

## Responses to economic crises: Stabilization and adjustment policies

### I. Issues:

Growth important for poverty reduction (impact on inequality unclear)  
Instability of growth (crises) bad for poverty and for inequality.

Questions that need to be addressed:

What are the symptoms and causes of crises?  
How do countries respond to economic crises?  
How to re-establish macroeconomic equilibria? Stabilization policies.  
How to restore growth? Adjustment policies.  
How to avoid future crises?

### II. Causes of disequilibria

#### 1. External shocks: shortage of foreign exchange ( $D$ for $\$ > S$ of $\$$ )

- Debt crisis (Latin America and Africa 1980s): excessive borrowing (easy money following the oil price boom and debt-led-growth), rising interest rates ( $i$ ) on outstanding foreign debt (U.S. anti-inflation policy), and ceiling on new debt (loss of confidence by international lenders), leading to defaults on debt servicing.
- Sudden halt in FDI/FPI and capital repatriation (Peso crisis Mexico 1994, Asian crisis 1997, confidence crisis Brazil 2002). Speculative crisis on expected devaluation.
- Price shocks: falling prices of exports (coffee (Central America crisis 2002), minerals), increasing prices of imports (oil shock 1970s). Devaluation Mercosur countries makes Argentine goods over-priced in the international market, leading to a decline in export earnings.
- Falling foreign aid inflows: debt fatigue (fall in aid Africa).
- Falling flow of remittances from workers abroad (tightening of U.S. border, Gulf crisis).

#### 2. Internal unsustainable policies ( $D > S$ )

- Overvalued exchange rate ( $e \downarrow$ ) encourage imports and discourages exports, leading to balance of trade deficit (Argentina crisis 2001 with Currency Board and fixed exchange rate in spite of inflation)
- Extensive government subsidies without fiscal resources (populism) creating public debt and inflation.
- Price distortions (e.g., on  $i$ , food prices) benefiting consumers, creating excess demand and shortages.
- Soft budget constraint on public sector firms inducing moral hazard behavior among managers: government quasi-fiscal deficit creating public debt and inflation.
- Bubble economy (Asian financial crisis 1997): excessive borrowing by domestic firms (lack of bank regulation) and inefficient investments (cronyism), creating debts that cannot be repaid.

### III. Symptoms of disequilibria

1. Inflation, hyperinflation ( $\dot{P}$ ).
2. Balance of current accounts deficit (balance of trade  $< 0$ , debt service payments  $\uparrow$ ) and falling balance of capital accounts (FDI/FPI  $\downarrow$ , foreign borrowing  $\downarrow$ , K outflight  $\uparrow$ ).<sup>1</sup>

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<sup>1</sup> Recall that:

Balance of trade (BoT) =  $E - M$

Balance of current accounts = BoT + Net remittances + Net I income from abroad - Debt service payments

Balance of capital accounts = FDI/FPI + Foreign borrowing (debt) + Aid - K outflight

Balance of payments = B of current accounts + B of capital accounts.

E.g.: U.S.: BoT  $< 0$ , BoCA  $< 0$ , BoKA  $> 0$ , BoP = 0.

E.g.: Japan, Taiwan: BoT  $> 0$ , BoCA  $> 0$ , BoKA  $< 0$ , BoP = 0.

3. Fiscal budget ( $B$ ) deficit leading to money creation and borrowing on the domestic market. Government borrowing on the domestic financial market crowds-out private borrowing and investment by raising  $i$ .

