Structural Adjustment Programs

The roles of the IMF and the World Bank

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On three occasions over the past decade, the Papua New Guinea government has been driven by financial crisis to request assistance from the International Monetary Fund (IMF) and the World Bank in the form of Structural Adjustment Programs (SAPs). This paper examines the causes of financial crises, the function and design of SAPs, the forms of assistance provided by the IMF and the World Bank, and the experience with SAPs in Papua New Guinea and elsewhere.

There is considerable antagonism within Papua New Guinea towards the IMF and the World Bank, driven largely by the belief that these organisations somehow impose their will upon a reluctant government. It is important to understand, however, that the IMF and the World Bank in fact provide assistance to Papua New Guinea at the government's invitation.

An SAP is generally undertaken when the recipient government has encountered severe problems in its management of the country and with nowhere else to turn had to request the assistance of the international finance organisations. The international finance organisations' demands that changes be made in the recipient country's management of its economy in exchange for financial assistance may be seen as overriding that country's sovereignty. However, a crisis-struck government must invite the IMF and the World Bank to assist. Much of the antagonism towards these international agencies stems from a lack of understanding of their functions, thus it is highly desirable that their role be made clear, especially to people like the Kumul scholars who can help spread this understanding to the people of Papua New Guinea.

Causes of financial crises

A financial crisis arises when a loss of confidence in the government makes domestic and international lenders unwilling to lend to it, or willing only to lend at very high interest rates. Essentially, this loss of confidence means a loss of creditworthiness. If the country's exchange rate is fixed, the loss of confidence will be most obviously reflected in loss of the central money authority's reserves of foreign currencies due to people's abandonment of the local currency and buying up of foreign currency. This loss of international reserves creates the necessity for devaluation of the currency, and together the loss of international reserves and the currency devaluation combined with difficulties in borrowing make it much more difficult for the country to service its foreign loans and finance imports. Devaluation means that it takes more of the domestic currency to buy the same quantity of imports and to service the same amount of foreign debt. If the country has a floating exchange rate, loss of confidence will reflect immediately in the depreciation of the currency, and it will experience the same difficulties in financing imports and servicing debt. The only bright spot in a currency devaluation or depreciation under these circumstances is that exporters will earn more in domestic currency terms from their exports. They will, however, be faced with higher prices for imports, as well as generally higher inflation throughout the economy and higher interest rates.

Financial crises can have different causes. We can categorise causes as either external or internal. An external cause would be a sharp decline in the global demand for and price of the country's major export(s), as the result of a global recession. Similarly, a sharp rise in global demand for and price of an important import such as petroleum would cause great financial difficulties, as happened to many developing countries during the 1973–74 oil crisis. Most international crises reflect in prices of traded goods, in exchange rates or in interest rates. However, such external factors will not cause a financial crisis unless a country is in an unusually fragile state economically.

The internal causes of financial crises are many and varied—for example, natural disasters, civil unrest, closure of major projects such as mines, and poor economic management. Again, such internal factors will only cause a financial crisis if a country's economy is in poor shape. The most common cause is poor economic management, which can take many forms. It may involve the setting of the exchange rate at too high a level, causing exports to become internationally uncompetitive and imports too cheap, making life difficult for exporting and import-competing industries. As in the roots of the Asian financial crisis of 1997–98, investors may have made large—particularly short-term—borrowings in foreign currencies, believing that the country's fixed exchange rate would be maintained. When it appeared that the currencies would have to be devalued, money flooded out of the country, causing the devaluation to be even larger than it otherwise would have been.

Poor fiscal management in the form of uncontrolled expenditures, leading to excessive budget deficits, is probably the most common cause of financial crises. Poor management of state-owned enterprises, particularly financial enterprises, can be part of this kind of problem. By taking on responsibility for running businesses, governments assume the contingent liability of covering any losses. Such contingencies are often not adequately planned for in the national budget.

Poor economic management usually reflects in expectations about budget deficits. If it is suspected that an unsustainable budget deficit is looming—that is, that the country will not be able to borrow to fill the deficit gap—and there is the prospect of higher inflation and higher interest rates, there will be a loss of confidence in the government. Investors will take their funds out of the country, thus actually causing the devaluation they fear.

In Papua New Guinea's case, economic crisis first hit after the closure of the Panguna mine in Bougainville in 1989. The closure caused a huge loss in export earnings (up to 40 per cent), leaving Papua New Guinea unable to service foreign debts and maintain imports. Thus, Papua New Guinea called on the IMF and the World Bank to provide loans to make up for the loss of export earnings. The loans were given under an SAP, but when new mines came on-stream and exports increased not long after the implementation of the SAP, Papua New Guinea abandoned it.

