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THE WORLD BANK

Washington, D.C.

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The World Bank

1818 H Street NW

Washington DC 20433

Telephone: 202-473-1000

Internet: www.worldbank.org

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Future Role of the Bank - set

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OFFICE MEMORANDUM

*J: Please file 1 copy in Divisional Strategy
1 copy in a folder with material for WAPTI's retreat,
1 copy in Mr E Stern's Man (my blackbook), and circulate 1 copy to all staff for info. This material would be part of background material next fall.*

DATE: July 5, 1985
TO: Bank Department Directors, Deputy and Assistant Directors, and Division Chiefs
FROM: Alan Drattell, Chief, Internal Communications
EXTENSION: 74685 (Rm. D-839)
SUBJECT: "Future Role of the Bank"

*(17)
7/27*

Recently a number of managers have sought more information on the "Future Role of the Bank," and it would appear that some did not receive the briefing note given to the media at the time of the April Development Committee meeting. We hope you find the attached paper useful.

Pm.

FOS-01

0055

Soto, Alfredo
B 308

(C/v)

Perspectives On The Future Role Of The World Bank

April 19, 1985

Introduction

The World Bank has been involved with reconstruction and development for 40 years. In that time its operations in more than 130 countries have had a volume of over \$135 billion and they have been joined by funds from other sources to finance investments of a total value several times this amount. Moreover, in this period The World Bank has made a most significant contribution as an adviser to governments on development strategies and as a leading center for research into development issues. The World Bank will continue to play leading and critical roles in promoting economic and social progress in the developing nations so that their people may have a better and fuller life.

An enormous amount has been accomplished in many of the developing nations over the last four decades to improve living standards, with such indicators as those for infant mortality, life expectancy, healthcare services, nutrition, literacy, all providing clear and encouraging evidence. The World Bank has contributed to this progress. But the challenges and complexities of development remain formidable and it is vital that The World Bank continue to have the capacity — the human resource skills and the capital — to assist its member nations to meet these challenges in the most productive and effective manner.

The World Bank has moved with speed in recent years to adapt its approaches in view of the severe strains in the world economy, the inadequacies in economic policies in a variety of nations, and the sharp decline in capital flows. The Executive Directors have discussed the objectives and the function of the Bank in the context of these developments. This paper describes the principal conclusions, with particular emphasis on how The World Bank can best assist member governments in the most efficient use of their scarce resources — domestic and external — and in formulating and implementing policies which will fully utilize the skills of their people and reduce their dependence on external capital.

The discussions covered the strategies of both The World Bank and the International Finance Corporation (IFC). This paper deals with the conclusions about The World Bank's role, but the Executive Directors also dealt with other aspects. For instance, they approved a new five-year program for the IFC to broaden and expand the scope of the Corporation's activities. The objectives of the Economic Development Institute have been modified to reduce the emphasis on training of individuals and focus more on developing local training institutions. Greater priority will also be given to Africa. The Bank's borrowing and

lending policies were also reviewed. The Bank's active research program was reviewed, and increased emphasis will be given to work on the costs and benefits of policy intervention between institutions and incentives -- all related to the increased role of the Bank in the adjustment process.

The Bank's role in the adjustment process and its catalytic roles were at the center of the discussions, together with the Bank's role as a supplier of long-term capital in a period when little growth is expected in commercial bank lending. There is a consensus that the Bank should continue to build on its traditional strengths -- in project design, in close supervision during project implementation, and in institution building -- that the resumption of growth in the developing countries and of the efforts to alleviate poverty must have the highest priority, and that the Bank must continue to assist members in formulating and implementing adjustment programs which will enable them to sustain accelerated and equitable development.

The various roles of The World Bank, in the adjustment process, as a lender for specific investments, as a catalyst, as described in this paper, cannot be divorced from issues concerned with the resources available to The World Bank. The final section of this paper highlights some of the issues with regard to World Bank resources. To play its diverse roles to maximum effect The World Bank must maintain the resource base necessary to ensure that it continues to be a full and major partner for development.

The Bank's Relationship With Its Borrowers

Critical to the Bank's role in assisting countries to adjust, to change global conditions, indeed to all of its operations, are its relationship with individual borrowing governments.

The rationale for World Bank operations in any country is to promote sustainable, equitable development through a combination of financial and non-financial services, rather than to transfer a pre-determined volume of resources over a period of time. The evolution of the Bank's lending instruments reinforces this linkage. The Bank's ability to adopt a medium- and long-term perspective in providing assistance to borrowers is vital. The problems to be addressed typically require a series of operations that act in a cumulative manner and proceed at a politically realistic pace. This, of course, presupposes an ability to respond with support that can be sustained over a number of years in all of The World Bank's country relationships. In today's environment it also demands a wider range of lending instruments for The World Bank to be used in differing specific country circumstances to improve the functioning of their economies for long-term growth. (See Attachments I and II.)

Linkages of Lending Instruments

The World Bank's involvement in adjustment lending stems from its concern with promoting a sound investment program and a sustainable development process. Its lending for adjustment and for long-term investment should be seen as related. Technical assistance loans have been central to adjustment in numerous nations. Lending for rehabilitation and maintenance plays a significant role in ensuring efficient use of resources. Loans for financial intermediation assist in securing production responses to changes in policies and such loans support financial system reform and the restructuring of enterprises.

One of the central lessons of development experience is that a narrow focus on designing and financing sound specific investments does not by itself assure satisfactory development in countries where there are major weaknesses in policies or institutions. The significance of this has been underscored by the events of recent years. Policies or institutions that have not made the most efficient use of resources could be tolerated in the buoyant environment of the 1960s, but in the less favorable environment of recent years such a framework has proven to be unsustainable in many countries.

Adjustment Lending

The Bank started structural adjustment lending in 1980. An important role for the Bank over the next several years in many borrowing countries will be to continue support for structural adjustment. In countries where the immediate problems of stabilization have been surmounted, support for new investment can be gradually increased. But even in these cases, the shortage of resources will underline the importance of increasing domestic resource mobilization and improving the efficiency with which resources in general are used.

In many countries of Sub-Saharan Africa and in middle-income countries that have yet to achieve sustainable growth there will continue to be a need for structural adjustment loans and sector adjustment loans in support of policy and institutional reforms. It should be possible to do this with an overall mix of lending instruments broadly similar to that which exists currently. In this area, as in others, the Bank will seek to continue to strengthen its cooperation with the International Monetary Fund.

The volume of structural adjustment loans made by the Bank fails to reflect the full extent of the institution's involvement in policy and institutional issues, and of its support for structural change. In practice, such loans have been made in relatively few countries (16 so far) where governments sought World Bank support for a broad-based and comprehensive program of structural change. Such

operations accounted for about 3% of total lending in FY1980 and rose to over 8% in FY1984.*

In a number of other countries, structural change has been promoted through operations focussing on particular sectors. These operations — called sector adjustment loans — are narrower in scope than structural adjustment loans. Such loans have increased -- from less than 1% in FY1980 to over 8% in FY1984. A growing number of sector adjustment loans is likely in the years ahead as the adjustment process develops and lending operations focus increasingly on constraints within specific sectors.

Structural and sector adjustment loans are fast-disbursing (the funds are normally disbursed to borrowers within four years of loan signing, compared with five to nine years for certain other types of loans); they are paid out in tranches, and the loan proceeds can be used for broad categories of imports. Together these types of loans constituted approximately 17% of total World Bank lending in FY1984, compared with less than 4% in FY1980. Their use was concentrated in countries where foreign exchange shortages were impeding the effective use of productive capacity. Fast-disbursing funds were particularly useful as they were provided in support of trade policy reforms (e.g. tariff reform; liberalization of quantitative restrictions; credit for exports) or resource mobilization actions (e.g. changes in user charges; reform of parastatal enterprises) or more selective approaches to public investments.

The flexibility shown by The World Bank, as demonstrated by the rather marked growth in the use of these instruments, has been generally welcomed. Indeed, some have observed that the extent of the change in World Bank operations in recent years is perhaps not yet fully appreciated in the outside world. In the future the prospect is that these instruments will continue to play an important role. As experience with development has deepened, much has been learned about appropriate policies in support of development. Growing use of these instruments reflects this increased appreciation of the importance of a suitable policy framework for sound growth.

It is quite possible, should global recovery be sustained, that there will be some reduction in coming years in World Bank adjustment loans for some of the major middle-income debtor nations as a share of total Bank lending operations. On the other hand there may be increasing use of structural and sectoral adjustment loans in Sub-Saharan Africa in support of the types of reform programs described in the Bank's report: "Toward Sustained Development in Sub-Saharan Africa - A Joint Program of Action."

* The World Bank's fiscal year (FY) runs from July 1 to June 30.

Investment & Development

The World Bank's support for investment, whether in the public or private sector, must be based on a policy and institutional setting that promotes an efficient use of scarce resources. Given the trade and capital flow prospects facing most World Bank borrowers over the next several years, many countries are likely to achieve acceptable rates of growth and development only if they manage to obtain greater returns from the limited investments they undertake, and find ways of increasing the efficiency of resource use through policy and institutional changes.

The nature of The World Bank's support of investment and poverty alleviation is an evolutionary one. It involves no abrupt change in the composition of lending by sector as compared to what has been the pattern in recent years. Agriculture and rural development will continue to be the largest single sector in World Bank operations. These operations will differ from those in the 1960s and early 1970s reflecting the lessons of experience with increased emphasis on the policy and institutional setting in borrowing countries. Sector management issues will receive more attention, and countries will get more help to make better investment decisions and to introduce more flexible pricing policies.

World Bank support for investment in infrastructure (transport, telecommunications, energy) will also evolve along lines that are already rather clearly demarcated. The increased emphasis on striking an appropriate balance between new investment and maintenance or rehabilitation of existing capacity will continue. Programs to assure that public sector enterprises operate at a profit will receive increased attention and support will be provided to governments which wish to realign the balance between public and private sectors, to make greater use of private sector capacity.

A significant part of World Bank lending will continue to address human resource priorities. Lending for population and health, for example, will increase. In view of the great pressure on resources available to governments, attention will inevitably have to be given to reforms in social services designed to make them more cost-effective so that they can be extended to increasing numbers of people with minimal increases in resources. World Bank support in these areas will be provided on a sustained basis.

Maintenance & Rehabilitation

An area of expansion in World Bank operations has been that of loans focussing on maintenance and rehabilitation. Such loans, which accounted for more than 10% of total World Bank lending in FY1984, aim to

ensure the most efficient use of existing investments in infrastructure and industry. Major investments in infrastructure can be jeopardized if rather modest sums are not spent on maintenance. As highlighted in The World Bank's reports on Sub-Saharan Africa, donors have often preferred to finance additions to capacity rather than the mainly local and recurrent costs required to maintain capacity that already exists. Lending for maintenance and rehabilitation will continue to be an important feature of Bank operations.

Institutional Reform

Another reason for the rapid growth in sector lending has been the growing capability of domestic institutions in borrowing countries. This has made it possible for The World Bank to rely upon domestic institutions for detailed appraisal and supervision of specific investments.