#### IV. Needed adjustments to reduce disequilibria

Start from material balances equation: at equilibrium  $D = S$ , or

$$\text{National Expenditures} = D = P(C + I + G) + eP_M^{\$}M + e(\text{K outflight}) + e(\text{debt repayment}) = P(X + \text{Tax Rev.}) + eP_E^{\$}E + e(FDI + FPI + \text{aid}) + e(\text{new debt}) = S = \text{National Revenues}, \text{ or}$$

$$\begin{aligned} \text{Expenditures} - \text{Revenues} = D - S = & P(C + I - X) + P(G - \text{Tax Rev.}) + e(P_M^{\$}M - P_E^{\$}E) \\ & \text{(Private deficit)} \qquad \qquad \qquad \text{(Public deficit)} \qquad \qquad \qquad \text{(Trade deficit)} \\ & + e(\text{K outflight} - FDI - FPI - \text{Aid}) + e(\text{Debt repayment} - \text{New debt}) \approx 0 \\ & \qquad \qquad \qquad \qquad \qquad \qquad \qquad \qquad \qquad \text{(Capital accounts deficit)} \end{aligned}$$

If expenditures are in excess of revenues, we need to:

- Reduce the private deficit.
- Reduce the public deficit.
- Reduce the trade (and current accounts) deficit.
- Reduce the capital accounts deficit.

To do this, we need to:

- Decrease demand (short run)
- Increase supply (long run)

Reduce deficits:	Stabilization (short run) ↓ Demand	Adjustment (long run) ↑ Supply
Private deficit	↓ $C$ , ↓ $I$	↑ $X$
Public deficit	↓ $G$	↑ Tax revenues
Trade deficit	↓ $M$	↑ $E$
Capital account deficit	↓ K outflight, ↑ FDI, FPI, aid ↓ debt repayment, ↑ new debt	

$C$  = consumption,  $I$  = investment,  $X$  = output after tax,  $G$  = government expenditures, Tax = tax revenues,  $M$  = imports,  $E$  = exports.

#### V. Demand management (stabilization): ↓ $C$ , ↓ $I$ , ↓ $G$ , ↓ $M$ (IMF crisis-management programs)

1. *Devaluation* :  $e$  = pesos/US\$ ↑, i.e., the dollar becomes more expensive in terms of domestic currency. Consequences of devaluation: ↑ $E$ , ↓ $M$ ; tourism by foreigners ↑; tourism abroad by nationals ↓. Helps reduce the trade deficit.

2. *Fiscal austerity*: ↓ $G$ .

i) ↓ Current expenditures: ↓ subsidies, ↓ welfare programs, ↓ soft budget constraint, ↓ government employment.

Consequence: since it will ↓ skilled labor employment, is it politically feasible?

ii) ↓ Public investment (Public  $I$ ).

Consequence: since it will ↓ unskilled labor employment, is it politically easier but problematic for long term growth?

Consequence: Helps reduce the public deficit.

3. *Restrictive monetary policy*:  $\downarrow$  money supply,  $\downarrow$  credit.  
Consequence:  $\uparrow i$  induces  $\downarrow$  in  $C$  and  $I$ . Helps reduce the private deficit.
4. *Wage repression*:  $\downarrow$  real wage ( $w$ ), e.g., lag in adjusting the minimum wage to inflation.  
Consequence:  $\downarrow C$ . Helps reduce the private deficit.
5. *Price management* (heterodox approach)  
Put temporary controls on prices to contain inflation (but hard to enforce, and need to use the period of controls to reduce the public ( $\downarrow G$ ) and private ( $\downarrow C$  and  $I$ ) deficits).
6. *Decrease capital outflight and increase FDI, FPI*:  $\uparrow i$  to attract capital from abroad. Dilemma between devaluation and recession.
7. *Decrease debt repayment and negotiate access to stand-by loans*: default, debt rescheduling,, debt renegotiation, debt swaps. Conditionality lending.
8. *Put in place social safety nets* to manage the political feasibility of reforms and reduce welfare cost on the poor: Social funds.

