Folder Title:	Structural Adjustment Lending (SAL) Files - Book 7
Folder ID:	1837346
Series:	Records Relating to Structural Adjustment Lending Maintained by Directors and Senior Advisers of the Development Policy Group (DPG) and to Other Organizations
Dates:	12/1/1991 – 12/1/1992
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ADJUSTMENT
LENDING

1991 & 1992

Book VII

Grilli

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

DATE: July 17, 1992

TO: Ms. Luisita I. Guanlao, CTRFI

FROM: Satish Mannan, DPG

EXTENSION: 32738

SUBJECT: Adjustment Lending Information

As requested by you, please find attached a list of FY 91-92 adjustment operations with commitment and tranche information. In case you want to do any further processing, we have downloaded this information on the enclosed diskette in LOTUS-PRN format.

cc: Mr. Ray

/sb

REPORT TR112
FY91 IBRD AND IDA ADJUSTMENT OPERATIONS

REGION	COUNTRY	NAME	IBRD ($MIL)	IDA ($MIL)	NUMBER OF TRANCHES
AFR	BURKINA FASO	SAL I	.0	80.0	3
	COMOROS	MACROECON. REFORM & CAPA	.0	8.0	2
	GHANA	Priv. Invest. Promotion	.0	120.0	2
	KENYA	AG.SECTOR ADJUST. II	.0	75.0	2
		EXPORT DEVELOPMENT	.0	100.0	2
	MALI	SAL I	.0	70.0	3
	REPUBLIC OF	SAL II	.0	55.0	3
	RWANDA	SAL I	.0	90.0	2
	SENEGAL	TRANSPORT SEC. SECAL	.0	65.0	3
	TOGO	POPULATION/HEALTH ADJUST	.0	14.2	4
		SAL IV	.0	55.0	3
	UGANDA	AG SECTOR ADJ CREDIT	.0	100.0	2
	ZAMBIA	RECOVERY CREDIT	.0	210.0	2
EAP	INDONESIA	PSDL II	250.0	.0	1
	PHILIPPINES	ENV. & NAT. RES. MGT. (S	158.0	66.0	2
ECA	CZECHOSLOVAK	SAL I	450.0	.0	3
	HUNGARY	SAL II	250.0	.0	3
	POLAND	FIN. INST. DEVELOP.	200.0	.0	2
		HEAT SUPPLY RESTRUCTURIN	340.0	.0	2
		RESTR. AND PRIV.	280.0	.0	1
		SAL I	300.0	.0	2
LAC	ARGENTINA	PUB ENTRP REF ADJ	300.0	.0	3
	COLOMBIA	PUB SCTR REF	304.0	.0	3
	EL SALVADOR	SAL I	75.0	.0	3
	HONDURAS	SAC	.0	20.0	1
		SAL II	90.0	.0	3
	JAMAICA	TRADE&FIN SAD II	30.0	.0	2
	MEXICO	AGRIC. SECTOR ADJ. II	400.0	.0	2
		EXPORT SCTR	300.0	.0	1
	URUGUAY	DDSR SUPPORT	65.0	.0	1
	VENEZUELA	INTEREST SUPPORT LN	150.0	.0	1
NA	ALGERIA	ENTER.& FIN. SECTOR REST	350.0	.0	2
	EGYPT, ARAB	STRUCTURAL ADJUST.	300.0	.0	2

NOTE : SUPPLEMENTAL LOANS AND CREDITS NOT INCLUDED.

DPG
07/16/92

REPORT TR112
FY91 IBRD AND IDA ADJUSTMENT OPERATIONS

REGION	COUNTRY	NAME	IBRD ($MIL)	IDA ($MIL)	NUMBER OF TRANCHES
MNA	MOROCCO	FINANCIAL SECTOR DEVELOP	235.0	.0	2
SAS	SRI LANKA	PUBLIC MANUF. ENT ADJ.(S	.0	120.0	2

NOTE : SUPPLEMENTAL LOANS AND CREDITS NOT INCLUDED.

DPG
07/16/92

REPORT TR112
FY92 IBRD AND IDA ADJUSTMENT OPERATIONS

REGION	COUNTRY	NAME	IBRD ($MIL)	IDA ($MIL)	NUMBER OF TRANCHES
AFR	BURKINA FASO	AG. SECAL	.0	28.0	3
		TRANSPORT SECAL	.0	66.0	3
	BURUNDI	SAL III	.0	30.0	2
	GHANA	AGRIC SECAL	.0	80.0	3
		FINSAC	.0	100.0	3
	KENYA	EDUCATION SECT.ADJ.CREDI	.0	100.0	3
	MALAWI	ENTREPRENEUR DEV & DROUG	.0	120.0	2
	MOZAMBIQUE	ECON. RECOVERY CR.	.0	180.0	2
	REP. OF COTE	FIN SECTOR ADJ	150.0	50.0	2
		HUMAN RESOURCES ADJ	125.0	25.0	3
		REGULATORY REFORM	75.0	25.0	2
	SIERRA LEONE	IMPORT SUPPORT	.0	43.1	3
	TANZANIA	FIN SECTOR	.0	200.0	2
	UGANDA	SAC I	.0	125.0	2
	ZAMBIA	PRIVATIZATION/IND. REFOR	.0	200.0	3
	ZIMBABWE	SAP	125.0	50.0	2
EAP	LAO P.D.R.	SAC II	.0	40.0	2
ECA	BULGARIA	SAL I	250.0	.0	2
	HUNGARY	ENTERPRISE RESTRUCT/PRIV	200.0	.0	2
	ROMANIA	SAL I	400.0	.0	2
LAC	ARGENTINA	PUBLIC SCTR REF	325.0	.0	2
	BOLIVIA	SAC	.0	40.0	3
	HONDURAS	ENERGY SCTR	.0	50.6	3
	NICARAGUA	ECON.REC.CR.	.0	110.0	2
	PANAMA	ECON.REC.LN	120.0	.0	3
	PERU	FIN S REFORM	400.0	.0	2
		SAL	300.0	.0	1
		TRADE POLICY	300.0	.0	1
MNA	MOROCCO	SAL II	275.0	.0	2
	TUNISIA	ECON.& FIN.REFORM SUPPOR	250.0	.0	3
SAS	BANGLADESH	PUBLIC RESOURCE MGT ADJ	.0	150.0	3
	INDIA	OIL & GAS SECTOR DEVELOP	150.0	.0	1
		SAL I	250.0	250.0	2

NOTE : SUPPLEMENTAL LOANS AND CREDITS NOT INCLUDED.

DPG
07/16/92

GENERAL

File
Adj. lending

SecM92-1478

FROM: Vice President and Secretary

November 18, 1992

Adjustment Lending by Regional Development Banks and Selected Bilateral Donors

The attached paper is being distributed to the Executive Directors for information.

Questions may be addressed to Mr. Shilling (X82474) or Mr. Grilli (X35100).

Distribution:

Executive Directors and Alternates
Office of the President
Executive Vice Presidents, IFC and MIGA
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

ADJUSTMENT LENDING
by Regional Development Banks and Selected Bilateral Donors

Introduction

1. The Report on Adjustment Lending III was discussed by the Board on April 14, 1992. At that time several Directors asked about the adjustment lending activities of other development banks. Staff noted that other agencies had begun adjustment lending relatively recently in close association with the World Bank and IDA (subsequent references to the World Bank in this report will include IDA). Directors then requested further information on the amounts and terms of such lending. This note has been prepared in response to that request.

2. Adjustment lending by three regional development banks are reviewed. These are the African Development Bank (AfDB), the Asian Development Bank (ADB), and the Inter-American Development Bank (IDB). The European Bank for Reconstruction and Development has not been included since it does not engage in adjustment lending at this time 1/. Three bilateral donors that have provided substantial support for adjustment programs have also been covered 2/. These are the European Community, Japan, and the United States. The practice for bilaterals is to coordinate with the World Bank and the IMF the adjustment support that they provide. The information contained in this report has been gathered from annual reports and other documents of these agencies, material provided by them on request for this study, staff interviews and inputs from World Bank staff involved in cofinancing with these agencies.

3. In the late 1970s, World Bank staff and management had reached the conclusion that extremely distorted macroeconomic and sectoral policies seriously inhibited development prospects in many developing countries and greatly reduced the value of many worthwhile investment projects. Structural adjustment lending (SAL) was initiated, followed shortly

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1/ The Caribbean Development Bank has also made one adjustment loan for $34 million cofinanced with the World Bank. It is not included in the analysis since it does not have a formal program of adjustment lending, does not currently plan to initiate one, and the past amounts involved are small.

2/ A number of other bilateral donors that provide substantial assitance for adjustment programs are not covered. Of particular importance is the support of adjustment lending provided to the Special Program for Africa, which includes $700 million from France, $520 million from Sweden, $530 million from UK, and $465 million from Netherlands. Since SPA was launched in 1988, 15 bilateral donors plus the AfDB and the European Communities have provided adjustment financing in support of policy reform programs in 26 Sub-Saharan countries. For SPA-2, donors have pledged $7.3 billion, either for direct cofinancing with IDA operations or for coordinated financing, supporting well-defined adjustment programs.

thereafter by sector adjustment lending (SECAL) to address these obstacles. The broad objective of these programs was to change policies so as to improve the efficiency and competitiveness of economies facing external and internal difficulties. This would help enhance their medium-term growth and development prospects 3/. Adjustment lending has provided a powerful tool to assist and encourage countries undertaking difficult but necessary policy reforms and to help ease some of the short-term costs of these adjustments 4/.

4. Many of the factors that led the World Bank to undertake adjustment lending were also behind the tendency of the regional development banks and other donors to do the same. The presence of many of the same shareholders in the governing bodies of both the World Bank and the regional development banks helped disseminate knowledge of Bank programs and processes, so that cofinancing and parallel financing with the World Bank were soon established as the preferred means of the regional banks to begin their adjustment lending. For similar reasons, bilateral donors moved into adjustment lending. Yet, while recognizing that all donors supporting adjustment programs need to maintain consistency of approach and policy advice, bilaterals have in some cases preferred less rigid links to the World Bank programs, and correspondingly termed their lending as "coordinated" with that of the Bank 5/. In this report, "linked financing" will be used to refer generically to all three forms noted above.

5. As each agency has expanded into adjustment lending, policies and practices have been established. In most instances, the various agencies have opted to link their financing with the World Bank and/or have relied on the World Bank and the IMF for establishing the overall adjustment framework. Coordination and cooperation with the World Bank has been strengthened, and staff of the multilateral banks and bilateral donors have come to work closely together. Cross participation or joint missions have become common, and program negotiations are closely coordinated. Analyses and models are regularly shared between the

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3/ Extensive discussion of the rationale and effectiveness of adjustment lending is provided in the "Review of Adjustment Lending" series, the OED Reviews of Adjustment Lending, and other documents.

4/ Adjustment lending is also called "quick disbursing" and "policy based", each term emphasizing a different aspect of the instrument. In some cases, "program" lending is also included if it is related to policy reforms. For some donors (e.g., EC, USA), assistance to adjustment programs is provided in the form of grants.

5/ Cofinancing involves explicit cross-referencing of performance conditions and sanctions in the legal documentation of each institution's loans and usually identical conditions. In parallel financing, there is no explicit cross-referencing or cross default clauses in the documentation. However, in adjustment operations, the conditionality is generally identical and the use of parallel financing is for reasons of administrative preference. Coordinated financing implies a somewhat looser formal relation in terms of conditionality.

staffs of the institutions involved in each operation. These activities have naturally required additional time and effort of World Bank staff as well as of that of other institutions. As for the Bank, estimates from LAC indicate that coordination on major adjustment operations initially took up to the equivalent of 25% of appraisal staff time. This amount has come down substantially, as more experience has been gained and as IDB staff have been involved earlier in the design process. In Africa, a large amount of staff time has been devoted to cofinancing and aid coordination (averaging more than 22 staff years over the past three years) in the context of the SPA and other initiatives. Part of this has been devoted to adjustment lending coordination, though it is not possible to determine precisely how much was additional to the rest of the program. Much of the learning costs of the coordination process have by now been absorbed, and demand for this activity may also have, in general, reached a plateau as most agencies do not expect any further substantial increase in their adjustment lending. The possible exception here is lending to the FSU, depending on how the situation evolves in this area.

6. The regional banks and the bilateral donors have progressively developed more in-house capacity to do policy analysis. They are developing independent views on priorities in the adjustment process. As they become increasingly involved in making substantive contributions to program design and direction, this enhanced capacity has strengthened their ability to play an effective role in the policy discussions, and some have moved toward independent adjustment lending. The bilateral donors in particular have begun raising issues reflecting their own priorities and understanding of key factors in adjustment (e.g. social issues from the EC, private sector development from the US, and directed credit and two-tiered interest rates from Japan). Dialogue on these questions is ongoing and further analysis undertaken where necessary.

7. The majority of adjustment operations by the regional banks so far have either been cofinanced or parallel financed with the World Bank. In cases without explicit cofinancing (e.g. coordinated financing by the EC), the other agencies have taken care to coordinate their actions with the World Bank and the IMF. This assures consistent signals are sent to the government about programs and conditions of support. The regional banks and bilateral donors have generally preferred sector adjustment lending, when feasible 6/. They feel that the strengths and composition of their staffs allow them to make more positive contributions in these areas. Structural adjustment operations have usually been supported in the context of special programs such as the SPA. In some cases, adjusting countries have gained flexibility by availing themselves of parallel financing. Parallel loans have focused more extensively on certain aspects of the adjustment program, or allowed more flexibility in release of tranches in the separate loans, where the governments of countries undertaking

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6/ In some cases, the sector adjustment loans of the regional banks are close to sector investment or hybrid loans. The regional banks have also used program loans on some occasions, as has the World Bank, and these have been included in the adjustment lending series where appropriate. They have become infrequent as adjustment lending has emerged as the preferred instrument.

adjustment were having difficulties meeting all the conditions even though the program was largely on track 7/.

8. Despite the increasingly large participation of other agencies to the financing of adjustment programs in developing countries, the World Bank has continued to provide the largest share of it. The trends are shown in Table 1, beginning in 1987, the years in which participation of other agencies became substantial. The World Bank's share in total commitments has fallen somewhat over the 1987-91 period, but the high level of linked financing with most donors indicates that the extent of the World Bank's influence in the design and execution of the programs extends beyond its share in total financing. The percentages shown, moreover, probably understate the extent of coordination, as there is also adjustment lending undertaken with financial support of agencies not included in the table. This is alo coordinated with World Bank or IMF programs. Examples are the operations of other bilaterals within the SPA.

9. Following are more specific descriptions of the activities of the regional development banks, the European Community, and two bilaterals in the area of adjustment lending.

7/ The World Bank also has flexibility in granting waivers in such circumstances, but phasing disbursements with other loans may offer advantages in some instances.

Table 1: Adjustment Lending Commitments by Major Creditors
(US $ million)

Creditor /a	1987	1988	1989	1990	1991
World Bank Group	4,154	4,843	6,044	5,957	7,036
IBRD	3,475	3,815	4,959	4,179	4,996
IDA	679	1,028	1,135	1,778	2,040
African Development Bank	721	406	576	561	715
% Cofinanced with the World Bank	59%	100%	97%	98%	80%
Asian Development Bank	150	660	275	820	435
% Cofinanced with the World Bank	0.0%	0.0%	0.0%	15.2%	0.0%
Inter-American Development Bank	0	0	0	1,310	2,050
% Parallel funded with the World Bank	0%	0%	0%	100%	83%
European Development Bank/Community	0	69	263	105	178
% Coordinated financing with the World Bank	0%	100%	100%	100%	100%
JEXIM/OECF	293	1,521	3,063	1,209	1,968
% Cofinanced with the World Bank	100%	100%	58%	100%	85%
USAID	1,478	658	1,049	1,711	1,278
% Linked with the World Bank /b	0%	0%	0%	0%	0%
Total Non-World Bank	2,642	3,314	5,229	5,716	6,449
% Linked with the World Bank	27%	60%	49%	58%	61%
Grand Total	6,796	8,157	11,321	11,673	13,481
Share of World Bank Group	61%	59%	54%	51%	52%
Share of others	39%	41%	46%	49%	48%

Source: Annex, Tables A1 to A6, calendar years.

/a Indicating the preferred type of linked financing.

/b USAID coordinates its activities through CGs, etc., but prefers not to link as closely as the other donors.

The African Development Bank (AfDB)

10. The African Development Bank was the first regional bank to initiate adjustment lending, obtaining approval from its Governors in 1986 at the same time its overall resources were increased. The following year it began both structural and sectoral adjustment lending operations. The AfDB moved relatively early in this direction due to the severity of the adjustment problems faced by its members and the difficulty of financing traditional projects in many of its member countries due to severe distortions and limited investment budgets. The AfDB makes adjustment loans through both its regular facilities and the African Developmen Fund (AfDF), its soft loan window, depending on the creditworthiness of the country. The funds for the adjustment lending are drawn from the regular resources of the AfDB and the AfDF. The AfDB established a guideline limiting its lending for adjustment

over the 1987-91 planning period to about 25% of the total. This has been revised downward to 21.5% for the AfDF in 1991-93. Partly due to size and creditworthiness limitations a large number of the AfDB's clients are still facing severe economic difficulties and are not creditworthy for much more regular financing. Present AfDF resource availability suggests that allocations to adjustment lending are not likely to increase.

11. Although the AfDB had done multisector and program loans in the past, for adjustment lending it chose to associate with World Bank operations. Loans are normally cofinanced with the World Bank, or parallel Bank programs as closely as possible. An IMF program in a country is a precondition for the AfDB to do adjustment lending. Following the inauguration of the SPA most of the AfDB's adjustment lending to low-income sub-Saharan African countries has been in the context of that program 8/. AfDB has also made adjustment loans to other countries which are not low income, such as Nigeria and Cote d'Ivoire, or which are not in Sub-Sahara Africa, such as in the Mahgreb. Cofinanced operations have identical conditionality. In a few cases, parallel financing has been used, where the AfDB has supported the macro conditionality in the multi-sector (SAL) loans, but not included all the sector conditionality of the World Bank's operation. In these cases, it is conceivable that AfDB conditionality could be satisfied, but not that of the World Bank. If this were to happen, the AfDB staff would consult closely with the World Bank as to whether their proceeding with a tranche release would be consistent with the overall policy objectives of the program. In practice, it is unlikely that the AfDB would proceed if the World Bank expressed reservations about the country's compliance with its overall program.

12. Staff of the AfDB work closely with World Bank staff on adjustment operations. They generally participate in the appraisal mission, and sometimes the preparation mission as well. The AfDB may have a representative at the negotiations with the World Bank, and World Bank staff may be involved in the AfDB negotiations. The World Bank's resident mission in Abidjan has staff designated to coordinate with the AfDB, and the newly opened AfDB representative office in Washington will further facilitate contacts. The actual processing procedures in the AfDB for adjustment lending are quite similar to its normal procedures for project lending. Supervision of adjustment operations is coordinated with the World Bank and receives close attention because of the importance of these operations, especially those integrated into the SPA and Consultative Group activities.

13. The large volume of AfDB adjustment lending in 1987 reflects a bunching of several operations that had been under preparation while the final authority to do adjustment lending was being considered by the Bank's board. This amount included an industrial sector loan to Tunisia for $114 million and an export promotion loan to Nigeria for $256 million. The latter was not cofinanced with the World Bank, but was coordinated with the Bank's program in the country. Subsequently, nearly all operations have been cofinanced. In 1991, there was an agricultural sector loan to Tunisia for $130 million that was not cofinanced with the World Bank but did support an adjustment program in that sector which had earlier

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8/ A small number of operations have not been explicitly cofinanced with IDA, including adjustment related TA and some supplemental loans.

received a World Bank SECAL. Other than SALs, the AfDB has undertaken SECALs in agriculture and industry with the World Bank.

The Asian Development Bank (ADB)

14. The Asian Development Bank (ADB) made major revisions in its program lending policies in late 1987. It decided to expand its lending activities to support sector development programs aimed at achieving improved sector performance over the medium-term. The sector development programs cover a varying mix of adjustments in policy, improved investment programs, and institution building. Although the Asian economies were not suffering macroeconomic disequilibria to the extent that some African and Latin American countries were, most of them did face structural and sectoral problems. The ADB program (adjustment) lending is directed only toward sector adjustments; the ADB does not do structural adjustment lending. The ADB makes program loans from both its ordinary capital resources (at commercial terms) and from the Asian Development Fund (at concessional terms). There is an overall cap on program lending of 15%, with a sub-limit of 22.5% of the Asian Development Fund (ADF) resources, each averaged over three years. The program was reviewed at the request of the ADB Board in 1990 after two years of operation and found to be functioning effectively. It was concluded that it allowed the ADB to offer a broader scope of support to the economic development of its member countries. Adjustment lending authority was continued, and the guidelines of 15% and 22.5% were reconfirmed.

15. The ADB's program loans are designed from its own sector experience and dialogue with member countries, and they are focused on sectors where the ADB sees it has added value to offer. Sector programs that it would support are to: (a) be based on detailed sector analysis and dialogue within the country's overall development plan; (b) be fully compatible with the ADB country strategy; (c) have the full support of the borrowing country government; (d) have objectives and policies expressed in quantifiable and time bound terms; and (e) be fully coordinated with the activities of the World Bank, IMF, and other major donors. Beyond this coordination, the ADB has not typically engaged in direct cofinancing of adjustment operations with the World Bank, except in the case of one ADF operation (an agricultural sector operation in Bangladesh) in 1990. However, there is regular coordination; staff of each institution often participate in each others missions and contacts are maintained through the World Bank's resident mission in Manila. The ADB relies on the IMF and the World Bank to establish the macro framework, and then designs its sector programs based on its own analysis and strategy. In some cases, the World Bank and the ADB have agreed to take lead responsibility in different sectors, which has reduced the opportunities for cofinancing. In other cases, borrowers have preferred to sequence separate adjustment or program loans from the two institutions. Coordination, as a result, has been less tight than, for example, in the context of the SPA program.

16. ADB program loans normally have two tranches and disbursement procedures that facilitate the quick disbursing nature of the loans. Special import accounts are generally established in the recipient country's central bank, and disbursements are made against

allowed imports. Procurement follows normal commercial or government procedures unless the size of the individual import bill exceeds a loan specific threshold. The loans themselves are processed by normal procedures, but they require an additional review by the Loan and Technical Assistance Coordination Committee. So far, one loan has been post-evaluated by the ADB (Indonesia Export Promotion made in 1987) and found to have been successful in meeting its objectives. The ADB has not identified problems with its other loans.

17. Program lending amounts from the ADB have fluctuated from year to year depending on demand, but have stayed within the guidelines. Most of the program lending has been in agriculture ($1.4 billion in 1987-91) and in industry and finance ($720 million in 1987-91). In view of the ADB's primary interest in project lending and the relatively better economic management of most of its traditional borrowers, there is not likely to be an increase in adjustment lending in these countries. On the other hand, the recently opening countries of Indochina and the newly formed countries of the Asian FSU may require adjustment lending.

Inter-American Development Bank (IDB)

18. The Inter-American Development Bank obtained approval from its Governors to engage in adjustment lending at its 1989 Annual Meeting. It began such operations in 1990. The IDB focuses on sector adjustment lending. An overall target for adjustment lending over the three year (1990-92) funding period was established at about $5.6 billion for adjustment lending from both Ordinary Capital (at normal terms) and the Fund for Special Operations (at concessional terms). This was 25% of the total authorized lending. Often operations are blended from these two sources depending on country needs and availability of resources from the Fund for Special Operations. The latter are generally quite limited. In addition, IDB has also used its adjustment lending authority to participate in debt and debt service reduction operations with the World Bank and IMF. The policy decision to initiate adjustment lending by the IDB required that initial operations be linked with the World Bank while the IDB gained experience. Senior management in both institutions moved quickly to ensure very close cooperation between their staffs. The location of the headquarters of both banks in Washington has facilitated this high degree of coordination. Overall country programs and foward planning scenarios are shared between staffs.

19. Technically, the IDB undertakes parallel financing with the World Bank. Coordination is quite close, and staff generally participate in the appraisal and negotiations of the other institution. Normally, the IDB adopts identical macro conditionality to the World Bank, but may be modified at the sector level depending on its own country analysis and objectives. Its lending may also aim at deferring sector reforms and at supporting further institutional reforms necessary for the success of the sector adjustment. The range of the sector adjustment loans can be from "near SALs" to hybrid investment loans. Whatever the form, the IDB coordinates its supervision and tranche releases very closely with the World Bank and would not proceed with a disbursement over the objection of the Bank. Following the first year of operations, the IDB moved to make some adjustment loans that did not have parallel financing with the World Bank (Columbia and Chile). In the case of Chile, the

World Bank had phased out its adjustment lending operation, when the IDB made a sector adjustment loan, in the context of the Enterprise for the Americas Program of the United States. That program requires an adjustment operation with the World Bank or IDB to receive certain benefits. These operations were coordinated with the World Bank and consistent with the country strategy. In Peru, as part of a coordinated strategy to support reforms among the IMF, World Bank, IDB, and bilateral donors, the IDB provided adjustment lending before the Bank 9/. Furthermore, in some of the smaller Caribbean countries, the IDB may take responsibility for adjustment lending.

20. The processing of adjustment operations in the IDB follows normal procedures. Adjustment loans are required, in addition, to have a second review by the President's Program Committee, which concentrates on the substance of the conditionality. Because of their quick disbursing nature, they are often put on a faster processing track and receive closer management attention. Like the World Bank, the IDB uses three tranches in some of these loans, especially where there is institutional reform. Close management attention is accorded to supervision of these operations. IDB investment projects are now typically monitored from the field offices. Adjustment loans are still supervised from a specialized unit in headquarters, which provides more consistency of supervision and closer coordination with the World Bank.

21. Adjustment lending activity of the IDB began only in 1990, but has assumed substantial proportions. This rapid growth is facilitated by close links with World Bank operations. There is some possibility that the adjustment operations will increase in the near future as some shareholders are urging the IDB to provide more funding for upcoming debt and debt service reduction operations. However, that will be limited by the overall three year funding allocation. Need for continuing reform in several major debtors is likely to argue for a high level of adjustment lending for several years. The amount allocated will be determined in the context of the next replenishment.

The European Community

22. The European Community (EC) manages a substantial aid program in addition to the bilateral aid programs of its individual members. The latter tend to be predominantly project and loan oriented, while much of the EC assistance to developing countries is in the form of grants. A small amount of the EC program is provided in the form of subsidized project loans through the EIB. The EC program is administered in several distinct programs with different historical and treaty origins. The most important is the ACP (Africa, Caribbean, and Pacific) program based on a series of treaties referred to as the Lome Conventions. These treaties cover a range of economic relations, including trade preferences

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9/ The strategy involved clearance of IDB arrears first, since they were smaller. That allowed earlier disbursement of new funds, from the ADB. The second tranche of the IDB operation was disbursed in July. Peru is expected to clear its arrears to the World Bank in December, so the adjustment operations approved can be disbursed.

and economic and technical assistance. In response to the growing economic difficulties in these countries, the EC established a special program to provide general non-project import financing in December 1987. Commitments began in 1988. A fund of 550 million ECU for 1988-90 was established from available resources in the then current five year budget to fund Sector Import Programs (SIP) and General Import Programs (GIP). These grants had most of the policy based characteristics of sector and structural adjustment loans and were often associated with World Bank adjustment operations, especially through the SPA in Africa. This was the motivating force behind the reallocation of resources to the SIP and GIP. The Lome IV Convention of December 1989 formally included adjustment grants in the assistance program and allocated 1,150 million ECU out of a total aid program of 12 billion ECU of assistance for 1990-95 10/. The amount available for adjustment grants is not allocated by country, as is the rest of the program. It is allocated on the basis of need and performance in adjustment programs. In any country, up to 10% of the indicative allocation to that country can also be used for adjustment operations (a total of about 550 million ECU). In addition, ACP countries can access STABEX and SYSMIN 11/ resources in parallel with adjustment grants if the specific commodity conditions for those stabilization programs are met. Although countries are in principle entitled to these funds solely on the basis of stabilization criteria, the EC has, on occasion, associated the use of these resources with structural reform.

23. In addition to the ACP countries, the EC has assistance programs with the Southern and Eastern Mediterranean (SEM) countries covering a variety of relations, though these are less elaborate than with the ACP. Use of assistance allocations to SEM countries for adjustment operations has been authorized to begin in 1992, and an allocation (grant) of 300 million ECU for adjustment activities has been made for 1992-96. It may be augmented by a limited proportion of protocol budget funds, as is the case for the ACP countries. The first adjustment grant for 40 million ECU was made to Tunisia in April 1992. A grant of 50 million ECU was made to Jordan in July, and a grant of 70 million ECU has been approved for Algeria, provided that country continues its adjustment program. There is also a regional program for Latin America, but provisions for adjustment lending are not currently foreseen.

24. In 1989, the EC established the PHARE program to assist countries in Eastern Europe in their transitions to more market oriented economies. This program was initially for 1 billion ECU and has been oriented toward technical assistance and projects. Many of the specific project and technical assistance activities have been aimed at supporting adjustment programs of the World Bank and IMF arrangements. In addition, the EC has managed, for the G-24, a program of loans for balance of payments support and reserve build-up in Eastern Europe, also linked to reforms defined under World Bank adjustment operations and IMF arrangements. This program was funded to commit up to $3.3 billion in 1991. It is not yet decided whether this program will be extended or whether a similar one

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10/ ECU exchange rates are .98 ECU/$US in 1986, 1.15 in 1987, 1.18 in 1988, 1.10 in 1989, 1.27 in 1990, and 1.24 in 1991.

11/ Respectively, a commodity earning stabilization scheme and a mineral production stabilization scheme funded by the EC for the Lome countries.

will be mounted for the FSU. Despite the diversification of EC financing activities, its ACP programs constitute the bulk of EC adjustment operations for the period under review. The remainder of this discussion will focus on them.

25. As a federation of sovereign nations, the EC is careful to maintain its independence of decision-making in its assistance program, and it has therefore opted not to use cofinancing or parallel financing arrangements with the World Bank. However, it is also conscious of the need to coordinate assistance for adjustment programs to the maximum extent possible. In establishing eligibility for its structural adjustment facility, the EC considers a country's need and the effectiveness of its policies. As a matter of practice, the existence of a World Bank or IMF adjustment program is considered sufficient to satisfy these conditions. Within the framework provided by the Bretton Woods institutions, the EC is an increasingly active partner in the policy dialogue and program design, as well as in the financing. The EC is a major supporter of the SPA program and has cooperated closely with the World Bank in that effort. Staff of the EC frequently participate in World Bank missions, and the EC is active in SPA country meetings. In certain instances, the EC may pursue independent objectives with its adjustment financing (in social policy, for example), but would do so in coordination with the World Bank and the IMF. The EC has expertise in certain sectors and is playing an active role in designing programs and assuring their implementation. Food and trade policy are areas of particular interest, as is the general consistency of adjustment programs across countries.

26. An internal unit in the EC has been created to review structural adjustment grants and help determine the amount of support in each case. If there were not a World Bank or IMF program in place, the EC would require an additional internal step to determine eligibility of a country before engaging in adjustment operations. So far, this situation has not arisen, but the governing documents were structured to assure the possibility of independent action by the EC. Otherwise, the processing of adjustment operations is the same as for normal activities. It is expected that adjustment grants for SEM countries will be treated on a country by country basis. There is no formal coordination framework arrangement such as the SPA.

Japan

27. The Japanese government provides development assistance through two institutions: the Japan Export Import Bank (JEXIM) for non-concessional loans, and the Overseas Economic Cooperation Fund (OECF) for concessional loans. Use of one or the other source of funding is determined in accordance with each agency's primary business areas, which are based on the income level of the borrowing country, sector of the operation, and type of program or project. Frequently, both are active in the same country. Both agencies are primarily focused on project financing. In recognition of the severe economic difficulties faced by many countries and encouraged by other major participants in the development community, Japan has moved to provide some of its assistance in support of adjustment and debt and debt service reduction operations. Since 1987, JEXIM has

expanded its scope of business to provide adjustment lending, which is untied. Nearly all OECF procurement is now also untied, including its support for adjustment operations.

28. The decision to support adjustment operations is made on a case by case basis. Neither agency has a target level of adjustment lending nor a special fund. Both prefer project operations if possible. Adjustment operations of the OECF have been funded out of the Fourth ODA Plan, which ends this year. Another ODA plan will be agreed later this year and is expected to be substantially larger than the $50 billion committed in the Fourth Plan. Both agencies have also been included in the Expanded Capital Recycling Program, which had as its objective committing $65 billion over the period 1987-92, including $23.5 billion through JEXIM and $12.5 billion through OECF. This program expired in the middle of this year. No direct successor to that program has been announced. JEXIM expects to continue adjustment lending as needed. OECF does not foresee that there will be a significant change in the proportion of adjustment operations in its overall program, so these operations are likely to grow accordingly. The actual level will depend on economic circumstances in the recipient countries and the availability of adequate adjustment programs.

29. In order to assure full coordination with the adjustment programs, both agencies have adopted a policy of cofinancing with the World Bank, ADB, or IDB for adjustment operations. Other cofinanciers may also be involved in some operations. Neither agency has included policy conditionality in its loan agreements. However, they only cofinance programs which they believe appropriate for the development of the recipient countries. Development Bank or IMF programs are considered assurance of the appropriateness of the program. Staff frequently participate in World Bank appraisal missions and often in negotiations. Both JEXIM and OECF monitor their adjustment loans in conjunction with the cofinancier's review schedule. Both agencies have strengthened their capacities to evaluate structural and sectoral adjustment programs and related policy issues. OECF has begun to offer suggestions to the World Bank staff on appropriate conditionality, though timing differences in the processing has sometimes prevented timely input from occurring. The preference of OECF for passing on low interest rates in two step lending operations is a case in point, and a dialogue is engaged on this issue. At present, neither institution intends to undertake adjustment lending other than as cofinancing where there is a clear need for additional financing and where the country's overall performance is satisfactory to the institutions. These agencies would prefer to find project vehicles for providing assistance, even in these circumstances. However, if that is not feasible, they will select appropriate adjustment operations.

30. Both institutions follow their normal procedures for processing these loans. Although JEXIM exercises a high degree of independence, it consults closely with the Ministry of Finance when deciding on each adjustment loan. Otherwise, normal procedures are followed, and the processes are relatively quick. In the case of the OECF, decisions may take somewhat longer because it depends on four ministries and must obtain the approval from each for its operations. The projects themselves are monitored more closely than regular projects by the agencies and in collaboration with the institution leading the cofinancing.

31. In addition to cofinancing with the World Bank, JEXIM has provided $3 billion to the IMF in 1988 for use in its ESAF program to support structural reform. It also cofinanced three debt and debt service reduction operations with the IMF ($1,000 million for Mexico and $300 million for Philippines in 1989, and $300 million for Venezuela in 1991). The year to year variation in the share of lending allocated to adjustment lending reflects variations in numbers of cases and size of operation presented for financing rather than any policy on the amount of lending allocated to this activity.

United States (USAID)

32. The United States' development assistance program 12/ reoriented its aid toward policy based activities in 1981. This reflected a growing emphasis on the policy framework in aid programs. Over the decade of the 1980s, USAID's economic assistance was also converted largely to a grant basis. There are still a number of soft commodity loans under the recently approved Title III in the PL 480 program and also some housing assistance guarantees. Assistance is provided for both structural and sectoral adjustment programs through several different vehicles in the USAID portfolio of programs 13/. Sector operations tend to be preferred in some programs. There is no formal overall target or ceiling for adjustment grants under most programs, and there is no special program for adjustment operations. Some programs have their own limits, such as the Development Fund for Africa, which has a 30% upper limit on adjustment operations. USAID funds are allocated globally in relation to US political interests as well as economic needs, but the final share of adjustment aid and extent of policy conditionality in a country's allocation is a function of need, willingness to undertake reforms, and country performance. Because of the foreign policy considerations related to the aid allocation, some programs may be predicated on cooperation on non-economic issues (e.g. action on drug control), and some grants may not be based on substantial reform. On the other hand, policy conditionality is not infrequently associated with project operations.

33. USAID adjustment operations are coordinated with the World Bank and IMF programs where these institutions have programs in place. While they are not normally linked to Bank operations, as in the case of other donors, USAID programs may reinforce World Bank and/or IMF conditions. They may also extend them into greater detail, particularly in terms of institution building and implementation. In some cases, countries are offered menus of reforms and the amount of aid is a function of the number and intensity of reforms undertaken. In other cases, by mutual agreement, grants are made for prior action on a reform program to avoid the appearance of the US imposing policy reform. In the

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12/ The US foreign assistance budget includes a number of other categories of aid which are not comparable to the assistance discussed in this report, e.g. military assistance. The discussion and figures presented include only economic assistance and exclude funds for Israel.

13/ The distinctions are not critical for this discussion and relevant programs will be grouped.

cases of some countries in arrears to the World Bank and/or IMF, USAID (often with other bilateral donors) has been able to provide financial support for initial adjustment programs in advance of the Bretton Woods institutions. This has enabled these countries to begin programs after their arrears had been cleared (e.g. Zambia, Guatemala, Nicaragua).

34. Adjustment operations are processed in a manner similar to other projects, but they are likely to receive more management scrutiny and also more attention from Congress, particularly those under the category of cash transfers, which comprise the bulk of the adjustment grants. Adjustment grant disbursements are not formally tied, but are subject to agreements on their use, including allocation to debt service payments due to the US government, the multilateral banks, other creditors, etc. (US participation in the SPA has been largely untied however). The objective of this restriction is to assure that funds are used in "approved" transactions, but it is recognized that money is fungible, and this has not proven to be a serious restriction on the use of funds.

35. USAID adjustment assistance represents a substantial share of its total economic assistance program. The data used here was compiled by estimates from program categories, not by summing individual operations, and thus it represents an approximate total for adjustment operations. Some individual grants included may have relatively little policy basis. At the same time there are policy based operations in other programs not included. A more detailed USAID study done for FY 91 indicates a slightly higher total for policy based operations in that year. In addition to the assistance shown, there are some soft loans for commodity imports that may be conditioned on policy reform, while a substantial part of the $150 million a year in the housing guarantees program is related to policy reforms.

Summary

36. The amount of adjustment lending by other aid donors, both multilateral and bilateral, has grown substantially over the past decade. The widespread need for this kind of assistance in the late 1980s and the desire of other agencies to add this tool to their programs of assistance to developing countries have both contributed to this trend. The difficulty of undertaking policy based lending and the importance of close coordination among all donors have been widely recognized. As a result, the vast majority of adjustment lending has been closely linked in one way or another with the adjustment programs of the World Bank and/or the stabilization and extended arrangements of the IMF. This cooperation takes a variety of forms, from the fully integrated cofinancing in the SPA in Africa, to close cooperation and collaboration in developing country programs.

37. Donors have generally established indicative upper limits (explicit or implicit) on the amount of adjustment lending they will undertake, but administer these limits flexibly. Based on current programs and expectations, adjustment lending seems to be reaching a plateau as most agencies have established their programs and are not expanding their limits while at the same time many countries are beginning to move beyond the need for intensive adjustment lending. Indochina, Eastern Europe, and the FSU are major exceptions to this

trend, and operations in these areas may in some cases lead to an increase in the overall level of adjustment lending, at least in the near term.

38. Preparation and coordination processes for adjustment lending have been strengthened, and cross participation in World Bank and IMF missions with other agencies is common. One important consequence of the expansion of adjustment lending has been a substantial increase in the degree of collaboration and cooperation among donor agencies in their country assistance strategies and programs. This has occurred on both an institutional level and on a staff level. Lenders have also come to understand the close and vital links between macro and sectoral policy issues and specific project performance to a much greater extent than before, which can only lead to an improvement in the overall quality of assistance programs.

Annex

Table A1: Adjustment Lending by the African Development Bank
(US $ million)

	1987	1988	1989	1990	1991
Total lending	2,113	2,168	2,832	3,251	3,412
African Development Bank (AfDB)	1,343	1,405	1,865	2,158	2,254
African Deelopment Fund (AfDF)	770	764	967	1,093	1,158
Adjustment lending	721	406	576	561	715
African Development Bank (AfDB)	592	245	401	390	468
African Development Fund (AfDF)	129	161	176	170	247
Share of adjustment in total lending	34%	19%	20%	17%	21%
Share of adjustment in AfDB	44%	17%	21%	18%	21%
Share of adjustment in AfDF	17%	21%	18%	16%	21%
Amount cofinanced with the World Bank	425	406	558	548	572
African Development Bank (AfDB)	336	245	401	390	339
African Development Fund (AfDF)	88	161	157	157	233
Share of adjustment cofinanced with the World Bank	59%	100%	97%	98%	80%
African Development Bank (AfDB)	57%	100%	100%	100%	72%
African Development Fund (AfDF)	69%	100%	90%	92%	94%

Source: Recent issues of Annual Report of the African Development Bank.

Table A2: Program Lending by the Asian Development Bank
(US $ million)

	1987	1988	1989	1990	1991
Total lending	2,439	3,145	3,623	3,972	4,983
Ordinary capital resources (OCR)	1,481	2,062	2,260	2,492	3,636
Asian Development Fund (ADF)	958	1,083	1,363	1,480	1,347
Program lending	150	660	275	820	435
Ordinary capital resources (OCR)	75	330	54	200	250
Asian Development Fund (ADF)	75	330	221	620	185
Share of program in total lending	6%	21%	8%	21%	9%
Share of program lending in OCR	5%	16%	2%	8%	7%
Share of program lending in ADF	8%	30%	16%	42%	14%
Amount cofinanced with the World Bank				125	
Ordinary capital resources (OCR)					
Asian Development Fund (ADF)				125	
Share of program lending cofinanced with the World Bank				15%	
Ordinary capital resources (OCR)				0%	
Asian Development Fund (ADF)				20%	

Source: Annual Reports of the Asian Development Bank.

Table A3: Adjustment Lending by the Inter-American Development Bank
(US $ million)

	1987	1988	1989	1990	1991
Total lending	2,303	1,628	2,577	3,832	5,359
Ordinary capital operations (OC)	1,957	1,474	2,235	3,315	4,734
Fund for special operations (FSO)	346	154	342	517	625
Adjustment lending				1,310	2,050
Ordinary capital operations (OC)				1,296	1,864
Fund for special operations (FSO)				14	186
Share of adjustment in total lending				34%	38%
Share of adjustment in OC				39%	40%
Share of adjustment in FSO				3%	25%
Amount parallel with the World Bank				1,310	1,700
Ordinary capital operations (OC)				1,296	1,514
Fund for special operations (FSO)				14	186
Share of adjustment lending parallel with the World Bank				100%	83%
Ordinary capital operations (OC)				100%	82%
Fund for special operations (FSO)				100%	100%

Source: Annual Reports of the Inter-American Development Bank, staff of the IDB.

Table A4: Adjustment Grants by the European Community
(US $ million)

	1987	1988	1989	1990	1991
Total grants	1,925	2,915	2,688	3,095	5,386
ACP countries	898	1,414	1,429	1,595	1,627
All others	1,027	1,501	1,259	1,500	3,759
Adjustment grants (in ACPs)		69	263	105	178
Share of adjustment grants in ACPs		5%	18%	7%	11%
Amount of adjustment in ACPs coordinated with the World Bank		69	263	105	178
Share in adjustment in ACPs coordinated with the World Bank		100%	100%	100%	100%

Source: EC.

Table A5: Adjustment Lending by Japan
(US $ million)

	1987	1988	1989	1990	1991
Total lending	5,501	6,373	7,780	9,582	11,655
Japan Export Import Bank (JEXIM)	2,363	1,972	3,696	3,037	2,967
Overseas Economic Cooperation Fund (OECF)	3,138	4,401	4,084	6,545	8,688
Adjustment lending	293	1,521	3,063	1,209	1,968
Japan Export Import Bank (JEXIM)	0	870	2,300	540	950
Overseas Economic Cooperation Fund (OECF)	293	651	763	669	1,018
Share of adjustment in total lending	5%	24%	39%	13%	17%
Share of adjustment in JEXIM	0%	44%	27%	18%	22%
Share of adjustment in OECF	9%	15%	19%	10%	12%
Amount of adjustment cofinanced with the World Bank	293	1,521	1,763	1,209	1,668
Japan Export Import Bank (JEXIM)	0	870	1,000	540	650
Overseas Economic Cooperation Fund (OECF)	293	651	763	669	1,018
Share of adjustment cofinanced with the World Bank	100%	100%	58%	100%	85%
Japan Export Import Bank (JEXIM)		100%	43%	100%	68%
Overseas Economic Cooperation Fund (OECF)	100%	100%	100%	100%	100%

Source: JEXIM, OECF.

Table A6: Adjustment Grants by the United States
(US $ million)

	1987	1988	1989	1990	1991
Total assistance	2,712	1,821	2,212	2,816	2,267
Adjustment assistance	1,478	658	1,049	1,711	1,278
Share of adjustment in total assistance	54%	36%	47%	61%	56%
Amount of adjustment linked with the World Bank /a	0	0	0	0	0
Share of adjustment linked with the World Bank /a	0%	0%	0%	0%	0%

Source: USAID.

/a There is substantial coordination, but the links are not formalized as with other donors. USAID does participate in pledging arrangements such as through CGs, SPA.

Table A7: Adjustment Lending by the World Bank Group
(US $ million)

	1987	1988	1989	1990	1991
Total lending	18,209	19,141	22,331	21,476	24,180
IBRD	14,368	14,791	17,407	15,176	17,021
IDA	3,841	4,350	4,924	6,300	7,160
Adjustment lending	4,154	4,843	6,094	5,957	7,036
IBRD	3,475	3,815	4,959	4,179	4,996
IDA	679	1,028	1,135	1,778	2,040
Share of adjustment in total lending	23%	25%	27%	28%	29%
Share of adjustment in IBRD	24%	26%	28%	28%	29%
Share of adjustment in IDA	18%	24%	23%	28%	28%

Source: Annual Reports of the World Bank Group.

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: November 9, 1992

TO: Mr. Attila Karaosmanoglu, EXC

FROM: Lawrence Summers, DEC

EXTENSION: 33774

SUBJECT: Operational Directives on Adjustment Lending

1. Attached are revised versions of the two ODs on adjustment lending. Both of these have gone through a series of senior staff and Regional reviews. The Board/COW also reviewed a summary of the ODs on October 20. Subject to your concurrence, the ODs are now ready to be issued to staff, subject to a second look by the Regional Vice Presidents, which COD will elicit.

2. The two ODs are companion pieces which should together replace existing guidelines on adjustment lending. Each of them, however, responds to different needs. OD 8.60 is a general statement on policy in which both the Regional staff and the Board have expressed strong interest for quite some time. It provides important guidelines on key choices that have to be made in most adjustment lending operations and reflects the experience gained so far. OD 9.10 is more on procedures, and replaces the main part of the existing guidelines which are now badly out of date.

3. If it is difficult to issue both ODs simultaneously, the OD 8.60 should be issued first, and before a decision is made on what to do with ODs in general, since it responds to the substantive questions most frequently raised by staff. It would be a pity not to make full and immediate use of this OD now that the MDs, the Board and the Regional staff have endorsed it. The Board, which has been closely monitoring the progress of this OD since April, may also misinterpret any delay in issuing it to the staff. We will await your decision on how to proceed from here with the issuance of the ODs and their possible sequence.

4. Following are some details on the changes made to the last drafts that were submitted to you in July 1992.

Adjustment Lending (OD 8.60)

5. We have made several changes following the Board/COW meeting and a prior detailed review by the OD Review Group. While most of the changes are editorial, I would like to bring the following to your attention:

- In the section on Structural Adjustment and Stabilization, we have referred to public enterprise reforms and labor markets, as suggested during the COW discussion. References to the issue of the methods by which deficits are financed have also been added in the

Public Finances section. I believe the illustrations are now adequate and the balance is right.

- We have revised the subsection on Public Enterprise Policies and Privatization following comments by the OD Review Group.

- Poverty reduction: the first sentence of each paragraph has been changed to reflect the sentiments expressed in the Board.

- Environment. A new paragraph has been introduced.

- "Ownership". A new paragraph has been added (paragraph 42), based on the OED review.

- Conditionality. We have revised this section to better reflect the Board discussion.

Procedures and Documentation (OD 9.10)

6. This OD covers all the procedural issues, and corresponds to the OD 9.00 on investment lending. It has undergone many reviews; the current version reflects the comments and suggestions of the OD Review Group.

7. It is essentially a compilation of best practices on a range of issues, such as the new Loan Committee procedures for adjustment operations, the critical points at which non-Regional units should preferably be involved (or no longer need to be involved), retroactive financing, and tranche releases.

8. It also indicates best practices regarding Board documentation, which would obviate some difficulties now evident in this area. In some of the Regions, for example, the President's Reports do not systematically include sections on the overall adjustment programs and the macroeconomic backgrounds of the operations being proposed.

cc: Mr. Rajagopalan (OSP)

Attachments

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: July 23, 1992

TO: Distribution

FROM: Jan Wijnand, Chief, CODOP

EXTENSION: 81490/91

SUBJECT: Draft Operational Directive 9.10, *Processing and Documentation for Adjustment Loans*

1. Attached for your review and comment is draft OD 9.10, *Processing and Documentation for Adjustment Loans*. The directive is a companion to OD 8.60, *Adjustment Loans* (forthcoming), which sets out Bank policies in the area of adjustment lending; the two directives draw on various reviews of adjustment operations, in particular the three Reviews of Adjustment Lending discussed by the Board. This directive replaces Circular Op 87/06, *Guidelines for Preparing Adjustment Loans and Credits*, and operational memoranda listed in the Manual Transmittal Memorandum.

2. This directive sets out procedures for processing and documenting adjustment loans. In particular, it suggests a system for guiding and coordinating the preparation of adjustment operations that involves incorporating outside views from the earliest stages and using a Regional loan committee. Its annexes include a list of key steps in processing adjustment loans, a decision authority matrix, guidelines for preparing a President's Report, and sample table formats.

3. The formats shown in the tables on key indicators and balance of payments in Annex B4 replicate the formats recommended in OD 2.10, *Country Strategy Papers*. If these formats change when OD 2.10 is updated, they will also be updated in OD 9.10.

4. Annexes B5 and B6 are related to Country Strategy Statements, for which an Operational Directive has not yet been prepared. When that directive (OD 2.11) is issued, the two annexes will be deleted from OD 9.10.

5. Annex C, *Sample Format for Tranche Releases*, is an actual document that contains all the information necessary to support tranche release decisions. However, because it is rather long, in the next draft we hope to substitute a shorter one that is equally useful.

6. Please convey your comments by electronic mail to Mr. Anandarup Ray by c.o.b. August 17, 1992, and copy them to Mr. Enzo Grilli and Mrs. Jayati Datta-Mitra.

Attachment

Distribution:

Messrs./Mmes. Churchill (IENDR); El-Ashry (ENVDR); Grilli (DPGDR); Hamilton (PHRDR); Petit (AGRDR); Pouliquen (INUDR); Raghavan (2) (LOADR); Salop (OSPVP); Scott (ORGHD); Aiyer, Selowsky (LACVP); Blanchi, Hasan (ECAVP); Drysdale, Nankani (SASVP); El Maaroufi, Thomas (EAPVP); Husain, Squire (MNAVP); Martinez, Husain (AFRVP); Clift/Mattheisen (SECGE); Stern (ESMMR); Bhatia (PBDPR); Abbott (LEGLA); Song (CFSVP); Artus/Sengupta (FPRVP); Guerrero (DGO); Reif (EXTIE)

cc: Messrs./Mmes. Ray, Chaudhury (DPG); Wyss, Srinivasan, Datta-Mitra (COD).

Directives Manager's Files

A L L - I N - 1 N O T E

DATE: 16-Jul-1992 05:49pm

TO: Jane Armitage (JANE ARMITAGE)

FROM: Anandarup Ray, DPG (ANANDARUP RAY)

EXT.: 31443

SUBJECT: Adjustment Lending OD

Jane,

Many thanks for your help this morning. Mr. Shihata called to confirm that a) there can be no disbursements against local costs in ALs, b) but there is the option of disbursing SECALs against general imports subject to a negative list; this option is being increasingly used these days, even for "sectors" like "agriculture" and "energy". This means, of course, that governments are free to use the foreign exchange in any way they like: they can generate local currency resources to pay the severance checks or the teachers' salaries. This diffuses the whole issue.

If we still want to avoid, or minimize, ALs for the "local-cost-intensive" sectors, such as the social sectors, this will have to be introduced as a sort of "ex cathedra" statement.

Anando

CC: Enzo Grilli (ENZO GRILLI)

A L L - I N - 1 N O T E

DATE: 16-Jul-1992 05:09pm

TO: Larry Summers (LARRY SUMMERS)

FROM: Anandarup Ray, DPG (ANANDARUP RAY)

EXT.: 31443

SUBJECT: OD on Adjustment Lending CONFIDENTIAL

1. I met with Jane Armitage today to discuss the status of the above, which is with the MDs for review. Jane conveyed to me their preliminary views - a memorandum might come.

2. I understand that the critical paragraph dealing with budget - smoothing was approved, without change, by Ernie: in that sense a window of opportunity will remain for those who want to take on the burden of proving the fiscal case for adjustment lending.

3. Other substantive comments were: (a) the environment linkage should be given a lower profile in adjustment lending operations than currently suggested; they don't want the "tail wagging the dog", this is fine by me; and (b) the current treatment of privatization is too faithful a summary of the privatization paper. This would be tantamount to issuing an OD on privatization "through the backdoor", since the question of an OD on privatization was shelved during the Board discussion on the policy paper on privatization. Jane referred to the dissensions during that Board discussion, and thought it would be inappropriate to reproduce the "ideology" of that paper so faithfully. We may have to accept a somewhat attenuated language.

/sb

CC: Enzo Grilli (ENZO GRILLI)
CC: Michael Walton (MICHAEL WALTON)

Encl

A L L - I N - 1 N O T E

DATE: 16-Jun-1992 10:17am

TO: Lyn Squire (LYN SQUIRE)

FROM: Michael Walton, DECVP (MICHAEL WALTON)

EXT.: 38418

SUBJECT: RE: Adjustment Lending

Lyn--Thanks. Larry sent the note up the MDs for any reaction. There will still be the note to the board replying to the OED report and summarizing issues in teh OD, but if the new interpretation is consistent with the rules, we wouldn't need to present it as an issue for policy decision. Michael

CC: Marcelo Selowsky (MARCELO SELOWSKY)
CC: Anandarup Ray (ANANDARUP RAY)
CC: Enzo Grilli (ENZO GRILLI)
CC: Caio Koch-Weser (CAIO KOCH-WESER)

A L L - I N - 1 N O T E

DATE: 16-Jun-1992 08:28am

TO: Michael Walton (MICHAEL WALTON)

FROM: Lyn Squire, MNAVP (LYN SQUIRE)

EXT.: 36099

SUBJECT: Adjustment Lending

Michael:

The interpretation of the economic justification for adjustment lending provided in the note from Enzo, Marcelo, and me appears to be consistent with the legal interpretation provided in the Board paper entitled Authorized Purposes of Loans made or Guaranteed by the Bank and dated May 10, 1988. Pages 14 and 15 are relevant. In particular, they note the possibility of lending in support of a fiscal shock.

This suggests that wording along the lines of our note could be used in the O.D. without going back to the Board. Please keep me informed on this.

Lyn

CC: Caio Koch-Weser (CAIO KOCH-WESER)
CC: Enzo Grilli (ENZO GRILLI)
CC: Anandarup Ray (ANANDARUP RAY)
CC: Marcelo Selowsky (MARCELO SELOWSKY)

A L L - I N - 1 N O T E

DATE: 15-Jun-1992 05:53pm

TO: Lyn Squire (LYN SQUIRE)
TO: Ricardo Martin (RICARDO MARTIN)

FROM: Enzo Grilli, DPG (ENZO GRILLI)

EXT.: 35100

SUBJECT: Adjustment Lending Note

This is to confirm to you that Larry has sent our note to Mr. Stern to get his reaction. If o.k. it will become the basis for the OD on Adjustment Lending.

CC: Marcelo Selowsky (MARCELO SELOWSKY)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 12, 1992

TO: Messrs. P. Hasan, I. Husain, G. Nankani, M. Selowsky, L. Squire, V. Thomas

FROM: Anandarup Ray, DRG

EXTENSION: 38565

SUBJECT: ODs on Adjustment Lending

We are in the process of finalizing OD 9.10. Attached is a table that summarizes our understanding of the procedures being followed in most cases. Could we possibly have your reactions **by c.o.b. Monday, June 15**. If necessary, Fateh Chaudhri and I will be glad to meet with you at your convenience.

ARay:pl

RECOMMENDED STEPS IN PROCESSING ADJUSTMENT OPERATIONS 1>

Process Step	Regional								Outside Region										
	TASK MANAGER	Country Operations Division Chief	Country Department Director	Regional Environment Division	Procurement Advisor	Regional Vice President	Chief Economist	Senior Operations Adv. (SOA)	Managing Director (MD)	Vice President Devel. Econ. & Chief Economist (DECVP)	Legal VP	Vice President Cofin. & Fin. Adv. Services (CFSVP)	Vice President Fin. Policy & Risk Management (FPRVP)	Vice President and Secretary	Vice President Sector & Op. Policy (OSPVP)	Chairman Loan Committee	Disbursement Officer	DMF	IFC
1. Prepare Initiating Document (ID)	For	Cle	Sub	Rec	Rec	App	Cn	Cn	Cnin	Rec	Rec	Rec	Rec	--	Rec	--	Rec	Rec	Rec
2. Prepare Draft Initiating Memorandum (IM) and Review	For	Cle	Chr	Rec	Rec	Rec	Rec	Rec	--	Rec	Rec	Rec	Rec	--	Rec	--	Rec	Rec	Rec
3. IM Review by Regional Loan Committee (RLC) 2>	For	Cle	Sub	Rec	Rec	App	Cn	Cn	--	Rec	Rec	Rec	Rec	--	Rec	--	Rec	Rec	Rec
4. Preappraisal Meeting of Loan Committee (LC) 3> on IM	For	Cle	Cle	Rec	Rec	Sub	Rec	Rec	Rec	Rec	Rec	Rec	Rec	--	Rec	Chr	Rec	Rec	Rec
5. Loan Committee Minutes	For	Cle	Cle	Rec	Rec	Sub	Cn	Cn	Rec	Rec	Rec	Rec	Rec	--	Rec	App	Rec	Rec	Rec
6. Major Changes in Operation During Appraisal	For	Cle	Cle	Rec	Rec	Sub	Cn	Cn	App	Rec	Rec	Rec	Rec	--	Rec	Rec	Rec	Rec	Rec
7. Prepare Post Appraisal Letter/Telex	For	Cle	App	Rec	Rec	--	--	--	--	--	Cle	--	--	--	--	--	Cle	--	--
8. Prepare Yellow Cover President's Report (PR)	For	Cle	Chr	Rec	Rec	--	Cn	Cn	--	Rec	Rec	Rec	Rec	--	Rec	--	--	--	Rec
9. Prepare Green Cover PR and Notice of Negotiation	For	Cle	Sub	Cle	Cle	App	Rec	Rec	--	Rec	Rec	Rec	Rec	Rec	Rec	--	Rec	--	--
10. Revise Draft Legal Documents	Cle	Sub	--	--	Cle	App	--	--	--	--	For	--	--	--	--	--	Cle	--	--
11. Prepare Memo Seeking RVP Authorization to Negotiate	For	Sub	App	Cle	Cle	Ini	--	--	Rec	--	Cle	Rec	Rec	--	--	--	Cle	--	--
12. Negotiations	Chr																		
13. Major Changes in Operation During Negotiations	For	Cle	App	Cle	Cle	Ini	--	--	--	--	Cle	--	--	--	--	--	Cle	--	--
14. Prep. Draft Buff Cover PR and Draft Final Memo of President (MOP)	For	App	App	--	Cle	App	--	--	--	--	Cle	--	--	--	--	--	Cle	--	--
15. Prepare Draft Final Legal Documents	Cle	App	App	--	Cle	App	--	--	--	--	For	--	--	--	--	--	Cle	--	--
16. Prepare Memorandum Seeking RVP Approval of Draft Final Doc.	For	App	App	--	--	Ini	--	--	--	--	Cle	--	--	--	--	--	Cle	--	--
17. Prepare Statutory Committee Report (SCR)	--	--	--	--	--	Ini	--	--	--	--	For	--	--	--	--	--	--	--	--
18. Prepare Memorandum Confirming Final Approval by Government, Signing of SCR, and Compliance with Board Presentation Condtns	For	App	App	--	--	Rec	--	--	--	--	--	--	--	Rec	--	--	--	--	--
19. Print Documents	For	--	--	--	--	--	--	--	--	--	--	--	--	Rec	--	--	--	--	--
20. Prepare Release of MOP	For	--	--	--	--	--	--	--	--	--	--	--	--	Rec	--	--	--	--	--
21. Prepare Board Presentation Speech	For	App	App	--	--	App	--	--	--	--	--	--	--	Rec	--	--	--	--	--
22. Note to MD on Significant Issues	For	App	App	--	--	App	--	--	Rec	--	--	--	--	--	--	--	--	--	--

Key

App: Approve
Chr: Chair and approve minutes.
Cle: Clear without sanctioning authority.
Com: Comment on documents, with dissenting views incorporated into transmittal memorandum.
Cn: Consulted
Cnn: Consulted, if necessary
Sub: Submitted

For: Formulate a document or prepare an activity.
Ini: Initial and approve a document, or sign.
Rec: Receive a document.
Lc: Loan Committee.
MD: Managing Director.

1> Includes Structural Adjustment Loans and Credits (SAL), Sector Adjustment Operations (SECAL), Hybrid Operations, Rehabilitation Import Credits (RIC), Debt and Debt Service Reduction (DDSR) Operations, and Expanded Cofinancing Operations.
2> If the meeting is called, representation from outside should be at the Director or above level.
3> The Chairman, in consultation with the office of the President, may determine that there is no need for a meeting.

The World Bank
Washington, D.C. 20433
U.S.A.

LAWRENCE H. SUMMERS
Vice President Development Economics
and Chief Economist

June 10, 1992

Mr. Stern

Ernie,

The macroeconomic rationale for adjustment lending

I have been working with the Regional Chief Economists on the question of the circumstances under which there is a macroeconomic basis for adjustment lending. There's a clear view that a balance-of-payments "gap" is too limited a way of looking at the problem, even though in the bulk of actual cases there will be a current account deficit. The attached note was prepared by a small sub-group we charged with drafting the results of our discussions. I agree with it. This is heading for inclusion in the Operational Directive on Adjustment Lending, so I'd welcome your comments at this stage.

Lawrence H. Summers

Attachment

cc: Attila Karaosmanoglu

bcc: Mr. Grilli (w/out attach.)

June 9, 1992

Mr. Larry Summers

RE: Adjustment Lending

Larry,

As you saw, the statement was written in a form that would provide guidance to the staff (and to be included in the forthcoming Operational Directive). The Regional Chief Economists felt strongly that this was the number one priority. Consensus on the statement was achieved, and we have therefore, subject to your agreement with it, something that we can use to complete the Operational Directive. Anandarup Ray is responsible for it.

As for your questions, I would say the following:

1. Policy Message: The main policy message is that adjustment lending can be used, ceteris paribus, to finance both BOP "costs" and budget "costs" of reforms, but the latter need to be temporary and external borrowing has to be proved superior to reserve use, internal borrowing and to financing through higher taxes. The burden of proof is with the proponent.

2. Consistency with current policy: This is an adaptation of current policy, more than a basic innovation. In most cases the standard BOP rationale for adjustment lending will continue to apply. The statement, however, clarifies aspects of the current policy that apply to situations that are progressively acquiring more importance in our lending in Asia and Latin America: such as lending for the social sector and for the reform of state-owned enterprises. (Yet, Mr. Stern would probably say that Bank policy in this area should be "suitably obscure". The trick is to maintain flexibility, but to give staff some reasonably coherent and certain guidelines to the staff. The statement does both in my opinion).

3. Consultation with Mr. Stern: I believe that we should run the statement through the MDs, as a key part of the forthcoming Operational Directive on Adjustment Lending (which the Board wants to discuss in its main content). You may wish to touch base with Mr. Stern beforehand, especially if you had previous discussions with him on the subject.

I will be glad to further discuss strategy with you, if you feel that we can "go public" with the statement.

Enzo Grilli

cc: Mr. Walton

Eunice

A L L - I N - 1 N O T E

DATE: 08-Jun-1992 06:18pm

TO: Enzo Grilli (ENZO GRILLI)

FROM: Ricardo Martin, LACCE (RICARDO MARTIN)

EXT.: 38719

SUBJECT: Adjustment Lending

Your proposed response looks fine, but I would emphasize more in #1 the de-linking of the justification of adjustment lending with the existence of BOP "problems". It could go something like this:

The policy message is that adjustment loans can be used in all cases in which it is justifiable for the country to smooth consumption by borrowing abroad. Such cases include not only temporary external shocks, but also temporary costs associated to policy reforms to increase the efficiency of the economy and reduce poverty -- even when they do not have a direct BOP impact. Even in the absence of direct real costs of `justment, temporary budget financing to support reforms would be stifiable if it is shown to be superior to the alternatives (i.e. increasing taxes/reducing expenditures or borrowing internally).

CC: Lyn Squire (LYN SQUIRE)
CC: Marcelo Selowsky (MARCELO SELOWSKY)

done

Facsimile Transmittal

The World Bank

Development Policy Group

DATE: June 8, 1992

TO: Mr. Lyn Squire 70810
Mr. Ricardo Martin 69271

FAX No.:

****

FROM: Enzo Grilli

TELEPHONE:

FAX No.: (202) 477-1569 or 477-0569

NUMBER OF PAGES: _2__ (including this page)

SUBJECT: Adjustment Lending

Lyn/Ricardo,

I got this from Larry. My answers would be as follows:

1. The "new" policy message is that we can lend to support temporary budget expenditure if it makes reform easier, but the burden of proof (i.e. that financing via increased taxation/reduced expenditure or by borrowing internally is inferior to borrowing externally) is on the proposing region (naturally, in the presence of all other conditions: a viable program, appropriate conditionality, etc).

2. This would establish more clearly the boundaries within which lending in the absence of a BOP cost can take place, and would represent more an adaptation of current policy than as large innovation.

3. Yes, we should send the draft statement to Mr. Stern since it will be inserted in the Operational Directive on Adjustment Lending; and should therefore be cleared in advance with Senior Management.

Any comment/input on these skeleton answers would be appreciated. Thanks.

Enzo

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 8, 1992

TO: Enzo Grilli

FROM: Lawrence H. Summers LS

EXTENSION: 33774

SUBJECT: Adjustment Lending Statement

What's the policy message? Is this consistent with current policy? Should this be sent on to Ernie?

(file) cc: DPG

International Bank for Reconstruction and Development
International Development Association

copy also filed in Board Doc. B.B.

FOR OFFICIAL USE ONLY

SecM92-767
IDA/SecM92-237

FROM: Vice President and Secretary

June 8, 1992

Disbursements Under Adjustment Operations

Attached is a note entitled "Disbursements Under Adjustment Operations" dated June 8, 1992.

Questions on this paper should be referred to Mr. Raghavan (X84116), or Ms. Reinke (X84115).

Distribution:

Executive Directors and Alternates
Office of the President
Executive Vice Presidents, IFC and MIGA
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

DISBURSEMENTS UNDER ADJUSTMENT OPERATIONS

Introduction

1. The Bank's policy is to disburse against documentation related to eligible imports for adjustment loans[1]. The Articles of Agreement require the Bank to "**.... make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency**". When the Bank began to lend for adjustment operations, the standard disbursement procedures which were designed specifically for investment loans were not reviewed or modified to fit the new type of lending. Thus the Bank required borrowers to submit similar supporting documentation and data for adjustment as they did already for investment loans.

2. Current disbursement procedures stipulate that supporting documents - whether submitted to the Bank with withdrawal applications, or claimed through Statements of Expenditure (SOEs) and retained by the borrower - must include contracts, invoices, evidence of shipment and evidence of payment. To comply with these requirements, borrowers make special administrative arrangements to collect a large volume of documentation and undertake the time-consuming preparation of summary sheets detailing relevant transactions. These administrative arrangements are costly, and documentation requirements sometimes delay the disbursement process drastically or stall it because of difficulty in collecting documents from commercial banks or importers, thereby defeating the objective of quick disbursements.

Documentation Changes

3. Traditional disbursement documentation is still appropriate in cases where large contracts[2] are procured under simplified international competitive bidding (ICB) procedures. However, most disbursements for adjustment lending are against smaller contracts. To minimize administrative costs for borrowers, for contracts below the limit specified by the Bank for disbursement against SOEs - which is generally set to match the ICB procurement limit - the Bank will hereafter accept alternative disbursement documentation that provides safeguards for the Bank on use of funds and at the same time allows loans to be drawn down expeditiously as conditionality is met.

4. The customs certificates issued in most borrowing countries at the time of importation provide the information needed for the Bank to be assured that the goods are eligible, and that they have been supplied from member countries. These customs certificates are readily available within the existing framework of borrower procedures and import controls, and impose no additional burden on borrowers. To determine whether customs certificates can be accepted as the basis for preparation of SOEs, the adequacy of procedures for their preparation will be assessed by Bank staff to establish that they are based on underlying import documents and represent a reliable source of information. Where minor deficiencies in current systems are identified as the result of this assessment, these should be corrected before effectiveness; or, if these deficiencies would not expose the Bank to undue risk that funds would be misused, the first tranche could be released

---

1 "Bank" includes IDA, and "loans" include credits.

2 While this limit varies from one loan to another, the limit is frequently set as high as US$ 5 million equivalent.

with the condition of satisfactory corrective action before release of subsequent tranches or approval of subsequent adjustment loans.

5. The disbursement option based on data extracted from customs records would not be available in case of major deficiencies in the system unless these deficiencies could be addressed by the addition of pre-shipment inspection certificates by an independent third party which current government procedures in some countries require. In such cases, certificates confirming inspection of goods immediately prior to shipment prepared by agencies judged by the Bank to follow acceptable procedures would be required in addition to customs certificates which confirm arrival of goods. The process for determining acceptability of pre-shipment inspection agencies would be similar to that followed for customs, but an agency reviewed in connection with one loan would then be accepted for any other loans, subject only to periodic reassessment at intervals yet to be agreed.

6. For countries without customs control procedures acceptable to the Bank, an SOE from the central bank or another appropriate government agency providing similar information based on their review and retention of the underlying import documents (i.e. the existing documentation requirements) would continue to be acceptable.

7. In those cases where disbursements are based on customs or third party certificates outlined in paragraphs 4 and 5 above, evidence of payment which has so far been one of the key elements of the Bank's disbursement documentation would not necessarily be available to the agency preparing the certificate. In its place, as part of the standard withdrawal application form, the borrower would certify that the imported goods have not and will not be financed from other loans, credits or grants, or through barter arrangements.

Source of Supply Simplification

8. Source of supply (SOS) reporting - required for the information of the Bank's Executive Directors and management - currently classifies disbursements by supplying country, by state for goods of U.S. origin, and by individual U.S. or Canadian supplier for contracts valued at more than US$100,000 equivalent, as well as distinguishing between broad categories of goods. To maximize the benefits of the proposed change in disbursement documentation, borrowers will be asked to submit aggregated information by supplying country in SOE form, together with summarized customs data including details of suppliers and description of goods for the period covered by the SOE. SOS coding for reporting purposes will be limited to identification of the supplying country as provided by the borrower.

Advances to Special Accounts

9. In those countries where lack of access to funds makes it impossible to import goods unless funds are advanced from a Bank loan, the Bank will in future be prepared to make Special Account advances up to the full amount of the first tranche (excluding any retroactive financing limits set to permit financing of imports made prior to loan signing). Additional advances will be made as tranche conditionality is met subject to receipt of satisfactory documentation covering previous advances and audit reports.

Audit and Field Review

10. Audit provisions will remain in place requiring selective review by the borrower's independent auditors of procurement documents, invoices and bills of lading, and evidence of

payment where deemed appropriate. Field review of supporting documents by Bank staff will be selective and will focus primarily on documentation related to large transactions.

Conclusion

11. These procedures provide the safeguards needed to assure appropriate use of loan funds, and will greatly facilitate disbursements under adjustment operations by reducing the burden of special requirements currently imposed on borrowers.

June 8, 1992

E G copy

THE WORLD BANK/IFC/M.I.G.A.

Headquarters: Washington, D.C. 20433 U.S.A.
Tel. No. (202) 477-1234 // Fax Tel. No. (202) 477-6391 // Telex No. RCA 248423

FACSIMILE COVER SHEET AND MESSAGE

DATE: June 5, 1992 NO. OF PAGES: 2 (including this sheet) MESSAGE NUMBER: \

TO
Name: Mr. Larry Summers
Organization: \
Fax Tel. No.
City: \
Country: \

FROM
Name: Enzo Grilli
Dept./Div. \
Room No. \
Fax Tel. No. \
Dept/Div No. \
Tel. No. \

SUBJECT: Adjustment Lending Statement\

MESSAGE:

Larry,

This is the statement that we prepared. It is cleared by all concerned, even though it is not signed (on efficiency grounds).

Enzo

cc: Marcelo Selowsky
Lyn Squire
Ricardo Martin

ısmission authorized by: \

If you experience any problem in receiving this transmission, inform the sender at the telephone or fax number listed above.

1884 (2-90)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 5, 1992

TO: Mr. Lawrence H. Summers

FROM: Enzo Grilli, Marcelo Selowsky and Lyn Squire

EXTENSION: 81934, 39006, 34637

SUBJECT: Adjustment Lending

1. The most general economic rationale for adjustment lending is that it smoothes the costs of structural reforms. These are consumption costs, i.e. private or public consumption which, in the absence of external borrowing, would have to be foregone as a result, for example, of sudden and large changes in key relative prices occurring autonomously or because of reform of domestic policies. Confronted with significant transitional costs from adjustment measures, a country can borrow externally to reduce the economy-wide welfare losses that adjustment entails, by spreading these costs over time. Intertemporal optimization of consumption, aside from being economically rational, may also contribute to the social and political sustainability of the reforms undertaken in the adjusting country, thus making them more likely to succeed.

2. However, temporary consumption smoothing for a country undertaking structural adjustment can be attained not only by external borrowing, but also through the utilization of existing foreign exchange reserves. While the case for reserve use is generally cast in terms of "compensatory financing" to smooth out temporary BOP deficits, a country having adequate foreign exchange reserves, and expecting to return to current account balance in a relatively short time, can resort to using them to deal with the transitional consumption costs of structural adjustment as well. In calculating the marginal cost of reserve utilization the market credibility effects of changes in the stock of domestically held foreign exchange will have to be taken into account. Reduction in reserves may in fact affect the internal and external credibility of the government and of its policies. External borrowing for the purpose of consumption smoothing to be justified in the presence of reserve availabilities must be shown to be a superior alternative, i.e. to be less costly to the country than using reserves.

3. When external borrowing is justified from the country point of view, the rationale for the Bank extending quick-disbursing loans in foreign exchange (in the presence of a reform program judged to bring adequate benefits to the country) can be, therefore, generally defined in BOP terms: a) an actual current account deficit, and b) an anticipated current account deficit deriving from either the adjustment policies being implemented or other desirable objectives being sought (e.g. higher economic growth). These are the normal circumstances in which our adjustment lending takes place.

4. Some policy reforms may not have a real resource cost, but may have significant negative effects on the government budget, as in the case of recapitalizations of the domestic banking system in the framework of financial sector reform, or severance payments for redundant employees of public enterprises being restructured or privatized. In this case there might also be a rationale for public expenditure smoothing, given that the increase burdens on the budget are temporary. Unlike the previous, and more usual case, the reforms being implemented do not involve any real economy-wide welfare loss. Internal transfers are instead at issue. By compensating groups that stand to lose the most from the reforms being implemented, the government can increase their chance of success, thus ensuring that the benefits from reform will eventually accrue to the whole economy.

5. Financing this type of expenditure smoothing (or temporary budget imbalance) can be done through increased taxation (or reduction of other expenditures), government borrowing domestically from the private sector and by foreign borrowing. A case for external borrowing can be made if the alternative means of financing the additional expenditure (e.g. increasing taxes, borrowing domestically or expanding base money) were inferior (i.e. more costly than) external borrowing. Taxation--broadly defined--may be inferior to borrowing, external or internal, if the expenditure needs are temporary and increasing taxes generates dead weight losses for the economy. These may also increase if inefficient taxes are used. The decision between external or internal borrowing will depend on their relative costs to the government.

6. Since the objective of borrowing abroad is to smooth consumption, it must be expected that in general an optimal or market-determined allocation of the borrowed funds would result in increased consumption of tradeables and non-tradeables. In many cases, the adjustment measures themselves--trade and exchange rate reform, for example--may generate increased demand for foreign exchange. In other cases--a reduction in aggregate demand to stabilize the economy or the financing of a temporary budget expenditure, for example--smoothing may have a larger nontradeable component. In the first case, foreign funds will be absorbed with no change in the exchange rate. In the second, some appreciation will occur.

7. In conclusion, from the Bank's standpoint, quick-disbursing loans in foreign exchange are appropriate in most cases where consumption-smoothing is needed in the borrowing country (and reserves cannot be used or represent an inferior alternative), since reforms of price systems, trade regimes or even of the public sector are likely to have temporary balance of payments costs. Balance of payments imbalances generated by reforms can thus be financed through the use of these loans. In all these cases the traditional "balance of payments condition" for adjustment lending can be seen to apply.1/ In those

---

1/ Obviously, such condition applies even more directly when reforms are undertaken in the presence of a current account deficit (as it is normally the case after an external--say a terms of trade--shock has been absorbed).

cases where quick-disbursing loans are utilized to make possible temporary smoothing of budget expenditure, their use must be justified as a superior alternative to taxing (or other expenditure cutting) and to domestic borrowing.

cc: Mr. Ricardo Martin

World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: June 2, 1992 02:26pm EST

TO: William A. McCleary (WILLIAM A. MCCLEARY)

FROM: Nancy Birdsall, CECDR (NANCY BIRDSALL)

EXT.: 37458

SUBJECT: RE: ADJUSTMENT LENDING AND FISCAL ADJUSTMENT PROGRAMS

Two thoughts on your reply to Marcelo.

1. In the case of bop surplus but persistent fiscal deficit: When governments undertake fiscal adjustment there may be instances in which there are high upfront political costs combined with upfront resource costs. Reducing the size of the civil service or firing employees of public enterprises as part of privatization -- involving severance packages -- are examples. Suppose these are part of a comprehensive fiscal reform including tax and expenditure reforms, all on the part of a new government in a country where prior governments have talked reform but yielded to populist and vested interests' pressures when the going got tough. The Bank has two options: policy dialogue cum TA for the fiscal reform (let the government borrow domestically to finance the upfront transition costs); or policy dialogue cum AL money. Would the Bank's involvement only with TA money be enough to provide credibility such that the governmnet'd cost of borrowing domestically would not be higher than borrowing from the Bank? Suppose investors face higher information costs in assessing the government's fiscal reform package than the Bank, and see the Bank's willingness to lend as a measure of the Bank's technical assessment of the government's program (as well as ensuring some outside monitoring of the reforms, strengthening the hand of the reformers inside government? (In this case investors don't know that the Bank's record in enforcing conditionality is, at least in your view, "nothing to cheer about"!)

Is this not a case for AL despite the surplus in bop, and despite the lack of any past government record in reform? It may be a weak case, with a heavy burden of proof on Bank staff to make it. But there are transition costs to be smoothed, and without the Bank the government, because of lack of credibility, faces the prospect of driving up domestic interest rates, and therefore the Bank's money tied to enforcement capability as well as its possibly superior technical assessment made credible by its money, mean the overall cost of borrowing will be lower via the Bank.

2. On social sector adjustment lending, as long as there is a bop gap, would you still see a problem? The argument that AL can

smooth transitions applies -- even though any transitional costs will be local. I am not sure why you are assuming "earmarking of disbursements" in the case of ALs with social sector conditionality, when we do not earmark with, say, conditionality on privatization progress or pricing reforms in agriculture. Nor is it obvious that social sector reforms are "contribute relatively little to medium-term macroeconomic and structural adjustment." There are many cases in which conditionality would involve reducing expenditures in the medium run, or at least not increasing expenditures -- but with upfron transition costs. Consider refomr of old age security systems, or spending from tertiary to primary level, by replacing subsidies for univesrity students with loans. In the case of a bop surplus we are back in the world of para. 1.

CC:	EMENA ISC Files	(EMENA ISC FILES)
CC:	Zenaida S. Kalinger	(ZENAIDA S. KALINGER)
CC:	nissan liviatan	(PAPER MAIL)
CC:	Steven Webb	(STEVEN WEBB)
CC:	Andres Solimano	(ANDRES SOLIMANO)
CC:	Michael Walton	(MICHAEL WALTON)
CC:	Vinod Thomas	(VINOD THOMAS)
CC:	Lyn Squire	(LYN SQUIRE)
CC:	Anandarup Ray	(ANANDARUP RAY)
CC:	D. C. Rao	(D. C. RAO)
CC:	Gobind T. Nankani	(GOBIND T. NANKANI)
CC:	Ishrat Husain	(ISHRAT HUSAIN)
CC:	Parvez Hasan	(PARVEZ HASAN)
CC:	Enzo Grilli	(ENZO GRILLI)
CC:	Larry Summers	(LARRY SUMMERS)
CC:	Marcelo Selowsky	(MARCELO SELOWSKY)

A T L - I N - 1 N O T E

DATE: 01-Jun-1992 08:47am

TO: Enzo Grilli (ENZO GRILLI)

FROM: Lyn Squire, MNAVP (LYN SQUIRE)

EXT.: 36099

SUBJECT: Adjustment lending

Enzo:

Thanks for the summary. I have also seen Ricardo's note. I too like the summary but agree with Ricardo's point concerning your para. 5.

My suggestion is to place the first six lines of para. 6 immediately after para. 2. This may require some rewording to ensure continuity but the idea is to have the rationale (paras. 1 and 2) and the policy conclusion (first six lines of para. 6) together. This will establish firmly in the mind of the reader that this is the "standard" case.

Then continue with paras. 3 and 4 as a "special" case. I would delete para. 5 and conclude with the last four lines of para. 6. Again some rewording may be necessary to get the right flow.

Hope this helps.

Lyn

CC: Marcelo Selowsky (MARCELO SELOWSKY)
CC: Ricardo Martin (RICARDO MARTIN)

A L L - I N - 1 N O T E

DATE: 31-May-1992 07:53pm

TO: Enzo Grilli (ENZO GRILLI)

FROM: Ricardo Martin, LACCE (RICARDO MARTIN)

EXT.: 38719

SUBJECT: Adjustment Lending

Enzo:

This is a good summary. A few comments:

1. The last sentence in para. 2 should be reversed: "external borrowing must be a superior alternative, i.e. less costly than using reserves.

2. In para. 4 you might like to state that dead-weight losses of taxation may increase by quickly resorting to inefficient taxes. More efficient taxes may take more time to be implemented and to produce additional revenues. Thus we need temporary budget financing.

We have some problems with para. 5 and 6. It may be just a blem of presentation.

It is clear that when the argument is one of consumption smoothing (at the country level), the only alternative is external borrowing. To the extent the additional income out of that borrowing is spent on nontraded goods, that consumption smoothing may have an effect on the exchange rate. In the case of fiscal adjustment, only one part of society calls for consumption smoothing. Here, as you clearly point out, external borrowing must be compared with the alternatives of stronger actions on taxes, revenues and with domestic borrowing. All this comes out clearly.

Our problem is when you bring the differential traded/nontraded intensity of expenditures in the consumption smoothing relative to the fiscal support argument. The problem emerges in the last sentence of para. 5. The fact that we finance nontraded goods does not mean that first we need to look at the possibility of domestic financing. We should not mix the traded/nontrade issue with the consumption-smoothing / fiscal-support issue. The traded/nontrade intensity does not have a direct bearing in the choice of domestic vs. external borrowing. Let us exclude completely from the discussion the traded/nontrade issue. It does not add to the discussion. In either the consumption smoothing or the fiscal support case we will have to look at the possible effect of the loan on the exchange rate as part of the overall benefit/cost analysis of the l.

Marcelo and Ricardo .

Enzo: I will call you to see if you want to discuss this further, Ricardo.

CC: Lyn Squire (LYN SQUIRE)
CC: Marcelo Selowsky (MARCELO SELOWSKY)

The World Bank/IFC/MIGA
F I C E M E M O R A N D U M

DATE: May 29, 1992 07:15pm

TO: Marcelo Selowsky (MARCELO SELOWSKY)

FROM: William A. McCleary, EC1DR (WILLIAM A. MCCLEARY)

EXT.: 33014

SUBJECT: ADJUSTMENT LENDING AND FISCAL ADJUSTMENT PROGRAMS

1. Thanks for your EM which clarifies some of the issues raised in my note. I'm still skeptical, however, about your proposal for AL lending for fiscal adjustment in the context of current account/b.o.p. surpluses.

2. Let me begin by clearly laying out the initial situation. We are talking about a country with a present and expected current account surplus and public sector deficits and a high rate of inflation stemming -- at least in part -- from the monetary financing of these deficits (see your memo to Anandarap Ray dated April 17, 1992). Under such circumstances, the private sector must be running a still larger surplus; its saving exceeds its investment by an amount greater than the public deficit and -- perhaps together with the central bank -- it is accumulating foreign exchange(along with other financial assets). The central bank's financing of the public deficit is inflationaryand , if instead , the foreign exchange from the World Bank's AL were sold to the central bank to obtain the domestic currency to cover the deficit , we are agreed , that the result would also be inflationary -- the monetary base would be the same and the central bank acquires foreign exchange rather than government securities.

3. However, as you point out, alternatively the government could sell the foreign currency in local markets to acquire the domestic currency. Provided that the central bank is not buying an equivalent amount of foreign exchange, there is no increase inthe money base and hence the inflation rate ought to be lower than in para. 2. The currency would appreciate and the trade balance shrink as exports fall and imports rise -- thus the transfer is effected. Fair enough. However, instead of borrowing from the World Bank in order to obtain domestic currency, the government always had the option of avoiding inflationary finance by selling bills/bonds to the domestic non-bank public. The result would be some rise in domestic interest rates, a likely capital inflow, a currency appreciation, and a worsening of the trade balance. The outcomes of the two alternatives are not that different, certainly similar enough in economic terms to make us wonder whether it is worthwhile using World Bank resources, esp.

when/if there is a viable alternative.

4. One possibility that might differentiate the two alternatives more sharply could arise if borrowing from the Bank was relatively much cheaper because economic mismanagement had driven local real interest rates to exorbitant levels owing to fears of inflation, devaluations, etc.(the apparent difference in borrowing costs could turn out to be substantially less ex post if the expectations of domestic investors were borne out in subsequent real devaluations). Under these circumstances, the benefits of the presence of the World Bank in support of a fiscal reform which -- by your specification -- would have no impact on public deficit for several months seems problematic at best. What is really needed to reduce real interest rates and the inflation rate are actions which have an impact on the deficit , not the promise of actions some months hence. In sum, I don't see much gain from the presence of the Bank in this interim period when the better designed and less distortionary fiscal reform program is being developed and brought to the implementation stage. From the technical assistance side , yes fine, but from the provision of resouces side I'm not convinced.

5. Which brings me to the question of credibility. The bulk of credibility must derive from what the government has been able to accomplish in the past -- its proven track record of implmentation w/o reversals. Part of this consists of a reasonably broad consensus about policy directions such that significant changes would be unlikely from the opposition should elections be immanent or the government be subject to votes of confidence. In a situation where fiscal gaps are still a major problem, it is hard to imagine foreign or domestic investors gaining much comfort from a reform program which contains little or no up front actions. As for the role of IFIs, yes, in general they add by contributing oversight and by providing a carrot for the government to see the program through. But in this case I'm not sure how much they add. I take it that the IMF would not be involved because there is no b.o.p. problem. This leaves the Bank to monitor the implmentation of fiscal reform. As I pointed out in my previous note the Bank's record inenforcing conditionality is OK but certainly nothing to cheer about and here we have no compelling need for resources which would hold the government's feet to the fire.

6. In your objection to my comments on AL for the social sectors, you use the phrase " it is bad to finance expenditures on domestic goods with external funds " in quotations. I take it that you are using quotation marks because this is a statement not because you are attributing it to me because I never made this statement nor would I agree with it as a general proposition. One of my points on the social sectors was that one should be careful using foreign finance for local expenditures because under some circumstances this can lead to increased inflation and currency appreciation and these are not results that we are usually trying to encourage with AL. More

importantly, I think, I objected to the use of AL for the social sectors because (a) with agreements with government on the size and composition of social sector expenditure programs and on the budget deficit and its financing , the earmarking of disbursements was unnecessary and redundant; (b) it was hard to see why the social sectors needed fast-disbursing money(a sector investment loan would do just as well) ; and (c) social sector reforms were likely to contribute relatively little to medium-term macroeconomic and structural adjustment.

CC:	Larry Summers	(LARRY SUMMERS)
CC:	Enzo Grilli	(ENZO GRILLI)
CC:	Parvez Hasan	(PARVEZ HASAN)
CC:	Ishrat Husain	(ISHRAT HUSAIN)
CC:	Gobind T. Nankani	(GOBIND T. NANKANI)
CC:	D. C. Rao	(D. C. RAO)
CC:	Anandarup Ray	(ANANDARUP RAY)
CC:	Lyn Squire	(LYN SQUIRE)
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CC:	Michael Walton	(MICHAEL WALTON)
CC:	Andres Solimano	(ANDRES SOLIMANO)
CC:	Steven Webb	(STEVEN WEBB)
CC:	Nancy Birdsall	(NANCY BIRDSALL)
CC:	nissan liviatan	(PAPER MAIL)
CC:	Zenaida S. Kalinger	(ZENAIDA S. KALINGER)
CC:	EMENA ISC Files	(EMENA ISC FILES)

. - I N - 1 N O T E

DATE: 27-May-1992 03:51pm EST

TO: William A. McCleary (WILLIAM A. MCCLEARY)

FROM: Marcelo Selowsky, LACCE (MARCELO SELOWSKY)

EXT.: 39006

SUBJECT: Adjustment Lending to Assist Efficient Fiscal Adjustment

1. We both agree on a wide definition of balance of payments difficulties to include not only a pre-existing external gap but also one which is the result of the adjustment program itself.

2. It is in this context that lending for fiscal adjustment -- which temporarily may increase the current account deficit -- is worth considering. It takes time to implement efficient public sector reforms: improve tax collection, reduce public employment, design good programs to protect the poor, divest public enterprises, implement institutional reforms. Interim financing allows to take the time, rather than postpone reform or do it in a hard (socially costly) way, with hasty spending cuts and inefficient tax increases. Adjustment lending provides temporary relief while a permanent fiscal adjustment takes place.

3. Let me now consider some specific points raised in the memo. First, I think that it is fundamentally wrong to argue that external financing is as inflationary as financing from the Central Bank. The external loans do not have to involve any intervention by the Central Bank or change in the monetary base: the Government can simply exchange in the market as much foreign currency as it needs for the purchases of domestic goods. The result would be some appreciation of the currency and a somewhat smaller trade surplus - which is of course what is required to effect the external transfer. If there is a fixed exchange rate regime, external flows may indeed end up in higher reserves and generate monetary expansion, as you mention. But the final impact is still not equivalent to Central bank financing. The reason is that as increased liquidity starts to produce higher prices, the real appreciation produces an expenditure-switching effect (absent in pure Central Bank financing, where the exchange rate would have to depreciate pari passu) which would moderate the resulting overall inflation. The availability of external funds allows more imports to satisfy the expansion in liquidity and, thus, reduces its inflationary effect.

4. Second, does World Bank (or IMF) support help the credibility of an adjustment program? I think it does, for at least two reasons. One is that it reduces the costs of the program. As discussed above, external support makes it feasible to wait for a more efficient tax reform instead of quickly increasing revenues at a high distortionary cost, to protect better the poor, and to incorporate cross-country experience from the Bank in the design of the program. A better program has less opposition and it is more likely to be completed, i.e. it is more credible. A second reason is that IFIs' support gives a higher stake to the Government in maintaining the program, as it is a

condition of continuing external support, not only from the IFIs, but in many cases from other governments and even private banks as well.

5. The objection to financing social sectors (para. 4) is made on the basis that "it is bad to finance expenditures in domestic goods with external funds". But this does not recognize the role of market-clearing prices in decoupling income and spending. It would be an unlikely coincidence if public sector revenues and expenditures had the same degree of "intensity" in foreign exchange; why should we require that from the sources of financing? The "need for foreign exchange" is not a datum, it is an endogenous variable responsive to economic variables, such as the exchange rate. This does not mean that it is impossible to borrow too much. As with most economic variables, there is an optimal level of borrowing -- which may have been exceeded for some countries in the past, but which clearly does not require a matching of sources of financing and types of expenditures in every project undertaken. More important is the quality of these projects. In many countries social sector projects are among those with a highest return.

CC:	Larry Summers	(LARRY SUMMERS)
CC:	Enzo Grilli	(ENZO GRILLI)
CC:	Parvez Hasan	(PARVEZ HASAN)
CC:	Ishrat Husain	(ISHRAT HUSAIN)
CC:	Gobind T. Nankani	(GOBIND T. NANKANI)
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CC:	Andres Solimano	(ANDRES SOLIMANO)
CC:	nissan Liviatan	(PAPER MAIL)
CC:	Steven Webb	(STEVEN WEBB)
CC:	Nancy Birdsall	(NANCY BIRDSALL)
CC:	file	(PAPER MAIL)

The World Bank/IFC/MIGA
O ' I C E M E M O R A N D U M

DATE: May 26, 1992 12:41pm

TO: Enzo Grilli (ENZO GRILLI)

FROM: William A. McCleary, EC1DR (WILLIAM A. MCCLEARY)

EXT.: 33014

SUBJECT: Background Note on Adjustment Lending (AL)

1. On further reflection, I find the direction taken by our lunch meeting last Friday quite disturbing. There is broad support, I think, for adjustment lending in the cases of balance of payments (b.o.p.) difficulties and for the notion that these difficulties be interpreted broadly to include present gaps, expected future gaps, or gaps generated by the AL program itself as with trade liberalization or with a programmed higher investment level stemming from the desire to achieve a higher growth path. Accompanying all these cases would be a program of macroeconomic and structural adjustment conditionality that would be expected to lead to improved external and internal performance and creditworthiness in medium-term. If I understand things correctly, (and I'm not familiar with the details), the Bangladesh loan may fit these criteria--a larger public investment program (consisting of a rationalized smaller number of higher priority projects) is expected to jump-start the economy leading to higher growth and temporarily larger gaps. Provided that one finds Bangladesh macro adjustment and tax reform program convincing and provided that one is convinced that the larger investment program is feasible, a strong case for AL would exist. Where I begin to have trouble, however, is in the possible finding that more cases for AL likely exist and that the Bank needs to broaden the set of conditions under which AL would be allowed. I find the examples cited to date inconvincing.

