Annex: Country Experiences

Chilean Adjustment 1982–1988: Preserving the Country's Competitiveness

A sharp drop in world copper prices, rising interest rates, and significant real appreciation of the peso led to a massive economic recession in Chile in the early 1980s. Economic growth declined sharply from 5.3 percent in 1981 to –14 percent in 1982. The fiscal balance turned from a surplus of 5.5 percent of GDP in 1982 to a deficit of 3.4 percent in 1982 as revenues collapsed. The exchange rate peg was abandoned and capital outflow controls were imposed as international reserves were depleted. The sharp depreciation led to a deterioration of the balance sheet of the private sector, which was heavily externally indebted. The unemployment rate rose from 8.5 percent in 1981 to 24 percent by the end of 1982 and the financial system became highly vulnerable. In this context, the authorities began an ambitious fiscal adjustment supported by two consecutive IMF programs. A key objective was preserving the country's competitiveness.

The fiscal adjustment included the following measures:

- *Tax measures.* The authorities increased taxes on tobacco products, imposed temporary surcharges on personal income and real estate, introduced a gambling tax, and raised the automobile road tax by 60 percent for one year. The import tariffs were temporarily increased initially, but this policy was reversed in 1985 in an effort to preserve the country's competitiveness and to contain inflation. Successive measures included the broadening of the VAT coverage and an increase in the rate of taxes on luxury goods and property. In 1986 income tax was reformed by lowering tax rates for enterprises and individuals and providing tax benefits for reinvestment of earnings.
- *Spending measures.* The authorities successfully managed to reduce current expenditures, especially the wage bill. In 1982, wage indexation of public and private wages was abolished and the wage floor for collective bargaining was lowered. Moreover, the salaries of higher-paid employees of the public sector were cut by 10 percent and wage increases in the public sector were kept below inflation throughout the adjustment period. Public current expenditures declined from around 32 percent of GDP in 1982 to 26 percent in 1987.
- *Structural reforms.* The fiscal adjustment program was accompanied by a broad set of structural reforms aimed at (i) reducing the size of the state and liberalizing the economy, (ii) strengthening the tax system, and (iii) safeguarding the financial system. They included, in particular, the privatization of the social security system and of several public enterprises, the progressive liberalization of the exchange and trade system, adoption of a liberal foreign investment code, the simplification of personal and income taxes, and the recapitalization of financial institutions.

The successful large fiscal adjustment was supported by strengthening fiscal institutions. The fiscal deficit of 3.4 percent of GDP in 1982 turned to a surplus of 1.1 percent of GDP in 1988. Real GDP recovered in 1984 with an annual growth of 6.3 percent climbing to 7.4 percent by 1988. These efforts were also reinforced by continuous improvement of the fiscal framework over the next decades, including introduction of a resource fund, and, later, a structural fiscal balance rule, and buildup of precautionary savings. This enabled the authorities to implement countercyclical fiscal policies during commodity price shocks and smoothed economic growth.