This is a trend that the Bank welcomes and seeks to encourage through its own institution-building efforts. Where strong institutions exist — as they do, for example, in many countries in Asia and Latin America — the use of sector investment loans or loans to financial intermediaries (such as domestic investment banks) can be a highly efficient way of providing assistance. It is expected that this particular form of partnership in promoting development will play an increasing role.

Changes in global economic conditions have undoubtedly contributed to the crisis in Sub-Saharan Africa, but major factors have also been both weaknesses of domestic institutions and sometimes grave inadequacies in domestic policies. Much of the Bank's current work in this region focusses on policy adjustment and on critical institutional issues. The symptoms of institutional failure are numerous: roads and irrigation canals have deteriorated because of lack of maintenance; cost overruns are substantial because of delays and weak project management; and production and marketing goals are not met because of inefficient distribution systems. Poor public services in such critical areas as education, health, transportation, agricultural research and extension, have a major adverse impact on the productivity of investment and the formation of human resources. These institutional issues are by no means confined to Africa. They are the focus, and will continue to be the focus, of The World Bank's global operations.

One form of institutional strengthening which is likely to feature prominently in The World Bank's operations over the next few years is reform of publicly-owned productive enterprises. Many governments are determined to increase the efficiency of such enterprises or to transfer responsibility for their functions into private hands. The World Bank will continue to strengthen its work in areas that assist borrowers to secure enhanced operational efficiency of public enterprises, greater selectivity by governments in public sector investments and more adequate cost-recovery in such investments.

Sector Management

Sector management is already an important theme of World Bank operations in many countries. Faced with the prospect of an acute shortage of resources for the next several years, many governments are anxious to obtain assistance in developing sector investment strategies that are more selective and in devising institutional arrangements that will ensure that those strategies are carried out in a more disciplined fashion. Improvements in this area can yield important catalytic benefits.

Sector pricing issues have also loomed largely in recent years. Rapid changes in exchange rates and in domestic prices often were not followed by timely increases of state-controlled prices. This has quickly eroded production as insufficient prices discouraged producers from raising their output and undertaking new investments. In some cases, rectifying these distortions has been a central feature of the adjustment programs which countries have undertaken. The important need is to develop institutions and procedures that assure effective implementation of appropriate policies over time; that is, to "anchor" the policies by developing the systems required to cope flexibly with change in the future. This is a type of activity which The World Bank is well placed to assist because of its long experience in key sectors, and because of its tradition of supporting change gradually over a period of years.

Private Investment Environment

Increasing numbers of governments are recognizing the contribution that can be made by a buoyant private sector and the Bank will expand its work to formulate incentives, to expand credit and access to the availability of technological information to entrepreneurs in agriculture and industry. Such matters are prominent in many of the Bank's lending operations, as are issues concerned with trade policy (such as offering support for reducing tariffs, removing quantitative restrictions on imports and exports). The World Bank contributes, therefore, in an array of ways to the strengthening of an environment that encourages private sector development.

Experience shows that countries with outward-oriented trade and payments regimes benefit significantly because such approaches strengthen the forces for domestic efficiency and stimulate the setting of appropriate incentives. The World Bank's lending in the productive sectors addresses structural issues as a necessary complement to appropriate incentive systems. In agriculture, for instance, a major objective has been to make extension services more effective. Frequently, efforts have been made specifically to improve the system for distributing production inputs and for marketing output. In the manufacturing sector, policy-induced distortions and institutional weaknesses in the allocation of credit are being addressed, for example, through World Bank loans to financial intermediaries such as domestic investment banks.

Long-Term Constraints

The World Bank has a critical role to play in the resumption of sustained, long-term growth. The World Bank has a special responsibility to call attention to longer-term development problems that might otherwise be neglected given policy-makers' preoccupation with immediate pressures. Population issues are an example of this. While loans for health and population remain a small part of overall World Bank lending, analysis in this area has been a major feature of The World Bank's work on global issues — most notably, of course, in the 1984 "World Development Report." Moreover, The World Bank's commitment to these issues has been underlined in a number of ways. For instance, it has announced its intention to at least double population- and health-related lending over the next few years. It plans to strengthen the emphasis already placed on lending for basic education, especially for women, and on encouraging policy changes that will widen women's educational and employment options.

Similarly, in The World Bank's "Joint Program of Action for Sub-Saharan Africa" considerable stress is placed on the need to provide consistent and uninterrupted support for programs in education, agricultural research and forestry as well as for health and population. This advice is very much reflected in The World Bank's own lending plans. A first step has been taken in support of the recommended strengthening of problem-oriented agricultural research for Africa; namely, a contribution to the International Center of Insect Physiology and Ecology (ICIPE). Over the next few years, it is expected that other regional research institutions will be identified as suitable for World Bank support.

Environmental issues — in the sense of sustainable management of a country's resource base — and urbanization issues also form a part of The World Bank's dialogue with borrowing countries and of its current and prospective lending program. In addressing these long-term constraints, especially in the social sectors and when human resource development is the central concern, continuity of support is vital. It is an important element of World Bank country assistance strategies in all parts of the developing world.

The realization that sustainable development must be concerned with the distribution of the benefits of growth is central to The World Bank's continuing concern with progress in the alleviation of poverty. Just as the experience of recent years has demonstrated that good projects alone will not suffice to maintain growth if the policy and institutional setting is inadequate, targetted investment alone will not be effective in reducing absolute poverty if policies are biased against the small farmer or in favor of capital-intensive manufacturing; nor will it create job opportunities for the landless poor or the under-employed urban population.

Experience shows that there is most substantial complementarity between investments that will enhance the productivity of small-scale farming and small-scale industry and policy measures that will improve the efficiency of resource use. The point is that policy and institutional reform will not suffice to alleviate poverty — a sort of 1980s version of the "trickle down" theory — rather, that a combined approach is required. For example, the small-scale farmer needs a setting in which his returns are not eroded by an over-valued exchange rate or by price ceilings that favor the urban consumer. But he also needs programs that assure timely credit and efficient support services. The World Bank will continue to place emphasis on these areas in its lending and advisory work.

The Bank's Catalytic Role

The Bank's future role as a direct provider of finance and other services needs to be seen as part of the much larger overall flow of capital and technical assistance to developing countries. To be fully effective, the Bank will continue to structure its operations so as to complement and — to the extent possible — to exercise a constructive influence on these other flows. The Bank will continue to strengthen this catalytic role, notably in the areas featured below.

Official Development Assistance

The World Bank's potential contribution to greater aid coordination was elaborated in the "Joint Program of Action for Sub-Saharan Africa" and has received strong support from the donor community. The Bank will continue to seek close cooperation with official development agencies and play a leading role in coordination efforts. The main point that needs to be stressed is the critical importance of adequate funding of aid being made available in a disciplined way in support of reform programs.

Export Credits

The World Bank has a long history of cooperation with export credit agencies (ECAs). Co-financing with ECAs was initiated more than 20 years ago, but has involved relatively few projects and has often been coincidental. Over the past three years renewed consultations with a large number of ECAs have indicated an interest in a closer association with The World Bank. A number of specific proposals for more systematic collaboration have emerged from these consultations.

A more general issue concerns the extent to which The World Bank should participate in specific efforts designed to assure that the quality of the investments financed by export credits are appropriate. Promoting development is generally not a primary objective of export credits or of the ECAs. Their primary objective is to promote the exports of their countries. At times, this objective may be a variance

with development. Recognizing this dilemma, The World Bank has urged donor governments with active export credit programs in Sub-Saharan Africa, for example, to exercise restraint when aspects of their export credit programs are not consistent with development objectives. Correspondingly, The World Bank has urged recipient governments to exercise greater discipline when they vet investments and accept export credit financing. As part of its general effort to improve the quality of resource flows to low-income countries, The World Bank is prepared to assist recipient governments in strengthening their investment review mechanisms.

Commercial Banks

A number of specific co-financing arrangements with commercial banks have been considered, but beyond that there have been more general suggestions -- which have yet to be refined into specific proposals -- concerning a broader role for The World Bank in monitoring country conditions or in supporting the flow of new lending into sectors or uses considered to have high priority.

The specific discussions have centered on The World Bank's new "B Loan" co-financing programs. While still in the pilot phase, there is little doubt that these new instruments have stimulated the flow of capital into countries on better terms and in larger volumes than would otherwise be available. The World Bank will continue to refine and review these instruments. It will also continue to explore ways, working with governments and with commercial banks, in which it can be increasingly useful in securing commercial banking flows into high priority development areas in developing nations.

Private Direct Foreign Investment

Private direct investments can play a more prominent role over the next several years as a complement to other forms of capital flows to developing countries. A number of governments in the developing world have revised, or are revising, their posture toward this form of capital. They are looking for assistance from The World Bank, in collaboration with the International Finance Corporation, to increase private capital flows. The programs of the IFC are now being expanded.

And The World Bank is taking initiatives in this area as well. The legal codes governing foreign direct investment are often politically highly sensitive. The World Bank and IFC as multilateral development institutions are well placed to assist countries that wish to revise their codes and they have already helped several countries. The World Bank's work in the energy sector in the past few years is one notable example. IFC, based on its experience as an investor, has helped in structuring project arrangements so that risks and benefits are equitably shared between the host country and the foreign investor. This has been done, for example, in the case of project technology agreements and performance-related management fees. Many developing countries are interested in making fuller use of the technology, marketing contacts and risk capital available from foreign investors.

The World Bank and IFC, therefore, will expand their activities in this area in the years ahead.

An important initiative by The World Bank to encourage the flow of foreign investment to developing countries is the proposed Multilateral Investment Guarantee Agency (MIGA). In addition to its general promotional role, MIGA would have authority to guarantee investments against non-commercial risks. It is expected to focus on making guarantees or co-guarantees with the national insurance agency in countries where the national insurance agency was heavily exposed; guaranteeing investments from countries that do not have national programs; guaranteeing investments not now eligible for national programs if they were deemed beneficial for the host country; and guaranteeing multinationally-financed investments. MIGA could also reinsure guarantees written by national insurance agencies and private insurers under certain conditions. Consultations with potential signatories to such an agreement indicate growing support for such a concept. A draft convention has been submitted to the Executive Directors, who have agreed to discuss it in detail with a view to preparing an agreed text in the near future.

World Bank Resource Needs

The World Bank plays an array of significant roles. In its co-financing efforts, for example, it directly provides an instrument to increase the assurance of investors that the underlying project, as well as the growth prospects of the country, is sound. In its lending efforts the staff of The World Bank has a unique perspective from which to analyze the country's prospects and needed policy reforms, and to provide this analysis to policymakers. In order to carry out its roles the Bank's ability to increase its own lending is crucial. To provide the additional lending capacity a General Capital Increase for the IBRD and a replenishment of the resources available to the IDA will be needed in coming years. Such an expansion in the Bank's resources would enhance its effectiveness in its policy advice and simultaneously strengthen the capacity of the international system to cope with unanticipated eventualities.

Low Income Nations

Discussion of the capital needs of The World Bank should not only be conducted in terms of the Bank's distinct roles, but also in terms of changes and prospects in global conditions. In the case of the low-income countries that depend upon concessional capital, the relative stagnation of new commitments in recent years is a cause for deep concern. For Sub-Saharan Africa as a whole, the prospect that flows of external capital could decline (in net terms) to less than half the level of the early 1980s represents a critical obstacle to achieving satisfactory growth in the region.