2. First is the case of a country with a b.o.p. surplus and high inflation generated by a public sector deficit (Selowsky's case). Given that expenditure/tax reforms may not reduce the deficit immediately, it is argued, it would be desirable to have Bank AL financing substitute for inflationary budgetary financing. This is not convincing. In the first place, absent an increased need for foreign exchange (i.e., a smaller surplus), financing from the World Bank will be just as inflationary as financing from the central bank. The central bank ends up holding foreign exchange rather than government debt in its portfolio and the stock of base money would be the same in both cases. In the second, with no IMF program, no b.o.p. need, and no immediate impact on the inflation rate, it is hard to see how the World Bank's presence will assure the private sector (foreign and domestic) that the reform program will in fact be carried

through. What is needed for "credibility" is a fiscal program with a big down payment--a big impact up front. Lastly, economic reforms are a necessary and desirable part of development. The Bank does and should expect them as part of the progress expected of most countries and as part of maintaining/improving creditworthiness. It is not necessary nor desirable that the Bank reward all reforms with AL financing.

3. Second is the somewhat more general case of whether AL can be justified in situations of protracted b.o.p. surpluses (to narrow the range of possibilities a bit, assume that surpluses are expected indefinitely). While one can no doubt think of worthwhile reforms to be supported (e.g. financial restructuring, public enterprise reforms), many of the same questions as in para. 2 can be raised about the role the World Bank's presence is playing. More importantly, it is worth stressing that the provision of additional foreign exchange in these circumstances has costs that must be considered. In the absence of additional demands generated by the reform program, the additional foreign exchange, when converted into domestic currency to pay for non-traded goods, will generate added inflation, appreciate the currency, and cause a deterioration in the trade balance. While such costs may be worth bearing, we need to be explicit about the fact that they are being generated by the reform program and the chosen method of financing.

4. Last is the possibility of a adjustment lending for the social sectors. My problems with this have both a disbursement side and a conditionality side. The former is the question of whether ALs should be disbursed against local costs (non-tradables). I think that your para. 26 may be a bit too relaxed on this subject saying, "it makes no difference whether a particular SAL disburses against dollar tags or peso tags as long as policy conditionality remains the same." In general, I would agree as long as it is stressed that in both cases what you have is general import financing. Unless there is a commensurate growing need for foreign exchange to finance imports (arising from some other part of the government's program) you will run up against the problems cited in para. 3. In addition, it is difficult to see what is gained by earmarking some or all of the adjustment loan's proceeds against a subset of government budgetary expenditures. The history of counterpart funds/earmarking in adjustment loans is a checkered one at best and, given fungibility, we're only kidding ourselves about what it is that we're financing.

5. As for the conditionality side, an important part of any broad social sector operation would no doubt be an agreement with government on the size and composition of (capital and recurrent) expenditures in this area. This agreement--plus agreement with government on an overall macroeconomic program which would include the budget deficit and its financing--would provide the ex ante assurances needed of the government's commitment to an increased effort in the social sectors. It is hard to see what

additional contribution earmarking of fast-disbursing money to the social sectors would make (in any event, it is difficult to see why the social sectors need fast-disbursing money and why sector investment loans--which are slower disbursing and which do allow earmarking would not do just as well; however, the sector loan would have to be accompanied by the existence of a solid macro framework as earmarking by itself is not likely to assure that an expenditure program will be implemented). My final reservation about adjustment lending in the social sectors is as follows: In the traditional ALs, in addition to a b.o.p. need, one can identify a reform program that is contributing toward increased internal and external stability over time (perhaps as one of an expected series of operations leading toward that objective). As important as the social sectors are to economic development and the social justice, reforms in their performance produce more long-term and diffuse results--i.e., they do not make the contribution to medium-term stabilization and adjustment that other ALs would make. Until it can be demonstrated otherwise, I would be against any free-standing adjustment lending in the social sectors.

6. In sum, I am not convinced that there is much of a case for broadening the scope of adjustment lending. I remain open to being convinced on a case-by-case basis but I think it would be a mistake for the Bank to suggest that there is much scope for adjustment lending beyond the traditional b.o.p. rationale. First, as I've outlined above, the examples of new possibilities are not very convincing or may have troubling side effects. Second, ten plus years of experience with adjustment lending ought to have taught us some modesty about what has been achieved. As the various RALs show, implementation of conditionality is satisfactory but quite a bit short of impressive and there is an apparent connection between adjustment lending and improved economic performance. The improvement in performance for AL countries as a group is greater than that for non-AL countries and certain kinds of reforms have a beneficial effect as shown in RAL 3 (e.g., real exchange rate changes, budget deficits, reductions in inflation and price distortions). Beyond this, our knowledge of which reforms really matter and what their differential impacts are is very thin. Until our knowledge of what matters improves, the case for broadening the scope of adjustment lending, in my view, remains weak.

CC:	Larry Summers	(LARRY SUMMERS)
CC:	Parvez Hasan	(PARVEZ HASAN)
CC:	Ishrat Husain	(ISHRAT HUSAIN)
CC:	Gobind T. Nankani	(GOBIND T. NANKANI)
CC:	Marcelo Selowsky	(MARCELO SELOWSKY)
CC:	Lyn Squire	(LYN SQUIRE)
CC:	Vinod Thomas	(VINOD THOMAS)
CC:	D. C. Rao	(D. C. RAO)
CC:	Anandarup Ray	(ANANDARUP RAY)
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CC:	Nissan Liviatan	(PAPER MAIL)
CC:	Steven Webb	(STEVEN WEBB)
CC:	Nancy Birdsall	(NANCY BIRDSALL)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: May 20, 1992

TO: Distribution

FROM: Enzo Grilli, Director, DPG

EXTENSION: 81934

SUBJECT: Chief Economists' Lunch of May 22, 1992: Background Note on Adjustment Lending

Attached is a note prepared in DPG-CECMG dealing with some of the adjustment lending issues that came up during the preparation of the operational guideline. It is intended to serve as background for the luncheon meeting of May 22.

Attachment

Distribution:

Messrs. Summers, Hasan, Husain, Nankani, Selowsky, Squire, Thomas, Rao, Ray, Walton, Solimano, Liviatan, Webb, Ms. Birdsall

May 19, 1992

Some Issues in Adjustment Lending: A Background note for the meeting with the Regional Chief Economists of May 22, 1992

1. This note examines some of the issues regarding the preconditions for adjustment lending that surfaced during the discussions of the new guidelines.[1] The main issue has to do with the so-called "balance of payments" condition for Bank adjustment lending, its justification in the presence of relative price flexibility (in particular of the exchange rate) and its possible redefinition. The other concerns local cost financing. The note first briefly recaps Bank statements on the conditions for adjustment lending, then it examines their origin and rationale, and finally looks at the economically plausible justifications for adjustment lending (or for a country's external borrowing for structural adjustment). The issue of local-cost financing is examined at the end.

I. The BOP Condition for Bank Adjustment Lending

2. The earliest policy statement anchors the rationale for adjustment lending firmly in the balance of payments. The reason for initiating adjustment lending was "to assist countries ... prepared to undertake a program of adjustment to meet an existing or to avoid an impending balance of payments crisis (emphasis added)."[2]

3. The official rationale for adjustment lending does not seem to have changed much since then. Nor have public pronouncements of senior Bank managers. In a 1989 speech, for example, Mr. Stern stated that "we provide quick-disbursing loans because the actions being undertaken by the government have some balance of payments impact, some additional costs that we can help to defray... (emphasis added)". The BOP condition was maintained, if cast in looser terms, and seemingly endogenized in the (structural) policy reform programs pursued by member countries and supported by the Bank.

4. In practice, the scope and relevance of the balance of payments condition were always dealt with pragmatically by the Bank. BOP needs could be actual, expected as a result of policy changes (as in the case of many trade reforms that we supported), imputed as the internal (economic and social) cost of making reforms acceptable, or a consequence of (hoped for) higher growth (held down otherwise by the BOP gap). Yet, a vague specification of the BOP condition for Bank adjustment lending was not free of

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1 See the memoranda from Messrs Nankani and Selowsky included in Appendix 1.

2 "Lending for Structural Adjustment", R80-17, IDA/R80-22, Feb. 5, 1980.

problems. Wherever the link between the policy reforms being supported and the foreign exchange needs of the borrower appeared to be less than clearcut, the justification for lending (or not lending) inevitably became more problematic. In these cases senior Bank managers showed an inclination to define somewhat restrictively the ambit of application of Bank lending for structural adjustment. For example, in his 1989 speech, Mr. Stern states, ... "This (BOP) standard does not mean that there is no need for policy reform in sectors where the costs are not in foreign exchange. Indeed, we know that countries face major issues of reform in education and in the social sectors generally, in transportation, infrastructure, the environment and urban development. While the World Bank should be an active participant in those policy reforms, and a source of financial support, I think quick-disbursing assistance is not appropriate for these types of reforms (emphasis added)."[3]

5. The Bank "Reviews of Adjustment Lending" walked a thin line on the issue of BOP justification. Formally, they tried to stick close to the official position, while at the same time developing a theoretically stronger and more articulate rationale for adjustment lending, which were essentially that these loans facilitated a phased reduction of current account problems during the period of macro-stabilization (thus reducing BOP adjustment costs) and provided extra time for, and possibly reduced internal opposition to, longer-term structural adjustment measures. RAL III introduced an important new nuance in the BOP argument when it said that "the need for more external financing does not have to be present before the adjustment program begins, as in a balance of payments crisis. It might be generated by the investment and growth arising from the program (paragraph 13, page 9)." Balance of payments needs, therefore, could not only be endogenous to the reform program, but also dictated by a "raising of the sights": higher investments for higher growth.

6. In the past couple of years there has been further consideration of the possible situations in which adjustment lending would (or would not) be useful. As the result of better understanding of adjustment in member countries, and the evolution of the process of adjustment in many of them (in particular, the move to more flexible exchange rates), it has become clear that, in at least certain situations, the fiscal capacity of a country, and not its current account needs, might be the most serious constraints to continued structural adjustment. With increased price flexibility and resource mobility introduced in their economies, with excess absorption reduced and inflation brought under control, countries such as Chile, Mexico and Argentina are increasingly facing economic consolidation and growth issues that are not coupled with "traditional" balance of payments problems.

II. Origins and rationale of the BOP condition

7. Official Board documents (as distinguished from staff reviews such as the RALs) did not elaborate much upon the economic rationale of the balance

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[3] See Thomas et.al. editors. "Restructuring economies in distress." Mr. Stern made clear in the speech that he was expressing his personal views.

of payments condition. In the context in which adjustment lending was introduced -the aftermath of the second oil crisis- this rationale must have appeared quite obvious. The BOP position of member countries hit by an external shock was a clear indicator of their need for foreign financing. Its applicability to other situations and contexts (i.e. its scope and limitations) were not explored in any detail.

8. There may also have been at least an implicit doctrinal linkage to the "two-gap" approach of Chenery-Strout, in which a "binding" foreign exchange gap, already existing or likely to appear as a consequence of higher growth targets, provided an early rationale for foreign assistance. The Bank's "gap-fill" approach, embodied in the RMSM models, is akin to that of Chenery and Strout[4]. Because of this connection, concepts like the "foreign exchange gap" or the "foreign exchange constraint" have long been a part of the Bank's language. This is not to say, of course, that anyone really believed in the applicability of a strictly defined "binding" foreign exchange constraint: Chenery's polar case assumed no possibilities of increasing foreign exchange resources, either by expanding export volumes, or by saving on the import bill through import substitution, or reductions in the import-intensity of investments.

9. These were conditions considered dominant in the 1950s and 1960s, not in the 1980s. Yet, even if much of the general logic for the "dual-gap" approach breaks down when real exchange rate flexibility is introduced and domestic savings are assumed to be more readily transformable into foreign exchange,[5] there remained enough room "within the cracks" of the model, and particularly in the notion of some (residual) inflexibility of resource movements inside a developing economy, to still make the framework useful to rationalize the BOP condition for adjustment lending beyond situations of evident macro-economic crisis. If, for example, a country was willing and able to postpone consumption for investment, but lacked the foreign exchange to buy the imported intermediate inputs and capital goods or to shoulder the import expansion costs (in foreign exchange terms) of trade reforms, either because export supply or import demand were inelastic (or responded sufficiently only with a time lag) to price, then external borrowing (and Bank lending) would be justified. These were comfortable arguments, not only steeped in Bank tradition, but also easily "sellable". Another possible justification was that to rely completely on price adjustment to deal with an external imbalance might be too costly in welfare terms. A combination of quantity and price adjustments might be welfare superior, or could at least reduce domestic oppositions to certain policy reforms. Borrowing foreign exchange would therefore help the country adopt the best "mix" of adjustment strategies and ensure better sustainabiity of the reform process.

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4 H. Chenery and A. Strout, "Foreign Assistance and Economic Development", American Economic Review, 1966.

5 See Appendix 2, provided by Messrs Liviatan and Solimano, on the dual-gap model and its linkages to adjustment lending.

10. It is nonetheless clear that the vision underlying Bank official pronouncements on adjustment lending was that of a considerable expansion of the role of the Bank in the policy dialogue with member countries, and of a profound change in the development agenda that it pursued. The connections to the Chenery-Straut approach were probably more historical than based on an explicitly accepted model or even on a careful taxonomy of cases where a gap framework could justifiably be applied.

III. The evolving rationale for adjustment lending

11. With increased experience and better reflection[6] the question of when a country should borrow externally to support a structural adjustment program, or when the Bank should lend in support of it, have been put into better focus, and so have the optimality issues connected with external borrowing under conditions of price flexibility and resource mobility. Four broad (and often overlapping) justifications for a country seeking external financial support for a structural adjustment program have by now emerged: cost smoothing (most often in the presence of a BOP problem), transitory budget financing in the absence of a BOP problem, investment financing to accelerate growth and legitimacy buying.

12. The basic logic of cost smoothing is roughly as follows: If structural adjustment has significant transitional costs, in terms - for example - of real output foregone in the short run as a result of large and sudden changes in key relative prices, external borrowing can reduce the welfare losses which such costs entail by spreading the costs over time. A related benefit from external borrowing on these grounds is that by reducing the welfare losses from the adjustment costs which accompany structural reform, the reforms are made more palatable and thus more politically sustainable and likely to succeed in the long-run. This is essentially the general "case" for adjustment lending made in RAL II and expounded by Corbo and Fischer.[7]

13. Some policy reforms may not have a real resource cost, but may have a significant negative effect on the government budget, such as in the case of a financial sector reform involving government recapitalization of the banking system or in public sector adjustment situations. Budget financing becomes the issue here. A case for temporary external borrowing can be made if the alternative means of financing these additional expenditures (e.g. increasing taxes, borrowing domestically or expanding base money) were inferior to (i.e. more costly than) external borrowing.

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6 See a general illustration of the lending/borrowing issue in Appendix 3, adapted from a forthcoming paper of T.N. Srinivasan.

7 "Adjustment Programs and Bank Support: Rational and Main Results", in V. Corbo, S. Fischer and S. Webb eds., Adjustment Lending Revisited, 1992.

14. Structural adjustment often requires not only a different allocation of expenditure, including investment expenditures, but also a higher level of investment. If the cost of postponing additional consumption is higher than the cost of external borrowing, then it is preferable to borrow externally than to save more domestically to finance a higher level of investment. Not knowing the cost of postponing consumption (i.e the social discount rate), the rule of thumb is to borrow if and only if the expected return on investment exceeds the cost of external finance. This is in part the case newly stressed in RAL III, and the one that brings us back to the "primordial" logic for Bank existence: financing investments in member countries. The question here is why adjustment and not project lending, to which we will return later in this note.

15. Aside from economic justifications, there may be sound political motives for a country to borrow externally, especially from the World Bank, in support of a structural adjustment program. International support may, but need not necessarily, strengthen the governments hand in dealing with disaffected interest groups: it buys legitimacy. Getting external support may thus enhance the internal and external credibility of the program and thereby increase its chances of success. This is a justification stressed by both practitioners of adjustment and political economists.

IV. Issues related to the rationale for Bank adjustment lending

16. Should the World Bank provide external financial support for a structural adjustment program on all the above grounds or only in some of them? How strong is the economic (or the political economy) rationale for Bank support in each set of circumstances briefly sketched out above?

a) Cost Spreading

17. The economics of the case for spreading the costs of policy changes is straightforward. The case applies both to a situation where a BOP imbalance is already present and to one where there are BOP costs implicit in the policy changes being implemented. The political benefits also make sense. The problem is insuring that lending achieves the desired objective of promoting adjustment rather than the undesired consequence of providing a means by which to avoid adjustment. Conditionality is the mechanism by which the Bank attempts to insure the outcome will be adjustment promotion rather than adjustment avoidance, but conditionality is an imperfect mechanism. Generally it works only when it is not necessary, i.e. when the country is fully committed to the program. But when the country is not committed, it will not suffice.

b) Budget Financing

18. Financing for a limited time a government budget deficit, or that part of it which arises directly from an adjustment program, may be justifiable in principle. The overall government budget deficit (G-T) is identically equal to the sum of the private saving-investment balance (S-I)

and the current account deficit (M-X) or its equivalent: the increase in net external debt (ΔD). If the budget deficit goes up, then either private savings must rise, private investment must fall, or external borrowing must rise. If savings are given, then it boils down to either lowering private investment or borrowing from abroad. Both shift the burden of the higher budget deficit to the next generation, and choosing between them is a matter of which involves the lowest burden. If the return on investment is higher than the cost of external finance, then borrowing abroad is preferable to borrowing domestically, and squeezing an equivalent amount of private investment out of the credit market through higher interest rates. So, external borrowing to finance a budget deficit, in principle, is perfectly defensible.[8] However, the logic of the borrowers' fiscal need for Bank adjustment lending is not trouble free in practice, because of the implications of the key implicit assumption that the budget deficit is given and the possibility of adverse exchange rate consequences from external borrowing to finance a local currency deficit.

19. To illustrate the first point, consider, for example, the case where a government undertakes a financial sector reform which requires it to recapitalize the banks. This is what is likely to happen in the second phase of adjustment in countries such as Argentina and India. The reform raises government expenditures and, given the level of taxes, the budget deficit. But why assume a given level of taxes, or for that matter an increase in government expenditures, for there may well be other avenues to raise fiscal revenue or other expenditures in the budget that could be sacrificed to make room for those associated with the financial sector reform without increasing the budget deficit? If, however, government chooses not to raise taxes quickly or cut other expenditures so as to avoid financing the adjustment program by borrowing either domestically (at the expense of investment) or externally (at the cost of increasing indebtedness), what signal does that send to private agents in the economy? Quite possibly it is that the government cannot justify domestically its adjustment program, and the costs which arise from it, to those who presumably should benefit from it.

20. If the government is seen to lack the resolve to "bite the fiscal bullet", then private agents may not give it much credibility. If private agents do not view the program as credible, then borrowing domestically will be extremely costly, which naturally makes foreign borrowing look attractive. If the domestic real interest rate is higher than the international rate, the case for foreign borrowing may look very strong, but that may reflect (among other possible causes) the low credibility that private agents give the adjustment program, which may be based in part on the fact that the government has resorted for foreign borrowing to finance the budgetary costs associated with its adjustment program. It will not be forgotten that external borrowing

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8 There may be cases where the budget deficit is there to begin with, because of internal or external shocks affecting revenues or past policy failures. The costs of reducing the budget deficit too quickly may be too high. External borrowing in these circumstances acquires a "cost smoothing" logic.

to finance government budget deficits in the 1970s is what got many countries into trouble in the 1980s. The Bank ought to move carefully in this area.

21. There are also exchange rate consequences to external borrowing done to finance a budget deficit. The additional supply of foreign exchange, when transformed in domestic currency, will appreciate the exchange rate[9], thus indirectly also affecting the trade balance of the country. These are adverse consequences that need to be taken into account by the country and the Bank as well.

22. Finally, there is another consideration for the Bank to make. Meaningful conditionality may become more difficult to obtain in lending to a country that does not have a BOP problem (actual or potential) and Bank leverage will be diminished in this case. In the absence of a BOP problem (or the strong likelihood of it), governments may be more reluctant to take the necessary fiscal measures (or to take them quickly enough) and our ability to "hold" them to a pre-agreed plan may also be reduced.

c) Investment Financing

23. The basic logic for Bank lending in this case is no different from that of project lending. Financing long-term investment is the traditional business of the Bank. The rationale for an international public agency to be involved is that international financial markets are incomplete and imperfect because of some externality. If that logic still holds, then the Bank has its role to play, financing socially profitable investments which would otherwise not be undertaken by private investors. This generally argues for lending on a project by project basis, backed up by rigorous cost-benefit analysis. The problem is that project lending is slow to disburse and requires a long paper trail. Some countries, like Bangladesh and Nepal, are incapable of absorbing enough external finance on a project basis to raise significantly their investment ratios. Given their low capacity to implement project effectively, they seem to be condemned to a sort of "underemployment equilibrium".

24. In such circumstances, if one assumes that private and public savings remain unchanged (at least for a while), only a large cluster of investments financed from a common external budget can jump-start the economy and obviate the current account problem that any massive increase in public investments otherwise financed would generate. The recent Bangladesh Public Resource Management credit made this case for adjustment lending (a sort of economy-wide generalization of the logic previously applied to sector program loans). This justification, if more generally accepted, would represent a clear departure from the way adjustment lending has so far been viewed. An

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[9] The point is also made clearly in Figure 2 of Appendix 3. If an incremental investment requires only non-traded goods, external borrowing can keep current welfare constant, but not the consumption bundle or the exchange rate. In the latter case there must be a real appreciation to expand production of non-traded goods and to induce consumers to substitute traded for non-traded goods.

initial situation of no internal or external disequilibria, relatively ample foreign exchange reserves and low growth would in fact appear to be a classic case for investment, rather than adjustment lending. If project implementation capacity is also an important issue, to justify quick-disbursing lending one would have to show that there are significant economies of scale that can be obtained from the administration of clusters of projects financed from a common budget. What distinguishes the Bangladesh case, and should be kept in mind in judging the opportunity of adjustment lending in similar circumstances, is **a)** the existence of a macro-framework agreed with Bank and Fund, **b)** provisions for **close** scrutiny by the Bank of public expenditure -including investment policies, **c)** the existence of a program to increase public saving through tax reform.

d) Selling Legitimacy

25. In today's world, this may be the Bank's (and the Fund's) most important line of business, but it is not one that can be stressed too strongly and pushed too far. Legitimacy is important not only for implementing economic policy, but also for exercising political power, and the Bank is rightly forbidden by its charter from dabbling in the latter. Only the former provides an anchor for Bank action. Legitimacy, moreover, is hard to measure and can be too easily oversold as an argument. It needs to be considered (and dispensed) in small doses.

V. Local cost financing and the social sectors

26. Bank adjustment loans (SALs and SECALs) disburse against general imports (subject to some cosmetic restrictions). Disbursements are made against certificates and bills with dollar tags. Disbursements against local costs, which are done in project lending, are against "peso" tags. In either case this is general import financing, and there is no difference between the two modes of financing except that in the latter case they are tied to specific expenditures, and they are associated with different types of policy changes. In the case of local cost financing, there are particular project-specific expenses to be financed, and the institutional and cost-recovery issues are typically too micro to be focussed on in SALs and SECALs. But to put the point in another way, it makes no difference whether a particular SAL disburses against dollar tags or peso tags as long as the policy conditionality remains the same.

27. Restrictions against local cost financing by the Bank (which existed until quite recently) may have been a reason why adjustment lending has not been encouraged in the social sectors. There may have been other reasons of course. For example, it is often thought that the country should not have to borrow abroad to "finance" policy changes in education, health and environment. But while there may not be any direct impact on the balance of payments, there may well be one indirectly through the budget, as discussed earlier. In those circumstances where tax increases and public expenditure cuts elsewhere can be ruled out (the country is doing the best it can in this respect and is under our close supervision), the incremental costs of social

sector policy changes will lead to a higher deficit, that can be financed either by crowding out private investments or by inflationary financing; hence it might be better to borrow abroad by the same line of reasoning. Thus, if one does not stick to a strict balance-of-payments rationale for adjustment lending, one should not also be averse to social sector adjustment loans, to be disbursed against peso tags.

28. Given that the new Bank guidelines on costsharing no longer distinguish between local and foreign exchange costs, the remaining issue is when recurrent costs can be financed. Project loans can only go to finance capital costs (and not recurrent costs). Given this restriction, there have been instances when counterpart funds of SECALs have basically been used to finance recurrent costs of social programs. If it makes sense to finance recurrent costs (to get programs started, for example) the restriction on using proceeds from regular loans for such recurrent costs should perhaps be reviewed.

APPENDIX 1

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: April 17, 1992

TO: Mr. Anandarup Ray, DPG

FROM: Marcelo Selowsky, Chief Economist, LAC

EXTENSION: 39006

SUBJECT: Draft Operational Directive 8.60 on Adjustment Lending

1. Thank you for sending me the draft. My main comment is that we should not restrict adjustment lending to countries having "an actual or imminent balance of payments problem" (para. 5) if that definition refers only to a pre-existing problem. As the same paragraph recognizes later - and para. 49 elaborates further - a properly designed adjustment program may itself create the need for additional external financing. This may be the case not only with trade reforms, but with many other cases in which transitional financing is needed to support and maintain an adjustment program:

- Consider a country having high inflation fueled by public sector deficit but simultaneously, having a robust export performance. The government initiates an adjustment program, including reduction in public expenditures and tax reform. However, these measures do not reduce the deficit immediately. External financing may play a crucial role in giving the program time to work and thus avoid the need for inflationary budget financing. Funds from a SAL help to maintain a higher level of domestic absorption during the transition, allowing the economy to reach a new path of more efficient growth. As such, a SAL would be justified even if there is no imminent BOP problem.

- Or take the case when the most important reform needed is a reduction in generalized subsidies and price controls. External support would allow financing the additional costs of quickly setting up targeted programs to protect the poor and most vulnerable. As before, external financing facilitates the transition toward a more efficient and fiscally sustainable growth rate.

2. As I recall, adjustment lending was originally designed to support oil importing countries experiencing dramatic BOP shocks as oil prices skyrocketed in the early 1970s. Adjustment lending was to keep import levels while the country undertook the necessary reforms to improve efficiency and exports. But, as mentioned above, the need for adjustment lending may be endogenous to the reform program, i.e., not necessarily triggered by an external shock such as terms of trade or interest rates. In other words, a good adjustment program may induce a temporarily higher current account deficit to be financed by an adjustment operation.

3. In a sense the issue is simply defining what we mean by "a balance of payments problem". It should not be restricted to external shock adversely affecting the balance of payments or a situation where acceleration of growth would require additional imports -- then to be matched by increases in exports as time passes. Situations where the proper design of a reform program temporarily increases the current account deficit should also be included.

cc: Messrs. L. Summers, E. Grilli, I. Husain, V. Thomas, G. Nankani, P. Hasan and L. Squire

A L L - I N - 1 N O T E

DATE: 21-Apr-1992 02:41pm

TO: Anandarup Ray (ANANDARUP RAY)

FROM: Gobind T. Nankani, SASVP (GOBIND T. NANKANI)

EXT.: 84641

SUBJECT: ODs on Adjustment Lending

Anand:

I have some comments on OD 8.60 (see below) and none on OD9.10 other than that South Asia does not have a regional loan committee.

With respect to OD 8.60, I have the following comments:

(i) First, I agree with Lyn that the fiscal issue is one that pervades much of our conditionality, be it in the area of tax reform, trade reform, public enterprise reform ,financial sector reform, pricing and cost-recovery in inffrastrucutre and social services,etc.etc. and hence needs to be treated as a cross-cutting issue rather than just one other issue.

(ii) Second, I would like to suggest that we take advantage of a discussion that Larry and the Chief Economists are going to have shortly (and Larry has promised to touch base with Ernie before then) on the need for a BOP rationale for adjustment lending. As I understand it, present rules or conventions require either that there be a BOP need, or that a BOP need be imminent upon implementation of the policies being supported by the AL. This precludes a situation in which there is a fiscal gap which the AL is going to help address, but this fiscal gap is not accompanied by a BOP gap. This typically would arise in a Public Sector adjustment loan in which fiscal or expenditure reforms are being supported, but the country is one in which the private sector is flush with foreign receipts (but not the public sector e.g.in Brazil) or one in which there is a fiscal gap in spite of the public sector not having a foreign resource need on account of the availability of project-tied donor resources, AND where the latter is taken as a constraint. (If the latter is not a constraint, then a BOP gap would emerge as donor resources are withdrawn to correspond to the fiscal gap). The latter is similar to the current Bangladesh situation.

The key point in the above two examples is that a case for AL can be made on the basis of a fiscal rather than a BOP gap, and we do not make a fetish of the foreign exchange issue as we were prone to do in the days of the two- (or three-)gap model, when the underlying assumption of rigid exchange rates was a reasonable assumption (which it is not today).

I will concede, of course, that this justification for AL opens an escape valve for many weak ALs, because there is no hard

test such as that provided by a BOP-gap. And hence, on pragmatic grounds, we may still end up using the BOP criterion. That is a different issue from one in which ALs to support fiscal gaps where there are no BOP gaps are ruled out IN PRINCIPLE.

(iii) I also missed any reference to the need to look at issues of the capital account, in the sections dealing with trade policy reforms. The fact is, as we move further into the 90s, ans as most countries adopt simplified and relatively uniform tariffs, and given the prognosis for debt and aid flows, more and more of a reliance will have to be placed on non-debt private flows to meet external saving targets. This will require a great deal of reforms on the capital account side which we need to focus on. So far, our only advice has been to liberalize the trade account first, and the capital account later. There is no content to the intra-capital account reform issue.

(iv) On Poverty and Social Adjustment, I missed any reference to the need to ensure not only that public expenditures are sustained in the social sectors, but also that they be substantially restructured (within existing ceilings) to meet efficiency and equity objectives more effectively. Even more importantly, simply seeking changes that are enshrined in budgetary allocations for a year or two may meet some transitional needs, but the more important and significant need is for INSTITUTIONAL changes that will have an automaticity beyond the period of the AL.

(v) the para. on collaboration with the IMF (para. 38) is a change from the wording used in the famous agreement between Conable and Camdessus about the Fund being "primarily responsible for aggregate macroeconomic issues". Has there been an evolution to this definition of the division of labor?

(vi) While I agree with Frida that to have a section on sequencing that says there is no recommeded sequence is disappointing, I would not therefore drop it. Rather, I would say what you hav esaid, but add that experience to date suggests that for each of the following classes of country situations, the associated sequence should be rejected only if there are good reasons. And I would then give some heurestic or conjectural sequencing propositions, which if pressed to, I am sure DEC can provide. It is too important an issue to leave unattended. (And we also ought to be doing a lot of work it clarify the parameters in this area, so as to reduce the, at present, very large scope for judgements).

(vii) Is para. 45 a reflection of current thinking on the issue of whether policy conditions should only embody ACTIONS as opposed to including OUTCOMES? I seem to recall that we have flip-flopped on this one over the years. Or am I wrong?

(viii) I think the issue of the conditions under which single-tranching is justifiable deserves detailed treatment.

For many of our large-country borrowers, the attractions of the Indonesia approach to adjustment loans are great, given the sensitivities to externally-"imposed" policy conditions. It would be helpful to codify the conditions under which single-tranche loans can be justified, including the obvious one of a good implementation record.

Gobind

CC:	Parvez Hasan	(PARVEZ HASAN)
CC:	Ishrat Husain	(ISHRAT HUSAIN)
CC:	Marcelo Selowsky	(MARCELO SELOWSKY)
CC:	Lyn Squire	(LYN SQUIRE)
CC:	Vinod Thomas	(VINOD THOMAS)
CC:	Antonio Estache	(ANTONIO ESTACHE)
CC:	Jee-Peng Tan	(JEE-PENG TAN)
CC:	Nancy Ellen Vaughn	(NANCY ELLEN VAUGHN)

Appendix.

Adjustment Lending and the Two Gaps Model.

A widely used model for assessing foreign resource needs of borrowing countries is the two gaps model. This model is an extension of the Harrod-Domar model for an economy open to international trade. It focuses in two financing constraints for investment and growth[1]: The external gap or balance of payments and the savings (or internal) gap which is simply the savings-investment identity coming from national accounts. The foreign gap highlights the constraint posed by the availability of foreign exchange on the capacity to import intermediate and capital goods needed to support current production and growth. The savings gap, in turn, indicates the constraint on investment stemming from the availabilities of foreign and domestic savings. Incidentally, the RMSM model, used at the bank, is simply a two gap model . Recently the RMSM-X model extends the original model by introducing the fiscal gap and its financing.

Following Taylor (1979), figure 1 depicts the two gap model, with total investment in the vertical axis and the amount of capital inflow in the horizontal axis. The two upward sloping schedules are the foreign gap and the savings gap; with the foreign gap having a steeper slope than the savings gap as the investment-import coefficient is less than 1. In this case the "productivity" of foreign financing, in terms of enhanced investment and growth, is greater when the foreign gap is binding than when the saving gap is binding. Finally the gap includes an investment floor and an investment ceiling given by some guess on the absorptive constraint of the economy.

The area formed by the dashed lines in figure 1 gives the "feasibility set" in which the economy can operate from the viewpoint of investment and growth possibilities, given the position of the gaps and the technical and absorptive constraints of the economy. Exploring in more detail the nature of the solution yielded by this model we see that from the point D to E the

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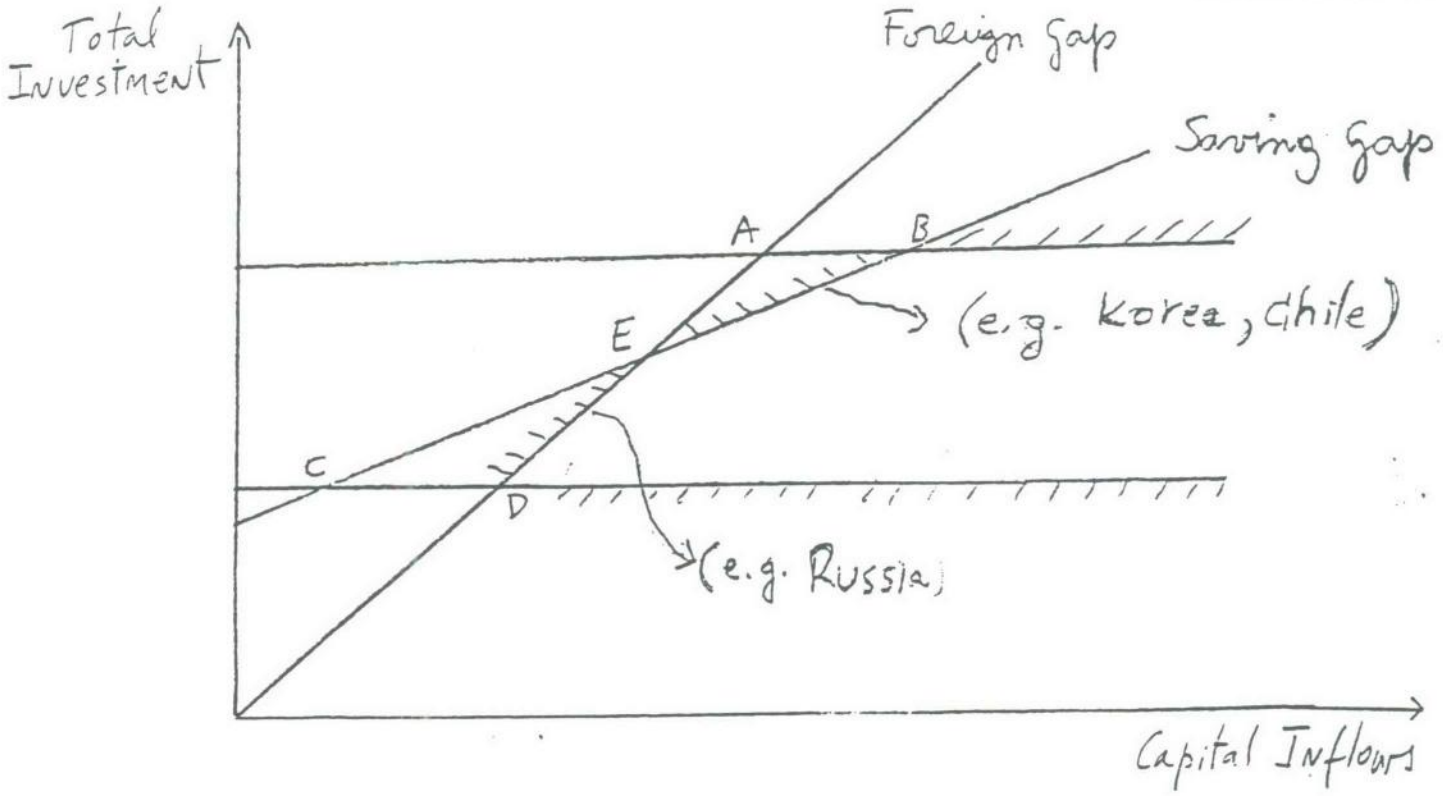
[1] See a presentation of the two gap model see L. Taylor (1979) Macro Models for Developing Countries Mc Graw-Hill, chapter 8.

economy is constrained by the foreign gap. Namely, investment can not be increased more (to speed up growth) without additional foreign exchange. Implicitly it is assumed that the home country can not produce domestically in sufficient amount and quality the required capital goods --machinery and equipment-- to support growth of output and therefore they must be imported. Also it is assumed that the possibilities for substitution between domestic and foreign capital goods are very limited.

In the case of a binding foreign gap there is "enough" domestic savings but what is really needed, from the viewpoint of financing investment, is foreign exchange. In particular, there is an excess of full employment savings over investment (a keynesian equilibrium in the goods and labor markets) that is reflected in excess capacity and unemployment because of the shortage of essential imports. Potentially, the economy is trapped in a low activity equilibrium because of the lack of sustainable foreign financing.

In turn, the segment EB represents the case in which the savings gap is binding. In this case the economy will be at a high level of utilization of productive capacities and , very likely, accumulating international reserves.



The model present some problems as a representation of an actual economy on several grounds. First, the model does not allow for changes in the real exchange rate as an adjustment mechanism to close "the gap between the gaps". Relative prices, chiefly the real exchange rate, do not adjust in face of external and internal imbalances. In many cases a country run a sizeable current account deficit in the balance of payments because the real exchange rate is grossly overvalued. In the two gap model adjustment takes place through changes in "quantities" namely through changes in the level of output (or the rate of capacity utilization) and the level of international reserves, depending upon which gap is binding. Second, the model was developed in the late fifties and sixties when there were pervasive capital shortage at global level for developing countries. This situation changed in the seventies with the recycling of petrodollars and the substantial increase in capital mobility. The eighties, particularly after 1982, brought back a period of limited access to foreign financing for LDC's. In the nineties, however, the trend seems to be in the direction of capital repatriation and a return of capital inflows to several regions, notably Latin America.

In spite of these shortcomings, the model still may be helpful to address, with due modifications of some assumptions, issues of adjustment lending. First, it is clear that the productivity or effectiveness of adjustment lending is reduced--though not eliminated by the reasons discussed before in the note-- when the economy is not restricted by the balance of payments, e.g. in the segment EB. Second, the possibility of exchange rate adjustment is ruled out in the two gap model, though it is a relevant one. In terms of figure 1 a real currency depreciation ~~amounts~~ cause the foreign gap to shift up to the left, therefore allowing a higher rate of investment for a given level of capital inflows, at least up to the point in which the external gap is still binding. In this connection a case is often made that with fully flexible exchange rates the external imbalances would disappear almost by definition and therefore reducing the need for foreign financing of the

country. This view has to be qualified in at least three directions. First, while it is true that the overall balance of payment is in equilibrium under flexible rates, still governments may have certain preference regarding the level of the current account and/or the composition of the balance of payments. Second, a flexible exchange rate regime may generate an equilibrium exchange rate that, though consistent with internal and external balance, is socially unsustainable because it entails a very low real wage. In turn this may lead to a cut in consumption with an adverse impact on welfare. The fact that a fully flexible exchange rate may cause adjustment problems can be appreciated if we think that the production possibility frontier may be very inelastic in the short term, so that a very large real depreciation of the exchange rate may be needed in order to shift resources to the tradeable goods sector. Again this may involve a cut in living standards that are unfeasible politically for a government to undertake. In this case the access to foreign financing--e.g. adjustment lending-- will contribute to the social sustainability of a program by avoiding a sharp decline in standards of living following the implementation of adjustment policies. Third, a related problem is that an adjustment of the real exchange rate to correct an external imbalance may generate recessionary effects in the short term because its effect on real wages and consumption uncompensated by an equivalent increase in investment and exports. In this case, adjustment lending may help to sustain a higher activity level than otherwise. The recessionary tendencies may arise because of the time lag often observed between the moment the real depreciation takes place and the time in which the response of capital formation and exports actually materializes. Moreover, because lack of complete credibility on the exchange rate policy and/or due to the existence of rigidities in labor markets, resources may be slow to move from the home goods to the traded goods sector. In sum, from an analytical and policy perspectives, considering the real exchange rate as an adjustment variable is an improvement over the two gap formulation of completely rigid prices. Nevertheless, this does not imply that the welfare costs and the policy

complications just mentioned will disappear just by introducing the possibility of greater exchange rate flexibility in the system. The income effects of changes in the real exchange rate have to be considered seriously. In that circumstances adjustment lending, and more generally foreign financing, still has a role to play in supporting the sustainability of the adjustment process.

Lending by the Bank: A general equilibrium illustration in the context of a small open-economy model.

Let's start from the premise that Bank lending for any purpose is made on the expectation that its use by the borrower will generate resources in the future for its service. This relationship need not be a direct one, as in the case of lending for a directly productive project. It can be thought to exist and operate through improvements in productivity brought about by policy changes being supported by lending. A second premise is that the resources that the Bank lends are in foreign exchange and that the purpose for which they are lent will in some way generate a matching demand for foreign exchange. The activity being supported need not require foreign exchange for its implementation. What matters is that the economy's overall demand for foreign exchange is augmented to the extent of the loan during the implementation of the activity for which the loan is made. Let's also assume that the cost of borrowing from the Bank is lower than that of domestic finance. In the absence of such condition, borrowing by the country would not be worthwhile (and lending by the Bank would not occur).

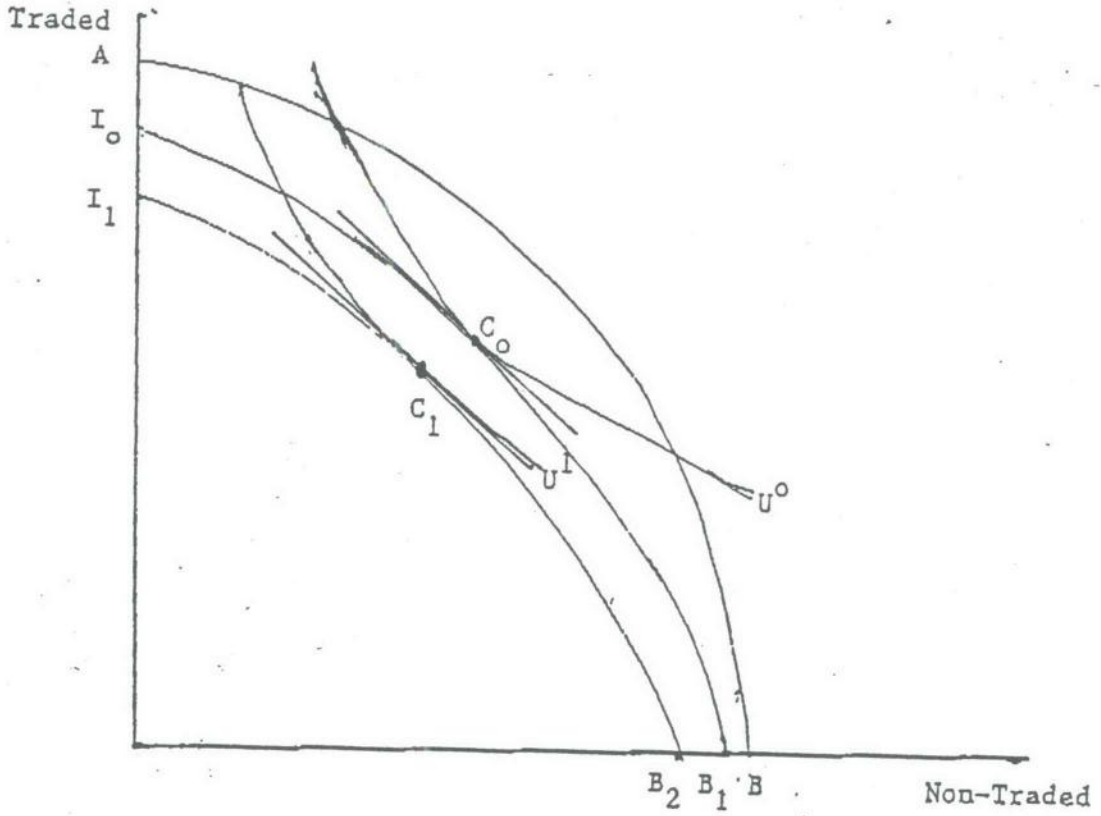
Given these general conditions, Bank lending to a country can be illustrated in two extreme cases: a) one in which only traded goods are required to finance the chosen activity (this is a situation that can be configured either as Bank financing of an investment consisting of imported machinery and equipment or of the balance of payments costs of trade

liberalization); b) another in which only non-traded goods are required to implement the activity in question (this case can be configured as Bank financing of either a social sector project requiring only domestic expenditure or the reform of the entire education's sector of a country in the context of an adjustment program).

Case a: Activity requiring only traded goods

Suppose that the economy's production possibility frontier is AB (Figure 1) and that at the initial level only AI_o units of traded goods are used up in investment. Then the availability frontier for consumption will be B_1I_o and the initial equilibrium consumption point will be one such C_o, where the frontier is tangent to the social indifference curve U^o. The relative price of traded to non-traded goods (the domestic real exchange rate) will be the slop of the tangent to the consumption frontier and indifference curves at C_o. Let's now consider an activity requiring an additional I_oI_1 units of traded goods. Implementing it without borrowing implies for the country that the availability frontier moves inward to B_2I_1 and the new equilibrium point would be C_1 on the (lower) indifference curve U^1 (at unchanged real exchange rate). The supply of I_oI_o of traded goods by the Bank would instead enable the activity to be undertaken and the economy could maintain consumption a C_o and welfare a U^o. By providing foreign exchange resources equivalent to I_oI_o the Bank meets the external resource needs of the country and makes it possible to maintain welfare at U^o and the real exchange rate unchanged.

Figure 1

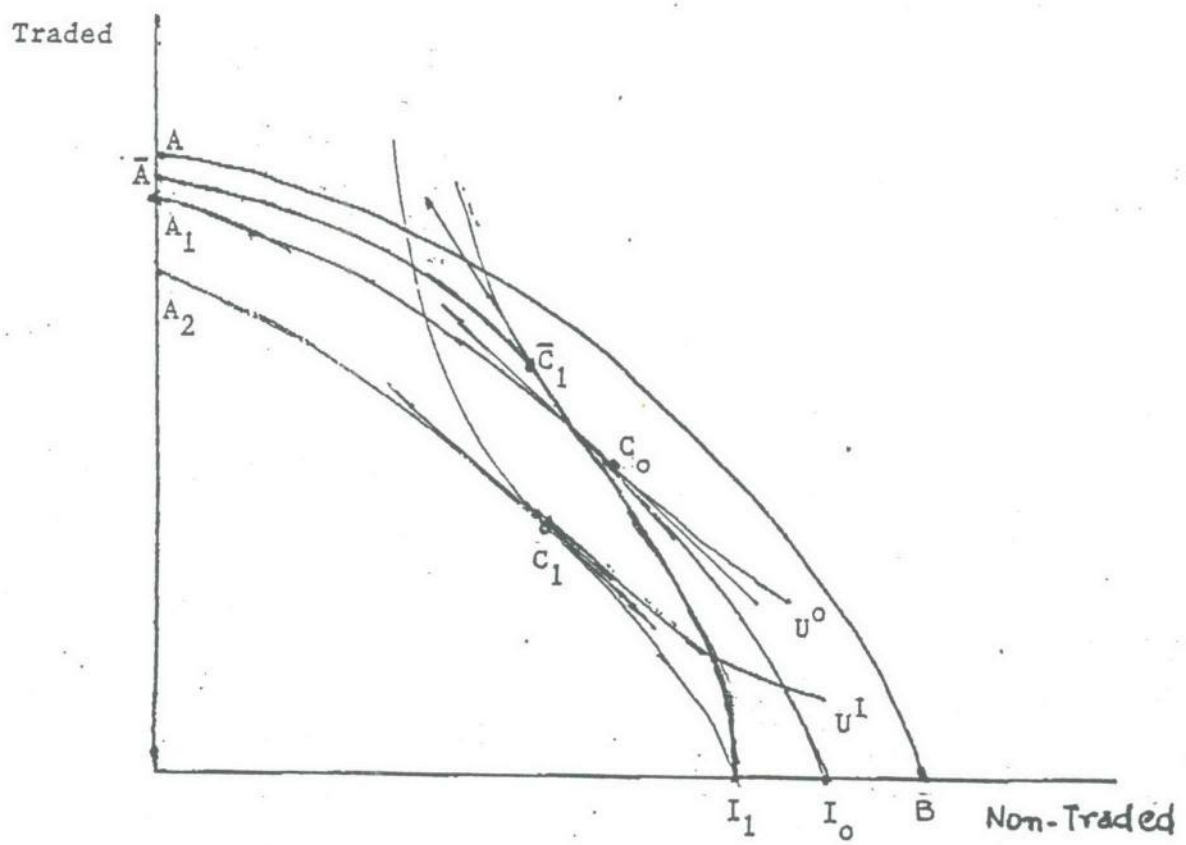


Case b: Activity requiring only non-traded goods

Consider now the opposite case in which the activity being considered requires only non-traded goods. At the initial equilibrium level (Figure 2) BI_o units of non-traded goods are used in investment; the consumption possibility frontier is A_1I_o and consumption attains at C_o on the social indifference curve U^o. If a desired new activity requires an additional I_oI_1 units of non-traded goods, without external borrowing the availability frontier of the economy would shift inward to A_2I_1, with

equilibrium consumption at C_1 and welfare falling to U^1. By lending $A_1\bar{A}$ of traded goods, the Bank could shift upward the availability frontier to AI_1 and allow it to touch the U^o indifference curve at $\bar{C}_1$, thus maintaining welfare at the previous level (with an appreciated real exchange rate). The Bank loan, in other words, fills the domestic resource needs that arise when welfare is maintained at U^o while the desired investment activity is undertaken.

Figure 2



Three points may be worthwhile stressing at this juncture. The first is that the polar assumption (activity requiring either traded goods or non-traded goods only) is not essential to the argument. The second is that the additional activity considered in the two examples must be worthwhile if financed by borrowing, which means that it must have demonstrable benefits and cause the economy to generate at some future points enough resources to service the loan. The third is that it would not have been undertaken without borrowing, i.e. the loss in current welfare (from U^o to U^1) would be more than the gains in discounted future welfare, if the domestic costs of additional resource were used as the discount factor. In other words, only the lower costs of external borrowing (with respect to domestic finance costs) makes the marginal activity worthwhile implementing.

May 18, 1992

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

Dominique -
I suggest you send copy to Mr. Joshi
4/17

DATE: April 16, 1992

TO: Mr. Basil Kavalsky, FRM

FROM: Dominique Lallement, CODMO

EXTENSION: 82849

SUBJECT: SAL and SECAL Disbursement Periods

1. Mr. Wijnand requested me to reply to your EM of April 9 to David Bock on IDA's undisbursed balances, in which you raised some questions regarding an "anomaly" between median disbursement periods for SAL and SECALs. The median disbursement profiles for IBRD/IDA SALs are three years while IBRD/IDA SECALs are five years. For IDA SAL credits, the profiles are four years long while IDA SECAL credits are over five years. The relevant standard disbursement profile tables are attached.

2. Some of the differences between the SAL and SECAL disbursement periods are pre-programmed and can be explained by the number of tranches. From the information kept manually by DPGDR (formerly EAS) staff for FY90 and FY91, there are two or less tranches for SALs, and about three tranches for SECALs (see attached report TR102). Another explanation for the longer SECAL disbursement period is that such loans/credits are often more complex than SALs, and require more policy adjustments during implementation from the borrower. Tranches are oftentimes not fully disbursed to encourage the borrowers to meet the policy conditions. Also, as IDA countries generally have more difficulties in meeting these requirements than IBRD countries do, IDA disbursement periods are consequently longer.

3. The longer SECAL disbursement periods, and the even longer IDA disbursement periods are fully as expected, and thus do not represent an "anomaly".

4. Unfortunately, none of the institutional level databases such as MIS, keeps the kind of information to perform a more detailed analysis. In particular, there are no system records of initially planned tranche releases with actual disbursements.

cc: Messrs. H. Wyss (CODDR), J. Wijnand (CODOP)

THE WORLD BANK
CENTRAL OPERATIONS DEPARTMENT
STANDARD DISBURSEMENT PROFILES
LENDING INSTRUMENT - SET

REGION : ALL REGIONS (IBRD/IDA)

INSTRUMENT	QUARTERS FROM APPROVAL DATE																		
	2	4	6	8	10	12	14	16	18	20	22	24	26	28	30	32	34	36	38
DEBT REDUCTION LOAN																			
	100																		
EMERGENCY RECONSTRUCTION LOAN																			
	0	10	18	30	42	66	82	94	98	100									
FINANCIAL INTERMEDIARY LOAN																			
	0	3	6	14	22	38	50	66	82	90	98	100							
SECTOR ADJUSTMENT LOAN																			
	0	10	26	34	50	62	78	94	98	100									
STRUCTURAL ADJUSTMENT LOAN																			
	0	50	66	86	98	100													
SPECIFIC INVESTMENT LOAN																			
	0	3	6	10	18	26	38	54	66	78	86	98	100						
SECTOR INVESTMENT&MAINTENANCE																			
	0	3	6	14	22	30	38	50	62	74	82	90	98	100					
TECHNICAL ASSISTANCE LOAN																			
	0	3	10	18	26	38	50	62	74	86	94	98	100						
ALL INSTRUMENTS																			
	0	3	6	14	22	30	42	54	62	74	82	90	98	100					

RUN DATE : 05/15/91

THE WORLD BANK
CENTRAL OPERATIONS DEPARTMENT
STANDARD DISBURSEMENT PROFILES
LENDING INSTRUMENT - SET

REGION : ALL REGIONS (IBRD)

INSTRUMENT	QUARTERS FROM APPROVAL DATE																		
	2	4	6	8	10	12	14	16	18	20	22	24	26	28	30	32	34	36	38
DEBT REDUCTION LOAN																			
	100																		
EMERGENCY RECONSTRUCTION LOAN																			
	0	10	22	34	42	62	78	90	98	100									
FINANCIAL INTERMEDIARY LOAN																			
	0	3	6	18	26	42	54	70	86	94	98	100							
SECTOR ADJUSTMENT LOAN																			
	0	10	34	46	58	78	94	100											
STRUCTURAL ADJUSTMENT LOAN																			
	0	25	50	86	100														
SPECIFIC INVESTMENT LOAN																			
	0	3	6	10	18	30	38	50	62	74	86	94	98	100					
SECTOR INVESTMENT&MAINTENANCE																			
	0	3	6	14	22	30	42	54	66	78	86	94	98	100					
TECHNICAL ASSISTANCE LOAN																			
	0	3	10	14	22	34	50	62	74	86	94	98	100						
ALL INSTRUMENTS																			
	0	3	6	14	22	30	42	54	66	78	86	94	98	100					

THE WORLD BANK
CENTRAL OPERATIONS DEPARTMENT
STANDARD DISBURSEMENT PROFILES
LENDING INSTRUMENT - SET

REGION : ALL REGIONS (IDA)

INSTRUMENT	QUARTERS FROM APPROVAL DATE																		
	2	4	6	8	10	12	14	16	18	20	22	24	26	28	30	32	34	36	38
EMERGENCY RECONSTRUCTION LOAN	0	6	18	26	46	70	82	94	98	98	98	100							
FINANCIAL INTERMEDIARY LOAN	0	6	10	18	26	42	50	62	78	82	90	98	100						
SECTOR ADJUSTMENT LOAN	0	22	34	42	50	66	82	90	94	98	100								
STRUCTURAL ADJUSTMENT LOAN	0	3	34	58	74	94	98	100											
SPECIFIC INVESTMENT LOAN	0	3	6	14	18	30	42	54	66	78	86	94	98	100					
SECTOR INVESTMENT&MAINTENANCE	0	3	10	14	22	34	42	54	66	74	82	90	98	100					
TECHNICAL ASSISTANCE LOAN	0	6	10	18	30	38	50	62	74	86	94	98	100						
ALL INSTRUMENTS	0	3	10	14	22	30	42	54	62	74	82	90	94	98	100				

DATA 1

REPORT TR102 (03/31/92)
FY90 - 91 IBRD & IDA ADJUSTMENT OPERATIONS ($ MIL)

FY	COUNTRY	ID	SHNAME	NT											
90	ALGERIA	5ALGPA082	ECONOMIC REFORM LOAN	2	IBRD1	150.0	IDA1	.0	ORIG1	10/31/89	EFFT	12/13/89	TRC1	0
					IBRD2	150.0	IDA2	.0	ORIG2	06/30/90	REL2	09/28/90	TRC2	1
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	BANGLADESH	8BANPA195	FINANCIAL SECTOR CR.	3	IBRD1	.0	IDA1	75.0	ORIG1	07/31/90	EFFT	06/22/90	TRC1	0
					IBRD2	.0	IDA2	50.0	ORIG2	01/31/91	REL2		TRC2	0
					IBRD3	.0	IDA3	50.0	ORIG3	03/31/92	REL3		TRC3	0
	CENTRAL AFRI	3CARPA024	SAL III	2	IBRD1	.0	IDA1	22.5	ORIG1	07/31/90	EFFT	08/24/90	TRC1	0
					IBRD2	.0	IDA2	22.5	ORIG2	~~01/31/91~~	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3	6/30/91	REL3		TRC3	0
	COTE D'IVOIR	3IVCPA058	WATER SUPPLY SEWERAG	2	IBRD1	50.0	IDA1	.0	ORIG1	07/31/90	EFFT	06/29/90	TRC1	0
					IBRD2	30.0	IDA2	.0	ORIG2	12/31/90	REL2	11/30/90	TRC2	1
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
		3IVCPA073	ENERGY SECTOR LOAN	3	IBRD1	30.0	IDA1	.0	ORIG1	01/31/90	EFFT	12/28/89	TRC1	0
					IBRD2	35.0	IDA2	.0	ORIG2	07/31/90	REL2	08/31/90	TRC2	2
					IBRD3	35.0	IDA3	.0	ORIG3	12/31/90	REL3	02/07/91	TRC3	2
		3IVCPA082	AG.SECT.ADJ.	3	IBRD1	50.0	IDA1	.0	ORIG1	11/30/89	EFFT	10/25/89	TRC1	0
					IBRD2	50.0	IDA2	.0	ORIG2	04/30/90	REL2	06/20/90	TRC2	2
					IBRD3	50.0	IDA3	.0	ORIG3	11/30/90	REL3	06/14/91	TRC3	1
	GHANA	3GHAPA063	EDUC SAC II	3	IBRD1	.0	IDA1	17.0	ORIG1	08/31/90	EFFT	07/18/90	TRC1	0
					IBRD2	.0	IDA2	17.0	ORIG2	08/31/91	REL2	12/19/91	TRC2	1
					IBRD3	.0	IDA3	16.0	ORIG3	08/31/92	REL3		TRC3	0
	GUINEA	3GUIPA029	EDUC SEC ADJ PROGRAM	3	IBRD1	.0	IDA1	6 6.7	ORIG1	~~07/31~~/90	EFFT	11/14/90	TRC1	0
					IBRD2	.0	IDA2	7 6.7	ORIG2	07/31/91	REL2		TRC2	0
					IBRD3	.0	IDA3	7 6.6	ORIG3	07/31/92	REL3		TRC3	0
	GUYANA	6GUYPA027	SAC	3	IBRD1	.0	IDA1	50.0	ORIG1	07/31/90	EFFT	08/29/90	TRC1	0
					IBRD2	.0	IDA2	15.0	ORIG2	01/31/91	REL2	05/08/91	TRC2	1
					IBRD3	.0	IDA3	13.0	ORIG3	10/30/91	REL3		TRC3	0
	HUNGARY	7HUNPA042	SAL	2	IBRD1	100.0	IDA1	.0	ORIG1	07/31/90	EFFT	07/03/90	TRC1	0
					IBRD2	100.0	IDA2	.0	ORIG2	03/31/91	REL2	01/24/91	TRC2	1
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	JAMAICA	6JAMPA056	AG SCTR ADJ	2	IBRD1	12.5	IDA1	.0	ORIG1	03/31/90	EFFT	03/28/90	TRC1	0
					IBRD2	12.5	IDA2	.0	ORIG2	03/31/91	REL2	03/20/91	TRC2	1
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	JORDAN	5JORPA071	TRADE ADJUSTMENT	0	IBRD1	.0	IDA1	.0	ORIG1		EFFT	02/26/90	TRC1	0
					IBRD2	.0	IDA2	.0	ORIG2		REL2	3/10/92	TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	MALAWI	3MALPA073	AGRIC SECTOR	2	IBRD1	.0	IDA1	34.6	ORIG1	04/30/90	EFFT	04/18/90	TRC1	0
					IBRD2	.0	IDA2	34.6	ORIG2	12/30/90	REL2	10/08/91	TRC2	1
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	MALI	3MLIPA062	AG SECAL	3	IBRD1	.0	IDA1	12.5	ORIG1	09/30/90	EFFT	09/14/90	TRC1	0
					IBRD2	.0	IDA2	7.5	ORIG2	09/30/91	REL2	12/12/91	TRC2	1
					IBRD3	.0	IDA3	5.0	ORIG3	09/30/92	REL3		TRC3	0
	MAURITANIA	3MTAPA025	AG SECAL/IRRIG IMPRO	2	IBRD1	.0	IDA1	9.0	ORIG1	04/30/90	EFFT	04/27/90	TRC1	0
					IBRD2	.0	IDA2	9.0	ORIG2	04/30/91	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
		3MTAPA050	P.E. SECTOR ADJ	3	IBRD1	.0	IDA1	18.0	ORIG1	07/31/90	EFFT		TRC1	0
					IBRD2	.0	IDA2	12.0	ORIG2	07/31/91	REL2		TRC2	0
					IBRD3	.0	IDA3	10.0	ORIG3	07/31/92	REL3		TRC3	0
	MEXICO	6MXCPA204	RD TRNS/TELECOM SCT	2	IBRD1	190.0	IDA1	.0	ORIG1	06/30/90	EFFT	06/25/90	TRC1	0
					IBRD2	190.0	IDA2	.0	ORIG2	12/30/90	REL2	05/08/91	TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
		6MXCPA214	SPEC INTERST SUPPRT	1	IBRD1	1260.0	IDA1	.0	ORIG1	02/28/90	EFFT	02/16/90	TRC1	0
					IBRD2	.0	IDA2	.0	ORIG2		REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0

REPORT TR102 (03/31/92)
FY90 - 91 IBRD & IDA ADJUSTMENT OPERATIONS ($ MIL)

FY	COUNTRY	ID	SHNAME	NT										
90	NIGERIA	3NIRPA125	EDUC UNIV DEVELOPMEN	3	IBRD1	.0	IDA1	40.0	ORIG1	09/30/90	EFFT	10/12/90	TRC1	0
					IBRD2	.0	IDA2	40.0	ORIG2	09/30/91	REL2		TRC2	0
					IBRD3	.0	IDA3	40.0	ORIG3	09/30/92	REL3		TRC3	0
	PAPUA NEW GU	4PAPPA049	STRUC ADJ LOAN	2	IBRD1	25.0	IDA1	.0	ORIG1	07/31/90	EFFT	10/04/90	TRC1	0
					IBRD2	25.0	IDA2	.0	ORIG2	01/31/91	REL2	12/23/91	TRC2	1
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	PHILIPPINES	4PHLPA183	DEBT MGMT. LOAN	2	IBRD1	150.0	IDA1	.0	ORIG1	12/31/89	EFFT	12/30/89	TRC1	0
					IBRD2	50.0	IDA2	.0	ORIG2	12/31/90	REL2	3/26/92	TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	SAO TOME & P	3STPPA007	SAC II/TA	3	IBRD1	.0	IDA1	3.3	ORIG1	09/30/90	EFFT	09/11/91	TRC1	0
					IBRD2	.0	IDA2	3.3	ORIG2	09/30/91	REL2		TRC2	0
					IBRD3	.0	IDA3	3.2	ORIG3	09/30/92	REL3		TRC3	0
	SENEGAL	3SENPA068	SAL IV	3	IBRD1	.0	IDA1	33.8	ORIG1	01/31/90	EFFT	02/22/90	TRC1	0
					IBRD2	.0	IDA2	25.3	ORIG2	12/31/90	REL2	12/20/91	TRC2	1
					IBRD3	.0	IDA3	25.3	ORIG3	12/31/91	REL3		TRC3	0
		3SENPA085	BANKING/FINANCIAL SE	2	IBRD1	.0	IDA1	27.0	ORIG1	12/31/89	EFFT	12/21/89	TRC1	0
					IBRD2	.0	IDA2	18.0	ORIG2	09/30/90	REL2	2/31/92	TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	SRI LANKA	8SRIPA086	ECO. RESTRUCT. CREDI	2	IBRD1	.0	IDA1	42.5	ORIG1	05/31/90	EFFT	05/04/90	TRC1	0
					IBRD2	.0	IDA2	42.5	ORIG2	01/31/91	REL2	09/27/91	TRC2	2
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	TANZANIA	3TANPA104	AGRIC. ADJUSTMENT CR	2	IBRD1	.0	IDA1	100.0	ORIG1	04/30/90	EFFT	04/10/90	TRC1	0
					IBRD2	.0	IDA2	100.0	ORIG2	12/31/90	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	TRINIDAD & T	6TRIPA019	SAL	2	IBRD1	20.0	IDA1	.0	ORIG1	12/31/89	EFFT	04/05/90	TRC1	0
					IBRD2	20.0	IDA2	.0	ORIG2	10/31/90	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	TUNISIA	5TUNPA119	PUB. ENT. I	2	IBRD1	70.0	IDA1	.0	ORIG1	01/31/90	EFFT	02/22/90	TRC1	0
					IBRD2	60.0	IDA2	.0	ORIG2	12/31/90	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	UGANDA	3UANPA056	ECONOMIC RECOVERY II	2	IBRD1	.0	IDA1	70.0	ORIG1	02/28/90	EFFT	02/20/90	TRC1	0
					IBRD2	.0	IDA2	55.0	ORIG2	08/31/90	REL2	10/15/90	TRC2	1
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	VENEZUELA	6VENPA028	PUB ENTP REFORM	3	IBRD1	157.5	IDA1	.0	ORIG1	10/30/90	EFFT	12/07/90	TRC1	0
					IBRD2	85.0	IDA2	.0	ORIG2	10/30/91	REL2	12/20/91	TRC2	1
					IBRD3	107.5	IDA3	.0	ORIG3	10/30/92	REL3		TRC3	0
		6VENPA029	FIN SEC ADJ	3	IBRD1	146.0	IDA1	.0	ORIG1	06/30/90	EFFT	12/07/90	TRC1	0
					IBRD2	71.0	IDA2	.0	ORIG2	12/30/90	REL2	12/30/91	TRC2	1
					IBRD3	76.0	IDA3	.0	ORIG3	06/30/91	REL3		TRC3	0
	YUGOSLAVIA	7YUGPA087	SAL II	2	IBRD1	150.0	IDA1	.0	ORIG1	05/31/90	EFFT	07/25/90	TRC1	0
					IBRD2	250.0	IDA2	.0	ORIG2	11/30/90	REL2	?	TRC2	3
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
91	ALGERIA	5ALGPA092	ENTER.& FIN. SECTOR	2	IBRD1	175.0	IDA1	.0	ORIG1	09/30/91	EFFT	06/27/91	TRC1	0
					IBRD2	175.0	IDA2	.0	ORIG2	04/30/92	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	ARGENTINA	6ARGPA073	PUB ENTRP REF ADJ	3	IBRD1	150.0	IDA1	.0	ORIG1	02/28/91	EFFT	06/21/91	TRC1	0
					IBRD2	75.0	IDA2	.0	ORIG2	02/28/92	REL2		TRC2	0
					IBRD3	75.0	IDA3	.0	ORIG3	02/28/93	REL3		TRC3	0
	BENIN, PEOPL	3BENPA049	SAL II	3	IBRD1	.0	IDA1	25.0	ORIG1	07/31/91	EFFT	10/15/91	TRC1	0
					IBRD2	.0	IDA2	15.0	ORIG2	02/29/92	REL2		TRC2	0
					IBRD3	.0	IDA3	15.0	ORIG3	10/31/92	REL3		TRC3	0
	BURKINA FASO	3BURPA054	SAL I	3	IBRD1	.0	IDA1	40.0	ORIG1	08/31/91	EFFT	09/17/91	TRC1	0
					IBRD2	.0	IDA2	20.0	ORIG2	08/31/92	REL2		TRC2	0
					IBRD3	.0	IDA3	20.0	ORIG3	08/31/93	REL3		TRC3	0

REPORT TR102 (03/31/92)
FY90 - 91 IBRD & IDA ADJUSTMENT OPERATIONS ($ MIL)

FY	COUNTRY	ID	SHNAME	NT										
91	COLOMBIA	6CLMPA200	PUB SCTR REF	3	IBRD1	100.0	IDA1	.0	ORIG1	~~12/31/90~~ 2/28/91	EFFT	02/19/91	TRC1	0
					IBRD2	100.0	IDA2	.0	ORIG2	12/31/91	REL2		TRC2	0
					IBRD3	100.0	IDA3	.0	ORIG3	12/31/92	REL3		TRC3	0
	COMOROS	3COMPA013	MACROECON. REFORM &	2	IBRD1	.0	IDA1	3.0	ORIG1	09/30/91	EFFT	09/30/92	TRC1	0
					IBRD2	.0	IDA2	3.0	ORIG2	09/30/92	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	CZECHOSLOVAK	7CZKPA003	SAL I	3	IBRD1	200.0	IDA1	.0	ORIG1	07/31/91	EFFT	08/15/91	TRC1	0
					IBRD2	125.0	IDA2	.0	ORIG2	01/31/92	REL2		TRC2	0
					IBRD3	125.0	IDA3	.0	ORIG3	06/30/92	REL3		TRC3	0
	EGYPT, ARAB	5EGTPA169	STRUCTURAL ADJUST.	2	IBRD1	150.0	IDA1	.0	ORIG1	09/30/91	EFFT	02/20/92	TRC1	0
					IBRD2	150.0	IDA2	.0	ORIG2	07/31/92	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	EL SALVADOR	6ESLPA030	SAL I	3	IBRD1	25.0	IDA1	.0	ORIG1	03/31/91	EFFT	05/23/91	TRC1	0
					IBRD2	25.0	IDA2	.0	ORIG2	09/30/91	REL2	12/26/91	TRC2	1
					IBRD3	25.0	IDA3	.0	ORIG3	12/31/92	REL3		TRC3	0
	GHANA	3GHAPA084	Priv. Invest. Promot	2	IBRD1	.0	IDA1	60.0	ORIG1	07/31/91	EFFT	07/19/91	TRC1	0
					IBRD2	.0	IDA2	60.0	ORIG2	03/31/92	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3	04	REL3		TRC3	0
	HONDURAS	6HDSPA055	SAL II	3	IBRD1	45.0	IDA1	.0	ORIG1	09/30/90	EFFT	11/14/90	TRC1	0
					IBRD2	20.0	IDA2	.0	ORIG2	02/28/91	REL2	10/23/91	TRC2	2
					IBRD3	25.0	IDA3	.0	ORIG3	12/31/91	REL3		TRC3	0
		6HDSPA059	SAC	1	IBRD1	.0	IDA1	20.0	ORIG1	01/31/91	EFFT	04/30/91	TRC1	0
					IBRD2	.0	IDA2	.0	ORIG2		REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	HUNGARY	7HUNPA058	SAL II	3	IBRD1	100.0	IDA1	.0	ORIG1	07/31/91	EFFT	07/19/91	TRC1	0
					IBRD2	75.0	IDA2	.0	ORIG2	03/31/92	REL2		TRC2	0
					IBRD3	75.0	IDA3	.0	ORIG3	09/30/92	REL3		TRC3	0
	INDONESIA	4INSPA295	PSDL II	1	IBRD1	250.0	IDA1	.0	ORIG1	11/30/90	EFFT	01/11/91	TRC1	0
					IBRD2	.0	IDA2	.0	ORIG2		REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	JAMAICA	6JAMPA067	TRADE&FIN SAD II	2	IBRD1	15.0	IDA1	.0	ORIG1	03/31/91	EFFT	03/25/91	TRC1	0
					IBRD2	15.0	IDA2	.0	ORIG2	12/31/91	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	KENYA	3KENPA111	AG.SECTOR ADJUST. II	2	IBRD1	.0	IDA1	33.5	ORIG1	03/31/91	EFFT	05/21/91	TRC1	0
					IBRD2	.0	IDA2	33.5	ORIG2	03/31/92	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
		3KENPA137	EXPORT DEVELOPMENT	2	IBRD1	.0	IDA1	37.0	ORIG1	01/31/91	EFFT		TRC1	0
					IBRD2	.0	IDA2	37.0	ORIG2	12/31/91	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	MALI	3MLIPA049	SAL I	3	IBRD1	.0	IDA1	22.0	ORIG1	02/28/91	EFFT	03/15/91	TRC1	0
					IBRD2	.0	IDA2	22.0	ORIG2	02/29/92	REL2		TRC2	0
					IBRD3	.0	IDA3	22.0	ORIG3	02/28/93	REL3		TRC3	0
	MEXICO	6MXCPA153	EXPORT SCTR	1 3	IBRD1	25.0 ~~100.0~~	IDA1	.0	ORIG1	04/30/91	EFFT	05/06/91	TRC1	0
					IBRD2	~~100.0~~	IDA2	.0	ORIG2	~~01/31/92~~	REL2		TRC2	0
					IBRD3	~~100.0~~	IDA3	.0	ORIG3	~~07/31/92~~	REL3		TRC3	0
		6MXCPA165	AG SCTR/FOOD SECURIT	2	IBRD1	200.0	IDA1	.0	ORIG1	07/31/91	EFFT	12/20/91	TRC1	0
					IBRD2	200.0	IDA2	.0	ORIG2	08/31/92	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	MOROCCO	5MYCPA148	FINANCIAL SECTOR DEV	2	IBRD1	75.0	IDA1	.0	ORIG1	07/31/91	EFFT	11/14/91	TRC1	0
					IBRD2	50.0	IDA2	.0	ORIG2	03/31/92	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3	01	REL3		TRC3	0
	PHILIPPINES	4PHLPA152	ENV. & NAT. RES. MGT	0	IBRD1	.0	IDA1	.0	ORIG1	[illegible]	EFFT	10/10/91	TRC1	0
					IBRD2	55.0	IDA2	.0	ORIG2	[illegible]	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0

REPORT TR102 (03/31/92)
FY90 - 91 IBRD & IDA ADJUSTMENT OPERATIONS ($ MIL)

FY	COUNTRY	ID	SHNAME	NT											
91	POLAND	7POLPA008	RESTR. AND PRIV.	1	IBRD1	75.0	IDA1	.0	ORIG1	09/30/91	EFFT	11/07/91	TRC1	0
					IBRD2	.0	IDA2	.0	ORIG2		REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
		7POLPA022	FIN. INST. DEVELOP.	2	IBRD1	25.0	IDA1	.0	ORIG1	08/31/91	EFFT	01/14/92	TRC1	0
					IBRD2	25.0	IDA2	.0	ORIG2	12/31/92	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
		7POLPA025	SAL I	2	IBRD1	100.0	IDA1	.0	ORIG1	08/31/90	EFFT	10/01/90	TRC1	0
					IBRD2	200.0	IDA2	.0	ORIG2	02/28/91	REL2	07/19/91	TRC2	2
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	RWANDA	3RWAPA059	SAL I	2	IBRD1	.0	IDA1	55.0	ORIG1	07/31/91	EFFT	10/07/91	TRC1	0
					IBRD2	.0	IDA2	35.0	ORIG2	05/31/92	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	SRI LANKA	8SRIPA057	PUBLIC MANUF. ENT AD	2	IBRD1	.0	IDA1	57.5	ORIG1	12/31/90	EFFT	12/13/90	TRC1	0
					IBRD2	.0	IDA2	57.5	ORIG2	12/31/91	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	TOGO	3TOGPA038	POPULATION/HEALTH AD	4	IBRD1	.0	IDA1	4.0	ORIG1	05/31/91	EFFT	03/15/92	TRC1	0
					IBRD2	.0	IDA2	4.0	ORIG2	04/30/92	REL2		TRC2	0
					IBRD3	.0	IDA3	4.0	ORIG3	04/30/93	REL3		TRC3	0
		3TOGPA045	SAL IV	3	IBRD1	.0	IDA1	25.0	ORIG1	12/31/90	EFFT	12/28/90	TRC1	0
					IBRD2	.0	IDA2	15.0	ORIG2	12/31/91	REL2		TRC2	0
					IBRD3	.0	IDA3	15.0	ORIG3	12/31/92	REL3		TRC3	0
	UGANDA	3UANPA067	AG SECTOR ADJ CREDIT	2	IBRD1	.0	IDA1	50.0	ORIG1	02/28/91	EFFT	01/03/91	TRC1	0
					IBRD2	.0	IDA2	35.0	ORIG2	10/31/91	REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	URUGUAY	6URUPA062	DDSR SUPPORT	1	IBRD1	65.0	IDA1	.0	ORIG1	07/31/91	EFFT		TRC1	0
					IBRD2	.0	IDA2	.0	ORIG2		REL2		TRC2	0
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0
	VENEZUELA	6VENPA041	INTEREST SUPPORT LN	1	IBRD1	150.0	IDA1	.0	ORIG1	12/31/90	EFFT	12/14/90	TRC1	0
					IBRD2	.0	IDA2	.0	ORIG2		REL2		TRC2	0
					IBRD3	.0	IDA3							
	IBRD3 .0	IDA3 .0	ORIG3	REL3		TRC3	0							
	ZAMBIA	3ZAMPA087	RECOVERY CREDIT	2	IBRD1	.0	IDA1	157.2	ORIG1	03/31/91	EFFT	03/13/91	TRC1	0
					IBRD2	.0	IDA2	80.0	ORIG2	08/31/91	REL2	01/21/92	TRC2	2
					IBRD3	.0	IDA3	.0	ORIG3		REL3		TRC3	0

cc: HR

A L L - I N - 1 N O T E

DATE: 25-Apr-1992 10:41am

TO: Enzo Grilli (ENZO GRILLI)

FROM: Michael Walton, DECVP (MICHAEL WALTON)

EXT.: 38418

SUBJECT: RE: BOP Justification of Adjustment Lending

Enzo--At the last Chief Economists' meeting last week, it was agreed that the next one should be a brown bag lunch to discuss adjustment lending, specifically the gap question. Larry certainly wants you there (probably Anandarup too?) for this discussion; I hadn't got to follow up as I was at a seminar at the end of the week. Its currently scheduled for May 14th--is that OK with you? Your idea of preparing a note sounds good--could serve as the basis for discussion at the lunch.

At the RAL4 board discussion, Preston promised a "discussion of adjustment lending" that would precede finalization of the OD--this would occur at, or around, the time of the discussion of the OED paper on adjustment lending. The British ED suggested a short note. We clearly want to avoid a policy paper, but if a management response to the OED paper is going to be required in any case, one option would be to include any substantive changes in adjustment lending within that. What do you think?

Shihata gave a pretty inscrutable reply to the Italian ED's changes, that notably failed to insist on a gap as prerequisite, resorting to more general language.

By the way, my own biases are anti-gap!

Mike

CC: Larry Summers (LARRY SUMMERS)

cc: AR

A L L - I N - 1 N O T E

DATE: 25-Apr-1992 03:48pm

TO: Enzo Grilli (ENZO GRILLI)

FROM: Larry Summers, DECVP (LARRY SUMMERS)

EXT.: 33774

SUBJECT: RE: BOP Justification of Adjustment Lending

Enzo--I certainly will include you in the CE lunches. Your plan looks goodto me. I'd envisioned the discussion this issue with the CE's in the way you suggest. I don't see the need for more than a very short paper at most. Far be it from me to snow the Board.
Larry

CC: Michael Walton (MICHAEL WALTON)

A L L - I N - 1 N O T E

DATE: 24-Apr-1992 04:34pm

TO: Larry Summers (LARRY SUMMERS)

FROM: Enzo Grilli, DPG (ENZO GRILLI)

EXT.: 81934

SUBJECT: BOP Justification of Adjustment Lending

I just learned that at the last lunch with the Regional Chief Economists you discussed the issue of the balance of payments justification for adjustment lending and that you promised them to revisit the present position (i.e., that a BOP problem, actual or caused by the reforms that we back, is an essential condition for fast disbursing loans).

As you know, this is both an economic and a political issue, with a long history and a fairly high variance of opinions around it. It also intersects with the task, that we currently have in hand, of producing the OD on adjustment lending. In principle, the OD should reflect current policies, and thus take the position that, until Bank policy on the necessary conditions for adjustment lending is changed, the existence of a balance of payments problem is necessary to justify quick-disbursing assistance. In practice, however, if senior management thinks that the issue should be revisited, and soon, it makes little sense to write an OD on "current" premises, and to have to change it in a short time.

There are, however, two concerns that I have with proceeding quickly with the change of this important condition. The first is substantive. The definition of what is a legitimate additional BOP cost of reforms is very difficult. I don't find, for example, the cases of BOP deficit endogeniety used by Marcelo in his recent memo to us particularly convincing. Take the first example that he used: a country that has a budget deficit, financed through inflationary means, and no BOP problems. In the presence of large excess savings in the private sector and of a current account surplus, the key insufficiency is in taxation. It is up to the government to put in place the necessary fiscal measures to deal with the budget imbalance. Adjustment lending in these circumstances is in principle hard to justify. Take the second case: substitution of generalized subsidies with targeted social programs. In such cases not to expect some expenditure reduction means again that the government is unwilling or incapable of curtailing its expenditure.

While we have always accepted "endogeneity" of BOP problems as an argument for financing reform packages through adjustment lending, (the very first Board paper (1981) recognized this), the problem here is how far one can push this notion

before it becomes a blanket justification for any type of adjustment lending, thereby weakening the logic of the target-instrument relationship in adjustment lending. Accepting a blanket endogeneity argument, and thus making loans available in the "expectation" of a BOP problem, may also create the wrong policy incentives, since the pressure on governments in recipient countries to take parallel actions in order to avoid the occurrence of a BOP problem will be diminished. We thus need at a minimum a careful definition of what constitutes an acceptable potential BOP problem. This is no easy task. Mr. Stern had tried to define it in his April 1989 speech, but in doing so, considerably limited the scope of adjusting lending by the Bank. This is unescapable and while O.K. by me, needs to be carefully weighted.

The second reservation is more political. If we make recognizable changes in current policy and reflect them in the OD without telling the Board and discussing the issue with them beforehand, we would certainly reinforce their suspicion about the whole process, and their desire to examine ODs in advance. This, I am afraid, would be almost inevitably the result of our going ahead too quickly with a revisitation. (I don't think that there is the option of changing our policy "en famille", without telling the Board. This would be suicidal.)

My advice would be the following. Why don't we first look in some depth at the need for change and examine the validity of the arguments now being put forward by some of the regions for a change in policy (which are in part dictated by experience and in part by sheer convenience). DPG and CEC, for example, could write a little note on this (Ray and Martha de Melo could do it). Then you could discuss it with the Chief Economists and decide. This procedure would also have the advantage of consensus building inside the Bank. We could, consult the legal department in the process and get things straighter bank-wide. After this you and the MDs could further decide on how to consult the Board. Meanwhile, we would proceed writing the OD on the basis of current understandings. We would issue the OD to staff on an interim basis if we anticipate a long delay in getting any proposed policy changes authorized by Senior Management and the Board. If there is no delay then we will amend the OD before issuance.

Finally, since you have regular and substantive meetings with the Regional Chief Economists, you may wish to include me in them. Attending the lunches would be quite useful to me (and hopefully also to you) and justified, given my interface functions with the Regions.

CC: Michael Walton (MICHAEL WALTON)

cc DPG

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: February 5, 1992

TO: Distribution

FROM: Enzo Grilli, Director, DPG

EXTENSION: 81934

SUBJECT: Status of the IMF in Regional Reviews

1. The IMF (ETR) has inquired on what practices we follow for the regional reviews of adjustment lending operations and CSPs, and on whether they are regularly invited to them. I know the practices in some of your regions, but not in all of them.

2. It would be helpful to me, in responding to the IMF, if you could take the time to write a note on what are the standard practices in your region, specifying inter alia: i) whether you have regional reviews at VP levels or only department level reviews; ii) who is responsible for their organization; iii) who attends them; iv) is your office involved; v) is the IMF normally invited and who makes this decision.

3. I would also appreciate it, if while doing this review of procedures in your regions you would check and ensure that DPG is regularly invited (practices seem to vary somewhat from region to region). Many thanks for your help.

Distribution
Messrs. Hasan (ECA), Squire (MNA), Husain (AFR), Selowsky (LAC), Thomas (EAP), Nankani (SAS)

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

DATE: February 5, 1992

TO: Distribution

FROM: John D. Shilling, Economic Advisor, DPG

EXT.: 81943

SUBJECT: **Review of SAL Supervision**

As you may recall, OED prepared a report on Effectiveness of SAL Supervision and Monitoring last summer (No. 9711, June 26, 1991). That report reviewed a number of SALs completed in the mid 1980's, identified issues related to supervision, and made several recommendations for improvements in the SAL processes. Following discussions with the JAC, it was agreed to present a paper to the Board responding to the issues raised, paying particular attention to more recent practice in supervising SALs. I suspect that many of the issues raised in the OED report have also been recognized by staff and action already taken to improve matters.

DPG have been asked by Mr. Karaosmanoglu to prepare the paper to the Board, with the assistance of COD. We have decided to attach this note to the RAL 3 paper which is scheduled for Board discussion in early March. The advantage is linking the discussion into a more general review of SALs. The disadvantage is a very short deadline. To meet the deadline, I very much need your assistance. What I would like is an up to date summary of current SAL supervision practices in your region, particularly in relation to the recommendations made in the OED report. Examples of recent best practices would be very useful. Comments on the overall usefulness of any of the recommendations would also be appreciated.

I have attached my brief summary of the recommendations of the OED report from both the executive summary and the main report. The paragraphs are referenced if you want to refer to the original. I have also noted whether the recommendations apply primarily to the Design of SALs, Management of the process, or Supervision proper.

I hope to get your views at the meeting we have scheduled for later this week or next, but any written comments would also be most welcome. Thank you very much for your prompt assistance in this matter.

Dist: I. Husain, Martinez (AFR), Nankani, I. Sud (SAS), Thomas, El Maaroufi (EAP), Squire, T. Husain (MENA), Hasan, Blanchi (ECA), Selowsky, Hicks, Aiyer (LAC)

cc: Grilli, Salop

Recommendations of

Effectiveness of SAL Supervision and Monitoring,

No. 9711, June 26, 1991

Main Recommendations from Executive Summary:

¶ 19 Increase the spacing between tranches or introduce more tranches to provide closer supervision. (D)

¶ 20 Improve Bank Fund collaboration. (D)

¶ 21 Sustain supervision and monitoring after project is completed. (S)

¶ 22 Monitor macroeconomic framework more closely. (S)

¶ 23 Monitor social impact more closely. (S)

¶ 24 Make conditionality more precise to ease supervision. (D)

¶ 25 Modify Form 590 for SALs to make more appropriate. (S)

Complete Form and Aide memoires in field. (S)

Have a senior staff provide a second opinion on the macro framework, in addition to the TM. (S)

Indicate recommended changes in conditions clearly. (S).

Include Form 590 in all reports to management on SAL. (M)

¶ 26 Give more priority and continuity to staffing for supervision. (M)

¶ 27 Give staff more recognition for supervision activities. (M)

¶ 28 Assure greater compliance with guidelines in OD 13.05. (S)

¶ 29 Encourage greater participation of the Resident Missions in supervision. (S)

Schedule supervision missions as least semi-annually. (S)

Provide more training seminars on supervision for staff. (M)

Provide more budget resources to assure adequate supervision. (M)

Improve record keeping on projects, including greater use of electronic filing and retrieval. (M)

D = Design of Project: M = Management of process: S = Supervision proper

Detailed Recommendations from Full Report:

Borrower Commitment

¶ 41 Pay greater attention to institutional structure of government and consensus building in designing operation. (D)

¶ 42 Obtain fuller ex-anti commitment of government to program. (D)

Mid-Course Corrections

¶ 45 Use more policy oriented model in the design of projects to aid in monitoring and revisions. (D)

¶ 46 Include more risk analysis and contingency planning in design. (D)

¶ 47 Consider terminating and restarting SALs in lieu of extensive mid course changes where initial assumptions no longer valid. (M)

Macroeconomic Monitoring

¶ 58 Review macroeconomic indicators at lease semi-annually. (S)

¶ Monitor performance indicators in substance as well as quantitatively, i.e. is the desired effect happening? (S)

Include senior staff in the macroeconomic monitoring. (M)

Incorporate finding of other missions regarding SAL performance into supervision reports. (S)

Include monitorable macroeconomic conditions in SAL if there is no IMF program. (D)

Increase Bank Fund collaboration, more like PFPs. (M)

Conditionality

¶ 69 Emphasize importance of "General Progress" clause. (D)

Make conditions more limited and specific. (D)

Include quantifiable measures of agreed policy change. (D)

Assure that all conditions are included in the Legal documents. (D)

Tranching and Sustainability of Reforms

¶ 77 Link disbursements more closely to actions, perhaps more time between tranches. (D)

Consider using more, but smaller tranches. (D)

Consider a series of small SAL operations, not a few large ones. (D)

Continue supervision beyond completion of operation and linking future operations to continuation of the adjustment program. (M)

Monitoring the Social Dimension

¶ 83 Include provision for taking account of and monitoring the social impact in the initial loan agreement. (D)

D = Design of Project: M = Management of process: S = Supervision proper

Guidelines on Project Supervision

¶ 90 Assure compliance with existing guidelines in OD 13.05. (S)

Revise Form 590 to make more appropriate for SALs. (S)

Include Form 590 (Implementation Summary) in all documents that discuss the SAL progress or performance. (M)

Complete Form 590 and aide memoires in field. (S)

Staffing and Incentives

¶ 102 Keep SAL core team together for whole operation, or at least TM for full cycle. (M)

As new staff join SAL teams, assure adequate overlap. (M)

Give more emphasis on and recognition for SAL supervision in staff evaluation. (M)

Include more on SALs in ARIS. (M)

Provide adequate budgets for SAL supervision, even beyond completion of project. (M)

Involve Resident Missions more in SAL supervision,. (S)

Provide staff more training on supervision. (M)

Borrower's Role in Supervision

¶ 104 Enhance borrower's role in supervision and note in Form 590. (S)

Make greater use of borrower's input in supervision process. (S)

Include greater borrower responsibility for project completion report in original agreement. (D)

Have ARIS assess borrower's effectiveness in supervision. (M)

Historical Records

¶ 107 Keep better project and supervision records and make greater use of electronic storage and retrieval technology. (M)

D = Design of Project: M = Management of process: S = Supervision proper

THE WORLD BANK / IFC / MIGA

OFFICE MEMORANDUM

DATE: January 24, 1992

TO: Mr. Steven Webb, CECMG

FROM: Pradeep Mitra, SA1CI

EXTENSION: 80419

SUBJECT: Rationale for Adjustment Lending

Introduction

1. Thank you for your EM of January 13. I do not believe that it responds to the concerns raised in my memorandum of November 22, so that it is worth reviewing the argument again.

The Problem

2. The situation in Bangladesh is as follows.

- Investment has suffered from a decade-long decline and the country is approaching the margin of its capital replacement requirements.

- Domestic savings is extremely low.

- Around 35 percent of public investment is financed by counterpart funds from non-project aid. [1] Absence of those funds would worsen the shortage of investible local taka resources, a large part of which in fact represents counterpart funds from non-project aid, precluding Bangladesh's leveraging foreign aid for investment.

- There is no immediate balance-of-payments need.

The Solution

3. The strategy being pursued by the Bank to raise investment and domestic savings via a Public Resource Management Adjustment Credit that was approved for appraisal by the OC last November is as follows.

- A prioritized public investment program, consisting primarily of physical and social infrastructure, has been prepared within a realistic resource envelope to help ensure that local resources are directed to high priority projects, thereby leveraging donor aid effectively and boosting the level of public investment.

1/Virtually the entire remaining amount is financed from project aid.

- Restraint has been placed on the growth of current expenditures.
- Structural tax reform. most notably a value added tax, has been undertaken to enhance public revenue which, in conjunction with restraints on current expenditures, should raise public savings.

4. Since it is expected that the rise in investment will precede the rise in public savings, with the rise in private savings following the resumption of economic growth, adjustment assistance can help bridge the difference between investment and domestic savings. Failure to bridge that gap would either require the Government to borrow from the banking system, an option that would violate the PFP-ESAF requirements or prevent the Government from increasing public investment in the first place, thus perpetuating a low savings and investment equilibrium.

Your Proposal

5. I do not believe that your suggestion for sector investment lending would be appropriate or implementable in this context. Although we are not in a position to endorse every individual project, our agreements with the Government cover macro-level management and composition of the public investment programme, In view of conditionality on current expenditure restraint and tax reform-induced public savings, the program seeks to ensure that the budgetary resources made available by the adjustment credit are used to support the prioritized investment programme. Indeed, it is my understanding that the Public Resource Management Adjustment Credit is the first operation that addresses fundamental reform in both the tax and the expenditure sides of the budget, thereby improving the overall macro-management of public resources. Moreover, experience shows that, in the absence of such conditionality, the proceeds from non-project lending can be diverted to low-priority uses. Thus, for example, efforts by USAID to try to associate local counterpart funds generated by the Title IV food aid program with individual projects were met with failure. With macroeconomic conditionality on public resource management in place, however, adjustment lending appears to be the most appropriate among existing instruments.