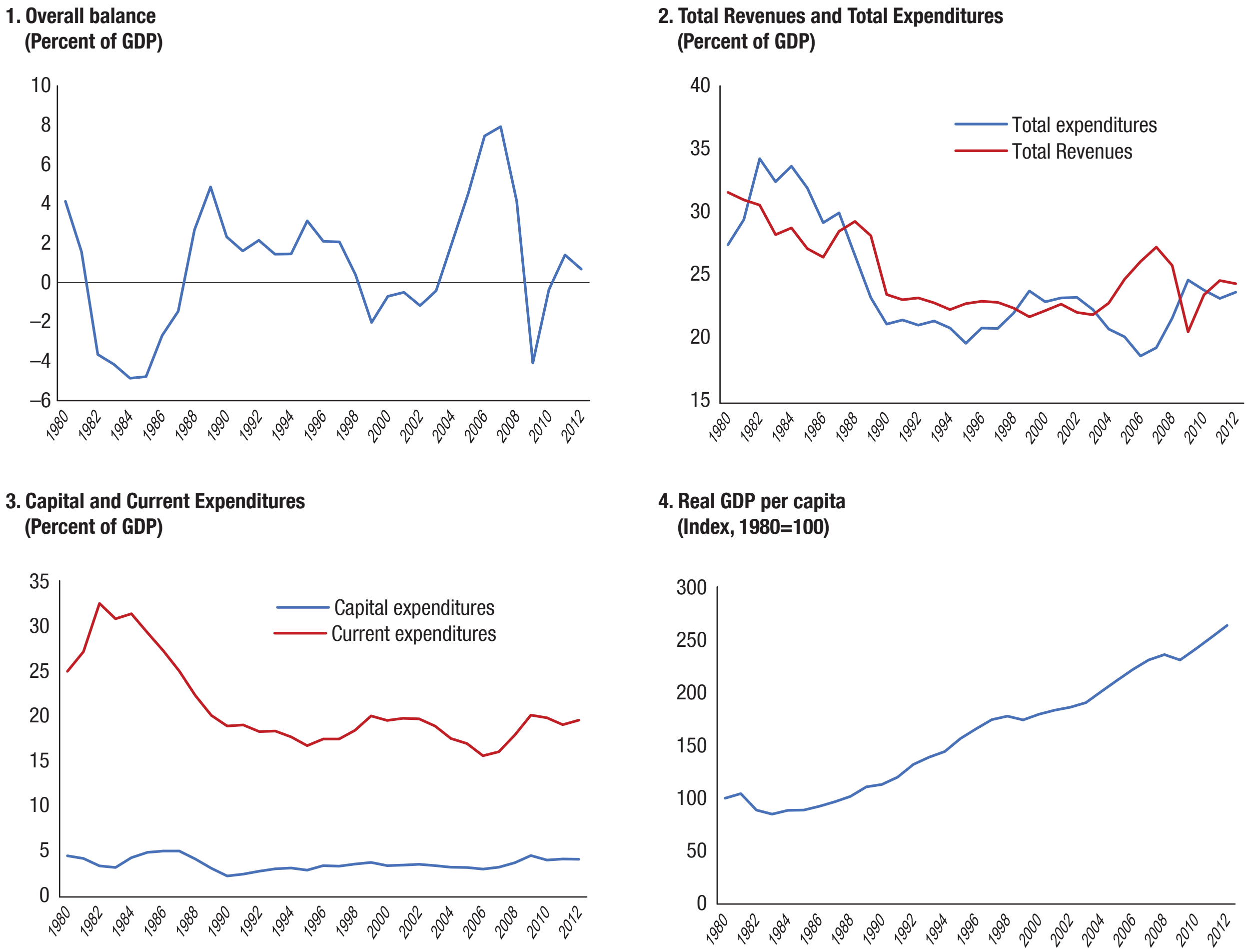
Nigerian Adjustment (1982–1990): From Trade Restrictions to Economic Liberalization

The significant drop in oil prices in 1981–82 led to sharp decline in oil revenues and exports (export volumes declined by more than 25 percent). Due to the delayed adjustment in imports, the current account deficit balance deteriorated from a surplus of about 5 percent of GDP in 1980 to a deficit of about 10 percent in 1982. International reserves were reduced to very low levels by 1982. The authorities initially implemented trade restrictions through fiscal and administrative measures to reduce the external deficit and raise custom revenues. This policy was abandoned in 1986 when efforts to liberalize the economy were initiated.

Trade restrictions and large capital spending cut (1982–86). The initial reaction to the growing current account deficit was a series of fiscal and trade measures to limit imports.

- Large increases in tariffs were accompanied by the reintroduction of an advance import deposit scheme (to as much 250 percent for luxury goods), the broadening of the coverage of items subject to import licensing or prohibition and the tightening of administrative controls on imports. Capital controls were also tightened.

Annex Figure 1. Fiscal Adjustments in Chile (1982–88)



Source: IMF staff estimates.

- On the spending side, capital expenditures that had grown tremendously during the oil boom were significantly reduced. Their share fell to 41 percent in 1983, from 62 percent of the federal government expenditures in 1981–82—they were further reduced by half in 1984. Current expenditures, on the other hand, kept growing due to large interest payments, increased transfers to state governments to help finance their deficits and subventions to the SOEs and public entities to help cover their losses. Fiscal discipline was eroded and the federal government's overall fiscal deficit averaged 6.5 percent of GDP from 1982 to 1985.
- The fiscal deficit was largely financed by the domestic banking system leading to a rapid growth of net domestic assets of domestic banks and to inflationary pressures. These pressures were reinforced by shortages of imported consumer goods. While the nominal exchange rate remained relatively constant due to a policy of gradual depreciation of the naira against a basket of seven currencies, the real effective exchange rate increased steadily. Production continued to weaken[24] as the sharp reduction in imports and increasingly complex regulations governing external trade began to cause disruption in economic activity and underutilization of productive capacity.

Structural adjustment efforts (1986–90). The abrupt decline in oil prices and oil revenues in 1985 exacerbated the country's difficulties leading the authorities

[24]Real GDP decreased on average by 3.7 percent per year from 1982 to 1985.

to adopt a comprehensive and radical program to resolve them the following year. In particular:

- They adopted a market-determined exchange rate system through the debut of a Second-Tier Foreign Exchange Market covering all transactions. An official (first-tier) exchange rate was initially maintained for foreign debt obligations but the two rates were unified during the following years.
- Import licensing was eliminated, such as export duties and most export licenses. Most price controls were also abolished.
- On the fiscal side, policies to improve the overall allocation of public expenditure were implemented. Moreover, authorities put considerable emphasis on the rationalization of states' fiscal positions. The size of the public sector was reduced through the commercialization and privatization of several SOEs.