The Special Facility for Sub-Saharan Africa — which is a one-time, three-year special undertaking — permits greater support for reform efforts than could otherwise be undertaken. But in the longer

term, as hopefully more and more African governments undertake essential policy reforms, the available support for those efforts will become smaller and smaller relative to the task. Additional IDA resources in support of policy reform will be needed if significant improvements in African growth are to be secured.

In addition, it will be critical that IDA should not only be in a position to further the policy reform efforts that it and the Special Facility are pursuing, but that it also be in a position to follow through with support for investments and institutional changes that will be needed to ensure that the reforms are lasting. IDA today plays a critical role in Sub-Saharan Africa and it will need to continue playing such a role in the years ahead -- a role it can only play to its full potential with expanded resources.

The decrease in concessional flows to low-income Asian countries is likely to be proportionately even larger in coming years than the decrease in such flows to Africa. At the same time, the aggregate external capital needs of IDA borrowers in Asia are now much larger than before as a result of China's membership in The World Bank. It has been possible to some degree to compensate for the fall in IDA funds for India and China with increases in IBRD lending to these nations. There will, however, be a continuing substantial need for concessional flows of funds to the low-income nations of Asia to stimulate their development.

The global shortfall in concessional flows -- and particularly the need to link expanded volume of such flows with improved performance -- argues for an early resumption of growth in IDA operations. The review of the seventh IDA replenishment (\$9 billion for the three-year period from mid-1984 to mid-1987), which is scheduled to take place this year, will provide an occasion for donors to consider what steps might be taken to expand IDA resources.

Middle-Income Countries

During most of the 1970s, private lending to developing nations grew at an average annual rate of 20% or more. In the next decade (to 1995) it is unlikely to grow much faster than 10% and may grow much more slowly than this. Although some middle-income countries, particularly in Asia, will have little difficulty in obtaining external private capital, others, particularly the heavily indebted commodity exporters, may find it much harder to do so.

Commercial bank flows to many developing countries have fallen dramatically, and the present reality is that there are net outflows from some of them. As a result, concern has been expressed that in capital flows to these middle-income countries, there should be a better balance between official and private sources, between short and long maturities and between fixed and highly variable interest rates. That would make these countries less vulnerable to disruptive changes in international capital markets.

Within this framework, IBRD resources have traditionally been an important component of the medium- and long-term official capital needed to strike an acceptable balance. Moreover, The World Bank has to play a catalytic role in helping to re-establish confidence among lenders and in providing a disciplined framework for commercial borrowing. This means that it should be a credible partner which has the ability to lend its own resources on a scale both the country and the co-financing institutions consider meaningful. Further, a critical consideration is the distinct prospect that demand for IBRD lending will grow as the transition from stabilization to resumed growth proceeds and as investment programs begin expanding again.

Thus in the years ahead it is essential that the IBRD has the capital base that enables it to stand fully ready to meet the increasing demands that are likely to surface from middle-income nations. The IBRD needs to have the capital base that provides it with the capacity to stimulate development initiatives and to respond to development needs in its middle-income member nations. It needs to be in a position to assist nations to enhance their access to non-official sources of capital. It needs to be able to play a credible advisory role in assisting nations to develop, which demands that it be seen by borrowers as an important source of finance in its own right.

The IBRD should play its assorted roles to its full potential in the years ahead and this may well involve significant growth in the levels of loan commitments. The IBRD should be in a position to be able to swiftly meet increased demands for assistance from its borrowers that are consistent with the goals and strategies for poverty alleviation and development touched upon in this paper. In the months ahead the Bank's management will review the future resource needs of the IBRD and commence discussions with the Executive Directors with regard to expanding the institution's future capacity to lend and so continue to be a full and major partner in the development process.

* * * *

The World Bank's Lending Instruments

World Bank support for structural change and policy reform have led to an evolution of its lending instruments. The various types of loans are shown below.

Lending Instrument

Objective

Specific Investment
Loans

To create new productive assets or economic and social infrastructure; to restore them to full capacity, or to ensure their maintenance.

Sector Operations

Sector Investment
& Maintenance Loans

To bring sector investments in line with economic priorities and ensure they are efficiently operated and maintained.

Financial Inter-
mediary Loans

To provide funds for enterprises and small- and medium-size farms through an intermediary within a competitive environment.

Sector Adjustment
Loans

To support comprehensive policy changes and institutional reform in a specific sector.

Structural Adjustment
Loans

To support, through a series of loans, specific policy changes and institutional reform to achieve efficient use of resources and contribute to a sustainable balance of payments in the medium- and long-term while maintaining growth.

Technical Assistance
Loans

To strengthen local institutions concerned with promoting diverse types of development approaches; or preparing, implementing or operating specific types of investments, or tasks related to such investments.

Emergency Reconstruction
Loans

To support rebuilding activities and rapid restoration of physical structure and productive activities after disasters.

Attachment II

Summary of Commitments by Main Category of Lending
Instrument FY80, FY81, and FY84, (Bank and IDA)

	Million \$		
	FY80	FY81	FY84
Specific Investment	6941	6064	6414
Sector Operations			
a) Sector Investment	1941	2533	4113
b) Financial Intermediaries	1765	2314	2043
c) Sector Adjustment	90	244	1318
Structural Adjustment & Program Loan	355	782	1272
Technical Assistance	125	279	324
Emergency Reconstruction	265	75	40
Total	11482	12291	15524

	Percentage Shares		
Specific Investment	60.5	49.3	41.3
Sector Operations			
a) Sector Investment	16.9	20.6	26.5
b) Financial Intermediaries	15.4	18.8	13.2
c) Sector Adjustment	0.7	2.0	8.5
Structural Adjustment & Program Loan	3.1	6.4	8.2
Technical Assistance	1.1	2.3	2.1
Emergency Reconstruction	2.3	0.6	0.3
Total	100.0	100.0	100.0

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION
OFFICE MEMORANDUM

Mr Bouhaouia (o/e)

DATE: August 5, 1985

TO: Mr. Ram Agarwala, SOAA

FROM: Tariq Husain, WAPDR *Tariq Husain*

EXTENSION: 76367

SUBJECT: Long Term Vision for Africa

1. May I congratulate you for taking the lead in this very worthwhile venture. The July 31, 1985 meeting made a good start and your decision to incorporate the various comments made in the meeting in a WDR style Issues Paper seems to be the optimal way to proceed. To help you in that process may I record some of the comments that I made then, and some after thoughts.

2. The topic is so important that you may want to consider involving famous names in spearheading this effort. For example, Sir Arthur Lewis could be asked to lend his name and mind to this venture which should include a few African thinkers along with some thoughtful Bank staff. May be we should consider this to be an "Africa only" version of the Bank's earlier global effort of "Partners in Development". It should, of course, not be driven by the completion-schedule of the 1986 Progress Report, but can certainly be the principal output of 1987. It has to be visionary i.e. it should offer believable hope for a better future and a feasible path to that future. Such an effort should not get mired into detail; the big picture is what would be needed which must, however, establish:

- A. the bleak implications of present trends (this is already done in many reports);
- B. the necessity of multi-national efforts within Africa (Regional integration, intra-African trade, artificiality of borders given African realities);
- C. the necessity of concerted and co-ordinated donor support for the medium to long term; the short term would be covered under the Africa debt rationalization study; it is the medium term structural change which would need the concerted, co-ordinated donor support which must accompany the debt-rationalization effort if African countries are to get out of the woods during the century;
- D. the necessity for the Bank to act in accordance with its mandate of a development institution by developing a portfolio which (1) honestly sees short term actions as the first steps of a medium term plan rather than actions driven by short term financial imperatives; and (2) displays a genuine concern with long term issues: development of human capital; prevention of physical degradation (desertification, soil erosion, deforestation, destruction of viable farming and eco-systems); nurture and development of domestic institutions which can carry on the

growth effort increasingly on their own; and helping create conditions which promote self-reliance. To do the above would require that the Bank help African nations to develop a more informed assessment of their physical resource base; particularly, water (ground and surface), forestry and mineral resources.

3. I am willing to help as best as I can. Good luck

THUSAIN/yb

cc: Messrs. Fuchs, Serageldin, Alisbah, (o.r.), de Azcarate, de la Renaudiere, Birnbaum, Eccles, Guetta, Bouhaouala, O'Brien, Gulhati, Isenman, Westebbe, D. Anderson, Abbai Noman

cc: WAP Division Chiefs
WAP Sector Work Co-ordinators

OFFICE MEMORANDUM

Mr. L. P. O. R. Mr. Pouliquen
 8/31/84
 AUG 31 1984

DATE: August 30, 1984
 TO: Mr. H. van der Tak, OPSVP
 FROM: Armeane Choksi, CPDST *Awe*
 EXTENSION: 61479
 SUBJECT: The Future Operations of the Bank

1. I understand that at the last OPS Director's meeting questions were raised as to what were the major changes made to the latest version of the report.

2. These are as follows:

- . An executive summary -- which is different from the summary and conclusions of the May 30 version -- has been added. It captures the main messages of the report.

- . The basic thrust of the report remains the same, the changes made refer to the details of our operations.

- . The changes (which have amounted to a net change of 16 pages) are scattered throughout the report, but are concentrated in Chapters 4 and 5.

- . The major suggestions/ideas are now underlined in the main report.

3. Examples of the sorts of changes made include the following. 1/ We have

- . eliminated factual inaccuracies;

- . clarified the fact that the project loans will continue to be a major component of the future product;

- . emphasized the importance of maintenance and rehabilitation projects for certain groups of countries; that increasing attention be paid to sector level issues; and that stronger links be made between multisector, sector and project level concerns;

- . highlighted some of the implications (e.g., organizational, financial and staffing) of the future product;

- . emphasized the importance of close collaboration with and provision of support to governments in the design of country assistance strategies;

1/ This list is not exhaustive.

- . clarified the notion of core/non-core programs and approaches to policy reform;
- . emphasized the relationship between CESW and Bank research;
- . emphasized the role of the Bank in poverty alleviation;
- . suggested that the project/non-project dichotomy or policy-based vs. project lending distinctions are no longer useful;
- . suggested that gradual transformation of the product rather than large drastic steps will be mandated by existing constraints;
- . increased the emphasis on monitorable reforms.

4. For those who have read the May 30 version, as a guide, I would suggest that they focus on the executive summary and then glance through the main report and focus their attention on (and, if necessary, around) the underlined sentences.

cc: Messrs. S.S. Husain (OPSVP), J. Wood (FPBVP) and OPS Directors

AChoksi:jl

OFFICE MEMORANDUM

JUN 7 1984

DATE June 6, 1984

TO Those Listed Below

FROM S. S. Husain, OPSVP *W*

EXTENSION 72283

SUBJECT The Future Operations of the Bank

1. Attached is a document on the Future Operations of the Bank. This is the product of one of twelve task forces commissioned to study the Future Role of the Bank. You are invited to a meeting--which is one of a series of five--to discuss this document on Monday, July 2, at 11.00 a.m., in Room D-1056. The purpose of this document is to act as a catalyst to stimulate thinking and discussions about the future of Bank operations. The mandate for preparing this document has been to take a "zero-based" look at this institution without regard to existing constraints (e.g., staffing, financial or organizational). It is, however, not intended to be a draft program for the future; the ultimate translation of any ideas or suggestions found to be acceptable will remain the continuing responsibilities of managers.