**VI. Supply management (adjustment):**  $\uparrow X$ ,  $\uparrow$  Tax Rev,  $\uparrow E$  (World Bank development programs, Washington Consensus)

### 1. *Liberalization and deregulation*

- 1.1. Trade liberalization: transform quotas and permits into tariffs,  $\downarrow M$  tariffs ( $\uparrow M$ ),  $\downarrow E$  taxes ( $\uparrow E$ ).  
Hopefully will increase exports more than imports.
- 1.2. Domestic price liberalization: remove price controls, remove subsidies: net effect on  $X$  hopefully positive.
- 1.3. Financial liberalization.  
Consequence:  $\uparrow$  savings and investment.
- 1.4. Deregulation:  $\downarrow$  licensing,  $\uparrow$  competition and  $\downarrow$  monopoly pricing, reform of procedures (de Soto).  
Use trade to increase competition, especially to oppose monopolies in small countries.
- 1.5. Foreign investment liberalization, improve the investment climate:  $\uparrow$  attractiveness for FDI/FPI.

### 2. *Privatization or change in management rules of public enterprises.*

- 2.1.  $\downarrow$  soft budget constraint on public enterprises and bureaucracies.
- 2.2. Create managerial incentives for public firm managers (after removing constraints that stifle public enterprises, e.g., delivery of subsidized services, forced employment creation)
- 2.3. Sale to private sector; elimination of state monopolies (parastatals); transfer of functions (devolution to users): does this lead to better management? does it lead to monopoly power?  
Consequence: decline in state services, decline in quasi-fiscal deficits, one-shot government revenues. Expected efficiency gains.

### 3. *Public investment priorities*

Target public  $I$  for: shift of private resources to sectors with comparative advantages; quest for economies of scale; infrastructure and public goods; technological change for agriculture. Investment promotion policies.  
Complementarity between public and private investment.

### 4. *Tax reforms* (key to compensate for $\downarrow$ trade sector revenues due to liberalization).

Non-distortive taxes (land tax, lump sum), value-added tax, income tax.

$\uparrow$  efficiency of tax collection (how decrease corruption in customs, income tax collection: raise salaries of officers?)

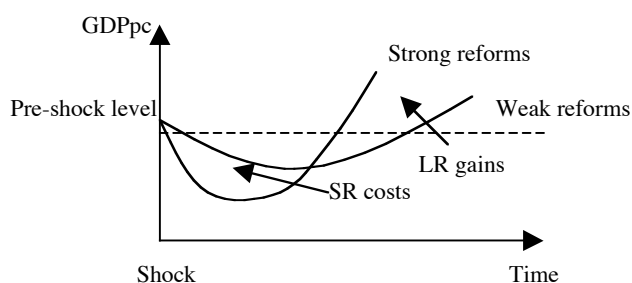
### 5. $\downarrow$ *Transactions costs*

- 5.1.  $\downarrow$  market failures.
- 5.2. Redistribute assets for efficiency gains (land reform), change in property rights (common property resources, collectives if justified), induce cooperative behavior.

### 5.3. Administrative reforms, bureaucratic reorganizations, rule of law for contracts.

## VII. Current policy issues and debates

- 1. Contradiction among components of reforms:** Improved price incentives (exchange rate devaluation and trade liberalization) but public expenditure compression (decline in public goods and services) has a negative effect on output response.
- 2. Political feasibility and sustainability of reform** when there are short run costs for long run gains: Need manage political feasibility of reforms through use of safety nets, political targeting of compensations.