Papua New Guinea called for assistance from the international agencies for the second time in 1995, following the financial crisis of 1994. This financial crisis was due solely to poor economic management. It followed a period of a rapid increase in export earnings due to the expansion of mining and the discovery and exploitation of the Kutubu oil field. There was in fact a 'mining boom', which meant that government revenues increased rapidly. However, poor budget policies and poor control of government expenditure caused government expenditure to increase even faster than revenues. Expectations of an unsustainable budget deficit and of resulting pressure for devaluation of the fixed exchange rate led to 'capital flight' and the rapid loss of central bank holdings of foreign currency reserves; in other words, anticipating a fall in the value of the kina, people took their money out of the country. The loss of international reserves was so large that by July–August 1994 they were close to zero. Accordingly, the kina was devalued. Soon afterwards, however, it was floated. The creditworthiness of the government fell sharply, with international lenders unwilling to lend to it to make up for the loss of international reserves. Government expenditure was placed under tight control and the IMF and World Bank were asked to help the economy recover.

The third request for international assistance was made by the incoming Morauta government in the wake of the financial crisis that had developed as the result of the Skate government's poor management. Again, government expenditure was out of control, the budget deficit was expected to increase sharply, international reserves had fallen sharply and the kina had depreciated rapidly, and inflation and interest rates had also increased rapidly. Because the creditworthiness of the government had been damaged and other lenders were unwilling to lend, the Morauta government turned to the international agencies for assistance. In fact, the Skate government had become so desperate for funds that it was on the point of recognising Taiwan as an independent state in exchange for loans.

Structural Adjustment Programs and the international finance agencies

The IMF and the World Bank were established after World War II as organisations with membership open to all countries. The IMF was to be a lender of last resort when countries experienced financial crisis and loss of creditworthiness. At the time, countries used fixed exchange rates and so were much more vulnerable to internal and external shocks than they are today. To help them avoid exchange rate devaluation in the event of a crisis (a 'balance of payments' crisis), the IMF was established to provide short-term loans at rates close to the market rates available for creditworthy borrowers.

The World Bank (formerly, the International Bank for Reconstruction and Development) was established to assist with the reconstruction of Western Europe following World War II. As with the IMF, a capital base was established to allow the World Bank to lend to countries at close-to-market rates in order to finance infrastructure projects. World Bank staff provided skills for the appraisal of such projects. Following rapid post-war reconstruction and international recognition of the lack of economic growth and development in the so-called Third World, the World Bank's focus shifted to performing the same functions for the developing countries.

Structural Adjustment Programs were initiated at the beginning of the 1980s for a number of reasons. An appraisal of completed World Bank projects suggested that the financial assistance the World Bank provided—largely in the form of physical infrastructure and, later, assistance in the development of education and health sectors—had in many cases been unsuccessful. It was concluded that the reason for the lack of success was that the economic policies of the recipient countries were not conducive to investment, thus these economic policies had to be reformed. Also, the structure of the recipient countries' economies had to be changed so their comparative advantages could be exploited. Research had shown that the success of the rapidly growing countries of East Asia was due to their openness to international trade, thus trade liberalisation was taken to be one of the most important policies to adopt.

Because of rapid increases in oil prices in 1973–74 and 1980–81, many developing countries—particularly those highly dependent on oil imports—experienced severe economic problems. These problems compounded after 1981 when the export prices of many of their major primary commodities fell sharply. Developing countries experienced great difficulty in servicing foreign debts and maintaining imports. These problems culminated in the 'debt crisis' of the first half of the 1980s, as a result of which the role of the IMF as a lender of last resort in the event of financial crises expanded greatly.

SAPs were seen as a joint solution to these two sets of problems. The IMF and the World Bank (as well as regional development banks such as the Asian Development Bank and also bilateral aid donors) would provide loans to assist countries to overcome the financial crisis. However, the provision of these funds would be conditional upon the countries agreeing to adopt economic policies more likely to lead to economic growth. Long-term loans would be available to assist with the restructuring of the economy in line with the changed economic policies. IMF loans had always been subject to conditionality, however from this point on conditionality became much more explicit in both IMF and World Bank loan arrangements.

The IMF would remain largely a lender of short-term funds for assistance with immediate balance-of-payment problems and difficulties in servicing debts and maintaining imports. The IMF's focus was on macroeconomic policies, particularly exchange rate policy, fiscal policy and financial sector policy. Changes in these policies would be sought in order to achieve stabilisation of the economy through reduction of budget deficits and deficits in the current account, and reduction of inflation and interest rates.

The World Bank's focus on the other hand was mainly on microeconomic policies such as trade policy and industry policy, as well as its traditional areas of physical and human infrastructure development. Industry policy reform involved privatisation of state-owned enterprises and agricultural marketing boards, and elimination of price stabilisation schemes. These changes in microeconomic policies would be expected to lead to changes in the structure of the economy in the long term. Trade liberalisation, for example, involving reductions in the assistance given to specific industries, would lead to the decline of these industries. Because the reduction in assistance given to these industries would mean cheaper inputs and lower real exchange rates, more economically efficient industries would develop, resulting in faster economic growth.

However, microeconomic and macroeconomic policies cannot be completely separated, and there have been inevitable overlaps in the activities of the two major international financial agencies, with tensions arising between the short and long-term objectives of stabilisation and structural change. For example, trade liberalisation usually means reductions in tariffs, which are often an important source of government revenue. However, reductions in revenues are not welcome to a government that is trying to reduce its budget deficit, particularly because it so difficult to quickly develop new taxation sources. Hence, actions to reduce budget deficits usually focus in the short term on reducing expenditure. This means that it is difficult, for example, to find expenditure for improving environmental policies aimed at reducing degradation of resources, or to make funds available for social safety nets in order to make structural change more politically acceptable.