2. I would appreciate it if you would confirm your participation by calling Ms. K. Tengra (X61480). We look forward to a lively discussion.

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cc: Messrs. Wood, FPBVP, Scott, PBDIP, Choksi, CPDST,
 Adams, AENVP, Rajapatirana, VPERS

Handwritten: LHS9
 I will not be here.
 pl. call -

FF 6/13

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WBG ARCHIVES

THE FUTURE OPERATIONS OF THE BANK

May 30, 1984

Product in relation to cofinancing.

Interaction between the various Tools
Policy objectives & Development objectives.

Parallelism between speed of disbursement & speed of policy changes

Discrimination between countries

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WBG ARCHIVES

THE FUTURE OF THE WORLD

that we ~~lose~~ can should be project lending. We have different tools let's mix them, establish a program that should be discussed with the country and the implementation of which would be subject to the country meeting some condition.

Impact of our role vis a vis commercial banks
If it is to materialize it could conceivably have an impact on what is expected from us.

Association between policy loans and quick disbursing operations

Policy measures vs policy process

Should ^{particular} Policy measures be associated to a lending operation or to a program.

Good diagnostic.

Sensible suggestions.

The question is less whether we should be moving into more policy work ^{provided it means proper} but how we do it and whether we shall succeed, particularly if the resources available to the Bank decrease.



Questions:

Policy means a process

Project versus policy lending: Isn't the distinction sharper than it needs to be?

We disburse either for balance of payment support, to help in a crisis situation or for investments. Ultimately we may go into a project - even if it is through an investment tranche - and the question is more whether we should do direct project lending or indirect project lending.

Care versus non care: Not too compatible with the concept. At the extreme it gives the impression that a country has an automatic right to a certain volume of lending. & besides it is not obvious

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SUMMARY AND CONCLUSIONS

Introduction

1. This paper is one of a series being prepared for the exercise on the Future Role of the Bank. The purpose here is to provide suggestions regarding directions for the Bank's future operations in light of the growing diversity and interdependence of developing countries and the recent changes that have occurred in capital flows and financing patterns worldwide. This report does not recommend any sharp break with the past. On the contrary, it suggests that the Bank not only retain its evolutionary character, but also accelerate in the direction that it has been moving in the last three to four years, i.e., towards being an economic institution rather than a purely financial one. To facilitate this acceleration and to assist in meeting the development objectives of our borrowers more efficiently, the report suggests new tools and approaches which, inter alia, include Development Policy Loans, the policy cycle, the targeting of conditionality to lending instruments, the development of "core" and "non-core" lending programs, mini-policy loans, a reorientation of Bank attention in a number of areas and differentiated assistance strategies in countries. This summary does not address all the issues and suggestions raised in the main report; the discussion here merely highlights some of the crucial considerations. The report itself focuses on the nature of the Bank's future product, i.e., its "tool-kit." It provides some preliminary ideas for ways in which the Bank's instruments can be used creatively, illustrates how this "tool-kit" can be used in different groups of countries and discusses issues of institutional coordination between the Bank and the Fund over the next decade as the Bank's product becomes increasingly diversified. The underlying theme of this report is that of continuing the adaptability and evolution of the Bank in response to the development experience and the problems faced by borrowing countries; an approach followed by the Bank in the past.

The Evolution of the Bank

2. The early years of the Bank were marked by a concern with establishing the Bank as a viable entity. The portfolio was, therefore, initially concentrated on Europe and Latin America. Diversification came slowly, with increased lending to Asia in the 1950s and the subsequent establishment of IDA. Lending for discrete investment projects in the power and railroad sectors was the preeminent focus; agriculture accounted for less than 10% of the portfolio and there was no lending to the social sectors. As the Bank matured, its experience with development problems suggested an expansion of lending in agriculture and a shift towards human resource development (i.e., education, health, nutrition and population) and the energy sector. Over time, greater operational flexibility in Bank procedures also emerged--e.g., local cost financing, reliance on LCB, preference for local manufacturers and construction firms--which reflected pragmatic responses to the development concerns of borrowing countries. In addition, a number of broader initiatives were undertaken; e.g., the establishment of EDI, to provide training for its borrowers, and IFC to facilitate private sector investments. The Bank group also undertook program assistance as an appropriate response to borrowers'

needs. This began with the industrial import support to South Asia in the 1960s, and program loans in the 1970s in response to the first oil crisis; the second oil crisis and the subsequent international recession in 1980 marked the introduction of structural adjustment loans (SALs) and the Special Action Program (SAP).

3. This broadening of the lending instruments is indicative of the Bank's evolution reflecting the development priorities of Bank borrowers. The range of options now ranges from traditional project lending to a discrete investment package, through subsector and sector loans, through a variety of program loans/credits (e.g., industrial and agriculture import loans and export development funds) to more comprehensive SALs. Loans have also expanded from a primary focus on new investments to cover rehabilitation and maintenance needs and, with the SAP, much greater flexibility is available to adjust cost-sharing arrangements and provide revolving funds. In summary, what has emerged is a continuum of lending options where the type of loan or credit can be specifically related to the particular needs of the country or sector. While considerable work has been attempted directed at categorizing types of projects and, in particular, at distinguishing between project and non-project lending, this effort has become less meaningful as clear dividing lines have disappeared. Moreover, recent legal reviews of the project/non-project distinction and its relationship with the Articles have emphasized that the reference to specific projects in the Articles implies essentially that lending should be related to specific productive purposes and does not prevent the Bank from developing new instruments in response to the needs of its member countries, even if these new instruments cannot easily be fitted in the project/non-project dichotomy. A current study indicates that the Articles of the Bank give the Bank all the flexibility it needs to develop appropriate instruments. Given this, it would appear timely to focus on which of the range of (actual or potential) instruments is most appropriate in the particular circumstances, rather than on characterization of loan instruments.

Emerging Issues for Developing Countries

4. The recent development experience and trends suggest that two broad emerging themes can be identified for developing countries: growing diversity between countries and increasing interdependence. These two themes have strong implications for the Bank's future. The growing differentiation among the Bank's borrowing countries is apparent in different measures such as levels of income, savings, investments and consumption; a variety of social indicators and the level of human resource and institutional development also indicate growing diversity. This increasing diversity has been a result of a number of factors and the need to recognize its existence is important in articulating the Bank's role. The second theme of importance is the growth of international economic interdependence arising from the increased integration of the Bank's member countries into the world economy. This global interdependence arises from the improved environment for trade expansion, the revolution in information and communication technology that has facilitated the specialization and integration of the financial markets, and demographic trends and migration that has created significant labor market linkages. These factors have created a global economic system that has led to strong growth linkages between the developing countries and the industrialized world. These emerging themes are likely to dominate the development process for the foreseeable future and, by definition, the Bank's future operations.

Future Directions for Bank Operations

5. Given these trends, two broad issues are likely to be of major concern to the developing countries over the next decade. The first is increasing the rate of physical and human capital formation, and the second is improving the productivity of investments and the efficiency of resource allocation. The effectiveness of the Bank as a development institution will be enhanced only if it addresses these two issues; i.e., if its financial intermediary function is performed within a framework of policies and institutions designed to improve the efficiency of resource allocation. To do this, the Bank will have several instruments at its disposal; the packaging of these instruments in different countries will be the Bank's operational product. The main components of this product will include: Bank loans (financing) and differential term of lending; technical assistance; policy advice; mobilization of external capital; and role in aid consortia. 1/

6. In general, Bank operations in a country would incorporate all these components; thus, the product would be multi-dimensional. It would also be flexible as the weights (or the relative emphasis) attached to each component of the product could vary by country by sector (if necessary) and over time. The product could, therefore, be tailored to the specific needs of the country. As a result, a country-focused approach can be undertaken with the country's "place" on the product spectrum being determined by its economic, financial and institutional capacity. By adjusting the product to specific country requirements, the Bank can maximize the joint effect of increasing physical/human capital formation and improving resource allocation through policy and institutional reforms.

7. Against this background, understanding the development concerns of the country will be crucial to the operations of the Bank. Working closely with governments to develop a three- to five-year country assistance strategy will permit the tailoring of the Bank's product to the specific requirements of the country; this may well imply a Bank focus limited to a few sectors in a country. A close and early collaboration with governments in designing the product will also be important in enhancing the Bank's credibility in the country, particularly where the focus of Bank attention will be on institutional and economic reforms. Convincing the governments of the importance of such reforms will not only depend on the institutional relationships developed, but also on the willingness of the Bank to provide long-term financial security to those countries willing to undertake them. But, there are many obstacles to such reforms and the Bank will have to pay increasing attention to the constraints to policy change; this will be an important aspect of increased product diversification in many countries.

8. As the Bank becomes increasingly involved in policy-linked lending, then it must address one fundamental question: if our advice is so good, why are governments reluctant to take it? Clearly, there are many factors that inhibit reforms; some are within the Bank's control and some are not. They

1/ The differential terms of lending, mobilization of external capital and the role in aid consortia are subjects of different papers on the Future Role of the Bank.

include: a lack of knowledge about how to implement such reforms; a misunderstanding of their potential benefits; the high premium placed by government on the short-term costs as opposed to the long-run benefits; identifying the winners and losers of policy reforms; the ideological perceptions of governments and their non-economic objectives (paras. 5.2 - 5.10). This suggests that the dynamics of policy change and the political economy of public policy are crucial areas for Bank attention, particularly as it begins to enter the domain of assisting governments in undertaking reforms. An understanding of these issues, and an explicit recognition of the constraints, should be important determinants of any Bank strategy that is designed to facilitate policy change, whether or not it is conducted in the context of a lending operation. Moreover, from a practical point of view, policy reforms cannot be formulated and implemented overnight, and certainly not within the time frame of the traditional project cycle. The issues of economic policy have to be studied carefully, and detailed and specific proposals for reforms must be formulated and legislated. In addition, implementation and effective monitoring procedures must be developed. All this suggests a more systematic and structured approach to policy formulation in the Bank than has typically been the case in the past when broader policy issues were often faced in the context of project loans.

9. One policy-formulating process--a "policy cycle" analogous to the project cycle--could be disaggregated into nine components: (i) an understanding with the government of the country's development objectives; (ii) an agreement with the government on the nature and substance of the problems; (iii) a diagnosis of the causes of the problems and delineation of directions for change; (iv) an analysis of factors inhibiting change; (v) the formulation and ranking of alternative policy packages which take account of the constraints to change; (vi) agreement with the government on a politically acceptable package of actions and a broad timetable; (vii) the formulation of a detailed and specific program which articulates the nature, sequencing and timing of individual steps; (viii) the implementation and monitoring of policy reform measures including feedback into the formulation of subsequent stages of policy reform; and (ix) the evaluation of the impact of policy changes on the achievement of objectives and the derivation of the lessons of experience for the future. As the Bank increasingly diversifies its product and moves towards policy-linked lending, particularly in the middle-income countries, the demands of borrowing countries will increasingly impose on the Bank the need for a more systematic approach to policy formulation.

