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13 The Politics of Stabilization and Structural Adjustment

Stephan Haggard and Robert Kaufman

13.1 Introduction

A major theme of the country studies in this volume is the relationship between policy choice and economic performance. What policies contributed to debt crises in the first place and what corrective measures have been most successful in managing them? This chapter, by contrast, examines the way political processes, both international and domestic, influence developing country stabilization and adjustment efforts. Of course, economic circumstance defines the policy agenda and is a powerful constraint on the range of policy options. But states that are similarly situated in economic terms have adopted different adjustment strategies and external bargaining positions because of domestic political constraints. Programs that succeed in one context are therefore difficult to implement in others. We review a range of different hypotheses about the politics of adjustment and build some contingent generalizations around the country cases included in this volume. While we cannot provide ironclad political laws, such analysis is important both in understanding the past and in generating realistic and sustainable programs in the future.

13.2 The International Politics of the Debt Crisis

One of the most notable features of the crisis period that began in August 1982 with the emergency rescheduling of the Mexican debt has

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We have benefitted from comments by Werner Baer, Jeff Frieden, Joan Nelson, Dani Rodrik, and Jeffrey Sachs.

been the politicization of international credit issues. Although the Reagan administration initially hoped to maintain a distance from the negotiations between debtors, banks, and the IMF that have characterized the postcrisis period, concerns about the stability of the international financial system impelled treasury and central bank officials from the creditor countries to become actively involved in the process. In the case of certain strategically important countries, such as Mexico, Turkey, and Egypt, traditional foreign policy concerns also came into play.

Notwithstanding calls for more comprehensive solutions, rescheduling remains the central mechanism for managing the debt crisis, which suggests that international credit flows to developing countries must be analyzed in a bargaining framework. Despite some marginal innovations, three features of the international bargaining structure have remained more or less constant. First has been the assumption—or the fiction—that all obligations are to be met in full. Until recently, relief had not been on the agenda, despite the development of a secondary market in which developing country debt traded at fairly deep discounts. Second, was the assumption that the burden of policy changes should fall primarily on the debtors rather than the creditors. Developing countries have failed in their political efforts to link the debt issue with developed country fiscal and trade policies, interest-rate management, or the reform of international commodity trade, and have had very uneven success in securing additional concessional aid flows. Finally, all negotiations have been handled on a case-by-case basis. Each debtor is expected to confront its creditors alone, rather than in collaboration with other debtor countries facing similar problems. Whatever practical arguments may be advanced in favor of this system over a more comprehensive one—and there are many (Cooper 1986)—it is clearly a bargaining structure that tends *eo ipso* to favor the creditors.

There are three resources that developing countries can bring to bear in these negotiations: size, political-strategic significance, and the availability of nonconditional resources.

13.2.1 Size

Evidence from recent rescheduling exercises suggests that larger debtors do better than smaller ones in the rates, maturities, and grace periods they receive (see table 13.1). They have also been more successful in securing additional forms of relief, including the concerted lending agreements (Sachs and Huizinga 1987). Larger debtors have also pioneered more unorthodox rescheduling agreements and adjustment packages. Mexico was the first country to negotiate a multi-year rescheduling agreement (MYRA), and Argentina was able to win IMF acceptance of the unorthodox price freeze and currency plan known as the Plan Austral.

Table 13.1 **Average Terms of Bank Debt Reschedulings, By Group of Countries (1978-June 1985)**

	Grace Period	Maturity	Interest Rates (spread over LIBOR)
Large Debtors (> $25 billion, Jan. 1, 1985)	3.25 years	11.31 years	1.41%
Medium-sized Debtors ($10 to $25 billion)	4.36 years	8.28 years	1.69%
Small Debtors (<$10 billion)	2.61 years	7.26 years	1.82%

(Note: Average terms for rescheduling of medium- and long-term bank debt, both public and private. Excludes restructuring of short-term debt, arrears and terms of trade facilities. Debtors are classified on basis of total external liabilities of banks and non-banks to banks end-December 1985. "Large" debtors are Brazil, Mexico, Argentina and Venezuela; "medium-sized" debtors reaching rescheduling agreements during the period are Chile, Philippines, Yugoslavia and Poland. Source: Watson, et. al. 1986.