The Pace of Disbursement

6. As mentioned in my earlier memorandum, the pace of disbursement is a separate issue. The latter should be tailored to the pace at which the savings- and investment-enhancing reforms take place. To that end, it is proposed that the Public Resource Management Adjustment Credit be disbursed in three tranches over a period straddling three fiscal years.

Conclusion

7. The Report on Adjustment Lending (RAL-3) provides the following rationale for adjustment lending: "Adjustment lending is intended to help fill a country's temporary balance of payments gap, and in doing so to support the government's program of policy reforms that will both act to close the gap to restore sustainable growth through more efficient use of resources". However, as argued in this note, the rationale for adjustment lending in an economy with no immediate balance-of-payments need needs to be broadened to recognize its role in supporting the transition from a low to a higher savings-investment equilibrium, provided the accompanying macroeconomic conditionality is designed to facilitate the latter outcome.

cc: Messrs./Mss. Wood, Kraske, Nankani, Thomas, Huang, Summers, Birdsall, Blejer, de Melo, Liebenthal, Walton, Scott,
SA1CI Bangladesh Team

A L L - I N - 1 N O T E

DATE: 14-Jan-1992 04:23pm

TO: Enzo Grilli (ENZO GRILLI)

FROM: Michael Walton, DECVP (MICHAEL WALTON)

EXT.: 38418

SUBJECT: Adjustment loans and CSPs

Enzo,

At this lunch with the Chief Economists Larry confirmed our eagerness to be in on the Regional reviews of both loans and CSPs, that he would plan to go to a fair number of the larger ones and you or your people would go/handle it otherwise--and would be managing the review process in DEC. Everyone was receptive to this, though the mechanics will vary by Region, since at least the two Asia regions probably will not have a Regional Loan Commmittee, so would use some other mechanism. PFPs were also raised by Ishrat and Gobind--they're keen to get DEC/you to review these as well. Larry agreed to the principle, with the proviso that you had less people than before and so couldn't quite so much.

On the CSP calendar who would be actually maintaining the data base in your group? Jane Armitage in the President's office is keen to talk with them to make sure she is in the loop.

Mike

A L L - I N - 1 N O T E

DATE: 14-Jan-1992 10:01pm

TO: Enzo Grilli (ENZO GRILLI)

FROM: Larry Summers, DECVP (LARRY SUMMERS)

EXT.: 33774

SUBJECT: RE: Supervision and Monitoring of SALs

Enzo--sounds like you have identified the right bureaucratic stratagem. I'll suggest it. Larry

The World Bank/IFC/MIGA
F I C E M E M O R A N D U M

DATE: January 14, 1992 04:02pm

TO: Larry Summers (LARRY SUMMERS)

FROM: Enzo Grilli, DPGDR (ENZO GRILLI)

EXT.: 81934

SUBJECT: Supervision and Monitoring of SALs

Larry,

In 1991 OED had prepared a report to the Joint Audit Committee of the Board on the subject of SAL supervision and monitoring which was fairly critical of past practices. JAC requested management comments, which we (qua EAS) provided on Moeen's instructions after consulting with regional staff. JAC then requested that the subject be discussed further in a Board seminar, for which they wished to have further written inputs from management (e.g. on what mangement was doing to implement the OED recommendations or to deal with the areas that OED had identified as needing attention).

We have just learned that a Board seminar has now been set for March 12, 1992. The question is what needs to be done about it. Not doing anything (one choice) would make it look that management does not care about OED recommendations. "Coping the best way we can" and writing something for the Board (another choice) is very difficult since there is no central department that deals with JAC supervision and monitoring issues. We did not perform this function before qua EAS, and we don't do it now qua DPG. COD is also out of this loop. We would run the risk of being embarrassed at the Board, also because I believe that nothing has been done by management on the implementation of OED recommendations.

This is one of the areas where we have even a larger crack in the system than we used to have before the reorganization. There is really no easy way to deal with the risks mentioned above.

Mr. Rajagopalan, who is being briefed by Mr. Wyss, may get in touch with you on this isue, and my first objective was to forewarn and inform you about it. You may decide with him that it is advisable to inform the MDs about the problem and discuss options with them. Aside from the two mentioned above, we (or the MDs) could try to deflect the issue of the Board seminar in March by taking the position that the upcoming RAL III and next OED reports on adjustment lending (both Board documents) will provide the Board with ample opportunity to discuss the question of supervision and monitoring and to do so in a more appropriate

context. Such a deflection, however, would have to be engineered in such a way as not to create the impression in the Board that we don't care about OED or that we don't take their requests seriously. The best way to do so would be to suggest that the OED Director make such a proposal to the JAC or the Board Steering Committee. Coming from OED it would sound less deflective. My understanding from talking to OED staff is that they would not be too unhappy about it.

Enzo

CC: Hans Wyss

(HANS WYSS)

M W

FINANCIAL SECTOR ADJUSTMENT LENDING: A PRELIMINARY ASSESSMENT OF THE BANK'S EXPERIENCE

April, 1991

Financial Policy and Systems Division
Country Economics Department

For Internal Staff Use Only

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FINANCIAL SECTOR ADJUSTMENT LENDING: A PRELIMINARY ASSESSMENT OF THE BANK'S EXPERIENCE

I. Introduction and Summary

1.1 Adjustment lending in Bank operations has recently been examined in the Reviews of Adjustment Lending (RAL1 and RAL2), which have stressed the increasingly important role this lending has taken in supporting policy reforms in developing countries[1]. Reflecting the importance which has been attached to having a healthy and undistorted financial sector to underpin growth and recovery, almost one third of all adjustment lending involves conditionality relating to the financial sector.

1.2 Indeed, the financial sector in developing countries has received increasing attention in World Bank lending over the past few years, and there is no indication that the increase will be short-lived. Loans primarily supporting financial sector adjustment have only recently emerged as an important instrument: only two financial sector adjustment loans (FSALs) had been approved before FY88, but FY90 fifteen loans of this type had been approved, with many more in preparation. Much financial sector conditionality has also been included in other adjustment loans. Whereas about five per cent of all adjustment lending conditionality before 1984 related to the financial sector, this figure has subsequently doubled.

1.3 To some extent this new emphasis is part of a shift in the focus of adjustment lending towards sectoral adjustment policy and institutional reforms. In part it reflects an increasing awareness of the severity of financial sector policy distortions in many member countries. The proximate cause of major financial sector adjustment loans to several member countries has been the discovery that significant parts of the banking system were insolvent. Insolvent banks needed to be dealt with, and there was a realization that supervision and control must be improved to avoid recurrence of the problem.

1.4 The importance and positive role of financial sector reforms in the development process is generally accepted. That a robust financial sector is essential to support economic development is now widely recognized, as is the huge cost - often borne by the budget - of policy errors in the sector. There is little dispute over the main types of reform that should be undertaken. Nevertheless, designing and negotiating conditionality for these loans has been a learning process for all concerned. It is too early to make a definitive assessment of the effectiveness of loan conditionality: many of the reforms are inherently of a long-term nature and, compared to other adjustment operations, FSALs are recent and remain few in number. For example, it will be several years before one can begin to assess how much the new institutional arrangements are helping to reduce the incidence of bank failures, or how much market-based choices regarding the direction of credit are improving the allocation of investable resources and promoting growth. However, with FSALs a growing part of the lending program, it is appropriate to consider what preliminary lessons can be drawn for future loans.

1.5 This paper thus represents an interim review intended to survey the problems and issues which have arisen in the Bank's adjustment lending in the financial sector. It complements RAL2 by providing a more detailed analysis for

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[1]The paper draws on a background note prepared for the Second Review of Adjustment Lending: Adjustment Lending Policies for Sustainable Growth, Policy and Research Series No. 14, 1990 (RAL2), and also has benefitted from a draft of "World Bank Policies Guiding Financial Sector Operations," Economic Advisory Staff, April, 1991 and the "Report of the Task Force on Financial Sector Operations," 1989.

the financial sector. Taking a perspective in tune with that of the (Levy) Report on Financial Sector Operations and the draft Operational Directive, the paper does not attempt to duplicate these documents, which contain comprehensive statements of policy and prescriptions for lending. Instead the paper focusses on some issues which remain controversial or unresolved. Some important issues for future financial sector operations are not discussed in much detail, either because there is not much experience from past adjustment lending operations or because they are the subject of other work[2].

1.6 Section II provides an overview of the main issues addressed by these loans under three headings: financial policy reforms, institutional rehabilitation and measures to strengthen and deepen the financial markets.

1.7 Section III turns to issues of project design: what are the preconditions for a successful operation; what should determine the size of a loan; and how can it best be disbursed.

1.8 Conclusions. Financial reform programs include:

- elimination of financial repression. This often requires a rationalization and liberalization of administered interest rates and reduced levels of financial sector taxation, including the effects of onerous reserve requirements. It also calls for reducing the administrative direction of credit, where it has been extensive.

- institutional rehabilitation dealing with the problems of delinquent loan portfolios and excessive costs in banking. Insolvent banks must be closed or restructured.

- strengthening of accounting and legal arrangements and improving the system of (and the institutional capacity to implement) bank and securities industry supervision and prudential regulation.

Within this accepted framework of policy reforms, the paper offers some observations and suggestions for shifts of emphasis (Box 1).

1.9 Financial sector reform operations are complex, and do not easily accommodate simplistic formulas. Six main conclusions of the analysis may be highlighted here:

1.10 First, to be credible, the strategy for financial sector adjustment should include significant reforms in each of the three areas of policy reform highlighted in Section II (and noted in para 1.8). Obtaining agreement on institutional rehabilitation is not enough if, for example, the banking system is still subject to repressive taxes and economic regulation. Likewise a strengthening of the system of bank supervision and prudential regulation would not be sufficient to warrant a loan if steps are not also being taken to deal with insolvent banks. Moreover, a country without significant problems in its financial sector should not receive a financial sector adjustment loan with light conditionality. Instead, the Bank should turn to other sectors more in need of reform to find appropriate conditionality for its adjustment lending to that country.

1.11 Second, full liberalization of interest rates should not be rushed,

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[2] In particular, empirical evidence on the effects of financial sector liberalization is the subject of a major research project, now in progress. Regarding contractual savings institutions, see Dimitri Vittas and Michael Skully, "Overview of Contractual Savings Institutions," WPS 605, March 1991, and D. Vittas, "Economic and Regulatory Issues of Contractual Savings Institutions," mimeo, CECFP, October, 1990.

especially in countries experiencing macroeconomic instability. Financial markets in developing countries are not sufficiently robust to cope well with the instability and inflationary surges associated with high budget deficits or external imbalances. While continued control of interest rates in the face of such instability imposes costs, these must be weighed against the risks of institutional collapse presented by liberalization. Freeing-up interest rates in an unsophisticated financial market can result in reckless overborrowing at unsustainably high interest rates ultimately leading to a crash. The first policy steps in such circumstances must be to regain control over the macroeconomy through appropriate fiscal and credit policies. Another precondition for full liberalization of bank lending and deposit interest rates is a sufficiently competitive or contestable banking structure. Prior to full liberalization, interest rates often must be rationalized and made positive in real terms. Real interest rates on directed credits should be both positive and at least equal to that charged prime borrowers, with any additional subsidies coming from the budget, rather than from financial institutions. Lastly, since institutional reforms and training programs take a long time to come to fruition, they should be commenced insofar as is feasible at an early stage in the reform process.

Box 1: Selected observations on the reforms

1. Reducing repression:
- In unstable macro conditions, interest rates may still need to be controlled, though their structure should be rationalized.
- Bank may have to be tolerant of a modest degree of "well-designed" selectivity in credit programs.
- Efforts to reduce financial sector taxation should be concentrated on those countries where this is among the most severe distortions.

2. Institutional rehabilitation:
- Measures to strengthen central banks and their independence should be given more attention.
- The need for decisive action to deal with failed banks is still the key issue. The ideal choice of institutional arrangements for intervening in failed banks and for making recoveries on their claims remains an open question and is probably dependent on country conditions.
- Where governments opt for rehabilitation instead of closure, the Bank should closely monitor the process.
- Attention needs to be given to who ultimately bears the cost of the losses in a failed banking system: often it is the depositors through inflation as well as the taxpayers.
- In addition to technical assistance, improving legal, regulatory and accounting frameworks requires political will to allow these professions to function.
- Many traditional DFIs will not survive in a reformed financial system.

3. Market deepening:
- Successful privatization needs attention to the competence of the purchasers and to assuring competitive conditions.
- Direct government action to develop capital markets can be counterproductive; indirect methods including privatization and removal of undue tax barriers are probably better.

1.12 Third, financial sector reforms can have major implications for fiscal policy and the budget, many of them implying a loss of revenue. These relationships have to be taken account of in reform programs if the reforms are to be sustained without destabilizing the fiscal position.

1.13 Fourth, where (as is the case in countries which are emerging from a centrally planned system) major structural reforms including a rationalization of prices are imminent or in progress, the initial emphasis in financial sector work should be on institutional strengthening and reforms in the legal and prudential sphere. Extensive liberalization of the financial sector would not normally be warranted until reform in the real sector was well-advanced. In countries where non-financial enterprises are severely distressed, whether because of the effects of structural reforms such as trade policy liberalization, or because of protracted recession, steps to address the financial restructuring of the enterprise sector, though an ambitious undertaking, should be initiated in parallel with plans to restructure the banks.

1.14 Fifth, the essence of financial market development involves the building of institutions and the associated human resources, and thus the time-scale required to put most financial sector reforms in place is measured in years

rather than in months. Consequently, loans in support of financial sector reform should often depart from the normal two-tranche quick disbursing model. In order to help ensure that the reforms envisaged are actually implemented in an adequate manner, there could be a battery of operations disbursed over a much longer period with each targeted at specific needs. The technical assistance loan could become much more widely used, instead of being a minor add-on to fast disbursing loans as is often the case at present, and FILs, which normally are slower disbursing loans, may prove well-suited for long-gestating reforms.

1.15 Finally, the staff and technical assistance requirements of financial sector loans are straining the resources both of the Bank and of borrowing countries. FSALs require a mix of expertise: monetary and fiscal economists, commercial banking experts, bank supervision experts, people with bank restructuring experience, etc. Generally, these skills are in short supply within the Bank, and staff rely on consultants for much of the work. Staff, however, may need additional training in order to use these consultants effectively. We also need to recognize that these programs are complex and very labor intensive, requiring additional preparation and supervision time (certainly much more than traditional development finance institution (DFI) operations and perhaps more than adjustment programs in other sectors), particularly if a FSAL contains significant institutional restructuring. If the Bank is to continue playing a serious role in financial sector reform and plans to implement an increased number of FSALs, then efforts must be made to establish a greater pool of expertise which can be drawn on to support the design of Bank loans as well as to help borrowing countries in implementing the loan conditions.

1.16 Looking toward future FSALs, increased emphasis on capital market development is expected, especially in view of heightened attention being focussed on private sector development. This change in emphasis is already underway in the form of the strengthening of contractual savings institutions, such as pension funds and life insurance companies, both of which may benefit from the ending of financial repression and the associated move to more market-based funding of government debt. The most effective measures in this area are likely indirect ones, such as encouraging the privatization of state-owned enterprises (to increase the supply of tradeable equity) and the encouragement of more equitable tax treatment of equity and debt-based finance. In addition to assistance in establishing a legal, regulatory, and institutional framework conducive to capital market growth, governments will benefit from Bank help on training in this area. Capital market development will also place further demands on Bank expertise. Coordination with the IFC will be of paramount importance in this area, as that with the IMF has proved to be thus far on FSAL operations.

II. The Policy Reforms Supported by FSALs

2.1 While other loans also involved conditions relating to financial sector reforms, this report focuses on the experience with adjustment loans or credits that had been approved by end-June 1990 in support chiefly of financial sector reforms. Of these, fifteen were explicitly described as financial sector adjustment loans or credits (FSAL)[3]. Two of these loans, totalling about $400 million, were approved before FY88. In 1988 a further five loans, totalling over $1100 million were approved; and a similar total sum was approved for four loans in FY89. Four new loans were approved in FY90, but with a smaller total sum of about $650 million[4]. Financial sector conditionality has also formed a central part of several SALs[5]; the paper covers several of these important cases also[6].

2.2 Matrix tables 1 and 2 lay out the key objectives of each of the fifteen FSALs as well as of the financial sector component of four other adjustment loans, together with the major reforms undertaken in each.

2.3 At the beginning of FY91 some two dozen adjustment operations with financial sector emphasis were being actively planned.

2.4 The symptoms of financial system distress observed in country after country are widespread bank insolvency and low levels of resource mobilization through the financial system. Distress is usually most evident in the aftermath of recession or other macroeconomic shocks, including trade liberalization or other reforms of a country's economic structure, but the root causes can be traced to weaknesses in financial sector structure and policy. As described in the 1989 World Development Report, the difficulties can usually be attributed to a combination of excessive direction of credit and control over interest rates, combined with inadequate attention to prudential supervision of financial institutions and a generally undeveloped legal, accounting and regulatory infrastructure.

2.5 Corresponding to this diagnosis, the issues addressed by financial sector operations can be conveniently grouped under three headings, first, financial repression, and the policy steps needed to eliminate it; second, institutional rehabilitation, including returning the banking system to solvency; third, market deepening, including the introduction or strengthening of non-bank financial markets. These three areas cannot be completely disentangled. For example financial repression, in the form of politically directed credit decisions, was at the root of the big bank failures in the Philippines, while interest rate ceilings generating negative bank lending margins left the banking system of Bangladesh unable to operate profitably. Likewise, the weaknesses of the banking system, or its repression, has meant that non-bank financial development has taken the form of an imperfect, and often informal, substitute for vigorous banks, (as with the curb loan market in Korea and the expansion of tontines in Cameroon) instead of providing complementary services especially in the form of a long-term capital market.

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[3]Including the Jamaica Trade and Financial Sector Adjustment Loan of FY87 and the Chile Financial Markets Loan of FY90. The terms "loan" and "FSAL" should be read to include IDA credits.

[4]Supplementary loans were also made in a number of these cases.

[5]And the Philippines Economic Recovery Loan of FY87.

[6]It should also be noted that similar conditionality is often included in financial intermediary loans, where there is no explicit quick-disbursing component; the dividing line between FSALs and intermediary loans can become somewhat blurred (see para 3.24 below).

Removing Financial Repression

Measures Adopted.

2.6 Measures to eliminate financial repression have generally focussed on relaxing interest rate controls, reducing taxation of financial intermediation and reducing the scope of directed credit programs.

2.7 FSALs have tackled interest rate reform in a number of ways, depending on the overall macroeconomic situation of the country, the health of the financial system and the degree to which the economy has already been liberalized in other arenas. In relatively open economies, where important reforms have already been taken on exchange rates, trade, fiscal reforms, etc., (Ghana, Mexico, Ecuador) financial sector reform programs have included measures to liberalize interest rates. In countries where fiscal or political pressures prevent full liberalization, countries have moved to bring interest rates to positive levels in real terms (Kenya, Pakistan). Financial sector reform programs have also begun to dismantle some subsidized credit programs, as was done in Bangladesh, Pakistan, Mexico and the Philippines, thus rationalizing not only the level, but also the structure of interest rates. This will also be a key component of reform in Yugoslavia, where the subsidies have been provided at the expense partly of the non-preferred borrowers - who had to pay very high interest rates - and partly of depositors, the value of whose deposits was severely eroded by inflation.

2.8 Taxation of the financial system can take explicit forms, as in the tax on gross interest receipts of banks in, for example, the Philippines, Thailand, Yugoslavia and the CFA countries. It also occurs in more hidden forms, as in the high reserve requirements imposed on banks and not remunerated at market interest rates in many countries notably Brazil and Turkey, or more generally in compulsory lending to government at low interest rates. Compulsory lending at low interest rates to privileged sectors other than government also amount to taxation of the financial sector. In Mexico, fully three-quarters of commercial banks' resources were tied up in this way.

2.9 FSALs have often identified these taxes for reduction, though the adverse budgetary implications of reduction has often led such reductions to be linked with an improvement in other fiscal receipts (Jamaica, Philippines). For example, a reduction in reserve requirements may reduce the profits of the central bank and thereby add to the consolidated general budget deficit. The elimination of interest rate subsidies may induce government to increase expenditure on budgetary subsidies to the affected sectors.

2.10 In line with steps to reduce interest rate subsidies, some countries have begun to reduce the role of government in the allocation of credit. Ecuador and the Philippines, for example, have taken steps to streamline their rediscount and directed credit programs. Mexico effectively abandoned all such programs affecting commercial banks. Ghana and Senegal have also been eliminating sectoral credit targets. In some countries, such as Uruguay and Kenya, credit allocation schemes are insignificant, and therefore were not covered in the programs. In others, such as Pakistan, the political sensitivity of sectoral credit programs meant that action on them was largely confined to reducing the subsidy involved.

Observations.

2.11 Moving towards a generally positive level of real interest rates, which was traditionally a linchpin of Bank financial sector conditionality, has become somewhat less central in recent policy discussions. In some countries, such as Bolivia and Uruguay, FSALs did not include interest rate conditionality because the reforms had already been adopted. Most countries now recognize the distortions which can result from holding interest rates generally below

inflation. Indeed, real interest rates in the latter 1980s throughout the developing world have gradually moved from negative to positive, an encouraging sign[7]. In Turkey, the authorities even went far beyond Bank proposals in their radical liberalization of interest rates[8].

2.12 In unstable macroeconomic conditions, where the rate of inflation is high and hard to predict, and where the financial condition of many bank borrowers may be fragile, there is a risk that, in the absence of ceilings, banks will bid up deposit interest rates to unrealistic levels in order to attract deposits to fund continued loans to weak borrowers. Pressures from international capital movements can also have an unreasonable impact on interest rates. In such circumstances it may be necessary to retain ceilings on interest rates, though this should not be an excuse to retain severe financial repression.

2.13 The arguments here are macroeconomic as well as microeconomic. At the micro-level at issue is the solvency of banks. Insolvent banks that continue to trade have an incentive to offer excessive interest rates to maintain their liquidity. The best course of action is to assess the condition of banks and to prevent those that are insolvent from continuing to trade. But in the short-run ceilings on deposit rates may be a necessary stop-gap in some countries.

2.14 At the macro-level, where economic policies are unstable and the financial markets are fragile, the market may not find the best equilibrium interest rate. In such circumstances, government action to set interest rates at a realistic level may succeed in focussing market expectations, and preventing speculative bubbles. On the other hand, attempts by the government to impose unrealistic interest rates will result in a recurrence of repression and evasion of controls. Successful interest rate policy requires considerable flexibility of approach and an ability to respond to market pressures.

2.15 More and more countries are turning to market-oriented systems of monetary policy. Such systems try to ensure that available liquidity, or the ability to lend, is distributed among banks on a market-determined basis, instead of being determined administratively (often through a system of bank-by-bank credit ceilings). They also allow the market to have a considerable role in influencing the general level of interest rates. Additionally, deeper and more sophisticated money markets increase banks' ability to borrow liquidity and may contribute to their willingness to lend more (and at longer term) and to hold smaller amounts of "excess" liquidity[9].

2.16 In moving toward a market-based interest rate structure, many countries have sought to begin by identifying a key rate, such as the yield on short-term government paper, to act as a benchmark for setting other rates. Setting other administered rates in relation to such a benchmark rate can help

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[7]Although a simple computation of ex post real deposit interest rates from published data fails to reveal an unambiguous picture, it seems clear from policy documents that the effect of many FSALs has been to increase the effective real interest rate. In a few countries, macroeconomic turbulence leading to inflationary surges temporarily reversed these effects, but even in those cases a reduction of the scope of subsidized lending has improved the efficiency of intermediation.

[8]But in this case they may have moved too quickly: the prevailing macroeconomic instability meant that liberalization resulted in very high real interest rates, and controls were reimposed. See also Box 5 below.

[9]The issues involved are discussed in Caprio, G. Jr., and P. Honohan, "Monetary Policy Instruments for Developing Countries", PRE Working Paper 528, October 1990.

facilitate rate changes when macroeconomic conditions change. This can be particularly useful in less developed and less competitive markets where liberalization of interest rates may not result in a competitively determined interest rate structure.

2.17 Yet determining the best overall level of interest rates has presented difficult problems of analysis in several countries. It is just where inflation is high and variable, as recently in Nigeria and Uganda, that it can become extremely difficult to evaluate the adequacy of the interest rate policy regime[10]. There needs to be continuous review of administered interest rates; this is an area in which there has to be close cooperation with the IMF (cf. Box 2). In particular, review every 6 - 12 months likely will not be adequate in these unstable environments.

Box 2: Role of IMF

The importance of the role of the IMF in policy discussions related to FSALs has varied from case to case. In several programs (Kenya, Ghana, Philippines, Nepal), the IMF has had Standby, EFF or SAF programs in place. In two of the countries with severe macroeconomic imbalances, the IMF did not have a program (Argentina and Turkey). The financial sector programs in both countries have been undermined largely because of those macroeconomic imbalances. The IMF has also played a less prominent role in Uruguay, although it voiced some reservations about the sustainability of the macroeconomic policies in place there. The importance of a solid macroeconomic framework to the success of financial sector reform programs, and the question of the relationship with IMF programs has already been discussed fully in RAL2.

At the operational level, there has already been cooperation between Bank and IMF staff on the design of financial sector operations, as in Jamaica and Kenya (conduct of monetary policy) and Philippines (banking supervision and legal issues). As both institutions are involved in financial sector reform, it is necessary to avoid duplication or overlap -- as well as possible omissions -- by adequate communication.

2.18 Less progress has been made in eliminating selected credits at preferential interest rates. Selective credit programs differ widely in the degree of distortion which they introduce, and in the degree to which they are enforced. Generally, programs involving significant interest subsidies do most damage. These programs are seen as a way of providing grants without budgetary cost, and they usually result in credit going to borrowers who cannot service it - even at the subsidized rate. This confusion of credit with grants has a corrosive effect on the banking system. An environment in which administrative or political direction of loans to particular borrowers or classes of borrowers is common has destroyed many banks, especially government-owned development banks[11].

2.19 Centrally planned economies provide the most extreme examples of credit being allocated not on the basis of repayment ability but in relation to planning objectives. The staff of banks in these countries generally have little or no experience in risk evaluation or in making sound judgments on the creditworthiness of borrowers. The poor quality of these banks' portfolio has been aggravated by the fact that much credit has been extended simply to cover the mounting cash deficits of loss-making state enterprises. In effect the planning objectives guiding credit allocation have themselves increasingly been driven by the credit appetite of the enterprises. The move to a market-oriented economic system in these countries requires a sea-change in the way bankers and their customers - and indeed the regulatory authorities - view the credit process.

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[10] This characterization applies especially in emerging socialist countries with large monetary overhangs, where price liberalization may generate inflationary forces that are difficult to predict with much precision.

[11] Privatization of banks, discussed below, is one way of distancing government from the process of credit selection.

2.20 Bank staff negotiating financial sector loans have been alert to these problems of administratively allocated credit and have promoted conditionality designed to eliminate them. It has not always proved feasible to obtain agreement to such conditionality (for example the Bangladesh operation was delayed for this reason) and in many cases this battle remains to be won both in political and intellectual terms.

2.21 Although a doctrinaire stance against all forms of government intervention in the credit process may never be justified[12], the Bank's traditional lack of enthusiasm for directed credit still seems well-grounded. Retaining a modest degree of selectivity may possibly be justified on the grounds that banks can be unduly cautious in entering into new fields. But most would agree that the categories favored by such intervention should be quite broad. Thus individual borrowers should not be targeted, or even sectors such as electronics or textiles; but it may be reasonable to have a target amount of lending for a category as broad as export development.

2.22 The importance and justification of existing directed credit programs should be analyzed as part of the formulation and evaluation of financial sector strategies. For example, for schemes based on an infant industry argument, the transitional needs should be clearly spelled out, along with "sunset" specifications and the eventual shift to normal credit flows to the targeted groups. All programs should be both transparent and affordable, and interest rates should be linked to market rates: in general, borrowers should be paying positive real interest rates at least equal to that for prime credits. Any other subsidies should come out of the budget, linked to the preferred activity, rather than to the act of borrowing. Excessively low interest rates may encourage more capital intensive processes than warranted by market forces.

2.23 It is now well recognized that abrupt removal of taxes in a fragile fiscal environment can result in inflationary financing of the resulting deficit. In some countries, lack of progress on the fiscal side has meant that in practice there has also been little progress in reducing financial sector taxation. Turkey is a case in point: it has benefitted from considerable adjustment lending while retaining financial sector taxation which is both poorly designed and imposed at very high rates. At the same time some countries (such as Senegal) with much lower rates of financial sector taxation have seen the reduction or even elimination of these taxes as part of loan conditionality. It would be better, in line with the recommendation in RAL2 that the most serious distortions should be tackled first in adjustment programs, to concentrate efforts to reduce financial sector taxation on those countries where this is among the most severe distortions.

2.24 It is also important to bear in mind the need for balance between the taxation of different sectors. Where production and consumption of the output of most sectors is taxed, it is not obvious that the financial sector should escape taxation entirely. However analysis of the comparative tax burden has shown that financial sector taxes are often high in comparison with the value added of the financial sector. Unremunerated reserve requirements and taxes on the gross interest receipts of banks have resulted in very high tax burdens especially where inflation is high.

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[12]Those who favor some intervention point to the considerable economic successes of Korea and Japan, both of which employed government intervention in credit markets in earlier periods. These countries also had well functioning bureaucracies, effective monitoring, and a high degree of financial discipline, and thus their lessons may not apply to countries lacking these characteristics.

Institutional rehabilitation

Measures Adopted.

2.25 Widespread insolvency in the banking system has prompted measures to rehabilitate and strengthen the affected banking institutions and also the regulatory agencies. Existing agencies had not been able either to identify emerging problems or deal with the collapse and minimize its adverse effects.

2.26 Measures proposed to deal with failed banks have included financial restructuring, the identification of new shareholders and managers and the adoption of detailed plans of action. Some banks have been closed (for example in Senegal and Cameroon); others were to be restructured (Ghana, Philippines) or consolidated (Kenya). In several operations, (Bolivia, Madagascar, Philippines) privatization has been one of the routes chosen to achieving improved performance.

2.27 FSALs and SALs have included conditionality related to these restructurings, though because of the short time horizon of most adjustment loans, the conditions have often been confined to requiring the completion of preliminary studies. Programs in Uruguay, Kenya and Madagascar have focused on individual institutions and have attempted to link disbursements to implementation of the restructuring. Others, such as those in Nepal and Pakistan, call for detailed restructuring plans for individual institutions, but do not require their implementation. In some other countries, (Turkey and Ecuador), the agreed conditions have required only studies of the modalities for intervening in troubled institutions. On the whole, it seems that institutional restructuring has usually taken longer than expected, and has often been less thorough than hoped for.

2.28 Almost all of the operations give considerable attention to the area of banking supervision and regulation. The work done in this area is designed to build an appropriate "infrastructure" for the financial system in the way of accounting and audit standards, performance monitoring, establishment of sensible prudential guidelines and improvement of the legal framework. Most of the operations include conditionality related to accounting standards for banks and performance monitoring, and greater attention is being paid to such matters as more sensible provisions against doubtful debts, accounting for interest due but not received. Banking laws are being revised in several cases. While there is progress towards bringing prudential guidelines (such as capital adequacy requirements) up to the standards recently adopted for industrial countries, it is not likely that such stringent standards will be promptly enforced in countries where banks' balance sheets remain weak. Nepal, Ghana and Kenya have all included gradual implementation of more stringent prudential regulations as part of their reform programs.

2.29 Institutional arrangements for bank supervision have been strengthened as part of the conditionality in many loans and inspection staff are being trained so that they can better identify the institutions that are getting into trouble. As discussed below, some operations have addressed issues surrounding deposit insurance schemes. Many operations have also given attention to needed improvements in the accounting standards, auditing procedures and legal systems, especially in regard to loan recovery. New laws have been drafted and training programs for accountants put in place (e.g. Algeria).

Observations.

2.30 The regulatory and supervisory agencies. A major theme running through much of the institutional restructuring is the strengthening of the monetary and bank supervision authorities. Unless the central bank is freed from the responsibility to subsidize particular sectors and borrowers, and until it is recognized that the proper contribution of the central bank to development is

in its success in helping maintain macroeconomic stability and establishing an efficient and soundly operating financial system, financial reform will remain shallow. Some reform programs have provided technical assistance to try to help to separate the subsidy function from true central banking (Argentina, Brazil[13]). There is an increasing consensus that a central bank which is effectively independent from the government is likely to be more successful in restraining inflation and maintaining a sound banking system. Strengthening the professional and technical capacity of the central bank can help, as can legislative changes in some cases. But effective independence of the central bank requires an awareness at the political level of the value of that independence and a commitment to ensuring that it is guaranteed in practice.

2.31 An important institutional question is how to allocate the responsibility for implementing bank restructuring. Countries must choose between entrusting the restructuring to the central bank or to the superintendency of banks or to a separate legal entity, such as a deposit insurance fund. In most cases, the central bank (or one of its arms) has played the leading role in restructuring programs (Bolivia, Ghana, Chile, Pakistan). In other cases, such as Argentina and the Philippines, an autonomous institution was viewed as likely to be more effective.

2.32 Country conditions will dictate the most appropriate institutional division of responsibilities. Some countries may lack the depth of human resources to warrant a separate restructuring agency, leading to the consolidation of bank supervision and restructuring in the central bank. Furthermore, the high standing and traditional independence of the central bank in some countries can ensure that adequate attention and resources are given to a restructuring program. By centralizing responsibilities the danger of destructive interagency rivalry (which appears to have emerged in Nigeria) can be avoided. As against this, other central banks have tended to be preoccupied with monetary management to the detriment of prudential issues; furthermore restructuring a failed bank and making recoveries from its delinquent portfolio can be a distraction from the ongoing process of bank supervision. If it is decided to take this function of bank restructuring out of the central bank and into a separate agency, it may be desirable at the time of the initial restructuring of a banking system in crisis, to second central bank staff to meet the initial bulge in the new agency's workload.

2.33 The agency that has the responsibility for intervening in failed banks must also have sufficient legal powers to do so, including the power to issue cease and desist orders and to remove management. It must also have the political independence needed to do its job effectively. Deposit insurance agencies with such powers have been established or strengthened in Nigeria, the Philippines, Venezuela and elsewhere, but restructuring does not necessarily entail having a deposit insurance system.

2.34 Indeed the desirability of deposit insurance remains an open question. Adverse experience with such schemes in the Philippines (where it was undercapitalized and unable to pay depositors promptly) as well as in the United States, suggests that the Bank should be slow to advise on the establishment of deposit insurance. Only where there is evidence that deposit mobilization is being seriously affected by lack of depositor confidence, and where the government's creditworthiness is sufficiently high for establishment of an insurance scheme to help restore confidence should deposit insurance be considered.

2.35 There are very considerable training needs in the area of bank

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[13]As elsewhere in the paper, parenthetical references to countries include some programs that were aborted or have not yet come to fruition. There are also some references to reforms where the lead role was taken by the IMF.

supervision, and much effort is being devoted to this area. The technical approach to strengthening bank supervision is relatively uncontentious. But having a well-trained team of bank inspectors will not always prevent poor banking practice. For one thing, there will inevitably continue to be some frauds that evade detection. Even more important in practice has been the gap between identification, by inspectors, of a problem bank and the implementation, by senior policymakers, of the necessary corrective action.

2.36 Recovering assets of failed banks is important not only for budgetary reasons, but to protect financial discipline where delinquent borrowers are able but unwilling to repay. Here again a number of institutional experiments are in progress. In the Philippines, Uruguay, Ghana, Senegal and Cameroon, distinct recovery agencies have been, or were to have been, established. That in Uruguay was to be jointly owned by private banks, while the others are publicly owned. A degree of skepticism has surrounded the establishment of publicly owned recovery agencies, especially where delinquent borrowers remain politically influential. In all cases only a fraction of the portfolio has been recovered, but it is too early to say whether an alternative mechanism would have worked better[14]. Generally, although the restructured bank's knowledge of the portfolio may enable it to contribute to the recovery process, it is unwise to leave the bad debts on its balance sheet. One solution may be to take bad loans off the balance sheet of the banks but to pay banks on a commission basis for loan collections.

2.37 Restructuring Insolvent Banks. A difficult question in rehabilitation relates to the speed and comprehensiveness of action to clean-up the banking system[15]. On the one hand, allowing technically insolvent banks to continue trading has often led to reckless and ultimately fraudulent behavior by management and shareholders. On the other hand, most governments balk at absorbing the heavy losses involved in restructuring banks. They are also reluctant to incur the political costs of enforcing losses on bank shareholders or of laying-off bank staff[16].

2.38 . Adjustment lending can help break through this reluctance to the extent that the proceeds of the loan may be used to ease the budgetary burden of recapitalizing the insolvent banks. Of course this should never be contemplated in the absence of action to resolve the underlying causes of the bank's failure: weak management, political loans or widespread enterprise failure. While none of the Bank's operations have neglected these criteria, it is difficult to judge whether enough has been done. In particular it is hard to be sure that the practice of giving political loans has been completely stamped out. Furthermore, it is all too easy to be over-optimistic about the prospective strength of the enterprise sector.

2.39 Deciding whether a failed bank should be liquidated or rehabilitated should be based on the franchise value of the bank's assets and of the human resources available to it. Except in some clear-cut cases, neither World Bank staff nor government officials are normally in a position to predict with absolute confidence whether a given institution, if restructured, can survive in the newly-reformed financial system. Another consideration to be borne in mind

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[14]One alternative which has been suggested is to sell the bad portfolio at a discount to a strong bank. This has not yet been tried in any developing countries.

[15]A related, but rather more technical, unresolved issue is whether rehabilitation should be tackled on a case-by-case or an across-the-board basis.

[16]Even though rehabilitation plans supported by Bank loans may include compensation for laid-off workers.

is that the closure, without replacement, of major banks may result in an unduly concentrated or oligopolistic banking structure. Furthermore, the closure of banks, both large and small, can have important political repercussions. In three of the recent FSALs, a more evolutionary approach has been adopted as a pragmatic way of easing into institutional restructuring (Box 3). In this approach, institutions were scaled down, and in some cases merged. They have subsequently had a chance to prove themselves. If they continue to be unsuccessful, it may be necessary to liquidate them. This approach will prove costly if the institutions continue to post losses and liquidation is repeatedly postponed, although less so than if they had not been downscaled. In well-articulated banking systems such as the Philippines, Mexico, Brazil and even Kenya, there is a strong argument for closing or merging insolvent financial institutions since they will find a new role only with great difficulty.

Box 3: Gradualism in bank restructuring

The Philippines Economic Recovery Loan (1987) included the rehabilitation of two large government banks. Because the future viability of the development bank, DBP, was uncertain, it received seed capital while it tried to build a new business. The 1989 FSAL endorsed a new strategy for DBP, reducing its retail operations in favor of refinance facilities for long-term funds. Such a change implies a significant downsizing of the institution. By refocusing and reducing DBP in a series of steps, the government may be able to limit the resource costs without the shock of an abrupt closure.

In Kenya, several weak financial institutions are to be merged into a single institution. Strict financial criteria would call for closure of these institutions, which the government felt was untenable politically. It remains to be seen whether a period of further pruning and consolidation of the new entity can make it viable.

Four banks in Uruguay are also being restructured in phases. One institution will be liquidated immediately, while the other three will have a chance to prove themselves under the restructuring.

2.40 Many of the recent FSALs have focussed on the commercial banks with little emphasis on development finance institutions. Exceptions are the loans to Ghana, Mexico and the Philippines, which required restructuring programs for DFIs. In other countries, DFI restructuring may take place under separate financial intermediary loans (Turkey, Sri Lanka). Nevertheless, DFIs are likely to be profoundly affected by financial sector reform programs, particularly in cases involving interest rate deregulation and the relaxation of credit allocation systems. Some DFIs envisage converting to full-service commercial banking, but, especially where they have been the primary channels for directed credit programs which are now being dismantled, they may not have the managerial capability to compete on a level playing field with other institutions. They may also need capital injections if they are to satisfy the same capital, accounting, reporting and loan classification requirements as other financial institutions. Overall, it is unclear whether DFIs will be able to survive in the reformed system. There are different views as to whether this prospect should be a cause for concern: some expect the commercial banks, assisted by emerging capital markets, to fill the need for term finance and development finance generally, once the subsidized provision of such finance is ended; others remain apprehensive that this market response may not be sufficiently vigorous, especially in low-income countries.

2.41 Some World Bank loans have included explicit conditions earmarking counterpart funds for meeting the cost of bank failures (Kenya, Philippines). Earmarking Bank funds essentially to make good on bad debts has been controversial. On the one hand it does ensure that the loan proceeds will not be spent without a financial restructuring of the banking system being accomplished. On the other hand, a perception could grow that Bank funds were readily available to resolve deficiencies in the banking system thereby weakening

financial discipline especially, but not only, in government-owned banks[17]. If it becomes routine that senior management of failed banks are removed, this danger may recede: such action has occurred in most, but not all, bank restructurings supported by adjustment lending. Furthermore, shareholders of weakened banks may begin to have an incentive to exaggerate their difficulties in the hope of benefitting from World Bank funds.

2.42 To avoid such difficulties, shareholders of failed banks should lose their investment in a recapitalization[18] and senior managers responsible for the bank failures should be removed. There are hard decisions to be made in this area. For example, how far down the line should the management be changed? Where is the new management to be found?

2.43 It is too early to attempt an assessment of how successful the rehabilitation of failing banks has been. Certainly, there have been cases where long delays have occurred in the implementation of the rehabilitation (Ghana[19] and Uruguay, for example). There are other cases where the rehabilitated institutions still appear weak (Kenya would be an example). The infusion of cash or other resources into weak institutions can distort the picture for quite some time: thus in the Philippines, the rehabilitated banks appear to be doing well, but the long-term prospects are still uncertain. On the other hand, in Cameroon, the rehabilitated institution got such a powerful injection that it has become easily the most profitable bank and its growth is threatening the stability of other fragile banks in the country.

2.44 Several governments have ensured that banks are protected from competition to allow them to rebuild reserves; tight credit ceilings often have improved bank profitability as a side effect, and (in a reversal of former practices) some countries now pay very high effective rates on Treasury bills to help the banks. As this kind of protection is damaging to the development of a self-reliant banking system, it should be discouraged.

2.45 The complexity of these restructuring problems means that the Bank has to be involved in the design of and technical support for such rehabilitation plans. Use of outside consultants has had mixed results: in Indonesia the continuity and commitment of the independent consultants engaged by the government has yielded significant improvements; but the cost of that work was high and could not have been borne by most smaller countries. The experience of Uganda, where international consultants engaged by the government produced rather bland and unhelpful reports, may be more typical. But if the Bank is to become more involved in the rehabilitation plans, there will be significant requirements for additional staff resources.

2.46 Where structural shocks have caused the enterprise failures that weakened the banks there is an acute need for financial restructuring of the enterprises themselves. It is important that potentially valuable human and physical capital does not remain unused because of inefficient bankruptcy procedures or because of the lack of managerial skills to design work-outs. This is an area for which World Bank adjustment programs do not yet have a systematic approach. The task is potentially enormous; but the problem of enterprise

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[17]Another potential problem is that earmarking the domestic proceeds to repay depositors whose funds were blocked might worsen the balance of payments position.

[18]In particular the old shareholders should not have first claim on shares in the restructured bank, as occurred in Cameroon.

[19]Much of the delay in Ghana was due to the difficulty of fielding a sufficiently large team of consultants to develop the rehabilitation plans.

restructuring is very much at the micro level and should be carried out largely in the private sector. Yet there is a need for the Bank to study further the mechanisms and legal framework for enterprise work-outs in developing countries and in those countries emerging from central panning in order to advise governments on the best course of action to adopt. This work should proceed in parallel with financial sector reform.

2.47 The scale of losses in the banking system failures of some countries are very large. In the Philippines, for instance, the losses of two banks amounted to one-sixth of one year's GNP, and in the West African Monetary Union the estimated net capital deficiency of failed banks at present totals about one-tenth of the seven country union's GNP.

2.48 The costs of bank insolvency are usually divided among the holders of equity claims, the depositors, other bank creditors and the taxpayer. Here are some examples: Because the social security and pension funds had large unreimbursed deposits in the two failed government banks in the Philippines, the authorities were able to sweep the problem under the carpet by replacing these deposit claims with unbudgeted Government obligations to these funds. Since the obligations are unlikely to be called upon for many years, the Government will then be able to raise taxes, shift other expenditures or reduce the benefits to fund holders to meet the obligations. In Guinea, exchange rate devaluation and rapid inflation substantially eroded the real value of depositors' claims in the closed banks by the time their funds were reconstituted. In that case, much of the loss was absorbed by the depositors. In Ecuador, the unanticipated acceleration of inflation helped borrowers and allowed banks to recover loans that, at the time the reform program was undertaken, appeared unrecoverable: here too the depositors suffered a serious erosion of purchasing power. In perhaps a majority of cases the taxpayer, present or future, has to pay the bill.

2.49 FSALs have been used in part to help meet the costs of restructuring, usually by recapitalizing institutions. The impact of restructuring on monetary conditions needs to be examined closely in such cases. Except where bank liquidity is an issue, the best solution - Ghana is an example - is usually for governments to substitute their own bonds for the non-performing assets in the banking system and thus defer the need for cash outlays and pressure on the budget. Country conditions will necessarily dictate the way in which the losses are distributed and whether to use Bank funds to recapitalize institutions.

2.50 Legal, regulatory and accounting framework. In addition to addressing the immediate needs of insolvent institutions it is necessary to establish a legal and regulatory framework and a structure of information flows that prevents the problem from recurring, as well as allowing the financial system to function more efficiently. In country after country severe weaknesses in these areas have been catalogued and many Bank loans have measures, including technical assistance components, to address the problem[20].

2.51 One of the most urgent problems in many countries is the lack of an experienced and credible auditing profession. Without reliable accounts, it is much harder for providers of funds to collect the information they need to make a sound decision; accordingly lending for what could be viable projects may not take place. Improving accounting is primarily seen as a technical assistance function. Perhaps more could be done to achieve pooling of auditing skills on a cross-country, regional, basis in order to give the profession greater independence from national political pressures.

2.52 The question of ensuring adequate protection for lenders to recover collateral is another problem that arises frequently. There is a tendency to see

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[20]The most far-reaching legal changes are needed in the reforming planned economies; but discussion of these is not attempted here.

this problem as one of inadequate laws. However, in practice the problem is more often in the reluctance of the courts to apply existing law sufficiently vigorously. It may prove counterproductive to financial efficiency in the long run to tilt the legislative scales so much in favor of the banks that bona fide investors are discouraged from borrowing.

Market deepening

Measures Adopted.

2.53 FSALs have also covered policies to deepen the financial markets and make them more competitive. The advocacy of privatization of state-owned banks can be included under this heading. Relaxation of entry restrictions, including provision for foreign banks to compete on a reasonable basis with domestic banks, has been advocated in many of the financial sector studies which have been prepared as a background to reform programs. However, except for a fairly weak requirement along these lines in the Venezuela loan, it does not appear to have found its way into loan conditionality.

2.54 Less emphasis has been placed in adjustment lending conditionality on measures directly focussed on extending the range of financial markets and improving their performance, though interest in the development of non-bank financial markets continues to grow.

2.55 A few programs have tackled the regulatory framework for nonbank financial institutions, as in Mexico (for brokers), Pakistan and Chile. Work in this area is likely to expand as the critical problems of the banking sector come under control.

2.56 Many countries, having seen the benefits obtained in some Asian countries, are anxious to develop money and capital markets. It is generally held that experience with trading of comparatively simple instruments such as government bills is the best way of developing the market skills needed for more complex markets such as those in long-term bonds and equities. Commercial banks are typically the most important participants in the market for government bills, but the development of such markets to include other participants, and to include trading in bank-accepted commercial paper can greatly improve the competitiveness of the banking system. Some programs (e.g. Ghana, Pakistan) have included conditionality related to the development of an interbank or government securities market as part of the move towards market-determined interest rates. This would also be a prerequisite for the move from a regime of bank-by-bank credit ceilings to indirect means of monetary control, as envisaged for example in the Senegal loan, which is also being recommended to a growing number of countries by the IMF as a means of enhancing the effectiveness of control over monetary aggregates.

2.57 Capital markets development has not figured prominently in most financial sector adjustment lending to date. The chief exception is the Chile Financial Markets Loan, which focusses exclusively on measures to improve the efficiency of securities markets. These include the streamlining of procedures for issuance of securities (to help promote securitization of bank loans), as well as a liberalization of the regulations governing the asset portfolio of insurance companies and pension funds. The loan also includes institutional strengthening, through the transfer of the securities depository to the private sector, improved monitoring of private risk-rating agencies, and encouragement of a new automated securities exchange by permitting it to be used by the main institutional investors. The need for such reforms is greater in Chile because of the large funds managed by non-bank institutions as a result of the earlier privatization of social security.

2.58 In many industrial countries, pension funds and life insurance

companies manage significant long term funds on behalf of their policyholders and beneficiaries and contribute significantly to the flow of investable funds. There is clearly scope for a beneficial expansion of such "contractual savings institutions" in developing countries also. Preparatory work is already underway for a loan to support a reform and expansion of the scope of contractual savings in Mexico.

2.59 In Kenya, Jamaica and Ghana, among others, the reform programs call for studies of policy and institutional constraints to capital markets development. As countries begin to emerge from their banking crises, they will wish to focus more on these issues. After all, many of the problems of failing banks could have been avoided if their borrowing clients had been less highly leveraged. If they had been able to finance their operations to a greater extent through equity, the banking system would have been much sounder.

Observations.

2.60 Bank Competition and Privatization. While there is undoubtedly merit to the claim that private banks operating independently of government pressure can help improve the efficiency of financial intermediation, it is important to approach the question of privatization carefully. For a successful privatization the private purchasers must have the competence to operate the bank in a safe and sound manner, the privatized entity must be adequately capitalized and the price agreed must be a fair market value[21]. These conditions have not always been satisfied, notably in the early case of the Chilean privatizations of a decade ago. After a banking crisis there may be too few healthy banks to provide strong competition for one another; this is a real danger in some of the smaller African countries. The authorities will have to be vigilant in such circumstances to ensure that the banks do not abuse their market power. In some smaller countries, the close ties between the political and business leadership imply that the independence of the monetary authorities will not be sufficient to allow them to exercise the necessary control.

2.61 . Many governments are concerned with a perceived loss of sovereignty if foreign-owned banks come to dominate the financial system. Probably both the benefits and risks of foreign bank entry have been overstated. It seems clear that foreign bank presence in Eastern Europe will be small for the foreseeable future. Many African countries have not found foreign-owned commercial banks surviving from the colonial period to be particularly innovative or energetic in the pursuit of lending opportunities associated with local investment. However, foreign banks can provide valuable externalities through the training of local staff. Furthermore, although the commercial banking system in small countries is particularly prone to cartelization[22], entry of foreign banks, or the threat of it, can do something to inhibit the emergence, or at least limit the detrimental effect, of local monopolies.

2.62 The institutional structure of the financial system in emerging

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[21]It is not always easy to establish a "fair" price in the sale of a bank. Where the bank is being sold to small local investors, full disclosure by the government is important. Where the sale is to a foreign bank, the opinion of independent consultants may of course be sought, but it may be even more useful to enter into negotiations with more than one potential buyer.

[22]There are many examples of limited competition in the smaller countries. Rwanda plans to retain interest ceilings - though at realistic levels - because of lack of banking competition; Tunisia has done the same. Partial financial liberalization can also contribute to market power: Gambia is only one of several countries where the interaction of some interest rate liberalization and tight credit ceilings resulted in high bank spreads.

centrally planned economies is prone to cartelization as a result of sectoral specialization or of the sheer size of the state-owned banks. This represents a serious obstacle to financial sector efficiency which will need attention. In China and the USSR, commercial banking emerged only recently with the establishment of large sectorally specialized banks which existed side-by-side with the long-established foreign trade banks. In Poland, banks were specialized by region rather than sector. In Hungary, as well as in Poland, Romania and the USSR, household savings were essentially monopolized by one (or in Poland two) institutions. Even if legal barriers to competition between the banks are being eroded, the tendency has been for banks to start with a well-identified clientele and sector of specialization; furthermore the banks are each so large that it is hard for new entrants to compete. At the same time several of these large state-owned banks are burdened with a portfolio of bad loans. On the one hand, therefore, the big banks have a competitive advantage of size, which helps them offer a large branch network, money transfer facilities and so on; on the other they have the drawback of a weak portfolio which threatens their very existence. This situation too needs a comprehensive corrective program probably including separation of the bad portfolio out of the state-owned banks (which will help reduce their size as well as establish their financial independence on a secure basis); moving away from sectoral and regional specialization; privatization and liberalization of entry[23].

2.63 More generally, there could be a greater emphasis in Bank financial sector work on helping countries decide on the overall public policy for the role of banks in the economy. It can greatly help the development of day-to-day policy if realistic objectives for the banking system (e.g. efficiency, stability, competition) are codified in advance. Even if the programs have been motivated by the urgency of dealing with a crisis, governments could benefit, at the time of far-reaching financial sector reforms, from a careful consideration of such general issues as whether banks should be specialized or universal, the appropriate geographic balance of the banking system (for example national versus regional), and the question of who would be appropriate as owners of the banks. These issues are not entirely neglected in the operations being reviewed, but they deserve more emphasis.

2.64 Capital Markets. The question of whether the Bank should greatly expand the scope of its work in developing capital markets and the remainder of the non-bank financial sector is of immediate importance. On the one hand, the emphasis to date in Bank programs on the banking sector has probably been appropriate, since the commercial banks typically dominate the financial system in developing countries, and because the severe financial distress in the banking sector needs to be addressed promptly. On the other hand, the poor performance and decline of many DFIs means that they may have to be replaced as providers of long-term and venture capital funds by the capital markets and the insurance industry. Governments need to be aware of the gaps which are thus becoming evident in their financial systems and of the measures which can help ensure that these gaps are closed.

2.65 Nevertheless, it has to be said that positive direct government action to develop capital markets may be counterproductive, since these markets function better without too much government interference[24]. For example, close regulatory control over the quantity and timing of stock issues often stifles market development without really helping market stability. Likewise, the establishment of a government-owned stock-broker may inhibit the emergence of a

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[23] A complete review of questions specifically relating to reforming centrally planned economies is beyond the scope of this paper.

[24] This may also be true of the informal financial markets which perform important services in many countries, and whose potential deserves further study.

competitive market. The record does not offer much encouragement either to government-owned venture capital companies. Finally, although they have been popular in many industrial countries, positive tax inducements to share ownership, or to stock-market listing, risk eroding fragile tax bases in developing countries and are not to be encouraged in most circumstances.

2.66 Probably the most effective measures in this area are indirect ones. For example, privatization of state-owned corporations is a good way of increasing the supply of good quality equities that can be traded on the stock market, though this will rarely be the primary goal of privatizations. Market development will also be helped if foreigners are allowed to trade and if there are not too many restrictions, for example regarding the repatriation of capital. Also, apart from certain strategic industries, limits restricting the percentage of a quoted company that can be held by one shareholder should be used sparingly Many such restrictions were imposed to attain political objectives which are no longer relevant or which have not actually been achieved[25]. Many existing restrictions on capital markets were imposed to attain political objectives which are no longer relevant or which have not actually been achieved.

2.67 Many countries could move forward in the development of non-bank financial markets by removing distorting taxes and lifting unduly onerous restrictions on the investment portfolio of insurance companies and pension funds. At present, tax policies often favor interest-bearing rather than dividend or capital-seeking investments. Many insurance firms are de facto captive markets for Government securities and have few free resources left for private sector investment: it should be possible to allow these institutions to diversify their portfolios much more without compromising the safety of their policy-holders claims. If authorized to hold more equities, the contractual savings institutions can play an important role in diffusing the concentration of wealth and ownership of industry.

2.68 An important area of technical assistance which can be provided by the Bank is on regulation and supervision of capital markets. This is a highly technical area in which few developing countries governments have adequate experience. The tendency has been to have a regulatory regime which is unresponsive to changes in the market environment, which prohibits some activities unnecessarily while ignoring behavior that poses serious risks to investors. Technical assistance to overhaul the regulatory machinery and to put in place improved systems is clearly needed. Above all, accounting and disclosure requirements must be strengthened to provide better information to potential investors. The deficiency of information is a serious barrier to the development of the equity market, as it is to all financial transactions. However, it is not clear that these technical improvements represent the type of broad-based policy reform that warrant quick disbursing adjustment loans.

2.69 Capital markets need the support of an institutional infrastructure (including brokers, exchanges, legal framework, supervision, etc.). Some of this requires government action and this is likely to be an area where Bank and IFC advice is increasingly sought. But as mentioned caution is called for in advocating the creation of new government institutions to support such markets where private institutions will serve as well. Task managers should ensure that adequate coordination takes place with the IFC, to avoid duplication of efforts and to ensure that all areas of capital market development (appropriate to the country's stage of development) are being covered.

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[25]However, most countries find it beneficial to have disclosure requirements once ownership passes certain percentage limits, and some insist on public tenders beyond various thresholds.

III. Project Design Issues

Commitment and Capacity to Implement

3.1 An adjustment loan will rarely succeed if the government is not committed, willing and able to implement the policy program. As the political costs of financial sector reforms are perhaps less obvious than in the case of other sectors, and because these reforms call on technical skills that are not well-developed in many countries, achieving these preconditions can be problematical.

Box 4: Politics and FSALs

The politics of restructuring financial institutions often makes agreement on adequate conditionality problematical, especially when the banks concerned are owned by persons with considerable political influence. In several of the loans, countries have not complied fully with the agreements set out in the design of the program. In Kenya, for example, the restructuring of several financial institutions was delayed and several institutions exempted because of pressures coming from the owners of those institutions. Political pressures can, on the other hand, work in different ways. For example, after a change of government political considerations can help accelerate the process of bank reform. An example is provided by the Philippines, where the banks that were financing the Marcos regime were quickly reformed after the revolution of 1986 (supported by the Bank with its Economic Recovery Loan). In Cameroon it is noteworthy that the four large banks that were liquidated between them covered the various political and regional groupings, suggesting that it was possible to maintain a political balance.

Another area of political pressure relates to the Government's access to financial resources through the banking system. In Argentina, the government was not prepared to meet conditionality which would have reduced its ability to finance government expenditures through the financial system, and would have necessitated either higher explicit taxes or reductions in government spending.

3.2 In several of the FSALs under review, countries failed to implement components fully because of political opposition (Box 4). A comprehensive reform program, in a country with extensive financial distress and significant distortions, is likely to entail considerable political risks for its leadership. Interest rate reforms may affect vested interests in politically sensitive sectors, such as rural agriculture. Restructuring financial institutions may also require political support, particularly if governments need to oust incompetent and corrupt managers and reduce access to credit for powerful individuals and groups. When banks are closed, bank employees will lose their jobs. In many cases where on technical grounds closure of insolvent banks seemed preferable to a financial restructuring the banks nevertheless survived, albeit in a scaled down form (e.g. Philippines, Kenya, Senegal).

3.3 The question that must be asked here is whether the political pressures have been adequately assessed. On the one hand it would be foolish to proceed without sensitivity to the political realities; on the other hand, Bank staff can help provide a political counterweight to be used by reforming governments against internal opposition. In some cases where the Bank was not involved, failed banks were simply closed (for example, Chad and Guinea).

3.4 The complexities inherent in restructuring financial institutions, reforming legal codes, and meshing monetary and fiscal policies with other sectoral reforms call for a high level of sophistication, both within the Bank as well as within the countries undertaking the reforms. In some countries, particularly in Africa and South Asia, reforms are likely to suffer because sufficiently trained staff are lacking in both the key government agencies (particularly the central bank) and the private sector.

3.5 Substantial training and technical assistance may be required before comprehensive financial sector reforms are accomplished. Experience suggests that training local staff is much more likely to result in wholehearted adoption of a reform program as well as its credible implementation than if consultants

are used for implementation. In some countries regulated salary structures fall far short of what is necessary to attract staff with the requisite abilities, and this needs to be corrected within budgetary limitations and taking account of local circumstances.

3.6 By contrast, countries like Chile, Malaysia, Singapore and Thailand have reached the stage where their government agencies can provide considerable technical assistance on financial sector issues to other developing countries. The Bank has begun to promote the use of consultants from these countries and in this role.

Macroeconomic Preconditions

3.7 The appropriate sequencing of economic reforms is widely discussed, with a conventional conclusion being that reform of goods prices (e.g. trade policy reforms) should precede liberalization of financial markets. In addition, it is maintained that macroeconomic stability must be achieved before financial markets are fully liberalized. Certainly, some of the early financial liberalization programs, especially those implemented in Latin America in the early 1980s, had no chance of surviving the turbulent macroeconomic conditions into which they were introduced. Although macroeconomic instability may have contributed to the perceived need for reform, the extremely high interest rates which followed decontrol, and which bankrupted many borrowers, were not anticipated. A similar phenomenon has been observed again more recently in Turkey, Argentina, Brazil and Mexico (Box 5).

3.8 Private capital inflows and outflows, distress borrowing by banks and their clients, and risk premia demanded by savers may have all played a role in the financial market turbulence which was experienced in these countries. Nevertheless, the conclusion that has been drawn from the Southern Cone experience is that interest rate liberalization should not be attempted where inflation rates are high and variable, budget deficits are out of control, or where external capital flows are especially volatile. Such macroeconomic imbalances must be corrected quickly and inflation brought under control before complete liberalization of interest rates is attempted. Coordination with the IMF (Box 2) is of greatest importance in this area to avoid premature liberalization, which could derail stabilization efforts.

Box 5: High Interest Rates

Countries which have not addressed problems of high inflation, excessive current account and fiscal deficits, or whose banking systems have negative net worth, are likely to face skyrocketing interest rates when they liberalize. In such environments, depositors will demand a higher premium for their funds, especially given the uncertainty of its value in a year's, month's or sometimes even a day's time. In Argentina, real interest rates reached 175 per cent per month in the first half of 1989. Interest rate liberalization in Turkey during an exchange rate crisis in October 1988 resulted in a 20 percentage point increase in one-year deposit rates to 85 per cent per annum before a ceiling was again imposed by the Central Bank. To remunerate such a high marginal cost of funds and to pay for the various reserve requirements and obligatory lending to preferred sectors etc., banks would have had to charge about 127 per cent to non-preferred borrowers, compared with an inflation rate of about 65 per cent.

3.9 This view of sequencing, which is now enshrined in Bank policy, at least so far as inflation rates are concerned, was not followed in several of the loans under review. Neither of the Turkey loans would have satisfied the draft Operational Directive's presumption against making an FSAL where the annual inflation rate exceeds 30 per cent. In Ecuador, inflation soared to an annual rate of 100 per cent shortly after disbursement of the first tranche (contributing to the delay in disbursing the second tranche). More recently the Venezuela loan went ahead despite inflation of 85 per cent in the twelve months before appraisal; a very recent slowdown in the rate of inflation was apparently considered sufficiently encouraging.

3.10 It would be easy to jump to the conclusion that financial sector

reforms should therefore be postponed to a late stage in the sequence of reforms. However, there are many institutional reforms that take time to implement and should be started early on, despite unfavorable macroeconomic conditions[26].

3.11 Even in the area of interest rate reform, much can be done short of full liberalization. Government action to rationalize interest rates is often an appropriate first step (particularly in countries where structural adjustment has just begun) rather than full liberalization. Rationalization should focus on establishing an internally consistent set of interest rates, at a realistic level. Deposit rates need to be set at rates which will attract savings into the financial system. Lending rates need to be pitched at a level which will adequately compensate lenders for the costs of intermediation and to differentiate for varying levels of risk and maturities. Preferential rates on directed credit programs should be dismantled. Governments can move in most of these areas without fully liberalizing markets, and before achieving macroeconomic stability. Much can also be done to prepare the ground for reform by taking the steps of institutional strengthening which have already been discussed[27].

Price Distortions and Enterprise Restructuring

3.12 Banks operating in an economy with severely distorted prices have a difficult time evaluating loan proposals. Borrowers whose activities are profitable under the prevailing regime may become insolvent if and when prices are reformed, as in Turkey before trade liberalization and Ghana before the exchange rate reform. The same is true in planned economies such as China, where a large proportion of the banks' portfolios represent loans to heavy industry which could no longer function if input prices were lifted to world levels.

3.13 Only by confining themselves to very short-term or well-collateralized loans could the banks be sure of surviving price reforms in such an environment. Although many financial reforms can be undertaken even in these circumstances, an all-out liberalization of the financial system while the threat, or indeed the inevitability, of price reform exists would be very risky and cannot be recommended. When prices are rationalized, a further rescue of the financial system will surely become necessary. Moreover, freeing the financial sector while the real sector continues to operate with distorted prices could add significantly to the volume of misdirected credit.

3.14 If trade or price reforms have produced widespread insolvency in the industrial and commercial sectors, enterprise restructuring should be one of the first steps in the process of financial sector reform. Clearly this is a large issue going beyond the scope of the present paper; only a few remarks are made here. It generally calls for a comprehensive, long-term and carefully sequenced effort. At all stages committed and competent local participants must be involved: it cannot successfully be imposed from outside. Bankers and financial experts will need to be trained in corporate restructuring. The restructuring should be geared towards the promotion of a competitive response to market changes, and therefore accompanied by removal of entry barriers and restrictions on trade as well as anti-competitive labor practices - whether imposed by cartels or by excessive government regulation. It is important that labor issues be

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[26]Institutional infrastructure reforms in the CFA franc countries in Africa represent an example of important work that can be pushed ahead despite unfavorable macroeconomic conditions.

[27]Sequencing issues are especially difficult in emerging socialist economies. The Board paper, "The Transformation of Economies in Central and Eastern Europe: Issues, Progress, and Prospects," April 4, 1991, contains a discussion of these issues both in the main text and in annex 4.

carefully addressed, including questions of severance pay and worker retraining. All of this implies a commitment of technical assistance resources on a greater scale than has been customary to date.

3.15 Financial sector liberalization should probably be tackled only where the clientele of the banking system can reasonably be expected to be profitable in the medium term (at undistorted prices).

Size and Type of Loan

3.16 The typical financial sector adjustment loan is large (up to $500 million for large countries) and quick-disbursing, normally in two tranches over a 12-18 month period. In line with the conclusion of RAL2, it is arguable that slower disbursing loans, of perhaps a smaller magnitude, would be more effective in supporting the kind of reform program undertaken.

3.17 It is unquestionable that, more often than not, loan size for FSALs has been driven by overall balance of payments financing requirements for the country and by the extent to which the Bank is committed to helping fill the gap. Furthermore, in some cases direct cash costs of financial reform have been negligible (as where regulations or laws are being revised). In most cases, the technical assistance component of loans has been a small fraction of the total. Even where funds have been required to recapitalize banks or deposit insurance agencies, it is not clear that the immediate impact of these measures on the countries foreign exchange needs have been very great: the funds required have been in domestic currency, not foreign exchange. Only where the access of depositors to funds has been blocked, and where unblocking the deposits will lead to increased purchases of imports is there a direct link between financial sector reform and current account balance of payments needs (Box 6).

3.18 It is already well accepted that FSALs should not be undertaken without the Bank having a clear strategy for the whole financial sector. This strategy should cover the three areas of relieving financial repression, institutional rehabilitation and market deepening. Furthermore, as already made clear in RAL1 and RAL2, a precondition for financial sector adjustment lending as in the case of other sectors, is that the Bank and the government should have reached an understanding on the diagnosis of the main impediments to growth across sectors. Without such an overall agreement there could be a risk that needed reforms might be effectively postponed by the decision to provide balance of payments financing through sectoral loans.

3.19 The RAL2 report recommended longer periods of disbursement for complex sectoral reforms, and this recommendation is especially relevant for financial sector loans. Already a few financial sector loans have moved in this direction of the slow-disbursing FSAL and have tried to link tranching to the anticipated pace of

Box 6: Cost of reforms

In loans which are largely oriented toward reforming the prudential supervision framework, the real costs to the government, political and financial, may be negligible, particularly if the conditionality is limited to studies, preparation of action plans and drafting of legislation.

On the other hand, where significant interest rate reform is involved, governments may need to marshall political support, particularly if the reforms will affect vested interests in industry or politically sensitive priority sectors. Nevertheless, it may be noted that interest rate reforms in several countries have preceded the FSALs, in some cases (Philippines, Bolivia, Uruguay) by a very long time.

Restructuring financial institutions may require both political and budgetary resources. On the political front, governments often need to oust incompetent and corrupt managers or directors and reduce credit to powerful individuals and groups. Many bank employees may have to be laid-off. Governments may encounter more resistance if they are restructuring private sector institutions, rather than government institutions under their own control. (In the Philippines, for example, officials of the Central Bank have been threatened with legal action by owners of intervened banks; the FSAL includes legal reforms designed to protect officials from unreasonable harassment.)

reform by breaking away from the two-tranche model. Given the strong institutional orientation of many of these operations, even more flexible tranching arrangements should be encouraged. Trying to compress an institutional reform program into an 18-month period leaves little time for adequate preparation of the program and even less leverage over its implementation. In many cases, Bank staff foresee from the start a need for additional loans to carry out the reforms already envisaged at the time of the first FSAL. Existing instruments do not seem to allow Bank staff to plan and execute a multi-year reform project in a coherent manner[28].

3.20 The Bank should consider using a broader array of instruments to carry out financial sector reform programs, with disbursements and expenditures tied more explicitly to the reform process. It may be necessary to go beyond the specific recommendations of RAL2 in this regard. For programs which emphasize technical assistance (i.e., banking supervision, legal reforms, strengthening audit and accounting standards, etc.) a pure technical assistance loan or a line of credit with significant technical assistance may be more appropriate than a large quick-disbursing credit. In fact it may often prove appropriate to have a battery of operations focussed on the various needs of overall financial sector reform. Line of credit operations are already being used to support financial sector reforms in Sri Lanka and Madagascar. The recent loan to Hungary for modernization of the banking sector is a kind of technical assistance loan which represents a good illustration of a major initiative targeted to precise financial sector needs and disbursed in accordance with implementation of the reforms. All too often in the past the technical assistance component has been seen as a subsidiary element to the quick-disbursing part of loans supporting financial sector reform. It is desirable that technical assistance receive a new emphasis in this context, including a new effort to convince governments, which are sometimes reluctant to borrow to finance technical assistance, of the benefits to be gained. TALs should receive special emphasis in markets where the human resources in the financial sector are least developed, which is usually in both the poorest developing countries and in emerging socialist economies. On the other hand, developed but distorted financial markets may need relatively little technical assistance, and instead more help in overcoming political barriers to change.

3.21 FSALs often serve as the beginning of concentrated involvement with the financial sector. Financial intermediary loans (FILs) can be used to follow up on institutional development. Bank FILs usually involve an apex lending institution as an intermediary, which in turn onlends the funds to private or public sector enterprises, and they also differ from most FSALs in that they are slower disbursing loans (since they disburse only as the ultimate borrower draws on the credit lines provided by the FIL). In addition to being used to channel resources to various productive activities, FILs are also used to promote the development of specific intermediaries, strengthen overall financial sector reforms, or to broaden financial markets (such as through the introduction of new instruments). Thus they may be an ideal follow up to an FSAL, especially for long-gestating institutional development.

Enforceability.

3.22 If the large sums being committed to FSALs are justified by the cost and difficulty of the policy measures which they support, it is important to be sure that the adjustments are actually made. The issue of non-implementation and of reversing reforms has been highlighted in the cases of Argentina and Turkey.

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[28]One instrument that is available, and is advocated by some, is the one-tranche FSAL, to be disbursed only when the reform program is substantially implemented. An alternative approach is to have several smaller FSALs in sequence, rather than one big FSAL.

In both cases, their inability to deal effectively with macroeconomic instability prevented the governments concerned from achieving the objectives of reform. In Argentina, the loan was not disbursed, despite significant amendments and resubmission to the Board.

3.23 In Turkey, five SALs (three of them involving many financial sector conditions) and two FSALs amounting to $700 million have been approved since 1981. While many important reforms have been undertaken in other sectors under the SALs and some key institutional questions tackled in the financial sector, the Turkish financial sector remains highly distorted. Apart from failure to implement loan conditions, which were then included in a subsequent loan and thus, arguably, were "paid for" twice over, the case of Turkey provides examples of policy reforms being reversed, generally under pressure of budgetary or balance of payments crisis. Perhaps in this case conditionality was too optimistic to begin with, leading to a softening of conditions which tended to become self-perpetuating.

3.24 If governments fail to implement agreed conditions, or if they reverse policies, then the Bank has a number of sanctions available to it. For instance, it can, and does, refuse to release tranches. The Bank's recent refusal to disburse the floating tranche of the Turkey FSAL2 may have helped proponents of reform to make fresh headway in Turkey. Should there be reversals of policy after disbursement of the loan, the Bank can still respond (short of calling the loan) by suspending preparation of subsequent operations.

3.25 Other early loans have also encountered some implementation problems. As mentioned above, institutional reform in Ghana has been much slower than scheduled, and the second tranche was disbursed only after a long delay. In Ecuador, a change of government meant that implementation, though closer to the schedule, appears to have been somewhat half-hearted in several areas, including interest rate and preferential credit reform.

3.26 Nevertheless, there is evidence that financial sector conditionality has been enforced at least as effectively overall as in other fields. The review of adjustment lending conditionality carried out by IENIN indicates that 62 per cent of financial sector conditionality was fully implemented, compared with an overall figure of 57 per cent. Among critical conditions, 91 per cent were fully or substantially implemented in the financial sector compared with less than 80 per cent in other sectors. Nor has implementation of financial sector conditionality been derailed by negative shocks: in countries with such shocks 83 per cent of financial sector conditionality was fully or substantially implemented, compared with less than 73 per cent for other sectors.[29]

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[29] Implementation was much less complete for the less heavily indebted middle income countries: only 30 per cent of financial sector conditionality was fully implemented in those countries, compared with 53 per cent for other sectors. This may reflect the greater leverage the Bank has vis-a-vis the low-income countries. These estimates of implementation rates may need to be revised in the light of an OED study now in progress.

MATRIX 1: OBJECTIVES OF LOANS

ARGENTINA	1. Increase deposit mobilization and confidence in the banking system; 2. Improve credit allocation; 3. Reduce the cost of credit.
BANGLADESH	1. Reinforce the government's fiscal efforts; 2. Reduce interest rate subsidies; 3. Assist financial restructuring of nationalized commercial banks.
BOLIVIA	1. Increase resource mobilization and confidence in the banking system; 2. Strengthen the financial conditions of banks; 3. Reduce the high cost of credit.
CHILE SAL2	1. Consolidate the banking sector and reprivatize intervened banks; 2. Strengthen the regulatory framework for the financial system; 3. Raise corporate saving and investment.
SAL3	1. Improve efficiency of long-term intermediation; 2. Develop capital markets; 3. Enhance diversification and security of pension funds.
FML	1. Strengthen securities markets and the banking system; 2. Provide additional funding for the emerging leasing sector.
ECUADOR	1. Strengthen the financial condition of financial institutions; 2. Raise the efficiency of financial intermediation; 3. Encourage long-term capital development and lending.
GHANA	1. Enhance soundness of banking institutions; 2. Improve deposit mobilization; 3. Develop money and securities markets.
JAMAICA TFSL	1. Improve efficiency of long-term intermediation; 2. Strengthen capital markets; 3. Provide a wider array of financial instruments.
KENYA	1. Improve resource mobilization and allocation; 2. Improve the efficiency of financial intermediation; 3. Foster financial prudence and discipline; 4. Increase confidence in and enhance the soundness of banking system; 5. Broaden and deepen capital and money markets.
MEXICO FSL1	1. Reinforce government's fiscal efforts; 2. Strengthen prudential regulations and supervision; 3. Reduce interest subsidies and fiscal transfer for them.
FSL2	1. Provide framework for macroeconomic consistency; 2. Assure permanent reduction in inflation and sustainable fiscal stance over medium term; 3. Provide precondition for recovery of growth.
NEPAL SAL	1. Encourage healthy development of commercial banking sector.
PAKISTAN	1. Rely increasingly on market-oriented mechanism for allocating credit; 2. Improve the health and efficiency of the banking system; 3. Establish a more efficient system to issue Government debt.
PHILIPPINES ERL	1. Reform tax system, trade policy and public investment program 2. Improve efficiency of government financial institutions.
FSL	1. Strengthen bank supervision and regulations including the legal framework; 2. Institutional arrangements for depositors' protection; 3. Reduce the high intermediation costs; 4. Improve fund mobilization and allocation of long-term credit.
SENEGAL	1. Introduce institutional and systemic changes to insure against systemwide failure; 2. Restructure the insolvent banking sector; 3. Improve financial intermediation.
TURKEY FSL1	1. Improve resource mobilization and allocation of credit; 2. Strengthen bank regulations and supervision; 3. Develop capital markets.
FSL2	1. Improve mobilization and allocation of funds and support financial deepening; 2. Foster a competitive banking environment and financial discipline; 3. Develop secondary market for government securities; 4. Promote foreign portfolio investments.
URUGUAY SAL2	1. Restore banking system to solvency; 2. Restructure the commercial banks for ultimate reprivatization; 3. Develop capital markets.
VENEZUELA	1. Liberalize financial policy environment; 2. Reduce government's direct role in financial intermediation; 3. Strengthen competitiveness and financial condition of intermediaries.

POLICY MATRIX 2.a
REFORM: INTEREST RATE

ARGENTINA	In 1987 all deposit rates were liberalized, as were loans financed with these deposits.
BANGLADESH	Government moved to more market-oriented approach to interest policy; money market rate to be market-determined.
BOLIVIA	Maintenance of market-oriented interest rates and eventual phasing out of the special exclusion for development-linked loans.
CHILE FML	Interest rate revised to encourage domestic savings.
ECUADOR	A certificate of deposit with a market determined rate has been created, and interest rates on all deposit instruments and on lending instruments other than those funded by the Central Bank have been freed; the minimum on-lending rates of the Central Bank preferential credit have been raised.
GHANA	Since February 1988 all interest rates have been liberalized.
JAMAICA	Removal of minimum saving deposit rates.
KENYA	Maintenance of positive real interest rates for loans and deposits; subsequently the government plans to liberalize all remaining administered interest rates (by June 1991).
MEXICO FSL1	Interest rates on bank deposits have been liberalized. Since project appraisal, the government has eliminated most interest rate subsidies.
FSL2	Actions taken to remove most interest rate subsidies.
NEPAL	Most interest rates have been liberalized; the remaining administered lending rates will become free gradually.
PHILIPPINES FSL	Adopt a general policy of market-oriented interest rates on all government sponsored loan programs and those funded by official borrowing; eliminate subsidies and distortions.
PAKISTAN	Increase rates of return on all concession schemes to positive real rates and further movement toward market rates of interest.
SENEGAL	In August 1989 the UMOA's Council of Ministers decided to suppress the two rediscount rates (i.e. normal and preferential) and to use the money market rate as the central rate. Its level was initially to be aligned with Paris rates and eventually determined by supply and demand.
TURKEY FSL1	Commitment to real positive rates on term deposits and achievement of positive real rates for preferential credit to the productive sector.
FSL2	Positive real rates on deposits but no liberalization of deposit rates because of fiscal situation and financial instability. Positive real lending rates to productive sectors, including agriculture by second tranche.
VENEZUELA	Interest rates i) to reflect opportunity cost and to encourage resource mobilization; ii) to vary based on risk and cost of funds; iii) to quickly respond to changing economic conditions; iv) to free from administrative determination.

POLICY MATRIX 2.b
REFORM: CREDIT ALLOCATION

ARGENTINA	Rediscount program was to be streamlined and scaled back over time and some rediscount rates increased.
BANGLADESH	Cost of subsidized lending to priority sectors to be made transparent in the interest rate schedule; government pay interest on loan to a public enterprise.
CHILE SAL2	Focus of credit allocation shifted towards private sector.
ECUADOR	Reduce the number of the Central Bank credit lines as well as the supply of credit to FI's.
GHANA	Discontinue sectoral credit targets; establish mechanism and criteria for determining use of special lines of credit and other schemes to be used only in specific circumstances; review efficacy of Credit Guarantee Scheme.
MEXICO FSL1	Elimination of forced lending to the Government and other favored sectors of the economy; new loans through development banks and trust funds will not carry any interest rate subsidies except for those to low income producers in agriculture.
FSL2	Distorting credits reduced.
PAKISTAN	Limit on mandatory sectoral credit targets and phase out refinance for special credit lines.
PHILIPPINES ERL	Reduce share of government financial institutions, and eliminate their special advantages in tax and credit.
FSL	Reduce and eventually eliminate the directed credit program; eliminate subsidies and distortions to allow for the Development Bank of the Philippines to act as a wholesaler of long-term funds.
SENEGAL	Abolition of targeted credit quotas by decree of September 1989; agreement to a study on measures which would permit the elimination of bank-by-bank credit ceilings.
VENEZUELA	Central bank's credit to be priced according to market conditions.

POLICY MATRIX 2.c
REFORM: CONDUCT OF MONETARY POLICY

ARGENTINA	During 1986 and 87, reductions in reserve requirements for incremental deposits were implemented.
BANGLADESH	Technical unit established to implement active monetary policies; subsidized refinance facility for priority sector replaced with more general rediscount facility; Central bank issued its own interest-bearing securities.
ECUADOR	Establish short-term reference rate for long-term instruments (before the release of the second tranche the Government must have started auctions of a first issue of Treasury Bills or stabilization bonds); promote variable rate long-term financial instruments.
GHANA	Development of indirect instruments for monetary management to absorb or inject liquidity as and when required; development of the secondary market in Government backed-securities and commercial paper and use it to manage twin objectives of liquidity and profitability.
JAMAICA	Phase out the liquid asset ratio as a tool of monetary policy (the Government reduced the liquid asset ratio from 48% to 38% of prescribed assets in 1986, and further to 35%, including a non-cash portion of 15% as of March 31, 1987; non-cash portion of the liquid asset ratio was to be eliminated prior to second tranche release).
KENYA	Move toward a reserve money management system rather than reliance on credit ceilings to contain monetary growth. The Government introduced 6% cash reserve ratio for commercial banks in 1986, activated a Central Bank rediscount facility in early 1988, and initiated the auction of Treasury bonds of 1-5 years maturities in 1988. The government is committed to maintaining positive interest rates. The central bank has taken measures to develop secondary market.
PAKISTAN	Announcement of Government program to issue three to twelve months securities at auction; appointment of primary dealers and establishment of proper institutions/procedures at the State Bank of Pakistan and the Ministry of Finance.
SENEGAL	Abolish bank-by-bank credit ceilings and replace them with indirect instruments of monetary control (e.g. mandatory reserves).
TURKEY	Gradual elimination of transaction taxes and reduction in reserve and liquidity requirements but ties to progress on fiscal front and a study of taxation of financial instruments.
VENEZUELA	Reviews of monetary instruments aiming at enhancing flexibility and effectiveness and reducing disruptive effect.

POLICY MATRIX 2.d
REFORM: BANKING REGULATION & SUPERVISION

ARGENTINA	Key accounting regulations amended to take account of weaknesses in prudential regulation (i.e. loan classification and interest accrual on non-performing loans).
BANGLADESH	New supervision/inspection institutions to be formed and staffing doubled; major training effort made; data collection and monitoring to be improved.
BOLIVIA	Government established an independent banking superintendency with licensing and regulatory powers and a firm legislative basis (but apparently not charged with bank inspections). Some regulatory reforms (e.g. loan portfolio classification, provisions and interest accruals) embodied in legislation. A division (GSF) of Central Bank has been established to try to anticipate banking crises and provide financial assistance to problem banks. Twice yearly audits of all banks made mandatory.
CHILE SAL2	Strengthen monitoring systems of superintendency of banks and SBFIs. Provision adequately for losses on loans, investments and repossessed collateral assets.
SAL3	Improve public awareness of disclosure limits; create more flexible system of risk classification for securities and strengthen prudential regulation of mutual funds and insurance companies to require diversification and limit related-party investments.
FML	Technical assistance component to support government supervision institutions.
ECUADOR	Reform banking law to facilitate mergers among banks and DFIs; evaluate portfolio quality of financial institutions; exclude all overdue interest from FI's income unless it's fully provisioned.
GHANA	Implementation of prudential measures such as establishment of a minimum capital adequacy ratio; limitation on exposure to single borrowers; require audit reports on banks to be submitted to the central bank based on international standards; require banks to classify their portfolios according to internationally accepted guidelines; strengthen internal controls and in-house audits of banks, external audit using international auditors.
JAMAICA	Strengthen banking inspection department of Central Bank; draft banking legislation aiming at strengthening supervisory powers.
KENYA	Revised banking Bill to strengthen Central Bank's ability to intervene expeditiously in troubled institutions; set out appropriate prudential supervision and reporting requirements; enable Central Bank to impose penalties on financial institutions without meeting requirements of banking act. Issue regulations which link capital adequacy requirements to assets and require banks and NBFI's to maintain capital of 7.5% of assets, including off balance sheet items. Develop standardized financial reporting formats in cooperation with banking and accounting industries.
MEXICO FSL1	Prepare an action program to improve prudential supervision, including provisioning, disclosure requirements, and supervision of brokers.
FSL2	Laws on money market passed; action program to be established to address problems in loan classification be riskiness, stringent provision for loan losses; disclosure of banks' financial state, and better supervision system.
NEPAL	Uniform financial statement formats for banks; a committee to set criteria for bank external audits and review audit reports; new loan classification system and accounting policies for provisions and interest suspension; Credit Information Bureau. Implement prudential measures such as establishment of minimum capital adequacy ratio and limitation on exposure to any single borrower.
PAKISTAN	Strengthen Central Banks' prudential regulations; broaden institutions monitored to include some non-bank financial institutions, review its organization and establish a credit bureau by second tranche; improve legal environment for debt recovery and settle Government-guaranteed debt to banks.
PHILIPPINES ERL	A system to improve performance monitoring of government financial institutions.
FSL	Strengthen bank supervision and regulation including legal framework, guidelines for asset valuation and loan loss provision, commercial banks' reporting requirements, accounting principles governing preparation and reporting of bank's finance.
SENEGAL	Upgrade bank inspections and ensure follow-up of inspection reports; update banking laws and regulations and develop a uniform accounting system.
TURKEY	Imposition of fixed maturities on all loans; revision of loan classification system; reductions in loan concentration; increase number of bank examiners; audit of banks by external auditors including portfolio audit; tighten entry requirements.
URUGUAY SAL2	Adopt uniform financial statement formats for banks; establish a new loan classification system and accounting policies for provisions and interest suspension. Implement prudential measures such as establishment of a minimum capital adequacy ratio and limitation on exposure to any single borrower.
VENEZUELA	Autonomy and authority of bank supervision institution to be strengthened; regulations on banks to be tightened.

POLICY REFORM MATRIX 2.e
REFORM: BANK RESTRUCTURING

ARGENTINA	The Government established a deposit insurance corporation with extensive power to restructure or liquidate insolvent banks. The Central Bank sold the loan portfolio of 180 liquidated institutions through public tenders.
BOLIVIA	The three major public sector banks were seen as in need of major restructuring. The mining bank BAMIN was to be partially privatized. Adoption of satisfactory plans of action and implementation schedules to restructure the agricultural bank BAB (probably involving its conversion into a full service bank) and the BANEST was a requirement for credit effectiveness.
CHILE FML	Recapitalize the five intervened banks and reprivatize them. Establish a Deposit Insurance Scheme.
ECUADOR	Establish a mechanism to reorganize troubled financial institutions and guarantee their deposits; three banks and two DFIs entered rehabilitation programs.
GHANA	Formulation of a framework specifying the modalities for restructuring banks, in particular measures for dealing with non-performing loans, including loans to state-owned enterprises; and rescheduling or conversion of Government's loans to banks. Proposals and targets for a reduction of banks non-performing portfolio.
KENYA	The Government had prepared a detailed program for restructuring ten of the weakest institutions; with technical assistance, the Government is expected to carry out this program.
MEXICO FSL1	An action program for restructuring the DFI's including a redefinition of their loans, reduction in transfers and improved efficiency of their operations.
FSL2	Financial institutions merged; commercial banks restored to solvency and their capital increased; fund to finance restructuring banks; one-third of commercial banks sold privatized; commercial banks to be run on commercial basis.
NEPAL	Prepare "independent problem analysis and strategy study" to strengthen the two largest commercial banks RBB and NB. Require RBB and NB to prepare action plan for improving debt recovery.
PAKISTAN	Development of a restructuring plan for the NCB's by the Central Bank, looking at their portfolio quality, providing them with more autonomy, abolishing obligatory consortium financing and announcing the disinvestment of NCBs up to 20% of their capital.
PHILIPPINES ERL	Establish new charters and policy statements for government financial institutions; install new management teams and boards of directors; transfer non-performing loans to governments; and reduce staffing.
FSL	Appoint the Philippines Deposit Insurance Corporation by law to act as receiver/liquidator of failing banks and increasing its capital.
SENEGAL	Purge private/semi-public banks of non-performing assets through write-offs or restructuring or liquidate public banks. Establish a viable financing scheme for write-off of non-performing assets and liquidation of public banks, with appropriate burden sharing by Central bank, Government and private shareholders.
TURKEY	Study of exit mechanism for dealing with insolvent banks, with its establishment by second tranche; action plans for state-owned banks by second tranche.
URUGUAY SAL2	Establish an interim institutional arrangement with the National Development Corporation for the transfer of ownership and control of three insolvent banks from Banco Republica to the market.
VENEZUELA	Some government-owned banks to be privatized; a few banks to be liquidated or restructured.

POLICY MATRIX 2.f
REFORM: CAPITAL MARKETS

BANGLADESH	Capital markets to be strengthened; a committee established to study and design the market framework.
CHILE SAL2	Amend law to permit wider participation of pension funds in equities; reduce stamp tax; modify tax laws to encourage equity investments, notably by rendering more advantages to eligible mutual funds.
FML	Securities market was primary focus of financial reform; measures to broaden institutional investors possibilities structures; legal and regulatory framework liberalize investment of pension funds and life insurance companies; leasing sector to be developed.
ECUADOR	Companies law has been reformed to permit firms to issue bonds not backed by specific real assets; to require higher minimum capital; and to require external auditing of larger firms.
GHANA	Conduct study of investors, corporate issuers and secondary trading to determine demand; Review the experience in other countries, possibly with IFC assistance; develop with technical assistance a suitable regulatory framework depending upon outcome of study; give financial and logistical support to Institute of Chartered Accountants (ICA) to review and upgrade auditing standards for corporate sector.
JAMAICA	Strengthen capital markets via reducing fiscal constraints (i.e., reduce the differences in taxation of credit and equity); development of new financial instruments; and analyze capital markets to identify the policy and institutional changes needed for more efficient financial intermediation; establishment of an interim stock market inspection unit.
KENYA	Agree with IDA on appropriate form of taxation on financial instruments and implement appropriate investor protection measures.
TURKEY	A study of Government securities market, including steps to stimulate secondary market activities.
URUGUAY SAL2	Modernize laws, regulations and judicial procedures concerning leasing, corporation, investment, banking and bankruptcy procedures.

A2 Rationale

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

cc: Riedel

Office Memorandum

DATE: July 15, 1992

TO: Messrs. Mitra, Nankani, Selowsky, Squire, Thomas

FROM: Anandarup Ray, Acting Director, DPG

EXTENSION: 31443

SUBJECT: Paper on Adjustment Lending: Some Analytical Issues by Mr. T. N. Srinivasan

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Please find attached a paper that we had requested from Mr. Srinivasan in connection with DPG's work on the rationale for adjustment lending. We would greatly appreciate your comments, and suggestions for elaboration, if any, by August 10.

cc: Mr. Grilli (o/r)

/sb

July 15, 1992

TO: Mr. Jim Riedel

Paper on Adjustment Lending by Mr. T. N. Srinivasan

Enzo and I would appreciate your reactions before you leave, if at all possible.

Anondo Ray

cc: Mr. Grilli (o/r)

July 1992

ADJUSTMENT LENDING: SOME ANALYTICAL ISSUES

T. N. Srinivasan
Samuel C. Park Jr. Professor of Economics
Yale University

1. Introduction

The origins of structural adjustment loans (SAL's) were the serious balance of payments problems of many developing countries stemming from the second oil shock of 1979 and from domestic policy experience. Although SAL was initially "expected to last three to five years for a particular country...(it) has nevertheless intensified rather than disappeared as the terms of trade for most developing countries deteriorated further, real interest rates increased, and the debt crisis and slow growth persisted. Moreover, the scope of adjustment operations has widened as the Bank has increasingly undertaken sectoral adjustment loans" (World Bank (1988), p. 10). The original purpose of SAL in 1980 was "to assist countries...prepared to undertake a programme of adjustment to meet an existing or to avoid an impending balance of payments crisis" (Ibid, p. 10). Three features of SAL were to distinguish it from traditional project lending and occasional programme lending: "First, it will be a fundamental instrument for the dialogue between the Bank and the country on various aspects of development policy and on the nature and scope of changes to be supported. Second, it will provide finance over a number of years in direct support of specific policy reforms. Third, it would provide foreign exchange to fiance imports not linked in advance to specific investment programmes. Such loans would therefore disburse quickly" (World Bank 1988, p. 10 quoting from a February 5, 1980 memorandum to the Board of Executive Directors). Of the three, the

really important distinguishing feature is the first. Indeed it is difficult, if not altogether infeasible, to achieve policy reforms through conditionality clauses in project and programme lending. After all, "To have made loan agreements for financing, say, a port or power project, conditional on economy-wide policy reforms would not have been effective" (World Bank (1988), p. 12).