10. Such an approach may be necessary, but not sufficient to encourage governments to implement reforms. In many cases, governments may not be able to formulate and/or implement such reforms; or they may be unable or unwilling to commit themselves to such reforms. This suggests that in approaching the issues of policy and institutional change, the form and nature of conditionality attached to the Bank's lending instruments will be crucial to their successful implementation. A related issue that the Bank faces is: which instrument is most appropriate for different types of policy reforms?

11. Experience has shown that to be most effective, reforms attached to Bank loans should be as direct, precise and limited as possible; a "Christmas tree" approach is more than likely to be infeasible and would, therefore, lack credibility. Furthermore, experience has also shown that where policy/institutional issues are directly related to successful project implementation or

completely
open
ended.

What about
agreement
on the Bank
program?

lie at the project level, then (policy-based) project loans would be the appropriate instruments; however, if subsector or sectoral institutions and policies are important, then subsector and sector loans (respectively) would be more appropriate. And if broader policy/institutional issues that are multi-sectoral in nature or affect the macroeconomic environment (e.g., a public investment program) are critical, then SALs or similar forms of lending would be appropriate. This suggests that there be increased "targeting" of policy conditions to the lending instruments. Tying sectoral policy changes, such as interest rate reforms or energy price changes, to a DFC loan or a power project, respectively, would not be an effective approach in most instances.

12. Furthermore, an essential aspect of Bank operations is maintaining a long-term presence in the borrowing countries. This may, however, conflict with increased product diversification and the increased conditionality that accompany lending operations designed to bring about fundamental institutional and policy reforms. While this dilemma is not easily resolved, considerable flexibility exists to develop different approaches to ensuring the Bank's long-term presence and simultaneously encouraging countries to undertake the necessary reforms. One approach would be to devise a "core" lending program for each country which would have to be explicitly derived, taking into account the country's specific considerations, including some judgement on the minimum amount of financial transfers necessary for the Bank to maintain its long-term presence in that country; this would be some percentage of a country's annual total lending program and would be allocated to operations not expected to encounter difficulties or delays due to policy-related issues. The balance--the "non-core" program--would consist of loans with conditionality where it is made clear to borrowers that funds would not be provided if agreement on appropriate policy or institutional measures cannot be reached; this amount would constitute "pure" additionality. This "core" concept is currently being applied in some parts of the Bank (Tanzania and Egypt). This approach could also be combined with multi-year (regional/Bank-wide) lending forecasts. Thus, under the system described, the Bank would have increased flexibility; an annual "core" program would be firm and relatively predictable, but the "non-core" would be flexible and could be adjusted across countries and over time, depending on individual country progress in implementing institutional and policy reforms. As a guiding principle, the "core" program could emphasize increases in physical and human capital formation and be "soft" on conditionality, while the "non-core" could emphasize better resource allocation through policy and institutional changes (paras. 5.26 - 5.29).

what order of magnitude?

The Future Evolution of the Bank's Lending Instruments

13. The lending instruments through which the Bank can direct resource transfers and influence change range from the macro/multi-sectoral level to the micro level; they currently include SALs, sector loans, subsector loans and project loans. Conceptually, all these lending instruments have a policy/institutional reform component; an investment component, or what is financed; and a disbursement component, or how funds are spent. In addition, a fourth element has been added with SALs--a tranche component. By modifying and/or combining these various existing components in different ways, it is possible to develop a range of instruments which are both appropriate to achieving the Bank's objectives in a particular situation and which are

attractive to the country involved (paras. 4.11 and 4.13). In principle, therefore, the institution already possesses tremendous flexibility in responding to different issues of development. To the extent that these new instruments simply reflect a reformulation of existing approaches, they should be easy to justify. To the extent that additional flexibility is required, existing Bank policies may have to be reviewed.

14. Viewed within such a framework, a Development Policy Loan (DPL) can be defined as a lending instrument that explicitly addresses multi-sectoral policy or institutional concerns; there is a wide range of variation in what it could finance and how it could be disbursed. In this context, a SAL becomes a special case of a more generalized class of loans as defined above. An interesting example of such a loan is the one being considered for Turkey in response to the need to find a way of maintaining the pace of disbursements reached under structural adjustment lending, once that form of lending stops.

15. Given that these Development Policy Loans would be designed to enhance the development process, their institutional and policy focus would be on the efficient allocation of resources for long-run development rather than on short-run adjustments to balance of payments problems. The sectoral focus of such reforms would, therefore, extend beyond the tradeables sectors to include the human resource and physical infrastructure sectors in those countries where this may be necessary. Such loans can also finance time-slices of public investment/expenditure programs. Furthermore, if the proceeds of such a loan can be disbursed quickly against recurrent expenditures, it will give the Bank direct access to the budgetary issues which have become so prominent over the past few years, particularly in Sub-Saharan Africa and the high-debt, middle-income countries. Also, the fast-disbursing feature--which can include recurrent expenditures and import support--would, when used, increase the marketability of such instruments, particularly when difficult policy and institutional reforms are attached to them.

16. Sector Policy Loans (SPLs) and Subsector Policy Loans (SSPLs) are conceptually no different from Development Policy Loans--in what they finance, how the funds are disbursed or the nature of the tranching--except that they would focus on policy/institutional reforms at the sectoral and subsectoral levels respectively; they are, however, different from sector loans as defined in OMS No. 1.19. There can be many different versions of these loans (paras. 4.19 - 4.22) and many are currently under consideration or implementation within the Bank in Pakistan, Turkey, Zimbabwe, Morocco, Bangladesh and Nigeria. Such loans can also be used to support a time-slice of sectoral/subsectoral investment programs and to finance equipment, credit, etc; quick disbursements would also be possible, where necessary.

17. Given that funds are fungible in most circumstances, such Development Policy Loans and Sector/Subsector Policy Loans are efficient mechanisms to transfer resources to countries. Since these are policy-based instruments, the loan amount should in some way be related to the economic and political costs of adjustment associated with the reforms. Their relatively faster disbursement characteristic, where used, will be particularly attractive when developing countries face unanticipated shocks and crises; in such circumstances, these loans, unlike traditional "project" loans, would be inherently countercyclical. Such instruments clearly add to the flexibility of this institution to respond to the domestic policy and the international economic

Shouldn't be
disbursed
somewhere
if free return
of the policy
change - off
short term -> policy decision
if long term
=> Imp on
resource allocation

environment likely to face developing countries in the next decade. Consequently, arbitrarily determined ceilings on "non-project lending" (of 10% or any other amount) would only set up artificial constraints on the Bank's operations and, thus, restrict its flexibility and contribution to the development of its borrowing members.

18. While policy loans should be large when the conditions merit and when governments are prepared to take significant actions, policy-linked lending does not necessarily imply large loans. One approach that may be worth considering is the design of small "policy implementation loans"--analogous to T.A. or engineering loans currently made--that could encourage the first steps on policy adjustments. The Bank could then offer to refinance them into larger loans aimed at physical measures (e.g., industrial rehabilitation) that need to follow the policy measures. This approach would allow the Bank a lot more flexibility in how it approaches countries which do not meet current SAL criteria. A variant of this approach has been attempted in Senegal and Mauritania.

19. Project lending will continue to be an important part of the Bank's future product, particularly in low-income countries. The key issues here are the importance of country commitment, project complexity, the macro/sectoral policy environment and project management. These factors have often been cited as causes of project failure; the lessons of experience seem to indicate that more specific tailoring of projects to countries and the exact nature of that tailoring will be crucial to project success in the future. This suggests that the Bank retain and enhance its current flexibility in the design of projects.

20. Project complexity and design, in particular, will be major issues of concern for the future. The Bank's experience so far suggests that the high-population countries in Asia (India and China) can undertake and implement projects as complex as the more advanced middle-income countries of East Asia and Latin America, but that care should be taken in not overburdening projects in Sub-Saharan Africa and in many of the EMENA countries; in these countries, institutional and absorptive capacity will act as major constraints. In the design of projects in some developing countries, a more evolutionary approach may be appropriate. But the lower the income level and institutional capacity, the less likely that such an indigenous evolutionary process can be developed in the short run. Nevertheless, our own supervision efforts can be geared to reviewing the need for design adjustments. In this context, it might also be appropriate to consider the principles developed in R and D work in the West. They emphasize flexibility in goal setting, reliance on multiple and parallel approaches, flexibility in coordination of components, gradualism and sequentialism. Pilot agricultural projects, therefore, may be suitable in countries with poor institutional capacity so as to reduce uncertainty and to learn from gradual, incremental steps; similarly, it may be better to build cheap roads and let the ensuing traffic pattern decide which are to be upgraded and made permanent (paras. 4.27 - 4.31).

21. The Bank's experience also indicates that the number of covenants should be fewer for projects, particularly in low-income countries, and the nature of those covenants simpler. In these countries, it is also important to differentiate those objectives that are essential to the project and require a covenant that the Bank intends to enforce from general policy

statements that are desirable, but not essential for the achievement of the project's objectives. Most importantly, project conditionality will depend on the nature of the total package of activities of the Bank in a particular country. As mentioned earlier, the effectiveness of conditionality declines as it gets farther from direct project objectives. As a general rule, the weaker the institutional structure of the country, the lower should be the proportion of non-project conditions attached to the project instrument.

22. The instruments that the Bank can currently bring to bear in stimulating private sector activity include DFC loans, SALs, EDFs and policy advice through CESW. The instruments discussed earlier--Development Policy Loans and Sector/Subsector Policy Loans--can also be used in series to alter the overall policy environment and address issues of the incentive regime in specific sectors where the bias against the private sector is strong (paras. 5.30 - 5.38). Development experience has also demonstrated that institutional development is an important corollary of policy reform; the two must go together. But the complexity of the task ahead for developing countries and the Bank in this area cannot be underestimated. The Bank, currently, has a panoply of instruments for supporting institutional development, but they have not been systematically used in the context of institutional development. Also, since institutional issues arise at various levels of the economy, a more flexible use of instruments may help. Thus, the suggestion made earlier--that the Bank targets its conditionality to specific lending instruments--can apply equally to specific issues of institutional development. The types of instruments described earlier should be increasingly used to make "free standing" institutional development loans. For the "macro" aspects of institutional development, public sector administration, an approach for the future would be to integrate issues of public sector management lending with economic policy reforms through policy-linked loans such as Development Policy Loans, where possible; this would develop and strengthen the emerging pattern under SALs. In principle, such "policy and institutional reform loans" could be macro or sectoral in character (as appropriate) and could also include slower-disbursing elements (e.g., in the context of public sector financial restructuring) which would be on a time track closer to the pace of institutional change; this would partly deal with some of the time disparities experienced in SALs.

23. Much of the Bank's attention on developing public sector institutions often implies the strengthening of these institutions. To the extent that the public sector is considered necessary in certain functions (e.g., public utilities, roads, ports, etc.), the argument for the support of institutional development is obvious. There may, however, be certain areas where the participation of the public sector may not be necessary, particularly when the public sector has grown to be large and inefficient and is a hindrance to economic development and growth. An effective Bank strategy should, therefore, be selective and identify not only those institutions that ought to be strengthened, but also those that need to be reformed, merged or eliminated. Until now, this issue has received relatively less attention as the focus has essentially been on those institutions that need strengthening. But, given the financial and human resource constraints facing many governments, one of the Bank's most effective contributions would be to help countries in achieving a restructuring or even a dismantling of selected institutions, such as some marketing boards in agriculture and certain public enterprises in industry, to permit the smooth and efficient functioning of the economy. This is now being done in a few cases in some countries.