- 3. Credibility of reforms:** Role of commitment mechanisms to give guarantees that reforms will stick (rules and delegation, independence of Central Bank, trade rules under NAFTA and GATT, regional integration, democracy for credibility, bureaucratization, state instead of government policies).
- 4. Pace of reforms:** Shock treatment/cold turkey approach (to achieve political feasibility and reduce the risk of counter-reform) versus gradualism (management of supply side (China puts into place the household responsibility system (incentives reform) before market liberalization); increase elasticity of supply response; rebuild alternative institutions; help transition to competitiveness in open economy regime)?
- 5. Optimum sequencing of reforms:** No unique formula, but frequently recommended sequence is as follows: (1st) stabilization, (2d) trade and tax reforms, (3d) financial regulation, (4th) public sector reforms, (5th) productive sector reforms, (6th) financial liberalization. Is early financial liberalization too dangerous in allowing speculative attacks (e.g., Asian crisis)?
- 6. Short run versus long run effects of fiscal austerity:** Choice of which government expenditures to cut. Cuts in public I (fairly neutral on growth in the short run; hurt unskilled construction workers; and bad for growth in the long run) versus cuts in current expenditures (high short run welfare costs for public employees and the subsidized, but less long term growth benefits than public I)? Hence, how to resist political pressures to sacrifice long run efficiency ( $\downarrow$  public I) for sheltering the short run welfare of the politically important (maintain current expenditures)?
- 7. Political context of reform:** Authoritarian (imposed, e.g., in Chile, Mexico, China, Asia) vs. democratic (social compact: negotiated, e.g., Costa Rica, Russia) reforms? Both can work.
- 8. Output response to the reforms.** Success of adjustment is based on the assumption that the elasticity of supply response is high: is this correct? Need micro-reforms, need good governance, need institutions, need public goods. This is a “**second generation**” of reforms beyond the Washington Consensus to deal with market failures and institutional gaps that constrain response.
- 9. Regulate short term capital flows to avoid speculative attacks.** Impose taxes on short run capital movements (Tobin tax in Chile)? Only allow capital exports after a one year stay in the country (Malaysia).
- 10. Did the IMF interventions worsen the Asian crisis** by applying the same austerity policies as for the debt crisis? Increasing demand may have been a better solution and giving quick loans to shore currencies against speculative attacks (see below: Stiglitz critique of IMF).

**11. Should the IMF serve as a coordinating mechanism** of private capital movements instead of trying to act alone in stabilizing currencies?

**12. Some free advice:** (1) Try to anticipate the crisis to respond by increasing supply (Indonesia) instead of equilibrating via demand contraction (IMF recipes) once crisis has occurred. (2) Try to succeed in one single attempt as repeats are increasingly unpopular (Africa, Mexico). Hence is shock treatment preferable?

**13. Managing the social costs of reforms**

Role of safety nets programs (social funds) to shelter the poor in transitions (e.g., PROCAMPO program in Mexico to protect farmers from NAFTA shock, guaranteed employment schemes and workfare, food aid). Seek Pareto optimality after compensation: gainers compensate the losers

**14. Stabilization and adjustment not necessarily bad for all poor**

Pre-crisis subsidies were regressive: did not benefit the poor (e.g., subsidies to higher education, gasoline). Rural poor produce tradables that benefit from RER depreciation. The urban poor consume protected import substitutes (ISI).

**15. Political economy of reforms**

Groups most hurt by the reforms are non-poor: Civil servants and urban middle-class consuming tradable goods. These groups are politically powerful, making implementation of the reforms difficult (Ecuador).

**16. Conditionality of aid not effective**

IMF conditionalities on aid (adjustment lending) not effective for policy reforms:

Time consistency problem: agree on reforms, and then renege. Lack of commitment device.

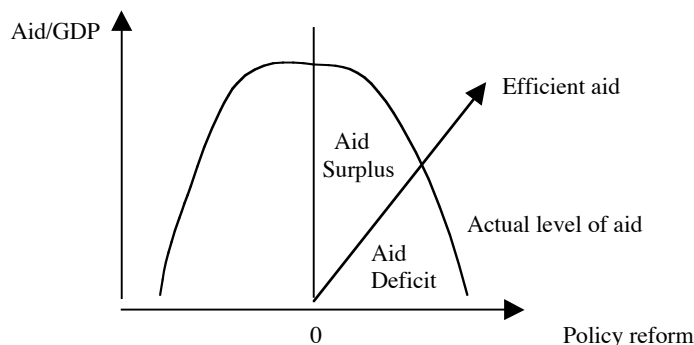
Conditionality compromises government sovereignty and ability to signal good policies (ownership of reforms by country instead of IMF).