An exception to this rule concerns the likelihood of repudiation. Until Brazil's suspension of payments in February 1987, large countries had been content to exercise the tacit *threat* of repudiation; the smaller and weaker countries—Bolivia, Peru, Ecuador, Costa Rica, the Dominican Republic, Honduras, the Ivory Coast, Zaire and Zambia—actually exercised the option. Small debtors may be more tempted to "free ride," particularly in a setting where increasing numbers of other countries are doing so. The reason for small country repudiation may also have to do with bank strategy and reputational concerns. Banks may prefer to allow small states to repudiate rather than to concede to the financing required to keep loans performing.

13.2.2 Strategic Significance

Size is not the only variable of significance in determining bargaining outcomes, however. A number of smaller states, including Zaire, have manipulated their strategic position or concern about domestic political instability to gain additional assistance. Turkey probably provides the clearest example of how geo-strategic concerns influence official assistance. Of $9.8 billion of debt that Turkey restructured between 1978 and 1987, $5.5 billion was negotiated through a consortium of OECD governments. The OECD did link its 1979 offer of concessional finance to acceptance of an IMF program, but the amount of additional assistance totalled $3 billion over the next three years despite the fact that the 1979 program was not particularly successful. The OECD commitments were followed by unusual levels of assistance from the World Bank and IMF, including five consecutive structural adjustment loans and a three-year standby agreement in 1980 that brought Turkey's total IMF commitments to 870 percent of quota, the largest multiple awarded to any country up until that time.

More generally, central banks of the Group of Five have played an important role in managing particular crises through the organization of rescue packages and the provision of bridging loans. Informal conventions have divided these international lender of last resort responsibilities along lines of regional and political influence. Germany played a leading role in Turkey and Poland; the United States in Mexico; France in Francophone Africa (Wellons 1987, chap. 7). This decentralized pattern of leadership includes the provision and orchestration of concessional assistance, which, as is well known, also follows lines of political interest.

13.2.3 Nonconditional Resources

A final factor influencing debt negotiations, particularly with the IMF, is the availability of nonconditional resources. These resources naturally shift bargaining power toward the debtors and make them less likely to accept Fund conditionality. This tendency is particularly clear among the capital-importing oil exporters, including Venezuela, Nigeria, Mexico, Ecuador, and Indonesia prior to the Pertamina crisis. The stylized facts are as follows. Commodity booms make governments more dependent on commodity-based revenue because of the relative ease politically of taxing commodity exports as opposed to income. The income from commodity exports also provides the basis for additional foreign borrowing. This double windfall has three political consequences. First, it reduces the political incentives to undertake any adjustments that have distributional consequences. Second, it increases the range of political claims on state-controlled resources, not only from rent- and revenue-seeking groups in society, but from spending constituencies within the government itself. Finally, the windfalls provide governments with resources that can be used for political ends, whether through corruption and the "financing" of elections, pork-barrel expenditures on particular projects that cement geographical bases of support, or the expansion of subsidies and entitlements.

It is thus common to see increased government revenues from commodity booms mark the beginning of a cycle of increased borrowing, widening fiscal deficits and, ultimately, a return of balance of payments crises. Mexico provides an example. In 1978 when the country began to experience a boom as the result of increased oil revenues, it repaid its obligations to the IMF and abandoned the terms of a standby reached in 1976. A new cycle of borrowing began, purportedly to finance investment in the oil sector itself. By early 1982, voices within the government and the international financial community were urging caution.

Yet there was a political decision not to stop the country's growth prior to elections. Central to the fiscal problems the country faced was a rapid expansion of subsidies to food and domestic energy consumption designed to cement the ruling party's support among the urban working and middle classes.

13.2.4 Cooperation among Debtors

In addition to the possibility of operating within the prevailing case-by-case bargaining structure, debtors may conceivably seek to alter the rules of the game through cooperative behavior. Up until now, the barriers to collective action among debtors have been greater than those facing the relatively small group of money-center banks. Banks have thus been able to discourage a debtor cartel by isolating and punishing recalcitrant debtors, while rewarding others, such as Mexico, for good behavior. The debtors with real power have therefore preferred the advantages of striking their own separate deals to the risks of cartel leadership.

The barriers to collective action among debtors should not be overestimated though. LDC debt is also heavily concentrated on the borrower side. Given this concentration, the defection of one large debtor would be enough to change the system substantially, even with the assumption of free riding. There can be little doubt that the negotiations surrounding Brazil's February 1987 suspension of interest payments will have a profound effect on future reschedulings. Learning among debtor governments increases the possibility that concessions granted in one case will become the basis for demands by other countries even in the absence of overt collaboration.