24. There is a wide range of alternatives to strengthening and expanding public sector institutions. This includes the privatization of delivery services, the contracting out of services and the divestiture of public enterprises. There are many examples of countries that have undertaken such institutional reforms (paras. 5.51 - 5.53). This suggests that the Bank's own project work be guided by the principles of institutional reform rather than by the establishment or the proliferation of numerous new project-level public entities and institutions designed specifically to ensure the success of Bank projects. For example, existing institutions could be used, project design could economize on scarce marginal/administrative resources in the public sector and future Bank lending for large-scale public enterprises, when undertaken, could be opened up to participation by private investment and finance and to increased competition from domestic producers and from foreign trade.

The Role of Country Economic and Sector Work

25. The country economic and sector work (CESW) program of the Bank will increasingly form the intellectual basis for the Bank's future product. The Bank's inputs into policy analysis and formulation will clearly be of crucial importance, particularly as this institution moves towards a more diversified product. This increased emphasis imposes a special responsibility on the Bank to ensure that its analysis and recommendations, from the project to the macroeconomic level, are of high quality. Furthermore, the quality of research institutions and policy advisers in developing countries is rapidly increasing; in some, the technical quality of individuals may even exceed that of the Bank's staff. This increased domestic competition places an added responsibility on the Bank to retain superior quality staff to ensure high-quality advice; the receptivity to and credibility of the Bank's advice on policy and institutional reforms will depend critically on this issue. In fact, high-quality analytical work will be a sine qua non for the Bank's future product. The current erratic quality could potentially constitute a major constraint to the future evolution of the Bank.

26. Given the increasing importance of policy and institutional reforms, a more sharply focused CESW program geared to the Bank's lending operations will be essential. Such a program should not only support an active policy dialogue and policy-based lending, but also monitor the policy changes and their effects. Furthermore, the worsening of the international economic environment in recent years and the increasing difficulties faced by developing countries suggests a need for CESW to provide the basis for specific (rather than generalized) measures of reform. This is crucial if the Bank is to effectively channel its conclusion and recommendations through its operations into actual policy reform. Stronger links between CESW and the Bank's operations also suggest that greater attention be placed on: the political economy of policy change; the economic (and, if possible, the political) implications of policy reforms; identification of more efficient ways of achieving non-economic objectives of the government; the adjustment costs during the transition period; how to implement policy changes during the transition period; transmitting the lessons of successful and unsuccessful approaches to policy reform to decision-makers in borrowing countries; the relationship between short-term stabilization and adjustment and long-term growth; and careful reviews of public expenditure programs with a view to identifying marginal projects and "white elephants." Addressing many of these

issues will be difficult as inadequate research and analysis has been done on them. Consequently, Bank research has a major role to play in order to provide the intellectual foundation for CESW and the future evolution of the Bank's operations. The Bank, through disseminating its CESW to a wider audience, can also play a catalytic role in influencing the flow of external capital from various sources. There are, however, numerous issues that will have to be resolved if the Bank wishes to pursue this route (paras. 5.56 - 5.66).

The Evaluation of the Bank's Product

27. As the Bank's product becomes increasingly diversified, both the methodology and the procedures for assessing its product ex-ante (appraisal), monitoring the efficiency of the Bank's "production process" during implementation (supervision), and assessing the effectiveness and impact of the Bank's operations ex-post (evaluation) will need to evolve. The existing methodology and procedures have been developed and refined over the years primarily to determine the economic benefits of individual projects. The available methodology for dealing with the less tangible components of the Bank's product--such as institutional development or policy reform--is still primitive and unsystematic; no acceptable methodology is in sight as it is difficult to identify the causal link between a policy measure and the ultimate outcome. The ex-post evaluation of the use of instruments, such as Development Policy Loans and Sector Policy Loans, may be easier if the funds are to be used to finance development programs and when the policy reforms are pre-conditions for such loans designed to improve the efficiency of resource use and the debt service capacity of the country. The rate of return on these loans can then be calculated in the traditional way without guessing the situation "without" policy reforms.

28. Also, most of the policy reforms required involve a change in the country's legislation. At present, because they are easier to monitor, these changes in legislation are the basic indicators of the country's compliance with current SAL agreements. However, the true economic effects of concern are whether productive units, as a result of the reforms, are now facing more appropriate signals. The issue is whether--by monitoring legislation, instead of effective incentives faced by these units--the Bank, in fact, measures changes in the true economic effects of these reforms. Clearly, there can be significant discrepancies between legislative changes and "effective" changes and numerous examples abound (para. 4.41). This suggests that to monitor and evaluate the impact of policy reforms, even when all of them are ostensibly undertaken by the government, the direct surveying of randomly selected enterprises should be undertaken to document the net impact on the firms; monitoring legislated changes alone may not be enough. Obviously the focus, timing and frequency of such firm-level surveys would depend on the signals to be monitored.

29. Better preparation and appraisal will in itself facilitate better supervision and evaluation of the Bank's future product, if the objectives are better defined, the inputs (costs) more detailed, and a phased implementation schedule, with intermediate and final targets, made explicit. The supervision and the evaluation of the Bank's future product will be more systematic and precise only if the intended effects and impact of the Bank's operations are well defined in advance. Furthermore, ex-ante and ex-post evaluation of

broad, i.e., sectoral/subsectoral, priorities will become increasingly important. This suggests that the evaluation of operations will need to extend its focus from project specific to system-wide issues. Moreover, ex-post reviews of a decade of Bank operations in a particular country, would also be useful for the Bank's future operations in order to draw lessons on the broader (systemic) issues of the Bank's country assistance strategy.

The Market for the Bank's Product

30. The Bank no longer operates in a quasi-monopolistic international capital market as it used to; the world has changed and the Bank is only one among many players in the market providing development finance. Furthermore, the Bank's product has changed; it has become more complex and continues to evolve. Consequently, the issue of client receptivity to the product of the Bank is crucial. The receptivity to the Bank's product will be, inter alia, a function of the nature of our relationship with a particular government and the competitiveness of the Bank's loans with policy advice, technical assistance and conditionality relative to assistance provided by other donors and alternate sources of finance without these complementary components. In many countries, the lengthy project cycle is perceived as a cost relative to alternate sources of finance from institutions whose appraisal procedures are far more rapid. Put another way, over the next decade, the Bank's product will frequently be put to the market test, for a variety of reasons. The Bank will, therefore, constantly have to evaluate its product in each country--particularly when the product fails the market test--and decide on the adjustments, if any, that should be made.

31. The characteristic that will most obviously affect the marketability of the Bank's product is the attachment of explicit policy conditionality. In the past, there have been two situations when the Bank has been reasonably successful in having governments accept its policy/institutional advice. First, when governments have no choice but to accept, i.e., alternate sources of funds are limited; the very low-income countries, possibly the middle-income, high-debt countries, and countries that have faced a sudden reversal in their fortunes due to say, an unexpected commodity price decline, fall under this category. The second situation is when the Bank has convinced the government of the logic of its position; this requires painstaking effort, but it can convert Bank conditionality from being a cost to becoming a perceived benefit and, thus, positively affect the marketability of the Bank's product. The flexibility inherent in the Bank's product, however, suggests that this perceived "negative" aspect, where it exists, may be compensated by altering the other characteristics of the loan. For example, such loans could be fast-disbursing; a characteristic for which most governments would pay a high premium. In addition, the specific terms of the loan may also be changed. These include altering the repayment profile--e.g., by offering borrowers a constant payment/variable maturity loan--and the grace and repayment schedules (paras. 4.47 - 4.49). Some of these changes are likely to have an impact on the Bank's income and may also provide an implicit economic subsidy to the borrowers; they, therefore, warrant further examination.

32. Ideally, however, the Bank should develop a relationship with its borrowers in which its policy advice is welcomed for its own sake, for its objectivity and sophistication, and may be provided whether it is lending or not in any particular year. If it could build further on its reputation for

high-quality policy advice, the Bank may also be able to provide such advice (for a fee) to countries that have graduated out of IBRD lending, but continue to need assistance on how to effectively manage their economies. Over the next decade, the Bank will also have to address the issue of providing technical assistance/policy advice without lending to countries and on a reimbursable basis. The market for this component of the product would probably be the more sophisticated Bank borrowers who may prefer to "unbundle" the product, countries that have graduated out of the Bank and, as now, the capital-surplus, oil-exporting countries (paras. 4.56 - 4.58).

Elements of the Bank's Assistance Strategies

33. The discussion so far has outlined the general framework for the Bank's future operations. This part discusses how this framework can be applied in different groups of countries; the purpose here is to be illustrative, not prescriptive. The diversity and interdependence themes discussed earlier lead to a useful country typology as an organizing framework. This typology divides the developing world into five groups: Sub-Saharan Africa; India/China; other low-income countries; high-debt, middle-income countries; and other middle-income countries. As discussed earlier, these countries and the Bank, over the next decade, will jointly have to address ways of increasing physical and human capital formation and improving the productivity of investments and the efficiency of resource use. Also, a crucial consideration for the Bank, over the next decade, will be whether it should be a "full-service" institution in every country. The position taken here is that it should not; the Bank may have the capability in the aggregate of providing a full range of services, but it should be selective in the provision of services and in the focus of attention in each country. Consequently, the underlying theme for future Bank assistance strategies is that of selectivity of issues/sectors and selectivity of instruments in different countries.

34. Suggestions regarding the choice of issues/sectors suitable for Bank involvement across the many different types of borrowers are difficult to make a priori, in view of the wide variability among countries in terms of the relative importance and the nature of particular sectoral problems. Nevertheless, it will be important that the Bank exercise selectivity in the choice of sectors and issues focused on in individual countries in order to avoid dissipating its energies and resources and losing the benefits of critical mass, in terms of both leverage and experience. Among the considerations which would naturally figure into the choice of issues and sectors to be addressed in a specific country are: the perceived receptivity of the client to our initiatives in a given sector or issue area, the activities of other donors and financial institutions in a particular sector, the resources we have at our disposal, and the Bank's likely comparative advantage over the planning period. It will be important in this selection process to take a relatively long-term view, recognizing that we may be better off addressing a range of issues in sequence rather than simultaneously.

35. Against that background, it is useful to discuss the choice of instruments for different country groups, where it is possible to develop indicative scenarios regarding the instruments likely to be most relevant and effective for the various groupings. As a general rule, for the lower-income countries, all of the Bank's instruments will have to be utilized, while for those at the higher end of the income spectrum, the Bank's activities can

But selectivity
should
not lead
to application of
different
standards

focus more on the macro and sectoral levels rather than on the micro (projects) level. There will not be sharp distinctions in the suggested mix of instruments between groups at the margin; the distribution will change as one moves from one country group to the other, with Sub-Saharan Africa and the middle-income, high-debt group representing the extremes in this typology.

