of the study and the research methodology employed in the study. It covers the period from 1981 to 2000 and tries to bring out the significant achievement and failures with the help of certain macro economic indicators. It also brings out some limitations of the study.

Chapter III examines the developments in Indonesia before 1981. It then explains the main cause namely fall in the price of oil for the serious balance of payments situation in Indonesia between 1981 and 1985 under which it adopted the economic stabilization programme and made reasonable progress. It undertook further reforms from 1991. However, its rapid progress came to a halt in July 1997 when it was struck by the severe financial and currency crisis.

Chapter IV describes the good progress made by Thailand in the pre reform period. It was also struck by the balance of payments crisis in first half of 1980s and it adopted economic stabilization programme from 1985-86. Thailand also made satisfactory progress between 1985 to 1995.

However because of its wrong policy of pegging its currency Baht to Dollar, and large inflow and outflow of short term external capital exposed it to the severe financial and currency crisis in July 1997.

Chapter V examines the factors that led to the severe balance of payments crisis as well as external debt crisis. These countries adopted the economic stabilization programme in 1981 but the consequences were most disappointing and in some cases, the IMF and the World Bank discontinued the adjustment leveling and in some cases these countries stopped implementing the reform programme. The chapter examines in detail the reasons why Sub-Saharan African countries failed in implementing this programme and how the Fund and the Bank modified their lending polices in the light of the unfavourable consequences of the first decade of reforms.

Chapter VI examines how India fell into the balance of payments crisis in 1981 and how it slowly started liberalizing its economy. It explains in detail the factors that led to the sudden loss of foreign exchange reserves in 1990 and 1991 and the factors that contributed to the unprecedented balance of payments crisis. It also examines the contents of the economic stabilization programme and the structural adjustment programmes adopted by India. It also examines why it has succeeded in certain areas and why it has failed in some other.

Chapter VII provides summary and conclusions of the study. It also includes the suggestions for further work in this area.