13.3 The Domestic Politics of Stabilization and Adjustment

The international and domestic politics of stabilization and adjustment are closely linked. Since no debtor government can deflect all of the costs of adjustment, each must also bargain with domestic actors over how to allocate burdens on the home front. The central political dilemma is that stabilization and adjustment policies, no matter how beneficial they may be for the country as a whole, entail the imposition of short-term costs and have distributional implications. Two questions are of importance: Why do governments choose the policy packages they do—the question of program *design*—and what are the political conditions under which they will be sustained, the problem of *implementation*. We focus on the influence of three clusters of variables: the power of different interest groups; the nature of central government institutions, including the bureaucracy; and the influence of short-term political calculations, including those associated both with elections and with other, less institutionalized, political transitions.

13.3.1 Interest Groups: Business, Labor, and the Urban-Rural Balance

Business-Government Relations

The central problem confronting any government in its relations with the private sector is in establishing a credible and predictable policy environment. Confidence in government policy is a major factor in determining time horizons and willingness to take risk, and thus affects levels of investment and capital flight. Other things being equal, leftist governments and political systems with a history of populist attacks on business and property rights will face greater difficulties establishing the credibility of policy, regardless of their stated intentions. Perhaps the sharpest contrast among the countries included in this project is between Argentina and Korea. Argentine politics in the postwar period has been deeply polarized between populist and antipopulist forces. A close relationship exists between political cycles and the broad swings in the country's macroeconomy. The Korean political system under Park Chung Hee (1964–79), by contrast, while not without periods of unrest, was based on a firm business-government alliance. Populist and leftist forces were excluded, if not repressed. Policy was coherent and credible, contributing to a high level of investor confidence.

It is important to note, however, that segments of business may have reason to oppose orthodox stabilization and structural adjustment measures; much depends on their sectoral position and international finance and trade links. Firms with strong international financial ties and export-oriented industries are more likely to support orthodoxy. Even where they are not *politically* organized, liquid asset holders constitute a constraint on governments of both the left and right through the threat of capital flight (Frieden forthcoming). Those without dependence on international financial markets, by contrast, will have less reason to back a conciliatory policy toward international creditors, and may positively oppose credit restraint and the removal of various sectoral supports. While export-oriented firms will support more liberal trade and exchange rate policies, firms in import-substituting sectors that have been heavily subsidized and protected will present an obstacle to market-oriented reforms, including import liberalization. The longer such policies have been in place, the more politically difficult it is to make the transition to outward-oriented policies. These types of cleavages among different segments of business are particularly visible in the large, Latin American countries, including Brazil and Mexico.

The Political Role of Labor

The urban informal sector has operated as a constraint on government policy in a number of countries. The lifting of food subsidies, in particular, has frequently resulted in spontaneous rioting (Bienen and Gersovitz 1985). In general, however, the organized workers of the modern sector, both public and private, are best positioned to act politically against stabilization and devaluation, with their anticipated consequences for employment and real wages. Other things being equal, one would expect the degree of unionization and the likelihood of adopting and sustaining orthodox stabilization and structural adjustment measures to be inversely correlated. Those governments relying heavily on labor support are more likely to tolerate inflation, experiment with heterodox programs, and adopt tough bargaining postures with external creditors.

This expectation is not necessarily borne out, however. As with the private sector, the political behavior of labor depends on sectoral position. Equally important, however, is the institutional context within which labor operates. Where strategic labor sectors are weak and penetrated, the burdens of stabilization policies are easy to impose, although the economic program, and the government itself, may encounter long-term costs in the form of decreased legitimacy. Weak or controlled labor movements in the Philippines and Korea granted the government greater leeway in imposing the costs of stabilization, at least initially. Labor control was also a central feature of the stabilization programs of the "bureaucratic authoritarian" governments of Argentina, Brazil, Chile, and Uruguay over the 1960s and 1970s.

Literature on the advanced industrial states suggests that where labor is organized in peak associations with a secure place in the political process, it may be easier to induce them to trade short-term wage restraint for longer-term gains. This holds true even under leftist governments (Goldthorpe 1984). None of the developing countries have developed the kind of corporatist arrangements linking business, government, and labor that are found in the small European democracies. Nonetheless, Venezuela and Mexico suggest that the integration of labor into multiclass parties may affect the government's ability to negotiate compensatory agreements that ease the adjustment process.