But he
country should
take care of
the projects

36. In Sub-Saharan Africa, given the weak capacity to manage institutional and policy changes, the full flexibility of the Bank's product will have to be called upon--from the project level to the subsector, sector and macro level--as our activities will span the entire product spectrum in order to support lending and institutional and policy reform, provide technical assistance, and mobilize external capital from commercial banks as well as from foreign direct investments. Clearly, the Bank's activities in these countries will be extremely labor-intensive and will, over the next decade, require the highest concentration of our staff resources per dollar lent.

37. At the project level, these countries will require strong support for design and appraisal, technical assistance in implementation and institution building and training for future cadres, and project lending should be directed to alleviating their long-term constraints. It is also essential that projects be redesigned in accordance with the lessons of experience; they should, therefore, be relatively small, simple in design and decentralized, economizing on scarce managerial and technical resources. Greater emphasis on maintenance and rehabilitation will be warranted as will more flexible disbursement procedures, particularly in the area of local and recurrent costs. The Bank may also consider lending through other institutions, e.g., the ADB or ECOWAS. A regional approach may be effective if significant externalities are involved as in the case of soil erosion. But the record of such cooperation has been disappointing. The use of NGOs may be a preferred route (paras. 6.9 - 6.14).

BOARD

38. For those Sub-Saharan countries with only a few relatively strong sectoral ministries, Sectoral/Subsectoral Policy Loans which, for example, finance time-slices of sectoral or subsectoral public expenditure programs in return for institutional and policy reforms may be more appropriate. In many countries, the restructuring of such expenditure programs may be necessary and should focus not only on capital expenditure, but also on the recurrent cost components. In some countries, reforms in a particular sector may be implemented through an overarching sectoral or subsectoral conditionality--which involves an agreed sectoral (or subsectoral) strategy for institutional and policy reforms--combined with the financing of discrete projects with traditional project covenants to ensure project viability; failure to abide by the agreed sectoral strategy would result in reduced or no further project lending; such an approach is being considered in Pakistan.

39. In those countries with relatively strong central institutions--such as in Kenya, Senegal and Malawi where several SAL programs are currently being launched--the use of macro loans, such as Development Policy Loans, may be effective instruments to cover a broad range of policy issues addressing the macroeconomic environment. These could include trade policy reforms, public expenditure reforms, and a variety of sector-specific issues--such as those in industry, agriculture, energy, education and transport--where the urgency for reform is very high. The Bank may also consider using Development Policy Loans or Sector Policy Loans to encourage institutional reforms; i.e., to

induce changes in the public administration system, reforming public enterprises, and other forms of institutional development. Disbursements for these loans can take place against any necessary activity that will enhance the functioning of the economy. Within a sector, a Sector Policy Loan can also be used to reform a particular sectoral institution, such as a cotton or tea authority or the Ministry of Agriculture. The Bank's experience with such loans, however, is limited and is an area in which it should tread cautiously (paras. 6.15 - 6.18).

40. Sub-Saharan Africa will also require the highest concentration of IDA lending. The importance of high levels of ODA from all donors also needs to be emphasized. Decreased aid, and IDA in particular, will reduce the prospects of much needed reform. Given the shortage in IDA funds, the Bank should concentrate its financial assistance on and provide long-term financial security to those countries within Sub-Saharan Africa that are prepared to undertake the fundamental measures necessary to stimulate economic growth; this implies much greater selectivity of countries on the part of the Bank than in the past.

41. The use of Bank instruments in the other low-income group will also have to span the full range, from the project to the macro level. The institutions, in some of these countries, are stronger than those in most of Sub-Saharan Africa, and this may permit greater flexibility in using Subsector and Sector Policy Loans (e.g., as in Pakistan). These instruments can be used to increase producer incentives in agriculture, enhance exports, and assist in correcting management and institutional deficiencies in selected sectors. Most of the issues raised regarding the use of different types of Bank instruments in Sub-Saharan Africa can be translated, with suitable modifications, to this group and does not warrant repeating; the principles are the same.

42. In India and China, where the institutional structures are far better developed than in the previous two groups, suggests the potential feasibility of using macro instruments such as Development Policy Loans to bring about policy and institutional changes. But, neither China nor India has expressed any interest in such loans as SALs and, given the size of their economies and their sensitivity on any broad conditionality, the multi-sector Development Policy Loan approach is not likely to be employed, at least, in the near future. However, the logic of moving to broader subsector and sector instruments is strong. The issue, therefore, is the willingness on the part of these borrowers to move to discuss the broader issues of economic development and accept Subsector/Sector Policy Loans, initially on the institutional side, but, over time, to include issues of economic policy reform. Accomplishing this will require an ability to provide appropriate incentives to China and India. The approach suggested for Sector and Subsector Policy Loans provides for more flexible use and rapid disbursement of financing. Also, if it is clearly established that funding can be awarded on the basis of past performance, then these instruments might become more attractive to these countries.

43. Project lending, however, would continue to be suitable instruments for the development of physical and human infrastructure. Power investments, in particular, should be highlighted, but other investments in the energy sector would also be an appropriate focus of Bank attention. The large size of these countries suggests that the Bank locate a few critical areas where the project instrument can have a sector-wide influence. Also, the industrial

sectors, in both these countries, have the potential of being dynamic sources of growth. In China, a major effort is under way to opening up that economy and increasing the reliance on markets and prices. To the extent that this objective is maintained, and a program of projects can be developed to facilitate this, then this effort has high priority. In India, where the thrust of our advice has been towards making the industrial sector more competitive internationally, various forms of Subsector/Sector Policy Loans would be effective instruments here, but a wide variety of policy issues--spanning the range from administrative and price controls to trade policy reform to credit allocation mechanisms--would need analysis and resolution. Moreover, except when clear and overwhelming policy/institutional objectives are identified, Bank support for large public sector investments may now be inconsistent with a strategy to facilitate the efficient expansion of the industrial sector (paras. 6.30 - 6.32).

44. Bank programs in India and China will continue to represent a small percentage of their overall resource requirements. This situation underlies the importance of both a clear sense of priorities and well-developed strategies for having an impact on government policies and institutions. This concern is particularly relevant in light of the current IDA situation. Given the increased creditworthiness of India--and assuming that it can be maintained through the future--and the borrowing flexibility available to China in light of its past conservative practices, the maintenance of large IDA flows to India and increased IDA to China will be critically dependent on an ability to trace the impact of such aid on these countries' future growth prospects. Furthermore, given the constraints on IDA and the needs of Sub-Saharan Africa, the relative level of IDA funds to these countries should be conditional, as suggested for the other groups of countries, on progress in moving towards broader policy and institutional reforms.

45. For the middle-income, high-debt group of countries, improving the macroeconomic environment and policies at the project level will require a relatively greater use of the Bank's macro instruments such as multi-sectoral Development Policy Loans or Sectoral Policy Loans, particularly those with fast disbursement characteristics, rather than micro instruments such as project lending. In some countries, particularly those of the Middle East--where the institutional structures are less well developed than those in the East Asian or Latin American ones--the entire spectrum of instruments may be required, both to address policy issues in the tradeables sectors to support the adjustment process and to enhance institutional reforms and human resource development to lay the foundations for longer-term growth.

46. The policy component of Development Policy/Sector Policy/Subsector Policy Loans would involve encouraging governments to continue with difficult, but necessary policies already undertaken or to undertake specific new changes; e.g., in their public expenditure programs; cost-effectiveness in the social services; reforms in public sector pricing, improvements in public sector efficiency; and the encouragement of private domestic and foreign sectors through changes in trade, financial and fiscal incentives to the tradeable sectors of the economy such as agriculture, industry, energy and services. In addition, the Development Policy Loans could also be used to address the "macro" prices of the economy such as the interest rate. Naturally, the focus would vary depending on the precise nature of the problem in each country, but the underlying need to minimize the short-run costs of

macroeconomic stabilization and achieve long-term structural adjustment will require coordinated policies in all these countries (paras. 6.35 -6.38).

47. Traditional project lending will remain important in those countries (such as Indonesia and Egypt) where institutions are less well developed. In general, however, the demand for new traditional Bank-financed physical projects in most of the high-debt countries will be weak over the next five years and will recover only gradually as fiscal programs are likely to continue to be under tight financial discipline. Thus, in the medium term, the use of Development Policy Loans and Sector Policy Loans rather than project loans, will dominate in this group of countries. Loans at the project level cannot, of course, be totally ruled out; where necessary, such Bank loans should be for working capital and support for the completion, rehabilitation and maintenance of projects already begun, but have been halted midstream due to fiscal constraints. This, in effect, would be "reverse co-financing" where Bank funds would be used for projects originally financed from some other official or private source.

48. In many of these countries, private commercial lending has become a very important source of external financing, particularly for the Latin American ones; in such cases, the Bank's incremental financial contribution will be small. While external commercial banks and other private lending sources are likely to be more cautious in expanding exposure, they are expected to stay in a big way, both to protect existing assets as well as to realize continuing profits in their traditional banking business in the region. The Regional Development Banks--the IDB and the ADB in particular--will continue to be important sources of alternate funds with minimal policy conditionality. Thus, the Bank would be only a marginal lender to the most industrialized countries such as Mexico and Brazil. Its leverage would be greater only in those countries where commercial lenders are expected to back off. The success of a policy-linked lending program would, therefore, vary across countries and over time and depend on the level of agreement on policy directions between the Bank and the country. The use of policy-linked lending would, therefore, have to rely very heavily on a convincing policy dialogue (paras. 6.42 - 6.44).

49. In the case of the other middle-income countries, the Bank should also focus on improving macroeconomic management and sectoral policies. As with the previous group, policy-linked loans at the macro and sectoral level rather than loans at the micro (project) level should be the major lending instruments; as before, economic and sector work will continue to play a major role in providing the intellectual foundations for the Bank's involvement. This strategy would require that the Bank become much more a wholesaler of projects, in that it would finance a small share of a large number of projects rather than a large share of single projects. This is not entirely new to some of these countries, but it does require a greater degree of sophistication on the part of the borrowers than is available in some of them--particularly those in Africa and the Middle East. As before, this implies a greater focus in those countries on institutional development, training of staff and managers, and increasing the education level in general.

50. In this heterogeneous group of countries, two caveats must also be borne in mind. The first is the recognition of the need for careful phasing in using the more macro loans such as Development Policy Loans and Sector

Policy Loans. In some countries, it will take time to identify and resolve important constraints, reach agreement with governments on a new type of instrument and develop our capabilities in these areas. The second point is that there will be no simple format for policy-linked lending across sectors or countries. Given the nature of the problems, the Bank should clearly focus on the broader issues in these countries; the exact focus of lending, however, may range from broad Development Policy Loans and Sector Policy Loans to Subsector Loans to traditional projects with (project-specific) policy packages attached to them. The distribution, however, will be skewed towards the first three instruments (Development Policy Loans, Sector Policy Loans and Subsector Policy Loans) and, as countries in this group develop, this distribution will become increasingly skewed away from traditional project loans (paras. 6.48 - 6.50).