The original purpose or rationale for SAL, was "to meet an existing or to avoid an impending balance of payments (BOP) crisis." Not only was SAL expected to help underwrite the adjustment programme (i.e. a medium-term macroeconomic framework worked out by the country with more or less help from the Bank) by providing part of the external finance but also act as a catalyst for external financing from other lenders. It is worth noting that the agreed-upon programme was to specify expectations about

> ". Consumption, savings, investment, and the external accounts
> . Production and employment
> . Public sector resource use and financing
> . Prices and interest rates
> . The effects of policy actions, institutional reforms, and the external economic environment
>
> Policy actions supported by adjustment lending usually included exchange rate and trade reforms, along with fiscal, monetary, and price reforms. Other issues, such as internal regulations and factor market rigidities, were highly relevant to the policy environment, but not always easy for the Bank to address. The loans specify schedules of measures the country is to take and, conditional on those measures, a schedule of Bank disbursements. Most countries receiving adjustment loans also receive assistance from the Fund, making it essential to ensure consistency between the Bank and Fund conditions. (It was recognized initially, as it has been since, that adjustment lending requires close collaboration with the Fund.) In most cases a Fund program, merely by its presence, certified that the effort at stabilization was adequate. Without such a stabilization effort, structural reforms in such areas as relative price changes could not be fully effective."
> [World Bank (1988), pp. 12-13]

Leaving aside the meaningfulness of the distinction between <u>stabilization</u> (presumably the function of <u>Fund</u> assistance) and <u>structural adjustment</u> for which

the Bank as well as the Fund lend, an issue to which I return in the next section, it is evident that while these expectations cover almost every economic policy that governments undertake, reforms of many of the policies are unlikely to have significant BOP implications. Yet as Managing Director (then Senior Vice President, Finance) Ernest Stern put it in a speech delivered on April 6, 1989 to a Bank conference on Adjustment Lending Issues and Country Experience, "it is my personal conclusion--one which is certainly not universally shared...that structural adjustment lending ought to be anchored in balance of payments problems." He went on to add

> First, we have not yet been able to define very well how to handle policy reform in countries without significant balance of payments problems. Quick-disbursing lending seems to appeal to everyone. But the justification I believe must underlie such loans--their contribution to the balance of payments costs that adjustments incur and that the country lacks the resources to meet--becomes weak if there is no immediate balance of payments problem.
>
> A related issue for your consideration concerns how we handle policy reform in sectors that have no direct impact on the balance of payments. How can we in the World Bank and in other development agencies be of greater assistance to governments in supporting the reforms necessary in the social sectors, in urban areas, in environmental management and in other spheres where quick-disbursing assistance may not be the proper tool both because the balance of payments impact is small or because the financial benefits of the loan do not go to the sector concerned? What kind of sectoral lending can we envisage that will be useful to our member countries, will be the basis for effective support for policy change in that sector and yet will not simply finance general imports?

This is indeed a central issue on which there still appears to be divergent views, if not confusion, within the Bank.

The origin of sectoral adjustment loans (SECALS) is the experience with a primarily macroeconomic programme. "But it soon emerged that in some countries it was not possible to undertake structural adjustment loans covering broad macroeconomic issues initially either because of political reasons or because of limited administrative capacity for such reforms. Furthermore, adjustment

problems sometimes had roots in particular sectors. And a sectoral approach had a great appeal where the major sources of the macroeconomic problem were sectoral institutions and policies. Thus sectoral adjustment lending joined the available instruments. The main areas that SECALs have addressed are trade, agriculture, industry, and energy" (World Bank (1988), p. 13).

It has been suggested that the SECAL documents rarely address in any detail the linkage of a SECAL with the overall adjustment programme of the country and its place within the Bank's total strategy of assistance to the country. Since the fortunes of a SAL (particularly its macroeconomic programme) and SECAL are intertwined it is obvious that if a SAL and one or more SECALS are being proposed for a country with overlapping time horizon, neither can be evaluated on its own.

The evaluation of SAL's raise some interesting and difficult issues. As is to be expected, the Bank was aware of the problems:

> "Adjustment loans differ from traditional project loans in that their benefits are difficult to pinpoint and estimate. The benefits hardly ever accrue directly to the borrowing government, but rather tend to be spread widely through the economy, accruing to labor and to capital, to farmers, retailers, importers, and other entrepreneurs. There is no practical way for the government to track down such widely dispersed benefits of the loan, nor can it cause the beneficiaries to pay the costs of the loan. Instead the government will typically turn to general revenues to service the debt. In a standard adjustment loan scenario, the cash to service the loans should be interpreted as being raised through taxes. There are thus two difficulties in appraising adjustment loans: the difficulty of identifying directly attributable benefits; and the likely need to make loan payments using funds that are not directly generated by the operation" (World Bank (1988), p. 14).

Compounding the two difficulties was the problem of fungibility:

> "...the reforms supported by a given adjustment loan might have been undertaken even without the loan; the foreign exchange used to finance a given positive list effectively frees up foreign exchange for some other purpose, such as repayment of loans. There is no practical way of completely overcoming the fungibility problem in any funding situation. However, attempts can be made to mitigate it, particularly within a long-term relationship between the Bank and the borrowing country. In making project and adjustment loans,

> the Bank has to satisfy itself about the overall economic framework in which the loans are made" (World Bank (1988), p. 15).

The evaluation of a SAL proposal has important intertemporal aspects as well, just like any other lending proposal. After all, the borrower should be in a position to service the debt in the future. The fact that most countries enter an adjustment programme with substantial external debt to begin with suggests that whatever policy reforms (macro and sectoral) that the SAL is meant to underwrite should be such as to enable the economy to generate resources in the future, not only to service pre-existing debt (net of any relief granted as part of the adjustment programme) but also that added by SAL. As mentioned earlier, while the 'benefits' from the SAL are likely to be diffused, the government as the borrower has to generate enough future revenue surpluses to service the debt. Also since the SAL debt is external its service by the government requires not only revenue surpluses, but also for the economy to generate the required external resources. Thus, any lending proposal including SAL would have to specify the total resources to be used for the purpose for which the Bank has agreed to lend, the Bank's share of the total, the time-phasing of resource use (total and the Bank's share) as well as the flow of 'benefits' accruing to the borrower's economy. Above all, in appraising the proposal the Bank would have to satisfy itself that the flow of benefits would not only be adequate, abut also that, given the fiscal system and the external trade and payments regime of the country, it would be feasible to service the loan.

The conditions just prior to the initiation of an adjustment programme, as described in Bank documents are worth noting:

> "The typical adjustment lending country faces macro-economic disequilibria such as an unsustainable current account deficit, a high fiscal deficit, and high inflation. It also faces

> microeconomic distortions such as impediments to factor mobility, barriers to domestic and foreign competition, and prices of tradables and public services unrelated to opportunity costs. And its institutions are weak, as typified by a severely impaired financial system and poor economic management. The macroeconomic disequilibria and the microeconomic distortions are usually the result of such weak institution and inappropriate policies. These problems were exacerbated by large external shocks--to the real interest rate, commodity prices, and the demand for exports--and by the associated drastic reduction in foreign financing.
>
> Adjustment programs must thus address stabilization, efficiency, and growth objectives. Structural reforms--including the correction of policies and the removal of institutional weaknesses and impediments--are essential to restore macroeconomic balances, increase the efficiency of resource use, and create conditions for sustainable growth" (World Bank (1990), p. 1).

It is clear from the above that if indeed the initial disequilibria, distortions and institutional weaknesses are so extensive and deep rooted and besides the economy is being subjected to large shocks, it is virtually impossible to design a programme that addresses all of them during its limited time horizon, and at its end ensures a stable and efficient economy growing at a satisfactory and sustainable rate, all the while absorbing possible shocks, let alone leveraging it on an adjustment loan or loans that even in the best of circumstances are unlikely to be large relative to the size of the economy. Presumably in a context in which the Bank is lending to the country for projects and programmes, the leverage of SAL could be greater and used conjunctively all three forms of lending together could conceivably address a number of objectives. Still the expectations from SAL's seem utterly unrealistic.

An *ex ante* evaluation of any proposed programme claiming to achieve all the above is difficult, if not impossible, given the multiplicity of objectives some of which are vaguely defined at best and the difficulty of controlling for myriad other factors besides the adjustment programme that would influence the course of the economy. An *ex post* evaluation that limits itself to the question whether

the economy was performing better in some well defined sense after adjustment is difficult, if not altogether infeasible, primarily because the relevant comparison, namely, with a counterfactual scenario of a continuation pre-adjustment disequilibria, distortions and weaknesses without adjustment is not easy to construct. Some evaluations of the adjustment experience, such as Cornia et al (1987) which simply compare economic performance before adjustment (which by definition is unsustainable) with the performance during or after adjustment, have to be rejected as meaningless on this ground alone. And others, which do attempt to proxy the counterfactual by comparing the performance of countries that undertook adjustment via a control group of countries (as in World Bank (1990)) or by using counterfactual simulations from an econometric model for the country, though obviously superior to the irrelevant and simplistic before or after comparison, are not problem-free either.

It is not easy to put together a relevant 'control group' of countries which did not undertake adjustment but had pre-adjustment situations comparable to that of the country that undertook adjustment. Unless econometric models track the pre-adjustment unsustainable disequilibrium path well and the methodology of comparison adequately captures the fact that the single realized actual path of the economy during adjustment and beyond, has to be compared with a distribution of counterfactual paths, the seemingly attractive econometric model based ex post evaluation is unlikely to be so in practice. It is not surprising that most ex post evaluations of adjustment programmes are inconclusive and controversial.

The rest of the paper is organized as follows. In Section 2 I discuss the usefulness of the distinction between stabilization and structural adjustment. Section 3 assesses the BOP rationale for SAL's in support of different objectives

using a simple analytical framework. Section 4 briefly addresses a methodology for ex ante evaluation of a SAL. Section 5 summarizes the conclusions.

2. Stabilization Versus Structural Adjustment

In the bygone era of food exchange rate regimes of Bretton-Woods, a distinction was made between a transient disturbance to the BOP of a country resulting in an actual or threatened loss of reserves was to be financed by a more or less automatic access to Fund resources while a permanent (or fundamental) disequilibrium in BOP was to be addressed by an exchange rate change with Fund finances provided under a stabilization agreement easing the cost of adjustment to the new long-run equilibrium. To the extent the fundamental disequilibrium reflected not only permanent changes in the external environment faced by the country, but also the pursuit of macroeconomic (monetary and fiscal) policies that were inconsistent with the maintenance of the exchange rate, the stabilization agreement spelled out the intention of the country's government to achieve specified targets with respect to certain broad macroeconomic indicators such as domestic credit and fiscal deficit through appropriate changes in macroeconomic policy. As is to be expected given the type of macroeconomic aggregates targeted the time horizon over which the changes were to be achieved was short, often three years or less. In the functional division of the spheres of the Bank and the Fund envisaged in the Bretton Woods agreement naturally the Fund was primarily responsible for providing resources for macroeconomic stabilization, while the task of providing long-term capital or development projects fell to the Bank. Of course with the demise of the Bretton Woods system of fixed exchange rates in 1971, the creation of several other facilities within the Fund for financing transient shocks, and the Bank's lending no longer being

confined to projects, this functional distinction became blurred. And with the oil shock of 1973 to the global trading and payments system called for responses by the two institutions which blurred the distinction even more.

An analytical distinction between stabilization and structural adjustment has been drawn by some authors (e.g. Buiter (1988)), as follows: stabilization policies are those that aim at returning an economy to an equilibrium path that it was following prior to some, presumably temporary and reversible, shock. Structural adjustment policies are oriented towards shifting the equilibrium path itself, presumably because the shock is permanent and irreversible. This distinction is based primarily on the nature of the shock to the economy and assumes that in the absence of the shock the economy would have continued along an equilibrium path. As such it does not seem to correspond to the contexts in which issues of stabilization and structural adjustment have arisen in the post-oil shock era. As mentioned earlier, a typical country undertaking adjustment starts from severe macro and microeconomic distortions whose disequilibrating consequences are either open or kept suppressed through controls of various kinds including typically import quotas, price controls and rationing.

It should be noted that a macro-distortion often has micro consequences (e.g. an overvalued real exchange rate distorts the allocation of resources between the production of tradables and nontradables) and micro distortions such as subsidies of various kinds have macro effects through their impact on the fiscal deficit, if on nothing else. Also if macro distortions create uncertainty through unpredictable rates of inflation and real interest, the resource shifts and investments in response to changes in micro incentives would not come about. Thus micro reform might prove ineffective without the removal of macro distortions, a fact that is recognized by the Bank. And some macro distortions

might have micro roots and their removal would require micro reforms, as the need for SECALS has attested.

When several distortions are present, and all of them are not removed simultaneously, the removal of a subset of distortions (say, micro distortions) could exacerbate the distortionary effect of the remaining micro and macro distortions. Moreover since the time period over which different sectors in the economy would adjust fully to any policy change and the costs of such adjustment would differ, the nature and the extent of micro and macro imbalances would be changing during the time horizon of the adjustment programme. Under these circumstances it does not make any practical or conceptual sense to distinguish between stabilization and structural adjustment. It is an open question whether it still makes sense to club together certain, primarily macro, policy reforms in a package under the rubric of stabilization with the role of their financing and monitoring assigned to the Fund and the rest of the reforms in the package deemed as structural adjustment with the Bank (and also Fund in its structural adjustment facilities) assuming the role of their financing and monitoring.

Cooperation between the Bank and the Fund is always desirable. But in itself it is not enough unless it goes all the way to full coordination in the sense of jointly designing the entire adjustment and stabilization programme (with its time phased micro, macro and institutional reforms, financing, monitoring and conditionalities) as an integrated whole and implemented. This implies, in particular cross-conditionality in the sense of the release of resources from one institution being conditioned also on performance with respect to those reforms supported by the resources of the other institution should not be formally ruled out. Clearly given an integrated programme it would make little sense to evaluate or monitor a subset of its components simply because of

the assignment of institutional responsibilities.

3. The Balance of Payments Rationale for SAL

At a basic and elementary level any lending by the Bank, whether it is a SAL, project or programme lending, involves providing foreign exchange resources to the borrowing country and as such its utilization has to involve the expenditure of foreign exchange. Thus regardless of the purpose of the loan, its utilization meets an actual or incipient demand for foreign exchange. In the context in which SAL's originated, namely, the second oil shock, the source of such demand was clear enough: with an increase in the price of imported oil there was a permanent terms-of-trade shock. It made sense to smooth the adjustment to the shock over an extended period of time rather than in a short period if the resources for smoothing were available and not prohibitively costly. And smoothing by definition involved financing initially a part of the added demand for foreign exchange due to the shock through borrowing rather than eliminating it altogether through immediate and complete adjustment. Resources are to be eventually generated to repay the loan once adjustment is complete. But in other contexts the link between the purpose for which the loan (in terms of foreign exchange) is made and the matching demand for foreign exchange arising in the course of its utilization might not be so direct and obvious.

The purpose which the Bank loan might serve could range all the way from financing old fashioned investment projects that produce a future flow of goods and services to underwriting policy reform, i.e. resources lent in support for some agreed upon changes in the policies of the borrower government. In between these two extremes is another old-fashioned category, viz. non-project assistance, to finance imports of raw and semi-processed materials (e.g.

fertilisers, petroleum), spares etc. to achieve fuller utilization of existing capacity in the borrower's economy. One should not get too enamored of the "concreteness" of projects and wary of the vagueness of policy-based lending. Abstracting from possible differences between the two in monitoring the use of borrowed resources and enforcing adherence to mutually agreed tasks, what matters really is whether the likely benefits are commensurate with the costs of borrowing. It does not matter whether such benefits in the form of augmented flow of goods and services in the economy arise from an investment project or from the efficiency gains in the use of existing resources through the adoption of better policies.

There need not be any direct linkage between the foreign exchange transfer from (to) the Bank to (from) the borrower as the loan is disbursed (serviced) and the form of resources spent on the agreed purpose of the loan and the benefits accruing as the purpose is achieved. Once again it is not essential that the activity being supported by the loan itself require foreign exchange for its implementation and generate foreign exchange on its completion. What matters is that the economy's demand for foreign exchange is augmented to the extent of the loan during the implementation of the activity and that the economy generates enough foreign exchange to service the loan once the activity is completed.

With these preliminaries out of the way let me illustrate the issues through a version of the static Salter (1959) model of a small open economy. The first illustration relates to financing a new opportunity for investment starting from an initial equilibrium. In Figures 1 and 2 the economy's production possibility curve is AB. Suppose for a moment that investment in the economy requires only traded goods as in Figure 1 and at the initial level of investment, AI_o units of traded goods are used up in investment. Then the availability

frontier for consumption is given by B_1I_o and the tangency of a social difference curve with it C_o denotes the initial equilibrium consumption point. The equilibrium real exchange rate (i.e. relative price of traded to non-traded goods) is of course the common slope of the indifference curve and the availability frontier at C_o. Assume that the Bank and the country have identified an investment opportunity whose implementation would require an additional I_oI_1 units of traded goods. If the Bank did not lend this amount, and the country undertook the investment, the economy's availability frontier moves to B_2I_1 and the new equilibrium consumption point moves to C_1. The new equilibrium real exchange rate is the common slope of the indifference curve and the availability frontier BI_1. Of course current welfare is lowered from U^o to U^1. Bank's lending of I_oI_1 in traded goods (i.e. foreign exchange) would enable the economy to maintain consumption at C_o and welfare at U^o. Put another way, the Bank lends to fill the foreign exchange gap of I_oI_1 that would arise were the investment to be undertaken while maintaining welfare at U_o and the real exchange rate unchanged. This is not to suggest of course that the only alternatives are to finance it entirely through domestic resources by allowing the real exchange rate to adjust or entirely through borrowed foreign resources. Indeed, intertemporal optimization might involve a combination of the two.

Consider now the polar opposite case (Figure 2) in which investment requires only <u>non-traded goods</u>. At the initial investment level $B\bar{I}_o$ units of non-traded goods are used up in investment and the availability frontier becomes $A_1\bar{I}_o$. Equilibrium consumption is at $\bar{C}_o$ and welfare at $\bar{U}^o$. Once again let a new investment opportunity arise requiring an additional $\bar{I}_o\bar{I}_1$ units of non-traded goods. With no borrowing, the availability frontier moves to $A_2\bar{I}_1$ equilibrium consumption moves to $\bar{C}_1$ and welfare falls to $\bar{U}^1$. However by lending $\bar{I}_1\ \bar{\bar{I}}_1$ of

traded goods thereby shifting the availability frontier to $\bar{A}\ddot{\ddot{1}}_1$ to touch the $\bar{U}^o$ indifference curve at $\bar{\bar{C}}^1$, welfare can be maintained at $\bar{U}^o$ while undertaking the additional investment opportunity. In this case compared to the equilibrium at $\bar{C}_o$, the real exchange rate is <u>different</u> at $\bar{\bar{C}}^1$ even though welfare is at the same level $\bar{U}^o$. The Bank loan fills a <u>domestic resource</u> gap that will arise were welfare is maintained at $\bar{U}^o$ while undertaking the additional investment and maintaining the real exchange rate at its level at $\bar{C}_o$. It is to be noted that whether the new investment opportunity requires <u>traded</u> or <u>non-traded goods</u>, in either case the Bank loan is in traded goods, i.e. foreign exchange. In both examples prior to the investment opportunity arising, the economy is in external equilibrium. The SAL thus meets an endogenous incipient demand for foreign exchange arising from the implementation of the investment project. Again posing the choice as between domestic finance through real exchange rate adjustment and foreign borrowing with no such adjustment is for illustrative purposes only.

The use of a static model for illustrating borrowing and repayment which by definition are intertemporal transactions is not meant to suggest that intertemporal aspects are not important but they are left implicit. Thus in effect two assumptions underlie the static analysis. First, the additional investment would be worthwhile if financed by borrowing. This in part also means that once implemented, the investment would generate enough resources to service the loan. Second, the same investment would not be worthwhile were it to be undertaken without borrowing, i.e. the loss in <u>current</u> welfare (from U^o to U^1 or from $\bar{U}^o$ to $\bar{U}^1$) is more than the gain in discounted future gain in welfare from undertaking the investment. Thus an opportunity for the Bank to lend, and the country to borrow, arises when the cost of the loan from the Bank is lower than that of domestic finance. It should also be noted that although for diagrammatic

illustration I made the polar assumptions that investment requires either traded goods or non-traded goods but not both, this is not essential to my argument. One can easily allow for the use of both goods in investment. The analysis can be illustrated also with Ron Findlay's version of the two-gap model in Chapter 10 of his 1973 book (International Trade and Development Theory, Columbia University Press).

Lending in support of a smooth adjustment to a permanent terms of trade shock such as the oil shock can be illustrated with the same model. To begin with assume that the economy's transformation curve between a non-traded good consumed at home ('home good') and a wholly exported good ('export good') in every period is AB as in Figure 3. In other words, there are no opportunities for factor accumulation that would shift the curve from one period to the next or access to the international capital market. Suppose a unit of a wholly imported and consumed good ('import good') costs one unit of export good in world markets. The economy is a small open economy that cannot influence world prices. Under these assumptions the economy's consumption transformation curve between the home and import goods is also AB. Thus in the initial (steady state) equilibrium the economy produces and consumes at P_o (Figure 3) in each period, exchanging OE_o units of export good for OE_o units of import goods.

Suppose now the world relative price of the imported good in terms the export good (i.e. the terms of trade) permanently shifts to 2 from the initial level of unity. Thus, the consumption transformation curve shifts down to A'B where each point on A'B is vertically below at half the distance (from the horizontal axis) from its corresponding point on AB. Immediate and full adjustment would take the economy to a new steady state with the consumption at C' on A'B (and production at P' vertically above it on AB) from then on. Welfare

in each period would fall from that associated with U^oU^o to that associated with $U'U'$.

With the production transformation curve remaining at AB in each period, if from any initial point on AB the economy can move to any other point on it costlessly, then clearly the economy would shift immediately to the new steady state. If such a move is costly, as for example in the model of Mussa (1982) in which the total capital stock and labour endowment are fixed (or equivalently the production transformation curve does not change from one period to the next) but the marginal cost of shifting capital from one use to another (starting from any initial distribution of total capital between uses) is increasing, it is not optimal to jump to the new steady state instantaneously but only to approach it asymptotically.

Suppose now that there is an opportunity to lend or borrow abroad at a fixed world interest rate (the economy is small in world capital markets as well) but there is no opportunity for domestic investment that shifts AB from one period to the next. If movement from one point to another on AB is costless, one can define an intertemporal welfare maximization problem for the economy in which the choice in each period is a production point on AB (which determines also the consumption of home good) and the consumption of the import good, which in turn determines, given the world relative price of the import good in terms of the export good, the change in net foreign assets of the economy. In one such optimization problem set out for a particular choice of functional forms for AB, and the utility function for each period with intertemporal welfare being the discounted sum of the streams of utilities in each period, it was found that the economy would neither borrow from nor lend to the world capital markets as long as the world rate of interest equals the economy's pure rate of time preference

(i.e. the utility discount rate). If the former exceeds (falls short of) the latter, then it would lend (borrow). The economy's terms of trade affected only the stream of utility levels and the amount borrowed or lent but not the decision whether to borrow or lend. This meant that the economy would immediately and fully adjust to a terms of trade shock as long as the time preference and world interest rates were the same. Of course, if this common rate was higher than the interest rate on a SAL from the Bank, clearly it would be worthwhile for the country to borrow from the Bank. And since the borrowing in effect is financing imports in excess of export earnings, there is a matching demand for foreign exchange arising from the loan.

Policy-based lending is also easily illustrated. Consider a standard Hecksher-Ohlin Samuelson two-traded goods model of a small open economy. The production possibility frontier (PPF) of the economy is AB in Figure 4. Initially there is an import tariff. Given the tariff, production is at P_t where the slope of the PPF equals the tariff inclusive relative price of imported good 2. Under balanced trade consumption is at C_t (on the world price line through P_t) at which the slope of the social indifference curve (not drawn) equals the tariff inclusive price, given the standard assumption that tariff revenues are returned to consumers in a lump sum fashion.

Suppose now with the Bank's prodding the country removes the tariff. Of course, if resources smoothly and instantaneously flow between sectors, production point will jump to P_f where the slope of the PPF equals the world relative price of good 2 in terms of good 1 and consumption point will jump to C_f when a social indifference curve touches on the world price line through P_f. Suppose resources do not move instantaneously between sectors so that the production point traces the PPF from P_t to P_f over time. However, consumers

Does the case of a SAL which addresses a fiscal gap in a country where the BOP is in equilibrium constitute an exception to the above reasoning? I should think not. The fact that the BOP is in equilibrium means only that the economy's aggregate investment equals the sum of aggregate domestic savings and sustainable foreign capital inflow. The existence of a fiscal gap means that the public sector's expenditure exceeds its revenues. Only if the private sector's investment equals its savings, the fiscal gap will equal foreign capital inflow and if this inflow is sustainable there is no case for fiscal reform anyway. Thus the existence of fiscal gap that is to be reduced or eliminated with support from a SAL implies that the fiscal gap exceeds the sustainable foreign capital inflow and is being financed by an excess of private savings over investment, i.e. fiscal deficit is crowding out private investment. In such a situation the SAL would presumably be aimed at increasing private investment by providing temporary financing of the fiscal deficit until the fiscal gap is eliminated by additional fiscal revenues generated by growth in the economy stimulated by increased private investment as well as by reduction in public expenditures, including reductions in budgetary support for loss making public enterprises through privatization or efficiency improvements. The essential idea is that private investment increases fairly quickly while the fiscal deficit takes longer to disappear. In the meantime, the increased aggregate investment would exceed aggregate domestic savings by more than the sustainable foreign capital inflow. In other words, it is this addition to the current account deficit that is being financed by SAL inflows. Thus an indirect BOP factor emerges in this case for SAL as well. The logic of the argument would suggest that in fact a fiscal surplus would be generated during the period of servicing the SAL.

Stern, in his speech referred to earlier, drew a distinction between the

need for policy reform and the need for a SAL and argued "that we provide quick disbursing loans because the actions being undertaken by the government have some balance of payments impact, some additional costs that we help defray. To me, that justification has been and continues to be the basic anchor for structural adjustment lending." This was his answer to his own question "Why bribe governments to do what they ought to be doing anyway?". The analysis and illustrations in this section suggest that it is not so much a question of bribing a government to do what it ought to be doing but recognizing that there are likely to be significant immediate costs, political and economic, to undertaking reform while the benefits come later. The time horizon is likely to be too short for the government to view the future benefits worth the current costs. By providing a SAL with an interest cost lower than the effective rate of time preference of the government, the Bank enables the government to cushion the immediate costs somewhat and thus induces it to undertake the reform. It is also clear that the BOP impact is to be viewed only as the mechanism through which foreign exchange resources of a SAL are transferred to the recipient country and it need not have any direct link with the particular policy reform that is supported by the SAL but only an indirect link through its effect on the economy as a whole.

A common confusion regarding the BOP rationale needs to be cleared up. It is sometimes suggested that in a regime of flexible exchange rates any incipient gap in BOP will be eliminated by a movement in the exchange rate, and as such there is no need for a SAL to fill the gap. This is a wrong conclusion from the correct reasoning that prices, if flexible, adjust to clear markets threatened by incipient excess demands or supplies. It is wrong because it implicitly assumes that adjustment through a price change rather than addition to supply (in

the case of excess demand) or demand (in the case of excess supply) from outside the system is neither feasible nor desirable. Indeed the first two illustrations in this section were meant to illustrate that real exchange rate adjustment would have released the resources needed for additional investment. A SAL would be appropriate if the real adjustment is costlier in terms of welfare than borrowing from the Bank thereby reducing, if not avoiding altogether, such adjustment.

4. A Methodology for Ex Ante Evaluation of Policy-Based Lending

The methodology of project evaluation such as that of Little and Mirrlees relies on the identification of the stream of inputs and outputs of a project and the incidence across relevant socio-economic groups of its benefits and costs. Using the relevant 'shadow' prices for commodities and income distributional weights for socio-economic groups the net social benefit of the project is computed. It is well known (for example, Srinivasan (1982), Kanbur (1991)) policy reform can be viewed as a project in the sense that its implementation would change the stream of inputs and outputs in the economy with an associated incidence of costs and benefits among socio-economic groups. In principle the net social benefit of policy reform supported by a SAL could be computed much in the same manner as in conventional projects. As mentioned earlier, unlike in the case of a conventional project, the change in the economy's output and input streams attributable to a policy reform are difficult to quantify to any desirable degree of precision and the incidence of its benefits and cost is likely to be too diffused to identify. However, these problems are generic to policy-based lending and, as such, unavoidable in its ex ante evaluation, whatever be the method used to do it. As such, one might as well use the Little-Mirrlees for this purpose. Many projects are likely to be 'small' relative to

the economy so that the effects of the project on the rest of the economy could be ignored. Many sectoral policy reforms are also likely to analogous to 'small' project. But some sectoral policy reforms and reforms of economy-wide policies (e.g. monetary, exchange rate etc.) have to be treated like 'large' projects with feed-back effects on the economy as a whole.

5. Conclusion

Briefly stated, the arguments in previous sections suggest:

(1) The balance-of-payments 'gap' that is filled by the utilization of a SAL is to be viewed, not as a rationale for the SAL itself but only as an addition to the foreign exchange needs of the economy occasioned by the implementation of whatever reform or adjustment the SAL is meant to support. The additional foreign exchange expenditure need not arise directly from the sector or activity which is being reformed or adjusted but only from the economy as a whole.

(2) The main reason for supporting policy reform through a SAL, even though its desirability is well understood by the government of the borrowing country and it might even be feasible to raise the needed resources, is not its direct BOP impact but the fact that, in the absence of a SAL to cushion the immediate or short-run costs of reform, the government is unlikely to undertake it.

(3) Whether the exchange rate is fixed or flexible is not germane to the issue of meeting the additional foreign exchange needs occasioned by the implementation of the adjustment programme. The issue is not whether the exchange rate would adjust to eliminate any excess demand or supply of foreign exchange under a flexible exchange rate regime. It is whether the elimination

of the excess demand or supply through an adjustment of the exchange rate imposes a higher or lower welfare cost on the economy compared to financing it without such adjustment through external borrowing or lending.

(4) The fact that an economy has a fiscal 'gap' without a BOP 'gap' in itself has little to do with the decision whether a SAL should be considered. As long as the fiscal gap is crowding out private investment, a SAL for fiscal reform might be in order. Of course, an excess demand for foreign exchange to utilize the SAL would come about in such a case because of a quick rise in private investment with the fiscal deficit coming down with a considerable lag.

(5) The objectives of SAL's as they are described in Bank documents are too many and too far ranging to be leveraged on a SAL or set of SAL's and SECALS.

(6) The distinction between stabilization and structural adjustment does not appear to be analytically strong. Assignment of the financing and monitoring of stabilization exclusively to the Fund, while both the Bank and the Fund lend and monitor structural adjustment is less important than the two institutions jointly designing, financing and monitoring an adjustment programme imposing cross conditionality where appropriate.

(7) While in principle a project evaluation methodology, such as that of Little and Mirrlees, is applicable for ex ante evaluation of a SAL, ex post evaluation is more problematic since the relevant counterfactual to be compared with the performance of the economy during and after adjustment, viz. what would have been the performance of the economy in the absence of adjustment, is difficult to put together.

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Figure 1

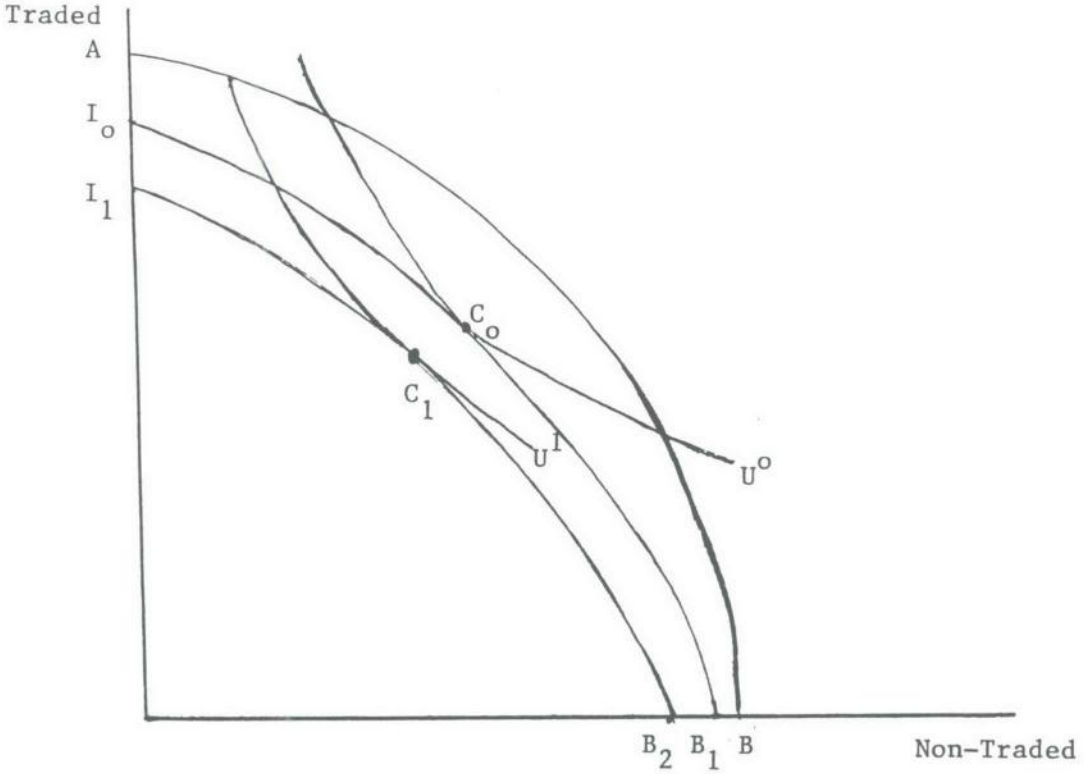
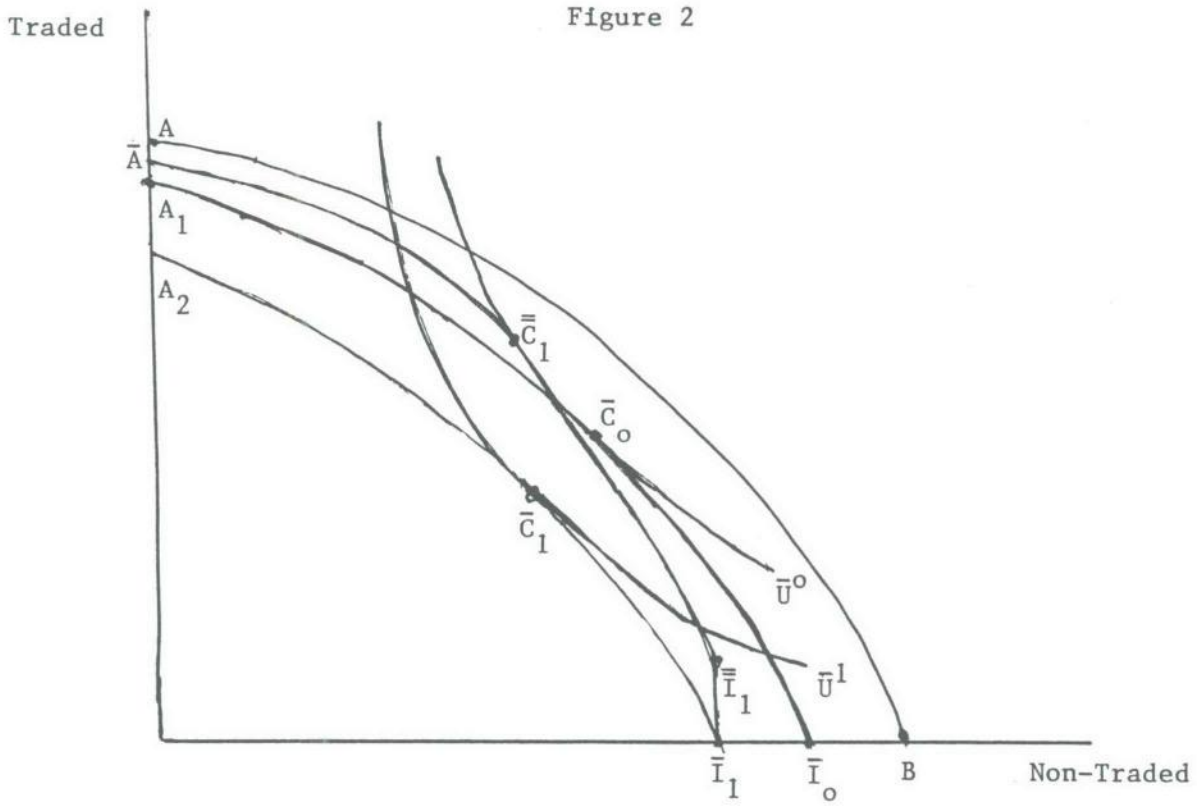


Figure 2



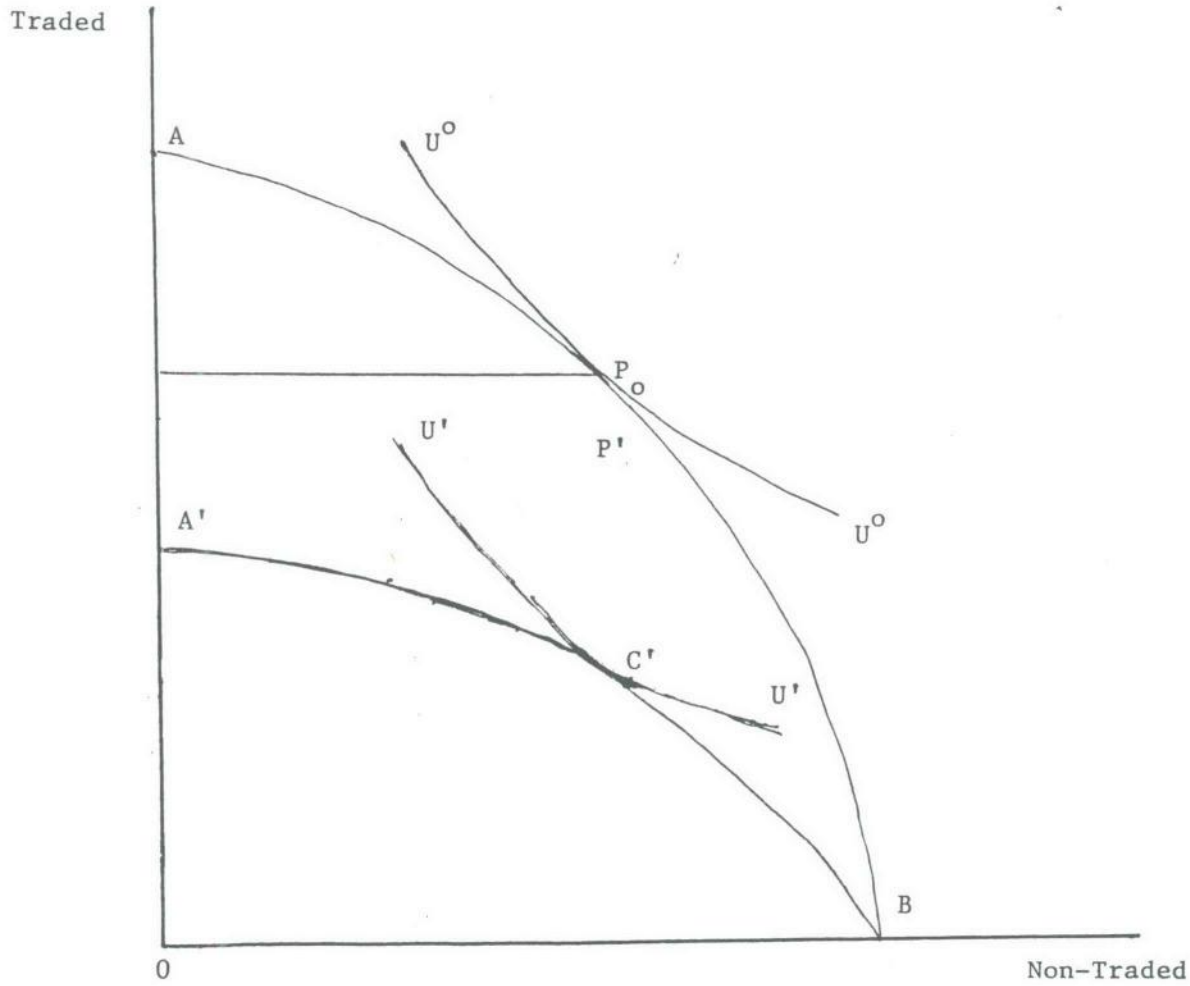


Figure 3

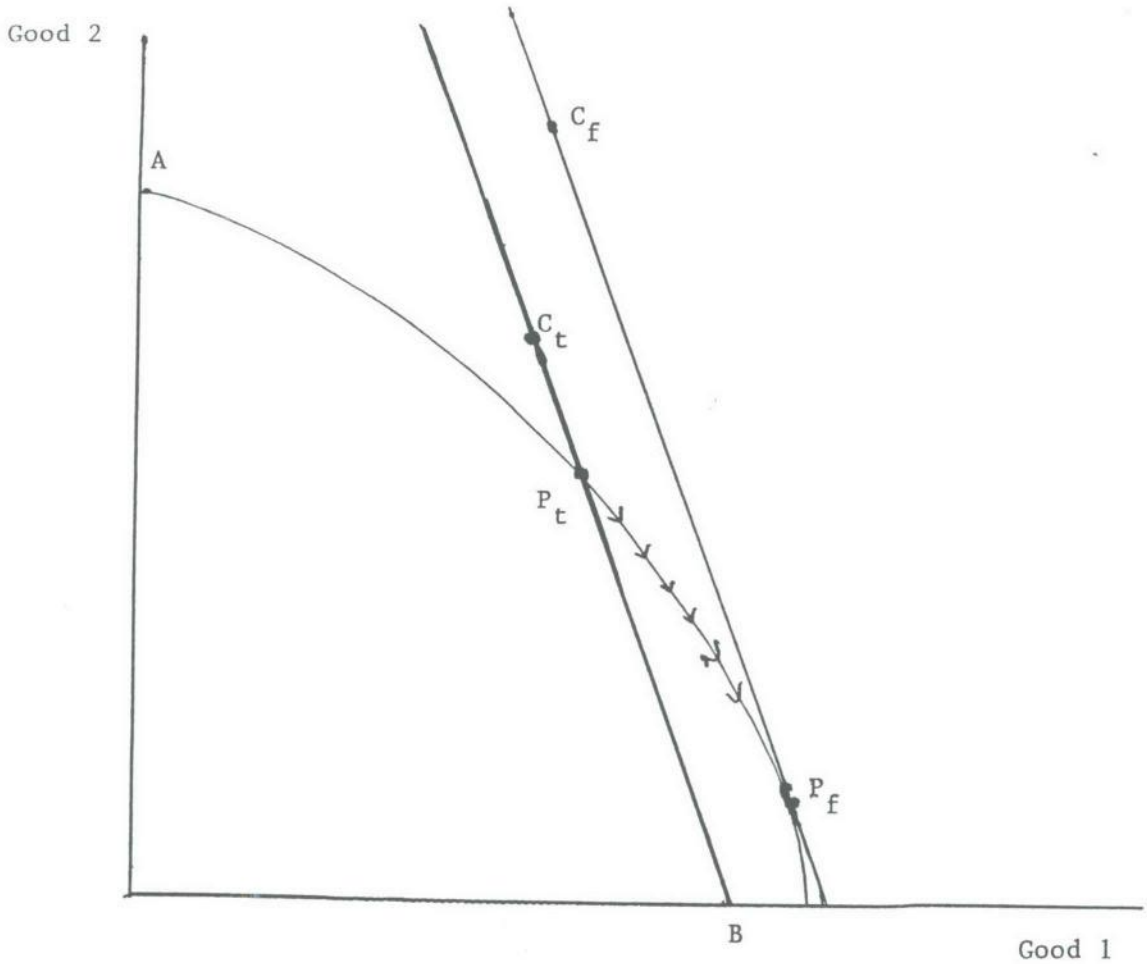


Figure 4

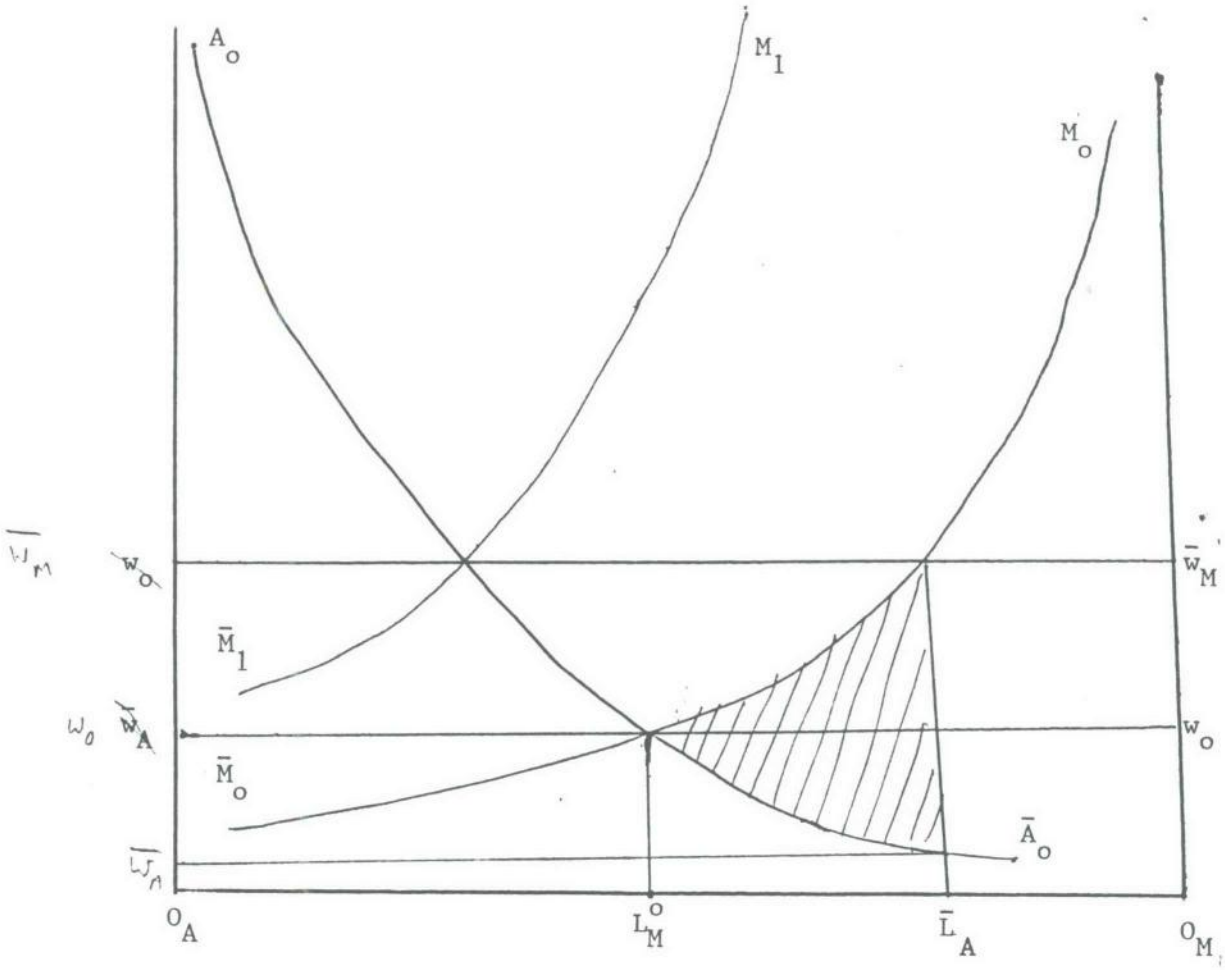


Figure 5

4619 cc: AR

The World Bank
Washington, D.C. 20433
U.S.A.

Mr. Grell

ERNEST STERN
Managing Director

92 JUN 25 PM 1:58

RECEIVED
GENERAL ECONOMICS
ECONOMIST

June 24, 1992

Mr. Summers

Larry:

Rationale for Adjustment Lending

Perhaps we had better discuss this at some point because I cannot accept the OD as proposed. We do not yet live in a world of convertible currencies and free capital accounts. And, even if we did, foreign borrowing always has a foreign exchange risk which can be substantial and has costs. And, of course, the reason why there should be a careful review is that there may be cases where foreign borrowing is the better option.

As to how we describe it, I am eclectic. Of course, I am concerned about abuse -- guidelines are written to prevent that. There are already plenty of examples of spurious justifications for quick-disbursing adjustment lending.

cc: Mr. Karaosmanoglu (o/r)

cc: AR

The World Bank
Washington, D.C. 20433
U.S.A.

LAWRENCE H. SUMMERS
Vice President Development Economics
and Chief Economist

June 23, 1992

Mr. Ernest Stern

Ernie,

Rationale for adjustment lending

I didn't find convincing the reasons you gave for rejecting the use of adjustment lending for budget smoothing, as part of the overall rationale for such lending in terms of consumption smoothing.

In a world of convertible currencies, I fail to see the rationale for discriminating between local and foreign exchange finance. We should always carefully assess the optimal pattern of finance of an actual or expected shortfall in resource availabilities, and always avoid giving countries soft options, but that applies equally to finance of an external or internal deficit.

The number of cases where budget smoothing is the main rationale may well be small, but it seems to me, and to the Regional Chief Economists, that there will be cases where the availability of adjustment finance to help smooth fiscal outlays can contribute significantly to leverage. Severance pay could be an important example in the coming years. I believe this is an area in which blanket prohibitions are inappropriate, but that the case for use of external borrowing should be carefully based on country circumstances, with the onus of proof on the advocate to avoid any tendency to softness.

The view that an increase in the deficit of 2-3 percent of GDP is not of concern is neither consistent with the behavior of the IMF nor that of asset prices. The issue is how any potential worsening in the public resource position is best financed. I completely agree that there should be a careful evaluation of the alternatives--exactly along the lines of your last paragraph. But there is no reason why external borrowing should always be inferior to the alternatives. I am a big advocate of sensible tax reform, but we know it sometimes takes years.

Perhaps your real concern is that the risks of abuse justify a *per se* rule in this case. If so, shouldn't we be explaining it in these terms? And I wonder if there is not a case for experimenting with a moderate degree of discretion, subject to strict assessment.

Lawrence H. Summers

cc. Mr. Karaosmanoglu
bcc. Messrs. Grilli, Selowsky, Squire

4590

The World Bank
Washington, D.C. 20433
U.S.A.

ERNEST STERN
Managing Director

92 JUN 18 PM 2:23

June 17, 1992

Mr. Summers

Larry:

Thanks for the note on adjustment lending. The analysis of the effects of adjustment on the current account is appropriate. However, I could not accept the conclusion on the budget smoothing side, circumscribed though it is.

First, I do not believe lending by us, particularly by the Bank, for local currency support is desirable. We do so when we are financing indirect foreign exchange costs--which is not the case here--or in "exceptional" circumstances. Although the latter has been very flexibly interpreted over the years there are, or should be, limits. Second, it is difficult to envisage severance payments reaching a percentage of budget which would be considered material. And, in any event, such costs should be taken net of asset sales. Recapitalization of the banks or other restructuring could involve costs which might be in terms of the national budget but even then the case for external borrowing is not established.

If the costs are temporary, and the budget in approximate balance, a one-time, 1-2 year, deficit of 2-3% of GNP should not be of concern. Cases where the swings are larger than that must be rare. Adjustments in the education and other social sectors normally would not qualify.

Taxation is written off much too quickly. If the costs are temporary, tax surcharges are a fine, explicit and transparent device to have the nation share in financing the adjustment effort. It creates a true sense of ownership which quiet borrowing from external sources does not. Of course, inefficient taxes are bad but there are remedies for that. Even if taxes, or deficits are ruled out we need to be much clearer about the comparative cost to governments of domestic versus external borrowing. This cannot be simply a matter of comparing interest rates. For a country with no external debt, the issue may be straightforward; not so for a country with a large debt and a high debt service ratio. The presumption ought to be that in those cases the borrowing should be domestic. And I would not have thought it justified to incur the 15 years worth of foreign exchange denominated interest costs to smooth budgetary expenditures over 2-3 years. In any adjusting country with a sound program, and real interest rates, domestic borrowing should be no problem. It can be relatively short term. It carries no foreign exchange risk. We ought not to be providing a soft option.

Ernie

CC: AR

The World Bank
Washington, D.C. 20433
U.S.A.

LAWRENCE H. SUMMERS
Vice President Development Economics
and Chief Economist

June 10, 1992

Mr. Stern

Ernie,

The macroeconomic rationale for adjustment lending

I have been working with the Regional Chief Economists on the question of the circumstances under which there is a macroeconomic basis for adjustment lending. There's a clear view that a balance-of-payments "gap" is too limited a way of looking at the problem, even though in the bulk of actual cases there will be a current account deficit. The attached note was prepared by a small sub-group we charged with drafting the results of our discussions. I agree with it. This is heading for inclusion in the Operational Directive on Adjustment Lending, so I'd welcome your comments at this stage.

Lawrence H. Summers

Attachment

cc: Attila Karaosmanoglu

bcc: Mr. Grilli (w/out attach.)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 5, 1992

TO: Mr. Lawrence H. Summers

FROM: Enzo Grilli, Marcelo Selowsky and Lyn Squire

EXTENSION: 81934, 39006, 34637

SUBJECT: Adjustment Lending

1. The most general economic rationale for adjustment lending is that it smoothes the costs of structural reforms. These are consumption costs, i.e. private or public consumption which, in the absence of external borrowing, would have to be foregone as a result, for example, of sudden and large changes in key relative prices occurring autonomously or because of reform of domestic policies. Confronted with significant transitional costs from adjustment measures, a country can borrow externally to reduce the economy-wide welfare losses that adjustment entails, by spreading these costs over time. Intertemporal optimization of consumption, aside from being economically rational, may also contribute to the social and political sustainability of the reforms undertaken in the adjusting country, thus making them more likely to succeed.

2. However, temporary consumption smoothing for a country undertaking structural adjustment can be attained not only by external borrowing, but also through the utilization of existing foreign exchange reserves. While the case for reserve use is generally cast in terms of "compensatory financing" to smooth out temporary BOP deficits, a country having adequate foreign exchange reserves, and expecting to return to current account balance in a relatively short time, can resort to using them to deal with the transitional consumption costs of structural adjustment as well. In calculating the marginal cost of reserve utilization the market credibility effects of changes in the stock of domestically held foreign exchange will have to be taken into account. Reduction in reserves may in fact affect the internal and external credibility of the government and of its policies. External borrowing for the purpose of consumption smoothing to be justified in the presence of reserve availabilities must be shown to be a superior alternative, i.e. to be less costly to the country than using reserves.

3. When external borrowing is justified from the country point of view, the rationale for the Bank extending quick-disbursing loans in foreign exchange (in the presence of a reform program judged to bring adequate benefits to the country) can be, therefore, generally defined in BOP terms: a) an actual current account deficit, and b) an anticipated current account deficit deriving from either the adjustment policies being implemented or other desirable objectives being sought (e.g. higher economic growth). These are the normal circumstances in which our adjustment lending takes place.

4. Some policy reforms may not have a real resource cost, but may have significant negative effects on the government budget, as in the case of recapitalizations of the domestic banking system in the framework of financial sector reform, or severance payments for redundant employees of public enterprises being restructured or privatized. In this case there might also be a rationale for public expenditure smoothing, given that the increase burdens on the budget are temporary. Unlike the previous, and more usual case, the reforms being implemented do not involve any real economy-wide welfare loss. Internal transfers are instead at issue. By compensating groups that stand to lose the most from the reforms being implemented, the government can increase their chance of success, thus ensuring that the benefits from reform will eventually accrue to the whole economy.

5. Financing this type of expenditure smoothing (or temporary budget imbalance) can be done through increased taxation (or reduction of other expenditures), government borrowing domestically from the private sector and by foreign borrowing. A case for external borrowing can be made if the alternative means of financing the additional expenditure (e.g. increasing taxes, borrowing domestically or expanding base money) were inferior (i.e. more costly than) external borrowing. Taxation--broadly defined--may be inferior to borrowing, external or internal, if the expenditure needs are temporary and increasing taxes generates dead weight losses for the economy. These may also increase if inefficient taxes are used. The decision between external or internal borrowing will depend on their relative costs to the government.

6. Since the objective of borrowing abroad is to smooth consumption, it must be expected that in general an optimal or market-determined allocation of the borrowed funds would result in increased consumption of tradeables and non-tradeables. In many cases, the adjustment measures themselves--trade and exchange rate reform, for example--may generate increased demand for foreign exchange. In other cases--a reduction in aggregate demand to stabilize the economy or the financing of a temporary budget expenditure, for example--smoothing may have a larger nontradeable component. In the first case, foreign funds will be absorbed with no change in the exchange rate. In the second, some appreciation will occur.

7. In conclusion, from the Bank's standpoint, quick-disbursing loans in foreign exchange are appropriate in most cases where consumption-smoothing is needed in the borrowing country (and reserves cannot be used or represent an inferior alternative), since reforms of price systems, trade regimes or even of the public sector are likely to have temporary balance of payments costs. Balance of payments imbalances generated by reforms can thus be financed through the use of these loans. In all these cases the traditional "balance of payments condition" for adjustment lending can be seen to apply.1/ In those

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1/ Obviously, such condition applies even more directly when reforms are undertaken in the presence of a current account deficit (as it is normally the case after an external--say a terms of trade--shock has been absorbed).

cases where quick-disbursing loans are utilized to make possible temporary smoothing of budget expenditure, their use must be justified as a superior alternative to taxing (or other expenditure cutting) and to domestic borrowing.

cc: Mr. Ricardo Martin

SAL file

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: June 23, 1992 02:01pm

TO: Nancy Birdsall (NANCY BIRDSALL)

FROM: William A. McCleary, EC1DR (WILLIAM A. MCCLEARY)

EXT.: 33014

SUBJECT: Adjustment Lending and Fiscal Adjustment Programs

1. Thanks for your EM of June 2 commenting on my previous EMs on the above subject. I am a bit tardy in responding to you because of my absence from the office for a few days and the press of the usual stuff we are all subjected to around here.

2. It might be helpful if I outlined a few principles that have motivated my comments to date. What bothered me about our luncheon meeting that day was the possibility it raised of the Bank getting into AL in situations where it seemed to me AL was either not justified or it was unclear whether AL was superior to other instruments the Bank has at its disposal. I think of AL as "extraordinary finance" (without sounding too much like Mr. Shihata, I hope). That is, that to merit such assistance, any particular country must demonstrate a need for fast-disbursing money (a gap of some sort that cannot be financed from the usual sources such as project finance or sector investment loans) and that it is undertaking a reform program which would lead the Bank to believe that the need is temporary (admittedly "temporary" is turning out to be a somewhat longer period than any of us believed where we started out with AL). This means that the the money itself should serve some useful purpose (allowing a higher level of investment and/or smaller cuts in private/public consumption such as needed to make the program socially and politically feasible) and the country is taking measures to assure that future b.o.p. gaps will be brought into line with likely available foreign finance and with its capacity for servicing external obligations. The assurances that there is a credible reform program is crucial because the Bank is always walking a thin line with AL--too generous or prolonged adjustment lending can allow government to postpone serious reform measures. I think one can point to a fair number of cases in the 1980s where Bank AL--plus support from other multilateral and bilateral institutions--has allowed governments to duck needed reforms (i.e., either the Bank should have applied more pressure to assure conditionalities were fully implemented or it should have reduced the volume of AL lending which would have put more pressure on the government to make the needed reforms). Lastly, as I pointed out in my original EM, economic reforms are an integral part of economic progress; I see no particular reason why in general the Bank need to support them with fast-disbursing

money--unless there is some clear and demonstrable gain from doing so. With these thoughts in mind, let me turn to the two cases mentioned in your note.

3. As for the persistent b.o.p. surplus/fiscal deficit case, my general feeling is that we should not be engaged in AL in such circumstances at all. There is no b.o.p. need, disbursements of our money by themselves accomplish little that couldn't be achieved by non-bank borrowing domestically (except possibly to lower the cost on a portion of deficit financing), and our money itself is providing very little leverage. Even leaving these concerns aside, I have problems with your characterization of the Bank's possible role in establishing credibility. If inflation is longstanding and previous governments have consistently been unable to maintain tough policies, will the presence of the Bank have much of a reassuring effect on domestic/foreign lenders and investors when they all know that serious measures to reduce money supply growth and cut aggregate demand are still many months away--and may not be taken even then? Most of the studies of anti-inflation policies with which I'm familiar strongly suggest that strong upfront policy actions are needed which usually result in declining output and employment; even then inflation often stubbornly persists because of inertial factors. It is hard to see what the Bank presence is accomplishing in those months before serious actions are taken except to provide cheaper financing than if the government had borrowed domestically--not a very big bang for our buck, and a possible illusionary one at that if the expectations embodied in the differentials between domestic and foreign interest rates are borne out in subsequent devaluations.

4. With respect to adjustment lending for the social sectors, there are several points to be made. First, I raised the possibility of "earmarking of disbursements" because the issue has been raised in the debate over the future of AL in the Bank; some have advocated AL as a means for getting more money into the social sectors --even though it meant disbursing against local costs as would almost certainly have to be the case given the content of social sector expenditures--and for strengthening the hand of ministers/officials working in these areas. In general, I don't think that such earmarking is a good idea. If there is a b.o.p need that justifies fast-disbursing money, why not disburse against imports?; its administratively easier (than earmarking or counterpart funds) and runs less risk of being slowed down because of sector specific problems. Secondly, I'm skeptical about AL for the social sectors because I think in most instances sector investment loans (SILs) would do the job as well or better. The essence of SILs is the rationalization of the size and composition of sectoral recurrent and investment programs which really must be at the heart of any reform program. The relatively slower pace of disbursements under SILs lends itself to assuring that these expenditures shifts are lasting and that the complementary institutional reforms which are so crucial in these areas actually take hold. The SIL can also contain other

conditionalities, e.g., cost recovery, curriculum and testing reforms, staff allocations and salaries (the only difference is that SILs tend to contain less conditionality than SECALs).

5. Lastly, getting to the question of whether social sector SECALS are ever justified. It seems to me that the first question to ask is why a SECAL and not a SIL? In answering this question, it is important to recognize that many of the benefits of social sector reforms are fairly long-term--e.g., increased labor productivity and lower population growth. That is, there is not a fairly quick short- to medium-term impact on internal and external balance that we expect from adjustment lending. However, some social sector reforms may have such an impact through, e.g., increased cost recovery, subsidy reductions, rationalization of expenditures programs to financeable levels, reforms of social security programs. Provided a social sector reform program can be demonstrated to have a significant medium-term impact on internal/external balance, a SECAL would be justified. It would be up to the Region to demonstrate that this was so, that a SECAL was a better vehicle for reform than a SIL, and that, together with other SAL/SECALs already in place, there were strong possibilities for a sustainable growth path being achieved in the medium-term.

CC:	Larry Summers	(LARRY SUMMERS)
CC:	Enzo Grilli	(ENZO GRILLI)
CC:	Parvez Hasan	(PARVEZ HASAN)
CC:	Ishrat Husain	(ISHRAT HUSAIN)
CC:	D. C. Rao	(D. C. RAO)
CC:	Anandarup Ray	(ANANDARUP RAY)
CC:	Lyn Squire	(LYN SQUIRE)
CC:	Vinod Thomas	(VINOD THOMAS)
CC:	Michael Walton	(MICHAEL WALTON)
CC:	Andres Solimano	(ANDRES SOLIMANO)
CC:	Steven Webb	(STEVEN WEBB)
CC:	Nissan Liviatan	(PAPER MAIL)
CC:	Marcelo Selowsky	(MARCELO SELOWSKY)
CC:	Gobind T. Nankani	(GOBIND T. NANKANI)
CC:	Zenaida S. Kalinger	(ZENAIDA S. KALINGER)
CC:	EMENA ISC Files	(EMENA ISC FILES)

A L L - I N - 1 N O T E

DATE: 27-May-1992 03:51pm

TO: William A. McCleary (WILLIAM A. MCCLEARY)

FROM: Marcelo Selowsky, LACCE (MARCELO SELOWSKY)

EXT.: 39006

SUBJECT: Adjustment Lending to Assist Efficient Fiscal Adjustment

1. We both agree on a wide definition of balance of payments difficulties to include not only a pre-existing external gap but also one which is the result of the adjustment program itself.

2. It is in this context that lending for fiscal adjustment -- which temporarily may increase the current account deficit -- is worth considering. It takes time to implement efficient public sector reforms: improve tax collection, reduce public employment, design good programs to protect the poor, divest public enterprises, implement institutional reforms. Interim financing allows to take the time, rather than postpone reform or do it in a hard (socially costly) way, with hasty spending cuts and inefficient tax increases. Adjustment lending provides temporary relief while a permanent fiscal adjustment takes place.

3. Let me now consider some specific points raised in the memo. First, I think that it is fundamentally wrong to argue that external financing is as inflationary as financing from the Central Bank. The external loans do not have to involve any intervention by the Central Bank or change in the monetary base: the Government can simply exchange in the market as much foreign currency as it needs for the purchases of domestic goods. The result would be some appreciation of the currency and a somewhat smaller trade surplus - which is of course what is required to effect the external transfer. If there is a fixed exchange rate regime, external flows may indeed end up in higher reserves and generate monetary expansion, as you mention. But the final impact is still not equivalent to Central bank financing. The reason is that as increased liquidity starts to produce higher prices, the real appreciation produces an expenditure-switching effect (absent in pure Central Bank financing, where the exchange rate would have to depreciate pari passu) which would moderate the resulting overall inflation. The availability of external funds allows more imports to satisfy the expansion in liquidity and, thus, reduces its inflationary effect.

4. Second, does World Bank (or IMF) support help the credibility of an adjustment program? I think it does, for at least two reasons. One is that it reduces the costs of the program. As discussed above, external support makes it feasible to wait for a more efficient tax reform instead of quickly increasing revenues at a high distortionary cost, to protect better the poor, and to incorporate cross-country experience from the Bank in the design of the program. A better program has less opposition and it is more likely to be completed, i.e. it is more credible. A second reason is that IFIs' support gives a higher stake to the Government in maintaining the program, as it is a

condition of continuing external support, not only from the IFIs, but in many cases from other governments and even private banks as well.

5. The objection to financing social sectors (para. 4) is made on the basis that "it is bad to finance expenditures in domestic goods with external funds". But this does not recognize the role of market-clearing prices in decoupling income and spending. It would be an unlikely coincidence if public sector revenues and expenditures had the same degree of "intensity" in foreign exchange; why should we require that from the sources of financing? The "need for foreign exchange" is not a datum, it is an endogenous variable responsive to economic variables, such as the exchange rate. This does not mean that it is impossible to borrow too much. As with most economic variables, there is an optimal level of borrowing -- which may have been exceeded for some countries in the past, but which clearly does not require a matching of sources of financing and types of expenditures in every project undertaken. More important is the quality of these projects. In many countries social sector projects are among those with a highest return.

CC:	Larry Summers	(LARRY SUMMERS)
CC:	Enzo Grilli	(ENZO GRILLI)
CC:	Parvez Hasan	(PARVEZ HASAN)
CC:	Ishrat Husain	(ISHRAT HUSAIN)
CC:	Gobind T. Nankani	(GOBIND T. NANKANI)
CC:	Lyn Squire	(LYN SQUIRE)
CC:	Vinod Thomas	(VINOD THOMAS)
CC:	D. C. Rao	(D. C. RAO)
CC:	Anandarup Ray	(ANANDARUP RAY)
CC:	Michael Walton	(MICHAEL WALTON)
CC:	Andres Solimano	(ANDRES SOLIMANO)
CC:	nissan Liviatan	(PAPER MAIL)
CC:	Steven Webb	(STEVEN WEBB)
CC:	Nancy Birdsall	(NANCY BIRDSALL)
CC:	file	(PAPER MAIL)

The World Bank/IFC/MIGA
F I C E M E M O R A N D U M

DATE: May 26, 1992 12:41pm

TO: Enzo Grilli (ENZO GRILLI)

FROM: William A. McCleary, EC1DR (WILLIAM A. MCCLEARY)

EXT.: 33014

SUBJECT: Background Note on Adjustment Lending (AL)

1. On further reflection, I find the direction taken by our lunch meeting last Friday quite disturbing. There is broad support, I think, for adjustment lending in the cases of balance of payments (b.o.p.) difficulties and for the notion that these difficulties be interpreted broadly to include present gaps, expected future gaps, or gaps generated by the AL program itself as with trade liberalization or with a programmed higher investment level stemming from the desire to achieve a higher growth path. Accompanying all these cases would be a program of macroeconomic and structural adjustment conditionality that would be expected to lead to improved external and internal performance and creditworthiness in medium-term. If I understand things correctly, (and I'm not familiar with the details), the Bangladesh loan may fit these criteria--a larger public investment program (consisting of a rationalized smaller number of higher priority projects) is expected to jump-start the economy leading to higher growth and temporarily larger gaps. Provided that one finds Bangladesh macro adjustment and tax reform program convincing and provided that one is convinced that the larger investment program is feasible, a strong case for AL would exist. Where I begin to have trouble, however, is in the possible finding that more cases for AL likely exist and that the Bank needs to broaden the set of conditions under which AL would be allowed. I find the examples cited to date inconvincing.

2. First is the case of a country with a b.o.p. surplus and high inflation generated by a public sector deficit (Selowsky's case). Given that expenditure/tax reforms may not reduce the deficit immediately, it is argued, it would be desirable to have Bank AL financing substitute for inflationary budgetary financing. This is not convincing. In the first place, absent an increased need for foreign exchange (i.e., a smaller surplus), financing from the World Bank will be just as inflationary as financing from the central bank. The central bank ends up holding foreign exchange rather than government debt in its portfolio and the stock of base money would be the same in both cases. In the second, with no IMF program, no b.o.p. need, and no immediate impact on the inflation rate, it is hard to see how the World Bank's presence will assure the private sector (foreign and domestic) that the reform program will in fact be carried

through. What is needed for "credibility" is a fiscal program with a big down payment--a big impact up front. Lastly, economic reforms are a necessary and desirable part of development. The Bank does and should expect them as part of the progress expected of most countries and as part of maintaining/improving creditworthiness. It is not necessary nor desirable that the Bank reward all reforms with AL financing.

3. Second is the somewhat more general case of whether AL can be justified in situations of protracted b.o.p. surpluses (to narrow the range of possibilities a bit, assume that surpluses are expected indefinitely). While one can no doubt think of worthwhile reforms to be supported (e.g. financial restructuring, public enterprise reforms), many of the same questions as in para. 2 can be raised about the role the World Bank's presence is playing. More importantly, it is worth stressing that the provision of additional foreign exchange in these circumstances has costs that must be considered. In the absence of additional demands generated by the reform program, the additional foreign exchange, when converted into domestic currency to pay for non-traded goods, will generate added inflation, appreciate the currency, and cause a deterioration in the trade balance. While such costs may be worth bearing, we need to be explicit about the fact that they are being generated by the reform program and the chosen method of financing.

4. Last is the possibility of a adjustment lending for the social sectors. My problems with this have both a disbursement side and a conditionality side. The former is the question of whether ALs should be disbursed against local costs (non-tradables). I think that your para. 26 may be a bit too relaxed on this subject saying, "it makes no difference whether a particular SAL disburses against dollar tags or peso tags as long as policy conditionality remains the same." In general, I would agree as long as it is stressed that in both cases what you have is general import financing. Unless there is a commensurate growing need for foreign exchange to finance imports (arising from some other part of the government's program) you will run up against the problems cited in para. 3. In addition, it is difficult to see what is gained by earmarking some or all of the adjustment loan's proceeds against a subset of government budgetary expenditures. The history of counterpart funds/earmarking in adjustment loans is a checkered one at best and, given fungibility, we're only kidding ourselves about what it is that we're financing.

5. As for the conditionality side, an important part of any broad social sector operation would no doubt be an agreement with government on the size and composition of (capital and recurrent) expenditures in this area. This agreement--plus agreement with government on an overall macroeconomic program which would include the budget deficit and its financing--would provide the ex ante assurances needed of the government's commitment to an increased effort in the social sectors. It is hard to see what

additional contribution earmarking of fast-disbursing money to the social sectors would make (in any event, it is difficult to see why the social sectors need fast-disbursing money and why sector investment loans--which are slower disbursing and which do allow earmarking would not do just as well; however, the sector loan would have to be accompanied by the existence of a solid macro framework as earmarking by itself is not likely to assure that an expenditure program will be implemented). My final reservation about adjustment lending in the social sectors is as follows: In the traditional ALs, in addition to a b.o.p. need, one can identify a reform program that is contributing toward increased internal and external stability over time (perhaps as one of an expected series of operations leading toward that objective). As important as the social sectors are to economic development and the social justice, reforms in their performance produce more long-term and diffuse results--i.e., they do not make the contribution to medium-term stabilization and adjustment that other ALs would make. Until it can be demonstrated otherwise, I would be against any free-standing adjustment lending in the social sectors.

6. In sum, I am not convinced that there is much of a case for broadening the scope of adjustment lending. I remain open to being convinced on a case-by-case basis but I think it would be a mistake for the Bank to suggest that there is much scope for adjustment lending beyond the traditional b.o.p. rationale. First, as I've outlined above, the examples of new possibilities are not very convincing or may have troubling side effects. Second, ten plus years of experience with adjustment lending ought to have taught us some modesty about what has been achieved. As the various RALs show, implementation of conditionality is satisfactory but quite a bit short of impressive and there is an apparent connection between adjustment lending and improved economic performance. The improvement in performance for AL countries as a group is greater than that for non-AL countries and certain kinds of reforms have a beneficial effect as shown in RAL 3 (e.g., real exchange rate changes, budget deficits, reductions in inflation and price distortions). Beyond this, our knowledge of which reforms really matter and what their differential impacts are is very thin. Until our knowledge of what matters improves, the case for broadening the scope of adjustment lending, in my view, remains weak.

CC:	Larry Summers	(LARRY SUMMERS)
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CC:	Steven Webb	(STEVEN WEBB)
CC:	Nancy Birdsall	(NANCY BIRDSALL)

June 4, 1992

Mr. Enzo Grilli

Enzo:

1. All foreign borrowing is consumption-smoothing, not a special feature of adjustment loans (ALs). The distinguishing characteristics are two (a) quick-disbursing (this also can occur with non-adjustment lending), and (b) policy-based. This is the key.

2. Foreign borrowing in any form, including additions to reserves, is justified only if rate of return > marginal cost of borrowing. This is the key criterion that needs to be cited.

3. When a "disturbance" occurs, e.g. when an investment opportunity occurs, or when terms of trade declines, or when a policy change becomes feasible, there are alternative ways of financing, of which foreign borrowing would generally be one.

4. There should be no bar against social sector financing if Nos. 2 and 3 are satisfied.

Anando Ray

Enzo
See some notes on last page

- Expand on policy recommend.
- Summary recommend.

ALL-IN-1 NOTE

DATE: 03-Jun-1992 04:34pm

TO: Ricardo Martin (RICARDO MARTIN)
TO: Lyn Squire (LYN SQUIRE)

FROM: Enzo Grilli, DPG (ENZO GRILLI)

EXT.: 81934

SUBJECT: Adjustment Lending/Version 2

Ricardo and Lyn,

Many thanks for your comments and suggestions, which I have fully incorporated in the new text (I believe). If you have not yet looked at the previous version, could you please look at this one (which is slightly more polished) and fax it back to me with any changes that you still see as desirable (Fax# 71569). I will then give it to Larry (who already asked for it yesterday!). Thank you.

---

1. The most general economic rationale for adjustment lending is that it smoothes the costs of structural reforms. These are consumption costs, i.e. private or public consumption which, in the absence of external borrowing, would have to be foregone as a result, for example, of sudden and large changes in key relative prices occurring autonomously or because of reform of domestic policies. Confronted with significant transitional costs from adjustment measures, a country can borrow externally to reduce the economy-wide welfare losses that adjustment entails, by spreading these costs over time. Intertemporal optimization of consumption, aside from being economically rational, may also contribute to the social and political sustainability of the reforms undertaken in the adjusting country, thus making them more likely to succeed. Since most adjustment measures aimed at modifying trade and exchange rate regimes, or at raising investments, have negative current account consequences, at least in the short run, borrowing in foreign exchange in these cases can be thought as meeting some of the additional demand generated by the policy changes being put in place (i.e. as financing additional expenditure in tradeable goods).

2. However, temporary consumption smoothing for a country undertaking structural adjustment can be attained not only by external borrowing, but also either through the utilization of existing foreign exchange reserves. While the case for reserve use is generally cast in terms of "compensatory financing" to smooth out temporary BOP deficits, a country having adequate foreign exchange reserves, and expecting to return to current account balance in a relatively short time, can resort to using them to deal with the transitional consumption costs of

structural adjustment as well. In calculating the marginal cost of reserve utilization the market credibility effects of changes in the stock of domestically held foreign exchange will have to be taken into account. Reduction in reserves may in fact affect the internal and external credibility of the government and of its policies. External borrowing for the purpose of consumption smoothing to be justified in the presence of reserve availabilities must be shown to be a superior alternative, i.e. to be less costly to the country than using reserves.

3. When external borrowing is justified from the country point of view, the rationale for the Bank extending quick-disbursing loans in foreign exchange (in the presence of a reform program judged to bring adequate benefits to the country) can be, therefore, generally defined in BOP terms: a) an actual current account deficit, and b) an anticipated current account deficit deriving from either the adjustment policies being implemented or other desirable objectives being sought (e.g. higher economic growth). These are the normal circumstances in which our adjustment lending takes place.

4. Some policy reforms may not have a real resource cost, but may have significant negative effects on the government budget, as in the case of recapitalizations of the domestic banking system in the framework of financial sector reform, or severance payments for redundant employees of public enterprises being restructured or privatized. In this case there might also be a rationale for public expenditure smoothing, given that the increase burdens on the budget are temporary. Unlike the previous, and more usual case, the reforms being implemented do not involve any real economy-wide welfare loss. Internal transfers are instead at issue. By compensating groups that stand to lose the most from the reforms being implemented, the government can increase their chance of success, thus ensuring that the benefits from reform will eventually accrue to the whole economy.

5. Financing this type of expenditure smoothing (or temporary budget imbalance) can be done through increased taxation (or reduction of other expenditures), government borrowing domestically from the private sector and by foreign borrowing. A case for external borrowing can be made if the alternative means of financing the additional expenditure (e.g. increasing taxes, borrowing domestically or expanding base money) were inferior (i.e. more costly than) external borrowing. Taxation--broadly deferred--may be inferior to borrowing, external or internal, if the expenditure needs are temporary and increasing taxes generates dead weight losses for the economy. These may also increase if inefficient taxes are used. The decision between external or internal borrowing will depend on their relative costs to the government. In making this decision, however, the government should consider the possible drawbacks deriving from external borrowing on its internal credibility as well as on the domestic exchange rate. Borrowing externally (i.e. in foreign

exchange) to financing domestic costs (i.e. expenditure in non-tradeable goods) will entail an appreciation of the domestic exchange rate and a loss in external competitiveness.

6. In conclusion, from the Bank's standpoint, quick-disbursing loans in foreign exchange are appropriate in most cases where consumption-smoothing is needed in the borrowing country (and reserves cannot be used or represent an inferior alternative), since reforms of price systems, trade regimes or even of the public sector are likely to have temporary balance of payments costs. Balance of payments imbalances generated by reforms can thus be financed through the use of these loans. In all these cases the traditional "balance of payments condition" for adjustment lending can be seen to apply.1/ In those cases where quick-disbursing loans are utilized to make possible temporary smoothing of budget expenditure, their use must be justified as a superior alternative to taxing (or other expenditure cutting) and to domestic borrowing.

1/ Obviously, such condition applies even more directly when reforms are undertaken in the presence of a current account deficit (as it is normally the case after an external--say a terms of trade--shock has been absorbed).

Enzo

1. All foreign borrowing is consumption-smoothing, not a special feature of adjustment loans (ALs). The distinguishing characteristics are two a) quick-disbursing (this also can occur with non-adj lending), and b) policy-based. This is the Key.

2. Foreign borrowing in any form, including additions to reserves, is justified only if rate of return > marginal cost of borrowing. This is the Key criterion that needs to be cited.

3. When a "disturbance" occurs, eg when an investment opportunity occurs, or when terms of trade declines, or when a policy change becomes feasible, there are alternative ways of financing, of which foreign borrowing would generally be one.

4. There should be no bar against social sector financing ~~or trend~~ if nos 2 and 3 are satisfied.

an
June
92

The World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: June 2, 1992 02:26pm

TO: William A. McCleary (WILLIAM A. MCCLEARY)

FROM: Nancy Birdsall, CECDR (NANCY BIRDSALL)

EXT.: 37458

SUBJECT: RE: ADJUSTMENT LENDING AND FISCAL ADJUSTMENT PROGRAMS

Two thoughts on your reply to Marcelo.

1. In the case of bop surplus but persistent fiscal deficit: When governments undertake fiscal adjustment there may be instances in which there are high upfront political costs combined with upfront resource costs. Reducing the size of the civil service or firing employees of public enterprises as part of privatization -- involving severance packages -- are examples. Suppose these are part of a comprehensive fiscal reform including tax and expenditure reforms, all on the part of a new government in a country where prior governments have talked reform but yielded to populist and vested interests' pressures when the going got tough. The Bank has two options: policy dialogue cum TA for the fiscal reform (let the government borrow domestically to finance the upfront transition costs); or policy dialogue cum AL money. Would the Bank's involvement only with TA money be enough to provide credibility such that the governmnet'd cost of borrowing domestically would not be higher than borrowing from the Bank? Suppose investors face higher information costs in assessing the government's fiscal reform package than the Bank, and see the Bank's willingness to lend as a measure of the Bank's technical assessment of the government's program (as well as ensuring some outside monitoring of the reforms, strengthening the hand of the reformers inside government? (In this case investors don't know that the Bank's record in enforcing conditionality is, at least in your view, "nothing to cheer about"!)

Is this not a case for AL despite the surplus in bop, and despite the lack of any past government record in reform? It may be a weak case, with a heavy burden of proof on Bank staff to make it. But there are transition costs to be smoothed, and without the Bank the government, because of lack of credibility, faces the prospect of driving up domestic interest rates, and therefore the Bank's money tied to enforcement capability as well as its possibly superior technical assessment made credible by its money, mean the overall cost of borrowing will be lower via the Bank.

2. On social sector adjustment lending, as long as there is a bop gap, would you still see a problem? The argument that AL can

smooth transitions applies -- even though any transitional costs will be local. I am not sure why you are assuming "earmarking of disbursements" in the case of ALs with social sector conditionality, when we do not earmark with, say, conditionality on privatization progress or pricing reforms in agriculture. Nor is it obvious that social sector reforms are "contribute relatively little to medium-term macroeconomic and structural adjustment." There are many cases in which conditionality would involve reducing expenditures in the medium run, or at least not increasing expenditures -- but with upfron transition costs. Consider refomr of old age security systems, or spending from tertiary to primary level, by replacing subsidies for univesrity students with loans. In the case of a bop surplus we are back in the world of para. 1.

CC:	EMENA ISC Files	(EMENA ISC FILES)
CC:	Zenaida S. Kalinger	(ZENAIDA S. KALINGER)
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CC:	Parvez Hasan	(PARVEZ HASAN)
CC:	Enzo Grilli	(ENZO GRILLI)
CC:	Larry Summers	(LARRY SUMMERS)
CC:	Marcelo Selowsky	(MARCELO SELOWSKY)

A L L - I N - 1 N O T E

DATE: 27-May-1992 01:14pm

TO: See Distribution Below

FROM: Michael Walton, DECVP (MICHAEL WALTON)

EXT.: 38418

SUBJECT: Adjustment lending rationale

Here are some additional points on the rationale for adjustment lending.

1. I'd agree strongly with Lyn that the principle of consumption-smoothing in response to structural change should be more vividly and explicitly at the core of the rationale for adjustment lending: that's pretty much what we ended up with in RALIII, but it was still somewhat muted. The structural change can be due to an external shock or bad past policies.

2. Assessing the balance of payments/reserve issue can be cast in this context. Reserve accumulation beyond the level needed to provide assurances that a country has resources for transactions and precautionary (expected or unexpected shocks) motives, i.e. to confer "credibility" to the international markets, are equivalent to foregone consumption in the present period. It makes no sense for the Bank to provide resources for consumption smoothing in place of a country's use of its own reserves: it is foolish from the country's perspective the case of IBRD borrowers, and it is foolish from an international welfare spective in the case of an IDA country. The matter for judgment, that was somewhat clarified in the meeting, concerns the need to form a view on what level of Central Bank reserves were necessary for credibility (the Morocco SAL argued that a higher reserve level than historicially was important in the coming years to build a credible basis for a move to convertibility--that would be an example of a valid reason for a change in view on optimal reserve levels.)

3. In deciding the balance between adjustment and investment lending I think we need to give more explicit attention to the question of which category of spending is suboptimal in the present and future for a country, relative to a situation without lending. If it is private or public consumption, there is a prima facie case for adjustment lending; if it is public investment there is a prima facie case for investment lending--specific or sectoral (though adjustment lending might be used, for example, to support an overall shift from public consumption to investment); and if it is private investment it could be either (financial intermediary loans may be a better instrument).

4. I think there is a muddle on the view that limiting finance to imports is preferred from a macroeconomic perspective (whether this flows from thinking in terms of a gap and fixed coefficients, or fears of Dutch Disease effects). First, with some complementarity of inputs, increased imports will allow increased domestic spending, and so will increase demand on nontradeable goods markets, so it is a fiction to think we avoid this by avoiding finance of local costs. Second, in most countries there are some unemployed resources, and increases domestic demand, consistent with external balance, is exactly what is ted--to reduce un/under employment in the short run, and increase incentives

for new investment in the medium term. This implies being relaxed about whether we are financing local or foreign costs (provided other sensible conditions ly--Lyn's list is good), but only have significant lending levels, adjustment or investment, in the context of sensible macroeconomic policies (and indeed Dutch Disease effects may be important for some countries).

DISTRIBUTION:

TO:	Enzo Grilli	(ENZO GRILLI)
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CC:	Nancy Birdsall	(NANCY BIRDSALL)
CC:	Anandarup Ray	(ANANDARUP RAY)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE : May 27, 1992

TO : Mr. Enzo Grilli

FROM : Anandarup Ray

EXT. : 81947

SUBJECT: **Rationale for Adjustment Lending**

Attached please find a note I did last weekend to experiment with the idea of applying the Little-Mirrlees scheme to the present context. I am sure this type of an approach will have very limited appeal in the Bank at this time. Nonetheless, it might assist your discussions with Marcelo and Lyn.

cc with copy: Messrs. Selowsky, Squire

ARay:pl

Anandarup Ray
May 24, 1992

The Rationale for Adjustment Lending

1. This paper elaborates upon the so-called "balance-of-payments" rationale for adjustment lending. A general definition is first proposed, and compared with the Bank's approach to investment analysis. The proposed interpretation is then illustrated with reference to five types of cases that have frequently come up in recent discussions.

2. The paper suggests that the rationale for adjustment lending be placed in the same cost-benefit framework of analysis that the Bank developed in the 1970s for investment analysis: a country should borrow upto the point where the marginal cost of borrowing equals the social discount rate. Provided that the marginal cost does not exceed this level, a country should borrow from the Bank if the Bank is a competitive source of funds (allowing for quality, externality, and the "technical assistance" component). And the Bank should lend if the country is creditworthy. What distinguishes adjustment lending from investment lending is that the former smooths consumption streams (higher initially than it otherwise would be), and that it is policy-based. If this approach is accepted then there is no need to explicitly contrast the balance-of-payments rationale with other types of rationale, eg the fiscal rationale.

The General Approach

3. We propose an interpretation of the "balance-of-payments" rationale for adjustment lending that is well-grounded in theory and conformable to the approach developed in the Bank for investment analysis. There is no reason why the Bank should use logically disparate approaches in evaluating different forms of lending. Indeed the concern with the balance of payments that was so natural at the time Mr. Stern introduced the concept of adjustment lending, was also dominant when Ian Little and James Mirrlees, and subsequently Herman van der Tak and Lyn Squire, developed the approach to investment analysis. [1] The debates and discussions on the "LM" approach during the late 1960s and

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[1] See Lyn Squire and Herman G. van der Tak: Economic Analysis of Projects (1975); for a subsequent comparative analysis and update on Bank practice see Anandarup Ray: Cost-Benefit Analysis (1984). For a Bank policy statement see Anandarup Ray and Herman van der Tak. "Economic Analysis of Projects", Operational Manual Statement, 1980.

early 1970s went over dozens of interpretations of the so-called balance-of-payments "constraints" and "gaps."[2]

4. The purpose of the present discussion is to focus on concepts rather than measurement. The reason is that adjustment programs are much broader than individual investments, and they contain mostly policy changes. Consequently, while the analysis of policy changes does not introduce any methodological differences, measurement of their effects is generally not possible in Bank practice.[3]

The format of analysis

5. With this important caveat, let us write N_i as the net present value of the time-stream of costs and benefits associated with an adjustment program, A_i. This N_i can be written as $N_i = E_i - S_i$. The first term, E_i, is the net economic benefits in the traditional sense. It measures change in national income plus change in consumers' surplus. It is measured, however, in the foreign exchange numeraire. A particular value of E is equivalent, by choice of numeraire, to an increase in international reserves by the same amount.

6. The second term, S_i, is a distributional term that captures the influence of redistribution effects between savings and consumption, and between people. We can write $S_i = S_i (C_i, v, d)$, where C_i is the change in private consumption, v is the savings "premium" relative to consumption, and d is the distribution parameter. The distribution parameter can be discussed in several different ways, as in Little-Mirrlees, or Harberger, or Streeten and Burki, Selowsky and Reutlinger, and World Development Report 1990. We shall not however discuss this parameter in this paper; it may nonetheless be interesting to observe that from a practical point of view the differences between all these viewpoints are not necessarily all that great.[4] If there is no premium on savings then the term S_i disappears.

Optimality of reserves and borrowing

7. The savings premium is worth a comment. In Little's first version, it was derived from the net present value of public investments (demand price). Public savings

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[2] See, for example, R. Findlay (1973), ..., and D. Lal, "Foreign Exchange Constraints in Economic Development: A geometric note," The Indian Economic Journal (1972)

[3] See J. Dreze and N. Stern, ..., "Handbook of Public Economics," vol. II, which explains why both policy changes and investments can be evaluated in the same framework.

[4] For a more detailed discussion, see Anandarup Ray, "Perfecting tools to measure the alleviation of poverty," OECD (1989).

were assumed to be totally inclastic.[5] When this is relaxed, the premium can be interpreted as the marginal cost of public finance. The results obtained by Fullerton and Shoven suggest that the premium might be quite high in developing countries: perhaps $2 per dollar raised.

8. Implicit in all this was the simplification that private and public savings, as well as private and public investments, were equally valuable at the margin. This is a totally inappropriate assumption these days. We must distinguish between private and public; the marginal value of private investments clearly exceeds that of public expenditures (the state should contract).

9. In the context of adjustment programs, the point is to lower the marginal cost of taxation, by introducing a broad VAT for example.[6] It is also a standard objective to raise the productivity of public investments.

10. Because foreign exchange is the chosen numeraire, the savings premium is identically equal to the scarcity value of uncommitted international reserves. Excess reserves mean that:

> Marginal cost of public finance is greater than the marginal value of public expenditures.

In this "Surplus" situation, the excess reserves ought to be transferred back to the private sector in the form of lower taxes or lower borrowing. Reserves are optimal when equality holds.

11. Both E_i and S_i will depend on other shadow prices, in particular, on the ratio of shadow exchange rate to market rate, ratio of the shadow wage rate to the market rate, and the discount rate (or, the accounting rate of interest which must equal the marginal cost of foreign borrowing when borrowing is optimal). Now since foreign borrowing, like domestic borrowing and taxation, is a source of public funds, optimal reserves imply

> Marginal cost of foreign borrowing (say, f) equals the accounting rate of interest (ARI, the marginal rate of return to public investments, or to expenditures more broadly).

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[5] As such the savings premia are really the annual shadow prices of the intertemporal budget constraints, developed by Stephen Marglin in his PhD dissertation in 1959.

[6] This is different from Harberger's approach, which assumes that the government borrows at the margin, and that the relevant distortion is relatively small (the savings premium is quite negligible). This is an awkward assumption for many of the economies in the 1980s and 1990s. However, it might still be the appropriate assumption for project analysis if a parallel policy reform program is in place to reduce the marginal cost of funds to the public sector.

12. Thus, the decision at the margin is:

a) retire debt or lend abroad if

$$f > ARI$$

In this case the country can still hold World Bank loans in its portfolio if they are cheaper than ARI (and quantity-constrained).

b) optimality implies

$$f = ARI$$

c) borrow more if $f < ARI$. One would expect to find loans from the World Bank in the country's portfolio mostly in cases (b) and (c).

Adjustment and investment lending

13. We have said nothing thus far to distinguish between adjustment lending and project lending. There are indeed no differences in principle. In the case of adjustment programs, the country first defines the feasible programs and then chooses the best one by maximizing N_i, over i. In the case of projects, a similar exercise takes place but the focus is only on the range of options relevant to the project. The differences are in content. In projects, we are evaluating certain expenditures for exogenously given time-vectors of shadow prices; in adjustment programs we are asking instead: should we bring shadow prices in line with market prices, and if so how fast and in what sequence?

14. Account must be taken of the time vector of F, foreign capital inflows, because these have to be paid back. If the amount of F is invariant with respect to the particular adjustment program chosen, then we simply maximize N_i as earlier indicated. The feasible set is defined to begin with as consisting of programs that can pay back F. This is the standard Bank procedure in the case of investment lending.

15. This assumption is likely to be less justified in the case of adjustment lending than in the case of project lending. If the terms and amounts of foreign borrowing depend on the choice of the adjustment program, then the maximization process will simultaneously determine the optimum borrowing strategy and the best adjustment program. [7]

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[7] For a seminal article using shadow prices which makes this point, see Marcelo Selowsky and Ricardo Martin in "World Bank Economic Review," January 1988. See also Martin and Selowsky, "Journal of Development Economics" (1984).

16. In associating foreign borrowing with adjustment programs, we assume that the latter involves costs. This need not always be the case (an increase in agricultural producer prices which improves both the budget and the balance of payments), but in general there will be costs endogenous to each program. In practice, of course, the largest chunk of the borrowing requirements arises from external shocks, which indeed have triggered most adjustment programs.

17. Let us note, parenthetically, that there can be no meaningful distinction between local and foreign costs and benefits because all such effects are reduced to a common numeraire via shadow pricing.

The rationale

18. To sum up, we interpret the BOP rationale as a finding (or a presumption, which will in many cases be so obvious as not to require refined measurement) that a feasible adjustment program exists such that a) it is the best among competing alternatives, and b) its yields are sufficiently high to justify the borrowing required.

19. Following are the key characteristics of adjustment loans:

a) Foreign borrowing smooths the adjustment costs. A very simple example is that of real depreciation following an external shock. With foreign borrowing, the real depreciation will be less now, but more later when the time comes to pay back the loan (Selowsky-Martin, as cited earlier).

b) Adjustment loans are policy-based. Besides cushioning the impact of external shocks, adjustment lending promotes policy reform. In fact a sine qua non of adjustment lending is that the country would take the necessary adjustment measures. In addition to the various types of institutional changes promoted through adjustment loans, the policy- based nature of adjustment can be envisaged as the process of moving shadow-to-market price ratios closer to one.