What have we learned about SAPs?

None of the three SAPs introduced in Papua New Guinea appear to have led to much improvement in the economic management of the economy. The Morauta government eventually came to exhibit the same problems of fiscal mismanagement that led to the two previous financial crises and requests for SAPs. Papua New Guinea's experience of SAPs can add to our substantial knowledge of these programs in general, acquired over the past 20 years. What have we learned about SAPs during this time?

First, it is clear that the economic reforms involved in SAPs are difficult to achieve. The short-term changes necessary to achieve stabilisation of an economy have generally been relatively easy to make. This applies to Papua New Guinea, where inflation rates, interest rates, and budget deficits have been reduced fairly quickly. However, the same problems have arisen again just as quickly. Reforms intended to ensure structural change in the economy are generally much more difficult to achieve. One of the reasons for this is that the response to changes in prices such as those caused by trade liberalisation takes a long time in coming, apparently because of investors' caution about policy changes and reluctance to make investments until the changes appear credible to them. The more volatile government policy has been in the past, the longer it is likely to take for the government's reforms to be seen as credible. On the other hand, the costs of the reforms—for example, the loss of employment and devaluation of capital that result from a reduction in tariffs—are felt almost immediately. This asymmetry in the impact of the costs and benefits of structural adjustment make reform arguments difficult to sustain. However, it should not be forgotten that the costs of not making changes and continuing with bad policies can be much greater than the costs of adjustment to the policy changes.

Second, it seems that unless what is now called 'ownership' of the reforms by the recipient country is actually achieved, implementation of the reforms will always be difficult. The imposition of policy changes from the 'top', as usually occurs when reforms are agreed upon in international agreements, always creates problems. A sufficient part of the population also has to be convinced that the reforms are worthwhile, otherwise there will be resistance, which may result in 'backsliding' from the reforms. Thus, the politics of building majority support for reforms is itself a very important part of the reform process. It has been argued that the Morauta administration's privatisation reforms had such a bad outcome because insufficient attention was given to convincing the public of their desirability. Conditionality appears to have been ineffective in many cases, and this may also be related to ownership, since without ownership of reforms it is difficult to implement them and meet the conditions of the loans.

Third, coalition governments find it difficult to carry through with economic reforms because coalition partners threaten to leave if they do not support the reforms. This has been a problem in Papua New Guinea, where governments have been made up of several parties and independent members of parliament. Changes that have recently been made to the electoral system in Papua New Guinea to make crossing the floor more difficult and force members to be more representative of their electorates may help to make coalition governments more stable and therefore more able to carry through with reforms.

Fourth, appropriate sequencing of the reforms is important but remains a contentious issue among economists. Sequencing may depend upon each country's particular circumstances. Trade liberalisation has often been the first reform undertaken. However, if the investment environment is not very friendly because of, say, law and order problems, then there may be little response to trade liberalisation. Liberalisation of the capital market is widely believed to be the best reform to follow trade liberalisation. However, if the credit market is under-developed and would benefit from opening up to foreign banks, trade opening may also prove ineffective. Privatisation of state-owned enterprises, including public utilities, has been another popular reform. However, if secure land title to these properties is not available, then they cannot be sold easily and may only sell at a substantial discount.

Conclusions

A great deal of antagonism has been directed at the SAPs of the IMF and the World Bank in Papua New Guinea. This antagonism is largely due to misunderstanding and misinformation. The international financial organisations create and provide these programs at the invitation of recipient governments, who usually approach the international finance organisations when they are suffering financial crisis—which in simple terms means that they have lost creditworthiness and find it difficult to borrow to service debts and finance imports. Financial crises can develop for many reasons, but the most common reason is government financial mismanagement. As well as helping to resolve the immediate crisis, however, an SAP usually involves structural economic changes intended to help the recipient country avoid such crises in the future and place the economy on a more rapid and sustainable growth path.

The three SAPs undertaken in Papua New Guinea have apparently not led to improvements in the economic management of the economy, nor to placing it on a more rapid and sustainable growth path. Economic management in the final days of the Morauta administration appeared to be no better than in earlier administrations, and over the past three years the PNG economy has suffered a huge loss in per capita gross domestic product.

Lessons learned from developing countries' experiences of SAPs over the past 20 years appear to have relevance to Papua New Guinea. Without ownership of reforms, that is, widespread agreement within the community, reforms are unlikely to be successful. For the same reason, conditionality appears not to have been very helpful in ensuring the implementation of reforms. The unstable coalition governments in Papua New Guinea and the lack of ownership of the reform programs also appear to have presented obstacles to the carrying through of SAPs. Perhaps changes in the electoral system will help solve some of these problems. It is not clear, however, that the underlying problems leading to PNG's unsatisfactory performance have been fully appreciated and addressed.