The greatest difficulty comes in intermediate cases where labor is capable of defensive mobilization, but uncertain about its longer-term place in the political system. This situation is typical of a number of developing countries making the transition to democracy, including Brazil, where labor movements have previously been under strong government control.

The Role of the Rural Sector

For some policy reforms, including devaluation and food pricing policy, the balance of power between rural and urban interests may be the most salient cleavage. In general, countries in which political elites are forced to be attentive to the countryside should pursue policies favorable to agricultural and rural interests, including realistic exchange rate policies (Sachs 1985). This, in turn, is likely to occur where political parties have rural roots or where the peasantry is available for revolutionary mobilization. Indonesian macroeconomic policy following the rural uprisings of the mid-1960s provides a particularly clear example.

Several caveats are in order, however. First, predictions are difficult to make on the basis of simple proxies of the urban-rural balance alone. A large unorganized rural sector can easily be offset by concentrated urban interests, as is the case in a number of African countries. Second, it is not clear that the turn to outward-oriented growth in the East Asian NICs can be linked to a concern with rural interests. Fears of insurgency and rural unrest were behind the land reforms in Korea and Taiwan in the fifties, but the turn to export-led growth is more clearly traced to a decline in aid flows and the structural problems associated with import-substitution. It can be argued, however, that these structural problems were partly a function of the *absence* of natural resource exports that could finance continued import-substitution. In Latin America, by contrast, the availability of such resources allowed import-substitution to continue for longer than it might have otherwise.

13.3.2 The Role of Political Institutions

As the foregoing discussion should make clear, policy choice is not only a function of the distribution of interests, but of the institutional context in which they operate. The major debate on stabilization among political scientists concerns whether authoritarian or elected governments are more "successful" at stabilization (Haggard 1986; Kaufman 1985; Remmer 1986; Ames 1987, chap. 5). Cross-national studies do not yield conclusive results, but this probably has to do with the crudeness of the authoritarian-democratic dichotomy. A distinction must be made between "strong" and "weak" authoritarian governments. "Strong" authoritarian governments possess a number of organizational resources that make them more successful in imposing the costs of stabilization, at least in the short run. These include a relatively insulated decision-making process, weak legislatures, and corporatist organization, or control, of interests. Korea's ability to adjust swiftly during the early 1980s, for example, can be traced in part to a tightly controlled budgetary process and controls on labor.

Many "authoritarian" governments, however, are in fact quite weak, characterized by extensive patron-client networks, a low degree of insulation from the political demands of society, extensive interference in even routine economic decision making by political elites and a high degree of instability. At the extreme, some "authoritarian" regimes are little more than personal autocracies in which the lines between public and private finances are blurred. The succession of Bolivian military juntas in the late 1970s and early 1980s is representative of a system in which central political institutions are extremely weak. Such systems are likely to have more difficulties than "strong" authoritarian regimes in imposing costs, and will probably fare worse than many democracies.

This is particularly true where democracies have evolved stable patterns of interest group representation and consultation; just like "authoritarian" governments, democracies constitute a heterogenous category. A distinction is possible between those plebiscitary democratic systems, such as Peru, that rest on broad, mass appeals and those with more institutionalized systems of representation, usually involving stronger party systems, such as Colombia. Such institutional mechanisms aggregate broader interests, and can thus act as a check both on the disruptive impact of plebiscitary appeals as well as on particularistic rent seeking.

Analysis of institutional capacity must be extended to the bureaucracy itself. The attention given to policy reform among economists has not, in general, been matched by adequate attention to the administrative requirements of successful policy implementation. Quite obviously, the administrative capacity of government is a crucial determinant of the success of a number of policy measures, particularly those structural adjustment measures demanding government support. The transition to export-led growth in Korea, for example, involved not only reforms in the broad system of incentives, but a complex system of *organizational* supports to exporters, including the provision of market information and technical assistance, a complex drawback system, and subsidized credit. All of these policies rested on an efficient bureaucracy (Haggard, Kim, and Moon 1987).

The characteristics of the bureaucracy likely to affect its performance include patterns of recruitment, particularly the extent to which they are meritocratic or not, and the degree of coordination among different ministries and between ministries and state-owned enterprises. This last issue is particularly salient for the analysis of the debt crisis. In all of the cases included in this project, state-owned enterprises were crucial in the expansion of foreign debt. Obligations were frequently incurred without central government or ministerial approval, and even without the monitoring that would give central bank and finance ministry officials an adequate picture of debt aggregates.