20. Fiscal and balance of payments effects, to be discussed further in the next section, are interdependent, and it is not necessarily a fruitful idea to disentangle them: those effects are already incorporated, "weighted," and integrated in the expression N_i. Nonetheless, one can differentiate as to the source of the immediate "disturbance" -- external sector or the fiscal sector (for example, inflationary financing), much along the lines of Balassa and Mitra in the early 1980s.

21. But focussing on the fiscal side brings out another aspect of smoothing. An external or internal shock, or a debt crisis, increases the scarcity premium on public savings,[8] and thereby the accounting rate of interest (the shadow interest rate)[9]. Foreign borrowing smooths out the shadow price of public savings. But this smoothing is but another way of looking at the consumption smoothing earlier referred to.

22. Thus we should adopt a broad rationale. Adjustment lending should be considered when there is a good adjustment program; the presence of an external shock strengthens the rationale but is not by itself sufficient. In principle it does not matter whether the cause of a crisis is a BOP shock or a policy slippage leading to inflation. However, the actual design of programs will of course depend on the origin of the problems they are intended to address.

Five Cases

23. We now discuss five cases that have been frequently cited in recent discussions to illustrate the general approach outlined above. These cases are:

a) A trade liberalization cum devaluation program, as mentioned in the draft guidelines on adjustment lending.

b) An increase in public investments from an initial condition of stable and sustainable low-growth equilibrium, in order to shift to a higher growth path.

c) Adjustment lending to reduce the need to rely on domestic sources for financing budget deficits while countries move toward efficient and sustainable reductions in public sector deficits, which takes time.

d) Local cost financing through adjustment lending.

e) Adjustment lending to finance social sector interventions.

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[8] Note this is also the shadow price of foreign exchange resources in Little's system. Not to be confused with the same terminology in Selowsky-Martin.

[9] Since the latter is really the rate of fall of the savings premium.

Trade liberalization

24. The idea in the first case is that of smoothing out the trade liberalization process. This is a natural extension of the early rationale for adjustment lending and was fully anticipated in the 1980 Board paper. In recent years the balance of payments support provided by the Fund and the Bank to India can, for example, be regarded as being partially intended to mitigate the impact effect of liberalization and prevent overshooting of the exchange rate (which has been fixed temporarily). But as the India case also illustrates it is very difficult to disentangle the effects of trade liberalization per se from the rest of the program.

Public investment-led growth [10]

25. The second case represents a savings-constrained situation in which external finance fills the current account deficit that opens up until savings increase. If one assumes that private and public savings remain approximately unchanged, an increase in public investments will show up one-for-one in an increased current account deficit that we are to finance. However, this rationale for adjustment lending -- used innovatively in the Bangladesh public resource management credit -- may easily be misinterpreted and become a blanket justification for adjustment lending in all countries in all seasons. Indeed much of the explosive foreign borrowing in the 1970s went to finance ambitious public investment schemes intended to jolt the economy to higher growth paths.

26. What distinguishes the Bangladesh case from the typical profligacy experienced so widely in the past is that there is: i) an adjustment program agreed with the Bank and the Fund, ii) provision for close scrutiny by the Bank of public expenditure policies, and iii) a program to increase public savings through tax reform (in particular the introduction of a value-added tax). However, irrespective of its merits (and we do not imply any criticisms here) this case does represent a clear departure from the way adjustment lending has been viewed in the past: an initial situation of no internal or external disequilibria, satisfactory foreign exchange reserves, and low growth is the classic case for investment lending, rather than adjustment lending.

27. The Bangladesh approach may be viewed as an extension of the logic by which financing of time-slices of sectoral investment programs was introduced in the 1970s: if sectoral institutions are strong enough to manage projects and do cost-benefit analysis themselves, we can expedite resource transfers and enhance policy dialogue by focusing on the sectoral level and avoiding the micro-analysis of the traditional project-by-project approach. If we can trust the government to do a good job, or if it allows us to supervise

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[10] I am indebted to Pradeep Mitra for his comments.

their budget policies closely through the tranching process, then why not? Ultimately this is a question of credibility and track record. The PFP process and the tranching apparatus are new instruments that can be particularly helpful in this context.

Debt service and phased adjustments

28. The third case, suggested by Selowsky, is very similar in that it also assumes that adjustment lending from us would substitute for inflationary financing or borrowing from the domestic private sector (which would increase the interest rate and crowd out private investments).[11] It is also assumed that tax reforms are in progress and that public expenditures are being trimmed, but to do this takes time while the domestic financing of the deficit must be cut immediately. The difference is in the initial conditions. The government needs to reduce or eliminate domestic borrowing quickly; external finance helps the fiscal adjustment by allowing all progress made in the primary surplus to be fully translated into lower domestic borrowing. Only after domestic borrowing has been eliminated or reduced to acceptable levels would the continuing improvement in the primary surplus start to reflect itself into lower external borrowing. Thus, the adjustment path that Marcelo has in mind is different from the Bangladesh case. There is an ex-ante balance of payments rationale in this case although at the margin foreign borrowing supplements the budget for a particular phase of the adjustment process.

Local cost financing

29. Another issue that has been discussed quite a lot in the recent past concerns local cost financing under adjustment lending. Adjustment loans disburse against general imports (subject to some irrelevant cosmetic restrictions). Disbursements are made against certificates and bills with dollar tags. Disbursements against local costs, which are done in our project lending, are against peso tags. In either case this is general import financing, and there is no difference between the two modes of financing except in so far as they are tied to specific expenditures and are associated with different types of policy changes. In the case of local cost financing, there are particular project-specific expenses to be financed, and the institutional and cost-recovery issues are typically too micro to be focussed on in SALs and SECALs. But to put the point in another way, it makes no difference whether a particular SAL disburses against dollar tags or peso tags as long as the policy conditionality remains the same.

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[11] See Marcelo Selowsky: "External Financing and Adjustment," Finance and Development, June 1991.

30. The reason for this is that the same amount of foreign exchange is being added to the foreign exchange market in either case, and identical conditionality assures that the demand and supply curves shift the same way. The effects on the exchange rate and the final uses of the foreign exchange will thus be identical. This conclusion is different from that reached by El Serafy and his "task force." They took a different view and recommended that there be no local cost financing under adjustment lending.

Social sector adjustment lending

31. It is often thought that a country should not have to borrow abroad to "finance" policy changes in such sectors as education, health, and environment. But while there may not be any direct impact on the balance of payments, there may well be one indirectly through the budget, as we discussed earlier. For if tax increases and public expenditure cuts elsewhere are ruled out (the government is doing the best it can in this respect) the incremental costs of social sector policy changes will lead to a higher deficit, to be financed either by crowding out private investments or by inflationary financing; hence it would be better to borrow abroad by the same line or reasoning. Thus, if we adopt the proposed approach, we should also be not averse to social sector adjustment loans, to be disbursed against peso tags. However, one must ensure that satisfactory progress is being made with reforms of the tax system and of public expenditure policies.

Summary

32. Adjustment lending is intended to help a country smoothen the costs of adjustment over time. While a country may benefit from quick-disbursing external resources under many situations, a key precondition of adjustment lending is the assurance that the government will pursue a satisfactory and implementable program of adjustment and policy reforms. In assessing the case for adjustment lending, Bank staff should a) ensure that the overall adjustment program is satisfactory and likely to be feasible, b) in particular, examine the options of financing adjustment through reforms of taxes and public expenditures, and through non-inflationary domestic borrowing, c) ascertain the special advantages that a country may have in borrowing from the Bank, for example, in terms of effects on the terms and availability of other foreign capital, and d) ensure that there is a reasonable presumption that the government will be able to service Bank loans.

A L L - I N - 1 N O T E

DATE: 22-May-1992 05:02pm

TO: Enzo Grilli (ENZO GRILLI)
TO: Marcelo Selowsky (MARCELO SELOWSKY)

FROM: Lyn Squire, MNAVP (LYN SQUIRE)

EXT.: 36099

SUBJECT: Adjustment Lending

Enzo/Marcelo:

I suspect I am as thrilled as you to be working on this note. Be that as it may, here are my thoughts:

i) We should start with the obvious point that a necessary condition for adjustment lending is the need to smooth consumption in the face of some external or policy-induced shock. We can then argue about what constitutes such a shock.

ii) Once we reach agreement on (i) the relevant question is how to finance the consumption smoothing. Whatever the logic for the existence of World Bank lending, from the country's perspective all that matters is that we constitute one possibility. The country (or the Bank on its behalf) should appraise all options and choose the cheapest. From the perspective of the World Bank, our rationale must be either (a) the country would have adjusted without us but our financing is cheaper or (b) the country would not have adjusted without us.

iii) So I would conclude that adjustment lending requires the fulfilment of four conditons -- demonstration of the need for smoothing, demonstration that WB money is the cheapest (or only) means of financing the smoothing, assurance that the country would indeed take the necessary adjustment measures, and reasonable assurance that we would be repaid.

iv) On the issue of investment versus adjustment lending, we can always render the two equivalent with appropriate assumptions about fungibility. But these may not always hold in practice. Instead, I would argue that investment lending is justified if we are a cheaper source of funding or if the project would not be done without our financial participation and if we are reasonably sure about repayment. This is the same as my second and fourth conditions in para (iii). Adjustment lending, on the other hand, requires these plus the other two conditions of para (iii).

Lyn

CC: Ishac Diwan (ISHAC DIWAN)
CC: Michael Walton (MICHAEL WALTON)

CC: Anandarup Ray (ANANDARUP RAY)

A L L - I N - 1 N O T E

ATE: 22-May-1992 05:30pm

TO: Enzo Grilli (ENZO GRILLI)

FROM: Masood Ahmed, IECDI (MASOOD AHMED)

EXT.: 33801

SUBJECT: Additional thoughts on adjustment lending rationale.

Enzo,

After our meeting today, I was trying to clarify my own thinking on a couple of points and came up with the following, which may be useful in your preparation of the summary.

First, let's exclude the easy case of a prospective bop deficit. Whether it's exogenously caused or related to the implementation of the adjustment program, a prospective bop gap is a clear and well established extension of the traditional bop need argument.

Where we made a significant advance in today's meeting, in my view, was to focus on the case where :
-the pre-adjustment situation is charecterized by a bop current account surplus and significant reserves; and
-the post adjustment situation, in the absence of Bank financing, would be lower reserves but still a bop current account surplus.
I would interpret the concensus as being that in this situation, assuming usual caveats on quality of program etc., adjustment lending could be justified on bop grounds iff the fall in reserves reduced them to below the critical threshhold for maintaining "market credibility" on both domestic and international markets. In this sense, such a fall in reserves culd be construed to be a valid extension of the prospective bop gap case in a world where due to global integration and capital account liberalization, the level of reserves becomes a more important variable for private creditors/invesators to watch, and where the optimal level of reserves is itself likely to be higher than in the past. (Operationally, this more liberal interpretation of the bop need would be the easiest way to justify adjustment lending in bop surplus/large reserve countries).

On tahe other hand, if the adjustment program left reserves at a lower level but still higher than the minimum thresh hold for market credibility, the rationale for adj lending would have to be made on non-bop grounds. (This also excludes the simple fiscal gap rationale, because the govt could always borrow on local markets or from the central bank). Credibility, conditionality, bank can do what the Govt would not do on its own, etc. are all plausible reasons for supporting adj lending in

this case, but the onus would be on the project staff to build a case around these points and further to show that the amount of the loan was now defined in terms not of bop need but in terms of what was needed to achieve these other (more fuzzy?) objectives. Also in these cases there is no intellectual basis for saying in the Board documents that the loan responds to a bop need, even an implicit one.

Finally, on the point about why we should be willing to lend for projects but not SAL's in a bop surplus country, I am not sure that the visa card/mortgage analogy provides the full explanation. So let me offer the following three hypotheses as to why historically the Bank has required some kind of special bop case to be made for adjustment lending but not for project lending.

-i- Because adjustment funds were institutionally scarcer; the notion being that we operate below our overall lending capacity as an institution but close to the self/board imposed ceiling for adjustment lending;

ii- Because there was a greater unease about fungibility on adjustment lending and the notion that the "better monitoring" or greater efficiency associated with traditional project lending (which makes it justified even in the presence of other sources of finance) did not apply with the same degree of confidence for adjustment loans; and

iii- Because there was some sense of adjustment lending being easier and/or sexier to do, with the risk that if left to the market, it would crowd out traditional project loans within the lending limit for a prticular country.

The first reason assumes that the scarcity of Bank funds argument (which is the same as saying that the opportunity cost of Bank funds is greater than the intereast rate we charge) applies to adjustment loans which are volume constrained but not to project loans where the market is clearing at the going interest rate at the aggregate institutional level. The two latter reasons reflect some notion of internal market failure which has to be corrected by imposing additional "costs" on doing adjustment loans!

Do send me a copy of the summary when you have it; I would be interested to see how it finally comes out.

Regards,
Masood.

CC:	Marcelo Selowsky	(MARCELO SELOWSKY)
CC:	Vinod Thomas	(VINOD THOMAS)
CC:	Lyn Squire	(LYN SQUIRE)
CC:	Larry Summers	(LARRY SUMMERS)
CC:	Nancy Birdsall	(NANCY BIRDSALL)
CC:	Michael Walton	(MICHAEL WALTON)

The World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: May 22, 1992 06:26pm

TO: See Distribution Below

FROM: Anandarup Ray, DPG (ANANDARUP RAY)

EXT.: 81947

SUBJECT: Chief Economists' Lunch

1. Enzo suggested I write down the conclusion as I heard it. This is what I heard.

2. Larry said (i) we need to be very liberal in defining the BOP rationale. This rationale could be in terms of a) actual BOP problem, b) an anticipated BOP problem, c) an anticipated problem that is endogenous to the policy changes being supported, d) the fact that Bank's involvement has external effects (lowers cost of borrowing from others); e) Bank association gives the program credibility etc. etc. (ii) even when the broad BOP rationale fails, e.g. if there is a BOP surplus, there might still be a case if there is a "technical assistance component" to our adjustment lending (we have this special capacity to get things done, sending Shahid Husain to the field etc.)

3. In effect Larry said that the current doctrine is all right as long as the BOP issue is understood in a general sense.

4. I do not guarantee accuracy of these notes, however.

5. My view is that BOP surplus means marginal cost of borrowing (MSB) is greater than the accounting rate of interest (ARI), i.e. benefits from using borrowed funds. In this case the country should pay us for technical assistance, like Saudi Arabia still does although not enough for us to send Shahid Husain. We should not make either adjustment loans or investment loans in such a case.

6. Let us say reserves are optimal, i.e. no BOP problem. In that case a shift in Government expenditures should be financed by taxes, domestic borrowing and foreign borrowing perhaps by foreign borrowing entirely, as assumed by Mitra and Selowsky in their respective cases. The issue is not whether the shift represents additional demands for traded or non-traded goods, but whether the planned use of resources would yield a rate of return, evaluated at shadow prices, that equals or exceeds the cost of borrowing. If the additional demand is for traded goods only, then our foreign exchange resources will be spent entirely on Government imports (thus elating our Legal Department). If the additional demand is partly for non-traded goods, some amount of foreign exchange will need to be sold and there will be an

exchange rate effect (as in the paper).

7. That is, it does not matter whether the shift originated from a BOP shock, or a fiscal shock.

8. Nor does it matter whether we are talking about an adjustment loan (AL) or an investment loan (IL). The same rate of return criterion holds (in either case there is the same Net Present Value test). The time patterns are different and the expenditures financed, direct or indirect, are different. Since adjustments supposedly take a short period of time, ALs are quick-disbursing (one can think of a series of ALs to correspond to the true adjustment period)*

9. Another point is that the optimum borrowing strategy equalizes the MSB for all types of borrowing. This takes into account the non-monetary pros and cons of borrowing from the Bank. We do not have to worry about this supply side issue.

10. In practice we do not know the MSB or the ARI (we can guess though; Chief Economists should put more of their resources on this). We do not know what the optimum level of reserves are. If you poll the country economists, the median answer would be 3 months imports. We have to play our hunches.

11. Thus a possible conclusion would be that when the actual or expected levels of reserves appear to be about right, adjustment lending would only be justified under very strict conditionality on tax and public expenditure reforms. Lending for non-traded goods sectors would be as much justified as for traded goods. In the case of surplus reserves or rosy prospects, do not lend, but provide technical assistance if paid for.

* An interesting point in this cost-benefit framework concerns "tied-ness". Just as project financing can be tied, thereby affecting the time-stream of costs and benefits, ALs can also be tied. This will affect the rate of return of the AL.

DISTRIBUTION:

TO:	Enzo Grilli	(ENZO GRILLI)
TO:	Marcelo Selowsky	(MARCELO SELOWSKY)
TO:	Lyn Squire	(LYN SQUIRE)
TO:	Michael Walton	(MICHAEL WALTON)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE : May 21, 1992

TO : Mr. Lawrence H. Summers

FROM : Enzo Grilli

EXT. : 81934

SUBJECT: **Brief for the Friday Lunch**

1. The idea of adjustment lending in a situation in which there is no apparent BOP disequilibrium has gained wide currency in the Bank in recent months. My perception is that in many parts of the Bank adjustment lending will decline sharply if we have to adhere strictly to the traditional BOP rationale.

2. As explained in our background note for the discussion, we have no problems in principle with broadening the rationale for adjustment lending. We can easily envisage cases in which it is sensible for a country to seek adjustment loans from the Bank even though there is no immediate BOP pressure. For example, a privatization program in an initial situation of external and internal balance may involve a large amount of severance payments. There is no reason why the country should not borrow from us to finance such payments (if we are the cheapest source), and there is no reason for us not to finance such payments either if we are satisfied with tax and expenditure policies.

3. In practice, however, a broadening of the BOP rationale may open the flood gates, and some checks and balances may be useful. Subject to your agreement, we would propose in the new guidelines that adjustment lending in support of fiscal imbalances be considered only if:

- there is an overall adjustment program we can support,
- a tax reform program, including the introduction/broadening of VAT, reasonably efficient direct taxes, and improvements in tax administration,
- satisfactory public sector enterprise pricing policies,
- provision for close supervision by us of the public expenditure program.

4. You may want to orient the discussion with the Regional Chief Economists towards this type of a conclusion, which would then be reflected in the OD.

cc: Messrs. Walton, Ray

ARay:pl

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE : May 20, 1992

TO : Enzo Grilli

FROM : Anandarup Ray AR

EXT. : 81947

SUBJECT: **The Adjustment Lending Paper**

1. Attached is a draft note (or brief) from you to Mr. Summers on the outcome that we would prefer on Friday.

2. Attached also is a completed version of our May 11 draft, which I finished over the weekend. It introduces a brief general discussion of the rationale in terms of cost-benefit analysis (paras 12-19), before going to the issues. It defines the Selowsky case more precisely than before (para 25). It adds recommendations in para 26, and ties social sector financing to those recommendations (bottom of para 29). It mentions the SECAL issue, but without emphasis (para 30). This revised draft is for your background information.

ARay:pl

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE : May 20, 1992

TO : Mr. Lawrence H. Summers

FROM : Enzo Grilli

EXT. : 81934

SUBJECT: **Brief for the Friday Lunch**

1. The idea of adjustment lending in a situation in which there is no apparent BOP disequilibrium has gained wide currency in the Bank in recent months. There is a perception in many parts of the Bank that adjustment lending will decline sharply if we have to adhere strictly to the traditional BOP rationale.

2. As explained in my background note for the discussion, we have no problems in principle with broadening the rationale for adjustment lending. We can easily envisage cases in which it is sensible for a country to seek adjustment loans from the Bank even though there is no immediate BOP pressure. For example, a privatization program in an initial situation of external and internal balance may involve a large amount of severance payments. There is no reason why the country should not borrow from us to finance such payments (if we are the cheapest source), and there is no reason for us not to finance such payments either if we are satisfied with tax and expenditure policies.

3. In practice, however, a broadening of the BOP rationale may open the flood gates, and some checks and balances may be useful. Subject to your agreement, we would propose in the new guidelines that adjustment lending in support of fiscal imbalances be considered only if:

- there is an overall adjustment program we can support,
- a tax reform program, including the introduction/broadening of VAT, reasonably efficient direct taxes, and improvements in tax administration,
- satisfactory public sector enterprise pricing policies,
- provision for close supervision by us of the public expenditure program,
- financial sector reforms and other changes to broaden the domestic capital market and lower the cost of borrowing,

- the budgetary support can be seen as a distinct phase in the adjustment program, to be terminated as soon as pre-defined improvements in public finances have occurred.

ARay:pl

May 19, 1992
A. Ray

Some Issues with Adjustment Lending

1. This note is intended to bring out some issues regarding the preconditions for adjustment lending which surfaced during discussions on the new guidelines.[1] The main issue concerns the so-called "balance of payments" rationale for adjustment lending - where did it come from, what was its justification, how narrowly or broadly should this be defined in the presence of relative price flexibility? The note first briefly recap Bank policy statements, then it examines their origin and rationale, and finally looks at the plausible justification for adjustment lending (or for a country's external borrowing). In this context it raises some issues on which attention is needed inside the Bank.

I. Bank policies

2. The earliest policy statement anchors the rationale for adjustment lending firmly in the balance of payments. The reason for initiating adjustment lending was "to assist countries ... prepared to undertake a program of adjustment to meet an existing or to avoid an impending balance of payments crisis (emphasis added)."[2]

3. The official rationale for adjustment lending does not seem to have changed much since then. Thus, in a speech in 1989, Mr. Stern said that "we provide quick-disbursing loans because the actions being undertaken by the government have some balance of payments impact, some additional costs that we can help to defray... (emphasis added)". The BOP condition was maintained, if cast in looser language and seemingly endogenized in the (structural) policy reform programs pursued by member countries and supported by the Bank. The question of the effective scope of the balance of payments condition was always dealt pragmatically. In the same 1989 speech, one reads:
... This standard does not mean that there is no need for policy reform in sectors where the costs are not in foreign exchange. Indeed, we know that

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1 The Operational Directive 8.60, on "Adjustment Lending".

2 "Lending for Structural Adjustment", R80-17, IDA/R80-22, Feb. 5, 1980.

countries face major issues of reform in education and in the social sectors generally, in transportation, infrastructure, the environment and urban development. While the World Bank should be an active participant in those policy reforms, and a source of financial support, I think quick-disbursing assistance is not appropriate for these types of reforms."[3]

4. The three "Reviews of Adjustment Lending" have stuck close to these positions. Only the RAL III introduces an important nuance when it says that "the need for more external financing does not have to be present before the adjustment program begins, as in a balance of payments crisis. It might be generated by the investment and growth arising from the program (paragraph 13, page 9)." According to this view, the balance of payments needs may well be endogenous to the reform program being supported by adjustment lending.

II. Origins of the BOP condition

5. None of the official documents elaborate upon the economic rationale of the Balance of Payments condition. In the context in which adjustment lending was introduced -the aftermath of the second oil crisis- this rationale was quite obvious, but its applicability to other situations and contexts were not explored in any detail.

6. There may of course have been a doctrinal linkage to the "two-gap" approach of Chenery -in particular to the Chenery-Strout model in which a binding foreign exchange gap, already existing or likely to appear as a consequence of higher growth targets, provided the rationale for foreign assistance. The Bank's "gap-fill" approach, embodied in RMSM, is quite akin to this Chenery-Strout model. Perhaps because of this connection, concepts like the "foreign exchange gap" or the "foreign exchange constraint" have long been a part of the Bank's language. This is not to say of course that anyone really believes in the applicability of a binding foreign exchange constraint strictly defined: Chenery's polar case assumed no possibilities of increasing foreign exchange resources, either by expanding export volumes, or by saving import-bills through import substitution or reductions in import-intensity of investments.

7. The vision underlying Mr. Stern's introduction of adjustment lending was that of policy-based lending - a profound expansion of the role of the Bank in policy dialogues and the development agenda. The rhetorical connections to the Chenery approach was a coincidence. It was also essentially fortuitous that the timing of adjustment lending meshed with the second oil shock due to the outbreak of the Iraq-Iran war. The enormous impact of that war on the current account deficits of the oil importing developing countries provided the immediate rationale, as amply stressed in the first Board paper of February, 1980.

8. The identification of countries in need of adjustment lending was made through the BOP imbalance they faced. "Structural adjustment" was

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3 See Thomas et.al. editors. "Restructuring economies in distress."

conceived at that time very much in terms of trade liberalization cum devaluation, or more broadly as the adoption of an outward-oriented development strategy that required expansions in the traded sector, and within that in exports at the expense of inefficient import substitution.

9. The concept of gaps is very much an artifice of fixed-price models. For example, if a country has flexible exchange rates, and aggregate demand policies that ensure flexibility in the real exchange rate as well, then the notion of gaps need to be replaced by the notion of optimum inflows of foreign savings: the country would benefit from foreign savings up to the point where the rate of return from investments equals the marginal cost of borrowing. The focus shifts from "needs" and "requirements" to productivity of resource use.

10. But the connection between the two approaches is clear. The larger the "gap", that is the larger the impact effect of the oil price increases, the larger the adjustment problem. It was recognized that the inter-sectoral shifts of resources would take time - five to seven years it was thought - especially in state-run economies or economies with many interventions and regulations that muffled the exchange rate signals and inhibited factor mobility. As later emphasized, there are also many supply-side issues here, particularly in low income countries with poor infrastructure and undeveloped markets.

11. The effects of the second oil price shock were compounded by the onset of the debt crisis in 1982, the increases in world interest rates, the continuing stagnation or decline in commodity prices, and slow growth and increasing protectionism in the industrial countries. With the emergence of hyperinflation in many countries, the focus shifted to fiscal imbalances of the government, which were generally recognized as the source of instability and inflation. At this time, fiscal adjustments and changes in trade and exchange rate regimes have become the main pillars of adjustment programs.

III. The Basic Rationale

12. Adjustment lending by the Bank is quick-disbursing and policy-based:

- the need for quick-disbursing resource transfers. Countries often seek foreign resources when faced with external "shocks", such as exogenous drops in export revenues or increases in interest rates. When these shocks are very short-term in nature, the country may consider seeking "compensatory" financing", for example from the IMF. However when a shock lasts for sometime, policy changes are needed to cope with it.[4] It is only when policy reforms are necessary that the Bank will consider providing adjustment loans.

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[4] One can also envisage the demand for quick-disbursing resources arising out of internal shocks, such as floods and harvest failures, or out of mismanagement of public sector budgets, etc.

(It is true that the Rehabilitation Import Credits are not policy-based, but they are used infrequently and are to be thought of as precursors to adjustment loans rather than as adjustment loans themselves).

- policy reforms. A policy reform can, by itself, justify foreign borrowing to smooth out the transition costs. For example, the extent of real depreciation accompanying trade liberalization would be less with foreign borrowing than without. When there are such endogenous costs with policy reforms, these add to the resource transfers that otherwise would be needed. While in nearly all cases the demand for adjustment loans emanate from disturbances in the external sector, it is possible to envisage situations in which a policy program is launched with Bank support even though there is no external disequilibrium to begin with.

13. The new guidelines spell out the various types of adjustment lending done by the Bank and discusses the nature of overall adjustment programs as well as subprograms, for examples stabilization, taxation and public expenditures, trade policy, financial sector and privatization. Issues such as sequencing are also discussed.

14. These matters can be cast in terms of the same cost-benefit framework as we use for investment analysis, although actual measurements are extremely difficult when many policies are simultaneously changed.

15. Often the policy changes being supported can be interpreted in terms of changes in shadow prices. Thus the trade reforms typically supported by the Bank imply that the ratio of the shadow exchange rates to the actual exchange rates will move toward unity.

16. Similarly the marginal cost of raising public resources may be very high at the time an adjustment program is initiated because of a thin capital market or an inefficient tax system; the policy changes will lower this cost. Cut-backs in public expenditures will increase their marginal value, so that the use of scarce resources by the public sector does not imply outright waste, when compared to the marginal cost of raising revenues or to the marginal value of private expenditures.

17. The analogy with shadow prices is also helpful in understanding some of the issues in this context. For example, in the shadow-pricing framework it matters not whether costs are local or foreign - the issue is whether the correct shadow exchange rate is used to express them both in the same numeraire, for example the foreign exchange numeraire.

18. At the most general level, the rationale for borrowing to help finance adjustment programs is simply that such programs yield at least as high a rate of return as the marginal cost of borrowing. In principle it does not matter what immediate concerns motivate adjustment borrowing, i.e. whether the initial "disturbances" occur in the external accounts or in the fiscal accounts, or whether there is any disequilibrium in the first place.

19. A decision by the Bank to provide adjustment lending depends on various practical considerations which are difficult to capture in any statement of principles. For example, lending in a situation of balance of payments problems carries with it a much greater sense of urgency and leverage than in a situation of internal policy slippages. Much depends on the credibility of the government's adjustment program, the political support it enjoys and its track record.

IV. Issues

20. The rationale for adjustment lending is first discussed below in terms of three types of cases that have come up in recent discussions. These cases are:

a) a trade liberalization cum devaluation program, as mentioned in the draft guidelines on adjustment lending,

b) an increase in public investments from an initial condition of stable and sustainable low-growth equilibrium, in order to shift to a higher growth path,

c) adjustment lending to reduce the need to rely on domestic sources for financing budget deficits while countries move toward efficient and sustainable reductions in public sector deficits, which takes time.

21. The idea in the first case is that of smoothing out the trade liberalization process. This is a natural extension of the early rationale for adjustment lending. In recent years the balance of payments support provided by the Fund and the Bank to India could for example be regarded as being partially intended to mitigate the impact effect of liberalization and prevent overshooting of the exchange rate (which has been fixed temporarily). But as the India case also illustrates it is very difficult to disentangle the effects of trade liberalization per se from the rest of the program.

22. The second case represents a savings-constrained situation, in which external finance fills the current account deficit that opens up until savings increase. If one assumes that private and public savings remain approximately unchanged, the jump in public investment will show up one-for-one in an increased current account deficit that we are to finance. This rationale for adjustment lending - used innovatively in the Bangladesh public resource management credit - may easily be misinterpreted and become a blanket justification for adjustment lending in all countries in all seasons. Indeed much of the explosive foreign borrowing in the 1970s went to finance ambitious public investment schemes intended to jolt the economy to higher growth paths.

23. What distinguishes the Bangladesh case from the typical profligacy experienced so widely in the past is that there is: i) an adjustment program agreed with the Bank and the Fund, ii) provision for close scrutiny by the Bank of public expenditure policies, and III) a program to increase public savings through tax reform (in particular the introduction of a value-added

tax). However, irrespective of its merits (and we do not imply any criticisms here) this case does represent a clear departure from the way adjustment lending has been viewed in the past: an initial situation of no internal or external disequilibria, ample foreign exchange reserves, and low growth is the classic case for investment lending, rather than adjustment lending.

24. The Bangladesh approach may be viewed as an extension of the logic by which financing of time-slices of sectoral investment programs was introduced in the 1970s: if sectoral institutions are strong enough to manage projects and do cost-benefit analysis themselves, we can expedite resource transfers and enhance policy dialogue by focusing on the sectoral level and avoiding the micro-analysis of the traditional project-by-project approach. If we can trust the government to do a good job, or if it allows us to supervise their budget policies closely through the tranching process, then why not? Ultimately this is a question of credibility and track-record. The PFP process and the tranching apparatus are new instruments that can be particulary helpful in this context.

25. The third case, suggested by Selowsky, is very similar in that it also assumes that adjustment lending from us would substitute for inflationary financing or borrowing from the domestic private sector (which would increase the interest rate and crowd out private investments). It is also assumed that tax reforms are in progress and that public expenditures are being trimmed, but to do this takes time while the domestic financing of the deficit must be cut immediately. The difference is in the initial conditions. The government needs to reduce or eliminate domestic borrowing quickly; external finance helps the fiscal adjustment by allowing all progress made in the primary surplus to be fully translated into lower domestic borrowing. Only after domestic borrowing has been eliminated or reduced to acceptable levels, would the continuing improvement in the primary surplus start to reflect itself into lower external borrowing. Thus, the adjustment path that Marcelo has in mind is different from the Bangladesh case. There is an ex-ante balance of payments rationale in this case although at the margin foreign borrowing supplements the budget for a particular phase of the adjustment process.

26. These cases suggest that we should aim at the following conditionality when we consider adjustment lending for fiscal support, i.e. in a situation in which there is no external disequilibrium, or there are sufficient funds from other lenders to cover the gap due to external debt service and trade deficits:

- a tax reform program, including the introduction, or broadening, of VAT, reasonably efficient direct taxes, and improvements in tax administration,
- provision for close supervision of the public expenditure program,
- financial sector reforms and other changes to broaden the domestic capital market and lower the cost of public borrowing,
- overall macroeconomic policies, and complementary reforms (for example in trade), which are credible and sustainable.

Even so, budgetary support should be seen as a distinct phase in the adjustment program, to be terminated as soon as the pre-defined improvements in public finances have occurred.

Local cost financing and the social sectors

27. Another issue that has been discussed quite a lot in the recent past concerns local cost financing under adjustment lending. Adjustment loans disburse against general imports (subject to some irrelevant cosmetic restrictions). Disbursements are made against certificates and bills with dollar gaps. Disbursements against local costs, which are done in our project lending, are against peso tags. In either case this is general import financing, and there is no difference between the two modes of financing except in so far as they are tied to specific expenditures and are associated with different types of policy changes. In the case of local cost financing, there are particular project-specific expenses to be financed, and the institutional and cost-recovery issues are typically too micro to be focussed on in SALs and SECALs. But to put the point in another way, it makes no difference whether a particular SAL disburses against dollar tags or peso tags as long as the policy conditionality remains the same.[5]

28. The issue is important because restrictions against local cost financing are sometimes thought to be the principal reason why adjustment lending have not been encouraged in the social sectors. If this is the reason then we should remove the negative signal.

29. There may be other reasons of course. For example, the endogeneity argument: it is often thought that the country should not have to borrow abroad to "finance" policy changes in education, health and environment. But while there may not be any direct impact on the balance of payments, there may well be one indirectly through the budget, as we discussed earlier. For if tax increases and public expenditure cuts elsewhere are ruled out (the country is doing the best it can in this respect and is under our close supervision), the incremental costs of social sector policy changes will lead to a higher deficit, to be financed either by crowding out private investments or by inflationary financing; hence it would be better to borrow abroad by the same line or reasoning. Thus, if we broaden the balance-of-payments rationale, we should also be not averse to social sector adjustment loans, to be disbursed against peso tags. However, the conditions listed in paragraph 26 should apply before social sector adjustment loans are contemplated.

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[5] The reason for this is that the same amount of foreign exchange is being added to the foreign exchange market in either case, and identical conditionality assures that the demand and supply curves shift the same way. The effects on the exchange rate and the final uses of the foreign exchange will thus be identical.

Other issues

30. As the Bank's practice has evolved, macro-economic conditionality in SECALs tends to get the short shrift. However, individual sub-programs should always be placed in the overall reform context, and the "boiler-plate" conditionality that macro policies be "satisfactory" should be spelled out in the Letter of Development Policy.

ARay:pl

A C & RDBs

The World Bank/IFC/MIGA

O F F I C E M E M O R A N D U M

DATE: September 27, 1992 09:24pm

TO: Sri-Ram Aiyer (SRI-RAM AIYER)

TO: Philip Birnbaum (PHILIP BIRNBAUM)

FROM: John D. Shilling, EA3CO (JOHN D. SHILLING)

EXT.: 82474

SUBJECT: Report on Adjustment Lending of RDBs

Thank you for your past support on this report. Senior managment has just reviewed the draft and raised several questions. In the draft I reported that since the RDBs had begun adjustment lending, there had been increased coordination of operations at a staff level and that this had taken additional staff time and effort. The MDs have asked how much additional time this has taken. Do you have any quantitative or other measures of this in your respective regions? TRS data on aid coordination or numbers of SW spent per project in working with the RDBs. I would appreciate anything along these lines you could give me in the next couple of days. My phone is now 82474 and office A10-037.

Thanks, Jed

CC: Enzo Grilli (ENZO GRILLI)

THE WORLD BANK
DEVELOPMENT POLICY GROUP

ROUTING SLIP	**DATE** September 24, 1992

NAME	**ROOM NO.**
Mr. Jed Shilling	A10-037

	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		URGENT

RE: **Adjustment Lending of RDBs**

REMARKS:

Jed,

Please see if you can take care of these comments. Thank you. Let's get together soon.

Enzo

FROM: Enzo Grilli	**ROOM NO.** S-9055	**EXTENSION:** 35100

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: September 23, 1992 E. Grilli

TO: Mr. Lawrence H. Summers, DECVP

FROM: Jane Armitage, EXC

EXTENSION: 81114

SUBJECT: Paper on Adjustment Lending of Regional Development Banks

Please find attached a note summarizing EXC's main comments on the above-mentioned draft paper. A marked-up copy of the paper, with more detailed comments, is also attached.

cc: Mr. Karaosmanoglu

Comments on draft paper: Adjustment Lending of Regional Development Banks

The paper still needs substantial editing (there are a fair number of typos, words missing, unclear sentences etc.) See attached marked up copy.

On substance, three major comments:

(i) the tone of the paper is extremely positive about coordination with other MFIs and donors on adjustment lending. Is this an accurate picture? Ernie notes "frequent difficulties" with the ADB in terms of having our conditionality undercut. As a recent example, he suggests making reference to problems with the India Financial Sector. The section on JEXIM/OECF does not mention their strong critique of the Bank's approach to adjustment which they believe is much too quick to condemn directed and or subsidized credit. Finally, I seem to remember that about eighteen months ago there was a difficult exchange of views between the EEC and the Bank about the design of reform programs and the need to incorporate the "social dimensions" more fully. A recognition of how our partners differ in terms of their approaches to adjustment would make for a more balanced paper.

(ii) the aggregate data in the paper does not give much sense of how much coordination effort is needed. Table 1 gives a good overview of the total volume of adjustment lending, the distribution by major creditor and the percentage cofinanced with the Bank. However, there is little value-added in the information on each separate creditor found in Tables 2-7. Many of the data were already presented in Table 1. The new figures on total lending are of little relevance to the issue of coordination of adjustment lending and are largely covered in the text. It would be much more useful to have some disaggregated data for the major creditors, particularly for the adjustment lending which was not co-financed with the Bank. Suggest including a table for each creditor showing the actual operations (country, size, sector) which were not co-financed with the Bank. This would give better indication of the coordination effort needed.

(iii) a major message of this paper is the need for effective coordination given the rapid growth in adjustment lending by other donors. Beyond a couple of lines in Para 4, the paper says very little about how to do this cost-effectively, what problems have been encountered, how they are being solved. Some examples of best practice and failures would strengthen the paper and make its overall message that coordination is working well more convincing.

Other specific comments/suggestions follow:

Para 4. The logic of the last sentence is weak. If countries need adjustment lending, we should continue to provide it. If we have moved on the the post-adjustment phase, why is there a case for adjustment lending by other creditors? Which are the countries which need adjustment support but where we are not the principal external funding agency?

Para 5. The last section of Para 5 seems to set up a straw man. We have waivers to ensure that "minor technical points" do not delay release of a tranche. If there are substantive problems with meeting our conditionality, then another donor continuing to disburse under a parallel financed loan risks undercutting our position. If this really provides valuable flexibility, some specific examples would be useful.

Para 6. This para states that Table 1 only includes formal cofinancing and parallel financing. However, the data on the EC refers to coordinated financing. If coordinated financing is also included, presumably the US support for SPA would also qualify.

Para 7. This para continues the case for independent adjustment lending that was initiated in Para 4. The argument remains weak. Sector adjustment is not a post-adjustment phase, it is a central part of structural adjustment and merits our full support. Why would it make sense for us to withdraw from adjustment lending on the grounds that a country had reached the post adjustment stage, and yet make a case for continued support for sectoral adjustment by other creditors?

Paras 16-17. The distinction between cofinancing, parallel financing and coordinated financing seems confused. Para 16 states that initial operations must be cofinanced. Then Para 17 states that the IDB undertakes parallel financing. Which is correct? If IDB undertakes parallel financing it is unnecessary to state "and there are no explicit cross conditionality clauses" - according to footnote 4 that is part of the definition of parallel financing. Para 17 then goes on to state that IDB moved on to make adjustment loans without explicit parallel financing. What does that mean? Why had we phased out adjustment lending in Colombia and Chile, if there was still a need for sectoral adjustment?

Table 8. Why is this table stuck at the end of the paper (with no reference in the text)? The share of adjustment lending in 1992 appears to be 30 % for IBRD and 32 % for IDA. I thought the guidelines were 25 % and under exceptional cases up to 30 % for IDA. Does this need an explanation?

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

MASTER

DATE: September 15, 1992

TO: Mr. Attila Karaosmanoglu, Managing Director

FROM: Lawrence H. Summers, DECVP

EXTENSION: 33774

SUBJECT: Paper on Adjustment Lending of Regional Development Banks

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The attached draft of this paper, prepared at the request of some Executive Directors, has been reviewed by FRM, the concerned RVP offices of the Bank, and the relevant sections by the concerned agencies, who also contributed background data and information. Their comments have been incorporated.

One issue to be decided is whether to include the sections on the bilateral agencies. Given their large role in helping finance adjustment operations and some differences in their policies, a brief review of the policies of the major bilaterals adds useful information. The three selected are representatives. On the other hand, since all bilaterals are not covered fully, though mention is made of most, there may be some sensitivities involved in the choices made. I would appreciate your guidance on this point.

We are assuming this will simply be circulated to Directors as an information memo from management.

cc: Messrs./Mmes Stern, Sandstrom, Grilli, Kavalsky, Shilling, Walton, Armitage

ADJUSTMENT LENDING
by Regional Development Banks
and Selected Bilateral Donors

Introduction

1. During the discussion of the Report on Adjustment Lending III on April 14, 1992, several Directors asked about the adjustment lending activities of other development banks. Staff noted that other agencies had begun adjustment lending relatively recently in close association with the World Bank (including IDA throughout). Directors then requested further information on the amounts and terms of such lending. This report has been prepared in response to that request. The three regional development banks reviewed are the African Development Bank (AfDB), the Asian Development Bank (ADB), and the Inter-American Development Bank (IDB). The European Bank for Reconstruction and Development has not been included since it does not engage in adjustment lending at this time 1/. Three bilateral donors that have provided substantial support for adjustment programs have also been included to illustrate the extent of support for adjustment programs from that quarter. These are the European Communities, Japan, and the United States. A number of other bilateral donors also provide assistance for adjustment programs 2/. Their practice is also to closely coordinate their adjustment support with the World Bank and the IMF programs. The material in this report has been gathered from annual reports and other documents of these agencies, material provided by them on request for this study, interviews with senior staff of the other agencies, and interviews with Bank staff involved in cofinancing with these agencies.

2. In the late 1970s, World Bank staff and management had reached the conclusion that extremely distorted macroeconomic and sectoral policies seriously inhibited development prospects in many developing countries and greatly reduced the value of many worthwhile investment projects. To counter these obstacles, structural adjustment lending (SAL) was initiated, and shortly thereafter sector adjustment lending (SECAL). The objective of these programs was to change policies so as to improve the efficiency and competitiveness of economies facing external and internal economic difficulties and thereby to restore or

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1/ The Caribbean Development Bank has also made one adjustment loan for $34 million cofinanced with the World Bank, as would future adjustment loans, if any. It is not included in the analysis due to the small volume of its adjustment lending.

2/ Of particular importance is the cofinancing of adjustment lending provided to the Special Program for Africa, which includes $700 million from France, $520 million from Sweden, $530 million from UK, and $465 million from Netherlands. Since SPA was launched in 1988, 15 bilateral donors plus the AfDB and the European Communities provided adjustment financing in support of policy reform programs in 26 Sub-Saharan countries. For SPA-2, donors have pledged $7.3 billion, either for direct cofinancing with IDA operations or for coordinated financing, supporting well-defined adjustment programs.

enhance their medium-term growth and development prospects. Adjustment lending has provided a powerful tool to assist and encourage countries undertaking difficult but necessary policy reforms and to help ease the short-term balance of payments impacts of these adjustments 3/.

3. The same factors that led the World Bank to undertake adjustment lending have been behind the moves of the regional development banks and other donors into adjustment lending - the need for an adequate policy framework in order to do satisfactory project lending and the need for quick disbursing funds to ease difficult adjustment periods. In addition, where countries were undertaking adjustment programs with tightly constrained domestic budgets, investment programs were cut and counterpart funds were often not available for new investment projects, limiting the scope for project assistance. The governing bodies of the regional development banks include many of the same major credit shareholders as the World Bank and the IMF, and these bodies favored a cautious approach to adjustment lending by the regional banks. Thus coordination or cofinancing with the World Bank was established as the preferred means for the regional banks entering adjustment lending. The bilateral donors generally have followed the same course in their movement into adjustment lending. Moreover, it was recognized by all that careful coordination was needed among all donors supporting adjustment programs in order to assure consistency of approach and policy advice.

4. As each agency has expanded into adjustment lending, policies and practices have been established, patterned to a large extent on those of the World Bank. By and large, they have generally opted to cofinance with the World Bank and/or have relied on the World Bank and the IMF for establishing the overall adjustment frameworks. In all cases, coordination and cooperation with the World Bank was strengthened, and staff of the multilateral banks and bilateral donors have come to work more closely together than previously. Cross participation or joint missions have become common and negotiations are closely coordinated. Analyses and models are regularly shared between the staffs of the institutions involved in each operation. These activities have ~~The increased coordination~~ ~~has~~ absorbed additional time and effort on the part of World Bank staff as well as staff of the other institutions. But this has been necessary to assure coordination. The regional banks and the bilateral donors have progressively developed more in-house capacity to do policy analysis and are increasingly involved in making substantive contributions to program design and direction. This enhanced capacity has strengthened their ability to play an effective role in the policy discussions and allowed some to move toward independent adjustment lending. This is proving very useful in countries where the World Bank is shifting from adjustment assistance to the next phase of its programs or in countries where the World Bank is not the principal external funding agency.

increased coord. to assure coordin!

?

?

3/ Adjustment lending is also called "quick disbursing" and "policy based", each term emphasizing a different aspect of the instrument. For various reasons, different institutions sometimes prefer one or the other term. In some cases, "program" lending is also included if it is related to policy reforms. For some agencies, assistance to adjustment programs is in the form of grants.

all/some?

which?

such as.....

5. The majority of operations so far have either been cofinanced or parallel financed with the World Bank 4/. In cases without explicit cofinancing, the other agencies have taken care to coordinate their actions with the World Bank and the IMF in order to assure consistent signals are sent to the government about its program and the conditions of support. The regional banks and bilateral donors have generally preferred sector adjustment lending where it is feasible 5/. They feel that they have more positive contributions to make in these areas. Structural adjustment operations have usually been in the context of well defined programs, such as the Special Program for Africa (SPA). In some cases, the use of parallel financing has added valuable flexibility. If release of a tranche under a World Bank loan were delayed over minor technical points, a parallel financed loan might be able to disburse to provide for essential imports where the bulk of the conditionality is satisfied and where the particular concerns of the parallel loan are met. Such activities are closely coordinated with the Bank, and can help avoid some of the disadvantages of the "all-or-nothing" aspect of tranche releases.

? comparative advantage of staff?

? we have waivers

just over half (51-54%) last 3 years

6. The World Bank has provided the majority of adjustment lending since 1987, when other agencies began to engage more actively in this kind of operation, as shown in Table 1. The World Bank's share in total commitments has fallen somewhat over this period, but the high level of cofinancing or coordinated financing with most donors indicates the extent of ~~influence~~ involvement the Bank has in the design and execution of the programs. The percentages include only formal cofinancing and parallel financing. They understate the extent of coordination, as most of the remaining lending is also coordinated with World Bank or IMF programs.

but EC line says "aid" too

mention SPA

7. To the extent that other agencies have resources available, expansion of their adjustment lending in conjunction with the World Bank has helped mobilize more resources for countries undertaking difficult reform programs with the World Bank. Many of its traditional borrowers are now completing their adjustment programs and moving into post-adjustment phases of their development strategies. Sector adjustment lending by other development agencies to these countries, could help ease the [redacted] process in some cases. In other areas of the world, however, demand for adjustment lending is expected to grow. Eastern Europe and the Former Soviet Union (FSU) fall in this category. While the EBRD does not plan to engage in adjustment lending in these areas, several of the bilateral

transition

seconds are part of adjustment they are not post adjustment

4/ Cofinancing involves explicit cross-referencing of performance conditions and sanctions in the legal documentation of each institution's loans and usually identical conditions. In parallel financing, there is no explicit cross-referencing or cross default clauses in the documentation. However, in adjustment operations, the conditionality is generally identical and the use of parallel financing is for reasons of administrative convenience. Coordinated financing implies a somewhat looser relation in terms of conditionality.

5/ In some cases, the sector adjustment loans of the regional banks are close to sector investment or hybrid loans. The regional banks have also used program loans on some occasions, as has the World Bank, and these have been included in the adjustment lending series. They have become infrequent.

meaning?

what?

why?

donors, the EC in particular, are committed to substantial balance of payments support in conjunction with the World Bank and IMF programs in this region.

Table 1: Adjustment Commitments by Major Creditors
(US $ million)

Creditor	1987	1988	1989	1990	1991
World Bank Group	4,424	4,707	6,094	5,957	6,879
IBRD	3,475	3,615	4,959	4,179	4,871
IDA	949	1,092	1,135	1,778	2,008
African Development Bank	721	406	579	561	718
% Cofinanced with the World Bank	59%	100%	96%	98%	79%
Asian Development Bank	150	660	275	820	435
% Cofinanced with the World Bank	0.0%	0.0%	0.0%	15.2%	0.0%
Inter-American Development Bank	0	0	0	1,310	2,050
% Cofinanced with the World Bank	0%	0%	0%	100%	83%
European Development Bank/Community	0	69	263	105	0
% Coordinated financing with the World Bank	0%	100%	100%	100%	0%
JEXIM/OECF	293	1,521	3,063	1,209	1,968
% Cofinanced with the World Bank	100%	100%	58%	100%	85%
USAID	1,478	658	1,049	1,711	1,278
% Cofinanced with the World Bank	0%	0%	0%	0%	0%
Total Non-World Bank	2,642	3,314	5,229	5,716	6,449
% Cofinanced with the World Bank	27%	60%	49%	58%	61%
Grand Total	7,066	8,021	11,323	11,673	13,328
Share of World Bank Group	63%	59%	54%	51%	52%
Share of others	37%	41%	46%	49%	48%

Source: Tables 2 to 7.

The African Development Bank

8. The African Development Bank was the first regional bank to initiate adjustment lending, obtaining approval from its Governors in 1986 at the same time its overall resources were increased. It began adjustment lending the following year. It makes both structural and sectoral adjustment loans. The AfDB moved relatively early in this direction due to the severity of the adjustment problems faced by its members and the difficulty of financing traditional projects in many of its member countries due to severe distortions and limited investment budgets. Although it had done some program and multi-sector lending in the past, it approached adjustment lending carefully, establishing close links with the World Bank. The AfDB makes adjustment loans through both its regular facilities and the African

Developmen Fund (AfDF), its soft loan window, depending on the creditworthiness of the country. The funds for the adjustment lending are drawn from the regular resources of the AfDB and the AfDF. The AfDB established guidelines of about 25% of its total lending for adjustment lending for the 1987-91 planning period. The percentage has been revised to 21.5% for the AfDF 1991-93. The AfDB is also programming its lending at 21.5%, though it still has the 25% guideline. A large number of the AfDB's clients are still facing severe economic difficulties and are not creditworthy for much more regular financing. The AfDF resources are, of course, limited, and allocations to adjustment lending are not likely to increase.

? why

?

9. Loans are cofinanced with the World Bank, or parallel Bank programs as closely as possible. An IMF program in a country is a precondition for the AfDB to do adjustment lending. Following the inauguration of the SPA, all the AfDB's adjustment lending to low-income sub-Saharan African countries has been in the context of that program, though a small number of operations have not been explicitly cofinanced with IDA. It has also made adjustment loans to other countries which are not low income, such as Nigeria and Cote d'Ivoire, or which are not in Sub-Sahara Africa, such as in the Mahgreb. Cofinanced operations naturally have identical conditionality. In parallel financed operations, the AfDB tends to support the macro conditionality in the multi-sector (SAL) loans, and may not include all the sector conditionality of the World Bank's parallel operation. In these cases, it is conceivable that AfDB conditionality could be satisfied, but not that of the World Bank. In such cases, the AfDB staff would consult closely with the World Bank as to whether their proceeding with a tranche release would be consistent with the overall policy objectives of the program. In practice, it is unlikely that the AfDB would proceed if the World Bank expressed reservations about the country's compliance with its overall program.

example

10. Staff of the AfDB work closely with World Bank staff on adjustment operations. They generally participate in the appraisal mission, and sometimes the preparation mission as well. The AfDB may have a representative at the negotiations with the World Bank, and Bank staff may be involved in the AfDB negotiations. The World Bank resident mission in Abidjan with staff designated for coordination with the AfDB and the newly opened AfDB representative office in Washington facilitate these contacts. The actual processing procedures in the AfDB for adjustment lending are quite similar to their normal project procedures. Project supervision is coordinated with the World Bank, and it receives close attention because of the importance of these operations and the integration of most adjustment lending into the SPA and Consultative Group activities.

confusing sentence

? ?

? Project or adjustment operation?

11. Table 2 summarizes the amounts of adjustment lending undertaken by the AfDB. The large amount in 1987 reflects a bunching of several operations that had been under preparation while the final authority to do adjustment lending was being considered. Included are an industrial sector loan to Tunisia for $114 million and an export promotion loan to Nigeria for $256 million. The latter was not formally confinanced with the World Bank, but was coordinated with the Bank's program in the country. Subsequently, nearly all operations have been cofinanced. The AfDB also makes a number of institution building TA grants under this category, and these are not cofinancing operations. They are not included in the total.

to what

% declines to 79% for 1991, why? Is this going to continue?

Little value added to this table. Need more disaggregated info, especially on the Non-cofinanced operations.

Table 2: Adjustment Lending by the African Development Bank
(US $ million)

	1987	1988	1989	1990	1991
Total lending	2,113	2,168	2,832	3,251	3,412
African Development Bank (AfDB)	1,343	1,405	1,865	2,158	2,254
African Deelopment Fund (AfDF)	770	764	967	1,093	1,158
Adjustment lending	721	406	579	561	718
African Development Bank (AfDB)	592	245	401	390	468
African Development Fund (AfDF)	129	161	178	170	250
Share of adjustment in total lending	34%	19%	20%	17%	21%
Share of adjustment in AfDB	44%	17%	21%	18%	21%
Share of adjustment in AfDF	17%	21%	18%	16%	22%
Amount cofinanced with the World Bank	425	406	558	548	568
African Development Bank (AfDB)	336	245	401	390	339
African Development Fund (AfDF)	88	161	157	157	229
Share of adjustment cofinanced with the World Bank	59%	100%	96%	98%	79%
African Development Bank (AfDB)	57%	100%	100%	100%	72%
African Development Fund (AfDF)	69%	100%	88%	92%	92%

already in Table 1

US$ 150M not co-financed, why? where? what for?

Source: Recent issues of Annual Report of the African Development Bank.

The Asian Development Bank

12. The Asian Development Bank (ADB) made major revisions in its program lending policies in late 1987 to expand its lending activities in support of sector development programs aimed at achieving improved sector performance over the medium-term. The sector development programs cover a varying mix of adjustments in policy, improved investment programs, and institution building. Although the Asian economies were not suffering macroeconomic disequilibria to the extent that some African and Latin American countries were, they did face structural and sectoral problems. The ADB program (adjustment) lending is directed only toward sector adjustment programs; the ADB does no structural adjustment lending. The ADB makes program loans from both its ordinary capital resources (commercial terms) and from the Asian Development Fund (concessional terms). There is an overall cap on program lending of 15%, averaged over three years, with a sub-limit of 22.5% of the Asian Development Fund resources, also averaged. The program was reviewed at the request of the ADB Board in 1990 after two years of operation and found to be functioning effectively. It was concluded that it allowed the ADB to offer a broader scope of support to the economic development of its member countries. Adjustment lending authority was continued, and the guidelines of 15% and 22.5% reconfirmed.

all? many?

13. The ADB's program loans are designed from its own sector experience and dialogue with member countries, and they are focused on sectors where the ADB sees it has added value to offer. Sector programs that it would support are to: (a) be based on detailed

sector analysis and dialogue within the country's overall development plan; (b) be fully compatible with the ADB country strategy; (c) have the full support of the borrowing country government; (d) have objectives and policies expressed in quantifiable and time bound terms; and (e) be fully coordinated with the activities of the World Bank, IMF, and other major donors. Beyond this coordination, the ADB has not typically engaged in direct cofinancing with the World Bank, except in the case of one ADF operation (an agricultural sector operation in Bangladesh) in 1990. However, cooperation is close; staff of each institution often participate in the missions of the other, and contacts are maintained through the World Bank's resident mission in Manila. Analyses and models are regularly shared between the staffs of the two institutions. By concentrating on sector programs, the ADB relies on the World Bank and IMF for establishing the macro framework. It then is able to design its sector programs in coordination with that framework. In some cases, the World Bank and the ADB have agreed to take lead responsibility in different sectors [which has reduced the opportunities for cofinancing.] In other cases, borrowers have preferred to sequence separate adjustment or program loans from the two institutions (examples, advantages/disadvantages?)

has it been that good?

rationale?

? ∅ cofinancing anyway

14. ADB program loans normally have two tranches and disbursement procedures that facilitate the quick disbursing nature of the loans. Special import accounts are generally established in the recipient country's central bank, and disbursements are made against allowed imports, which are usually procured in normal commercial or government ways unless the size of the individual import exceeds a loan specific threshold. The loan themselves are processed by normal procedures, but they require an additional review by the Loan and Technical Assistance Coordination Committee. So far, one loan has been post-evaluated (Indonesia Export Promotion made in 1987) and found to have been successful in meeting its objectives. The ADB has not identified problems with its other loans.

15. Table 3 summarizes the amounts of program lending made by the ADB. Program lending amounts have fluctuated from year to year depending on demand, but have stayed within the guidelines. In view of the ADB's primary interest in project lending and the relatively better management of most economies in its region, there is not likely to be a great deal of pressure to expand this window, though it remains a valuable tool for the ADB.

What about "new" SE Asia countries
Vietnam
Cambodia
Laos
+ Asian FSU countries

Table 3: Program Lending by the Asian Development Bank
(US $ million)

	1987	1988	1989	1990	1991
Total lending	2,439	3,145	3,623	3,972	4,983
Ordinary capital resources (OCR)	1,481	2,062	2,260	2,492	3,636
Asian Development Fund (ADF)	958	1,083	1,363	1,480	1,347
Program lending	150	660	275	820	435
Ordinary capital resources (OCR)	75	330	54	200	250
Asian Development Fund (ADF)	75	330	221	620	185
Share of program in total lending	6%	21%	8%	21%	9%
Share of program lending in OCR	5%	16%	2%	8%	7%
Share of program lending in ADF	8%	30%	16%	42%	14%
Amount cofinanced with the World Bank				125	
Ordinary capital resources (OCR)					
Asian Development Fund (ADF)				125	
Share of program lending cofinanced with the World Bank				15%	
Ordinary capital resources (OCR)				0%	
Asian Development Fund (ADF)				20%	

Source: Annual Reports of the Asian Development Bank.

Inter-American Development Bank

16. The Inter-American Development Bank obtained approval from its Governors to engage in adjustment lending at its 1989 Annual Meeting. It began such operations in 1990. The IDB focuses on sector adjustment lending. An overall target for adjustment lending over the three year (1990-92) funding period was established (at about $5.6 billion) for adjustment lending from both Ordinary Capital (normal terms) and the Fund for Special Operations (soft terms). This was 25% of the total authorized lending. Often operations are blended from these two sources depending on country needs and availability of FSO resources. The latter are generally quite limited. In addition, the IDB has used adjustment lending authority to participate in debt and debt service reduction operations with the World Bank and IMF. The policy decision to initiate adjustment lending by the IDB required that initial operations be cofinanced with the World Bank while the IDB gained experience. Senior management in both institutions moved quickly to ensure very close cooperation between their staffs. The location of the headquarters of both banks in Washington has facilitated this high degree of coordination. Overall country programs and foward planning scenarios are shared between staffs.

17. Technically, the IDB undertakes parallel financing with the World Bank, and there are no explicit cross conditionality clauses. Nevertheless, the extent of coordination is quite close. Staff generally participate in the appraisal and negotiations of the other institution. Normally, the IDB adopts identical macro conditionality to the World Bank, but

may vary or extend some of the sector specific conditionality depending on its own country analysis and objectives. It may also deepen the sector reforms and support further institutional reforms necessary for the success of the sector adjustment. The range of the sector adjustment loans can be from "near SALs" to hybrid investment loans. Whatever the form, the IDB coordinates its dialogue and tranche releases very closely with the World Bank and would not proceed with a disbursement over the objection of the Bank. Following the first year of operations, the IDB moved to make some adjustment loans without explicit parallel financing with the World Bank. In the cases of Colombia and Chile, where the World Bank had phased out its adjustment lending operations, there was still justification to support sector adjustment, which the IDB could satisfy without cofinancing a World Bank operation. Naturally, these operations were coordinated with the World Bank and consistent with the country strategy. In Peru, as part of a coordinated strategy to support reforms among the IMF, World Bank, IDB, and bilateral donors, the IDB was to provide adjustment lending before the Bank 6/. Furthermore, in some of the smaller Latin American countries where the World Bank does not have a large presence, it is foreseen that the IDB would take responsibility for adjustment lending to help economize on overall resource use.

18. The processing of adjustment operations in the IDB follows normal procedures. Adjustment loans are required, in addition, to have a second review by the President's Program committee on the substance of the conditionality. Because of their quick disbursing nature, they are often put on a faster processing track and receive closer management attention. Like the World Bank, the IDB uses three tranches in some of these loans, especially where there is institutional reform. Supervision is also monitored more closely. IDB investment projects are now typically monitored from the field offices. Adjustment loans are still supervised from a specialized unit in headquarters, which provides more consistency of supervision and closer coordination with the World Bank.

19. Table 4 shows the adjustment lending activity of the IDB. It began only in 1990, but has assumed substantial proportions. It is closely linked with World Bank operations, and the rapid growth has been founded in that cooperation. There is some possibility that the adjustment operations will increase in the near future as shareholders are urging the IDB to provide more funding for upcoming debt and debt service reduction operations. However, that will be limited by the overall three year fund ending allocation. Need for continuing reform in several major debtors is likely to support a high level of adjustment lending for at least another replenishment period.

6/ The strategy involved clearance of IDB arrears first, since they were smaller, and would allow earlier disbursement of new funds.

Table 4: Adjustment Lending by the Inter-American Development Bank
(US $ million)

	1987	1988	1989	1990	1991
Total lending	2,303	1,628	2,577	3,832	5,359
Ordinary capital operations (OC)	1,957	1,474	2,235	3,315	4,734
Fund for special operations (FSO)	346	154	342	517	625
Adjustment lending				1,310	2,050
Ordinary capital operations (OC)				1,296	1,894
Fund for special operations (FSO)				14	156
Share of adjustment in total lending				34%	38%
Share of adjustment in OC				39%	40%
Share of adjustment in FSO				3%	25%
Amount cofinanced with the World Bank				1,310	1,700
Ordinary capital operations (OC)				1,296	1,544
Fund for special operations (FSO)				14	156
Share of adjustment lending cofinanced with the World Bank				100%	83%
Ordinary capital operations (OC)				100%	82%
Fund for special operations (FSO)				100%	100%

Source: Annual Reports of the Inter-American Development Bank, staff of the IDB.

The European Communities

20. The European Communities (EC) manage a substantial aid program in addition to the bilateral aid programs of its individual members. The latter tend to be predominantly project and loan oriented while the EC assistance to developing countries is predominantly in the form of grants. A small amount of the EC program is provided in the form of subsidized project loans through the EIB and is not discussed here. The EC program is administered in several distinct programs with different historical and treaty origins. The most important is the ACP (Africa, Caribbean, and Pacific) program based on a series of treaties referred to as the Lome Conventions. These treaties cover a range of economic relations, including trade preferences and economic and technical assistance. In response to the growing economic difficulties in these countries, the EC established a special program to provide general non-project import financing in December 1987, and commitments began in 1988. A fund of 550 million ECU for 1988-90 was established from available resources in the then current five year budget to fund Sector Import Programs (SIP) and General Import Programs (GIP). These grants had most of the policy based characteristics of adjustment loans and were often associated with World Bank adjustment operations, especially through the SPA in Africa, which was the motivating force behind this initiative. The Lome IV Convention of December 1989 formally included structural adjustment grants in the assistance program and allocated 1,150 million ECUs out of a total aid program of 12 billion ECUs of assistance for 1990-95. The amount set aside for structural adjustment is not allocated by country, as is the

footnote ECU | $ exchange rate

rest of the program. It is allocated on the basis of need and performance in adjustment programs. In any country, up to 10% of the indicative allocation to that country can also be used for adjustment operations (a total of about 550 million ECUs). In addition, ACP countries can access STABEX and SYSMIN resources in parallel with adjustment grants if the specific commodity conditions for those stabilization programs are met. Although countries are in principle entitled to these funds solely on the basis of the commodity criteria, the EC has, on occasion, associated the use of these recipients with structural reform.

21. In addition to the ACP countries, the EC has assistance programs with the Southern and Eastern Mediterranean (SEM) countries covering a variety of relations, though these are less elaborate than with the ACP. Use of assistance allocations to SEM countries for adjustment has been authorized to begin in 1992. An allocation of 300 million ECUs for adjustment lending has been made for 1992-95, and it may be augmented by some of the aid allocated under the current protocol with these countries. The first loan for 40 million ECUs has been made to Tunisia in April 1992. There is also a regional program for Latin America, but provisions for adjustment lending are not currently foreseen. In 1989, the EC established the PHARE program to assist countries in Eastern Europe in their transitions to more market oriented economies. This program was initially for 1 billion ECUs and has been oriented toward technical assistance and projects. Many of the specific projects and technical assistance has been aimed at supporting adjustment programs of the Bank and IMF arrangements. In addition, the EC has managed for the G-24 a program of loans for balance of payments support and reserve build-up in Eastern Europe. This was funded to commit up to $3.3 billion in 1991. It is not yet decided whether this program will be extended or whether a similar one will be mounted for the FSU. The balance of payments support for Eastern Europe is all conditioned on satisfactory performance under IMF and World Bank adjustment programs, so it is in effect a form of informal cofinancing. No additional conditionality is imposed by the EC. The rest of this discussion will focus on the ACP program. The SEM program of adjustment lending has barely begun, and the programs in Eastern Europe and FSU are special cases for the time being.

22. As a federation of sovereign nations, the EC is careful to maintain its independence of decision-making in its assistance program. However, it is also conscious of the need to coordinate assistance for adjustment programs to the maximum extent possible. In establishing eligibility for its structural adjustment facility, it must consider a country's need and the effectiveness of its policies. As a matter of practice, the existence of a World Bank or IMF adjustment program is considered sufficient to satisfy these conditions. Within the framework provided by the Bretton Woods institutions, the EC is an active partner in the policy dialogue and program design, as well as in the financing. The EC is a major supporter of the SPA program and has cooperated closely with the World Bank in that effort. Staff of the EC frequently participate in World Bank missions, and the EC is active in the SPA country meetings. In certain instances, the EC may proceed independently of operations of the Bretton Woods institutions on some sectoral issues, but would only do so in close coordination with the World Bank and the IMF. The EC has expertise in certain sectors and is increasingly playing an active role in designing programs and assuring their implementation. Food and trade policy are areas of particular interest, as is the general consistency of adjustment programs across countries.

23. An internal unit in the EC has been created to review structural adjustment grants and help determine the amount of support in each case. If there were not a World Bank or IMF program in place, the EC would require an additional internal stage to determine eligibility of a country before engaging in adjustment lending. Otherwise, the processing of adjustment operations is the same as for normal activities. It is expected that adjustment lending for SEM countries will be treated on a country by country basis. There is no formal coordination framework arrangement such as the SPA.

Are there examples where this has happened.

24. Table 5 summarizes the adjustment grants of the EC. In effect, it covers only the ACP program. The amounts available are determined by the envelope agreed in Lome IV.

Table 5: Adjustment Grants by the European Community
(US $ million)

	1987	1988	1989	1990	1991
Total grants	1,925	2,915	2,688	3,095	
ACP countries	898	1,414	1,429	1,595	
All others	1,027	1,501	1,259	1,500	
Adjustment grants (in ACPs)		69	263	105	
Share of adjustment grants in ACPs		5%	18%	7%	
Amount of adjustment in ACPs coordinated with the World Bank		69	263	105	
Share in adjustment in ACPs coordinated with the World Bank		100%	100%	100%	

Source: EC.

Japan

25. The Japanese government provides development assistance through two institutions: the Japan Export Import Bank (JEXIM) for non-concessional loans, and the Overseas Economic Cooperation Fund (OECF) for concessional loans. Use of one or the other source of funding is determined in accordance with each agency's primary business areas, which are based on the income level of the borrowing country, sector of the operation, and type of program or project. Frequently, both are active in the same country. Both agencies are primarily project financing institutions. In recognition of the severe economic difficulties faced by many countries and encouraged by other major participants in the development community, Japan has moved to provide some of its assistance in support of adjustment and debt and debt service reduction operations. Since 1987, JEXIM has expanded its scope of business to provide adjustment lending, which is untied. Nearly all OECF procurement is now also untied, including its support for adjustment operations.

26. The decision to support adjustment operations is made on a case by case basis. Neither agency has a target level of adjustment lending nor a special fund, and both prefer project operations if possible. Operations of the OECF have been out of the Fourth ODA Plan, which ends this year. Another ODA plan will be agreed later this year and is expected to be substantially larger than the $50 billion committed in the Fourth Plan. Both agencies have also been included in the Expanded Capital Recycling Program, which had as its objective committing $65 billion over the period 1987-92, including $23.5 through JEXIM and $12.5 through OECF. This program has been largely achieved, and it expired in the middle of this year. No direct successor to that program has been announced. JEXIM expects to continue adjustment lending as needed. OECF does not foresee that there will be a significant change in the proportion of adjustment operations in its overall program so these operations are likely to grow accordingly. The actual level will depend on economic circumstances in the recipient countries and the availability of adequate adjustment programs.

27. In order to assure full coordination with the adjustment programs, both agencies have adopted a policy of cofinancing with the World Bank, ADB, or IDB for adjustment operations. Other cofinanciers may also be involved in some operations. In addition, the JEXIM has engaged in parallel lending with the IMF in support of commercial debt and debt service reduction operations. Neither agency has included policy conditionality in its loan agreements. However, they only cofinance programs which they believe appropriate for the development of the recipient countries. World Bank or IMF programs are considered assurance of the appropriateness of the program. Staff frequently participate in World Bank appraisal missions and often in negotiations. Both JEXIM and OECF monitor their adjustment loans in conjunction with the cofinancier's review schedule. Both agencies have strengthened their capacities to evaluate structural and sectoral adjustment programs. At present, neither institution intends to undertake adjustment lending other than as cofinancing where there is a clear need for additional financing and where the country's overall performance is satisfactory to the institutions. These agencies would prefer to find project vehicles for providing assistance, however. If that is not feasible, they will select appropriate adjustment operations. In some cases, they may be more selective than the World Bank.

28. Both institutions follow their normal procedures for processing these loans. Although JEXIM exercises a high degree of independence, it consults closely with the Ministry of Finance when deciding on each adjustment loan. Otherwise, normal procedures are typically followed, and the processes are relatively quick. In the case of the OECF, decisions may take somewhat longer because it depends on four ministries and must obtain the approval from each for its operations. Both institutions have developed more capacity to evaluate macro policy issues. OECF has begun to offer suggestions to the World Bank staff on appropriate conditionality, though timing differences in the processing has sometimes prevented timely input from occurring. The projects themselves are monitored more closely than regular projects by the agencies and in close collaboration with the World Bank and IMF as appropriate.

29. Table 6 summarizes the adjustment lending activity of the Japanese institutions. In addition to the figures shown, JEXIM has provided $3 billion to the IMF in 1988 for use

in its ESAF program to support structural reform, and it cofinanced three debt and debt service reduction operations with the IMF ($1,000 million for Mexico and $300 million for Philippines in 1989 and $300 million for Venezuela in 1991). The variation in the share of lending allocated to adjustment lending reflects variations in numbers of cases and size of operation presented for financing rather than any policy on the amount of lending allocated to this activity.

Table 6: Adjustment Lending by Japan
(US $ million)

	1987	1988	1989	1990	1991
Total lending	5,501	6,373	7,780	9,582	11,655
Japan Export Import Bank (JEXIM)	2,363	1,972	3,696	3,037	2,967
Overseas Economic Cooperation Fund (OECF)	3,138	4,401	4,084	6,545	8,688
Adjustment lending	293	1,521	3,063	1,209	1,968
Japan Export Import Bank (JEXIM)	0	870	2,300	540	950
Overseas Economic Cooperation Fund (OECF)	293	651	763	669	1,018
Share of adjustment in total lending	5%	24%	39%	13%	17%
Share of adjustment in JEXIM	0%	44%	27%	18%	22%
Share of adjustment in OECF	9%	15%	19%	10%	12%
Amount of adjustment cofinanced with the World Bank	293	1,521	1,763	1,209	1,668
Japan Export Import Bank (JEXIM)	0	870	1,000	540	650
Overseas Economic Cooperation Fund (OECF)	293	651	763	669	1,018
Share of adjustment cofinanced with the World Bank	100%	100%	58%	100%	85%
Japan Export Import Bank (JEXIM)		100%	43%	100%	68%
Overseas Economic Cooperation Fund (OECF)	100%	100%	100%	100%	100%

Source: JEXIM, OECF.

United States (USAID)

dummy

30. The United States' development assistance program 7/ began reorienting its aid toward policy based activities in 1981 by administrative decision. This reflected a growing emphasis on the policy framework in aid programs. Over the decade of the 1980s, USAID's economic assistance was also converted largely to a grant basis. There are still some soft commodity loans under the recently approved Title III in the PL 480 program and some housing assistance guarantees. Assistance is provided for both structural and sectoral

7/ The US foreign assistance budget includes a number of other categories of aid which are not comparable to the assistance discussed in this report, e.g. military assistance. The discussion and figures presented include only economic assistance and exclude funds for Israel.

adjustment programs through several different vehicles in the USAID portfolio of programs 8/. Sector operations tend to be preferred in some programs. There is no formal overall target or ceiling for adjustment grants under most programs, and there is no special program for adjustment operations. Some programs have their own limits, such as the Development Fund for Africa, which has a 30% upper limit on adjustment operations. USAID funds are allocated globally in relation to US political interests as well as economic needs, but the final share of adjustment aid and extent of policy conditionality in a country is a function of need, willingness to undertake reforms, and country performance. Because of the foreign policy considerations related to the aid allocation, some programs may be predicated on cooperation on non-economic issues (e.g. action on drug control), and some grants may not be based on substantial reform. On the other hand, policy conditionality is not infrequently associated with project operations.

31. USAID adjustment operations are closely coordinated with the World Bank and IMF programs where these institutions have programs in place, but there is not normally a formal cofinancing or parallel financing arrangement. USAID programs may restate World Bank and/or IMF conditions 9/ and may extend them into greater detail, particularly in terms of institution building and implementation. In some cases, countries are offered menus of reforms and the amount of aid is a function of the number of intensity of reforms undertaken. In other cases, by mutual agreement, grants are made for prior action on a reform program to avoid the appearance of the US imposing policy reform. Participation in consultative groups and support groups reinforces the level of coordination between the USAID program and the World Bank. In the cases of some countries in arrears to the World Bank and/or IMF, the USAID (often with other bilateral donors) has been able to provide financial support for initial adjustment programs in advance of the Bretton Woods institutions, which would begin programs after their arrears had been cleared. USAID has also been able to support some countries' reform programs through technical assistance grants and advisory programs after the need for balance of payments support has passed.

this is true for all donors/MDBs

eg: (Zambia?)

32. Adjustment operations are processed in a manner similar to other projects, but they are likely to receive more management scrutiny and also more attention from Congress, particularly those under the category of cash transfers, which comprise the bulk of the adjustment grants. Adjustment grant disbursements are not formally tied, but are subject to agreements on their use, including allocation to a debt service payments due to the US government, the multilateral banks, other creditors, etc. (US participation in the SPA has been largely untied however). The objective of this restriction is to assure that funds are used in "approved" transactions, but it is recognized that money is fungible, and this has not proven to be a serious restriction on the use of funds.

8/ Other than the loan programs mentioned above, the other distinctions are not critical for this discussion and relevant programs will be grouped.

9/ At one point, legislation prohibited USAID agreements from explicitly requiring countries to comply with conditions of the Bretton Woods institutions, but allowed the same conditions to be repeated as conditions for the USAID agreement.

changed?

33. Table 7 summarizes the support for adjustment programs by USAID. Adjustment assistance represents a substantial share of the total economic assistance program. These figures are compiled by program category, not by individual operation and are an approximate total of adjustment operations. Some individual grants covered may have relatively little policy basis. But there are policy based operations in other programs not included here. A more detailed USAID study done for FY 91 indicates a slightly higher total for policy based operations in that year. In addition to the assistance shown here, there are some soft loans for commodity imports that may be conditioned on policy reform, and a substantial part of the $150 million a year in the housing guarantees program is related to policy reforms.

meaning unclear

Table 7: Adjustment Grants by the United States
(US $ million)

	1987	1988	1989	1990	1991
Total assistance	2,712	1,821	2,212	2,816	2,267
Adjustment assistance	1,478	658	1,049	1,711	1,278
Share of adjustment in total assistance	54%	36%	47%	61%	56%
Amount of adjustment cofinanced with the World Bank	0	0	0	0	0
Share of adjustment cofinanced with the World Bank	0%	0%	0%	0%	0%

Source: USAID.

Summary

34. The amount of adjustment lending by other aid donors, both multilateral and bilateral, has grown substantially over the past decade. The widespread need for this kind of assistance in the late 1980s and the desire of other agencies to add this tool to their programs of assistance to developing countries have both contributed to this trend. The difficulty of undertaking policy based lending and the importance of close coordination among all donors has been widely recognized. As a result, the vast majority of adjustment lending has been closely associated in one way or another with the adjustment programs of the World Bank and/or the stabilization and extended arrangements of the IMF. This cooperation takes a variety of forms from the fully integrated cofinancing in the SPA in Africa to close cooperation and collaboration in developing country programs, as in Latin America.

35. Donors have generally established indicative upper limits (explicit or implicit) on the amount of adjustment lending they will undertake, but administer these limits flexibly. Based on current programs and expectations, adjustment lending seems to be reaching a plateau as most agencies have established their programs and are not expanding their limits and as many countries are beginning to move beyond the need for intensive adjustment

lending. Eastern Europe and the FSU are major exceptions to this trend, and operations there may lead to an increase in the overall level of adjustment lending in the near term.

36. Preparation and coordination processes for adjustment lending have been strengthened, and cross participation in World Bank and IMF with other agency missions is common. One important consequence of the expansion of adjustment lending has been a substantial increase in the degree of collaboration and cooperation among donor agencies in their country assistance strategies and programs. This has occurred on both an institutional level and on a staff level. Lenders have also come to understand the close and vital links between macro and sectoral policy issues and specific project performance to a much greater extent than before, which can only lead to an improvement in the overall quality of assistance programs.

Table 8: Adjustment Lending by the World Bank Group
(US $ million)

	1987	1988	1989	1990	1991
Total lending	17,674	19,221	21,367	20,702	22,685
IBRD	14,188	14,762	16,433	15,180	16,392
IDA	3,486	4,459	4,934	5,522	6,293
Adjustment lending	4,424	4,707	6,094	5,957	6,879
IBRD	3,475	3,615	4,959	4,179	4,871
IDA	949	1,092	1,135	1,778	2,008
Share of adjustment in total lending	25%	24%	29%	29%	30%
Share of adjustment in IBRD	24%	24%	30%	28%	30%
Share of adjustment in IDA	27%	24%	23%	32%	32%

Source: Annual Reports of the World Bank Group.

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

DATE: September 15, 1992

TO: Mr. Attila Karaosmanoglu, Managing Director

FROM: Lawrence H. Summers, DECVP

EXTENSION: 33774

SUBJECT: Paper on Adjustment Lending of Regional Development Banks

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The attached draft of this paper, prepared at the request of some Executive Directors, has been reviewed by FRM, the concerned RVP offices of the Bank, and the relevant sections by the concerned agencies, who also contributed background data and information. Their comments have been incorporated.

One issue to be decided is whether to include the sections on the bilateral agencies. Given their large role in helping finance adjustment operations and some differences in their policies, a brief review of the policies of the major bilaterals adds useful information. The three selected are representatives. On the other hand, since all bilaterals are not covered fully, though mention is made of most, there may be some sensitivities involved in the choices made. I would appreciate your guidance on this point.

We are assuming this will simply be circulated to Directors as an information memo from management.

cc: Messrs./Mmes Stern, Sandstrom, Grilli, Kavalsky, Shilling, Walton, Armitage

ADJUSTMENT LENDING
by Regional Development Banks
and Selected Bilateral Donors

Introduction

1. During the discussion of the Report on Adjustment Lending III on April 14, 1992, several Directors asked about the adjustment lending activities of other development banks. Staff noted that other agencies had begun adjustment lending relatively recently in close association with the World Bank (including IDA throughout). Directors then requested further information on the amounts and terms of such lending. This report has been prepared in response to that request. The three regional development banks reviewed are the African Development Bank (AfDB), the Asian Development Bank (ADB), and the Inter-American Development Bank (IDB). The European Bank for Reconstruction and Development has not been included since it does not engage in adjustment lending at this time 1/. Three bilateral donors that have provided substantial support for adjustment programs have also been included to illustrate the extent of support for adjustment programs from that quarter. These are the European Communities, Japan, and the United States. A number of other bilateral donors also provide assistance for adjustment programs 2/. Their practice is also to closely coordinate their adjustment support with the World Bank and the IMF programs. The material in this report has been gathered from annual reports and other documents of these agencies, material provided by them on request for this study, interviews with senior staff of the other agencies, and interviews with Bank staff involved in cofinancing with these agencies.

2. In the late 1970s, World Bank staff and management had reached the conclusion that extremely distorted macroeconomic and sectoral policies seriously inhibited development prospects in many developing countries and greatly reduced the value of many worthwhile investment projects. To counter these obstacles, structural adjustment lending (SAL) was initiated, and shortly thereafter sector adjustment lending (SECAL). The objective of these programs was to change policies so as to improve the efficiency and competitiveness of economies facing external and internal economic difficulties and thereby to restore or

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1/ The Caribbean Development Bank has also made one adjustment loan for $34 million cofinanced with the World Bank, as would future adjustment loans, if any. It is not included in the analysis due to the small volume of its adjustment lending.

2/ Of particular importance is the cofinancing of adjustment lending provided to the Special Program for Africa, which includes $700 million from France, $520 million from Sweden, $530 million from UK, and $465 million from Netherlands. Since SPA was launched in 1988, 15 bilateral donors plus the AfDB and the European Communities provided adjustment financing in support of policy reform programs in 26 Sub-Saharan countries. For SPA-2, donors have pledged $7.3 billion, either for direct cofinancing with IDA operations or for coordinated financing, supporting well-defined adjustment programs.

enhance their medium-term growth and development prospects. Adjustment lending has provided a powerful tool to assist and encourage countries undertaking difficult but necessary policy reforms and to help ease the short-term balance of payments impacts of these adjustments 3/.

3. The same factors that led the World Bank to undertake adjustment lending have been behind the moves of the regional development banks and other donors into adjustment lending - the need for an adequate policy framework in order to do satisfactory project lending and the need for quick disbursing funds to ease difficult adjustment periods. In addition, where countries were undertaking adjustment programs with tightly constrained domestic budgets, investment programs were cut and counterpart funds were often not available for new investment projects, limiting the scope for project assistance. The governing bodies of the regional development banks include many of the same major credit shareholders as the World Bank and the IMF, and these bodies favored a cautious approach to adjustment lending by the regional banks. Thus coordination or cofinancing with the World Bank was established as the preferred means for the regional banks entering adjustment lending. The bilateral donors generally have followed the same course in their movement into adjustment lending. Moreover, it was recognized by all that careful coordination was needed among all donors supporting adjustment programs in order to assure consistency of approach and policy advice.

4. As each agency has expanded into adjustment lending, policies and practices have been established, patterned to a large extent on those of the World Bank. By and large, they have generally opted to cofinance with the World Bank and/or have relied on the World Bank and the IMF for establishing the overall adjustment frameworks. In all cases, coordination and cooperation with the World Bank was strengthened, and staff of the multilateral banks and bilateral donors have come to work more closely together than previously. Cross participation or joint missions have become common and negotiations are closely coordinated. Analyses and models are regularly shared between the staffs of the institutions involved in each operation. The increased coordination has absorbed additional time and effort on the part of World Bank staff as well as staff of the other institutions. But this has been necessary to assure coordination. The regional banks and the bilateral donors have progressively developed more in-house capacity to do policy analysis and are increasingly involved in making substantive contributions to program design and direction. This enhanced capacity has strengthened their ability to play an effective role in the policy discussions and allowed some to move toward independent adjustment lending. This is proving very useful in countries where the World Bank is shifting from adjustment assistance to the next phase of its programs or in countries where the World Bank is not the principal external funding agency.

3/ Adjustment lending is also called "quick disbursing" and "policy based", each term emphasizing a different aspect of the instrument. For various reasons, different institutions sometimes prefer one or the other term. In some cases, "program" lending is also included if it is related to policy reforms. For some agencies, assistance to adjustment programs is in the form of grants.

5. The majority of operations so far have either been cofinanced or parallel financed with the World Bank 4/. In cases without explicit cofinancing, the other agencies have taken care to coordinate their actions with the World Bank and the IMF in order to assure consistent signals are sent to the government about its program and the conditions of support. The regional banks and bilateral donors have generally preferred sector adjustment lending where it is feasible 5/. They feel that they have more positive contributions to make in these areas. Structural adjustment operations have usually been in the context of well defined programs, such as the Special Program for Africa (SPA). In some cases, the use of parallel financing has added valuable flexibility. If release of a tranche under a World Bank loan were delayed over minor technical points, a parallel financed loan might be able to disburse to provide for essential imports where the bulk of the conditionality is satisfied and where the particular concerns of the parallel loan are met. Such activities are closely coordinated with the Bank, and can help avoid some of the disadvantages of the "all-or-nothing" aspect of tranche releases.

6. The World Bank has provided the majority of adjustment lending since 1987, when other agencies began to engage more actively in this kind of operation, as shown in Table 1. The World Bank's share in total commitments has fallen somewhat over this period, but the high level of cofinancing or coordinated financing with most donors indicates the extent of influence the Bank has in the design and execution of the programs. The percentages include only formal cofinancing and parallel financing. They understate the extent of coordination, as most of the remaining lending is also coordinated with World Bank or IMF programs.

7. To the extent that other agencies have resources available, expansion of their adjustment lending in conjunction with the World Bank has helped mobilize more resources for countries undertaking difficult reform programs with the World Bank. Many of its traditional borrowers are now completing their adjustment programs and moving into post-adjustment phases of their development strategies. Sector adjustment lending by other development agencies to these countries, could help ease the transaction process in some cases. In other areas of the world, however, demand for adjustment lending is expected to grow. Eastern Europe and the Former Soviet Union (FSU) fall in this category. While the EBRD does not plan to engage in adjustment lending in these areas, several of the bilateral

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4/ Cofinancing involves explicit cross-referencing of performance conditions and sanctions in the legal documentation of each institution's loans and usually identical conditions. In parallel financing, there is no explicit cross-referencing or cross default clauses in the documentation. However, in adjustment operations, the conditionality is generally identical and the use of parallel financing is for reasons of administrative convenience. Coordinated financing implies a somewhat looser relation in terms of conditionality.

5/ In some cases, the sector adjustment loans of the regional banks are close to sector investment or hybrid loans. The regional banks have also used program loans on some occasions, as has the World Bank, and these have been included in the adjustment lending series. They have become infrequent.

donors, the EC in particular, are committed to substantial balance of payments support in conjunction with the World Bank and IMF programs in this region.

Table 1: Adjustment Commitments by Major Creditors
(US $ million)

Creditor	1987	1988	1989	1990	1991
World Bank Group	4,424	4,707	6,094	5,957	6,879
IBRD	3,475	3,615	4,959	4,179	4,871
IDA	949	1,092	1,135	1,778	2,008
African Development Bank	721	406	579	561	718
% Cofinanced with the World Bank	59%	100%	96%	98%	79%
Asian Development Bank	150	660	275	820	435
% Cofinanced with the World Bank	0.0%	0.0%	0.0%	15.2%	0.0%
Inter-American Development Bank	0	0	0	1,310	2,050
% Cofinanced with the World Bank	0%	0%	0%	100%	83%
European Development Bank/Community	0	69	263	105	0
% Coordinated financing with the World Bank	0%	100%	100%	100%	0%
JEXIM/OECF	293	1,521	3,063	1,209	1,968
% Cofinanced with the World Bank	100%	100%	58%	100%	85%
USAID	1,478	658	1,049	1,711	1,278
% Cofinanced with the World Bank	0%	0%	0%	0%	0%
Total Non-World Bank	2,642	3,314	5,229	5,716	6,449
% Cofinanced with the World Bank	27%	60%	49%	58%	61%
Grand Total	7,066	8,021	11,323	11,673	13,328
Share of World Bank Group	63%	59%	54%	51%	52%
Share of others	37%	41%	46%	49%	48%

Source: Tables 2 to 7.

The African Development Bank

8. The African Development Bank was the first regional bank to initiate adjustment lending, obtaining approval from its Governors in 1986 at the same time its overall resources were increased. It began adjustment lending the following year. It makes both structural and sectoral adjustment loans. The AfDB moved relatively early in this direction due to the severity of the adjustment problems faced by its members and the difficulty of financing traditional projects in many of its member countries due to severe distortions and limited investment budgets. Although it had done some program and multi-sector lending in the past, it approached adjustment lending carefully, establishing close links with the World Bank. The AfDB makes adjustment loans through both its regular facilities and the African

Developmen Fund (AfDF), its soft loan window, depending on the creditworthiness of the country. The funds for the adjustment lending are drawn from the regular resources of the AfDB and the AfDF. The AfDB established guidelines of about 25% of its total lending for adjustment lending for the 1987-91 planning period. The percentage has been revised to 21.5% for the AfDF 1991-93. The AfDB is also programming its lending at 21.5%, though it still has the 25% guideline. A large number of the AfDB's clients are still facing severe economic difficulties and are not creditworthy for much more regular financing. The AfDF resources are, of course, limited, and allocations to adjustment lending are not likely to increase.

9. Loans are cofinanced with the World Bank, or parallel Bank programs as closely as possible. An IMF program in a country is a precondition for the AfDB to do adjustment lending. Following the inauguration of the SPA, all the AfDB's adjustment lending to low-income sub-Saharan African countries has been in the context of that program, though a small number of operations have not been explicitly cofinanced with IDA. It has also made adjustment loans to other countries which are not low income, such as Nigeria and Cote d'Ivoire, or which are not in Sub-Sahara Africa, such as in the Mahgreb. Cofinanced operations naturally have identical conditionality. In parallel financed operations, the AfDB tends to support the macro conditionality in the multi-sector (SAL) loans, and may not include all the sector conditionality of the World Bank's parallel operation. In these cases, it is conceivable that AfDB conditionality could be satisfied, but not that of the World Bank. In such cases, the AfDB staff would consult closely with the World Bank as to whether their proceeding with a tranche release would be consistent with the overall policy objectives of the program. In practice, it is unlikely that the AfDB would proceed if the World Bank expressed reservations about the country's compliance with its overall program.

10. Staff of the AfDB work closely with World Bank staff on adjustment operations. They generally participate in the appraisal mission, and sometimes the preparation mission as well. The AfDB may have a representative at the negotiations with the World Bank, and Bank staff may be involved in the AfDB negotiations. The World Bank resident mission in Abidjan with staff designated for coordination with the AfDB and the newly opened AfDB representative office in Washington facilitate these contacts. The actual processing procedures in the AfDB for adjustment lending are quite similar to their normal project procedures. Project supervision is coordinated with the World Bank, and it receives close attention because of the importance of these operations and the integration of most adjustment lending into the SPA and Consultative Group activities.

11. Table 2 summarizes the amounts of adjustment lending undertaken by the AfDB. The large amount in 1987 reflects a bunching of several operations that had been under preparation while the final authority to do adjustment lending was being considered. Included are an industrial sector loan to Tunisia for $114 million and an export promotion loan to Nigeria for $256 million. The latter was not formally confinanced with the World Bank, but was coordinated with the Bank's program in the country. Subsequently, nearly all operations have been cofinanced. The AfDB also makes a number of institution building TA grants under this category, and these are not cofinancing operations. They are not included in the total.

Table 2: Adjustment Lending by the African Development Bank
(US $ million)

	1987	1988	1989	1990	1991
Total lending	2,113	2,168	2,832	3,251	3,412
African Development Bank (AfDB)	1,343	1,405	1,865	2,158	2,254
African Deelopment Fund (AfDF)	770	764	967	1,093	1,158
Adjustment lending	721	406	579	561	718
African Development Bank (AfDB)	592	245	401	390	468
African Development Fund (AfDF)	129	161	178	170	250
Share of adjustment in total lending	34%	19%	20%	17%	21%
Share of adjustment in AfDB	44%	17%	21%	18%	21%
Share of adjustment in AfDF	17%	21%	18%	16%	22%
Amount cofinanced with the World Bank	425	406	558	548	568
African Development Bank (AfDB)	336	245	401	390	339
African Development Fund (AfDF)	88	161	157	157	229
Share of adjustment cofinanced with the World Bank	59%	100%	96%	98%	79%
African Development Bank (AfDB)	57%	100%	100%	100%	72%
African Development Fund (AfDF)	69%	100%	88%	92%	92%

Source: Recent issues of Annual Report of the African Development Bank.