The initial results of the program were mixed. The large depreciation from exchange-rate liberalization led to an increase in oil revenue (in domestic currency) but dramatically raised the external public debt, which rose to more than 100 percent of GDP in 1986 leading to a sharp increase of the external debt service. The effects of the depreciation and more relaxed fiscal policy stance in 1987 and 1988 (the overall fiscal deficit reached 13.5 percent of GDP in 1988[25]) led to a sharp rise in inflation with an average rate of 37 percent per year between 1987 and 1989. However, Nigeria's economic performance improved between 1988 and 1990 with an average real GDP growth of 8.4 percent per year due to the strengthening of the country's competitiveness and rising oil prices. The authorities managed to reduce the fiscal deficit to 2.9 percent of GDP in 1990 but the fiscal policy remained procyclical during the 1990s and most of the 2000s. As a result, the country faces the recent drop in oil prices with very limited buffers.

Canada: Taming the Deficits and Reducing Debt

In 1993, when a new federal government was elected, Canada was recovering from recession and facing a large fiscal deficit. The fiscal situation of the federal government had also deteriorated over the preceding years. The overall deficit was higher than 5 percent of GDP in 1992 and 1993, the interest bill was nearly 30 percent of expenditures and debt was 65 percent of GDP. In 1995, the *Wall Street Journal* declared Canada an "an honorary member of the Third World" and referred to the Canadian dollar as the northern peso.

The government began a period of fiscal tightening with the 1994 budget. The target was a 3½ percent of GDP reduction in the overall deficit for 1993/94–1995/96 with 0.4 percentage point of GDP coming from tax increases and 3 percentage points from expenditure reductions. Tax measures included higher excises and corporate income tax rates, and the broadening of both personal and corporate income tax bases. Expenditure cuts were widespread and included wages, employment, unemployment insurance, and agricultural and business subsidies. The public service was reduced by nearly 45,000 positions over a two-year period. Key components of the adjustment process were the identification of a medium-term target (interim target of overall deficit of 3 percent of GDP in three years and balanced budget within five years) and the establishment of a contingency reserve. The finance minister briefed parliament on a semi-annual basis on progress being made in achieving the target, which helped improve public "buy-in" for the reforms.

The fiscal consolidation that took place over the 1993–2000 period improved the general government primary balance by 10 percentage points of GDP. The general government maintained a surplus through 2002, 8.5 percentage points above the initial 1993 position, despite a growth slowdown. Debt was reduced from 100 percent to 61 percent of GDP.

Malaysia 1985–1990: Revitalization of the Private Sector

A series of policy initiatives led to large deficits in the early 1980s, at a time when Malaysia had to manage the large fall in commodity prices. Large-scale development projects, such as launching a state-owned heavy industry sector, and other counter-cyclical fiscal policies aimed at offsetting the impact of the global recession in the early 1980s, pushed fiscal deficits to 17 percent of GDP by 1982. These policies became even more unsustainable after the sharp drop in the prices of Malaysia's major primary export commodities and the resulting recession.

By 1985 government debt had doubled, reaching 83 percent of GDP with SOEs accounting for 25 percent of GDP. Under the Fifth Malaysia Plans, which covered the period 1986–90, the government initiated a comprehensive reform package focused on reducing government expenditure and revitaliz-

[25]Source: IMF Staff Report for the 1992 Article IV consultation.

ing the private sector. Spending reforms included a freeze on public employment, a deferral of wage adjustments and a rationalization of non-essential capital expenditures. These reforms were accompanied by institutional changes aimed at improving strategic prioritization and devolution of decision making to line ministries.

Between 1986 and 1990 government expenditure fell by 9 percentage points of GDP (7 percentage points of which were current expenditures). Tax reforms sought to lower the tax burden and incentivize private investment. The excess profit tax was abolished, import duties on manufacturing sectors that had enjoyed tariff protection in the past were dismantled, corporate tax rates were reduced, and incentives such as tax holidays and targeted allowances were created. Revenue losses were offset by widening the sales tax base and improving revenue administration. The key element in the reform package was a widespread privatization and economic liberalization program. SOEs were restructured or liquidated and the proceeds were earmarked to pay down the debt. New laws were created that liberalized the regulatory framework and relaxed foreign investment rules.

The reforms put Malaysia on a rapid growth trajectory. Over the period from 1986 to 1997, growth averaged around 8 percent of GDP, private investment increased to 32 percent of GDP from 14 percent, real per capita income nearly doubled and poverty declined from 19 percent to 6 percent.

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