While it should be clear that bureaucratic capabilities matter, several amendments are required. First, the ability of bureaucracies to act, even highly competent ones, is dependent on the larger political context. In Mexico over the last two decades, for example, the influence of the treasury and central bank has changed directly with the broader political strategy of successive administrations. Second, bureaucracies can easily become overdeveloped or wedded to organizational routines that impede, rather than facilitate adjustment. While central government guidance was important in earlier phases of export-led growth in Korea, Taiwan, and Singapore, dirigiste traditions may now present barriers to more rapid growth. The dogmatic course pursued by entrenched laissez-faire technocrats in Argentina and Chile in the late 1970s provides another example of bureaucratic rigidity.

The bureaucracy must also be viewed not only as an administrative structure, but as an interest group in its own right. Civil servants are politically significant actors in a number of countries, particularly small, low-income states where they play an important role in urban coalitions. Establishing control over the expansion of the government itself is one of the most difficult tasks associated with stabilization and adjustment. Brazil's difficulties in reining in its sprawling state-owned enterprise sector provides an example.

13.3.3 Political Cycles and Transitions

The broad analysis of interest groups and institutions is useful in drawing some cross-national comparisons, but we also want to know what political forces influence policy changes over time *within* particular countries. This demands closer attention to the short-term survival strategies of politicians (Ames 1987). One important hypothesis centers on electoral cycles. Incumbant governments will manipulate macroeconomic policy to maximize their short-term electoral chances, tolerating higher levels of inflation in order to achieve lower levels of unemployment, for example. Adjustment programs are more likely to be abandoned prior to elections, while post-election periods, particularly where incumbants have been returned, are more conducive to stabilization.

The evidence for the business cycle claim is weak in the advanced industrial states and its analytic underpinnings have also been challenged. Brian Barry (1985, 300) notes, for example, that it assumes "a collection of rogues competing for the favors of a larger collection of dupes." Some of the factors mitigating the electoral cycle in the advanced industrial states are likely to be absent in the developing countries, however. Policy-making institutions are weaker and less insulated and publics less informed. Lower levels of income and extensive poverty are likely to make instrumental appeals more powerful. The one, thorough cross-national study done on the cycle for a group of developing countries finds strong evidence for politically motivated fiscal policy (Ames 1987). Individual country studies included in this project, such as those for Mexico (chap. 7 in this volume) and the Philippines (chap. 8), also suggest the existence of political cycles of spending.

The political cycle model must be extended to cover noninstitutionalized transitions between democratic and authoritarian regimes. Given the uncertainty surrounding such transitions, new democratic governments are likely to pursue expansionist policies early in office, a pattern exactly the opposite of that predicted for institutionalized democracies. The expansionist phases of the Cruzado and Austral plans in Brazil and Argentina reflect this pattern. New authoritarian regimes, by contrast, frequently come to power amidst political-economic crises precisely to impose "discipline." This was true, though under differing circumstances, in Brazil (1964), Argentina (1966 and 1976), Turkey (1971 and 1980), Indonesia (1966), Bolivia (1971), and Korea (1980). Authoritarian governments will pursue more politically motivated policies only as they face opposition and attempt to make the transition to constitutional rule (Ames 1987, chap. 5).

13.4 Conclusions

Drawing conclusions for policy from political analysis may, at first, seem difficult, since a number of variables that are relevant are not manipulable. In fact, there is probably more room for political maneuver and persuasion than is frequently recognized. The reform process is not merely a technical, policy-making exercise, but demands the building of political coalitions of support. This can be facilitated by campaigns of information targeted at groups that stand to gain. Imposing costs is, of course, more difficult, but groups will be more likely to acquiesce to short-term costs if they are consulted and sense that their position in the political system is secure. In a number of policy areas, compensation to potential losers may be less costly than an effort to force through policies that are likely to fail politically. The timing of the introduction of reform measures is also at least partly manipulable, and can affect the likelihood of program success. In some cases, it may be wiser simply not to initiate a program at all, rather than to introduce measures that are doomed to failure. Political analysis also suggests the importance of a range of longer-term reforms that affect the capacity of governments over time. These include administrative reform and training, which have been given inadequate weight in Fund programs to date. In the end, however, there is no substitute for a nuanced understanding of the political and social setting into which economic programs are introduced.

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