The Asian Development Bank

12. The Asian Development Bank (ADB) made major revisions in its program lending policies in late 1987 to expand its lending activities in support of sector development programs aimed at achieving improved sector performance over the medium-term. The sector development programs cover a varying mix of adjustments in policy, improved investment programs, and institution building. Although the Asian economies were not suffering macroeconomic disequilibria to the extent that some African and Latin American countries were, they did face structural and sectoral problems. The ADB program (adjustment) lending is directed only toward sector adjustment programs; the ADB does no structural adjustment lending. The ADB makes program loans from both its ordinary capital resources (commercial terms) and from the Asian Development Fund (concessional terms). There is an overall cap on program lending of 15%, averaged over three years, with a sub-limit of 22.5% of the Asian Development Fund resources, also averaged. The program was reviewed at the request of the ADB Board in 1990 after two years of operation and found to be functioning effectively. It was concluded that it allowed the ADB to offer a broader scope of support to the economic development of its member countries. Adjustment lending authority was continued, and the guidelines of 15% and 22.5% reconfirmed.

13. The ADB's program loans are designed from its own sector experience and dialogue with member countries, and they are focused on sectors where the ADB sees it has added value to offer. Sector programs that it would support are to: (a) be based on detailed

sector analysis and dialogue within the country's overall development plan; (b) be fully compatible with the ADB country strategy; (c) have the full support of the borrowing country government; (d) have objectives and policies expressed in quantifiable and time bound terms; and (e) be fully coordinated with the activities of the World Bank, IMF, and other major donors. Beyond this coordination, the ADB has not typically engaged in direct cofinancing with the World Bank, except in the case of one ADF operation (an agricultural sector operation in Bangladesh) in 1990. However, cooperation is close; staff of each institution often participate in the missions of the other, and contacts are maintained through the World Bank's resident mission in Manila. Analyses and models are regularly shared between the staffs of the two institutions. By concentrating on sector programs, the ADB relies on the World Bank and IMF for establishing the macro framework. It then is able to design its sector programs in coordination with that framework. In some cases, the World Bank and the ADB have agreed to take lead responsibility in different sectors, which has reduced the opportunities for cofinancing. In other cases, borrowers have preferred to sequence separate adjustment or program loans from the two institutions.

14. ADB program loans normally have two tranches and disbursement procedures that facilitate the quick disbursing nature of the loans. Special import accounts are generally established in the recipient country's central bank, and disbursements are made against allowed imports, which are usually procured in normal commercial or government ways unless the size of the individual import exceeds a loan specific threshold. The loan themselves are processed by normal procedures, but they require an additional review by the Loan and Technical Assistance Coordination Committee. So far, one loan has been post-evaluated (Indonesia Export Promotion made in 1987) and found to have been successful in meeting its objectives. The ADB has not identified problems with its other loans.

15. Table 3 summarizes the amounts of program lending made by the ADB. Program lending amounts have fluctuated from year to year depending on demand, but have stayed within the guidelines. In view of the ADB's primary interest in project lending and the relatively better management on most economies in its region, there is not likely to be a great deal of pressure to expand this window, though it remains a valuable tool for the ADB.

Table 3: Program Lending by the Asian Development Bank
(US $ million)

	1987	1988	1989	1990	1991
Total lending	2,439	3,145	3,623	3,972	4,983
Ordinary capital resources (OCR)	1,481	2,062	2,260	2,492	3,636
Asian Development Fund (ADF)	958	1,083	1,363	1,480	1,347
Program lending	150	660	275	820	435
Ordinary capital resources (OCR)	75	330	54	200	250
Asian Development Fund (ADF)	75	330	221	620	185
Share of program in total lending	6%	21%	8%	21%	9%
Share of program lending in OCR	5%	16%	2%	8%	7%
Share of program lending in ADF	8%	30%	16%	42%	14%
Amount cofinanced with the World Bank				125	
Ordinary capital resources (OCR)					
Asian Development Fund (ADF)				125	
Share of program lending cofinanced with the World Bank				15%	
Ordinary capital resources (OCR)				0%	
Asian Development Fund (ADF)				20%	

Source: Annual Reports of the Asian Development Bank.

Inter-American Development Bank

16. The Inter-American Development Bank obtained approval from its Governors to engage in adjustment lending at its 1989 Annual Meeting. It began such operations in 1990. The IDB focuses on sector adjustment lending. An overall target for adjustment lending over the three year (1990-92) funding period was established (at about $5.6 billion) for adjustment lending from both Ordinary Capital (normal terms) and the Fund for Special Operations (soft terms). This was 25% of the total authorized lending. Often operations are blended from these two sources depending on country needs and availability of FSO resources. The latter are generally quite limited. In addition, the IDB has used adjustment lending authority to participate in debt and debt service reduction operations with the World Bank and IMF. The policy decision to initiate adjustment lending by the IDB required that initial operations be cofinanced with the World Bank while the IDB gained experience. Senior management in both institutions moved quickly to ensure very close cooperation between their staffs. The location of the headquarters of both banks in Washington has facilitated this high degree of coordination. Overall country programs and foward planning scenarios are shared between staffs.

17. Technically, the IDB undertakes parallel financing with the World Bank, and there are no explicit cross conditionality clauses. Nevertheless, the extent of coordination is quite close. Staff generally participate in the appraisal and negotiations of the other institution. Normally, the IDB adopts identical macro conditionality to the World Bank, but

may vary or extend some of the sector specific conditionality depending on its own country analysis and objectives. It may also deepen the sector reforms and support further institutional reforms necessary for the success of the sector adjustment. The range of the sector adjustment loans can be from "near SALs" to hybrid investment loans. Whatever the form, the IDB coordinates its dialogue and tranche releases very closely with the World Bank and would not proceed with a disbursement over the objection of the Bank. Following the first year of operations, the IDB moved to make some adjustment loans without explicit parallel financing with the World Bank. In the cases of Columbia and Chile, where the World Bank had phased out its adjustment lending operations, there was still justification to support sector adjustment, which the IDB could satisfy without cofinancing a World Bank operation. Naturally, these operations were coordinated with the World Bank and consistent with the country strategy. In Peru, as part of a coordinated strategy to support reforms among the IMF, World Bank, IDB, and bilateral donors, the IDB was to provide adjustment lending before the Bank 6/. Furthermore, in some of the smaller Latin American countries where the World Bank does not have a large presence, it is foreseen that the IDB would take responsibility for adjustment lending to help economize on overall resource use.

18. The processing of adjustment operations in the IDB follows normal procedures. Adjustment loans are required, in addition, to have a second review by the President's Program committee on the substance of the conditionality. Because of their quick disbursing nature, they are often put on a faster processing track and receive closer management attention. Like the World Bank, the IDB uses three tranches in some of these loans, especially where there is institutional reform. Supervision is also monitored more closely. IDB investment projects are now typically monitored from the field offices. Adjustment loans are still supervised from a specialized unit in headquarters, which provides more consistency of supervision and closer coordination with the World Bank.

19. Table 4 shows the adjustment lending activity of the IDB. It began only in 1990, but has assumed substantial proportions. It is closely linked with World Bank operations, and the rapid growth has been founded in that cooperation. There is some possibility that the adjustment operations will increase in the near future as shareholders are urging the IDB to provide more funding for upcoming debt and debt service reduction operations, however, that will be limited by the overall three year fund ending allocation. Need for continuing reform in several major debtors is likely to support a high level of adjustment lending for at least another replenishment period.

6/ The strategy involved clearance of IDB arrears first, since they were smaller, and would allow earlier disbursement of new funds.

Table 4: Adjustment Lending by the Inter-American Development Bank
(US $ million)

	1987	1988	1989	1990	1991
Total lending	2,303	1,628	2,577	3,832	5,359
Ordinary capital operations (OC)	1,957	1,474	2,235	3,315	4,734
Fund for special operations (FSO)	346	154	342	517	625
Adjustment lending				1,310	2,050
Ordinary capital operations (OC)				1,296	1,894
Fund for special operations (FSO)				14	156
Share of adjustment in total lending				34%	38%
Share of adjustment in OC				39%	40%
Share of adjustment in FSO				3%	25%
Amount cofinanced with the World Bank				1,310	1,700
Ordinary capital operations (OC)				1,296	1,544
Fund for special operations (FSO)				14	156
Share of adjustment lending cofinanced with the World Bank				100%	83%
Ordinary capital operations (OC)				100%	82%
Fund for special operations (FSO)				100%	100%

Source: Annual Reports of the Inter-American Development Bank, staff of the IDB.

The European Communities

20. The European Communities (EC) manage a substantial aid program in addition to the bilateral aid programs of its individual members. The latter tend to be predominantly project and loan oriented while the EC assistance to developing countries is predominantly in the form of grants. A small amount of the EC program is provided in the form of subsidized project loans through the EIB and is not discussed here. The EC program is administered in several distinct programs with different historical and treaty origins. The most important is the ACP (Africa, Caribbean, and Pacific) program based on a series of treaties referred to as the Lome Conventions. These treaties cover a range of economic relations, including trade preferences and economic and technical assistance. In response to the growing economic difficulties in these countries, the EC established a special program to provide general non-project import financing in December 1987, and commitments began in 1988. A fund of 550 million ECU for 1988-90 was established from available resources in the then current five year budget to fund Sector Import Programs (SIP) and General Import Programs (GIP). These grants had most of the policy based characteristics of adjustment loans and were often associated with World Bank adjustment operations, especially through the SPA in Africa, which was the motivating force behind this initiative. The Lome IV Convention of December 1989 formally included structural adjustment grants in the assistance program and allocated 1,150 million ECUs out of a total aid program of 12 billion ECUs of assistance for 1990-95. The amount set aside for structural adjustment is not allocated by country, as is the

rest of the program. It is allocated on the basis of need and performance in adjustment programs. In any country, up to 10% of the indicative allocation to that country can also be used for adjustment operations (a total of about 550 million ECUs). In addition, ACP countries can access STABEX and SYSMIN resources in parallel with adjustment grants if the specific commodity conditions for those stabilization programs are met. Although countries are in principle entitled to these funds solely on the basis of the commodity criteria, the EC has, on accasion, associated the use of these recipients with structural reform.

21. In addition to the ACP countries, the EC has assistance programs with the Southern and Eastern Mediterranean (SEM) countries covering a variety of relations, though these are less elaborate than with the ACP. Use of assistance allocations to SEM countries for adjustment has been authorized to begin in 1992. An allocation of 300 million ECUs for adjustment lending has been made for 1992-95, and it may be augmented by some of the aid allocated under the current protocol with these countries. The first loan for 40 million ECUs has been made to Tunisia in April 1992. There is also a regional program for Latin America, but provisions for adjustment lending are not currently foreseen. In 1989, the EC established the PHARE program to assist countries in Eastern Europe in their transitions to more market oriented economies. This program was initially for 1 billion ECUs and has been oriented toward technical assistance and projects. Many of the specific projects and technical assistance has been aimed at supporting adjustment programs of the Bank and IMF arrangements. In addition, the EC has managed for the G-24 a program of loans for balance of payments support and reserve build-up in Eastern Europe. This was funded to commit up to $3.3 billion in 1991. It is not yet decided whether this program will be extended or whether a similar one will be mounted for the FSU. The balance of payments support for Eastern Europe is all conditioned on satisfactory performance under IMF and World Bank adjustment programs, so it is in effect a form of informal cofinancing. No additional conditionality is imposed by the EC. The rest of this discussion will focus on the ACP program. The SEM program of adjustment lending has barely begun, and the programs in Eastern Europe and FSU are special cases for the time being.

22. As a federation of sovereign nations, the EC is careful to maintain its independence of decision-making in its assistance program. However, it is also conscious of the need to coordinate assistance for adjustment programs to the maximum extent possible. In establishing eligibility for its structural adjustment facility, it must consider a country's need and the effectiveness of its policies. As a matter of practice, the existence of a World Bank or IMF adjustment program is considered sufficient to satisfy these conditions. Within the framework provided by the Bretton Woods institutions, the EC is an active partner in the policy dialogue and program design, as well as in the financing. The EC is a major supporter of the SPA program and has cooperated closely with the World Bank in that effort. Staff of the EC frequently participate in World Bank missions, and the EC is active in the SPA country meetings. In certain instances, the EC may proceed independently of operations of the Bretton Woods institutions on some sectoral issues, but would only do so in close coordination with the World Bank and the IMF. The EC has expertise in certain sectors and is increasingly playing an active role in designing programs and assuring their implementation. Food and trade policy are areas of particular interest, as is the general consistency of adjustment programs across countries.

23. An internal unit in the EC has been created to review structural adjustment grants and help determine the amount of support in each case. If there were not a World Bank or IMF program in place, the EC would require an additional internal stage to determine eligibility of a country before engaging in adjustment lending. Otherwise, the processing of adjustment operations is the same as for normal activities. It is expected that adjustment lending for SEM countries will be treated on a country by country basis. There is no formal coordination framework arrangement such as the SPA.

24. Table 5 summarizes the adjustment grants of the EC. In effect, it covers only the ACP program. The amounts available are determined by the envelope agreed in Lome IV.

Table 5: Adjustment Grants by the European Community
(US $ million)

	1987	1988	1989	1990	1991
Total grants	1,925	2,915	2,688	3,095	
ACP countries	898	1,414	1,429	1,595	
All others	1,027	1,501	1,259	1,500	
Adjustment grants (in ACPs)		69	263	105	
Share of adjustment grants in ACPs		5%	18%	7%	
Amount of adjustment in ACPs coordinated with the World Bank		69	263	105	
Share in adjustment in ACPs coordinated with the World Bank		100%	100%	100%	

Source: EC.

Japan

25. The Japanese government provides development assistance through two institutions: the Japan Export Import Bank (JEXIM) for non-concessional loans, and the Overseas Economic Cooperation Fund (OECF) for concessional loans. Use of one or the other source of funding is determined in accordance with each agency's primary business areas, which are based on the income level of the borrowing country, sector of the operation, and type of program or project. Frequently, both are active in the same country. Both agencies are primarily project financing institutions. In recognition of the severe economic difficulties faced by many countries and encouraged by other major participants in the development community, Japan has moved to provide some of its assistance in support of adjustment and debt and debt service reduction operations. Since 1987, JEXIM has expanded its scope of business to provide adjustment lending, which is untied. Nearly all OECF procurement is now also untied, including its support for adjustment operations.

26. The decision to support adjustment operations is made on a case by case basis. Neither agency has a target level of adjustment lending nor a special fund, and both prefer project operations if possible. Operations of the OECF have been out of the Fourth ODA Plan, which ends this year. Another ODA plan will be agreed later this year and is expected to be substantially larger than the $50 billion committed in the Fourth Plan. Both agencies have also been included in the Expanded Capital Recycling Program, which had as its objective committing $65 billion over the period 1987-92, including $23.5 through JEXIM and $12.5 through OECF. This program has been largely achieved, and it expired in the middle of this year. No direct successor to that program has been announced. JEXIM expects to continue adjustment lending as needed. OECF does not foresee that there will be a significant change in the proportion of adjustment operations in its overall program so these operations are likely to grow accordingly. The actual level will depend on economic circumstances in the recipient countries and the availability of adequate adjustment programs.

27. In order to assure full coordination with the adjustment programs, both agencies have adopted a policy of cofinancing with the World Bank, ADB, or IDB for adjusment operations. Other cofinanciers may also be involved in some operations. In addition, the JEXIM has engaged in parallel lending with the IMF in support of commercial debt and debt service reduction operations. Neither agency has included policy conditionality in its loan agreements. However, they only cofinance programs which they believe appropriate for the development of the recipient countries. World Bank or IMF programs are considered assurance of the appropriateness of the program. Staff frequently participate in World Bank appraisal missions and often in negotiations. Both JEXIM and OECF monitor their adjustment loans in conjunction with the cofinancier's review schedule. Both agencies have strengthened their capacities to evaluate structural and sectoral adjustment programs. At present, neither institution intends to undertake adjustment lending other than as cofinancing where there is a clear need for additional financing and where the country's overall performance is satisfactory to the institutions. These agencies would prefer to find project vehicles for providing assistance, however. If that is not feasible, they will select appropriate adjustment operations. In some cases, they may be more selective than the World Bank.

28. Both institutions follow their normal procedures for processing these loans. Although JEXIM exercises a high degree of independence, it consults closely with the Ministry of Finance when deciding on each adjustment loan. Otherwise, normal procedures are typically followed, and the processes are relatively quick. In the case of the OECF, decisions may take somewhat longer because it depends on four ministries and must obtain the approval from each for its operations. Both institutions have developed more capacity to evaluate macro policy issues. OECF has begun to offer suggestions to the World Bank staff on appropriate conditionality, though timing differences in the processing has sometimes prevented timely input from occurring. The projects themselves are monitored more closely than regular projects by the agencies and in close collaboration with the World Bank and IMF as appropriate.

29. Table 6 summarizes the adjustment lending activity of the Japanese institutions. In addition to the figures shown, JEXIM has provided $3 billion to the IMF in 1988 for use

in its ESAF program to support structural reform, and it cofinanced three debt and debt service reduction operations with the IMF ($1,000 million for Mexico and $300 million for Philippines in 1989 and $300 million for Venezuela in 1991). The variation in the share of lending allocated to adjustment lending reflects variations in numbers of cases and size of operation presented for financing rather than any policy on the amount of lending allocated to this activity.

Table 6: Adjustment Lending by Japan
(US $ million)

	1987	1988	1989	1990	1991
Total lending	5,501	6,373	7,780	9,582	11,655
Japan Export Import Bank (JEXIM)	2,363	1,972	3,696	3,037	2,967
Overseas Economic Cooperation Fund (OECF)	3,138	4,401	4,084	6,545	8,688
Adjustment lending	293	1,521	3,063	1,209	1,968
Japan Export Import Bank (JEXIM)	0	870	2,300	540	950
Overseas Economic Cooperation Fund (OECF)	293	651	763	669	1,018
Share of adjustment in total lending	5%	24%	39%	13%	17%
Share of adjustment in JEXIM	0%	44%	27%	18%	22%
Share of adjustment in OECF	9%	15%	19%	10%	12%
Amount of adjustment cofinanced with the World Bank	293	1,521	1,763	1,209	1,668
Japan Export Import Bank (JEXIM)	0	870	1,000	540	650
Overseas Economic Cooperation Fund (OECF)	293	651	763	669	1,018
Share of adjustment cofinanced with the World Bank	100%	100%	58%	100%	85%
Japan Export Import Bank (JEXIM)		100%	43%	100%	68%
Overseas Economic Cooperation Fund (OECF)	100%	100%	100%	100%	100%

Source: JEXIM, OECF.

United States (USAID)

30. The United States' development assistance program 7/ began reorienting its aid toward policy based activities in 1981 by administrative decision. This reflected a growing emphasis on the policy framework in aid programs. Over the decade of the 1980s, USAID's economic assistance was also converted largely to a grant basis. There are still some soft commodity loans under the recently approved Title III in the PL 480 program and some housing assistance guarantees. Assistance is provided for both structural and sectoral

7/ The US foreign assistance budget includes a number of other categories of aid which are not comparable to the assistance discussed in this report, e.g. military assistance. The discussion and figures presented include only economic assistance and exclude funds for Israel.

adjustment programs through several different vehicles in the USAID portfolio of programs 8/. Sector operations tend to be preferred in some programs. There is no formal overall target or ceiling for adjustment grants under most programs, and there is no special program for adjustment operations. Some programs have their own limits, such as the Development Fund for Africa, which has a 30% upper limit on adjustment operations. USAID funds are allocated globally in relation to US political interests as well as economic needs, but the final share of adjustment aid and extent of policy conditionality in a country is a function of need, willingness to undertake reforms, and country performance. Because of the foreign policy considerations related to the aid allocation, some programs may be predicated on cooperation on non-economic issues (e.g. action on drug control), and some grants may not be based on substantial reform. On the other hand, policy conditionality is not infrequently associated with project operations.

31. USAID adjustment operations are closely coordinated with the World Bank and IMF programs where these institutions have programs in place, but there is not normally a formal cofinancing or parallel financing arrangement. USAID programs may restate World Bank and/or IMF conditions 9/ and may extend them into greater detail, particularly in terms of institution building and implementation. In some cases, countries are offered menus of reforms and the amount of aid is a function of the number of intensity of reforms undertaken. In other cases, by mutual agreement, grants are made for prior action on a reform program to avoid the appearance of the US imposing policy reform. Participation in consultative groups and support groups reinforces the level of coordination between the USAID program and the World Bank. In the cases of some countries in arrears to the World Bank and/or IMF, the USAID (often with other bilateral donors) has been able to provide financial support for initial adjustment programs in advance of the Bretton Woods institutions, which would begin programs after their arrears had been cleared. USAID has also been able to support some countries' reform programs through technical assistance grants and advisory programs after the need for balance of payments support has passed.

32. Adjustment operations are processed in a manner similar to other projects, but they are likely to receive more management scrutiny and also more attention from Congress, particularly those under the category of cash transfers, which comprise the bulk of the adjustment grants. Adjustment grant disbursements are not formally tied, but are subject to agreements on their use, including allocation to a debt service payments due to the US government, the multilateral banks, other creditors, etc. (US participation in the SPA has been largely untied however). The objective of this restriction is to assure that funds are used in "approved" transactions, but it is recognized that money is fungible, and this has not proven to be a serious restriction on the use of funds.

8/ Other than the loan programs mentioned above, the other distinctions are not critical for this discussion and relevant programs will be grouped.

9/ At one point, legislation prohibited USAID agreements from explicitly requiring countries to comply with conditions of the Bretton Woods institutions, but allowed the same conditions to be repeated as conditions for the USAID agreement.

33. Table 7 summarizes the support for adjustment programs by USAID. Adjustment assistance represents a substantial share of the total economic assistance program. These figures are compiled by program category, not by individual operation and are an approximate total of adjustment operations. Some individual grants covered may have relatively little policy basis. But there are policy based operations in other programs not included here. A more detailed USAID study done for FY 91 indicates a slightly higher total for policy based operations in that year. In addition to the assistance shown here, there are some soft loans for commodity imports that may be conditioned on policy reform, and a substantial part of the $150 million a year in the housing guarantees program is related to policy reforms.

Table 7: Adjustment Grants by the United States
(US $ million)

	1987	1988	1989	1990	1991
Total assistance	2,712	1,821	2,212	2,816	2,267
Adjustment assistance	1,478	658	1,049	1,711	1,278
Share of adjustment in total assistance	54%	36%	47%	61%	56%
Amount of adjustment cofinanced with the World Bank	0	0	0	0	0
Share of adjustment cofinanced with the World Bank	0%	0%	0%	0%	0%

Source: USAID.

Summary

34. The amount of adjustment lending by other aid donors, both multilateral and bilateral, has grown substantially over the past decade. The widespread need for this kind of assistance in the late 1980s and the desire of other agencies to add this tool to their programs of assistance to developing countries have both contributed to this trend. The difficulty of undertaking policy based lending and the importance of close coordination among all donors has been widely recognized. As a result, the vast majority of adjustment lending has been closely associated in one way or another with the adjustment programs of the World Bank and/or the stabilization and extended arrangements of the IMF. This cooperation takes a variety of forms from the fully integrated cofinancing in the SPA in Africa to close cooperation and collaboration in developing country pograms, as in Latin America.

35. Donors have generally established indicative upper limits (explicit or implicit) on the amount of adjustment lending they will undertake, but administer these limits flexibly. Based on current programs and expectations, adjustment lending seems to be reaching a plateau as most agencies have established their programs and are not expanding their limits and as many countries are beginning to move beyond the need for intensive adjustment

lending. Eastern Europe and the FSU are major exceptions to this trend, and operations there may lead to an increase in the overall level of adjustment lending in the near term.

36. Preparation and coordination processes for adjustment lending have been strengthened, and cross participation in World Bank and IMF with other agency missions is common. One important consequence of the expansion of adjustment lending has been a substantial increase in the degree of collaboration and cooperation among donor agencies in their country assistance strategies and programs. This has occurred on both an institutional level and on a staff level. Lenders have also come to understand the close and vital links between macro and sectoral policy issues and specific project performance to a much greater extent than before, which can only lead to an improvement in the overall quality of assistance programs.

Table 8: Adjustment Lending by the World Bank Group
(US $ million)

	1987	1988	1989	1990	1991
Total lending	17,674	19,221	21,367	20,702	22,685
IBRD	14,188	14,762	16,433	15,180	16,392
IDA	3,486	4,459	4,934	5,522	6,293
Adjustment lending	4,424	4,707	6,094	5,957	6,879
IBRD	3,475	3,615	4,959	4,179	4,871
IDA	949	1,092	1,135	1,778	2,008
Share of adjustment in total lending	25%	24%	29%	29%	30%
Share of adjustment in IBRD	24%	24%	30%	28%	30%
Share of adjustment in IDA	27%	24%	23%	32%	32%

Source: Annual Reports of the World Bank Group.

cc: EG.

A L L - I N - 1 N O T E

DATE: 20-Aug-1992 09:41am

TO: John D. Shilling (JOHN D. SHILLING)

FROM: Basil Kavalsky, FRM (BASIL KAVALSKY)

EXT.: 80523

SUBJECT: Adjustment Lending by RDBs

1. Most of my comments relate to the scope and style of the paper rather than the substance. In general, the substance of the paper responds to the original request. However, it might be useful to elaborate on the discussion of IDB in two areas. First, it would be useful to include something on the Enterprise for the Americas initiative, since the IDB has provided hybrid private sector development loans under this aegis. Second, we should include some explanation of the situation with Peru, where IDB arrears have been cleared, and a trade adjustment loan has been disbursing. (A financial sector loan is on hold).

2. The tone of the paper comes across as somewhat patronising towards the capacities and efforts of the RDBs in the macro area. The implication that the RDBs haven't done this because they don't have the skills and experience is not plausible. As we ourselves have demonstrated time and again in moving into new areas of lending, it is possible to gear up very quickly if there is political will to get something done. It is certainly cheaper and more efficient for the RDBs to rely on the Bank and the Fund, but I suspect that the main reason for their slowness in getting into this area lies in concern about the potential for a much more adversarial relationship with their borrowers. Contrary to your assertion, the RDBs do not have the same shareholders as we do. Non-regional developing countries are not represented, while the regionals have substantially larger voting power than do the developing countries in IBRD.

3. I think it is a mistake to include the bilateral lenders. Other bilaterals will take it as a slight on their efforts and it adds nothing to the response. My inclination would be to make it a far shorter paper, essentially eliminating the introduction and the bilateral sections. I would try to make the response more direct and descriptive.

4. The paper shows signs of haste in the preparation and needs substantial editing. It would also be helpful to include sources for the data and to footnote the tables to indicate some of the definitional issues which arise with regard to adjustment lending in the different RDBs.

CC: Enzo Grilli (ENZO GRILLI)
CC: Lorene Yap (LORENE YAP)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

Background paper for Kavaloky mtg. 5/28, 9:30 Shilling & Cavill attending

DATE: May 21, 1992

TO: Lorene Yap, Chief Officer, FRMRO

FROM: Jane Kirby-Zaki, FRMRO

EXTENSION: 80576

SUBJECT: Cooperation on Adjustment Lending

1. Attached are preliminary data and background information on the amount of adjustment lending from the regional development banks - Asian, African, and Inter-American - and the EC, as well as the share cofinanced with World Bank operations.

2. Adjustment lending is a relatively new instrument for these institutions, introduced to the IADB lending program in 1990; to the EC (Lome Convention) in 1988; the AsDB in 1988; and the AfDB in 1987.

3. All have a general policy of cooperation with the Bretton Woods Institutions on adjustment lending, especially in the case of macro-economic structural adjustment programs. However, cooperation does not always translate into formal cofinancing - for example, the Asian Development Bank appears not to formally cofinance our adjustment operations, although Bank and AsDB staff do coordinate operationally. The IADB has received a mandate from its member countries for making freestanding sectoral adjustment programs on a case-by-case basis beginning in 1991, superseding a condition of their last capital increase that such lending take place only as cofinancing with the World Bank. The relationship is the closest in the case of the AfDB, with joint appraisal missions and participation in negotiations, and formal cofinancing of all operations.

4. There is also generally a ceiling placed on the share of adjustment lending within the total portfolio. This is 25 percent (yearly average) for the AfDB and IADB, and 15 percent for the AsDB (of total lending, with a higher sub-ceiling for AsDF). In the case of the EC, about 10 percent of Lome IV is earmarked for structural adjustment support.

5. I expect to receive 1991 data for the AfDB by the end of this month, as well as some feedback on operational cooperation with the IDB and how the LAC regional staff views the IDB adjustment operations which are not formally cofinanced with the Bank. I'll forward this and any other relevant information on to you.

Attachments

I. African Development Bank/African Development Fund

African Development Bank Group
(Commitments, by Year of Approval, US$ mil.)

Policy-Based Loans	1987	1988	1989	1990	1991 2/
Total 1/	763.11	558.11	576.33	547.35	
of which: AfDB 1/	634.14	396.98	400.82	377.00	
AfDF 1/	128.97	161.13	175.51	170.34	
Share Cofinanced with World Bank (%) 3/			100%	100%	100%
Amount Cofinanced with SPA 4/		246.8	68.8	157.3	249.4

1/ Source: Annual Reports, AfDB Group, 1987 through 1990.
2/ 1991 data will be available in late May.
3/ 100% is assumed since this is general AfDB policy.
4/ Source: SPA tables.

Background Information

1. Policy-based loans, as shown above, include both sectoral and structural adjustment loans, all of which have policy conditionality.

2. As a general rule, all adjustment operations are formally cofinanced with the World Bank. The African Development Bank cannot fund adjustment unless there is an IMF program, which usually also implies there is a World Bank structural adjustment program. A ceiling has been placed on the share of adjustment in total lending, not to exceed 25 percent on an average yearly basis.

3. While a substantial portion of adjustment cofinancing has occurred within the framework of the SPA, an even greater amount has been extended for non-SPA countries, including North African countries, such as Morocco, Tunisia, Algeria, and Egypt. Coordination is very close between Bank staff and AfDB staff, who participate jointly in appraisal and negotiations.

II. Asian Development Bank/Asian Development Fund

Asian Development Bank
(Commitments, by Year of Approval, US$ mil.)

Program Lending	1987	1988	1989	1990	1991
Total		660.0	275.0	820.0	435.0
of which - OCR		330.0	54.0	200.0	250.0
- AsDF		330.0	221.0	620.0	185.0
Cofinanced with IBRD/IDA				125.0 1/	
Share of program lending cofinanced with World Bank		0%	0%	15.2%	0%

Source: Asian Development Bank, CFCU, Manila
1/ One AsDF operation was formally cofinanced. The related IDA credit totalled $75 million.

Background Information

1. Program lending from the Asian Development Bank is extended for sectoral adjustment, generally not as formal cofinancing of World Bank adjustment operations. Still, there is a great deal of coordination on policies, and Bank economic and sector work is often shared with AsDB, whose capacities to carry out ESW are more limited. AsDB staff participate in Bank appraisal missions or negotiations only on an ad hoc basis. In addition to formal annual consultations, local coordination between the Bank and AsDB in field offices is increasing, as is informal coordination by staff at the operational level.

2. During the recent AsDF-VI replenishment, AsDF donors agreed on the following points, which were adopted into the AsDB policy framework for program lending.

- A satisfactory medium-term macroeconomic framework was essential, and all developing member countries without one should develop and implement one either alone or as appropriate with assistance of the Bretton Woods institutions. The AsDB program lending should support reforms. The AsDB should refrain from making investments in sectors where the policy environment is adverse.

- The AsDB Board was requested to develop procedures for regular review and approval by the Board for program tranche releases

- AsDB operations should "strive for consistency with adjustment programs and macroeconomic arrangements negotiated between the DMC and the Bretton Woods institutions" and increase consultations with the World Bank and other major donors.

- The level of adjustment in total AsDB lending (both AsDF and OCR - Ordinary Capital Resources) had been set at a ceiling of 15 percent. Donors agreed that since AsDF had a higher share of adjustment than OCR, a sub-ceiling of 22.5 percent would be set for the AsDF alone, within the overall ceiling of 15 percent.

  (Reference: ADF VI: Report of the Donors (approved December 1991) and Working Paper 5-92, Arrangement for Lending from ADF and TASF Operations Funded by ADF Contributions, dated 2 April 1992.)

III. Inter-American Development Bank and Fund for Special Operations

Inter-American Development Bank
(Commitments, by Year of Approval, US$ mil.)

Sector Lending	1987	1988	1989	1990	1991 1/
Total				1310.0	2050.0
of which - OC				1264.0	1954.0
- FSO				46.0	96.0
Cofinanced with IBRD/IDA				1310.0	1700.0
Share of sector lending cofinanced with World Bank				100%	83%

Source: IADB Annual Reports, 1990 and 1991
1/ For 1991, the amount and share cofinanced with the World Bank includes both formal cofinancing and loans otherwise associated (such as Peru-$452m., Guyana-$30m., and Uruguay-$150m.). Loans not cofinanced include Chile-$150m. and Columbia-$200m. Only the adjustment components of hybrid loans are counted. Technical assistance components are not counted.

Background Information

1. Under the March 1989 Seventh Replenishment Agreement, sector lending (fast-disbursing, policy-based lending) was introduced into the IADB program. It was also agreed that sector lending would account for approximately 25 percent of all lending in the 1990-93 period and that during the first two years of this period, sector loans were to be cofinanced with the World Bank.

2. During 1991, the IADB was authorized by its Board of Governors to allow flexibility in making sector loans independently of World Bank adjustment operations in some cases. Of the twelve sector loans approved in 1991, two adjustment operations, the Chile Investment Sector Reform Program and the Columbia Investment Sector Program, were not cofinanced [or linked] with World Bank programs. Others were linked but not formally cofinanced. In the case of Peru, the Trade Sector Reform was approved, and the first tranche was disbursed, ahead of the IBRD Trade Sector Reform. In Uruguay, the Financial Sector Adjustment loan was linked to the policy conditions of the IMF and World Bank structural reform programs and was partially earmarked for debt and debt service reduction (DDSR) under a Brady operation.

3. Under the Enterprise for the Americas Initiative (EAI), countries which provide an investment environment conducive to private sector growth can receive U.S. bilateral debt relief as well as trade preferences. As a means of expanding operational support to encourage private sector growth under the EAI, the IADB is making investment sector loans (policy-based instruments designed to correct major impediments to private investment). At least three of the adjustment operations carried out in 1991 (Bolivia, Chile, and Jamaica) were specifically in support of this initiative.

IV. European Community - Lome Conventions

European Community
(Commitments, by Year of Approval, ECU mil.)
For ACP Countries

Structural Adjustment Grants 1/	1987	1988	1989	1990	1991
Total		384	88	20	91
Of which: -Coordinated with World Bank		384 (100%)	88 (100%)	20 (100%)	91 (100%)
-Coordinated with SPA		384	88	20	80

Source: EC, Brussels
1/ Macroeconomic structural adjustment support only.

Background Information

1. A facility for supporting structural adjustment was introduced by the Commission of the European Communities in 1988 for the ACP (African, Caribbean, and Pacific) countries undertaking World Bank and/or IMF structural adjustment programs. Funding of ECU 500 million ($590 million) was mobilized from previous Lome conventions and reflows, to be extended as grants. In the recent Lome IV Convention (EDF6) covering 1991-96, a specific allocation for adjustment was made, setting aside $1.3 billion of the $13.2 billion (ECU 12 billion) pool of funding. In addition, beginning in 1992, SEM (Southern and Eastern Mediterranean) countries with Bank and/or IMF programs will be eligible as well, but funded from a separate financing protocol. Likely recipients include Algeria, Egypt, Jordan, Morocco, and Tunisia. Two operations (Algeria and Tunisia) were approved in 1991; they are not included in the totals shown above.

2. The amounts shown above refer to macroeconomic structural adjustment only. Not included are additional amounts of sectoral adjustment lending and import support extended to the ACP countries, with much looser policy conditionality.

3. A substantial portion of total EC adjustment support (encompassing the macroeconomic and the sectoral and import support) has been extended within the SPA. The CEC is the largest single donor to SPA-2, pledging ECU 1 billion ($1.332 billion) for 1991-93. Much of this is coordinated financing, in the form of import support. While the EC at first wished to keep distance from World Bank policy conditionality in Africa, the combination of the SPA framework and historical factors such as the collapse of the socialist economies have led to closer coordination. The EC has also chaired an important SPA working group on counterpart funds, central to the SPA-2 focus on public expenditures.

WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: May 13, 1992

TO: Mr. Basil Kavalsky, Director, FRMDR

FROM: GG Enzo Grilli, Director, DPG

EXTENSION: 81934

SUBJECT: Paper on RDB and Adjustment Lending

I talked to Attila about Mr. Potter's request for a note on what RDBs do in the area of adjustment lending and coordination with the Bank.

Attila wishes to keep the note as factual as possible: i.e. i) "volume" of RDB's adjustment loans; (ii) co-financing vs. autonomous adjustment loans; iii) policies followed in autonomous adjustment loans, plus consultation/coordination practices. He also thinks that we should include the EC and perhaps one or two of the bilaterals, if we can and find it relevant (e.g. Japan), but be prudent about it, since we really have no mandate and coordination of activities, beyond the basics, is a shareholders' issue.

I have asked Jed Shilling to take the lead on the project, in collaboration with you. The first step would be for us to do a little outline, with a schedule, which we would then communicate to Attila. We hope to be able to do most of the work from here, but some travel might be involved (e.g. to the EC and EBRD). Could you let me know who on your side can help and keep an eye on the project, for example with comments on the outline and suggestions on how to approach the various RDBs. Obviously we will involve the Regions (Chief Economists and/or Operations' Advisers) and enlist their help as well.

Thank you.

cc: Mr. Shilling

Review of Adjustment Lending by Regional Development Banks and Other Official Creditors

Disbursement guidelines compared to normal loans and to IBRD

Supervision, follow-up practices

Specific Case Examples

Cofinancing cases

Stand-along cases

Summary and Conclusions

Comments

The should be presented as a factual review of the practices of other AL providers. Most of the background information (both data and policy statements) should be taken from published sources, for which I will need a part time RA. I would then draw on Bank staff for information on how things have worked in practice. This would then be followed up with correspondence or phone conversations with relevant senior people in the other institution, and perhaps visits in September as appropriate. I expect the paper will come out about 15 pages, with about 10 pages of annex tables.

We should organize a panel to help with the contacts and description of RDB practices. It should probably include the Chief Economist and/or Senior Operations Advisor in each region, and someone from CFS on cofinancing and JEXIM. Will Basil's person co-manage with me?

On the timing:

Preparatory work, initial contacts etc	thru June 5
(I am on vacation the rest of June)	
Review, analysis, first drafts	July-Aug
EC, Other(?) visits	mid Sept
Final draft for management review	Oct 2
Final to Board	Oct 23

OED

NUMBER 32

OED Précis

Operations Evaluation Department June 1992

Adjustment Lending: Lessons from a Decade of Experience

From a modest start in FY80, SALs and SECALs have expanded to an average of 26 percent of Bank lending over the past six years. A new OED study of adjustment in 42 countries notes the progress made over the decade in the design and implementation of adjustment: greater awareness of differences among countries, clearer policy frameworks, more flexible strategies to address the social dimensions of adjustment and poverty, and more importance given to the quality and timing of economic and sector work and country policy dialogue.*

Experience shows that a sound macroeconomic policy framework is a critical element of successful adjustment programs, and that it is very difficult for countries to make progress without it. Also needed are complementary measures to strengthen social, economic, and institutional infrastructure. And, both in the financial and the real sector, experience confirms the need for long-term commitment, by the Bank and borrower governments, to accomplish the institutional change that is a prerequisite for economic growth.

Macroeconomic policy

Sound macroeconomic policies are an important component of successful adjustment programs. Typically, stabilization is needed when a country has high inflation, is losing foreign exchange reserves, and has an unsustainable current account deficit. Tightening the overall fiscal position was a central element of the macroeconomic adjustment loan program for most of the adjusting countries. Of the 42 countries, 28 reduced their fiscal deficits during their adjustment periods and 24 of these reduced inflation. Thirty five implemented real devaluations, and 32 of these had subsequent improvements in the resource balance. Thirty seven increased their domestic-international interest-rate differential across the adjustment period, and 31 of these gained foreign exchange reserves.

A major problem area for SAL/SECAL countries is debt sustainability, complicated by high international interest rates and exchange rate movements. Out of 34 countries examined, 21 had sustainable debt paths. In general, middle-income countries were more successful at stabilizing their debt paths. For many low-income countries that are adjusting, continued access to concessional assistance, and possibly debt reduction or restructuring, will be necessary.

Though investment rates fell, as might have been expected, in most countries during adjustment, evidence from about half the countries studied shows that the positive relationship between investment and growth is reestablished after the adjustment period and that real devaluation contributes to post-adjustment growth.

Lessons:

- An explicit and realistic macroeconomic framework can provide internally consistent policy targets, contribute to program credibility, and reduce the recovery lag.
- Slow growth and difficulties in fiscal adjustment exacerbate debt problems. They need to be addressed by appropriate restructuring or concessional resource transfers.

Fiscal reforms

There is further scope for improving the fiscal aspects of SALs and SECALs. Though taxes have generally been easier to reform than expenditures, experience stresses the need to choose instruments that address the main causes of the deficit and to allow them enough time to take effect.

Revenue: Most tax reforms associated with SALs have been soundly designed, but implementation—including consensus building by government, changes in tax collection systems, and efforts to improve tax

** "World Bank Structural and Sectoral Adjustment Operations", Report No. 10870, June 30, 1992. OED reports are available from the Internal Documents Unit and from Regional Information Services Centers.*

Public Enterprise Reform

Of the 245 adjustment operations the Bank had approved by September 30, 1991, two thirds had some public enterprise (PE) reform component. Most of the reforms sought to strengthen enterprises being retained in the public sector; they emphasized financial restructuring, followed by organizational and management restructuring. Support for divestiture rose over time: 14 percent of the early adjustment operations had a divestiture component, compared with 52 percent of those approved in FY88-91.

Lessons:

- *Information:* Prepare PE reforms according to the specific circumstances of countries and enterprises. Development of the information base, information flow network, and auditing and accounting standards in the PE sector should be a high priority in most countries.
- *Efficiency:* Emphasize efficiency; do not let this goal be overshadowed by the need to reduce the fiscal burden of PEs on the government budget.
- *Transparency* in the financial relations of governments and PEs is important; otherwise serious problems of indirect transfers may remain disguised.
- *Mitigating social costs:* Attend to the modalities of financing severance payments and other measures to mitigate the social costs of unemployment.
- *Divestiture:* Emphasize quality over quantity. Decisions on which enterprises to sell, and to whom, should be carefully made. In sales negotiations, look beyond prices offered and focus on the quality of would-be investors and their plans for the enterprise. Especially for large and politically visible transactions, keep negotiations as transparent as possible, consistent with reasonable speed.
- *Alternatives to privatization:* Consider using management contracts and leases, at least as temporary solutions, in countries with underdeveloped capital markets and weak entrepreneurial classes.
- *Strengthen administrative capacity* of governments to divest . Small, skilled units can be useful for overseeing the privatization process and keeping decision makers informed.

administration—has taken longer than expected.

Expenditure: Only a third of the countries successfully reformed public expenditure. In civil service reform, reduction of subsidies, and increased allocations for operation and maintenance, slow progress is being made. Expenditure planning, evaluation, and monitoring mechanisms still require much attention, and in this sense, structural adjustment is yet to come.

Lessons:

- In most of the 42 countries, the institutional apparatus for tax collection, expenditure planning, evaluation, and monitoring still needs strengthening.
- Adjustment to internal balance has largely been achieved by sharp cuts in expenditure, especially on infrastructure and productive investment. The Bank needs to advise its adjusting member countries more systematically regarding the mix of revenue and expenditure measures meeting development requirements.

Financial sector reforms

Financial reform programs have generally been suitably designed, but building the necessary institutions requires a lengthy commitment from both the government and the Bank.

Most of the adjusting countries undertook financial reforms with support from the Bank, either through financial sector adjustment loans (FSALs) or through SALs. Reforms included liberalization and rationalization of interest rates, reduction of excessively high liquidity and reserve ratios, and dismantling subsidized credit programs. Several countries began to restructure insolvent banks, introduce better accounting and legal frameworks, and strengthen monetary and bank supervision. Modest progress was made in deepening and developing capital markets.

Financial sector reforms that followed macroeconomic stabilization succeeded. Countries that deregulated interest rates too early had frequent policy reversals; the financial sector remained weak, with high real interest rates, insufficient credit to productive sectors, and overexpansion in personnel and branches.

Lessons:

- Begin institutional and competition reforms early in the adjustment process, and wait for macroeconomic stabilization and liberalization in the real economy before starting widespread financial liberalization.
- Allow realistic time frames for financial sector adjustment.

Social impact

Across countries, the same adjustment goals have been achieved with different effects on populations, reflecting differences in initial conditions as well as in program design. Some social groups are bound to suffer from adjustment programs, at least in the short run. But there is ample scope for better design of adjustment packages to safeguard already-disadvantaged groups.

Lessons:

- Increase reliance on expenditure-switching, rather than expenditure-reduction, policies, and on restructuring social expenditures towards priority activities such as primary education and health.
- Sustain, if not intensify, emphasis on basic, long-term issues of poverty and human development, rather than solely concentrating on compensatory measures when designing adjustment programs. Targeted projects and programs can be used to address

problems among both the "new poor" and the "chronically poor", if well designed and used to accompany, not substitute for, more basic reforms.

- Help countries develop capacity to document and analyze the social impact of alternative policy mixes and to monitor changes in social indicators.

Sectoral adjustment

SALs are a better instrument for supporting macroeconomic policy reforms; SECALs are better for supporting sector-specific institutional and policy reforms. Attempts to bend either instrument to the purposes of the other have not succeeded. Investment lending is also important to build the infrastructure needed to support the private sector response to adjustment programs. For each country, it is important for the Bank to plan an appropriate, suitably sequenced, mix of lending instruments as part of its assistance strategy.

Industry

Trade regimes have been liberalized and simplified, with positive effects on the growth of production and exports. Reforms in domestic regulations—where relatively little has yet been accomplished—should now receive more attention as a source of further efficiency gains. Much of the initial supply response to trade liberalization came from higher use of capacity. In most countries, investments in infrastructure and industry now require more attention for industrial growth to be sustained.

Twenty eight of the 42 countries had important Bank-sponsored adjustment programs in their industrial sectors. Thirteen achieved successful industrial adjustment, judged by the growth of their value added or exports. The programs in nine other countries were moderately successful; the programs in the other six failed.

Lessons:

- Pay more attention to the progress of macroeconomic stabilization, which is indispensable in laying the groundwork for microeconomic reforms.
- Support analysis and reform of regulations that constrain supply response in industry. Ease policy-induced distortions in factor and product markets that discourage domestic competition and investment and hinder the entry and exit of firms and factor mobility in general. Pay special attention to creating a favorable environment for private and direct foreign investment in industry.
- Give more attention to the role of technological capability and institutional efficiency in productivity growth. Market forces, alone, will not always lay the basis for satisfactory progress in these areas. Study these issues in the specific context of adjusting countries and help develop capability to design and implement effective policies and programs.
- Comprehensively address issues of medium- and long-term industrial growth. In the medium term, help build up public investment in infrastructure and create conditions for private and direct foreign investment. For the present, include a modest industrial policy in adjustment programs that gives support to small and medium-sized industries, export of manufactures, and development of technology.

Environment

Adjustment policies have implications for the physical environment. Input and output pricing policies, taxes and subsidies, as well as general macroeconomic management have environmental effects, both positive and negative. None of the operations included in this review had an environmental component, though a number of more recent adjustment operations do; analysis of the impact on natural resource use and pollution needs more emphasis in the Bank's adjustment work.

Sources

The study reviews experience with 99 adjustment operations audited through September 30 1991 in 42 countries. Most of these operations were approved in the mid-1980s, and the latest in FY89. Though operations in progress are not covered, country experiences have been updated through other Bank sources.

Energy

Adjustment operations furthered progress in some key areas of energy policy that had proved difficult to address through project lending. Designs were generally appropriate, but countries made less progress than expected toward efficient energy use.

Adjustment in the energy sector featured prominently in 21 of the operations studied, in 13 countries. Most of these operations centered on energy price reform and took place while oil prices were relatively high. With some important exceptions, energy prices remain regulated by governments and do not reflect economic costs. Difficulties often arose from the lack of systemic reform in the public enterprise sector, the regulatory environment, and the policy environment for enterprises.

Lesson:

- Provide further support, through SALs, for the reform of legal and policy frameworks affecting energy supply and use, followed or accompanied by energy SECALs and investment lending.

Agriculture

Agricultural adjustment operations undertaken without sound macroeconomic policies, especially exchange rate policies, have not led to the expected improvements in sectoral performance. Some ASALs were themselves the overall adjustment package. This was an unduly risky lending strategy.

Recommendations

- Recognize the diversity of economic and political structures and administrative capabilities.
- Work closely with the borrower to develop a program supported by appropriate ESW.
- Avoid supporting reforms over too wide a front simultaneously, especially when the adjusting country has severe political, social, and administrative constraints.
- Work to safeguard positive transfers of resources, especially in high-debt countries. To keep adjustment programs on track, be prepared to adjust the level of resource transfers to help compensate for temporary exogenous shocks.
- Address the backlog of investment needed in infrastructure, and increase support for public and private investment in social and economic infrastructure.
- Strengthen the policy framework for private investment through sector operations that help develop markets, improve resource mobilization, and increase the economy's flexibility.
- Improve coordination with bilateral and multilateral aid agencies with respect to policy reform and financial and technical assistance; ensure close links with NGOs.
- Improve monitoring of social impact of adjustment lending.
- Even after final tranche release, continue close monitoring of macroeconomic framework and reforms through ESW and policy dialogue.
- Continue close cooperation and consultation with the Fund.

Twelve ASALs in 11 countries were studied, including five countries in Sub-Saharan Africa. Many of these operations supported the removal of price distortions, especially input subsidies. Borrowers tended to adopt such price reforms more on fiscal than on efficiency grounds, and more out of concern to sustain imports than to adjust agricultural policies.

Six of the ASALs were unsatisfactory, and the only unequivocal success among the other six was shortlived. In several countries in which agriculture is the dominant sector, ASALs were negotiated after the Bank and borrower had failed to agree on a SAL. In other cases, ASALs were charged with some of the fiscal goals better addressed by SALs.

In each of the five African countries, agricultural growth picked up strongly during adjustment, and was complemented by improvements in GDP growth in the post-adjustment period.

Lessons:

- Seek a reform plan that will have a broad domestic constituency, making policy change politically feasible and sustainable. Visible borrower commitment is key.
- Where a strong focus on macroeconomic policies is needed, ASALs should follow or accompany IMF programs or SALs, not try to substitute for them.

Borrower "ownership"

A statistical analysis of 81 operations showed that the extent of borrower ownership strongly predicted overall program outcome in 73 percent of the operations. The Bank should proceed cautiously where significant doubts exist about borrower ownership.

The strongest influences on borrower ownership were political stability; support (or lack of opposition) from various constituencies; and official attitudes toward certain kinds of reform. For borrowers, frequent and intense interaction with the Bank did not outweigh the effects of binding constraints on policy change.

Lessons:

- Through understanding of the country's political system, identify a measurable degree of ownership that will facilitate the start of reforms. To the extent possible, preparatory economic and sector work (ESW) should assess the likely impact of adjustment on various constituencies.
- Within an adjustment program, include support for complementary institutional development that provides incentives for the different agencies to back the goals of the program.

Technical assistance

Experience confirms many of the lessons drawn by other studies, and especially the need for complementary institutional development programs to have realistic timeframes and for the Bank to manage TA with rigor and borrower involvement.

Lessons:

- Implement free-standing TA for institutional development and capacity building at its own pace. Sustained improvements may take longer to achieve than the timeframe of even a series of fast-disbursing adjustment operations.
- Ensure quality supervision—particularly to help identify bottlenecks and resolve difficulties.
- Actively involve the recipient in design. Programs should not be too ambitious for recipients to "own" and absorb.
- Cooperate closely with other donors to avoid duplication of effort and conflicting advice and objectives.

OED Précis is designed to help inform Bank managers and staff of new evaluation findings and recommendations for the Bank's current and future work programs. It is produced by the Operations Evaluation Department of the World Bank for distribution to the Bank's executive directors and staff. The views here are those of the Operations Evaluation staff and should not be attributed to the World Bank or its affiliated organizations. Please address comments or enquiries to the managing editor, Rachel Weaving, T7-015, World Bank, ext. 31719.

OED file

August 28, 1992

Mr. Lawrence H. Summers

JAC Meeting on the OED Report on Adjustment Lending: August 31, 1992 - Briefing of Mr. Landau

Larry,

Yesterday I briefed Mr. Landau, at his request, on the OED Report. Three concerns emerged from the conversation that we had:

1) Conditionality in SALs and SECALs (number of conditions, flexibility and relationship to program ownership);

2) Trends in the volume and share of adjustment lending in total Bank lending;

3) The possibility for the JAC to see the draft OD.

2. On 1) I told him what we were doing already. On 2) I told him that the report did not offer any solid basis for projecting the future, which depended instead on the speed at which adjustment lending would be phased out in successful countries, the trends in Africa and the demands from the CIS states (which in turn depended on their policy stances). On 3) I recalled the Board discussion and decision to circulate a brief summary of the OD for discussion at the Board in the form of the Seminar after the OED report had been reviewed. I told him that we were ready to do so at the end of October. As for the JAC seeing the whole OD, this was an issue that he should take up with the Managing Directors. He said that he would consult Mr. Stern. I will try to learn if he has done so and what Mr. Stern told him before the meeting.

Enzo Grilli

cc: Messrs. Walton, Ray

File Copy

File the attachments as well

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 25, 1992

TO: Mr. Carl Jayarajah

FROM: Anandarup Ray AR

EXTENSION: 38565

SUBJECT: Second Overview of Structural Adjustment and Sectoral Adjustment Loans

1. The volume is in pretty good shape overall, and it responds well to earlier comments. I would urge you, however, to consider the latest comments from Steve Webb, Melanie Johnson and Sunita Kikeri. Let me also add quickly the following points with reference to your Executive Summary (applies also to the corresponding portions of the main text). I list the points in the order in which they arise:

- In page i, first bullet, add "poverty alleviation" as an objective along with economic growth,

- In page ii, first sentence: "Many of the SAL/SECALs.....by the IMF". The way you have written this raises a highly sensitive Bank-Fund issue right at the start. Since this is not your intention here you may wish to change it to read: "In general SALs and SECALs were closely coordinated with the stabilization policies supported by the Fund. Several SALs and SECALs contained specific macroeconomic policy conditions. (Even in the few cases where Fund arrangements were not in place at the time of SALs, there was coordination and collaboration at the technical level).

- Page iii. The investment pause should refer to private investments. Does it?

- On the public enterprise issue, you seem to have taken the stand that changing ownership per se does not matter, to which I had objected before (as does Ms. Kikeri). The experience with attempted improvements in public enterprises is very poor, as the report brings out. Consequently, perhaps you should take the position that privatization is the way to go. At least your data do not contradict the view that ownership changes are of fundamental importance.

- Also on public enterprises, p. viii, top bullet, negotiations on the quality of the investors, etc. can be particularly vulnerable to abuse (some strong caveats would be welcome about ensuring transparency etc.).

- On financial sector reforms, Ms. Johnson's points seem to be particularly appropriate.

- On industry and agriculture, p. xi, the first three points regarding industry apply all the more strongly to agriculture, since agriculture, both traditional and non-traditional, is the major traded sector in many of these economies. The Krueger/Valdez research shows how sensitive agriculture is to macroeconomic policies, especially the real exchange rate and especially in Africa. Thus, I suggest that you repeat and reiterate these lessons for agriculture, adding emphasis. With reference to p. xxiii, and xxvi, the comments about SALs and AGSALs are misleading. You should say that "when AGSALs have taken place without sound macroeconomic policies, especially with respect to the real exchange rate, they have not led to the expected improvements in sectoral performance. AGSALs should therefore be accompanied by SALs or IMF programs with strong focus on macroeconomic policies".

- With reference to Bank-Fund collaboration, page xvi, please delete "the requirement that Fund programs should accompany all SALs...imperative". There is no such requirement except for CIS states. The general agreement only requires technical cooperation when a Fund program is not in place.

- The discussion on the social issues is fine.

cc: Messrs. Grilli, Walton, Baird, Webb, Sheng
Ms. Birdsall, Ms. Kikeri

A L L - I N - 1 N O T E

DATE: 25-Jun-1992 09:47am

TO: Anandarup Ray (ANANDARUP RAY)

FROM: Michael Walton, DECVP (MICHAEL WALTON)

EXT.: 38418

SUBJECT: OEC report on adjustment lending

Anandarup-- I read the executive summary and the chapter on the poor in the revised version. I think it's in pretty good shape overall: I think the points that Sunita Kikeri and Melanie Johnson make are very good (and should be underlined) but that there aren't big policy differences. The chapter on the poor has been responsive to the comments made and is now a useful piece that is sensible and claer on hte general points and makes good use of case studies and examples to illustrate these.
Mike

CC: Enzo Grilli (ENZO GRILLI)
CC: Nancy Birdsall (NANCY BIRDSALL)
CC: Martha De Melo (MARTHA DE MELO)
CC: Steven Webb (STEVEN WEBB)

Dave
3:05
6/25

Please Fax to
Mark Bird
Soonest

A L L - I N - 1 N O T E

DATE: 24-Jun-1992 10:15am

TO: Michael Walton (MICHAEL WALTON)
TO: Enzo Grilli (ENZO GRILLI)

FROM: Nancy Birdsall, CECDR (NANCY BIRDSALL)

EXT.: 37458

SUBJECT: Attached em from M. Johnson - for information

CC: Melanie Johnson (MELANIE JOHNSON)

Comments on OED's Second SAL/SECAL Overview

This note incorporates comments from Andrew Sheng, Jerry Caprio and Melanie Johnson. Please feel free to contact us if you have any questions.

Ross Levine and Melanie through this report the first time it came around. This version doesn't seem vastly changed. The regression analysis is still in there in Section D -- Ross felt that it was not very helpful. The paper by King and Levine is the state of the art on finance and growth, and is conspicuous by its absence in the discussion. Also, it is surprising that in a review like this there is no mention of the findings of the FSAL Review (FINANCIAL SECTOR ADJUSTMENT LENDING: A PRELIMINARY ASSESSMENT OF THE BANK'S EXPERIENCE) that went to the former Operations Committee in April 1991, especially since many of the same points are covered here in an abbreviated discussion.

Generally the chapter is a bit more upbeat about the Bank's record in the financial sector than we would expect. The authors backtrack a bit in the end, when they admit that in many cases we have gotten only studies and action plans because of the short disbursement period. And we should not consider ourselves very successful if many of our clients still have bankrupt financial institutions. Their rosy outlook may come from the fact that the only PCR completed on an FSAL to date is the Ecuador operation, which may have been one of the more tightly constructed FSALs. The authors admit that it may be too early to tell much about FSALs.

Most of our comments are specific points of clarification:

Para. 4.3: The obvious cause of financial sector distress are the losses in the real sector (often the result of external shocks, high levels of protection and bad governance). The other factors only compound the problem.

Para. 4.6: High inflation treated as separate cause of negative real rates; it is usually administered interest rates alone or in combination with a rise in inflation that produces negative real rates.

Para 4.7: even forced financing at positive rates can entail a loss for commercial banks, as in Japan.

Para. 4.10: I think they want to say that the proliferation of directed credit leads to noncompetitive behavior, not the other way around.

Paras. 4.11-4.12: I believe it is not necessarily bad that banks are the center of financial activity in many of our countries. Given the rudimentary level of accounting and information available in most countries, commercial banks are probably best placed to provide financing. Capital market development will come as enterprises grow and become more sophisticated.

Para. 4.13: They might want to use "grupo" examples from Mexico, Chile, etc. Note also that successful reform goes with strong central banks also because the latter

have played leadership role in developing the money market, in addition to helping on overall macro policies.

Para 4.20: in what sense are Indonesian reserve requirements too low? Not for the purpose of monetary control, as not only have the Indonesians achieved reasonably low inflation rates, but in theory and in practice (U.K., Canada) reserve requirements of zero are just fine for indirect implementation of monetary policy. Nor should it be a problem with revenue; rather I would say that the authorities success is getting reserve requirements down to levels that most countries should aim for reflects their success at tax reform and their commitment to not tax financial intermediation.

Para. 4.26: I'm still not convinced we think that the only way to privatize banks is to recapitalize them first. It is probably the best way to get serious investors. The important point to make here is that bank restructurings cost the government money one way or another: either through recapitalizing, selling at a low cost, granting special treatment to the privatized banks, etc. "There is no free lunch."

Para. 4.37: They say that the DFIs will be replaced by contractual savings institutions. Perhaps it is more appropriate to say that some of the functions fulfilled by DFIs (mobilizing term resources) will be taken over by the CSIs -- but CSIs do lots of other things other than invest in industry. And I can't see an insurance company going into the agricultural lending business any time soon.

Para. 4.33: Should we add something about the importance of good information for capital markets development?

Para 4.49: the statement on sequencing is misleading. Financial reforms consist of many types of policies, some of which take a considerable amount of time to come to fruition (e.g., it may take longer to build accounting, banking, or bank supervision professions than to reduce tariffs). So some financial reforms should be commenced as soon as possible, not wait for after "real" sector reforms are advanced. This is admitted in para 4.51, so I would not obscure the reasoning with the blanket statement here. Similarly, para 4.50 says "well before the financial sector is deregulated." What does this mean? Complete deregulation of interest rates. If so, fine. If not, please specify which aspect of financial reform is being discussed.

Box 4.1: Financial sector losses are de factor quasi-fiscal losses, thanks to explicit or implicit deposit insurance. Thus, much more fiscal retrenchment will be necessary than is apparent because the government must take into consideration the quasi-fiscal losses of the central bank and/or commercial banks plus DFIs. All too often, the Bank or IMF agree with the government on a fiscal target that excludes these quasi-fiscal losses, and consequently, fiscal adjustment is inadequate (Argentina, Yugoslavia).

cc: AR

A L L - I N - 1 N O T E

DATE: 23-Jun-1992 03:24pm EST

TO: Carl Jayarajah (CARL JAYARAJAH)

FROM: Sunita Kikeri, CECPS (SUNITA KIKERI)

EXT.: 37653

SUBJECT: Second SAL/SECAL Overview

I received the revised version of the above report late last week. I had been asked by Mary Shirley to comment on Chapter 5 (Public Enterprise Reforms) of the earlier draft. My comments were sent to Mark Baird at the end of May.

The revised version of chapter 5 is still weak. None of the suggested changes have been made. Particularly troublesome is the failure to convey two principal messages of public enterprise reform and privatization that were covered in our recent Board paper, i.e.: (i) that ownership matters for improving PE efficiency, and that PE reforms short of privatization have been difficult to implement and, more important, difficult to sustain. There is ample evidence that could be cited in the OED review; and (ii) that variations in country and enterprise circumstances are crucial in determining success in design and implementation of reform under Bank adjustment operations. Both these points deserve far greater emphasis in the report.

In addition, the chapter could be further strengthened by following-up more closely on some of the points raised in my earlier comments, particularly on institutional arrangements, labor redundancies, and implementation issues in divestiture.

CC: Mary Shirley (MARY SHIRLEY)
CC: Nancy Birdsall (NANCY BIRDSALL)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 22, 1992

TO: Mr. Carl Jayarajah, OEDD2

FROM: Steven Webb, CECMG

EXTENSION: 37469

SUBJECT: Second SAL/Secal Overview

As you asked me to, I read carefully through the box comparing your major findings with RAL-3.

In substance, almost all the findings look fine.

The finding on Industry needs clarification. What does it mean: "... providing support to small and medium industries, manufacturing exports, and technology development ..."? Does it mean small- and medium-sized firms? Any firms of this size? Would the support be some sort of direct subsidy, or just the provision of infrastructure, services, and legal frameworks needed by such firms? Is this a recommendation for export subsidies for manufacturing exports?

All of the findings in section A (Confirmation) are indeed in RAL-3.

Some of the points in section B ("Points of Added Emphasis") were also strongly made in RAL-1 and 2. We endorsed them in RAL-3 and declined to treat them in detail only because of the thorough pervious coverage. These are especially the points under Macro Stabilization and Financial Sector, and the latter two under Bank-Fund Relations and the second under General Issues. (Also, the three recommendations at the end o the macro section in the Exec Summary are very close to the three preconditions for AL listed in RAL-1.) So you could refer to the earlier RAL-s for additional confirmation. We tried to make the RAL series a cumulative process, and your report also adds to that process.

Looking through the Executive Summary, it seemed too long and seemed to de-emphasize its main findings by giving too much space to obvious and non-novel generalizations -- for example the first two sentences in the section on macroeconomics.

cc: M. de Melo (CECMG); Birdsall (CECDR); Walton (VPDEC).

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 24, 1992

TO: Mr. Steven Webb, CECMG

FROM: Carl Jayarajah, OEDD2

EXTENSION: 31661

SUBJECT: Second SAL/SECAL Overview

Thank you for your comments on the box comparing OED findings with RAL-3, your memo of June 22, 1992.

Please let me know if you have any further comments on the revised version. Thanks.

Attachments.

cc. Maiyne Cheng.

Box 2
Major Findings: Comparison with RAL III [a]

A. Points of Confirmation

Stabilization and economic liberalization are necessary to provide a healthy environment for longer-term growth. However, the private investment response in many low-income countries is still constrained by weaknesses in infrastructure, human development and market institutions.

A clear macroeconomic framework is needed for stabilization. The Government must be willing to stay with the program during the initial period of recession until growth resumes.

The Bank should cooperate with the relevant parts of the Government in preparing the program, and be prepared to lend or raise the resources necessary for the program to be carried through to the recovery.

The Bank should promote reform of the regulatory system and facilitate policies for increasing domestic competition.

There is increasing awareness of the importance of adequate quick-yielding O&M allocations and, more recently, of the trade-off between civilian and military expenditure in public expenditure decisions.

FSALs should begin with a reform of the banking sector followed by equity market development. Substantial technical assistance should be provided for financial sector development.

While reforms to improve institutions and promote competitiveness take time and can be started early, financial liberalization should, in general, follow stabilization and be coordinated with reforms in the real sectors.

There should be greater emphasis on a restructuring of public social sector expenditures in favor of efficient, poverty-reducing activities such as primary education and basic health care.

Social Funds and Social Action Programs are useful but they cannot be a substitute for restructuring of public social sector expenditures.

While the Bank relies on the Fund to identify and design the appropriate macroeconomic strategy, it should have independent capability to analyze macroeconomic policies and monitor economic outcomes.

The PFP process has considerable merit in ensuring a unified approach to the design and implementation of adjustment programs and is a valuable instrument for mobilizing maximum financial support.

Conditionalities which are critical to an adjustment operation should be identified and explicitly linked to tranche release. Arranging for "up front" conditionality is the best way of handing the political uncertainties.

There should be systematic collection of detailed data on public social sector expenditures.

Government ownership is essential for the success of an adjustment program.

a. Findings and recommendations from RAL I and II, endorsed by RAL III, are included in the comparison.

Box 2
Major Findings: Comparison with RAL III (Cont'd)

B. Points of Added Emphasis

Macroeconomic Stabilization

Conditions should be realistic, mid-course review and correction should be allowed for exogenous events.

A satisfactory macroeconomic framework should be in place for successful sector adjustment operations.

Fiscal Reform

An assessment of the dominant cause of the deficit, i.e., inadequate revenue or excessive spending, is a prerequisite for fiscal policy formulation in determining the appropriate revenue-increase/expenditure-cuts combination.

Tax reforms should be simple in design since absorptive capacity constraints limit implementation in many countries.

Public Enterprise Reform

Public enterprise reforms, including divestiture, should emphasize efficiency improvements. In the past, this objective has often been overshadowed by the need to reduce the fiscal burden of public enterprises.

Public enterprise reforms should be based on adequate knowledge about the public enterprise sector. Careful preparation for reforms , backed by technical assistance if necessary, is important.

Development of the information base, information flow network and auditing and accounting standards in the public enterprise sector should be a high priority in most countries.

The budget constraint faced by public enterprise should be hardened and the financial transactions between public enterprise and the government should be made more transparent.

In countries with underdeveloped capital markets and weak entrepreneurial classes alternatives to privatization, such as management contracts and leases, should be seriously considered.

Social Impact

The Bank should continue to intensify its focus on tackling the fundamental determinants of poverty and human development within adjustment programs, as well as through project lending.

The social impact of alternative adjustment packages should be carefully analyzed when designing adjustment operations in individual countries. The Bank should support the development of the relevant analytic capacity both within the Bank and in member countries.

Industry

More attention should be given to issues of technological capability and institutional efficiency in the industrial sector. Programs should take up the task of studying these issues in the specific context of adjusting countries and develop government capability so that effective policy programs can be designed and implemented.

Box 2
Major Findings: Comparison with RAL III (Cont'd)

Agriculture

Designers of sectoral reform should be sensitive to the risks of pursuing any SAL-type agenda under the cover of an ASAL label.

ASAL designers need to show more even-handedness when attempting to reduce price and other sector distortions. Such efforts should cover outputs as well as inputs.

Delays in implementing some ASAL policy reforms and related institutional changes lead to corresponding delays in disbursements. This suggests the need to (a) move conditionality up front as a sure way of reducing disbursement delays, and (b) discriminate carefully between ASALs and other sector lending instruments that support policy reforms but are less oriented towards quick disbursement.

Technical Assistance

Free-standing technical assistance aimed at institutional development and capacity building should proceed at its own pace without specific reference to the adjustment operation it is supporting since worthwhile improvements in these areas can rarely be accomplished during the implementation of one, or even a series of fast-disbursing adjustment projects.

Because insufficient absorptive capacity has in many cases reduced the effectiveness of technical assistance, programs should not be too complicated or ambitious relative to the capacity of the recipients.

To avoid conflicting objectives and advice and duplication of effort, coordination with other donors is important, and borrower preference with respect to advisory assistance needs to be taken into account.

The effectiveness of technical assistance is significantly affected by the degree of supervision by Bank staff. The evaluation of technical assistance should be improved.

Bank-Fund Relations

Close attention is needed to the timing and sequencing of Fund and Bank programs to ensure that the policy mix is consistent and operates in a complementary fashion; this requires full disclosure and coordination in the design of the respective programs.

The successful fusion of Bank-Fund knowledge and experience depends to a large extent on the cooperation of individual country economic staff; continued efforts are needed to strengthen this process through formal and informal means.

General Issues

The Overview provides an analytical framework as well as measurement criteria of borrower "ownership".

The Bank should support the development of data bases and systems to monitor movements in economic and social indicators.

cc: PR

THE WORLD BANK/IFC/M.I.G.A.

ROUTING SLIP	DATE: August 25, 1992
NAME	ROOM NO.
Mr. Enzo Grilli	S 9055
cc: Nancy Birdsall	N 11-051
M. de Melo	N 11-075

	URGENT		PER YOUR REQUEST
	FOR COMMENT		PER OUR CONVERSATION
	FOR ACTION		SEE MY EMAIL
	FOR APPROVAL/CLEARANCE		FOR INFORMATION
	FOR SIGNATURE		LET'S DISCUSS
	NOTE AND CIRCULATE		NOTE AND RETURN

RE: Second SAL/Secal Overview

REMARKS:

Here is my correspondence with Carl on comparing the OED report with the RALs.

Many of the "points of added emphasis" were also in RAL I or II, but perhaps the OED tells more on them.

FROM:	ROOM NO.:	EXTENSION:
Steven B. Webb SW	N 11-069	37469

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE : May 26, 1992

TO : Mark Baird, OEDD2

FROM : Anandarup Ray, DPG

EXT. : 81947

SUBJECT: **OED Study on Adjustment Lending**

1. This is an impressively broad and important document. The degree of conviction it carries and the amount of work left vary by section, as is only to be expected at this stage.

2. The chapter on macroeconomic policy, Chapter II, is the best at this stage. I agree with Steve Webb's comments, in particular that it is a useful complement to the RAL reports (his comments are attached).

3. On fiscal policy, Chapter III is quite well-done, but there are several anomalies or questions that might be looked into further:

- the statement (para 3.12) that revenues decreased in Jamaica, Malawi, and Togo following comprehensive tax reforms need to be better and more carefully documented. This also applies to the similar statement about VAT revenues. These statements, if true, are obviously of great importance, not just to us but to the Fund as well. Even if the Report's findings can be substantiated for those cases mentioned, one should be cautious about generalizations,

- "trade-off" between tariff liberalization and budget balance goals (para 3.09) is a misleading one. In most cases, depreciations of the real exchange rate and corrections of the anti-export bias due to differential tariff protection are necessary elements of adjustment programs (resource balances must improve). Slowing down tariff reductions because of revenue reasons may therefore defeat the whole purpose,

- on expenditures, what comes through is that the whole subject of public expenditure allocations is rather muddled. If our practice is based on very broad "presumptions" and "hunches", perhaps it is best to say so directly. When one adds "infrastructure" to "social sectors" and to "O&M", etc., very soon everything looks like a priority. The review point is to what extent our advice was well-grounded on facts and methodology.

- in particular, it is not clear what to make of the many references to social sector expenditures as a ratio of the

budget. Low-income countries are unfavorably compared from this point of view with higher-income countries. But one would expect these ratios to be smaller for lower income countries than for higher income countries - the latter can "afford" less growth (and future poverty alleviation) and more current poverty alleviation than low-income countries. Analysis of these ratios and trends in social expenditures should be grounded in theory.

- in the end perhaps the most lasting impact we can make is to help governments set up the institutional apparatus for proper analysis and monitoring of public expenditures. But there are no recommendations in this area.

4. On the financial sector issues in Chapter IV, please see attached comments from Ross Levine and Melanie Johnson. On the sequencing of financial sector reforms, perhaps the best statement is in the recent overview by Corbo and Fischer, which the authors can refer to. It all depends on which particular aspect we are talking about. As far as capital account convertibility is concerned, I think there is a reasonable consensus that it should follow rather than lead other reforms, such as those in trade and exchange rate regimes.

5. Chapter V on public enterprise reforms seems basically consistent with the findings of the privatization paper. However, the need to change ownership is not highlighted. I wonder how many of the reformed parastatals have suffered reversals. I also wonder whether and to what extent special privileges had to be introduced in order to develop attractive packages. I have requested Ms. Shirley to review this chapter and forward her comments to you directly.

6. Mike Walton has provided you with detailed comments on the social impact chapter (Chapter VI), attached. There is a recurrent recommendation, appearing in the summaries and boxes as well, that macropolicy packages should be better designed from the point of view of social impact. Although this sounds like praise of motherhood, such statements can easily cause overreactions in the Board unless one carefully explains just what is meant. Illustrations of what the authors have in mind would be helpful.

7. On agriculture (Chapter VII), I felt that some more work might be helpful. The sections on disbursements and cost-of-funds seemed out-of-place, since if they are relevant at all, they should be general points. The strongest recommendation here, that is still struggling to get out, is that an AGSAL, as done in the past, is a poor substitute for a SAL. If the idea of adjustment lending is to assure an adequate macro environment for sectoral and project-level interventions then AGSALs have not been the right instruments. This links with the macro-conditionality recommendation of Chapter II.

8. On "ownership", I have nothing to add to Steve Webb's note (attached). I do have some comments on the Bank's role in supporting adjustment (Chapter XII), as follows:

- I like the idea of up-front conditionality; is a judgment possible regarding the merits of single-tranching?

- I do not believe that country operations departments have much leeway in interpreting compliance with conditionality. In any case tranche releases have to be approved by high management, and at least implicitly by the Board.

- the discussion of the desired degree of specificity in macro-conditionality should be made consistent with Chapter II.

- The PFP Box needs to be carefully edited in the light of the progress made in Bank-Fund collaboration.

- I do not see the trade-off between adjustment and investment lending (para 12-23).

cc: L. Summers, E. Grilli, N. Birdsall, M. Walton, A. Sheng, M. Blejer, S. Webb, M. Shirley.

ARay:pl

A L L - I N - 1 N O T E

DATE: 20-May-1992 09:47am

TO: Mark Baird (MARK BAIRD)

FROM: Michael Walton, DECVP (MICHAEL WALTON)

EXT.: 38418

SUBJECT: OED study, social impact chapter

Here are some comments on Chapter 6 on the social impact of adjustment.

1. The introduction and conceptual issues section are good. Two quibbles: both secondary and primary incomes determine poverty (6.4); and in 6.5 I'd give more weight to the pattern of growth, though would, of course, agree on the importance of human capital.

2. The macro section misses discussion of consumption-smoothing, whether through temporary pauses in investment or foreign capital inflows. This is important because that is part of the rationale for Bank, SPA type inflows, and is a factor in the Cote d'Ivoire Ghana comparison.
- I would make more effort to put Cote d'Ivoire and Ghana on the same footing in the discussion: I agree on which did better, but this is both a close and sensitive comparison that would be strengthened if there was also common treatment of external factaors including capital inflows and what is and is not tradeable in agriculture (food appears to be tradeable in Cote d'Ivoire and not in Ghana). Why did rural-urban equality improve in Cote d'Ivoire? I recall the French complained about unfair comparisons on OED's trade report.
- on Indonesia, what were the alternatives that it didn't pursue? the statement on 6.12 hasn't much meaning without filling this in.
- in the Philippines the econometric work hasn't been updated to my knowledge, but there has been analysis of the 1985-88 period--Guillermo Hakim has done this. Poverty declined, but I don't know how much was simply due to recovery.
- the Jamaica has some odd phrasing--that economic and social indicators didn't worsen despite drastic reforms. This needs to be sorted our relative to non-adjustment-related decline, who did and did not benefit from devaluation, and whether social indicators were robust because of weak short-run impact of social spending on quality of life indicators or because the social spending was useless.

The last bullet in 6.16 should reintroduce the role of secondary incomes--compensatory measures, for example are a complement or alternative where macro measures don't shield the poor.

3. I like the way the spending analysis is set up, but as acknowledged, it doesn't go very far, because it is limited to total social spending.
 - is interest included in total spending? THere are different views on whether it should or not, but there should be an explicit discussion
 - 6.22 points to the limitations of the analysis--is this an indictment of adjustment lending that OED lacks the data to assess intrasectoral issues? RAL3 has some examples. I can think of Chile verus Costa Rica, where I recall Chile effectively retargeted lower social spending and Costa Rica didn't.

4. The conclusion of the special programs is OK but pretty limp: I would sharply distinguish between the "problem" that many programs are compensatory--I don't see this as a problem at all, and we should, at a minimum, be putting more effort into sensible systems of targeted transfers; and the problems of weak implementation and lack of incorporation of these programs into a country's institutions--this may require more fundamental rethinking on these schemes.

5. The boxes simply repeat what's in the text.

CC:	Enzo Grilli	(ENZO GRILLI)
CC:	Anandarup Ray	(ANANDARUP RAY)
CC:	Sanjay Pradhan	(SANJAY PRADHAN)
CC:	Steven Webb	(STEVEN WEBB)
CC:	Helena Ribe	(HELENA RIBE)

A L L - I N - 1 N O T E

DATE: 19-May-1992 10:53am EST

TO: See Distribution Below

FROM: Melanie Johnson, CECFP (MELANIE JOHNSON)

EXT.: 37663

SUBJECT: OED Structural Adjustment Review -- Financial Sector Chapter

These comments supplement those of Ross. Do we want to put together a formal note from the division?

While I agree with Ross that the chapter provides a good overview of what has happened with FSALs over the past few years, I am uncomfortable with some of the more categorical statements made therein. The most egregious example comes at the end of para. 4.10, where the authors state that the removal of financial sector distortions "is a process that can only be started in the duration of an FSAL." First, there are a number of countries that have undertaken financial sector reforms without the blessings/conditionality/funding of the Bank. Second, even for countries working with the Bank on financial sector reform, there are a number of instruments for doing so: financial sector conditionality in SALs, hybrid loans, FILs with a strong institutional development component, etc. Saying that only FSALs are appropriate is just wrong and may be sending a rather dangerous message to the Board and our ' rowers.

The second of these statements comes in para. 4.28, where they state that "banks can only be successfully sold off after being recapitalized." I agree that the governments are likely to attract the most serious investors if they clean up the portfolios of the banks that they intend to sell. But banks (or parts of banks) have been sold without massive recapitalizations. If the fiscal situation is tight and the government gets a respectable offer, I suspect that the Bank would be happy to see the sale go through. Obviously, the government will pay for the bad loan portfolio in other ways: a low sale price for the assets, the provision of other incentives (regulatory forbearance, low interest loans, etc.).

The chapter also seems unable to make up its mind about how much emphasis to give to capital markets development. In the end, they seem to be saying that the banking system comes first, and then worry about contractual savings and equity markets. I think that they would strengthen these sections by making clear several of the constraints to capital markets development in our borrower countries: lousy information (accounting, financial management, audit standards); lack of a regulatory framework for capital markets; lack of skills; lack of understanding of these instruments, especially among small investors. So we should focus on building up the infrastructure and temper our expectations accordingly.

The chapter does not give much attention to the lack of skills in the financial sector and the need for institutional development -- as Ross says, y seem quite fixated on macro stability and interest rate policies, they lose

sight of some of the very important elements of financial sector reform. The lack of skills will be critical in Africa, Eastern Europe and the CIS for some e. Institutional development is one of the areas of reform (along with the legal/regulatory framework) that can be worked on while other macro and real sector reforms are underway.

DISTRIBUTION:

TO:	Ross Levine	(ROSS LEVINE)
TO:	David Scott	(DAVID SCOTT)
TO:	Michael Walton	(MICHAEL WALTON)
CC:	Gerard Caprio	(GERARD CAPRIO)
CC:	Andrew Sheng	(ANDREW SHENG)

A L L - I N - 1 N O T E

DATE: 22-May-1992 09:40am

TO: Carl Jayarajah (CARL JAYARAJAH)
TO: Mark Baird (MARK BAIRD)

FROM: Steven Webb, CECMG (STEVEN WEBB)

EXT.: 37469

SUBJECT: OED SAL Overview -- Ownership and Political Economy

This chapter, like the Macro chapter, performs the useful function of showing, with common-sense methods, the verity of a major tenet of Bank thinking on adjustment lending -- government ownership is essential for the success of an adjustment program. All three RALs have stressed the point; RAL-3 referred to the earlier version of the chapter. I have only a few suggestions on presentation.

Praising ownership sounds too much like praising motherhood. What your report and the RALs push for is UP-FRONT ownership. Perhaps you could clarify that. The alternative is not AL with no ownership, which would be absurd, but rather AL with the expectation that the beneficial effects of adjustment would generate ownership. I think that first-hand experience with the repeated failures of this approach is what led John Holsen in RAL-1 to recommend ownership as a PRE-condition for AL.

Sustaining ownership of the program is also important. Your research does not address the issue much -- it can't do everything -- but you might at least mention it as a separate issue. We are doing a lot on it in our political economy project. It involves, especially in democratic settings, which are becoming more universal, bringing into the political process the groups that benefit from the adjustment program.

The country-specific passages need to make clear what period they are referring to. For instance, the references to weak ownership in Bolivia and Philippines refer to the early 1980s, I presume. For Senegal, the SAP of the early 1980s seems to be a clear case of non-ownership; the 86-87 SAP seems to be a case of initial but not sustained ownership. For Thailand, there was strong ownership of the macro parts of the program, but not of the import-liberalizing parts.

Good luck.

Steve

CC: Nancy Birdsall (NANCY BIRDSALL)
CC: Mario Blejer (MARIO BLEJER)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: May 19, 1992

TO: Mr. Mark Baird, Chief, OEDD2

FROM: Steven Webb, CECMG

EXTENSION: 37469

SUBJECT: SAL/SECAL Overview

As I said at the seminar Tuesday, this report covers an impressive amount of ground. Carl, Bill and the others involved deserve congratulations.

I thought of a few further comments on the Macro chapter:

- The policy-by-policy review of performance and outcomes is an impressive accomplishment and makes the report a complement to the RAL reports, which took an aggregate approach in evaluating the links from policy performance to economic outcomes. Many readers may wonder about the complementarily; a short explanation or footnote might be useful. RAL-3 is consistent with the OED report in that both find that most adjusting countries (different samples and different periods) reduced fiscal deficits, reduced inflation, had real devaluation, and improved their resource balance. (The resource balance result is not explicit in RAL-3, but is implicit in the results for exports, domestic saving and investment. The RALs did not look at interest rate differentials and net reserves.) The OED and RAL reports agree that investment is a problem area, but RAL-3 finds some hopeful signs of improved investment efficiency and of recovery in private investment in recent years.

- The scoring in Tables 2.1 and 2.2 is useful idea, especially when coupled with the discussion of the non-good-good cases. (What do the N/As for documentation in Table 2.2 mean? They make the process appear ad hoc.) The objectives focus too much on short-run crisis management; It seems like an evaluation of the effectiveness of Fund programs. What about export-led growth, domestic resource mobilization, and greater efficiency?

- The analysis of Debt Dynamics seems to be missing the grant element of concessional interest rates on official lending to low-income countries. Therefore some of them seem to have unsustainable debt dynamics, when it is actually sustainable as long as concessional lending continues. The arguments for using LIBOR as the interest rate for all countries are convincing, but then the subsidy element should be deducted from the primary deficit. It might then be interesting to note the countries for whom debt sustainability depends on the continuation of lending at concessional rates.

cc: Branson, Jayarajah (OEDD2), Walton (VPDEC), Easterly, M. de Melo (CECMG).

A L L - I N - 1 N O T E

DATE: 20-May-1992 12:51pm

TO: Enzo Grilli (ENZO GRILLI)
TO: Anandarup Ray (ANANDARUP RAY)

FROM: Ross Levine, CECFP (ROSS LEVINE)

EXT.: 38738

SUBJECT: OED Report: Financial Sector

Per Requests by Michael Walton and Nancy Birdsall, I have put together some comments on the Financial Sector Chapter of the OED report on SALs and SECALs. These have been sent to Miachel Baird and Mr. Jayarajah. Melanie Johnson has some additional comments on the Financial Sector Chapter that she will send to you.

Comments: Financial Sector Reforms, Chapter IV of the OED report on SALs/SECALs

On the whole Chapter IV, "Financial Sector Reforms," of the Second Overview of Structural Adjustment and Sectoral Adjustment Loans provides a nice overview of World Bank financial sector reform operations. Specifically, the authors should be complimented for giving a generally solid conceptual overview and for emphasizing the coordination of financial sector reforms with other reforms. There are, however, some areas in the report that could be easily strengthened.

The report often seems to equate the purpose of financial sector reform with avoiding or coping with financial distress or financial crisis (see paragraphs 4.2, 4.7, 4.21, 4.25, 4.49, etc.). While financial sector reforms may be targeted at coping with or avoiding crises, this is not the only goal of financial sector reform. Financial sector reforms are designed to improve resource mobilization and allocation - avoiding and dealing with crises is a part of this objective.

Along these same lines, the Chapter systematically under-emphasizes that financial intermediaries - if working effectively - evaluate firms and monitor managers and thereby influence the allocation of credit, not just the mobilization of resources (see paragraph 4.2). Thus, financial intermediaries can alter the efficiency with which any given quantity of resources are allocated, not just the quantity of available resources. Given the Chapter's under-emphasis on financial intermediaries as institutions that can provide "value added" to the economy, the Chapter seems to over-emphasize the role of interest rate liberalization and under-emphasize what these insitutions do.

Section D - while suggestive - is (1) poorly done and (2) very poorly interpreted. The section is poorly done because it does

not control for the influence of other policies. (What if the regressions include measures of fiscal policy?) The section is poorly interpreted because it says that financial intermediation "contributed" to growth and that financial reform would "add even more to the growth performance ..." (par 4.44). We should not confuse causality with correlation, and we should note that there are no policy variables that directly reflect "financial reform" in the analysis. While the authors may know this, this care should be reflected in the document.

Finally, it is just not true that economic theory (in general) suggests that macroeconomic stabilization should be achieved before financial liberalization (par 4.49). Many types of financial reform and liberalization could be helpful even with large fiscal deficits and large and variable inflation rates. Although more caution would have to used in designing financial reforms in such a context and although financial reforms would certainly work better in a stable macroeconomic environment, this does not imply that financial sector operations need to wait until macro- stability (some how defined) is achieved.

In a few places the Chapter makes statements like interest rates became "... too high ..." (par. 4.19). This is hard to interpret; what is too high? Similarly, during the period discussed by the report, there were wide swings in world real interest rates. Even in industrialized countries without (much) financial repression, real interest rates were negative (e.g., real rates were negative in the U.S.). Thus, the Chapter in paragraphs like par 4.8 should isolate countries with very negative real rates.

Record Removal Notice

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File Title		Barcode No.
Structural Adjustment Lending (SAL) Files - Book 7		1837346
Document Date	**Document Type**	
May 28, 1992	Memorandum	

Correspondents / Participants
To: Messrs. Al-Ghannam (EDS22) and Collins (EDS01)
From: V. Rajagopalan, OSPVP

Subject / Title
Management Response to OED Study on World Bank Support for Trade Policy Reform Under Adjustment Programs

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: May 27, 1992

TO: Mr. Attila Karaosmanoglu

FROM: EG Enzo Grilli, Director, DPG

EXTENSION: 81934/5

SUBJECT: Management Response on the OED Study on Trade Policy Reform

We have received no objections from the Regions, and have forwarded a copy of the attached to COD. We have added a sentence to paragraph 16 to accommodate one suggestion (highlighted for your easy reference).

cc: Mr. Summers
Ms. Lallement, CODMO

Attachment

Management Response to OED Study (Report No. 9527) on
World Bank Support for Trade Policy Reform
Under Adjustment Programs

1. The OED study reviews adjustment programs and adjustment operations in nine countries during the 1980s. While the report has a special trade focus, much of the analysis and many of the recommendations concern macro-economic and other issues such as the social impact of adjustment. This is appropriate, given the important interrelationships which exist, but it requires that this response will also need to address a broader set of issues than trade narrowly defined.

2. This management response comprises a review of the major summary and recommendations of the OED report, the extent to which these have already been incorporated into World Bank policy, and a brief technical review of adjustment loans during FY92 which shows the extent to which that policy has been translated into the specifics of relevant lending operations. Important sources for identifying Bank positions and their rationale are the three "Review of Adjustment Lending" (RAL) reports to date,[1] the report "Strengthening Trade Policy Reform" (STPR),[2] and "World Bank Policies Guiding Financial Sector Operations,"[3] while the relevant President's Reports are used as the basis for the review of the specifics of adjustment loans.

I. Major OED Recommendations and World Bank Policy

3. The OED study offers major recommendations which are grouped into seven major areas, around which this response is organized:

(1) Macroeconomic policy,
(2) The extent and scope of trade reform,
(3) External and internal competition policies,
(4) Efficiency, growth, and trade reform,
(5) Conditionality,
(6) "Borrower Ownership" of Programs, and
(7) The social impact of trade policy adjustment.

These sets of issues are also identified in the attachment to the memorandum of April 22, 1992, by Messrs. Al-Ghannam and Collins (attached); their presentation is the specific agenda for this response.

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1 RAL1, R88-199; RAL2, SecR90-51; RAL3, R92-47

2 SecM89-1454

3 R91-80

Macroeconomic Policy

4. The first OED recommendation, and one of the most important aspects of macroeconomic policy addressed by the OED report, is the need for a credible fiscal program to achieve and maintain internal balance as a pre-condition of an adjustment loan. Management agrees with this recommendation which has been endorsed in the RALs.

5. One of the main findings of RAL 2 was "Public sector reform programs aimed at reducing public sector fiscal deficits ... should have high priority in most adjusting countries[4]". Of particular importance was the need to target macroeconomic indicators, including public savings as discussed in Chapter 4. The first recommendation of RAL 3 in the executive summary is to "Stay the course on macroeconomic ...reform" and "continue to give adjustment support to countries whose governments are committed to removing the remaining macroeconomic imbalances".[5] RAL 3 notes that 77 percent of all SALS for FY89-91 contained fiscal policy conditionality, as did 60 percent of all adjustment loans (SALs and Secals) during those years. More specifically, about one quarter of all adjustment loans have contained some conditions on the level of fiscal deficits and public expenditures[6]. In emphasizing the importance of a credible fiscal program as a key component of improved policies, RAL 3 notes that "Adjustment lending is also associated with improved policies. Between the early and late 1980s, average fiscal deficits in the intensive adjustment lending group declined from almost 5 to 3 percent of GDP in middle-income countries and from over 8 to 5.5 percent of GDP in low-income countries".[7]

6. The second OED recommendation is that tariff-cutting reform (which reduces tax revenues) should follow internal stabilization for which improved fiscal balance is essential. This is a more complex issue to address. "There is widespread agreement that in countries where inflation is high, top priority should be given to reducing the fiscal deficit, and the adjustment program must not threaten this goal. But there is agreement that reducing protection is an important goal as well, and that it should be done early in the program. Tariff-cutting reform can be combined in a package with other trade reforms that increase revenues and decrease anti-export bias (eliminating quantitative restrictions, raising low tariffs or eliminating exemptions on imported inputs for protected industries, etc.) or with expenditure reductions or with revenue-raising measures. Rather than arguing that revenue reducing tariff cuts should be delayed one could argue that these other measures should be advanced to keep from exacerbating the fiscal deficit. And, in fact, this is what has usually happened, with the net result that the whole program for trade reformers has on

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4 RAL2, summary and conclusions, paragraph 1.27.

5 RAL 3, Executive Summary, para. xxviii.

6 RAL3, para.3.14

7 RAL 3 Executive Summary, paragraph viii.

average reduced fiscal deficits, relative to other countries."[8] But the trade-offs will vary from country to country and case by case analysis is required. RAL2 explicitly endorsed this kind of approach: "Trade reform needs to be rapid enough to develop momentum without being so sudden as to ... generate budget deficits".[9]

7. The third major OED recommendation is that trade reform should generally proceed in three stages: conversion of quotas to tariffs, equalizing tariffs, and then reducing tariffs, and that the timing of trade policy should thus be coordinated with the stabilization program. RAL1 notes that "The sequence has been first to depreciate the exchange rate and reduce export restrictions, next to cut back on quantitative restrictions, and then to reduce tariffs and their dispersion.[10] This approach was also endorsed in STPR.[11] There is clearly agreement on the need to first convert quantitative restrictions to tariffs. Whether tariffs should be equalized before being lowered would seem to depend on the outcome of the approach suggested in paragraph 6 above as to whether the fiscal position permits an early tariff reduction or not.

8. The next OED recommendation is that the adjustment loan should be based on an analysis of the country's debt burden and should support the country's efforts to achieve a sustainable debt path. Put another way, for an adjustment path to be feasible and appropriate for support, adequate external financing should be available. Bank management has approached this question from two perspectives. First, the debt question needs to be framed in the context of the financing envelope available for adjustment. Second, the debt question should be forcefully addressed to ensure, inter alia, an economic environment conducive to increasing private investment.