**17. Inconsistency between timing of aid and reforms**

Aid for adjustment declines precisely when reforms make aid more effective (Collier & Gunning)

IMF accounts for aid as part of fiscal deficit, which is to be reduced.

Hence, there is aid surplus before the policy reforms, and aid deficit after the reforms relative to maximum aid effectiveness.



**18. From Washington Consensus to critiques**

**Washington consensus** (John Williamson, Institute for International Economics)

- Fiscal discipline (low deficits)
- Public expenditure priorities: from overall subsidies to education and health
- Tax reform
- Financial liberalization
- Exchange rate competitiveness
- Trade liberalization, market-based pricing
- Capital markets liberalization
- Privatization

- Deregulation

**Washington contentious** (Nancy Birdsall, Carnegie Endowment for International Peace and Inter-American Dialogue): ten + 1

- Rule-based fiscal discipline: transparency.
- Smoothing booms and busts: reduce volatility
- Social safety nets that trigger automatically.
- Schools for the poor: public subsidies for poor.
- Taxing the rich: close tax loopholes for the rich.
- Giving small business a chance.
- Protecting workers' rights: right to collective bargaining.
- Dealing openly with discrimination (indigenous groups, women).
- Repairing land markets: land market assisted land reform.
- Consumer-driven public services.
- Reducing rich country protectionism (agriculture, textiles).

### **Stiglitz critique of IMF: Globalization and Its Discontents**

- IMF: Privatization of public firms. Critique: Non-competitive sales creates concentration of wealth. Privatization without regulation creates monopolies and corruption (Russia).
- IMF: Liberalization of capital markets to attract FDI, FPI. Critique: Speculative money is destabilizing. Need introduce controls over short term capital movements (Malaysia, Chile). Postpone liberalization of capital markets until regulation is in place. Raising interest rates leads to bankruptcies of firms and worsens recession.
- IMF: Market based pricing, elimination of subsidies (food, water, energy). Critique: "IMF riots" delegitimize governments, increase poverty, and worsen crisis. Countries need have better safety nets in place, e.g., unemployment insurance.
- IMF: Trade liberalization. Critique: OECD countries protect (U.S.: textiles, steel) and subsidize (U.S.: agriculture, airlines) while using IMF conditionality lending to force market opening in LDCs and the elimination of subsidies. WTO rules on intellectual property rights (TRIPS) endear pharmaceuticals for LDCs. MDC need open their markets to LDC products.
- IMF: Loans need to be negotiated in secrecy, including to access governments confidential information. Critique: Need increase transparency to hold IMF accountable to LDC interests. Reduce the weight of U.S. Treasury Department (U.S. only country with veto power) and increase that of LDCs in IMF decision-making.
- IMF: Basic stabilization package sound. Critique: Need to be adapted to heterogeneity of cases, e.g., Latin American 1982 debt crisis (inflation, fiscal deficits) different from Asian 1997 crisis (no inflation, fiscal surpluses). Latin America needed austerity; Asia needed stimulus package (expansionary fiscal and monetary policies: deficit spending, new loans, restore confidence). IMF "made East Asia's recessions deeper, longer, and harder".
- IMF: Conditionality on loans (on average 111/loan) needed to induce structural reforms. Critique: conditionality does not work and signals weakness to FDI-FPI, undermining confidence, and increasing capital outflight.
- IMF: Use bailout loans when countries cannot repay debts. Critique: Share risk with creditors by introducing bankruptcy clauses. Bailouts benefit creditors (MDC lenders) and allow to maintain overvalued exchange rates longer, helping capital outflight.
- IMF: Model assumes that markets work. Critique: Many markets fail (asymmetrical information). Need put in place institutional infrastructure to make markets work (laws to enforce contracts, regulation of financial sector). Countries like Sweden rely less on markets and more on government: no single model exists!

**Responses to critiques:** Kenneth Rogoff (IMF), Barry Eichengreen (*Foreign Affairs*).