9. RAL3 states (in its summary of major recommendations of earlier RALs) that a key point is "Provide adequate - but not excessive - financing. If there is too little external financing, the full benefits of the program are not realized." [12] RAL3 goes on to state that "The overhang of external debt is another source of uncertainty, discouraging private investment in industries producing tradeable goods. Investors fear that the government will impose austerity or tax measures to raise foreign exchange and service the debt.... Debt reduction plans, carried out as part of a broader adjustment effort, have

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8 STPR, Vol. 1, Table 2

9 RAL2, para 4.29

10 RAL1, para. 3.11

11 STPR, Vol. 1, Para. 8

12 RAL3, Introduction, para. 17,

helped reduce uncertainty and build popular confidence in the viability of reform programs."[13]

10. The last OED recommendation concerning macro-economic policy is that the real interest rate for savers be at least as high as international real rates. A general formulation of interest rate policy consistent with this recommendation is contained in "World Bank Policies Guiding Financial Sector Operations." "Phasing out of interest rate subsidies (subsumed in the general move toward market interest rates) should be an important objective of the Bank's policy dialogue in the financial sector."[14] RAL 2 identifies the need for higher interest rates in noting that "financial liberalization that allows real interest rates to rebound from very negative to near-zero levels often has a positive impact on measured private savings...due to reduced flight into consumer durables and foreign capital ...."[15] Further, RAL 2 notes that "the success of structural reform depends on the maintenance of a supportive macroeconomic environment - competitive and stable real exchange rates, low and predictable inflation, domestic interest rates that are competitive with international interest rates,and a sustainable current account deficit."[16]

The Extent and Scope of Trade Reform

11. In the first major OED recommendation under this rubric, the OED report notes that tax regimes have a strong impact on trade, and that tax reforms need to be considered as part of a package in which tariffs are to be reduced. Specifically, broadly based taxes which do not discriminate between imports and domestic substitutes are desirable. This concern was specifically addressed in RAL 1, which identified value added taxes as a desirable tax alternative.[17] STPR also made this point and contrasted Mexico, where such an approach was successfully implemented, with Morocco, where it was not.[18]

12. The second major OED recommendation in this area is to increase the price of tradeables relative to non-tradeables: RAL 1[19] notes that a realistic exchange rate is essential (which would frequently involve a devaluation as the trade regime is liberalized); this theme is also reflected repeatedly in the subsequent RALs and STPR.

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13 RAL3, para. 2.24

14 R91-80, para. 16

15 RAL 2, para.7.16

16 RAL 2 , para. 4.12

17 RAL 1 para. 3.22

18 STPR, Vol. II, paras 5.33-5.35

19 RAL 1, para. 3.16

External and Internal Competition Policies

13. The OED report notes that reforms in internal competition policies often lag trade policy reforms, and recommends earlier reforms to strengthen the effectiveness of trade reforms. RAL 3[20] recommends to "Take a broad view of constraints on the private sector and increase attention to "second-generation" policies to support the business environment...reforms to remove barriers to entry and exit...." RAL 2[21] contains a more explicit discussion, including "Increasing competition has become a higher priority for industrial policy reform (components of adjustment programs) and should be encouraged...." STPR devoted a section specifically to the linkages between trade reforms and internal sector reforms, concluding that may times they are highly complementary and should be undertaken together. There are times, however, when one should follow the other.[22]

Efficiency, Growth, and Trade Reform

14. There are two OED recommendations under this rubric. First, in order to achieve adjustment objectives, the investment rate needs to pick up. The second, particularly in the least developed countries, is for greater attention to development and maintenance of physical and human capital infrastructures. These recommendations are entirely appropriate. The central focus of RAL3 in on investments and their role in the adjustment process. Chapter 2, entitled "Private investment and the business environment", and in Chapter 3, "Structural Adjustment and the Level and Composition of Public Expenditures" dealt with these issues. There is no appreciable difference between OED's views and priorities regarding investments and those of the Bank's management.

Conditionality

15. The OED report recommends that conditionalities should be based on a clear definition of performance criteria and assessment of implementation capacity of the government and they should emphasize a few key variables that are easy to monitor.

16. The concern with conditionality has been reflected in discussion of adjustment lending since its inception. RAL 1 notes that "Close to three quarters of all adjustment loans have had tranche releases delayed because of insufficient progress in fulfilling conditions...A somewhat tighter approach, combined with realism and simplicity in conditions, seems advisable[23]." However, the trade-off between focussing on selected and key conditions on the

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20 RAL 3 , para. xxix

21 RAL 2, para. 4.72

22 STPR, paras. 7.39-7.55

23 RAL 1, Summary and Conclusions, para. 17.

one hand, and on providing specificity and hence credibility, on the other hand, is a very difficult one to address in practice. Management is giving and will continue to give detailed attention to appropriate conditionality with a view to ensuring that operations contain key conditionality appropriately formulated as essential for the success of the program.

Borrower Ownership of the Program

17. The OED report notes that government ownership of the adjustment program is a key aspect of any successful program, that assistance strategies need to be underpinned by operationally-oriented economic and sector analysis combined with a productive policy dialogue. Further, it is important to have an appreciation of the political economy of adjustment.

18. This is presented in RAL3 as a main recommendation of the previous RALs: "The government must "own" the program - understand it, accept it, and explain it to the public. As discussed above, ownership helps explain the success or failure of past adjustment loans."[24] Borrower ownership is clearly a main pillar of Bank policy. Specific measures for promoting ownership and sustainability of trade reforms are discussed in STPR, Ch. 4 "Political Economy of Trade Reforms."

The Social Impact of Trade Adjustment Policy

19. The OED report recommends that adjustment programs should include poverty alleviation as an objective and incorporate tangible measures for reducing the potential short-run burden on the poor. All three RALs strongly endorse this approach. As an example, the executive summary of RAL 1 states as one of four main objectives to "Reinforce efforts to design adjustment policy programs to promote poverty-reducing growth. On assessing the design of adjustment measures, Bank staff should consider the short-and long- run effects on the poor, in line with the recommendations of Operational Directive 4.15."[25]

II. Review of Bank Policies as Reflected in 15 Adjustment Operations Approved during FY92

20. To provide an empirical basis for this management response, a review was conducted of 15 structural adjustment loans approved thus far in FY92. Included are 8 SALs/SACs, 2 economic recovery loans, 1 economic reform loan, and 4 sector adjustment loans (one trade, two financial sector, and one public sector adjustment loan) which broadly cover the areas of interest. The exclusions are those sector adjustment loans, such as agricultural sector loans, which would not be relevant for this analysis.

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24 RAL3, Introduction, para. 17.

25 RAL 3 para. xxxi

21. The analysis involved a review of each of the above loans measured against the OED recommendations. Of the 14 major recommendations, 11 are amenable to this kind of quantitative analysis. The three recommendations which are not included are one recommendation concerned with conditionality (conditionality should be based on a clear definition of performance criteria...) and the two recommendations concerned with "Borrower Ownership" of Programs. Because of a certain degree of overlap, the two OED recommendations concerning trade and tariffs have been combined for this analysis.

22. The table below gives a summary of the results:[26]

Recommendation		Addressed in Current Loan	Addressed in Previous Loan or Gov't Program	Not Addressed
1.	Fiscal Program	9	4	2
2/3.	Trade/Tariffs	7	5	3
3.	Debt	4	10	1
5.	Interest Rate	7	6	2
6.	Tax Reform	10	1	4
7.	Devaluation	5	7	3
8.	Competition	14	1	0
9.	Investment	15	0	0
10.	Infrastructure	10	3	2
11.	Social Impact	9	4	2

23. In assessing the above data, it is important to remember that one OED recommendation is by no means universally accepted, that is that stabilization should precede tariff reduction. Thus, there are cases such as Bolivia, which are entered as "not addressed" under item 2./3. in the above table, but which are widely considered as successful nonetheless.

24. Despite this concern which raises a question about several of the entries, the results are striking. Only 19 of the entries, out of a total of 150 (15 loans evaluated for 10 separate recommendations), are in the "not addressed " category.

25. In sum, there is overwhelming agreement between the OED recommendations and current World Bank practice.

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26 Details of the analysis are available in the office of Mr. Michael Lav.

III. Recommendation

26. In view of the above results, there does not seem to be a need to formulate a special program to implement the OED recommendations. Rather, management will continue to pursue and implement policies as discussed above.

May 26, 1992

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: May 21, 1992

TO: Distribution

FROM: Enzo Grilli, Director, DPG

EXTENSION: 81934\5

SUBJECT: Management Response on the OED Study on Trade Policy Reform

1. Attached for your review is the Management Response to the OED report "World Bank Support for Trade Policy Reform" (Report No. 9527), which was drafted following a JAC request for such a response.

2. May I have any comments you may have by c.o.b. Tuesday, May 26.

Attachment

cc: Messrs. Hasan, ESU; Husain, AFR; Nankani, SAS; Selowsky, LAC; Squire, MNA; Thomas, EAP.

Management Response to OED Study (Report No. 9527) on
World Bank Support for Trade Policy Reform
Under Adjustment Programs

1. The OED study reviews adjustment programs and adjustment operations in nine countries during the 1980s. While the report has a special trade focus, much of the analysis and many of the recommendations concern macro-economic and other issues such as the social impact of adjustment. This is appropriate, given the important interrelationships which exist, but it requires that this response will also need to address a broader set of issues than trade narrowly defined.

2. This management response comprises a review of the major summary and recommendations of the OED report, the extent to which these have already been incorporated into World Bank Policy, and a brief technical review of adjustment loans during FY92 which shows the extent to which that policy has been translated into the specifics of relevant lending operations. Important sources for identifying Bank positions and their rationale are the three "Review of Adjustment Lending" (RAL) reports to date,[1] the report "Strengthening Trade Policy Reform" (STPR),[2] and "World Bank Policies Guiding Financial Sector Operations,"[3] while the relevant President's Reports are used as the basis for the review of the specifics of adjustment loans.

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These sets of issues are also identified in the attachment to the memorandum of April 22, 1992, by Messrs. Al-Ghannam and Collins (attached); their presentation is the specific agenda for this response.

Macroeconomic Policy

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1 RAL1, R88-199; RAL2, SecR90-51; RAL3, R92-47

2 SecM89-1454

3 R91-80

4. The first OED recommendation, and one of the most important aspects of macroeconomic policy addressed by the OED report, is the need for a credible fiscal program to achieve and maintain internal balance as a pre-condition of an adjustment loan. Management agrees with this recommendation which has been endorsed in the RALs.

5. One of the main findings of RAL 2 was "Public sector reform programs aimed at reducing public sector fiscal deficits ... should have high priority in most adjusting countries[4]". Of particular importance was the need to target macroeconomic indicators, including public savings as discussed in Chapter 4. The first recommendation of RAL 3 in the executive summary is to "Stay the course on macroeconomic ...reform" and "continue to give adjustment support to countries whose governments are committed to removing the remaining macroeconomic imbalances".[5] RAL 3 notes that 77 percent of all SALS for FY89-91 contained fiscal policy conditionality, as did 60 percent of all adjustment loans (SALs and Secals) during those years. More specifically, about one quarter of all adjustment loans have contained some conditions on the level of fiscal deficits and public expenditures[6]. In emphasizing the importance of a credible fiscal program as a key component of improved policies, RAL 3 notes that "Adjustment lending is also associated with improved policies. Between the early and late 1980s, average fiscal deficits in the intensive adjustment lending group declined from almost 5 to 3 percent of GDP in middle-income countries and from over 8 to 5.5 percent of GDP in low-income countries".[7]

6. The second OED recommendation is that tariff-cutting reform (which reduces tax revenues) should follow internal stabilization for which improved fiscal balance is essential. This is a more complex issue to address. "There is widespread agreement that in countries where inflation is high, top priority should be given to reducing the fiscal deficit, and the adjustment program must not threaten this goal. But there is agreement that reducing protection is an important goal as well, and that it should be done early in the program. Tariff-cutting reform can be combined in a package with other trade reforms that increase revenues and decrease anti-export bias (eliminating quantitative restrictions, raising low tariffs or eliminating exemptions on imported inputs for protected industries, etc.) or with expenditure reductions or with revenue-raising measures. Rather than arguing that revenue reducing tariff cuts should be delayed one could argue that these other measures should be advanced to keep from exacerbating the fiscal deficit. And, in fact, this is what has usually happened, with the net result that the whole program for trade reformers has on

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4 RAL2, summary and conclusions, paragraph 1.27.

5 RAL 3, Executive Summary, para. xxviii.

6 RAL3, para.3.14

7 RAL 3 Executive Summary, paragraph viii.

average reduced fiscal deficits, relative to other countries."[8] But the trade-offs will vary from country to country and case by case analysis is required. RAL2 explicitly endorsed this kind of approach: "Trade reform needs to be rapid enough to develop momentum without being so sudden as to ... generate budget deficits".[9]

7. The third major OED recommendation is that trade reform should generally proceed in three stages: conversion of quotas to tariffs, equalizing tariffs, and then reducing tariffs, and that the timing of trade policy should thus be coordinated with the stabilization program. RAL1 notes that "The sequence has been first to depreciate the exchange rate and reduce export restrictions, next to cut back on quantitative restrictions, and then to reduce tariffs and their dispersion.[10] This approach was also endorsed in STPR.[11] There is clearly agreement on the need to first convert quantitative restrictions to tariffs. Whether tariffs should be equalized before being lowered would seem to depend on the outcome of the approach suggested in paragraph 6 above as to whether the fiscal position permits an early tariff reduction or not.

8. The next OED recommendation is that the adjustment loan should be based on an analysis of the country's debt burden and should support the country's efforts to achieve a sustainable debt path. Put another way, for an adjustment path to be feasible and appropriate for support, adequate external financing should be available. Bank management has approached this question from two perspectives. First, the debt question needs to be framed in the context of the financing envelope available for adjustment. Second, the debt question should be forcefully addressed to ensure, inter alia, an economic environment conducive to increasing private investment.

9. RAL3 states (in its summary of major recommendations of earlier RALs) that a key point is "Provide adequate - but not excessive - financing. If there is too little external financing, the full benefits of the program are not realized." [12] RAL3 goes on to state that "The overhang of external debt is another source of uncertainty, discouraging private investment in industries producing tradeable goods. Investors fear that the government will impose austerity or tax measures to raise foreign exchange and service the debt.... Debt reduction plans, carried out as part of a broader adjustment effort, have

helped reduce uncertainty and build popular confidence in the viability of reform

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8 STPR, Vol. 1, Table 2

9 RAL2, para 4.29

10 RAL1, para. 3.11

11 STPR, Vol. 1, Para. 8

12 RAL3, Introduction, para. 17,

programs."[13]

10. The last OED recommendation concerning macro-economic policy is that the real interest rate for savers be at least as high as international real rates. A general formulation of interest rate policy consistent with this recommendation is contained in "World Bank Policies Guiding Financial Sector Operations." "Phasing out of interest rate subsidies (subsumed in the general move toward market interest rates) should be an important objective of the Bank's policy dialogue in the financial sector."[14] RAL 2 identifies the need for higher interest rates in noting that "financial liberalization that allows real interest rates to rebound from very negative to near-zero levels often has a positive impact on measured private savings...due to reduced flight into consumer durables and foreign capital ...."[15] Further, RAL 2 notes that "the success of structural reform depends on the maintenance of a supportive macroeconomic environment - competitive and stable real exchange rates, low and predictable inflation, domestic interest rates that are competitive with international interest rates,and a sustainable current account deficit."[16]

The Extent and Scope of Trade Reform

11. In the first major OED recommendation under this rubric, the OED report notes that tax regimes have a strong impact on trade, and that tax reforms need to be considered as part of a package in which tariffs are to be reduced. Specifically, broadly based taxes which do not discriminate between imports and domestic substitutes are desirable. This concern was specifically addressed in RAL 1, which identified value added taxes as a desirable tax alternative.[17] STPR also made this point and contrasted Mexico, where such an approach was successfully implemented, with Morocco, where it was not.[18]

12. The second major OED recommendation in this area is to increase the price of tradeables relative to non-tradeables: RAL 1[19] notes that a realistic exchange rate is essential (which would frequently involve a devaluation as the trade regime is liberalized); this theme is also reflected repeatedly in the subsequent RALs and STPR.

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13 RAL3, para. 2.24

14 R91-80, para. 16

15 RAL 2, para.7.16

16 RAL 2 , para. 4.12

17 RAL 1 para. 3.22

18 STPR, Vol. II, paras 5.33-5.35

19 RAL 1, para. 3.16

External and Internal Competition Policies

13. The OED report notes that reforms in internal competition policies often lag trade policy reforms, and recommends earlier reforms to strengthen the effectiveness of trade reforms. RAL 3[20] recommends to "Take a broad view of constraints on the private sector and increase attention to "second-generation" policies to support the business environment...reforms to remove barriers to entry and exit...." RAL 2[21] contains a more explicit discussion, including "Increasing competition has become a higher priority for industrial policy reform (components of adjustment programs) and should be encouraged...." STPR devoted a section specifically to the linkages between trade reforms and internal sector reforms, concluding that may times they are highly complementary and should be undertaken together. There are times, however, when one should follow the other.[22]

Efficiency, Growth, and Trade Reform

14. There are two OED recommendations under this rubric. First, in order to achieve adjustment objectives, the investment rate needs to pick up. The second, particularly in the least developed countries, is for greater attention to development and maintenance of physical and human capital infrastructures. These recommendations are entirely appropriate. The central focus of RAL3 in on investments and their role in the adjustment process. Chapter 2, entitled "Private investment and the business environment", and in Chapter 3, "Structural Adjustment and the Level and Composition of Public Expenditures" dealt with these issues. There is no appreciable difference between OED's views and priorities regarding investments and those of the Bank's management.

Conditionality

15. The OED report recommends that conditionalities should be based on a clear definition of performance criteria and assessment of implementation capacity of the government and they should emphasize a few key variables that are easy to monitor.

16. The concern with conditionality has been reflected in discussion of adjustment lending since its inception. RAL 1 notes that "Close to three quarters of all adjustment loans have had tranche releases delayed because of insufficient progress in fulfilling conditions...A somewhat tighter approach, combined with realism and simplicity in conditions, seems advisable[23]." Management is giving and will continue to give detailed attention to appropriate

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20 RAL 3 , para. xxix

21 RAL 2, para. 4.72

22 STPR, paras. 7.39-7.55

23 RAL 1, Summary and Conclusions, para. 17.

conditionality with a view to ensuring that operations contain key conditionality appropriately formulated as essential for the success of the program.

Borrower Ownership of the Program

17. The OED report notes that government ownership of the adjustment program is a key aspect of any successful program, that assistance strategies need to be underpinned by operationally-oriented economic and sector analysis combined with a productive policy dialogue. Further, it is important to have an appreciation of the political economy of adjustment.

18. This is presented in RAL3 as a main recommendation of the previous RALs: "The government must "own" the program - understand it, accept it, and explain it to the public. As discussed above, ownership helps explain the success or failure of past adjustment loans."[24] Borrower ownership is clearly a main pillar of Bank policy. Specific measures for promoting ownership and sustainability of trade reforms are discussed in STPR, Ch. 4 "Political Economy of Trade Reforms."

The Social Impact of Trade Adjustment Policy

19. The OED report recommends that adjustment programs should include poverty alleviation as an objective and incorporate tangible measures for reducing the potential short-run burden on the poor. All three RALs strongly endorse this approach. As an example, the executive summary of RAL 1 states as one of four main objectives to "Reinforce efforts to design adjustment policy programs to promote poverty-reducing growth. On assessing the design of adjustment measures, Bank staff should consider the short-and long- run effects on the poor, in line with the recommendations of Operational Directive 4.15."[25]

II. Review of Bank Policies as Reflected in 15 Adjustment Operations Approved during FY92

20. To provide an empirical basis for this management response, a review was conducted of 15 structural adjustment loans approved thus far in FY92. Included are 8 SALs/SACs, 2 economic recovery loans, 1 economic reform loan, and 4 sector adjustment loans (one trade, two financial sector, and one public sector adjustment loan) which broadly cover the areas of interest. The exclusions are those sector adjustment loans, such as agricultural sector loans, which would not be relevant for this analysis.

21. The analysis involved a review of each of the above loans measured against the OED recommendations. Of the 14 major recommendations, 11 are amenable to this kind of quantitative analysis. The three recommendations which are not included are one recommendation concerned with conditionality

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24 RAL3, Introduction, para. 17.

25 RAL 3 para. xxxi

(conditionality should be based on a clear definition of performance criteria...) and the two recommendations concerned with "Borrower Ownership" of Programs. Because of a certain degree of overlap, the two OED recommendations concerning trade and tariffs have been combined for this analysis.

22. The table below gives a summary of the results:[26]

Recommendation		Addressed in Current Loan	Addressed in Previous Loan or Gov't Program	Not Addressed
1.	Fiscal Program	9	4	2
2/3.	Trade/Tariffs	7	5	3
3.	Debt	4	10	1
5.	Interest Rate	7	6	2
6.	Tax Reform	10	1	4
7.	Devaluation	5	7	3
8.	Competition	14	1	0
9.	Investment	15	0	0
10.	Infrastructure	10	3	2
11.	Social Impact	9	4	2

23. In assessing the above data, it is important to remember that one OED recommendation is by no means universally accepted, that is that stabilization should precede tariff reduction. Thus, there are cases such as Bolivia, which are entered as "not addressed" under item 2./3. in the above table, but which are widely considered as successful nonetheless.

24. Despite this concern which raises a question about several of the entries, the results are striking. Only 19 of the entries, out of a total of 150 (15 loans evaluated for 10 separate recommendations), are in the "not addressed " category.

25. In sum, there is overwhelming agreement between the OED recommendations and current World Bank practice.

III. Recommendation

26. In view of the above results, there does not seem to be a need to formulate a special program to implement the OED recommendations. Rather, management will continue to pursue and implement policies as discussed above.

May 19, 1992

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26 Details of the analysis are available in the office of Mr. Michael Lav.

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: April 29, 1992

TO: Mr. Enzo Grilli, DPGDR

FROM: Dominique Lallement, CODMO

EXTENSION: 82849

SUBJECT: JAC Request for a Management Response on the OED Study on Trade Policy Reform under Adjustment Operations

1. We have received a request from members of the JAC Subcommittee on OED (attached) for a Management Response on the OED Study mentioned above. The Minutes of the May 6, 1991 JAC meeting were ambiguous as to the need for such a Management Response, and no further request has been received until April 27th, 1992 when the memo from Messrs. Al-Ghannam and Collins reached me.

2. I would be grateful, therefore, if you could send me the proposed Management Response by May 15th, 1992, so that the Management Response can be forwarded to the JAC Subcommittee on OED by May 22nd, 1992 at the latest. As specified in OD 13.60, the Management Response should provide:

(a) an assessment of the validity, significance, implications, and current relevance of the major findings;

(b) a plan of action for their utilization, which identifies the nature of the work to be done, the unit responsible, and a timetable.

3. The Country Economics Department, the Industry and Energy Department, and the Industry and Trade Divisions of the TDs may be interested in providing you with their perspective.

cc: Mr. H. Wyss (CODDR)

DL
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Record Removal Notice

The World Bank Group Archives & Records Management

File Title		Barcode No.
Structural Adjustment Lending (SAL) Files - Book 7		1837346
Document Date	**Document Type**	
April 22, 1992	Memorandum	

Correspondents / Participants
To: Ms. Dominique Lallement, CODMO
From: Ahmed Al-Ghannam, EDS22, and Mark Collins, EDS01

Subject / Title
OED Trade Policy Reform and Small and Medium Industry

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
SHRI ALON	MAY 24, 2017

A L L - I N - 1 N O T E

DATE: 01-May-1992 04:13pm

TO: Dominique Lallement (DOMINIQUE LALLEMENT)

FROM: Enzo Grilli, DPG (ENZO GRILLI)

EXT.: 81934

SUBJECT: JAC Request for a Management Response on the OED Study on Trade Policy Reform under Adjustment Lending

1. Thank you for your note. As you remarked the JAC meeting took place in May 1991 and no further request came from JAC until April 1992. This would not seem to be a "hot" topic. I am therefore puzzled by the May 22 deadline. We are now at the end of the fiscal year, and I don't know if we can deliver by then, given also that senior management would have to review and approve the response. Best efforts notwithstanding, two weeks is quite a short time.

2. Would you or Mr. Wyss please tell the JAC that the time available is not sufficient and that we cannot promise to deliver a management response by May 22, given that their request did not reach us until April 27? We will start working on it, and try to get it done by the end of June or thereabout.

CC: Hans Wyss (HANS WYSS)
CC: Michael Walton (MICHAEL WALTON)
CC: Michael Lav (MICHAEL LAV)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: May 1, 1992

TO: Mr. T. Akiyama, Actg. Chief, IECIT and Mr. J. De Melo, Chief, CECTP

FROM: EG Enzo Grilli, Director, DPG

EXTENSION: 81934/5

SUBJECT: JAC Request for a Management Response on the OED Study on Trade Policy Reform under Adjustment Operations

I received today the enclosed request. Your Divisions, aside from having the trade expertise in DEC, have in the past been involved with the study of trade reforms and adjustment lending. Your inputs in responding to this request is therefore essential. DPG can coordinate the response, but our direct expertise on the matter is very limited. Can you, or your representatives, get together as soon as possible with Mr. Lav in DPG to organize the work on the note that we will have to prepare. Since the JAC Subcommittee on OED wants it by May 22, 1991, and the note will have to indicate the elements of an institutional response, we have to give us at least a week to put the note through Mr. Karaosmanoglu's office. So the effective **deadline is May 15**.

Enclosure

cc: Messrs. Summers; Rao, IECDR; Walton, DECVP; Lav, DPG;
Ms. Birdsall, CECDR.

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

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FROM: Dominique Lallement, CODMO

EXTENSION: 82849

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cc: Mr. H. Wyss (CODDR)

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Correspondents / Participants
To: Ms. Dominique Lallement, CODMO
From: Ahmed Al-Ghannam, EDS22, and Mark Collins, EDS01

Subject / Title
OED Trade Policy Reform and Small and Medium Industry

Exception(s)

Additional Comments
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The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
SHIRI ALON	MAY 24, 2017

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: January 22, 1992

TO: Mr. Attila Karaosmanoglu

THROUGH: Lawrence H. Summers

FROM: Enzo Grilli, Director, DPG

EXTENSION: 81934

SUBJECT: Monitoring and Supervision of Adjustment Lending

1. A Board seminar is scheduled for March 12 to discuss the question of monitoring and supervision of adjustment lending (AL). The occasion was the OED study of last year for the JAC, which was critical of past Bank practices. Moeen Qureshi responded to OED criticisms (EAS drafted a preliminary response after consulting the Regions, which thought little of the OED study), but JAC was not satisfied by it. Thus the seminar and the Directors' request for another response from management (at least on what it is doing to deal with the issues raised by OED).

2. As you know, while we do an annual report on the implementation and supervision of projects (ARIS), we do not do anything of this kind for AL. Management is therefore on weak grounds in this matter vis-a-vis the Board. It would be quite unwise, in my view, to hold the March seminar ill-prepared and to have to admit that the matter of reporting to the Board on monitoring and supervising SALs has fallen through the cracks, or that we have not done anything tangible to meet the concerns raised in the OED study, no matter how much we disagree with it.

3. We have two options to defuse this issue. The first would be to go to the Board seminar with an action plan quickly put together that includes the promise of either an annual (or less frequent) review for the Board of the implementation and supervision of SALs, to be incorporated in ARIS or as a stand-alone report. Matters to consider are a) the wisdom of such a new engagement, b) its costs, and c) the assignment of responsibilities to manage this task. The second alternative is to seek a postponement of the seminar (perhaps to the time when RAL III will be reviewed by the Board (in April 1992)), that would allow management more time to reflect on the pros and cons of an ARIS extended to SALs, accompanied by a promise to the Board that by then management will tell directors what it intends to do on this matter. The second alternative seems wiser than the first to me. In either case we need a decision from senior management on how to proceed in this matter, since it has Bank-wide implications.

The World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: January 16, 1992 11:04am

TO: Larry Summers (LARRY SUMMERS)

FROM: Enzo Grilli, DPGDR (ENZO GRILLI)

EXT.: 81934

SUBJECT: Supervision and Monitoring of SALs: once again

Larry,

Sorry to have to come back to this issue, but OED (I spoke to Kopp yesterday) now seems to think that in order to get acceptance of a proposal to JAC to postpone the March seminar it will be necessary to promise the Board an adequate management response to the implementation issues that OED raised in the report. This is reasonable, but puts the ball back in our court again.

I am not sure that the OED report is worth much effort on anybody's side, but to prepare a response and an action plan one would have to designate a party responsible for it and do a fair amount of work. COD now handles the Annual Report on Implementation and Supervision (ARIS) of projects, which it completes with heavy involvement of the regions. Nobody does an ARIS on SALs and SECALs and nobody ever did. It is odd but true. Two possibilities are open: 1) We go for an expanded ARIS, which will include adjustment loans and make it an annual affair, or 2) we go for a separate review of these issues in SALs and SECALs and make it either annual or "as needed". In the first case, COD should clearly be put in charge of it. In the second case we could maintain some joint responsibility with COD. In general, however, the issues at stake are much more in the domain of OSP than of DEC, which does its own economic review of adjustment lending, but does not get involved in supervision.

Enzo

CC: Michael Walton (MICHAEL WALTON)

OECF

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

cc: DPG

DATE: April 3, 1992

TO: Distribution

FROM: Lawrence H. Summers, DECVP

EXTENSION: 33774

SUBJECT: OECF Occasional Paper No. 1

As many of you are aware, the OECF wrote a critique of adjustment policy, arguing that more interventionist industrial strategies should be included. I attach for your information a comment on this that we recently sent to the OECF, along with their paper. This may be useful in your interactions with Japanese official agencies.

Regional Vice Presidents, Regional Chief Economists, Linn, Ms. Nishimizu

cc: N. Birdsall, D. C. Rao, E. Grilli

The Design of Structural Adjustment Policy: the OECF Commentary

1. The OECF's Occasional Paper No. 1 argues that structural adjustment programs rely too heavily on market liberalization and should include more interventionist government policies to promote investment and industrialization, especially where market failures are important. It also argues for a pragmatic approach to privatization that takes local political realities into account.

2. The World Bank welcomes this constructive exchange of views. As the 1991 World Development Report concluded, successful development depends on an appropriate balance between government action and the market. The report also highlighted the remarkable historical success of the East Asian economies. Other countries can learn much from this success; the Bank is eager to study and understand it better.

3. Governments have a major role to play in creating a supportive environment for long-run development. They need to take the lead in providing infrastructure, social services and a stable macroeconomic environment for entrepreneurs. In addition, provision of a safety net for the poor and vulnerable is also an important domain for public action. Governments also have to raise resources to provide these services in a manner that promotes rather than impedes development. The question posed by the OECF is whether these measures are sufficient for rapid growth, or whether governments should take a more proactive role in directing resources into priority activities.

4. Experience in LDCs seems to provide a mixed answer to this question. Selective interventions and an activist industrial strategy were used extensively in the fast-growing East Asian countries such as Japan and Korea. But they were also used extensively in many slow-growing and crisis-prone countries in Africa, Latin American and parts of Asia. Thus understanding what kinds of interventions work in differing conditions is critical: did Argentina and Tanzania pursue different forms of intervention from Japan and Korea or did other aspects of their environment make active industrial strategy unsuccessful?

5. In reviewing this experience a number of general considerations apply:

- Support for the industrial development depends both on efficient use of scarce resources and the development of industrial capabilities and well-functioning markets; similar considerations often apply to the agriculture and service sectors.

- The development of industrial capabilities and well-functioning markets (including the financial sector) takes time; and governments have an essential role to play in providing a secure long-term environment for entrepreneurs to invest, take risks and learn by doing.

- The most effective ways for a government to provide such a secure long-term environment depends on both the state of markets and the state of governments; these conditions vary sharply across countries and form as important a part of a country's initial developmental conditions as its resource endowment.

- In all countries -- whatever the mix of market and government capacities and failures -- provision of a stable macroeconomic environment is a necessary ingredient of a secure long-run environment. But how far governments can contribute by other measures, notably through selective interventions, depends critically on government capabilities.

6. This note review the four areas discussed in the OECF note -- investment, protection, credit and privatization -- to assess how differing initial conditions affect desirable government policies. Since the OECF note is mainly concerned with adjustment, the focus is primarily on countries that

faced adjustment difficulties and on what policies have been successful in securing a sustainable recovery.

7. The Bank regularly reviews the experience in adjustment lending -- the Third Report on Adjustment Lending is being discussed by the Executive Directors in April 1992.[1] This report concludes that adjustment lending is associated with higher growth and improved economic conditions. However, there is much that is less than fully understood about development and the adjustment process and further study is necessary. In particular, the Bank plans to undertake a major research study on the "East Asian Miracle" in the coming year, with support from the Japanese Government and collaboration with Japanese and other East Asian scholars. This study will assess the sources of success within East Asia and analyze what can and cannot be replicated in other parts of the world. In addition, a major study of the Effectiveness of Credit Policies in East Asia will be undertaken in collaboration with the Japan Development Bank.

Promoting investment

8. The OECF correctly identifies the need to increase private investment as critical to economic recovery and sustained growth. And private investment has had a hard time making a comeback in many adjusting countries. While Korea's private investment rate has been above 20 percent of GDP and rising, since 1982, in Mexico it fell from 18 percent in 1981 to 12 percent in 1984-87 before recovering to 17 percent in 1990. This pattern of a sharp fall, a pause and then a recovery is characteristic of middle income countries that are well along the adjustment path. Those that are still in the middle of implementing adjustment, such as Argentina, continue to suffer from depressed investment. (See Figure 1 (a).)[2]

9. In low-income countries the record is even more discouraging: private investment generally started lower and fell by more. In Kenya it dropped from 17 to 10 percent of GDP between the beginning and end of the decade, and in Bolivia it fell from 5 to less than 2 percent of GDP. In Ghana a sharp recovery has occurred but the absolute level is still low. (See Figure 1 (b)).

10. Is the pattern of contraction, pause and recovery of private investment over several years a problem? And what can governments do to support a private investment recovery?

11. A contraction and pause in private investment is a natural response to the changing conditions of an economy going through adjustment, as illustrated by Mexico.[3] A number of factors explain the response of private investors:

- A recession was unavoidable, since Mexico had been living beyond its means, following the oil boom and easy money of the late-1970s. Private investors only feel assured of profits once a recovery is securely underway.
- The government undertook radical changes in economic policy to restructure a highly protected and state-controlled economy. While supportive of long-term growth, in the transition period these measures increased uncertainty for the private sector.
- Substantial devaluations of the Mexican peso raised the cost of imported capital goods, so raising the cost of capital for investors.

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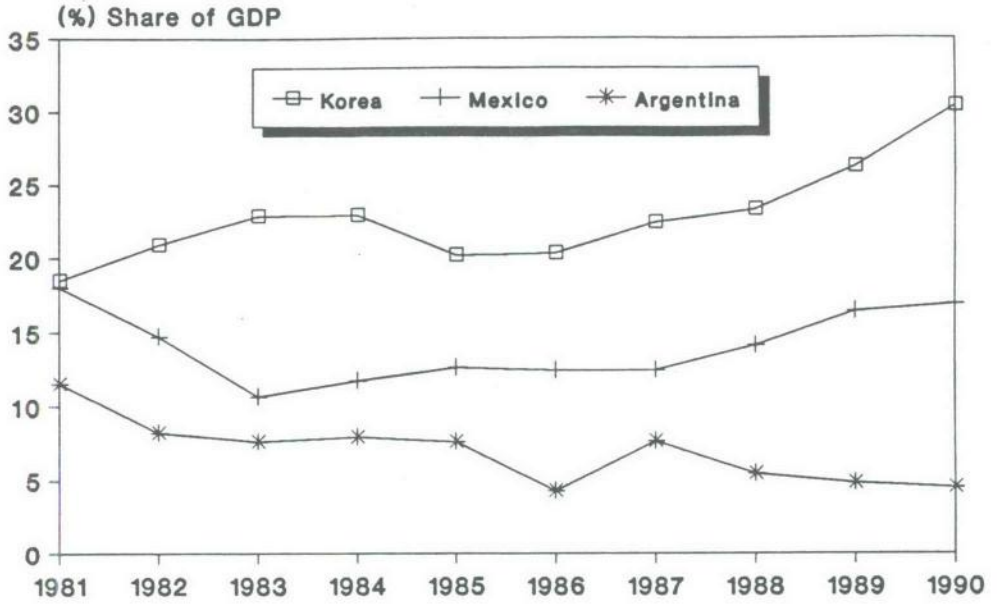
1 See World Bank, *The Third Report on Adjustment Lending: Private and Public Resources for Growth* Report no R92-47, IDA/R91-29, 1992.

2 See *The Third Report on Adjustment Lending*, Chapter 2, for a general review of the determinants of private investment in adjusting countries.

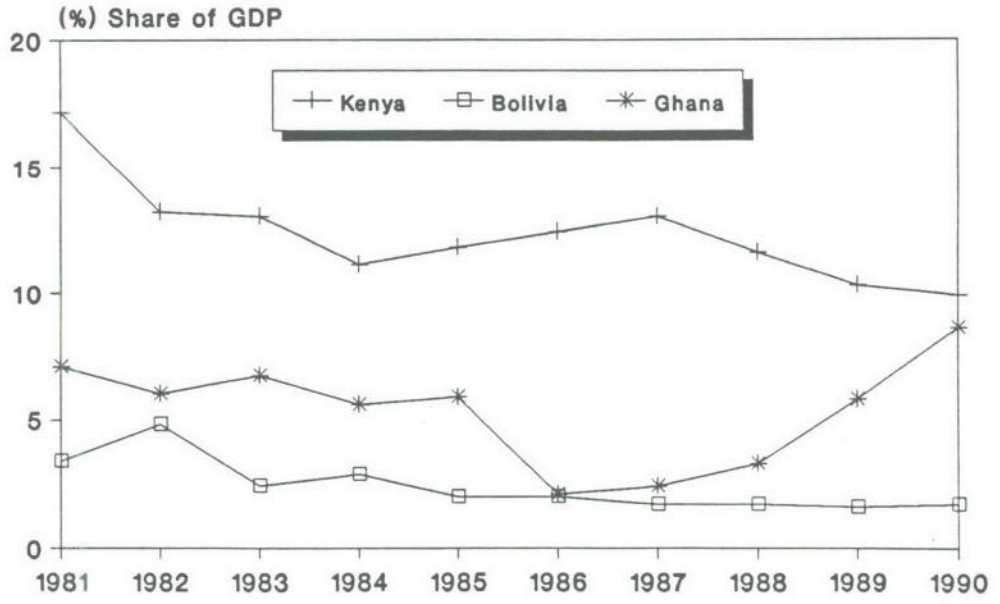
3 For a recent review of Mexico's adjustment, see World Bank, *Mexico in Transition: Toward a New Role for the Public Sector*, Report no. 8770-ME, 1991.

Figure 1: Private Fixed Investment

(a) Middle Income Countries



(b) Low Income Countries



Source: RAL III

• Real interest rates rose and stayed high until after the Brady debt reduction deal of 1990, owing to a substantial risk premium above US rates. This also raised the cost of capital.

12. Thus it is unsurprising that the path of private investment in Mexico differed so sharply from Korea's. The key difference from Korea was the absence of a secure long-term environment for private investors. But could less restrictive fiscal and monetary policy have helped speed a recovery? In the macroeconomic conditions prevailing in Mexico the effects are likely to have been exactly the opposite. In particular, tight fiscal policy (with a shift in the primary balance from a deficit of 9 percent of GDP in 1981-82 to a surplus every year from 1983, rising to 7 percent of GDP by 1989-90) was the central plank of a macroeconomic reform effort that not only had to redress past overborrowing, but was important in convincing the domestic and foreign private sectors that past excesses would not be repeated. More lax fiscal policy would have led to even higher interest rates, due to the immediate effects of higher net government borrowing in the markets, and the impact on confidence. Similarly, interest rate policy was largely impotent: with easy movement between the Mexican and US financial markets attempts to bring down interest rates would have exacerbated external outflows of private money.

13. Fortunately, the Mexican story has a happy ending. With the substantial completion of both macroeconomic adjustment and a major part of the reforms of the policy and incentive framework for the private sector -- supported by the government's plans to reach a free trade agreement -- confidence and a secure long-term environment has been restored. Real interest rates fell sharply after the Brady deal helped set the seal on macroeconomic adjustment; since 1991 Mexico has enjoyed an investment boom, financed by both domestic savings and private foreign inflows (including reflow of flight capital). Adjustment took a long time because Mexico's macroeconomic and structural problems were so severe -- many times worse than the problems Korea faced in its temporary setback of 1979-80. Since a decline in investment helped moderate consumption declines in the transition (while the government put growth-oriented policies in place) it also made sense on welfare grounds.

14. Other countries illustrate the impotence of fiscal and monetary measures to promote private investment when macroeconomic and policy conditions are so problematic that investor confidence is lacking. Argentina pursued an active policy of investment promotion using credit at subsidized interest rates. While this policy may have raised the investment rate in the 1970s, when macroeconomic conditions worsened in the early 1980s they proved ineffective. When inflation took off, controlled interest rates became severely negative: investment subsidies kept growing as investment kept falling in response to recession and the heightened uncertainty of an inflationary environment. In the end the value of investment subsidies actually exceeded the value of private investment! In addition, after 1982-83 the government reverted to protectionism to manage the external accounts. Not only was low investment a problem, but this mix of policies helped channel highly subsidized money into highly protected and often severely inefficient activities.

15. In Africa, Zimbabwe managed to prevent its macroeconomic problems (notably a fiscal deficit over 10 percent of GDP) spilling over into external financing problems or domestic inflation through comprehensive controls on all foreign exchange flows. Consequently, interest rates could be kept close to zero in real terms. Zimbabwe also had a quite favorable tax regime for private investors: 100 percent expensing of new investment in equipment as well as scope for writing off the same spending twice because of additional tax allowances on interest. However, investment stayed depressed for much of the decade. Analysis shows other influences on the cost of capital were more important: import rationing caused the price of investment goods to shoot up

from already high levels, and uncertainty over the rules of the game for private investors led to a high risk premium on equity finance.[4]

16. Many other examples illustrate that severe macroeconomic distortions are high uncertainty render the use of fiscal incentives or subsidized interest rates ineffective in boosting private investment. Colombia, Nigeria, Turkey and Venezuela all attempted to allocate investment at controlled interest rates, but failed to secure an investment recovery. (The issue of directed credit is discussed further below). The overarching influence on private investment is a credible policy framework that is credible. Examples of credible policy action that paves the way for a recovery in private investment include Indonesia, Thailand and Malaysia (in addition to Korea) in East Asia and Costa Rica, Chile, Mauritius and Mexico in other Latin America and Africa.

17. Fiscal incentives and interest rate policy can, however, play an important role where economy-wide conditions are sound. A rational system of tax allowances for investment may be an appropriate long-run policy: the World Bank's 1988 World Development Report argued for fiscal incentives that achieved a low tax rate at the margin for investors (for example through tax allowances), while achieving an average tax rate consistent with the government's fiscal requirements. Interest rates also matter for investment. If however, they are either highly negative or highly positive they signal problems for private investors: highly negative rates are a sure sign that the macroeconomy and financial sector are in disarray, while highly positive rates directly raise the cost of capital. Many countries needing adjustment suffered highly negative interest rates and then suffered highly positive interest rates until the economy stabilized (see Figure 2 for Mexico and Turkey -- in Chile real rates actually reached 50 percent in 1982; in Africa Tanzania had negative real rates of around 20 percent in the mid-1980s, and Uganda negative real rates in excess of 100 percent. By contrast in Korea the real interest rate was less variable and generally moderately positive--Figure 2). As discussed below, excessively high real rates of interest sometimes occurs when financial liberalization proceeds too far ahead of macroeconomic correction and financial sector development.

18. As noted above, the "problem" of private investment is often worse in low income countries for two reasons. First, many of these countries suffered more severe distortions; and second, the private sector was historically more underdeveloped (a consequence of their stage of development and a relatively high degree of reliance on state involvement in production in many cases). The key lesson from middle income countries apply here with equal force: effective overall economic policy changes are a prerequisite for an investment recovery. There are signs of a private investment recovery in some of the adjusting countries: in Ghana private investment rose from 2 to 9 percent of GDP between 1986 and 1990 (Figure 1 (b)); in Malawi it rose from 2 to 8 percent in the same period; and in Tanzania it moved from around 10 percent in the early 1980s to 18 percent in 1990.

19. Country experiences suggest that sound macroeconomic policy and resolution of severe distortions through credible policy changes are necessary conditions for a private investment recovery. Where these are absent, fiscal incentives and attempts to control interest rates are usually futile, and may be counterproductive since they undermine fiscal adjustment. Rational investment incentives and policies to support moderately positive real interest rates may, however, form an important part of long-term policies toward private investment, especially when an economy has shifted back to fair weather conditions.

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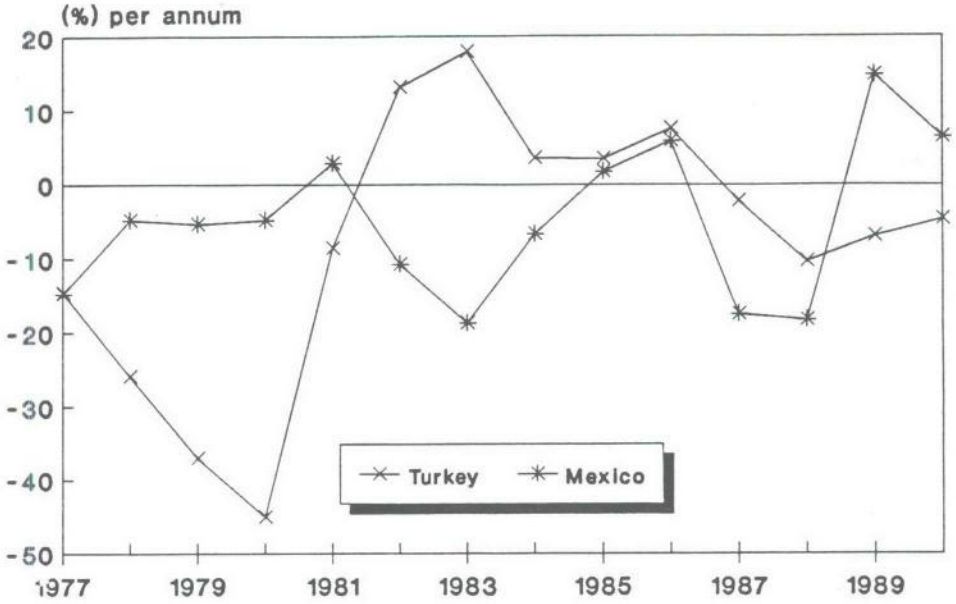
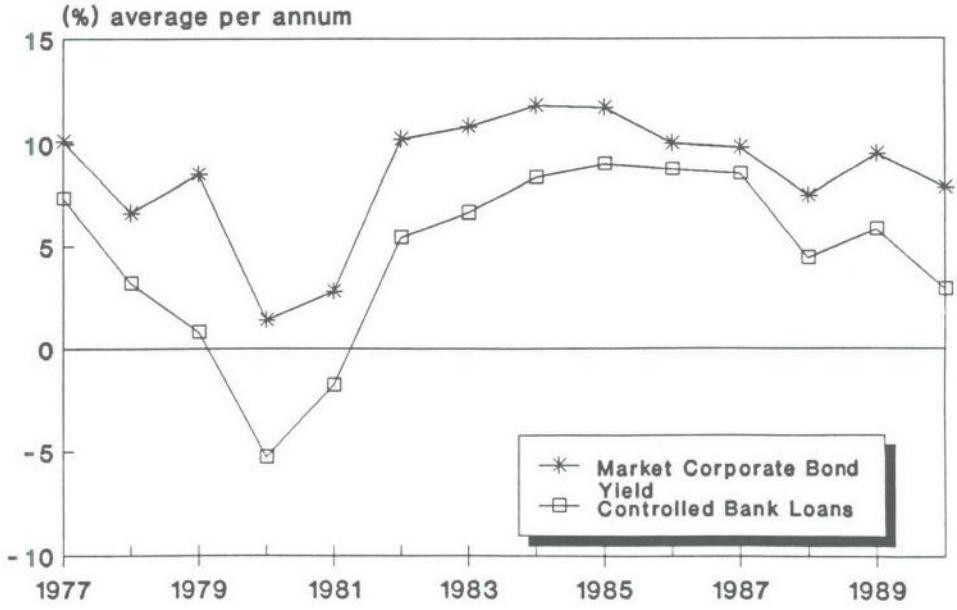
4 See World Bank, *Zimbabwe--Private Investment and Government Policy*, Report no. 7646-ZIM, 1989.

Figure 2: Real Interest Rates

(a) Mexico and Turkey



(b) Korea



Targeting protection and support for the private sector

20. Industrialization is central to the development process. Most countries have supported industrialization by taxing agriculture and providing protection for manufacturing, via import tariffs on domestically produced goods and the associated overvaluation of exchange rates (relative to a neutral trade regime). Most have also used quite differentiated degrees of protection, targeting activities considered to be of priority, and many have used import restrictions to provide very high effective levels of protection for domestic production. These policies, however, appear to have had sharply differing results in growth in industry and GDP: from stunning success in Korea to severe failure in Tanzania.

21. Differing initial conditions help explain differences in outcomes. In many East Asian countries differentiated protection appears not to have jeopardized growth and may well have provided a relatively secure domestic environment to nurture industrial and entrepreneurial capabilities. Successful countries enjoyed two characteristics:

- The maintenance of prudent macroeconomic policies.
- An emphasis on export production.

Korea clearly illustrates these conditions. Prudent macroeconomic policies were key to maintaining a stable, and probably slightly undervalued, exchange rate, thus avoiding severe biases toward the domestic market. Equally important was the export drive, that forced firms to participate in international markets, thereby imposing a performance standard on their production. Similarly in Japan high business performance standards were supported by strong internal competition. In both countries governments were active in picking strategic sectors for special support, and have achieved considerable success in developing strong export industries.

22. A major ingredient of the apparent success in managing resource allocation in these countries is the capabilities of the government. Japan and Korea can be characterized as having relatively autonomous governments with a clear developmental orientation, strong cohesive administrations with very little rent-seeking activities -- they are sometimes characterized as "hard" states.[5] The chosen development strategy emphasized performance standards and the governments had the independence and capability to impose these standards.

23. Where the state is less autonomous or has weaker administrative capabilities, as in Argentina, the Philippines or Tanzania, the consequences are completely different. Protection bolsters profits of inefficient activities and helps develop and sustain groups with a powerful interest in maintaining the status quo.

24. The problem is exacerbated where policies favor inward-oriented industrialization, since these policies tend to remove the performance guarantee provided by exporting. The net result is slower, not faster, industrial and aggregate growth and higher economic taxation of efficient activities (notably agriculture and exporting). Where inward-oriented policies are combined with poor macroeconomic management, the potential for foreign exchange and financial sector crises escalates rapidly, such as occurred in the Philippines in the mid-1980s.

25. Many African countries display extremes of resource misallocation resulting from a path of protected industrialization. Tanzania's industrialization drive led to the creation of industries that absorbed most

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5 See Tyler Biggs and Brian Levy, "Strategic Interventions and the Political Economy of Industrial Policy in Developing Countries", in Perkins, Dwight, and Michael Roemer, *Reforming Economic Systems in Developing Countries*, Harvard, 1991.

of the country's foreign exchange, often used in a grossly inefficient manner. Most firms, especially in the state-owned sector, only survived with high levels of protection, and many experienced negative value added at international prices. Rates of capacity utilization were extremely low. The parastatal Morogoro shoe factory was planned in the late 1970s (with World Bank support) as one of the largest shoe factories in the world with an 80 percent export orientation. Capacity utilization was running at 4 percent of rated capacity in the mid-1980s and it has never exported. Poor management, lack of training, poor product quality and equipment deterioration were symptomatic of the broader malaise of Tanzanian industry.

26. Since the mid-1980s the Tanzanian government has taken a series of steps to liberalize the Tanzanian trade regime: starting in 1984 with allowing own-funded imports, in 1988 the government began a gradual removal of quantitative controls on imports, and in 1989 reduce the range of tariff rates operating: from 18 categories ranging between 15 and 200 percent to four rates between 20 and 60 percent. Exchange rate movement and export retention schemes have supported this adjustment. These changes have been associated with a reversal of the fortunes of the industrial sector: manufacturing value added declined by 7 percent per annum between 1979-86 but rose by 5 percent per annum from 1986 to 1989. Firms identified as being relatively efficient in 1984 raised their output by 28 percent by 1989 while those that were inefficient reduced production by 22 percent.[6]

27. In Tanzania, as in many other countries, from Mexico to Indonesia, Bank staff have argued that trade liberalization would reduce the incentives for severe resource misallocation. However, this position has never been equated with a shift to free trade. Most liberalization programs have included gradual removal of quantitative restrictions, with a reduction in the level and dispersion of tariffs over many years -- as in Morocco or Indonesia. The longer time horizon grants temporary protection for adjusting industries during the transition. More recently, Latin American governments have moved more quickly: Mexico shifted from a protective system that had all domestic production protected by quantitative restrictions to moderate tariffs in about three years. In Eastern Europe some countries are themselves leading the way with more radical transitions than the Bank has supported elsewhere, often in response to the more severe distortions. It is too early to assess whether these measures will lead to excessive transitional costs.

28. In advising on the design of trade reform, Bank staff usually discuss the issues with the private sector, and the Bank is often a champion of efficient private sector business interests. Of course, private sector firms that stand to lose rents from protection will lobby for continued favored treatment. In the Philippines, the synthetic fibres industry benefited greatly from protection in the 1970s and early 1980s (and thus penalized downstream industries with their high cost products) and fiercely resisted the liberalization that was introduced in the mid-1980s. But private business often ends up pressuring for trade liberalization. In Zimbabwe, the Confederation of Zimbabwean Industries (that received completed protection for import competition through foreign exchange controls) came to be a supporter of a phased program of removal of quantitative restrictions over a five-year period. In Pakistan, Bank staff discussed alternative approaches with private sector representatives, and leaned toward gradual liberalization to allow time for adjustment. Private sector groups actually preferred a rapid Latin America-style shift to relatively even tariffs to get greater transparency and equality of treatment vis-a-vis the government. Both the Zimbabwean and Pakistani programs are being supported by adjsutment programs.

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6 See World Bank, *Tanzania: An Agenda for Industrial Recovery* Report no. 6357-TA, 1987 and *Tanzania: Economic Report, Towards Sustainable Development in the 1990s* Report no. 9352-TA, 1991.

29. Trade policy is only one aspect of industrial strategy. Bank staff working on the industrial sector also consider the domestic business and regulatory environment, the workings of factor markets, and the provision of financial and infrastructural services. Both adjustment and investment lending increasingly includes microeconomic interventions, for example in dismantling barriers to entry and exit, reforming investment codes, strengthening property rights, accounting standards and the legal framework for business activity. These measures are further supported by Bank lending to improve economic infrastructure, utilities and communications. The next section discusses finance.

Directed Credit and Financial Sector Reform

30. In the 1970s and early 1980s, the World Bank was a strong advocate of the use of development finance institutions to increase the availability of long-term credit to enterprises that had previously been excluded from traditional credit markets. As with the industrial sector, in many developing countries, particularly in Africa, the banking system was also largely foreign controlled. A handful of foreign banks established operations in these countries to finance trade and the operations of foreign investors. Most of the credit offered was short-term. DFIs were established with the blessing and financial backing of the World Bank throughout Latin America, Africa and South Asia to provide long-term credit and to serve the emerging indigenous entrepreneurs. With few exceptions, however, these institutions have failed miserably -- both in achieving their development objectives as well as in becoming financially self-sustaining institutions.

31. There are several reasons for the failure of the DFIs and, more generally, the failure of directed credit programs.[7] First, as long-term creditors, DFIs are more vulnerable to economic shocks than short-term lenders. As countries undergo adjustment and the inefficient firms begin to founder, the quality of the DFI portfolios usually declines more precipitously than that of the commercial banks. In countries where the distortions have been large, the failure rates in the DFI portfolios are enormous. Non-performing loans in the DFIs in Tanzania amount to over 95% of the portfolio. Investments which seemed to make sense financially with high levels of protection often turned out to be unviable once the protection was removed. This portfolio decline is particularly sharp for DFIs that either (i) lend to import substitution enterprises in highly protected sectors; (ii) lend to enterprises in foreign exchange; or (iii) have taken on a higher risk portfolio than the commercial banks (small enterprises, rural lending, highly concentrated portfolios). Many DFIs, especially in Africa, lack the skills to manage workouts for their troubled borrowers and thus sit back helplessly while their clients struggle in the new environment. The DFI in Rwanda, which has largely been conservatively managed, has been rocked by the current adjustment program. Most of its clients had been import-substitution firms, who can no longer compete with their overseas competitors. The DFI staff have little understanding of external markets and little experience restructuring failing companies. Consequently, non-performing loans now dominate the portfolio, the DFI faces a liquidity squeeze and there is little hope for a quick turn-around.

32. Similar problems occur in middle income countries that have suffered from macroeconomic problems and highly distorted incentive frameworks. A recent report by the Operations Evaluation Department found that six DFI

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7 In India and Bangladesh, for example, the government-owned commercial banks have been directed to finance "priority" sectors (agriculture, small industries, agroindustries), contributed substantially to the declining quality of their portfolios.

operations in Argentina, Costa Rica and Peru failed, largely because the overall environment for economic activity was so poor.[8]

33. Even in countries with less turbulent macroeconomic conditions, the DFIs have often fared poorly. The problems in these cases often lie in the lack of appropriate skills within the institutions and inappropriate pressure on the DFIs to lend to politically important projects and/or cronies and government officials. Government-owned DFIs have been particularly vulnerable to political pressures on their credit decisions and have had insufficient latitude to pursue delinquent debtors. Blame for DFI failures in many countries -- Kenya and the Philippines, for example -- lies at the feet of the government officials who directed credit to their friends and relatives. In Kenya, all of the DFIs have been used to channel funds to "influential" persons. The Industrial Development Bank, which had once been viewed as one of the premiere institutions in Africa, has been bankrupt and dormant for years. These institutions have been particularly vulnerable to abuse if they offer funds at subsidized rates. In addition, many DFIs have lacked the technical skills to put into place sound credit policies, portfolio management systems or adequate financial management. Government-owned DFIs, who are required to hire staff at civil servant salary levels, often have difficulty competing with private commercial banks for the "best and brightest."[9]

34. Finally, government-owned DFIs with access to cheap funds and little incentive for profit maximization also become complacent, much like their protected clients. When new private banks begin to open their doors in a country, or the existing commercial banks start to diversify their activities, the DFIs can often be left with only the least desirable clients. In India, the government-owned commercial banks and DFIs have lost some of their best clients to the capital markets and the intercorporate market. One of the DFIs in Botswana, the National Development Bank (NDB), had access to cheap and plentiful funds from the Government for many years. It focused its attention on agricultural lending -- a very high risk sector in drought-ridden Botswana. Loan collection efforts were lax, partially for political reasons, but also because the institution never faced liquidity constraints -- it could always get funds from the Government. As a result, NDB has one of the poorest portfolios in Africa and its operations are inefficient. Interestingly, another DFI in Botswana, the Botswana Development Corporation, has performed fairly well. It has significant private ownership, autonomous management and a much more diversified portfolio.

35. The Bank has found that access to credit, rather than the cost of credit, is much more important to the success of an enterprise.[10] Sadly, subsidized credit has usually been channelled to the influential rather than the needy in most developing countries. Those outside the system continue to pay usurious rates -- 60-100 percent per annum in real terms from moneylenders and suppliers in Pakistan for example. And if the subsidized credit is directed into the hands of unscrupulous people who have no intention of repaying, the interest rate charged doesn't matter. Moreover, the opportunity to recycle the money will also be lost because of the high default rates. In addition, directed credit programs that are diverted to the non-deserving also have an adverse impact on credit discipline of other entrepreneurs. If they

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8 See World Bank Operations Evaluation Department, Project Performance Audit Report on Six Latin American Industrial Credit and Small Scale Enterprise Projects. Report no. 9992, 1991.

9 Recruiting good staff becomes even more difficult if the institution is known to be corrupt.

10 Although in high inflation countries, with very high rates of interest, enterprises will take a toll if they have a heavy debt load. Again, the importance of achieving macroeconomic balance -- and reasonable real interest rates -- is key to the success of attracting and nurturing new investment.

see a "big man" get away with not paying, they begin to wonder why they should repay their loans. This ripple effect was seen most keenly in Kenya, in Kenya Industrial Estates. Non-defaulting "little" entrepreneurs saw the "big men" in the neighboring sheds get away with not paying their rent. Consequently, repayment rates began to decline across the board; the bad loans could no longer be confined to the politically-connected firms. In Pakistan, financial sector reforms (supported by the World Bank and the OECF[11]) that removed preferential treatment to the influential and cracked down on defaulters have been viewed as a championing the disadvantaged by small-scale entrepreneurs previously excluded by the system.

36. With small entrepreneurs, experience in Bangladesh and Indonesia has shown that they will pay market rates -- even higher -- if given access to credit. Most successful credit programs to small entrepreneurs, such as Grameen Bank in Bangladesh and KUPEDES in Indonesia, have had as guiding principles: lending at market rates (to discourage diversion of funds); loans in small amounts and for short maturities; thorough knowledge of the entrepreneur and assiduous followup. The administrative costs for these successful credit programs are very high -- often 15-20% of amounts outstanding. Indeed, if the government wishes to subsidize credit operations to ensure access to credit for groups that have traditionally been excluded, that subsidy is often best spent on providing extensive followup, training and support services to the entrepreneurs rather than lowering the cost of funds to the enterprise. In the long-term, subsidizing the provision of these services are more likely to improve the efficiency and profitability of these ventures than will the provision of cheap credit.

37. Given this poor record, the World Bank in recent years has re-oriented its approach to the financial sector, giving initial attention to re-establishing macroeconomic stability and improving the overall policy and institutional framework for finance. Financial sector adjustment programs usually cover a broad array of reforms, including banking regulation and supervision, the development of equity and capital markets (often a greater constraint to new investment than access to credit), money market development and bank restructuring.[12] The Bank recognizes also that financial sector reforms -- particularly where distortions are significant and/or financial institutions deeply distressed -- require a long time horizon, careful coordination with fiscal policy and important improvements in the technical capacity (accounting, financial management, legal) within the country. Indeed, the recently revised Operational Directive for Financial Sector Operations acknowledges the need in some countries to proceed carefully with financial liberalization: stable macroeconomic conditions and the development of a sound regulatory and legal framework are critical to the eventual development of market-based financial systems.

38. Financing of investment, however, remains an important objective and is supported through financial intermediary loans (FILs). These loans are often open to a broad array of financial institutions (including DFIs, if they meet the financial performance criteria). As countries implement financial sector reforms, they often also need investment finance. Programs are now under preparation in Morocco, Tunisia and Indonesia to support and supplement adjustment lending with FILs. In recent years, FILs have begun to fund a broader range of activities, including working capital finance, the restructuring of industrial enterprises, the provision of equity capital, funding for research and development, etc. The guiding principles embodied in the Bank's current approach to financial intermediary lending are to ensure

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11 See World Bank, President's Report on a Proposed Financial Sector Adjustment Loan to the Islamic Republic of Pakistan, March 1989.

12 See World Bank, Country Economics Department, Financial Sector Adjustment Lending: A Preliminary Assessment of the Bank's Experience, mimeo, 1991.

that loans go through sound intermediaries and that these institutions have sufficient autonomy and latitude to make credit decisions on a sound, commercial basis. Staff are devoting much time to the restructuring of financial institutions and providing technical assistance to selected institutions to ensure that they can carry out this role. In addition, the Bank continues to support targeted credit programs in selected countries and sectors (often rural finance, women, small enterprises). Bank staff work closely with government officials to ensure that these targeted programs are limited in scale and time; keep interest rate subsidies to a minimum to discourage abuse; and utilize private as well as public sector institutions (often involving non-government organizations at the "grass roots" level in the identification and followup of beneficiaries).

Privatization

39. The OECF paper suggests that privatization may not be an option where the indigenous private sector is underdeveloped, and where political concerns over the role of foreign and non-indigenous capital are important. The World Bank, like the OECF, has also found that the initial depth and institutional state of the private sector will have a powerful influence on the design of privatization.[13] The options are very different in Mexico, Poland and Mozambique. Moreover, in many countries (especially formerly socialist ones), even effective and rapid privatization will leave an important range of large-scale enterprises in state hands for lengthy transition periods. Measures to improve their efficiency through better public management and commercialization are also necessary. Finally, privatization does not take place in a political vacuum. It is important to explicitly face the political consequences of alternative policy options, whether the concern is with Chinese capital in Indonesia, the ex-nomenklatura in Czechoslovakia or foreign capital in Zimbabwe.

40. These factors, however, do not necessarily justify a "go slow" approach in cases where public enterprises form part of the general malaise of slow growth and macroeconomic disequilibrium. Privatization may be easiest in middle income Latin American or Asian countries, but is often most needed in low income Africa and in formerly socialist Europe and Central Asia.

41. Conditions for privatization are most favorable where markets are well developed. For firms producing potentially competitive products, ensuring market conditions are actually competitive, ease of entry and exit and a reasonable degree of openness to foreign competition are key. With natural monopolies, a sound regulatory framework is necessary to prevent abuse of monopolistic advantage. There is growing evidence that privatization brings gains in both cases. A recent Bank study of 12 privatized firms in Chile, Mexico, Malaysia and the UK found significant gains in 10. Productivity rose in eight and remained constant in the other four; many enjoyed increased investment; labor benefitted in nine cases (though in some cases there were layoffs with compensation); and consumers gained in nine. These gains occurred in both competitive and monopolistic infrastructural companies. Evidence from other studies is also supportive of such gains.

42. In countries with limited markets and thin private sectors, privatization can be more difficult. In many low income African countries, the absence of a private sector was one of the reasons for state investments in productive activities in the first place. In Eastern Europe -- and even more so in the CIS -- there were virtually no private firms in the large-scale sector and no market institutions. However these cases often represent the most inefficient cases of resource use in state enterprises. The squandering

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13 The World Bank has recently prepared a paper, *Privatization -- Lessons of Experience*, that is being discussed by the Board in April 1992.

of scarce domestic and foreign resources and the burden on budgets constitutes a major drag on development (and so on poverty reduction) from Tanzania to Poland. In Eastern Europe governments also consider it imperative to create an entrepreneurial, property-owning class if the gains from the transition to a market economy are to be achieved and locked in.

43. In these cases, different techniques for privatization will be needed from those available in middle income market economies. Foreign capital often has to play a larger role where domestic capital is weak, but need not always be dominant -- as with the recent successful privatization of the Niger Textile Company. Intermediate solutions, such as private management services, will sometimes be a desirable alternative in poor African countries. And mechanisms for rapid privatization, for example through the use of vouchers in Czechoslovakia and activist mutual funds in Poland, are being explored in Eastern Europe. These measures should go hand in hand with the development of corporate governance, both for public firms in the transition to privatization (that may be many years for some) and for newly privatized firms. Where state enterprises are hopelessly inefficient, liquidation is often best for development.

44. The track record on privatization in countries with weak market development is more limited than in the better-developed market economies. The potential conflicts raised by the OECF paper may be more acute, especially where the indigenous private sector is small. There are many cases in which non-indigenous or foreign capitalists dominate the larger scale private sector -- notably Indians in East Africa, whites in Zimbabwe and Lebanese in West Africa. Promoting advancement of the indigenous population is well justified on equity and political grounds, but the means used should take account of the tradeoffs. Attempts to reduce reliance on non-indigenous or foreign entrepreneurs through dependence on the public sector have usually failed miserably. In the short run, many African countries will face a choice between slower growth and continued reliance on non-indigenous and foreign capital, within a more liberal investment environment. Governments can more effectively help the indigenous population through investing heavily in their human capital and providing the environment for the development of indigenous entrepreneurship. This is often a long haul, but it will a much more difficult haul if the enterprise sector is a drag on the economy rather than a source of growth.

45. Success under these conditions is illustrated by Malaysia and Indonesia, where ethnic Chinese have formed a major part of the domestic entrepreneurial class. Tensions have been severe at times in both countries, but for the last two or more decades the governments have managed to maintain an environment in which the entrepreneurial sector has flourished while also promoting (especially in Malaysia) the development of indigenous capital. These governments have succeeded in providing the conditions for steady, poverty-reducing growth, and the resources for broad, redistributive investments in human capital. In Malaysia, where the tradeoffs clearly worked, the government is now actively phasing out selective credit, and has achieved better income and wealth distribution through privatization.

46. While some of the tradeoffs are unavoidably acute, design choices can help improve the prospects of success and deal with distributional and political concerns. Transparency in transactions is essential and information campaigns can be useful. Workers are usually heavily involved in negotiations. Deals can be designed to offer shares at favorable prices to workers or particular ethnic groups. Governments can maintain a golden share that gives some power over strategic decisions, but hand over control and management to the private sector.

Conclusion

47. Common to all of these issues is one question -- to what extent should the government provide a guiding hand to industrial development? In the 1970s and 1980s, the World Bank, in conjunction with many of its borrowers, was more inclined to accord the government a strong role in industrial development. The Bank supported the establishment of DFIs, funded state-owned enterprises and at times tacitly agreed that newly-developing industries needed trade protection. Experience, however, has led to changes in Bank thinking. It appears that many developing countries do not have the technical capacity to select "winners", impose performance standards or manage state enterprises efficiently. While, Japan and Korea appear to have had this capacity, but even here it is important to assess the costs of intervention (for example there is evidence that cheap, directed credit increased investment by firms in speculative assets in Korea in the 1980s[14]) and ask what would have happened in the absence of such intervention. In weaker states, the temptation to use industrial and financial policies as a political rewards system has often proven to be overwhelmingly strong, thus undermining the potential effectiveness of selective promotion activities. Consequently, it appears that for most developing countries, relying on imperfect markets -- rather than imperfect governments -- has the greater chance for promoting sustainable growth. Governments can be better utilized in assuring economic and political stability, providing the legal and regulatory framework for sound financial sector development, providing infrastructure, and ensuring that the next generation of entrepreneurs are adequately educated and trained. For most governments, these tasks pose a sufficiently large challenge in themselves.

48. There are, however, certainly outstanding issues in the design of adjustment policy and its link to the broader development process. The OECF's note has raised some valuable issues over the role of government. A potentially fruitful area of research is to seek to identify the government interventions at a micro level that are compatible with a realistic assessment of government capabilities. These interventions should be designed to build private capabilities whilst avoiding the costs of abuse. The planned study on the East Asian Miracle will both examine the role of an activist industrial policy in achieving rapid growth in East Asia, and assess what can and cannot be applied to other countries. The World Bank looks forward to further dialogue on this question and on other outstanding issues in adjustment and development policy.

April 3, 1992

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14 See Mansoor Dailami and E. Han Kim, "The Effect of Debt Subsidies on Corporate Investment Behavior", PRE Working paper, 1991, World Bank.

OECF OCCASIONAL PAPER NO. 1

ISSUES RELATED TO THE WORLD BANK'S APPROACH TO STRUCTURAL ADJUSTMENT

– PROPOSAL FROM A MAJOR PARTNER

OCTOBER 1991

THE OVERSEAS ECONOMIC COOPERATION FUND

ISSUES RELATED TO THE WORLD BANK'S APPROACH TO STRUCTURAL ADJUSTMENT

– PROPOSAL FROM A MAJOR PARTNER

1. Objectives

This paper discusses problems related to the World Bank's approach to structural adjustment, and proposes some ideas to solve these problems, based on the experiences of the OECF as a major partner in the structural adjustment lendings of the Bank.

The OECF has, since the mid-1980's , been in collaboration with the Bank in structural adjustment lendings. Cumulative amount of OECF financing of this type reached ¥450 billion as of the end of September 1991 (on a commitment basis).

2. Basic Idea on Structural Adjustment in This Paper

Structural adjustment policy is a medium term micro-economic policy that supplements the stabilization policy which itself is a short-term macro-economic policy. Structural adjustment policy aims at improving the efficiency of resource allocation through reforms of systems and

procedures. It is expected that the implementation of these policies will lead to a recovery of economic growth and to sustainable growth.

Structural adjustment lending is defined as a "quick-disbursing" loan in order to improve international balance of payments positions of developing countries, and to support structural adjustment policies implemented in developing countries, which are aiming at achieving sustainable growth.

In many developing countries, economic activities are excessively restricted. At the same time, in many developing countries, international balance of payments are deteriorating due to various reasons including heavy burden of debt repayment. Under the circumstances, structural adjustment lending can be considered to be one of the promising options for assisting developing countries. Structural adjustment lending is considered to have produced some positive results in many countries.

At the same time, there is still much room for improvement in structural adjustment lending as far as its content and the ways of implementation are concerned. The World Bank seems to be aware of these points, as various issues are discussed in the report of "Adjustment Lending Policies for Sustainable Growth", which was published by the Bank in 1990. However, we believe that there are

many other important points which are not taken up in the above mentioned report. This paper takes up four of these major points.

There is one common viewpoint among them. It is as follows:

It is fully recognized that efficient resource allocation through the market mechanism is an important issue of economic policy. However, when we make up economic reform program, various factors other than efficiency must also be taken into account. If efficiency of resource allocation is stressed too much without giving due consideration to these other factors, the program will not be a properly balanced one. This can lessen the significance of introducing the market mechanism itself. Therefore, a well-balanced program pursuing more than just economic efficiency is required. Furthermore, efficiency must be considered from long-term viewpoint.

3. The Issues Taken Up in This Paper

This paper does not intend to discuss all of the problems of the World Bank's approach to structural adjustment. The paper instead takes up four specific points that seem to have been overlooked by the Bank. The four points are as follows:

(a) What kind of steps are necessary to attain sustainable growth after the completion of structural adjustment? In other words, the impetus for sustained growth can be created by structural adjustment alone? If not, isn't it necessary to introduce some additional measures for investment promotion?

(b) If imports are liberalized too quickly, is it possible to develop industries, which will play leading roles in the next stage of economic development? If not, isn't it necessary to protect the domestic industry to some extent for a certain period of time in order to allow a viable export industry to develop?

(c) We are afraid that the financial sector policy of the Bank is too much stressing market mechanism. Isn't it indispensable to have development finance institutions lendings with subsidized interest rate, under some circumstances, in order to maximize the social welfare?

(d) Is privatization being carried out only when adequate conditions are found? Is the privatization program taking into consideration other important aspects than economic efficiency?

4. Policies for Attaining Sustainable Growth

The World Bank's approach toward structural adjustment seems to be based on the assumption that introducing market mechanism and eliminating the restrictions placed on private sector will lead to an improvement in the investment climate and stimulate economic activities, and finally will create the necessary conditions for sustainable growth.

Structural adjustments, including deregulation, no doubt have a favorable impact on economic activities. But will these adjustments by themselves have sufficient impact to generate sustainable growth? It is possible in an economy with strong potentiality of investment. But, in many developing countries, improvement of the investment climate through deregulation is not sufficient to cause the big wave of investment. For instance, in the Sub-Saharan countries, it would be hard to find a lot of entrepreneurs to create the anticipated wave of investment. Also, in many other countries, we find fundamentally similar situation.

In case the World Bank's strategy of "from structural adjustment to sustainable growth" is not workable, what kind of additional measures will be required? These should be a measure aiming "directly" at promoting investment. In this respect, Japanese fiscal and monetary policies in the post-war era may be worthy of consideration. These

were centered on preferential tax treatment and development finance institutions lendings. We must, however, be cautious, because the experience of one country cannot be easily applied to other countries. Modification should be made carefully taking into consideration the conditions of the specific country to be applied. It may also be necessary to implement for certain period only.

However, if any other suitable policy measures cannot be found, we would recommend to reconsider the investment promotion measures adopted in Japan in the post-war era.

5. Balance Between Trade Liberalization and Industrial Development

Trade liberalization is one of the important components of the structural adjustment programs of the World Bank. The importance of trade liberalization can be fully recognized as in many developing countries, international trade is excessively curbed, causing serious inefficiency. However, it should be admitted that excessive reliance on trade liberalization is also risky; if trade is deregulated too hastily, it tends to cause heavy costs.

When we argue that trade liberalization leads to the optimum allocation of resources, it means optimum allocation under the existing industrial

structures and technological levels of various countries. In this case, the comparative advantage of each country is a static advantage; and the comparative advantage of developing countries tends to be found mainly in primary products and light industry of low value-added. It is however natural that most of developing countries try to transform their industrial structures toward the industries of higher value-added, higher growth potential and higher technology. From the standpoint of developing countries, this shift of pursuing dynamic comparative advantage is also indispensable for the long-term improvement of the people's standard of living. This means that sticking to simple trade liberalization based on static comparative advantage may have a negative impact on the possibility of economic development.

When we consider trade liberalization, we must maintain the long-term view point, that is how to develop industries. It is too optimistic to expect that industries to sustain the economy of the next generation well come up automatically through the activities of the private sector. Some measures for fostering industry are required. As pointed out from time to time, industrial policy was adopted as a central measure in the economic development strategies in East Asia. On the other hand, while the World Bank is aware of the importance of export industries and supporting outward oriented development strategies, its structural adjustment approach seems to lack the long-term viewpoint of how to develop such industries, perhaps because it assumes that activities of

private sector will attain this goal. This lack is very regrettable.

Industrial development needs certain period of time and certain amount of social set-up-cost. Therefore, protection for a certain period of time is indispensable (argument of infant industries). At the same time, it should be noted that protection is often accompanied by harmful effects. Measures must be taken to prevent such harmful effects as far as possible. These include: (1) Identification of those industries which will have leading roles in the future, (2) the minimum level of necessary protection, (3) specific actions, in accordance with GATT, and the period of minimum requirement. In this respect, we wish to propose the idea of "Policy Dialogue on Industrial Development", to be done among donors and each developing country. In this dialogue, it is particularly important to identify promising products, for each specific developing country and the means of marketing as well as sales promotion in international market. The opinion of the private sector in the developed countries can be of particular help in this respect.

6. Significance of Development Finance Institutions Lendings and Subsidized Interest Rates

Financial sector is expected to play the central role in spreading market mechanism in developing economies. Therefore, the financial sector

takes an important position in the World Bank's approach toward structural adjustment. This is quite understandable.

The problem, however, lies with placing too much emphasis on the importance of market mechanism in financial sector reform. As a result, some of the roles of financial sector of developing economies seem to have been overlooked. A typical example is the discussion on interest rates. It seems that the significance of development finance institutions lendings with subsidized interest rates under certain conditions have been overlooked. In this respect, the World Bank has criticized "two-step loans" of the OECF, from time to time.

Note :

For example, the World Bank raised an objection to the OECF over the scheme of the ASEAN-Japan Development Fund (AJDF) in the Philippines. The basic points of the World Bank were as follows:

(1) AJDF is to provide long-term credit with interest rates below the prevailing market rate.

(2) This will have a negative impact on the development of the financial market and will serve to hamper the objectives of the Financial Sector Adjustment Loan (FSAL) which is being co-financed by the World Bank and the OECF.

As a result of the discussions between the World Bank and the OECF, it was agreed that the interest rate for small-to-medium scale industries under AJDF would be set at a level 2% below the 6-month time deposit interest rate.

Among various issues related to financial sector, we would like to focus our attention on the matter of subsidized interest rate. The following three points are to be raised for discussion.

(a) Since financial sectors are under-developed in developing countries, and financial institutions are not capable and experienced enough, market mechanism cannot fully function.

(b) As there are inherent limits of market mechanism itself, market mechanism cannot handle various issues properly. Government intervention in these areas, as a result, is indispensable.

(c) ODA has some aspects to distort market mechanism. Therefore, it is not appropriate to criticize "two-step loans" only, because of its market distortion.

(1) Financial Sector in Developing Countries

Needless to say, assuming that the condition of the financial sector in developing countries is similar to that of developed countries is not appropriate. In the case of LLDC, especially, financial sectors are still in the primary stage, and interest rates do not produce the desired results. In such cases, it is not proper to discuss the differences between market interest rate and subsidized interest rate. Even in

ordinary developing countries, financial sector does not function as expected, as the capability and experience of financial institutions is limited. As a result, the role played by market interest rate in promoting the efficiency of resource allocation is much more limited than in developed countries. Under the circumstances, it is indispensable to overcome the limit of market interest rate through government intervention.

(2) Limit of Market Mechanism

It is impossible to achieve optimum allocation of resources solely through market principle regardless of the level of development. There are many areas which cannot be handled by market mechanism ("market failure"), and government intervention is necessary to cope with such situations. Where market interest rate can not handle some problem, the introduction of subsidized interest rate, becomes indispensable. For instance, whenever some activities which are beneficial to society are not initiated due to the lack of incentives, it becomes necessary to provide additional incentives through subsidized interest rate. Introduction of subsidized interest rate can induce the desired activity, thus improving the welfare of society.

Some examples are listed below:

1) When the investment risk is too high regarding a particular activity

which is beneficial to society, subsidized interest rate will lessen the cost, and promote investment.

(Example)

(a) Case of scale merit

(b) Case of long gestation period

(c) Case of risks associated with technology and market development

2) When there is a significant discrepancy between private and social benefits ("externality"), subsidized interest rate is expected to increase private benefits and spur investment.

(Example)

(a) Case of rural industry: social benefits of increasing job opportunities in rural areas and preventing over-concentration in urban regions.

(b) Case of supporting industry or parts industry: social benefits of increasing added-value within the country, and thus strengthening

the basis of international balance of payments.

(c) Case of Investment for pollution control and environment protection

3) The case of imperfectness of information

(Example)

(a) Small-to medium-scale industries and venture business

4) The case to cover the social set-up costs of infant industries

We understand that the World Bank accepts subsidies for such market failures. In other words, while subsidies are permitted, subsidized interest rates are not allowed. We wonder whether there is any theoretical background for this argument. From theoretical and practical viewpoints, we believe both of subsidies and subsidized interest rates are useful tools. From practical viewpoint, in some cases, subsidies may have certain advantages; in certain cases subsidized interest rates may well achieve the desired goals. Therefore, a flexible manner to fully utilize the two options is the most important.

(3) ODA and the Distortion of Market Mechanism

ODA is supposed to deal with the cases of market failure. While in certain cases it tends to distort market mechanism, usually, this issue is not discussed. It is taken up only in the case of on-lending operations such as "two-step loans" of the OECF. We wonder why. If one is to criticize "two-step loans" of the OECF, then one should review if other type of ODA has no effect of market distortion.

In both cases of "two-step loans" as well as ordinary project loans, the developing country enjoy the benefit of getting funds with soft terms. This merit can trickle down through the recipient economy.

The benefit of concessionality is passed on to the "end user" (such as farmers) in the case of "two-step loans" of the OECF. In the case of project financing of the OECF, for a fertilizer plant, for example, the fertilizer price for farmers could be lower than other cases due to the low interest rate of the fund. While one is criticized, the other is not. We wonder why.

The World Bank often points out that subsidized interest rate tend to cause corruption. It is true that corruption is found in the financial sector of developing countries. But is this unique to subsidized interest rate? Can this problem be wiped out if subsidized interest rate is eliminated?

What is important, in our opinion, is to check at the time of appraisal whether there is the possibility of excessive inefficiency and unfairness due to subsidized interest rate. Assistance should be granted only if it is expected that such problems will not be so serious. When the disciplines of financial sector are in doubt, "two-step loans" type assistance will not realize desired results, regardless of the level of interest rate.

In conclusion, we would like to propose to utilize development finance institution lendings with subsidized interest rate in various cases above mentioned.

7. Points to be Noted With Respect to Privatization

Promotion of private sector is one of the important points in the World Bank's approach to structural adjustment. This is quite agreeable, as the essence of economic development is creativity of entrepreneurs and their investment. Privatization is of major significance, since many developing countries have large, inefficient public firms.

However, we wonder whether privatization is always the solution for improving efficiency of public sector. Various conditions in individual countries must be taken into account very carefully. Unfortunately, the

World Bank's approach seems to be almost similar for every country.

For instance, in Sub-Saharan Africa, indigenous private sector is very much underdeveloped. But the World Bank has promoted privatization in many countries in this region.

Another problem is the idea that all the private sector is to be treated equally, whether it be indigenous or foreign. This may be ideal from the standpoint of efficiency. However, the political and social realities in developing countries do not allow this, in many cases.

Most of developing countries have had bitter experience of colonialism. The idea to transfer the basic industries to foreign capital is a serious political and social issue in view of their history. Moreover, even from an economic standpoint, we must also consider that monopoly of foreign capital will lead to the repatriation of rents. The same argument can be made regarding non-indigenous capital (Indian capital in East Africa, Chinese capital in Malaysia and Indonesia).

It is necessary to adopt various factors other than efficiency as the criteria for decision making when considering privatization.

8. Beyond "the Decade of Efficiency"

Although efficiency and fairness are the major objectives to be pursued in economic policy, there is sometimes trade off between the two. In the 1980s, economic theory as well as economic policy were heavily oriented toward the pursuit of efficiency. In this sense, it was an unique period. However, this period has come to an end. What is now needed is a policy well balanced between efficiency and fairness, in order to improve the welfare of the entire society.

The World Bank's approach to structural adjustment may have to be changed reflecting the change of streams.

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cc: J S

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: March 13, 1992

TO: Mr. Attila Karaosmanoglu, EXC

FROM: Lawrence H. Summers LS

EXTENSION: 33774

SUBJECT: **Response to the OECF Critique of Adjustment Lending**

I attach for your review a draft response to the OECF's Occasional Paper No.1, that criticizes the design of adjustment lending. I discussed the issues with the OECF on my visit to Japan late last year. This is intended to serve both as the Bank's response to the OECF and as a document that should be useful to regional managers in their dialogue with Japanese official agencies. Note that we suggest attaching the review on Financial Sector Adjustment Lending to provide more detail on actual practice, but this is not necessary to the argument.

I also include the original paper from the OECF.

cc Messrs Linn, Grilli, Rao
Ms. Birdsall

Atts/

Reaction to OECF Occasional Paper No.1 on the World Bank's Approach to Structural Adjustment

1. The OECF's Occasional Paper No. 1 argues that structural adjustment programs should include a range of selective government interventions to promote investment and industrialization. It also argues for a pragmatic approach to privatization that takes local political realities into account. Part of the basis of this conclusion is that selective interventions and an activist industrial strategy has been an important part of the historical success of countries such as Japan and Korea.

2. The World Bank welcomes this constructive exchange of views. There is both common ground and differences of view. There is no disagreement between the World Bank and the OECF on the need for macroeconomic stability and the promotion of efficient resource allocation through encouraging the development of markets, reducing severe distortions and institutional development. It is also clear that there is much to be learnt from the experience of the East Asian economies, from their success in achieving rapid long-run growth and in their effective response to the shocks of the 1980s. The Bank plans to undertake a major research study on the "East Asian Miracle" in the coming year, with support from the Japanese Government and collaboration with Japanese and other East Asian scholars. This will assess the sources of success within East Asia and address the question of what can and cannot be replicated to the different institutional conditions of developing countries in other parts of the world. In addition, a major study of the Effectiveness of Credit Policies in East Asia will be undertaken in collaboration with the Japan Development Bank.

3. However, there clearly remain differences in view as to whether activist industrial strategy is desirable in the context of adjustment programs. The OECF argues for selective subsidies for investment and leading sectors to promote overall and industrial growth, through instruments such as protected product markets and directed subsidized credit. This is in contrast to World Bank thinking and Bank-supported adjustment programs, the main objective of which is a shift toward an undistorted and reasonably neutral system of incentives--both across sectors and within the industrial sector--supported by a sound, market-based financial system and a well-defined regulatory framework for private production. Sectorally targeted protection, directed credit, and production of competitive goods by state enterprises, are usually only considered to be acceptable in the transition.

4. The World Bank's position is based on the following considerations:

- The difference between success in fast-growing East Asian economies and problems in Latin American, African and South Asian economies does not lie in the avoidance of selective industrial policies in the latter group. Most have pursued such policies. The difference lies rather in macroeconomic mismanagement, public and private sector resource misallocation and, for some,

relative neglect of human and physical infrastructure.

• Selective industrial policy may well have helped raise both industrial and aggregate growth in the political and economic conditions of the East Asian successes, but there are major, unanswered questions on whether it can be replicated. The most difficult areas of replication lie in the correct choice of projects, sound management and monitoring of policy implementation, and timely exit from cases of "losers". Attempts to do so in "softer" states have often led to increased corruption and rent-seeking behavior with increased inefficient investment and macro-economic distortions. Government failure clearly outweighed market failure.

• There is hard evidence on the failure of directed credit in the circumstances of adjusting countries from Argentina to the Philippines in the dismal record of many Development Finance Institutions (often Bank-supported), especially in the adverse macroeconomic conditions of the 1980s. In fact, lessening intervention in credit decisions in the 1980s led to more credit flowing to smaller firms in Indonesia and Korea.

• Slow recovery in private investment is undoubtedly a concern in adjusting countries. However, there is no evidence that special subsidies is a way around the problem: the most important sources of depressed investment are uncertainty over the policy environment and, in some cases, a poor business environment. The cost of capital is sometimes a factor, especially where fiscal laxity and uncertainty is a source of high interest rates, but this problem is best tackled at its root, not via compensating subsidies. In the Bank's experience, access to finance has been a more importance constraint on investment than its cost.

• Most of the countries that are succeeding in pulling out of a macroeconomic crisis through effective adjustment programs changed their policy stance away from selective industrial strategy--including cases ranging from Indonesia in Asia, Ghana in Africa to Mexico in Latin America.

5. Adjustment policy needs to focus on those areas that lay behind adjustment difficulties--macroeconomic mismanagement, severely skewed incentives in product and factor markets, public sector inefficiencies, weak financial systems and, in some cases, neglect of spending on human and physical infrastructure. This is not a laissez-faire policy, and there is no question that government needs to play an activist role: in provision of economic and social infrastructure, in reaching the poor and in tackling situations of market failure, notably in certain kinds of environmental problem. But the evidence from past experience in now-adjusting countries is that the use of selective industrial policy is an ineffective and counterproductive technique both in raising investment and pulling an economy out of macroeconomic difficulties.

6. In fair weather conditions and in countries with strong administrative capabilities things may be different: there may be more scope for a government industrial policy that is proactive rather than essentially obstacle-removing. This is an important issue for future study, and will be one of the focuses of the East Asian Miracle study.

7. There are few differences of principle on privatization. The Bank fully

sector investment often reflect mistrust of government intervention, especially where directed credits favor public enterprises and crowd out private sector initiatives.

13. Mexico and Chile also illustrate how countries can pull out of a situation of depressed investment. Mexico is now having to manage large capital inflows, that are going to finance, at least in part, rapid investment growth. In Chile, private investment has been booming since the late 1980s. Both reached this point through effective macroeconomic adjustment--that involved tight monetary policies, backed by radical fiscal adjustment. Microeconomic reform, to ensure easy entry for private firms and a supportive business environment, was also important, but special incentives for investment were not. Substantial growth in the aggregate volume of credit available to the private sector was a supportive factor in these and other cases[1], but this was achieved by macroeconomic and fiscal adjustment and not credit channelling.

14. Getting an investment recovery is often a problem in adjusting countries. However, there is no evidence that special incentives help, while there is evidence that effective macroeconomic and microeconomic reform can cause an investment take-off, if with a lag. In fair-weather conditions of a stable macroeconomy and steady growth, the story may be different, and tax allowances for capital investment will often be appropriate[2], but that has little relevance to the problems of Peru and Ghana in the early 1990s.

Targeted protection and directed credit

15. The difference of views in these two areas is based on a common question: the OECF view that industrialization can be accelerated through focused support to selected activities, or leading sectors, through targeted protection from foreign competition and government-mandated support, of which directed, subsidized credit is a major form.

16. The strongest argument against this in most circumstances is that it has been tried in many now-adjusting countries, and has had high costs--and substantially higher costs than in the East Asian successes. Protection and directed credit may have contributed to rapid and reasonably efficient industrialization in Korea, but was a dismal failure in the Philippines. The core of the explanation lies in the combination of governance and the types of other policies being pursued. Japan and Korea can be characterized as having relatively autonomous governments with a clear developmental orientation, strong cohesive administrations with very little rent-seeking activities--

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[1] Empirical work suggests that the volume as well as the price of credit (i.e. the interest rate) influences private investment.

[2] See, for example, the discussion in the 1988 World Development Report, of the case for investment allowances that aim for a low, or zero, effective tax rate at the margin, but without discriminating across sectors.

"hard" states.[3] The chosen development strategy put a strong emphasis on performance standards--through export targets in Korea, for example--and the governments had the independence and capability to impose these standards. As noted above, they also pursued prudent macroeconomic policies

17. Where the state is less autonomous or has weaker administrative capabilities, as in Argentina, the Philippines or Tanzania, the consequences are completely different. Protection and subsidized credit bolsters profits of inefficient activities and helps develop and sustain groups with a powerful interest in maintaining the status quo.

18. The problem is exacerbated where the strategic choice is in favor of inward-oriented industrialization, since this further weakens the likelihood that exporting will provide some performance guarantee. The net result is slower, and not faster, industrial and aggregate growth and economic taxation of efficient activities (notably agriculture and exporting). Where it is combined with poor macroeconomic management, there are the ingredients for the type of foreign exchange and financial sector crisis that the Philippines went through in the mid-1980s.

19. African countries display extremes of resource misallocation from a path of protected industrialization. Tanzania's industries in the mid-1980s took most of the countries foreign exchange, but turned it into final goods in a grossly inefficient manner, with a significant proportion of negative valued added activities. As some protection has been lifted with the partial liberalization of the late 1980s, the locus of resource misallocation has shifted to the financial sector, with the state bank channelling credit to prop up inefficient, often state-owned activities.

20. The Tanzania case (around 1990) was a particularly perverse form of (passive) directed credit to inefficient activities, but the Bank's own experience with Development Finance Institutions provides a body of evidence: those countries that ran into serious adjustment difficulties also largely channeled resources to inefficient activities, that became loss-making either in the macroeconomic crisis, or as a consequence of the trade reforms that became necessary to tackle distortions in the product market. The Philippines, for example, has had some disastrous DFIs, and a recent OED report on six projects in Latin America found a dismal performance in Argentina, Peru and Costa Rica.[4]

21. With respect to the financial sector, it is often argued for Korea that financial sector development lagged the development of other parts of the economy. Directed credit contributed to this: to the extent it also raised the growth rate there was a tradeoff. However, in countries where such subsidies were growth-reducing rather than (possible) growth-increasing, there

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[3] See Levy and Biggs, "Strategic Intervention and the Political Economy of Industrial Policy", for a discussion of the sources of East Asian success.

[4] See OED Project Performance Audit Report on Six Latin American Industrial Credit and Small Scale Enterprise Projects (1991).

were only costs. These include a range of distortionary effects, including encouraging debt over equity, excessive capital-intensity[5], weakened incentives for debt recovery, sharpened financial sector dualism and incentives to corruption. The scale of costs were heightened when subsidized credit combined with protected product markets. Even in Korea, empirical evidence shows that subsidized credit tended to increase firms' investment in speculative assets.[6]

22. In extreme cases--such as in India--directed credit to finance government, generally inefficient state enterprises and better-off farmers (such favored activities account for 80 percent of the banks portfolio) has led to a squeeze on the private industrial and service sectors, that is potentially the most dynamic part of the economy. This, of course, leads to precisely the opposite result from that achieved in Japan and Korea.

23. Reviews of the beneficiaries of directed credit programs also find failures in reaching targeted groups: for example, analysis of the recipients of subsidized credit programs intended for the poor (for the 1990 WDR) found that these by and large failed.

24. The disagreement on whether directing cheap money to protected leading sectors can work in most countries should not mask the extensive areas of agreement with respect to incentive and financial sector policy. On industrial policy, some of the criticism is on a straw man, at least with respect to current thinking and practices. The World Bank agrees that industrial development is not just about liberalizing markets to get incentives right, but also about developing industrial capabilities and institutional development.

25. Bank industrial policy emphasizes the domestic business and regulatory environment, and both adjustment and investment lending increasingly includes microeconomic interventions, for example in dismantling barriers to entry and exit, reforming investment codes, strengthening property rights, accounting standards and the legal framework for business activity. This is further supported by Bank lending to improve economic infrastructure, utilities and communications. There is probably less understanding about the design of short-run policies to foster industrial capability. More work needs to be done on this area.

26. Equally important, in virtually no country has the Bank supported a radical shift to free-trade. The characteristic pattern has been a series of removals of quantitative restrictions, with a reduction in the level and dispersion of tariffs over a period of many years--as in Morocco or Indonesia. This grants a substantial degree of transitional protection for adjusting industries. In Latin America the recent trend has been to move more quickly: Mexico shifted from a protective system that had virtually all domestic

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[5] See empirical analysis of Indian agriculture by Binswanger that found credit subsidies led to capital-labor substitution.

[6] See Dailami, 1991

production protected by quantitative restrictions to moderate tariffs in about three years. However, with the resolution of its macroeconomic difficulties Mexico is looking increasingly like a potential success in industrial growth in the 1990s. In Eastern Europe some of the countries are themselves leading the way with more radical transitions than the Bank has supported elsewhere--in response to the more severe distortions. It is too early to assess whether this is leading to excessive costs in the transition.

27. With respect to financial sector policy, the Bank's view is certainly not that liberalization will solve everything--or always be desirable. Severe financial repression and sharply negative interest rates should always be avoided, but financial liberalization needs a sound macroeconomic and a satisfactory regulatory framework to work. There is a common concern with problems of weaknesses and market failures in the financial sector--for example in the limited availability of term finance and lack of availability of credit to small-scale enterprises. The Bank has assisted many countries in restructuring their distressed banking systems. By carving out bad loans, improving the legal and accounting framework, and strengthening financial institutions, these programs have directly tried to correct market failure by getting the market to work in a more transparent and efficient manner. A review of Financial Sector Adjustment Lending in the 1980s is attached for further details.

28. The focus of the Bank's work has primarily been on tackling financial sector problems through overall financial sector development. In most cases, the use of mandated credit allocations to compensate for lack of investment finance has been counterproductive to both financial sector and economic development. However, further work is needed to understand the role of credit policy in supporting private sector development. The planned joint study with the Japan Development Bank, on The Effectiveness of Credit Policies in East Asia, will be examining this.

Privatization

29. The OECF paper suggests that privatization may not be an option where the indigenous private sector is underdeveloped, and where political concerns over the role of foreign and non-indigenous capital are important.

30. Three points are clearly agreed upon:

(a) The initial depth and institutional state of the private sector will have a powerful influence on the design of privatization. The options are very different in Mexico, Poland and Mozambique.

(b) In many countries (especially formerly socialist ones), even effective and rapid privatization will leave an important range of large-scale enterprises in state hands for lengthy transition periods. For these, measures to improve efficiency through better public management and commercialization are also necessary.

(c) Privatization does not take place in a political vacuum, and it is important to explicitly face the political consequences of alternative policy options, whether the concern is with Chinese capital in Indonesia, the ex-

nomenklatura in Czechoslovakia or foreign capital in Zimbabwe.

31. However, these factors are not an argument to go slow in cases where public enterprises form part of the general malaise of slow growth and macroeconomic disequilibrium. Privatization may be easiest in middle income Latin American or Asian countries, but it is often most needed in low income Africa and in formerly socialist Europe and Central Asia.

32. Conditions for privatization are most favorable where markets are well developed. How to do it depends on the characteristics of the firm. For firms producing potentially competitive products the key issue is to ensure market conditions are actually competitive, with ease of entry and exit and a reasonable degree of openness to foreign competition. With natural monopolies it is necessary to ensure there is a sound regulatory framework to prevent abuse of monopolistic advantage. This can take longer. There is growing evidence that privatization brings gains in both cases. A recent Bank study of 12 privatized firms in Chile, Mexico, Malaysia and the UK found significant gains in 10 of these. Productivity rose in 8 and remained constant in the other four, many enjoyed increased investment, labor benefitted in nine cases (though in some cases there were layoffs with compensation) and consumers gained in nine. These gains occurred in both competitive and monopolistic infrastructural companies. Other evidence is also supportive of such gains.

33. In countries with limited markets and thin private sectors, conditions are more difficult. In many low income African countries, the absence of a private sector was one of the reasons for state investments in productive activities in the first place. In Eastern Europe--and even more so in the CIS--there were virtually no private firms in the large-scale sector and no market institutions. However it is in these cases that the most inefficient cases of resource use in state enterprises are to be found: the squandering of scarce domestic and foreign resources and the burden on budgets constitutes a major drag on development, and so on poverty reduction, from Tanzania to Poland. In Eastern Europe governments also consider it a political imperative to create an entrepreneurial, property-owning class if the gains from the transition to a market economy are to be achieved and locked in.

34. In these cases, different techniques will be needed. Foreign capital often has to play a larger role where domestic capital is weak, but need not always be dominant--as the recent successful privatization of the Niger Textile Company. Intermediate solutions, such as private management services, will sometimes be a desirable alternative in poor African countries. And mechanisms for rapid privatization, for example through use of vouchers in Czechoslovakia and activist mutual funds in Poland, are being explored in Eastern Europe. This has to go hand in hand with the development of corporate governance, both for public firms in the transition to privatization (that may be many years for some) and for newly privatized firms. Where state enterprises are hopelessly inefficient, liquidation is often best for development.

35. The track record on privatization in countries with limited market development is admittedly more limited than in the better-developed market economies. The potential conflicts raised by the OECF paper may be more

acute, especially where there is a small indigenous private sector. There are many cases in which non-indigenous or foreign capitalists dominate the larger scale private sector--notably Indians in East Africa, whites in Southern Africa and Lebanese in West Africa. The objective of promoting advancement of the indigenous population is well justified on equity and political grounds. But the means by which it is done needs to take account of the tradeoffs. Attempts to reduce reliance through dependence on the public sector have radically failed. In the short run, many African countries will face the choice between slower growth and continued reliance, with a more liberal environment for non-indigenous and foreign capital. Governments can more effectively help the indigenous population through investing heavily in their human capital and providing the environment for the development of indigenous entrepreneurship. This is often a long haul, but it will a much more difficult haul if the enterprise sector is a drag on the economy rather than sources of growth.

36. Success in these conditions is illustrated by Malaysia and Indonesia, where Chinese capital has been a major factor. Tensions have been severe at times in both countries, but for the last two or more decades the governments have managed to maintain an environment in which the entrepreneurial sector has flourished whilst also promoting (especially in Malaysia) the development of indigenous capital. This has helped provide the conditions for steady, poverty reducing growth, and the resources for broad, redistributive investments in human capital. In Malaysia, where the tradeoffs clearly worked, the government is now actively phasing out selective credit, and achieved better income and wealth distribution through privatization.

37. While some of the tradeoffs are unavoidably acute, there is scope for both improving the prospects of success and dealing with distributional and political concerns through design choices. Transparency in transactions is essential and information campaigns can be useful. Workers are usually heavily involved in negotiations. Deals can be designed to offer shares at favorable prices to workers or particular ethnic groups. Governments can maintain a golden share that gives some power over strategic decisions, but hand over control and management to the private sector.

Outstanding issues for adjustment lending

38. The OECF's paper proposes changes in the design of policies supported under adjustment lending. The evidence reviewed here suggests the kinds of targeted policies advocated may well have brought benefits in the East Asian successes, but have been tried and failed in most currently adjusting countries in other parts of the world. In countries from Argentina to Tanzania, and from Morocco to the Philippines, targeted subsidies have tended to increase inefficiencies, and have failed to raise investment.

39. However, there are outstanding issues in adjustment lending. It is worth setting the OECF's views against the Bank's own review of the outcomes and issues for adjustment lending. The Bank has completed two general reviews of adjustment lending and is now completing a third. The patterns of growth were as follows (see Figure 1):

- amongst countries that had an extensive experience with adjustment lending,

growth rates were restored to levels prevailing in the 1970s--about 3 percent per capita for middle income countries, but barely positive rates in per capita terms for low income countries

- adjustment takes many years, especially where macroeconomic imbalances are severe and distortions large--and there are transitional costs in declining output and rising poverty.

40. The work identified at least four areas where there are issues in the design of adjustment lending:

(a) the problem of low growth in low income countries has not been solved: the core policies of sound macroeconomic management and reduction of distortions in the incentive framework are clearly necessary, but they are not sufficient to lift most low income countries on to a high growth path;

(b) part of the problem (in both low income and many middle income countries) lies in weak conditions for private sector production, and more needs to be done to improve the business environment;

(c) another part lies in weak public sector performance, especially in the delivery of economic and social services, owing to misallocation of spending and low quality of service delivery;

(d) the poor often suffer in the transition; and more needs to be done in designing adjustment policies to reduce welfare declines and monitor changes in living conditions.

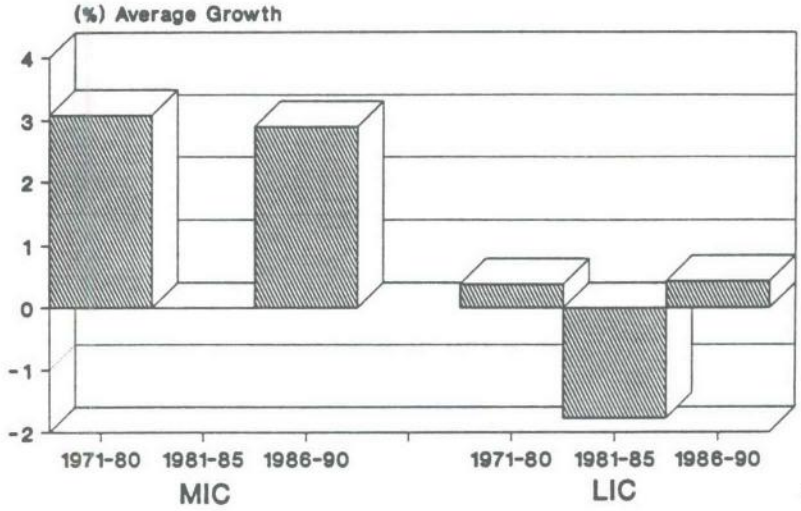
41. The kind of measures the OECF advocates is potentially relevant to (b), but the experience suggests it will be least applicable to countries where the problems are most severe. Activist industrial strategy can potentially raise growth rates, but success is only apparent in relatively strong states with an efficient administrations. Such a strategy is susceptible to costly abuse--and tends to lower rather than raise growth--in weaker states, and especially so in conditions of macroeconomic crisis.

42. There are certainly outstanding issues in the design of adjustment policy and its link to the broader development process. The OECF's note has raised some valuable issues, but its persuasiveness is weakened by its failure to consider the implications of its proposals for societies with "weak" governments. A potentially fruitful area of research is to seek to identify the interventions at a micro level that are compatible with a realistic assessment of government capabilities. These should be designed to build private capabilities whilst avoiding the costs of abuse. The planned study on the East Asian Miracle will both assess the role of an activist industrial policy in rapid growth in East Asia, and what can and cannot be applied to other countries. The World Bank looks forward to further dialogue both on this question and on the other outstanding issues in adjustment and development policy.

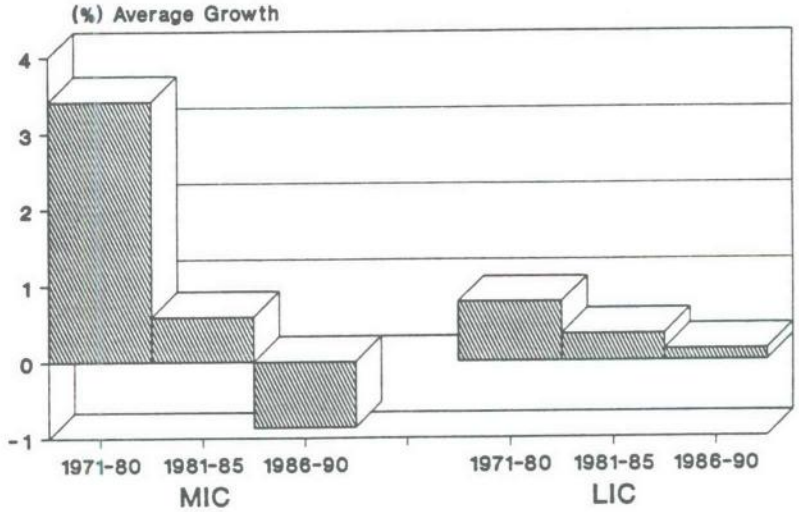
March 13, 1992

Figure 1: GDP Per Capita

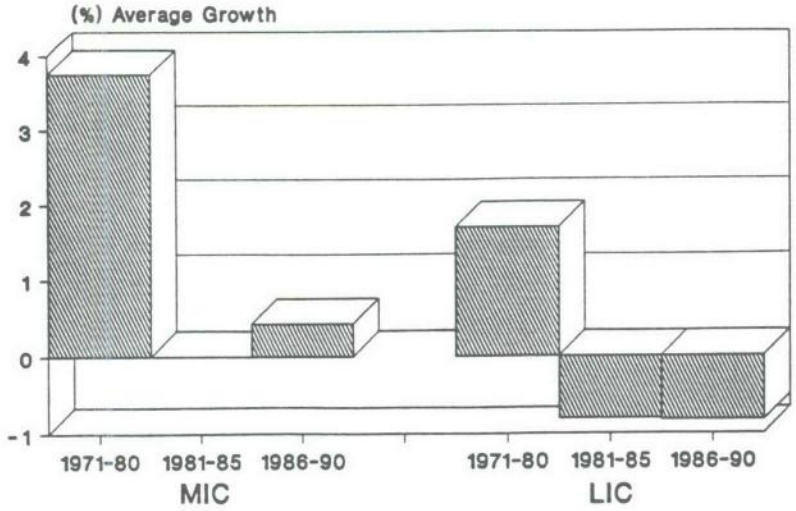
Intensive Adjustment Lending Countries



Other Adjustment Lending Countries



Non-Adjustment Lending Countries



Intensive adjustment lending countries are defined as those countries that received at least two structural adjustment loans or three adjustment loans of any type by June 1990, with the first loan becoming effective by June 1986. They are distinguished from other countries receiving Bank adjustment loans and from countries receiving no Bank adjustment assistance.

OECF OCCASIONAL PAPER NO. 1

ISSUES RELATED TO THE WORLD BANK'S APPROACH TO STRUCTURAL ADJUSTMENT

– PROPOSAL FROM A MAJOR PARTNER

OCTOBER 1991

THE OVERSEAS ECONOMIC COOPERATION FUND

ISSUES RELATED TO THE WORLD BANK'S APPROACH TO STRUCTURAL ADJUSTMENT

– PROPOSAL FROM A MAJOR PARTNER

1. Objectives

This paper discusses problems related to the World Bank's approach to structural adjustment, and proposes some idèas to solve these problems, based on the experiences of the OECF as a major partner in the structural adjustment lendings of the Bank.

The OECF has, since the mid-1980's , been in collaboration with the Bank in structural adjustment lendings. Cumulative amount of OECF financing of this type reached ¥450 billion as of the end of September 1991 (on a commitment basis).

2. Basic Idea on Structural Adjustment in This Paper

Structural adjustment policy is a medium term micro-economic policy that supplements the stabilization policy which itself is a short-term macro-economic policy. Structural adjustment policy aims at improving the efficiency of resource allocation through reforms of systems and

procedures. It is expected that the implementation of these policies will lead to a recovery of economic growth and to sustainable growth.

Structural adjustment lending is defined as a "quick-disbursing" loan in order to improve international balance of payments positions of developing countries, and to support structural adjustment policies implemented in developing countries, which are aiming at achieving sustainable growth.

In many developing countries, economic activities are excessively restricted. At the same time, in many developing countries, international balance of payments are deteriorating due to various reasons including heavy burden of debt repayment. Under the circumstances, structural adjustment lending can be considered to be one of the promising options for assisting developing countries. Structural adjustment lending is considered to have produced some positive results in many countries.

At the same time, there is still much room for improvement in structural adjustment lending as far as its content and the ways of implementation are concerned. The World Bank seems to be aware of these points, as various issues are discussed in the report of "Adjustment Lending Policies for Sustainable Growth", which was published by the Bank in 1990. However, we believe that there are

many other important points which are not taken up in the above mentioned report. This paper takes up four of these major points.

There is one common viewpoint among them. It is as follows:

It is fully recognized that efficient resource allocation through the market mechanism is an important issue of economic policy. However, when we make up economic reform program, various factors other than efficiency must also be taken into account. If efficiency of resource allocation is stressed too much without giving due consideration to these other factors, the program will not be a properly balanced one. This can lessen the significance of introducing the market mechanism itself. Therefore, a well-balanced program pursuing more than just economic efficiency is required. Furthermore, efficiency must be considered from long-term viewpoint.

3. The Issues Taken Up in This Paper

This paper does not intend to discuss all of the problems of the World Bank's approach to structural adjustment. The paper instead takes up four specific points that seem to have been overlooked by the Bank. The four points are as follows:

(a) What kind of steps are necessary to attain sustainable growth after the completion of structural adjustment? In other words, the impetus for sustained growth can be created by structural adjustment alone? If not, isn't it necessary to introduce some additional measures for investment promotion?

(b) If imports are liberalized too quickly, is it possible to develop industries, which will play leading roles in the next stage of economic development? If not, isn't it necessary to protect the domestic industry to some extent for a certain period of time in order to allow a viable export industry to develop?

(c) We are afraid that the financial sector policy of the Bank is too much stressing market mechanism. Isn't it indispensable to have development finance institutions lendings with subsidized interest rate, under some circumstances, in order to maximize the social welfare?

(d) Is privatization being carried out only when adequate conditions are found? Is the privatization program taking into consideration other important aspects than economic efficiency?

4. Policies for Attaining Sustainable Growth

The World Bank's approach toward structural adjustment seems to be based on the assumption that introducing market mechanism and eliminating the restrictions placed on private sector will lead to an improvement in the investment climate and stimulate economic activities, and finally will create the necessary conditions for sustainable growth.

Structural adjustments, including deregulation, no doubt have a favorable impact on economic activities. But will these adjustments by themselves have sufficient impact to generate sustainable growth? It is possible in an economy with strong potentiality of investment. But, in many developing countries, improvement of the investment climate through deregulation is not sufficient to cause the big wave of investment. For instance, in the Sub-Saharan countries, it would be hard to find a lot of entrepreneurs to create the anticipated wave of investment. Also, in many other countries, we find fundamentally similar situation.

In case the World Bank's strategy of "from structural adjustment to sustainable growth" is not workable, what kind of additional measures will be required? These should be a measure aiming "directly" at promoting investment. In this respect, Japanese fiscal and monetary policies in the post-war era may be worthy of consideration. These

were centered on preferential tax treatment and development finance institutions lendings. We must, however, be cautious, because the experience of one country cannot be easily applied to other countries. Modification should be made carefully taking into consideration the conditions of the specific country to be applied. It may also be necessary to implement for certain period only.

However, if any other suitable policy measures cannot be found, we would recommend to reconsider the investment promotion measures adopted in Japan in the post-war era.

5. Balance Between Trade Liberalization and Industrial Development

Trade liberalization is one of the important components of the structural adjustment programs of the World Bank. The importance of trade liberalization can be fully recognized as in many developing countries, international trade is excessively curbed, causing serious inefficiency. However, it should be admitted that excessive reliance on trade liberalization is also risky; if trade is deregulated too hastily, it tends to cause heavy costs.

When we argue that trade liberalization leads to the optimum allocation of resources, it means optimum allocation under the existing industrial

structures and technological levels of various countries. In this case, the comparative advantage of each country is a static advantage; and the comparative advantage of developing countries tends to be found mainly in primary products and light industry of low value-added. It is however natural that most of developing countries try to transform their industrial structures toward the industries of higher value-added, higher growth potential and higher technology. From the standpoint of developing countries, this shift of pursuing dynamic comparative advantage is also indispensable for the long-term improvement of the people's standard of living. This means that sticking to simple trade liberalization based on static comparative advantage may have a negative impact on the possibility of economic development.

When we consider trade liberalization, we must maintain the long-term view point, that is how to develop industries. It is too optimistic to expect that industries to sustain the economy of the next generation well come up automatically through the activities of the private sector. Some measures for fostering industry are required. As pointed out from time to time, industrial policy was adopted as a central measure in the economic development strategies in East Asia. On the other hand, while the World Bank is aware of the importance of export industries and supporting outward oriented development strategies, its structural adjustment approach seems to lack the long-term viewpoint of how to develop such industries, perhaps because it assumes that activities of

private sector will attain this goal. This lack is very regrettable.

Industrial development needs certain period of time and certain amount of social set-up-cost. Therefore, protection for a certain period of time is indispensable (argument of infant industries). At the same time, it should be noted that protection is often accompanied by harmful effects. Measures must be taken to prevent such harmful effects as far as possible. These include: (1) Identification of those industries which will have leading roles in the future, (2) the minimum level of necessary protection, (3) specific actions, in accordance with GATT, and the period of minimum requirement. In this respect, we wish to propose the idea of "Policy Dialogue on Industrial Development", to be done among donors and each developing country. In this dialogue, it is particularly important to identify promising products, for each specific developing country and the means of marketing as well as sales promotion in international market. The opinion of the private sector in the developed countries can be of particular help in this respect.

6. Significance of Development Finance Institutions Lendings and Subsidized Interest Rates

Financial sector is expected to play the central role in spreading market mechanism in developing economies. Therefore, the financial sector

takes an important position in the World Bank's approach toward structural adjustment. This is quite understandable.

The problem, however, lies with placing too much emphasis on the importance of market mechanism in financial sector reform. As a result, some of the roles of financial sector of developing economies seem to have been overlooked. A typical example is the discussion on interest rates. It seems that the significance of development finance institutions lendings with subsidized interest rates under certain conditions have been overlooked. In this respect, the World Bank has criticized "two-step loans" of the OECF, from time to time.

Note :

For example, the World Bank raised an objection to the OECF over the scheme of the ASEAN-Japan Development Fund (AJDF) in the Philippines. The basic points of the World Bank were as follows:

(1) AJDF is to provide long-term credit with interest rates below the prevailing market rate.

(2) This will have a negative impact on the development of the financial market and will serve to hamper the objectives of the Financial Sector Adjustment Loan (FSAL) which is being co-financed by the World Bank and the OECF.

As a result of the discussions between the World Bank and the OECF, it was agreed that the interest rate for small-to-medium scale industries under AJDF would be set at a level 2% below the 6-month time deposit interest rate.

Among various issues related to financial sector, we would like to focus our attention on the matter of subsidized interest rate. The following three points are to be raised for discussion.

(a) Since financial sectors are under-developed in developing countries, and financial institutions are not capable and experienced enough, market mechanism cannot fully function.

(b) As there are inherent limits of market mechanism itself, market mechanism cannot handle various issues properly. Government intervention in these areas, as a result, is indispensable.

(c) ODA has some aspects to distort market mechanism. Therefore, it is not appropriate to criticize "two-step loans" only, because of its market distortion.

(1) Financial Sector in Developing Countries

Needless to say, assuming that the condition of the financial sector in developing countries is similar to that of developed countries is not appropriate. In the case of LLDC, especially, financial sectors are still in the primary stage, and interest rates do not produce the desired results. In such cases, it is not proper to discuss the differences between market interest rate and subsidized interest rate. Even in

ordinary developing countries, financial sector does not function as expected, as the capability and experience of financial institutions is limited. As a result, the role played by market interest rate in promoting the efficiency of resource allocation is much more limited than in developed countries. Under the circumstances, it is indispensable to overcome the limit of market interest rate through government intervention.

(2) Limit of Market Mechanism

It is impossible to achieve optimum allocation of resources solely through market principle regardless of the level of development. There are many areas which cannot be handled by market mechanism ("market failure"), and government intervention is necessary to cope with such situations. Where market interest rate can not handle some problem, the introduction of subsidized interest rate, becomes indispensable. For instance, whenever some activities which are beneficial to society are not initiated due to the lack of incentives, it becomes necessary to provide additional incentives through subsidized interest rate. Introduction of subsidized interest rate can induce the desired activity, thus improving the welfare of society.

Some examples are listed below:

1) When the investment risk is too high regarding a particular activity

which is beneficial to society, subsidized interest rate will lessen the cost, and promote investment.

(Example)

(a) Case of scale merit

(b) Case of long gestation period

(c) Case of risks associated with technology and market development

2) When there is a significant discrepancy between private and social benefits ("externality"), subsidized interest rate is expected to increase private benefits and spur investment.

(Example)

(a) Case of rural industry: social benefits of increasing job opportunities in rural areas and preventing over-concentration in urban regions.

(b) Case of supporting industry or parts industry: social benefits of increasing added-value within the country, and thus strengthening

the basis of international balance of payments.

(c) Case of Investment for pollution control and environment protection

3) The case of imperfectness of Information

(Example)

(a) Small-to medium-scale industries and venture business

4) The case to cover the social set-up costs of infant industries

We understand that the World Bank accepts subsidies for such market failures. In other words, while subsidies are permitted, subsidized interest rates are not allowed. We wonder whether there is any theoretical background for this argument. From theoretical and practical viewpoints, we believe both of subsidies and subsidized interest rates are useful tools. From practical viewpoint, in some cases, subsidies may have certain advantages; in certain cases subsidized interest rates may well achieve the desired goals. Therefore, a flexible manner to fully utilize the two options is the most important.

(3) ODA and the Distortion of Market Mechanism

ODA is supposed to deal with the cases of market failure. While in certain cases it tends to distort market mechanism, usually, this issue is not discussed. It is taken up only in the case of on-lending operations such as "two-step loans" of the OECF. We wonder why. If one is to criticize "two-step loans" of the OECF, then one should review if other type of ODA has no effect of market distortion.

In both cases of "two-step loans" as well as ordinary project loans, the developing country enjoy the benefit of getting funds with soft terms. This merit can trickle down through the recipient economy.

The benefit of concessionality is passed on to the "end user" (such as farmers) in the case of "two-step loans" of the OECF. In the case of project financing of the OECF, for a fertilizer plant, for example, the fertilizer price for farmers could be lower than other cases due to the low interest rate of the fund. While one is criticized, the other is not. We wonder why.

The World Bank often points out that subsidized interest rate tend to cause corruption. It is true that corruption is found in the financial sector of developing countries. But is this unique to subsidized interest rate? Can this problem be wiped out if subsidized interest rate is eliminated?

What is important, in our opinion, is to check at the time of appraisal whether there is the possibility of excessive inefficiency and unfairness due to subsidized interest rate. Assistance should be granted only if it is expected that such problems will not be so serious. When the disciplines of financial sector are in doubt, "two-step loans" type assistance will not realize desired results, regardless of the level of interest rate.

In conclusion, we would like to propose to utilize development finance institution lendings with subsidized interest rate in various cases above mentioned.

7. Points to be Noted With Respect to Privatization

Promotion of private sector is one of the important points in the World Bank's approach to structural adjustment. This is quite agreeable, as the essence of economic development is creativity of entrepreneurs and their investment. Privatization is of major significance, since many developing countries have large, inefficient public firms.

However, we wonder whether privatization is always the solution for improving efficiency of public sector. Various conditions in individual countries must be taken into account very carefully. Unfortunately, the

World Bank's approach seems to be almost similar for every country.

For instance, in Sub-Saharan Africa, indigenous private sector is very much underdeveloped. But the World Bank has promoted privatization in many countries in this region.

Another problem is the idea that all the private sector is to be treated equally, whether it be indigenous or foreign. This may be ideal from the standpoint of efficiency. However, the political and social realities in developing countries do not allow this, in many cases.

Most of developing countries have had bitter experience of colonialism. The idea to transfer the basic industries to foreign capital is a serious political and social issue in view of their history. Moreover, even from an economic standpoint, we must also consider that monopoly of foreign capital will lead to the repatriation of rents. The same argument can be made regarding non-indigenous capital (Indian capital in East Africa, Chinese capital in Malaysia and Indonesia).

It is necessary to adopt various factors other than efficiency as the criteria for decision making when considering privatization.

8. Beyond "the Decade of Efficiency"

Although efficiency and fairness are the major objectives to be pursued in economic policy, there is sometimes trade off between the two. In the 1980s, economic theory as well as economic policy were heavily oriented toward the pursuit of efficiency. In this sense, it was an unique period. However, this period has come to an end. What is now needed is a policy well balanced between efficiency and fairness, in order to improve the welfare of the entire society.

The World Bank's approach to structural adjustment may have to be changed reflecting the change of streams.

RAL III

Record Removal Notice

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File Title	Barcode No.
Structural Adjustment Lending (SAL) Files - Book 7	1837346

Document Date	Document Type
April 13, 1992	Memorandum

Correspondents / Participants
To: Distribution
From: David Peretz, EDS03

Subject / Title
Third Report on Adjustment Lending (R92-47)

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

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File Title		Barcode No.
Structural Adjustment Lending (SAL) Files - Book 7		1837346
Document Date	**Document Type**	
April 8, 1992	Memorandum	

Correspondents / Participants
To: Executive Directors
From: Frank Potter

Subject / Title
Third Report on Adjustment Lending

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	May 24, 2017

ANNEX 3 - SUPERVISION OF ADJUSTMENT LENDING

EXCERPTED FROM THE THIRD REPORT ON ADJUSTMENT LENDING:

PRIVATE AND PUBLIC RESOURCES FOR GROWTH

March 24, 1992

(R92-47 - IDA/R92-29)

Annex 3 Supervision of adjustment lending

Introduction

A3.1 Adjustment operations flow out of the policy dialogue with member countries on economic reform objectives and measures. The supervision of adjustment operations merits special attention both to gauge the general status of that dialogue and to verify that the specific actions contemplated in the operations are being taken and that the pre-agreed objectives are being reached. Even after individual adjustment operations have been formally completed, the policy dialogue continues. The underlying reform program is often supported directly through follow-up operations (investment or adjustment) and implicitly through the overall lending program. The importance of continuity of the adjustment process is widely recognized by both management and staff, as well as by the borrowing countries. For these reasons, effective implementation of adjustment operations receives much attention, which extends well beyond the formal recorded supervision activities. A large part of the economic and policy dialogue and of meetings between senior country officials and the Bank's regional and country managers is also devoted to supervision of the adjustment program.

A3.2 Supervision of the entire Bank/IDA portfolio in individual countries, including adjustment operations, is regularly reviewed in Country Implementation Reviews at the Department level. Annually, the regional portfolios are reviewed in the Annual Report on Implementation and Supervision (ARIS) exercise, a Bankwide compilation of which is presented to the Board. The most recent ARIS was discussed by the Board on February 27, 1992. Furthermore, supervision issues that are specifically relevant to adjustment lending have been reviewed in specially focused studies. The recent OED report on *Effectiveness of SAL Supervision and Monitoring* (No. 9711, June 26, 1991) examined these issues in depth and made a number of recommendations.[56] IAD has also reviewed certain aspects of the supervision of adjustment operations for regional management and proposed modifications in procedures.[57]

Learning from experience

A3.3 The Bank has been flexible and adaptive in reviewing its activities and seeking to improve its effectiveness in this area. The series of reports on adjustment lending completed thus far is an important example. The structure and content of adjustment operations are continuously evolving as staff gain more experience and as circumstances faced by borrowers change. Practices have improved as staff learn better ways of doing things and as systematic reviews of adjustment operations and their implementation highlight problems. Supervision reviews, such as those mentioned above, contribute to this learning process. Coming at the end of the project cycle, they tend to be comprehensive in their analysis and deal with the problems of design and process management that have arisen. This is beneficial since improvements in design not only facilitate supervision, but also, and more important, strengthen the Bank's ability to support effective adjustment programs. The OED report, for example, identified scope for improvements in the design, management, and supervision of adjustment operations in about equal proportion. Many of its recommendations reflect well-known problems, and the report itself indicates that progress is evident in some areas. The Bank has just created a high-level Task Force under the leadership of Mr. Wapenhans to review portfolio management and evaluation. Recognizing the need for improvements in supervision of adjustment lending, it will also review and make recommendations in this area.

Supervision in the adjustment lending program

A3.4 Supervision of adjustment lending differs in several important aspects from supervision of other projects. Adjustment lending is designed to support an ongoing policy reform and structural adjustment program. Each operation funds an identifiable phase of that program, but these phases are not necessarily discrete activities with a well-identified beginning (ground breaking), focused activity (piling of bricks and mortar), and end (ribbon cutting), as with much project lending. Nor are the final results always as easily identified and measured; they show up in developing a more efficient economy, improving output growth, and sustaining balance of payments equilibria. Part of the "artistry" of designing adjustment operations, then, is in identifying quantifiable and monitorable indicators of progress and specifying appropriate target levels. Adjustment programs are, nevertheless, subject to many external and internal uncertainties and shocks that require ongoing adjustments in both policies and conditions. Supervision must work

within this framework and is, in consequence, necessarily a continuation of the policy dialogue. It aims not only at monitoring performance, but often also at helping the country and the Bank adapt the reform program and the related targets to evolving circumstances. Obviously, such activity requires a high level of policy sense and judgment. These two factors—integration into the policy dialogue and critical decisionmaking responsibility—explain both the importance of supervision of adjustment operations and its particular nature.[58]

Supervision and the policy dialogue

A3.5 Advising countries about overall policy directions has always been an essential part of the Bank's contribution to the development process. The advent of adjustment operations gave the Bank another instrument with which it could directly support policy reform in countries undertaking ambitious adjustment programs and a means by which it could play a larger role in helping shape those reforms. Adjustment operations are rarely stand-alone activities, but rather part of a series of operations supporting a multiyear program of macroeconomic and sectoral policy reform. The country economic and sector work usually lays the foundations for the reform program and contributes to the design of adjustment operations. During the adjustment period, much of the economic and sector work and country dialogue focuses on implementation of the reform program. In reality, supervision of adjustment operations melds with the policy dialogue, which continues after the intensive adjustment period is past. Lending activity then tends to shift to more specific investment operations, and actual monitoring of the adjustment program may occur through subsequent projects, general economic and sector analysis, policy discussions, or hybrid operations.

A3.6 With occasional exceptions, continuing dialogue is sufficient to prevent backsliding on adjustment measures after an adjustment operation is closed and formal supervision has ceased. In many of the cases where significant backsliding has occurred, there was a major breakdown in the policy dialogue, and country relations became strained. Such cases require concerted efforts to restore the basic dialogue before backsliding can be reversed. In these instances, slippage is not a supervision issue, but at the core of the dialogue. When a productive dialogue has been resumed and a country seeks further adjustment lending, lapsed and unfulfilled past conditions need to be made up to the extent they are still relevant. This is normally done in the context of new operations. For example, the recent Economic Recovery Loan to Panama picked up reforms that had lapsed under SAL II (1986-87) as conditions of negotiations and effectiveness. Similar treatment has been applied to Honduras and Zambia.

Supervision and decisionmaking responsibility

A3.7 A central focus of adjustment lending supervision is the tranche release recommendation. In conventional adjustment operations, this typically occurs about 12 months after the operation is effective. Operations with three tranches offer two such opportunities. On occasion, some supervision is involved in monitoring effectiveness conditions for the first tranche release, but normally those conditions are met by the time of Board presentation. The tranche release review is considered a very important activity in the borrowing country, not only because a substantial resource transfer hinges on the outcome, but also because a positive decision constitutes proof that the policy dialogue with the Bank is proceeding satisfactorily. It is also a visible activity in the Bank because it results in a recommendation to senior management and a report to the Board. In cases where there is any major modification in implementation of the program, a Board decision may also be required. For these reasons, tranche release reviews are conducted and monitored at senior levels in the Bank. In most cases, the Lead Economist participates in the supervision mission to consider a tranche release, or carefully reviews its findings. In cases where there are serious issues of performance, key regional managers (Division Chiefs and Department Directors) and senior management are also involved.

A3.8 Given the varied nature of adjustment operations, the actual mix of inputs going into supervision and the amount of subsequent decisionmaking differ from country to country and from operation to operation. Where the reforms concern changing regulations, rate schedules, and government practices (for example, tariff reform and trade facilitation measures), much of the conditionality can be satisfied by specific and well-identified actions. In these cases, it is relatively easy to specify and monitor performance, and neither supervision nor tranche release requires a large input of resources. On the other hand, programs that imply initiating extensive institutional and behavioral change (for ex-

ample, public enterprise reform) tend to be more difficult to implement and require more intensive supervision to assure that implementation of the agreed measures, which could include restructuring enterprises and government departments, is satisfactory. Moreover, substantial and detailed stimulus from the supervision missions may be needed to translate the overall SAL/SECAL framework into practical outcomes that achieve the program's objectives. This is more frequently the case with SECALs, where the range of skills and level of resources necessary for supervision can be quite extensive. How much Bank input is actually required depends on the government's own implementation capacity, the complexity of the reform program, and the evolution of external events. In cases where the adjustment operation is supporting a fundamental transformation of a country's economic structure, such as in the formerly centrally planned economies, more intensive supervision is also required. It is provided directly and through the country dialogue.

Design issues and the supervision of adjustment operations

A3.9 Shortcomings in project design often become apparent in the supervision process, either because they make the project difficult to supervise or because they require extensive subsequent inputs to make the project work. Design issues that have been identified for adjustment loans in the OED study and elsewhere include (1) insufficient attention to assuring the suitability of the macroeconomic framework (particularly for SECALs); (2) insufficiently precise and monitorable conditionality; (3) lack of full government commitment and ownership of the program and its implementation; (4) mismatches between timing of disbursements and reasonable periods to achieve reforms; and (5) insufficient attention to negative social effects of the adjustment measures.

A3.10 Past reports on adjustment lending have made a number of recommendations on how to improve adjustment operations, including paying closer attention to the macroeconomic framework, obtaining stronger national ownership, and assuring sufficient attention to social and poverty effects. Staff work to incorporate the RAL recommendations into new operations are discussed in the main report. Furthermore, at the regional level, a great deal of attention has gone into how to design better operations, drawing on the experience of other countries. For example, greater use is being made of peer review from experts outside the region in preparing projects.

A3.11 The social impact of adjustment policies supported by Bank loans and credits is also receiving greater attention, in the main body of this report and elsewhere. The proportion of adjustment projects with conditions on social spending, for example, has risen from 7% in 1979-85 to 11% in 1986-88 and 33% in 1989-90 (table 3.5 in chapter 3). Adjustment operations focus on mitigating negative social impacts in areas that can be affected by macro or sectoral policy action within the time frame of the adjustment program. These measures include protecting and redirecting education and health expenditures toward basic education and prevention, targeting food subsidies to the poor while reducing overall subsidies, establishing or strengthening social safety nets, especially in countries undergoing systemic transition, and allowing the poor greater access to capital through credit and land-titling reforms. Several other adjustment operations focusing explicitly on policy reforms to alleviate social impacts are under preparation.[59]

A3.12 But the issues addressed in adjustment operations constitute only a part of the Bank's overall approach to reducing poverty. Specific poverty alleviation operations are also being processed in a number of countries, recognizing that the time required to improve weak delivery systems for social programs is often longer than that of adjustment operations. These investment operations support programs to extend primary education and health care, improve water supplies and sanitation, create income opportunities for rural and urban poor, and other measures to reduce proverty. Poverty assessments are planned for 80 countries, and nearly 20 are completed. The *World Development Report 1990: Poverty*, the recently released Operational Directive on Poverty Reduction (OD 4.15), and the *Poverty Reduction Handbook* provide more direction and systematic analytic tools to staff to improve the design and monitoring of poverty alleviation measures.

A3.13 On timing of reforms, three-tranche operations are becoming more common to better match, inter alia, the disbursement profile with the period of the adjustment process. Only 7% of adjustment operations had three tranches in FY87. This figure rose to 17% in FY89 and 41% in FY91 (excluding debt reduction loans). Furthermore, between FY89 and FY91, implementation periods have lengthened from 2.2 to 2.5 years for SALs, and from 3.3 to 4.0 years for SECALs. The longer implementation

periods reflect primarily longer program design, although difficulties in sustaining adjustment programs have also contributed to delays in completing some operations.

A3.14 A great deal of effort is also going into making loan conditions more transparent and monitorable and strengthening the links to the macroeconomic framework; this not only eases supervision, but also makes better operations. Structuring macroeco-nomic conditions, however, requires a delicate balance. They need to be specific enough to encourage the desired policy changes and be monitorable, but still general enough to assure satisfactory progress on a reform program, rather than a limited response by the government to meet a few narrow quantitative targets. They also need to be flexible enough to allow alternative approaches as circumstances change. A great deal of judgment is involved in achieving an appropriate structure of conditionality at the design stage, as well as in supervising the implementation. The extent to which the number of conditions can be reduced depends on the complexity of programs, the stage of adjustment, and the number of prior actions taken by the governments. Reducing the number of conditions is a desirable goal, but its achievement does not depend solely on the Bank's actions.[60] The relatively greater use of SECALs in recent years, for example, has helped to improve the specificity of conditionality, but has also placed an added burden on staff to assure appropriate linkage between sector and macroeconomic conditions.

A3.15 Many factors that affect the success of an adjustment operation obviously can only be controlled partially at the design stage. Unexpected changes in internal and external circumstances can necessitate modification in the specific policy reforms and their sequence, which places greater burden on the supervision process and may require the staff to take on complex adaptation problems, including the redesign of parts of the operation. These and other factors can account for the wide variation in the amount of effort allocated to supervision, even among well-designed projects.

Management of the adjustment supervision process

A3.16 Successful supervision depends on the management of the process as well as the inputs devoted to the activity itself. Furthermore, proper reporting and recording of mission findings concerning the progress on adjustment is important. Management must make sure that findings from different activities, including economic and sector work and other policy dialogue, are integrated with supervision reports, most importantly to inform the tranche release decision and subsequent policy discussions. Issues that have been raised by the OED and other reports concerning management of the process include (1) the adequacy of resources supporting supervision; (2) the continuity and level of staffing of supervision; (3) the recognition given to staff for supervision; (4) the integration of different reporting activities; and (5) the ways of monitoring adjustment reforms beyond completion of individual operations.

A3.17 Managers have been innovative in finding ways to increase supervision activities within constrained budgets by combining tasks. Supervision actions are often included in economic and policy discussion missions; supervision missions are combined, and supervision activities are included in preparation of subsequent operations; and implementation issues are often discussed with high-level delegations from member countries to headquarters. These innovations have the added advantage of greater integration of findings from supervision and other economic and sector work activities into the decisionmaking process. On an annual per loan basis, recorded time spent on supervision of adjustment operations is much higher than for investment lending: 15.6 staff weeks (sw) per adjustment operation in FY91, compared to 11.8 sw for investment loans (table A3.1). Since this is only the formally recorded supervision time, it substantially underestimates the staff effort in overall monitoring of adjustment operations, which is carried out in other activities as well.

A3.18 This difference is most marked in the first three years of project implementation, where adjustment operations receive about 20 sw of supervision compared to about 14 sw for investment loans.

Table A3.1 Supervision per adjustment operation
(staff weeks per year)

	FY89		FY90		FY91	
Region	*Adj.*	*Inv.*	*Adj.*	*Inv.*	*Adj.*	*Inv.*
Africa	17.1	9.7	17.8	11.4	18.0	12.2
Asia	9.2	10.7	10.4	11.1	13.7	12.9
EMENA	20.6	9.5	16.7	9.9	14.3	10.7
LAC	10.3	8.8	14.9	9.8	12.9	10.4
Bankwide	15.0	9.8	16.3	10.7	15.6	11.8

Note: Recorded supervision time. It does not include monitoring of operations during economic and sector work or in the policy dialogue.

Thereafter, supervision of adjustment operations falls off sharply, as most are closed by the fourth year. Over the entire life of an operation, therefore, investment loans tend to have as much or more total supervision. For projects approved during FY80-89 and fully disbursed by February 1990, adjustment operations received an average total of 47 staff weeks of supervision compared to 68 staff weeks for investment operations. Supervision inputs per million dollars of commitment were 0.35 sw for adjustment operations and 1.34 sw for investment operations.

A3.19 Across the board, supervision per operation (adjustment and investment projects) is increasing. In the case of adjustment operations, the trend is mixed across regions. This is to be expected since adjustment operations are a smaller sample than investment loans and more subject to short-run variations. A modest relative shift in supervision resources toward investment lending seems to have occurred over the past three years. The average input for adjustment supervision is rising in Africa, where there have been more difficulties with adjustment operations, and in Asia. Supervision has risen, if less uniformly, in Latin America and the Caribbean, and has declined in Europe, the Middle East, and North Africa. The latter trend is due to a changing mix of operations. Adjustment activities in older clients have been winding down and their supervision activity declining. At the same time, there has been a sharp increase in the number of start-up operations in new clients in Eastern Europe, where supervision has only just begun. The region expects that the supervision effort will climb rapidly as these operations are implemented.

A3.20 Compared to investment lending, adjustment lending operations perform at least as well, if not marginally better, on average, in terms of the Bank's project rating criteria (table A3.2). Over the past three years, their average performance ratings have been slightly better overall and by region, with the exception of EMENA in FY89. Other than in Africa, there are few adjustment operations that are classified as problem projects. Whether this better performance is due to more intensive supervision in early years, to the high level of attention accorded to adjustment operations in most countries, or to other factors is not possible to determine; but such performance is consistent with the small relative shift in supervision resources toward investment supervision noted above. The adequacy of the level of resources devoted to all supervision is an important point that has been discussed in the ARIS and is also the subject of overall budget discussions.

Table A3.2 Portfolio status of project

	FY 89		*FY 90*		*FY 91*	
	Rating	*Share of problem projects*	*Rating*	*Share of problem projects*	*Rating*	*Share of problem projects*
Adjustment	1.6	8%	1.7	7%	1.8	11%
Investment	1.8	13%	1.9	17%	2.0	20%

Note: Ratings range from 1 (no significant problems) to 4 (major problems, not being addressed).

A3.22 All regions are giving more attention to supervision and emphasizing contributions to supervision in staff evaluations. Regional managements have explicitly stated this in the context of the most recent ARIS exercise. Continuity of staff is being emphasized to assure that those involved in the supervision were also involved in the design. Most regions report, however, that it does not appear to be necessary to retain the same task manager in all cases, since different skills may be more appropriate for supervision. Additional training on supervision is also receiving more attention.

Improvements in adjustment supervision practices

A3.23 The OED report raised a number of concerns about certain aspects of adjustment supervision itself, including (1) the monitoring of macroeconomic conditionality; (2) the monitoring of the social impact of adjustment; (3) the accuracy and completeness of the Bank reporting system; and (4) the involvement of resident missions in the supervision process. These are valid concerns. The experience with implementing adjustment loans over the past decade, plus a number of analyses, have contributed to more effective adjustment lending, in both design and execution, and also to better supervision of adjustment operations.[61] The learning and the efforts to improve have not ceased.

A3.24 It needs to be stressed that the practices of supervision are continually being modified at the regional and departmental levels. Innovation is often a direct result of experience, and it is usually related to particular country circumstances or the structure of particular operations. Successful innovations generally become widespread, as staff share their experiences. For example, the Africa region management now explicitly reviews adjustment lending implementation annually, project by project, to help resolve problems and disseminate best practices. In addition, systematic reviews of supervision

in regional implementation exercises and studies by units outside the regions have led to more general improvements in adjustment supervision.

A3.25 Close attention to sustaining a viable macroeconomic framework is very important to the success of adjustment loans. This is particularly true in SECALs, where the macroeconomic framework is less central to the explicit conditionality of the loan. Management in all the regions has emphasized the importance of Bank staff monitoring macroeconomic developments, even where there is an IMF program in place. This monitoring can be selective, with particular attention directed to those elements of the macroeconomic situation that are most relevant to the adjustment operation. When these are sectoral areas that do not receive priority attention from the IMF, the Bank particularly needs to monitor performance in close collaboration with IMF staff. This coordination is reported to be working better than in the past. Often with the assistance of the IMF, operations are being designed with more explicit macroeconomic performance expectations to facilitate this facet of the supervision. Some include quarterly or semiannual reviews to monitor progress on all conditionality, in addition to the tranche release supervision mission.

A3.26 The monitoring of performance called for in loan conditions is, of course, the central focus of formal supervision. In this regard, it is important to monitor the extent to which the fundamental objectives are being met, as well as the specific quantitative targets. Here a great deal of judgment and senior management's attention is required, particularly when circumstances change and conditions need to be modified.

A3.27 More attention is also being directed to monitoring the social effects of adjustment operations. The Operational Directive on Poverty Reduction (OD 4.15)[62] stresses the importance of protecting the poor during adjustment. Subject to fiscal and administrative feasibility, all adjustment operations are to provide safety net protection for the most vulnerable segments of the population, address distortions that especially disadvantage the poor, and support a reorientation of public expenditures toward infrastructure and social services for the poor. Priority Poverty Indicators are identified, to serve as a basis for monitoring during adjustment. Supervision of adjustment operations should focus on the loan conditions concerning social impacts in these operations. The broader poverty issues are vitally important, and they are being addressed through a number of other components in the Bank's country programs, as discussed above.

A3.28 The supervision process can be staff-intensive, and a number of measures have been instituted to improve efficiency. Resident missions are increasingly being used to help in supervision. There are now more resident missions than several years ago, which increases the number of countries where this is possible. The missions established in Eastern Europe, Egypt, and several other countries had among their objectives to monitor reform programs and assist in implementation of adjustment programs. Other regions are also making greater use of their resident missions in the supervision of adjustment lending where they have appropriate staff.[63] Furthermore, recipient governments are being involved to a much greater extent in supervision. In LAC, for example, it has become standard practice to have the government designate a principal counterpart office for each adjustment operation. That office then has responsibility for monitoring and facilitating the execution of the project. This is usually the office that had a large input into the design and negotiations of the project, so it is well placed and motivated to help in the supervision. This also strengthens the government's ownership of the program. Other regions are experimenting with similar approaches.

A3.29 Reporting and monitoring of supervision is also a critical component of good supervision. Management is aware of the shortcomings of some of the current forms (for example, Form 590) for the specific requirements of adjustment supervision, as has been noted in several studies of supervision. In practice, staff make up for this by providing full reporting in their Back-to-Office reports and aide memoires, but an appropriate form is needed to provide more uniform information to management. A revision of the form is under consideration. But to be fully effective, it should be linked to changes in reporting and documenting supervision so that a more fully integrated system of reports, record keeping (electronic), and retrieval is instituted. The Task Force on Portfolio Management will consider these questions. In the meantime, several regions are addressing the issue of keeping better and more accessible databases on project implementation. LAC and AFR have already installed database systems on All-in-One that include relevant project data, including project supervision reports. This helps staff

both prepare and supervise projects by providing easy access to useful information about similar projects and recent actions. Other regions are considering adopting this system.

Summary and recommendations

A3.30 Overall, the supervision of adjustment lending has been satisfactory in that these operations perform as well as or better than investment operations, but they are not trouble-free. Project performance has not improved, either, in the past three years. There is, therefore, room for further improvement, following the lead of the recent innovations and best-practice examples cited above.

A3.31 It is clear that adjustment operations must be well formulated and conditions properly monitored. Integration of the supervision with the overall macroeconomic dialogue remains central, both because the supervision is a key part of that ongoing process and because the findings of supervision activities need to be taken into account for future operations. It is important for the dialogue to continue to protect against backsliding. It has been recognized that taking account of and compensating for negative social effects is vital to the success of adjustment programs domestically, and progress in mitigating these impacts needs to be monitored regularly and carefully. Application of the new guidelines in this area (OD 4.15) will promote better supervision. Needless to say, achieving these objectives on supervision require adequate levels and mixes of staff and other resources and appropriate reporting processes. Performance of the Bank in this area is regularly evaluated at the regional level, most systematically in conjunction with preparing the ARIS.

A3.32 A number of recommendations have already been made in the ARIS that cover adjustment supervision as well as investment supervision.[64] The Task Force mentioned above will review the state of portfolio management generally and is expected to identify ways to strengthen the process, including:

- Reviewing standing instructions for supervision and revising as necessary to assure their appropriateness to adjustment operations.
- Reviewing the potential for better application of information technology and the use of databases for portfolio management and feedback Bank-wide.
- Assessing the adequacy of resource allocations for, inter alia, adjustment supervision, including the use of resident missions.
- Including the reporting on adjustment lending supervision in future ARIS reports.

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

DATE: March 3, 1992

TO: Attila Karaosmanoglu, Managing Director

THRU: EG Enzo Grilli, Director, DPG

FROM: John D. Shilling, Economic Advisor, DPG

EXT.: 81943

SUBJECT: **Supervision of Adjustment Lending Annex, Draft**

Attached is a draft of the Annex on Supervision of Adjustment Lending for the RAL3 report. This was prepared in response to a demand from the JAC for further discussion of this issue following a less than satisfactory discussion of the OED report with the JAC held on September 23, 1991. That meeting asked for a separate paper to the Board on SAL supervision. With your concurrence, the decision was made to include an annex to the RAL3 report instead.

Our initial intention for this annex was to give a broad discussion of supervision in the context of RAL3, showing a concern for the issues raised and indicating some changes in supervision practices that have already taken place and some additional steps that will be taken to strengthen the supervision process, rather than a point by point response to the OED report and recommendations. This was partly due to the short time frame for catching up to RAL3, and partly to lower the profile of the issue after the JAC meeting. Many of the OED recommendations concern the design of adjustment operations, which is more directly an issue for the body of RAL3. The Annex actually covers the substance of most of the OED points: some with specific data such as the number of adjustment operations with social impact conditions, others more generally, and recognizing the importance of full and careful monitoring of the macro conditionality. The ARIS also responds to a number of the OED recommendations for supervision generally, for example, more recognition of staff work on supervision.

As expected, the response of reviewers has been mixed. Some are happy with the current draft and others would have preferred more a point by point response to the OED recommendations. I am concerned that if we did the latter, we would end up focusing more attention on the Annex than it is wise at this point, and particularly on what decisions and commitments management wants to take with regard to all the OED recommendations -- beyond taking note of them and working to improve the supervision process. The specific commitments now included try to be responsive without going too far. Preparing a point by point response with more examples, etc., would also take more time. In response to the concern of those reviewers who sought more specificity in our response to the JAC, I have sharpened the text and included more information on supervision activities, but it still remains within the initial framework of a fairly general response. I need guidance from you at this point on whether this is satisfactory for the Board. The summary of the JAC meeting indicated that an outline of the paper should be reviewed by the Chairman. Should we share a copy of this draft with him at this stage, or discuss its contents?

cc: Mressrs./Mmes Summers, Walton, Armitage, Salop, Lallement

Supervision of Adjustment Lending

Introduction

Adjustment operations flow out of jointly agreed objectives and measures determined in the context of the policy dialogue with member countries. Their supervision merits special attention both to gauge the general status of that dialogue and to verify that the specific actions contemplated in the operations are being taken and the pre-agreed objectives are being reached. Even after individual adjustment projects have been formally completed, the policy dialogue continues. The underlying reform program is often supported directly through follow-up projects (investment or adjustment) and implicitly through the overall lending program. The importance of continuity of the adjustment process is widely recognized by both management and staff. For these reasons effective implementation in adjustment operations is given considerable attention.

Supervision of the whole Bank/IDA portfolio in individual countries, including adjustment operations, is regularly reviewed in Country Implementation Reviews at the departmental level. Annually, the regional portfolios are reviewed in the Annual Report on Implementation and Supervision (ARIS) exercise, a Bankwide compilation of which is presented to the Board. The most recent ARIS was discussed in the Board on February 27, 1992. Furthermore, supervision issues that are specifically relevant to adjustment lending have been reviewed in specially focussed studies. The recent OED report on Effectiveness of SAL Supervision and Monitoring, (No. 9711, June 26, 1991) examined these issues in depth and made a number of recommendations 1/. IAD has also reviewed certain aspects of the supervision of adjustment operations for regional management and proposed modifications in procedures 2/.

Considerations in SAL Supervision

Supervision of adjustment lending differs in several important aspects from supervision of other projects, in degree if not kind. Adjustment lending is designed to support an ongoing policy reform and structural adjustment program. Each operation funds an identifiable phase of that program, but these phases are not necessarily discrete activities with a well identified beginning (ground breaking), focussed activity (piling of bricks and mortar), and end (ribbon cutting), as with much project lending. Nor are the final results always as easily identified and measured, being set in terms of developing a more efficient economy, improving output growth, sustaining balance of payments equilibria. Part of the "artistry" of designing adjustment operations, then, is in identifying quantifiable and monitorable indicators of progress and specifying appropriate target levels. Adjustment programs are, nevertheless, subject to many external and internal uncertainties and shocks that require ongoing adjustments in both policies and conditions. Supervision must work within this framework and is, in consequence,

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1/ These were discussed with the JAC in a preliminary manner, and this annex provides further elaboration on points raised in that report.

2/ See p.95 of the 17th ARIS, R92-14, February 5, 1992, for a mention of the IAD findings in LAC. Africa is currently considering a report from IAD on its adjustment supervision.

necessarily a continuation of the policy dialogue. It aims not only at monitoring performance, but often also at helping the country and the Bank adapt the reform program and the related targets to evolving circumstances. Obviously, such activity requires a high level of policy sense and judgment. These two factors -- integration into the policy dialogue and critical decision making responsibility -- explain both the importance of supervision of adjustment operations and its particular nature [3]/.

Supervision and the Policy Dialogue: Advising countries about overall policy directions has always been an essential part of the Bank's contribution to the development process. The advent of adjustment operations gave the Bank another instrument with which it could directly support policy reform in countries undertaking ambitious adjustment programs and a means by which it could play a larger role in helping shape those reforms. Adjustment operations are rarely stand-alone activities, but rather part of a series of operations supporting a multi year program of macroeconomic and/or sectorial policy reform. The Country Economic and often Sector Work usually lays the foundations for the reform program and contributes to the design of adjustment operations. During the adjustment period, much of the ESW and country dialogue focusses on the reform program. In reality, supervision of adjustment projects melds with that part of the policy dialogue, which continues after the intensive adjustment period is past. Lending activity then tends to shift to more specific investment projects, and actual monitoring of the program may occur through subsequent projects, general ESW, policy discussions, or hybrid projects.

With occasional exceptions, continuing dialogue is sufficient to prevent backsliding on adjutment measures after an adjustment project is closed and formal supervision has ceased. In many of the cases where major backsliding has occurred, there was a major breakdown in the policy dialogue and country relations became strained. Such cases require major efforts to restore the basic dialogue before backsliding can be reversed. In these instances, slippage is not a supervision issue, but one of the basic dialogue. When a productive dialogue has been resumed and a country seeks further adjustment lending, lapsed and unfulfilled past conditions need to be made up to the extent they are still relevant. This is normally done in the context of new operations. For example, the recent ERL to Panama picked up reforms that had lapsed under SAL II as conditions of negotiations and effectiveness. Similar treatment has been applied to Honduras and Zambia.

In Bank procedures, supervision is normally defined as a discrete activity. This is appropriate within the investment project cycle, where the need for supervision ends once a project is closed (except for PCR type activities), but it is much less so in the context of adjustment lending. This view of supervision is reinforced by the accounting system. The result is that recorded time spent on supervision of adjustment operations tends to understate the actual effort spent, since adjustment lending has a much larger policy component than supervision of investment projects.

Supervision and Decision Making Responsibility: A central focus of adjustment lending supervision is the tranche release recommendation. In conventional adjustment operations, this typically occurs about 12 months after the operation is effective. Operations with three tranches offer two such opportunities. On occasion, some supervision is involved in monitoring effectiveness conditions

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[3]/ Some of the issues related to supervision of adjustment operations also apply to supervision of investment lending.

for the first tranche release, but normally those conditions are met by the time of Board presentation. The tranche release review is considered a very important activity in the borrowing country, not only because a substantial resource transfer hinges on the outcome, but also because a positive decision constitutes proof that the policy dialogue with the Bank is proceeding satisfactorily. It is also a visible operation in the Bank because it results in a recommendation to senior management and a report to the Board. In cases where there are major modifications in implementation of the program, a Board decision may also be required. For these reasons, tranche release reviews are conducted and monitored at senior levels in the Bank. In most cases, the Lead Economist participates in the supervision mission considering tranche release, or carefully reviews its findings. In cases where there are serious issues of performance, key regional managers (Division Chiefs and Department Directors) and senior management are also involved.

Given the varied nature of adjustment operations, the actual mix of inputs going into supervision and the amount of subsequent decision making normally differs from country to country and operation to operation. In cases where the reforms concern changing regulations, rate schedules, and government practices (e.g. tariff reform and trade facilitation measures), much of the conditionality can be satisfied by specific and well identified actions. In these cases, it is relatively easy to specify and monitor performance, and neither supervision nor tranche release work requires a large input of resources. On the other hand, programs that imply extensive institutional and behavioral change (e.g. public enterprise reform) tend to be more difficult to implement and then require more intensive supervision to assure that implementation of the agreed measures, which could include restructuring enterprises and government departments, are effectively taken. Moreover, substantial and detailed stimulus from the supervision missions may be needed to translate the overall SAL/SECAL framework into practical outcomes that achieve the program's objectives. This is more frequently the case with SECALs, where the range of skills and level of resources necessary for supervision can be quite extensive. How much Bank input is actually required depends on the government's own implementation capacity, the complexity of the reform program, and the evolution of external events. In cases where the adjustment operation is supporting a fundamental transformation of a country's economic structure, such as in the formerly centrally planned economies, more intensive supervision is also required. It is provided directly and through the country dialogue.

Many factors which affect the success of an adjustment operation obviously can be controlled only partially at the design stage. Unexpected changes in internal and external circumstance can place greater burden on the supervision process and require the staff to take on complex adaptation problems, including the re-design of parts of the operations [4]/. These and other factors can account for a wide variety of effort allocated to supervision, even among well designed projects

Supervision of Adjustment Operations

Learning from experience: The structure and content of adjustment operations are continuously evolving as staff gain more experience and as

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[4]/ While it has been a consistent goal of staff and managers of avoid overly complex projects, the problems countries are trying to solve with adjustment programs are often complicated and do not always lend themselves to simpler projects and conditionality.

circumstances faced by borrowers change. The Bank has been flexible and adaptive in reviewing its activities and seeking to improve its effectiveness in this area. The series of RAL reports completed thus far is an important example. Practices have improved as staff learn better ways of doing things and as systematic reviews of adjustment operations and their implementation highlight problems. Supervision reviews, in fact, tend to be comprehensive in their analysis. Coming at the end of the project cycle, they also deal with the problems of design and process management that have arisen. This is beneficial since improvements in design at the start not only facilitate future supervision, but also and more importantly, strengthen the Bank's ability to support effective adjustment programs. The recent OED report, for example, identified improvements in the design, management, and supervision of adjustment operations in about equal proportion. Many of its recommendations reflect well known problems, and the report itself indicates that progress is evident in some areas. Recognizing the importance of improvements in this area, the Bank has just created a high level task force under the leadership of Mr. Wapenhans to review portfolio management and evaluation. It will cover many of these issues and is expected to make recommendations covering the whole process, including supervision of adjustment lending, that will go beyond the scope of this report.

Project Design Issues: Shortcomings in project design often become apparent in the supervision process, either because they make the project difficult to supervise or because they require extensive subsequent inputs to make the project work. Design issues that have been identified for adjustment loans in the recent studies include: (i) insufficient attention to assuring the suitability of the macro economic framework (particularly for SECALs); (ii) insufficiently precise and monitorable conditionality; (iii) lack of full government commitment and ownership of the program and its implementation; (iv) mismatches between timing of disbursements and reasonable periods to achieve reforms; and (v) insufficient attention to negative social impacts of the adjustment measures.

Past RAL reports have made a number of recommendations on how to improve adjustment operations, including paying closer attention to the macro-economic framework, obtaining stronger national ownership, and assuring sufficient attention to social and poverty impacts. Staff work to incorporate the RAL recommendations into new operations, as discussed in the main report. Furthermore, at a regional level, a great deal of attention has gone into how to design better operations, drawing on the experience of other countries. Greater use is being made of peer reviews from experts outside the region in preparing projects, for example.

The social impact of adjustment policies supported by Bank loans and credits is also receiving greater attention: the proportion of adjustment projects with specific conditions on mitigating social impacts, for example, has risen from 7% in 1979-85 to 11% in 1986-88 and 33% in 1989-90. Parallel poverty alleviation projects are also being processed in a number of countries, recognizing that the time required to improve delivery systems for social programs is often longer than that of the adjustment operations. *The 1990 WDR on Poverty*, the recently released *Operational Directive on Poverty Reduction (OD 14.15)*, and the *Poverty Reduction Handbook* have provided more direction and systematic analytic tools to staff to improve poverty monitoring.

On timing of reforms, three tranche operations are becoming more common to better match, inter alia, the disbursement profile with the period of the

adjustment process. Only 7% of adjustment operations had three tranches in FY 87. This figure rose to 17% in FY 89 and 41% in FY 91 (excluding debt reduction loans). Furthermore, between FY89 and FY91, implementation periods have lengthened from 2.2 to 2.5 years for SALs, and from 3.3 to 4.0 years for SECALs. The longer implementation periods reflect primarily longer program design, although difficulties in sustaining adjustment programs have also contributed to delays in completing some projects.

A great deal of effort is also going into making conditionality more transparent and monitorable and to strengthening the links to the macroeconomic framework; not only to ease supervision, but because it makes for better projects. However, the extent to which the number of conditions can be reduced depends on the complexity of programs, the stage of adjustment, and the number of prior actions taken by the governments. Reducing the number of conditions is a desirable goal, but its achievement does not depend solely on the Bank's actions. The relatively greater use of SECALs in recent years, for example, has helped to improve the specificity of conditionality, but has also placed an added burden

Management of the Supervision Process: Successful supervision depends on the management of the process as well as the inputs devoted to the activity itself. Furthermore, proper reporting and recording of mission findings concerning progress on adjustment is important. Management must make sure that findings from different activities, including ESW and other dialogue, are integrated with supervision reports, most importantly to inform the tranche release decision and subsequent policy discussions. Issues that have been raised concerning management of the process include: (i) the adequacy of resources supporting supervision; (ii) the continuity and level of staffing of supervision; (iii) the recognition given to staff for supervision; (iv) the integration of different reporting activities; and (v) the ways of monitoring adjustment reforms beyond project completion.

Managers have been innovative in finding ways to increase supervision activities within constrained budgets by combining tasks. Supervision actions are often included in economic and policy discussion missions; supervision missions are combined and supervision activities included in preparation of subsequent projects; and implementation issues are often discussed with high level delegations from member countries to headquarters. These innovations have the added advantage of greater integration of findings from supervision and other ESW activities with the decision making process. On an annual per loan basis, recorded time spent on supervision of adjustment operations is much higher than for investment lending. This difference is most marked in the first three years of project implementation. Thereafter, supervisioin of adjustment operations falls off sharply as most are closed by the fourth year. Over the entire life of a project, therefore, investment operations tend to have as much or more total supervision. For projects approved during FY 80-89 and fully disbursed by February 1990, adjustment operations received an average total of 47 staff weeks of supervision compared to 68 staff weeks for investment operations. Inputs per $ million commitment for supervision were .35 sw for adjustment and 1.34 sw for investment operations.

Across the board, supervision per operation (adjustment and investment projects) is increasing. In the case of adjustment operation the trend is somewhat mixed by region. This is to be expected since adjustment operations constitute a smaller sample than investment projects and are more subject to short-run

variations. A (moderate) relative shift in supervision resources toward investment lending, within a growing total, seems to have occurred over the past three years. The average adjustment supervision input is rising in AFR, where there have been more difficulties with adjustment operations, and in Asia. Supervision has risen, if less uniformly, in LAC, and has declined in EMENA. The latter trend is due to a changing mix of operations. Adjustment activities in older clients have been

Supervision per Adjustment Operation (sw/yr)

Region	FY89		FY90		FY91	
	Adj.	Inv.	Adj.	Inv.	Adj.	Inv.
Africa	17.1	9.7	17.8	11.4	18.0	12.2
Asia	9.2	10.7	10.4	11.1	13.7	12.9
EMENA	20.6	9.5	16.7	9.9	14.3	10.7
LAC	10.3	8.8	14.9	9.8	12.9	10.4
Bankwide	15.0	9.8	16.3	10.7	15.6	11.8
Yrs 1-3 [a]	16.4	12.7	20.1	13.9	19.4	14.6

a. Average of Adjustment and Investment projects

winding down and their supervision activity declining, but there has been at the same time a sharp increase in the number of start-up operations in new clients in Eastern Europe, where supervision has only just begun. The region expects that the supervision effort will climb rapidly as these operations mature.

Compared to investment lending, adjustment lending operations perform at least as well, if not marginely better, on average, in terms of the Bank's project rating criteria. Over the past three years, their average performance ratings have been slightly better overall and by region, with the exception of EMENA in FY89. Other than Africa, there are few adjustment operations that are classified as problem projects. Whether this better performance is due to more intensive supervision resources in early years, to the high level of attention accorded to adjustment operations in most countries, or to other factors is not possible to determine; but such performance is consistent with the small, relative shift in supervision resources toward investment supervision noted above.

Portfolio Status of Projects[a]

	FY 89		FY 90		FY 91	
	Rating	% of Port.	Rating	% of Port.	Rating	% of Port.
Bankwide Adj.	1.6	8	1.7	7	1.8	11
Int [a]	1.8	13	1.9	17	2.0	20

a. Rating range from 1 (no significant problems) to 4 (major problems, not being addressed).

The adequacy of the level of resources devoted to all supervision is an important point that has been discussed in the ARIS report and is also the subject of overall budget discussions. Changes on this account would have to be weighed against possible reductions in other activities or a budget increase. This remains a critical issue for management attention.

All regions are according more attention to supervision and explicitly emphasizing contributions to supervision in staff evaluations. Regional managements have explicitly stated this in the context of the most recent ARIS exercise. Follow-up on these instructions will be monitored. Continuity of staff is being emphasized to assure that those involved in the supervision were also involved in the design. However, most regions report that it does not appear to be necessary to retain the same task manager in all cases, since different skills may be more appropriate for supervision. Additional training on supervision is also receiving more attention.

Improvements in Supervision Practices

Some concerns have been raised about certain aspects of the supervision process, including: (i) the monitoring of macroeconomic conditionality attached to it; (ii) the monitoring of the social impact of adjustment; (iii) the accuracy and completeness of the Bank reporting system; and (iv) the involvement of resident missions in the supervision process. These are valid concerns. The experience of implementing adjustment loans over the past decade, plus a number of analyses, have contributed to a more effective adjustment lending program, both in design and execution, and also to better supervision of adjustment operations. The learning and the efforts to improve have not ceased.

It is to be stressed that the practices of supervision are continually being modified at the regional and departmental levels. Innovation is often a direct result of experience, and it is usually related to particular country circumstances or the structure of particular operations. Successful innovations generally become widespread as staff share their experiences. For example, the Africa region management now explicitly reviews adjustment lending implementation project by project annually to help resolve problems and disseminate best practices. In addition, systematic reviews of supervision in regional implementation exercises and studies by units outside the regions have led to more general improvements in adjustment supervision. The following discussion of recent practice is drawn from interviews with regional managers and adjustment operation task managers and addresses most of the concerns that have been identified.

Close attention to sustaining a viable macroeconomic framework is very important to the success of adjustment loans. This is particularly true in SECALs, where the macro-economic framework is less central to the explicit conditionality of the loan. Management in all the regions has emphasized the importance of bank staff monitoring macro developments, even where there is an IMF program in place. This monitoring can be selective, with particular attention directed to those elements of the macro situation that are most relevant to the adjustment operation. When these are sectoral areas that do not receive priority attention from the IMF, the Bank particularly needs to monitor performance in close collaboration with IMF staff. This coordination is reported to be working better than in the past. Often with the assistance of the IMF, projects are also being designed with more explicit macro performance expectations to facilitate this facet of the supervision. Some include a mid term (to tranche release date) supervision review to monitor progress on all conditionality well before the scheduled tranche release date, which would be the focus of another supervision mission.

The monitoring of performance against all conditionality is, of course, the central focus of formal supervision. In this regard, it is important to monitor the extent to which the fundamental objectives are being met, as well as the specific

quantitative targets. Here a great deal of judgment and senior management's attention is required, particularly when circumstances change and conditions need to be modified.

More attention is also being directed to monitoring the social impacts of adjustment operations. The *Operational Directive on Poverty Reduction* [5]/ stresses the importance of protecting the poor during adjustment. Subject to fiscal and administrative feasibility, all adjustment operations are to provide safety net protection for the most vulnerable segments of the population, address distortions that especially disadvantage the poor, and support a reorientation of public expenditures towards infrastructure and social services for the poor. Priority Poverty Indicators are identified which are to serve as a basis for monitoring during adjustment. In view of the fact that efforts to mitigate the negative impacts of adjustment program often depend on creaky delivery systems, a number of departments are also processing parallel operations to address poverty and social impact issues. These operations have longer implementation periods commensurate with the rate of progress that can be made in improving delivery systems. Actions that can be undertaken directly and quickly are included in the adjustment operations. In addition, several adjustment projects focusing explicitly on reforms to alleviate social impacts are under preparation. Supervision of adjustment operations should focus on the conditionality concerning social impacts in these operations. The broader poverty issues are vitally important, and they are being addressed through a number of other components in the Bank's country programs.

The supervision process can be staff intensive, and a number of measures have been instituted to improve efficiency. Resident missions are increasingly being used to help in supervision. There are now more resident missions than several years ago, which increases the number of countries where this is possible. The missions established in Eastern Europe, Egypt, and several other countries had among their objectives to monitor reform programs and assist in implementation of adjustment programs. Other regions are also making greater use of their resident missions in the supervision of adjustment lending where they have appropriate staff [6]. Furthermore, recipient governments are being involved to a much greater extent in supervision. In LAC, for example, it has become standard practice to have the government designate a principal counterpart office for each adjustment operation. That office then has responsibility for monitoring and facilitating the execution of the project. This is usually the office that had a large input into the design and negotiations of the project, so it is well placed and motivated to help in the supervision. This also strengthens the government's ownership of the project. Other regions are experimenting with similar approaches.

Reporting and monitoring of supervision is also a critical component of good supervision. Management is aware of the shortcomings of some of the current forms (e.g. From 590) for the specific requirements of adjustment supervision, as has been noted in several studies of supervision. In practice, staff make up for this by providing full reporting in their BTORs and aide memoires, but an appropriate form is needed to provide more uniform information to management. A revision of the form is under consideration. But to be fully effective, it should be linked to changes in reporting and documentation records of supervision so that a more fully

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[5]/ Which was recently issued following the December Board seminar.

[6]/ This point was also emphasized in the ARIS.

integrated system of reports, record keeping (electronically), and retrieval is instituted. The Task Force on Portfolio Management will address these questions as well. In the meantime, several regions are addressing the issue of keeping better and more accessible data bases on project implementation. LAC and AFR have already installed data base systems on All-in-One that include all relevant project data, including project supervision reports. This helps staff both prepare and supervise projects by providing easy access to useful information about similar projects and recent actions. Other regions are considering adopting this system.

Summary and Recommendations

Overall, the supervision of adjustment lending has been satisfactory in that these projects perform as well as or better than investment projects, but they are not trouble free. Project performance has not improved, either, in the past three years. There is, therefore, room for further improvement, following the lead of the recent innovations and best practice examples cited above.

It is clear that integration of the supervision with the overall macroeconomic dialogue remains central, both because the supervision is a key part of that ongoing process and because the findings of supervision activities need to be taken account of in future operations. It is important for the dialogue to continue to protect against backsliding. It has been recognized that taking account of and compensating for negative social impacts is vital to the success of adjustment programs domestically, and progress in mitigating these impacts needs to be monitored regularly and carefully. Application of the new guidelines in this area (OD 4.05) will promote better supervision. Needless to say, achieving these objectives on supervision require adequate levels and mixes of staff and other resources and appropriate reporting processes. Performance of the Bank in this area is regularly evaluated at the regional level, most systematically in conjunction with preparing the ARIS.

The Task Force mentioned above will review the state of portfolio management generally and is expected to identify ways to strengthen the process. In addition to that and to increased attention from senior and regional management to assuring that adjustment operations are well formulated and conditions properly monitored, as discussed above, there are a number of actions to be undertaken on the basis of our current understanding of the issues.

To this end, complementing the recommendations already made in the ARIS that cover adjustment supervision as well as investment supervision [7/], the Bank proposes the following:

(a) Review the Form 590 and related OD on supervision for appropriateness to adjustment supervision and revise them accordingly in the context of the overall revision of portfolio management;

(b) review the regional project implementation databases for

(c) assure adequate resources are devoted to adjustment supervision, including appropriate senior staff and use of resident mission staff; and

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[7/] ARIS, pp. 37-40.

(d) include a separate and focussed discussion of adjustment lending supervision in future ARIS reports.

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

• Ral III file
• IMF file.

DATE: April 9, 1992

TO: Mr. John T. Boorman, Director, ETR, IMF

FROM: Lawrence H. Summers, Vice President, DEC

EXTENSION: 33774

SUBJECT: Your Memorandum on RAL-III

1. In reference to your memorandum to me of February 18 on the Third Report on Adjustment Lending (RAL-III), I would like to thank you for your comments and suggestions, most of which were incorporated into the draft circulated on February 28. Ms. Puckahtikom received a copy of the revised Executive Summary, as requested. We have also sent you copies of the Board version of RAL-III, which was issued March 24.

2. Although we have incorporated the language you suggested (i.e. that Bank staff will seek the views of Fund staff on macroeconomic policies and take these views into account), I wanted to clarify the Bank's position on the inclusion of macroeconomic conditionality in adjustment operations, to which you object as inconsistent with appropriate Bank-Fund collaboration. My reading of the record, including the March 31, 1989 Memorandum of Understanding, is that the Bank is not prohibited from having loan conditions that apply to macroeconomic issues. The two institutions have a strong obligation to consult each other in planning our actions in support of adjustment programs. And the Bank has a specific obligation to seek the Fund's views on the macroeconomic situation, particularly when there are no Fund arrangements in place (which, I understand, the Bank does regularly). But the Memorandum also stresses the independence of institutional decisions by the two organizations, with each proceeding with its own financial assistance according to the standards laid down in its own Articles of Agreement and the policies adopted by its Executive Board.

3. More substantially, perhaps, we have two specific concerns in writing conditions into adjustment operations that lead us to include macroeconomic targets at times. One concern is to safeguard our portfolio where a Fund program does not exist. The other is to provide complementary and supportive conditionality in areas not adequately covered by Fund programs. This has to do with both our focus on medium-term growth and structural change and with the "vintage" of existing Bank and Fund programs. You may recall that RAL-II had the following recommendations on ensuring macroeconomic stability, which were carefully drafted, with inputs from your side as well (paras. 1.31-2):

> 1.31 Adjustment lending must be consistent both with the Bank's development objectives and with the sound management of its portfolio. The Bank must therefore ensure that the macroeconomic situation will not seriously reduce the benefits from Bank Group support of a structural adjustment program or jeopardize the credit-worthiness of the borrower. Tranche release conditions in adjustment loans have always required satisfactory progress with the overall program, including its macroeconomic component. The

Bank and its borrowers have in some cases documented their understanding of the importance of a supportive macroeconomic situation by referring, either in the letter of development policy or in separate letters of understanding, to target values of key variables, such as public sector saving as a share of GDP, the change of the real exchange rate, the inflation rate, and the real interest rate.

1.32 We anticipate that such an approach will increasingly be reflected in loans brought to the Board. At the time of tranche release, if departures of macroeconomic indicators from their targets are jeopardizing the program's objectives, the Bank will seek the Fund's views on macroeconomic policies and take them into account in the Bank's assessment of the macroeconomic situation.

These conclusions seem sensible to me. What I wish to stress again here is that the purpose of macroeconomic conditionality in Bank adjustment lending is not at all to duplicate efforts of the Fund and certainly not to undermine them, but rather to complement and support them, and -- at the same time -- to address the concerns of our management and Board of Directors with respect to borrower creditworthiness.

4. I hope this helps clarify where we stand on the issue of macro-conditionality in Bank adjustment loans. I will be glad to sit down with you and talk some more about it, if you find it desirable.

cc: Messrs./Mmes. Walton, Grilli, Birdsall, Blejer, de Melo, Webb (IBRD); Ms. Puckahtikom (IMF)

cc: DPG

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: December 4, 1991

TO: Mr. Steven B. Webb, Sr. Economist, CECMG

FROM: Ishrat Husain, Chief Economist, AFRCE

EXTENSION: 34637

SUBJECT: RAL III

Thanks for inviting me to your seminar on RAL III. I benefitted a great deal from the useful exchanges and discussion that took place that day. While reflecting back on the issues and conclusions of the report, I thought it may help you and the other authors if I put together some of my reservations, concerns and suggestions in writing.

The report is focussed on Adjustment Lending (AL) operations of the Bank and, therefore, like its predecessors, asks the question about the impact of AL on various country performance indicators -- GDP growth, export growth, investment, inflation, etc. Leaving aside the difficult questions (a) whether AL, as designed, alters the policy outcomes of the recipient countries in the way postulated by the Bank, (b) assuming that these policy changes are desirable and move in the right direction, do they affect performance in a predictable way, and finally (c) whether we are measuring the performance rightly, my fundamental concern is about the coverage of countries under various groups, the methodology used in the paper and the interpretation of the results. Finally, I ask the question whether there are any lessons we can draw from RAL III to improve the design and content of the adjustment lending operations.

Country Coverage, Control Groups and Time Periods

The most important issue which will affect the final outcome is the coverage of countries under various categories used in the report. I do understand that these categories have been used in the previous reports and that you are following that precedent but don't you think it is time that we revisit this issue? The mere fact that a country has borrowed from the Bank and the Fund for adjustment does not necessarily imply that the country has successfully implemented the required policy changes. Countries have abandoned the programs in part or in whole. There are instances where the Fund or Bank conditions were met, tranche releases were made and loans were fully disbursed, yet the countries have back slided and rolled back the reforms. Thus to be able to compare the performance of "Adjustment Lending Countries" with those of "Non-adjustment Lending Countries" (NAL) correctly, it is essential to apply more rigorous criteria for inclusion in the AL group rather than the simple fact that the country has received an adjustment loan.

For example, we would not consider the following countries in SSA to be strong reforming countries (even though they are "intensive lending" countries in the RAL classification): Cote d'Ivoire (program was on and off during the 1980s); Tanzania (early program was abandoned and a strong program was resumed only in 1986); Mauritania; Nigeria (program only began in 1986); and Zambia (program has been mostly off track in the 1980s). In the NAL group, we would exclude Botswana, Lesotho and Rwanda, which followed reasonable policies during most of the 1980s -- but that would leave a sample of only three NAL SSA countries -- too small to interpret easily.

Second, the NAL group contains good performers such as Malaysia, Botswana, Portugal and Greece on one hand, and Liberia, Syrian Arab Republic, Mayanmar, Haiti and Nicaragua on the other hand. What do the countries have in common? Only that they did not have an AL from the Bank. Does this aggregation of countries lend itself to an analytically useful control group with which AL countries could be compared and sensible inferences drawn about the effectiveness of adjustment lending? Can we convince anyone about the strength of our results based on this comparison when the control group is so odd and heterogenous? Is there a better control group which can provide an analytically sound reference point? I suspect that this high variance in the NAL group would introduce bias in the estimation of significance.

The report uses 1986-90 as the "post program period." The adoption of full-fledged macro-economic adjustment programs has probably occurred later in SSA than in other regions. Of the 13 IAL SSA countries classified by RAL3, only about six have had fairly strong, uninterrupted reform efforts since the first half of the 1980s (Mauritius, Kenya, Ghana, Malawi, Madagascar, Togo). Thus, for SSA, there may not have been sufficient time for the reform measures and structural adjustment to have be fully reflected in economic performance. Moreover, given certain "initial conditions" in SSA that are not reflected in Table 2 -- those related to less economic diversity and more institutional weaknesses -- the response to reforms may take longer in this region. Thus, most adjusting SSA countries are still in the middle of the program period.

I suggest we should do some hard thinking and take some hard decisions to classify countries according to their actual reform performance so that we can have a meaningful assessment of the impact of adjustment lending.

Methodology

This report, like RAL II, uses the modified control group approach to correct the identification problem. I am not sure if this approach satisfactorily resolves the identification problem. This approach can achieve the desired results if the program effect equation is correctly specified and good instruments are used to explain the participation decision by the country. In a companion paper I have seen the specifications of the program effect equation but the choice of the variables was not convincing. A discussion of sensitivity tests would

illuminate how robust the conclusions are if different specifications are tried.

In case of SPA countries the terms of trade effects during the period of adjustment were more adverse than the non-SPA countries, but these were offset by better domestic economic policies and management culminating in relatively higher rates of GDP growth. The result from the modified control group approach concludes that the impact from adjustment in Africa, after accounting for the initial conditions, external environment, etc., is not as pronounced as in other countries. the GDP growth rate of Sub-Saharan Africa IAL is only 1.6 percent in 1986-90 period compared with 2.7 percent for all IAL countries. In a background paper, it is shown that the marginal effect of adjustment after controlling for initial conditions, external factors, policy stance in pre-program period are not statistically different among EIAL countries of SSA compared with the rest of SSA, although the periods compared are different. Hans Singer uses this finding in his paper to argue that welfare changes in the two groups were almost identical. I would submit that if the SPA countries had not made strong adjustment efforts internally, the welfare and income losses in SPA countries, in wake of the given terms of trade effects, would have been higher. The capacity of these low income countries to weather some of the exogenous shocks is a recent phenomenon and most welcome. This can be compared to India's capacity in the 1980s to have enough food in stock in face of severe drought conditions in contrast to the famine conditions of the 1960s.. I recognize that adjustment effort is still weak and fragile in the African countries but this point needs to be highlighted.

The data in the current version make it impossible to compare the change in the country performance indicators with the regression results; while both use 1986-90 as the final period, the initial period is 1971-80 for the performance indicators and 1976-80 for the regression results. Thus, it is impossible to judge if the improvement in 1.6 percentage points for GDP growth in the SSA IAL countries in 1986-90, compared to the earlier period, is better or worse than a comparison that does not take account of initial and external conditions. <u>As a minimum, Table 6a should give data for 1976-80.</u>

Medians are probably a more appropriate measure of central tendencies in the various groups when the indicators vary widely among countries -- especially inflation rates, real effective exchange rate indices, and black market premium. Some countries, like Zaire and Ghana, have had enormous devaluations, which will bias even the unweighted averages. The somewhat more muted response observed for Africa will be more understandable if the reform indicators are presented using medians ("average" devaluation will be less and inflation will probably be less). Finally, the IMF seems to use medians increasingly to describe results and we are moving this way in presenting African data. <u>Data in Tables 5a and 5b might be shown using medians.</u>

In the performance indicators, we have usually used export growth rates and investment growth rates, rather than ratios of GDP because of problems with deflators. The use of constant price series for the

ratios becomes harder to interpret when there are large real devaluations because price weights change. Results would be different depending on whether pre or post devaluation prices are used as weights. Base years before devaluations will give smaller changes in export shares than base years after devaluations. The fact that most devaluations in Africa occurred in the mid to late 1980s -- later than elsewhere -- may explain the smaller change in export shares in Table 7a. Moreover, we are mainly concerned about export growth rates -- not shares -- because this is the source of growth, and we are concerned about whether the capital stock is rising or falling. As a minimum, it would be interesting to explore an alternative presentation of Table 7a using export growth rates.

Fiscal deficits need to be precisely defined, as to whether they are before or after foreign grants (the text implies they are before all foreign financing) (Table 5a). However, as grant financing to support adjustment programs has increased in SSA, it follows that fiscal deficits before grants may in fact have to increase to absorb this financing. However, the critical factor affecting inflation is domestic financing of the budget deficit.

It is clear that adjustment status and external financing are highly correlated variables. Including both in a regression leads to collinearity, which biases measures of significance. The collinearity is probably worse for SSA countries because nearly all external financing is official, and donors are so closely coordinated. This may be one reason why many of the coefficients are not significant in the equations for SSA reported in Table 7. The appropriate correction, in this case, is not to include the variable for external financing.

Interpretation of the Results

The report's conclusion that investment as a share of GDP has declined sharply in the low-income AL countries (most of which are in Sub-Saharan Africa) relative to the levels of the 1970s and early 1980s needs some further analysis.

First, the decline in level of investment in the post-adjustment phase may have taken place as a result of a number of factors: (a) the efficiency of investment may have improved due to removal of price distortions, (b) rate of existing capacity utilization may have increased due to liberalization of import regime and thus the availability of raw materials and spare parts, (c) unproductive public investment programs may have been curtailed or cut back and as the share of public investment is relatively high, this would show up as a decline in total investment, and (d) the impact of large exchange rate changes (resulting from adjustment programs) could be very negative on level of investment as the increased (post-devaluation) prices of imported capital goods and inputs would reduce the investment demand in the short run. Thus, in the short run, it is quite plausible that the investment ratios may fall without any decline in growth rates. In SPA countries we have estimated that the average ICOR in 1988-90 period was 5 compared to 18 for the period 1980-84. (There may also be some measurement problems because as external financing shifts from projects to program

lending, investment expenditure may not be fully recorded.) The discussion in Chapter 2 should be amplified to examine the above effects and particularly the consequences of exchange rate changes.

Second, I do not dispute the need for increasing investment ratios in these countries -- particularly private investment in export-oriented sectors -- to reduce dependence on unsustainable level of foreign savings. But I would like to reiterate that the selection of 1970s or early 1980s as the base period for comparing investment rates is not right. A combination of negative real interest rates and the need to recycle surplus of oil exporting countries culminated in "excessive" supply of foreign funds to developing countries that boosted the investment rates in 1970s. Studies have shown the low productivity of these investments and the debt crisis of 1980s has highlighted the need for a more cautious and prudent approach towards foreign borrowing. I would therefore argue that the supply driven investment ratios of the 1970s were an aberration and should not be used as a norm to evaluate the behavior of investment in the 1980s. The data clearly bears this out. Gross domestic investment rates for Sub-Saharan Africa in 1970 was 15.1 percent and it is only by the mid 1970s that it jumped to 23 percent. Another reference period that is more representative of the trend should be chosen for the comparison of investment rate.

The choice of Ghana to examine investment performance is flattering to us but we would like to caution that (a) the data on investment in Ghana is very poor, and (b) the data reported in Chapter 2 is not even up-to-date. The latest numbers, if anything, show a rapid recovery in investment although from a very small base. This fact needs to be highlighted.

The results in Table 7 must be interpreted for SSA in light of the mixed groups (not all EIAL countries have sustained their programs, and not all IAL countries have strong reform programs, some OAL countries have strong, but recent programs, and some NAL countries have followed policies as good as any EIAL country) and the timing of the reforms. The conclusion that "the worst performers were all in SSA" (p. 34) is easily misinterpreted. "Worst" in this case is relative to the predicted values of the regression, which is at best a partial model. Moreover, to the extent that the groupings for the dummy variables are poor, the predicted values will be difficult to interpret. This section needs to be more carefully discussed or dropped.

The discussion of the different export growth responses across country groups should include a consideration of export diversity. There is readily available evidence that primary commodity concentration is higher in SSA adjusting countries than in other adjusting countries. Thus, the base for expanding export volume, when demand for primary commodities is weak, is smaller for these countries. Overcoming this problem is a longer-term development issue, not simply an adjustment issue. Getting policies correct will help speed the process but will have a more limited effect than if the more diverse were already in place. The Box on SSA could, however, use examples to show how this happens (e.g., Mauritius).

Design and Content of the Adjustment Loans

This report can provide a much useful service to those of us who are involved in designing AL operations if it is able to test the strength of the policy changes advocated in the AL operations and on the timing, sequencing and phasing of these reforms -- an issue that we have been grappling for quite some time. I am particularly concerned about the feasibility and time path of the conditionalities contained in the PFPs within the given time horizon that has to coincide with SAF/ESAF disbursements. The more frequent conditionalities employed in the PFPs to cut back fiscal deficits and current account deficits are (a) import compression, (b) limiting level of development expenditure, (c) cutting back O&M and other non-wage expenditures, and (d) lowering agriculture producer prices. It is not clear to me that either of these instruments would create a beneficial effect on the growth of GDP, exports, investment -- the variables you are measuring in RAL III. Thus it would be interesting to explore whether there is "stabilization overhang" in the design of adjustment programs supported by the Bank that may be contributing to the weak results contained in the report.

In my view, an understanding of the relationship between the instruments used in AL operations and the behavior of performance indicators -- however imprecise or qualitative as it may be -- would make a much better contribution than some of the other findings reported so far.

The report renders a useful service by bringing out differences in the performance of middle income countries and SSA. The next logical step is to investigate whether (a) the structural weaknesses in SSA call for different expectations about the success of the program as it will take longer to implement the reforms and the effects to take place in the economy, and (b) the policy prescriptions that may be valid at the level of development of MICs may not be applicable to SSA and a much broader differentiation in policy advice is needed.

Let me assure you that my colleagues and I are very keen to learn from the experience of adjustment in Sub-Saharan Africa and we attach a lot of importance to your work. But we want to be sure that we are measuring the comparative performance rightly across time and across country groups and that the interpretation of the results is unambiguous.

cc: Regional Management Team, AFR
Lead Economists, AFR
Group Team 2, AFR
Messrs. Summers, Linn, Rao, Birdsall, Grilli, Kavalsky, de Tray, Walton, Hasan, Selowsky, Thomas, Squire, Nankani, Blejer, Acharya, de Melo, Shirley, Shang, Nehru, Humphreys