51. As these countries gradually move to the upper end of the income scale, they will also have increasing access to external capital markets. The willingness of these countries to accept Bank loans with strict conditionality will then depend upon their willingness to accept the Bank's advice and to the extent other sources of funds without similar conditionality are available to them. Some of these countries, over the next decade, may become intermittent borrowers from the Bank. Consequently, for this group of countries, high-quality economic and sector work and the ability to "sell" it through its specificity, timeliness and a convincing policy dialogue will be increasingly important; but so will be the willingness of the borrowers to improve their economic management. Where the responsiveness of the borrower is low, the Bank should be less willing to respond to the country's need for external funding. Where the willingness is high, the potential for a much more diversified product will open up. Thus, for these countries, the Bank, building on the confidence of its policy analysis, would need to incorporate flexible enforcement features into its various lending instruments, and then have the political will to use them.

Bank Assistance Strategies and the Fund in the Different Country Groups

52. In the low-income countries, more than anywhere else, an effective external adjustment strategy requires a package of measures that deal with both macroeconomic policies and a wide range of reforms on the production side of the economy. There is a recognition within the IMF that external imbalances in low-income countries are not amenable to correction in a short period of time and do require extensive changes in the pattern of production. However, the Fund has been constrained in the design of programs by the limited expertise available to it. Neither has there evolved an adequate mechanism by which the Fund can tap and channel the expertise within the Bank in order to assist it in the design of adjustment programs. A growing Bank role in assisting governments in formulating and implementing reforms on the production side is, therefore, critical.

53. The Bank can muster the sectoral knowledge and expertise that is required to formulate and implement policy changes in areas such as agriculture, transport and industry in order to design reform programs on the production side that can complement Fund programs; the instruments by which this may be accomplished have been discussed. The major danger is that such adjustment packages may be viewed by the country as a substitute for Fund programs rather than complementary to Fund programs; as a result, the Fund has

been acutely sensitive about independent Bank initiatives that it feels may undermine its negotiating position. The most striking recent example of such a danger is in Tanzania. An increased Bank role in the design of adjustment programs will require more than the usual degree of consultation with the Fund.

54. For those countries likely to face severe debt problems in the next decade, the Bank and the IMF must now also begin to identify the mechanisms--which may be unique to some in Sub-Saharan Africa because of the relatively inflexible structure of their economies--to handle debt-rescheduling payments; flexible rescheduling schemes tied to the fluctuations in the country's terms of trade may be one approach. Some schemes may implicitly increase the economic subsidy to these countries. Nevertheless, given that political structures are fragile, and that the external environment can exact a heavy toll on these countries, they should have access, not only to subsidized funds, but also to medium- and long-term financial security. Such support should be made explicitly clear to those countries prepared to take bold steps in instituting reforms.

55. In the middle-income group, and the high-debt countries in particular, macroeconomic stabilization and structural adjustment must be pursued simultaneously and in a unified way. Thus, closer coordination between the Bank and the IMF is of paramount importance. The IMF has a comparative advantage in aggregate demand policies, but it is not ideally suited to address issues of aggregate supply, which is the Bank's strength; the Bank has several instruments which it could use to affect aggregate supply over the long term. It is the integration of such adjustment policies with short-term stabilization efforts that is essential to ensuring the long term of growth of these countries. But this integration is not easy, as demonstrated by the experiences of Argentina, Brazil, Chile and the Philippines. Here, trade liberalization programs designed to increase aggregate supply and facilitate long-term adjustments are being slowed down or reversed as governments attempt to stabilize their economies through credit restrictions and import limitations.

56. The beginnings of what could become a relatively new and different role for the Bank in this group of countries, vis-a-vis the IMF, are emerging from the various attempts which have been initiated in some of them, such as Turkey, Yugoslavia and Morocco. The IMF, in each case, has negotiated and agreed to the broad outlines of a stabilization program. The complementary role of the Bank would be to work with the governments to restructure their public expenditure (not just investment) programs, support their resource mobilization efforts in the public and the private sectors, and reform their trade and incentives regime in the industrial, agriculture and the energy sector. These adjustment policies could be undertaken through a series of Development Policy Loans/Sector Policy Loans that would provide suitable packages of longer-term financing to assist the governments in implementing the policy changes necessary to meet the IMF targets. Such joint "Economic Adjustments Programs" would require much more explicit, though not necessarily formal, coordination between the Bank and the Fund.

Institutional Coordination between the Bank and the Fund

57. As the Bank's product becomes increasingly diversified, it will

become vitally important for the Bank and the Fund to cooperate in the formulation of the policy advice they provide to their members. While recent changes in the international environment have eroded the distinction between balance of payments problems and those of economic growth and development, there continue to remain areas where the primary objectives of each institution are quite distinct. But, there now also exist numerous situations where concerns of both institutions overlap to a much greater degree. While a division of labor is necessary in order to facilitate relationships with our member countries, this should not be allowed to obscure the fact that many policy issues will cut across any boundaries of responsibility. Consequently, any approach to improving such cooperation would have to pay attention to three different types of situations: where the Fund's policy discussions impinge upon areas of Bank expertise; the Bank's policy discussions need to be coordinated with issues under Fund jurisdiction (primarily exchange rate policy); and areas of joint responsibility.

58. In the first case, the Fund has looked to the Bank for its views on issues such as the size and composition of investment programs, pricing policy and other measures to improve the efficiency of resource use. The main difficulties in coordination here have arisen primarily from programming and staff allocation problems. The solution, therefore, lies in the establishment of a more effective mechanism by which the countries, where the Fund is likely to require Bank assistance, can be identified in time and the necessary staff resources deployed. It is, therefore, suggested that the Bank and the Fund conduct periodic joint reviews at the regional level--possibly at the time of the indicative statements--to agree upon a group of countries in each region where the necessary issues do require further analysis, and the resources and time horizon for Bank work in support of the Fund are determined.

59. In the second case, there is general agreement within both institutions that there are policy issues which are of primary concern to the Bank and which have to be closely coordinated with exchange rate policy. However, the Fund, concerned as it is that prescriptions regarding exchange rate policy should not be inconsistent, has resisted the notion that the Bank take the initiative in policy discussions with the Government on this issue (except in those cases where Fund involvement in a country is marginal). Thus, there has emerged a recurring conflict between the objectives of avoiding inconsistent advice and the equally important objective of ensuring that policy advice to members is both comprehensive and well integrated.

60. In establishing a modus operandi which can reconcile this, a distinction must be made between analytical work done within the Bank which has an informal status and the official views of the institution as expressed in its official economic documents or in its negotiating position. In those cases where it is felt that exchange rate policy does impinge in a significant way on issues of central importance to the Bank's policy dialogue, a study outlining these linkages and tracing out the implications for exchange rate policy should be undertaken. Such studies might be initiated by the Bank separately or jointly with the Fund, but would only be available for internal use and would not be discussed with the governments. Such informal studies would help to sharpen and focus issues more clearly and would add an element of rigor that is sometimes lacking during informal exchanges of views between the two institutions. In addition, joint analysis would facilitate a less doctrinaire approach to the division of labor between the Bank and the Fund,

and thus, permit a more flexible approach to policy dialogue in member countries.

61. The third case includes a large area of economic policy that is recognized to be of mutual concern; the sorts of issues here include foreign borrowing policies, interest rates and other financial sector policies and tax policies. The degree of coordination in these areas is particularly dependent upon initiatives at the working level. At its best, coordination has involved the writing of joint reports and informal agreements as to which institution is best placed to take the lead in guiding the dialogue related to a certain policy area. In other cases, however, particularly when the two institutions have widely differing views, countries end up receiving very mixed and confused signals. While efforts should be directed at facilitating cooperation at the operational level, there will inevitably exist situations where fundamental differences in policy prescriptions divide the staff of the two institutions. In such situations, it may be useful to have some sort of high-level machinery for the resolution of such policy differences. Regional counterpart relationships, while useful, have not always been an effective channel for the resolution of deep policy differences.

62. Country experience demonstrates that the vital keys to effective collaboration are good relations at the working level and the development of a continuous, informal exchange of information and news. In order to foster such an exchange, the following steps should be emphasized: (i) the views of the other institution should be sought--and seriously considered--at an early stage in policy formulation before positions have become frozen as a result of deadlines or management clearances; (ii) the current practice of holding periodic joint seminars and workshops to discuss major issues of policy at both regional and country level should be encouraged; (iii) the exchange of information should cover both policy discussions in member countries and, in order to facilitate planning, the future work programs of country desks and the timings of future missions. When it is found to be useful, joint missions should be encouraged.

63. Regarding lending operations, in order to establish more effective complementarity between Fund programs and Bank policy-based lending, a much clearer conceptual distinction must be made within both institutions between different types of programs. In particular, a distinction has to be made between those situations where the two institutions are providing resources for what is, in effect, a single need of their members and those situations where the institutions are providing resources to support distinct objectives. For the Fund, this implies a much clearer differentiation between balance of payments difficulties associated with excess demand pressures and/or temporary changes in the terms of trade, and "structural" balance of payments difficulties. The design of adjustment programs for countries facing "structural" balance of payments difficulties should be conceived and planned as a joint product; this has implications for the way in which both institutions conduct their business (paras. 7.26 - 7.27). Similarly, for the Bank, a clearer distinction must be made between policy-based lending that is, in essence, supportive of Fund programs to achieve external adjustment (as SALs were originally conceived), and policy-based lending which attempts to achieve efficiency gains that are independent of the particular balance of payments adjustment policies that the country needs to pursue--such as through Development Policy Loans and as SALs have in some respects become--and which do not require Fund involvement.

64. Also, to the extent possible, a clearly specified three-year Bank assistance strategy, in most countries, should complement that of the Fund. In these countries, private commercial banks should also be brought into the picture and a three-way relation should be formed to facilitate the flow of long-term capital. A "compact" could be established between the recipient countries and the major international financial institutions (the Bank, the IMF and commercial banks) where, in return for substantial financial flows, an understanding is reached on the major policy/institutional reforms that will be undertaken by these countries to restore their creditworthiness (if necessary) and long-term growth prospects. Such a quadrilateral understanding would not only assist the economic development of the countries concerned, but also reduce the probability of default, particularly in the high-debt countries, and should, therefore, be in the interest of all parties concerned (paras. 7.28 - 7.30).

1. INTRODUCTION

1.1 This paper is one of twelve being prepared for the exercise on the future role of the Bank. These papers are sub-divided into three broad groups: assessing the environment; defining the Bank's role; and means of financing. ^{1/} The purpose of this paper is to stimulate Bank staff discussions regarding broad directions for the Bank's future operations, to provide some suggestions regarding these directions and to raise issues that warrant further examination. This report does not recommend any sharp break with the past. On the contrary, it suggests that the Bank not only retain its evolutionary character, but also accelerate in the direction that it has been moving in the last three to four years, i.e., towards being an economic institution rather than a purely financial one. To facilitate this acceleration and to assist in meeting the development objectives of our borrowers more efficiently, the report suggests new tools and approaches which, *inter alia*, include Development Policy Loans, the policy cycle, the targeting of conditionality to lending instruments, the development of "core" and "non-core" lending programs, mini-policy loans, a reorientation of Bank attention in a number of areas and differentiated assistance strategies in countries.

1.2 The discussion begins, in Chapter 2, with the evolution of the Bank's operations and the lessons of experience that have emerged over the recent past. Chapter 3 presents the emerging themes for the developing countries over the next decade. It demonstrates that recent trends indicate a growing diversity among developing countries and the increased interdependence between the developing and developed world; these trends are expected to continue for the next decade and this has implications for the Bank's role. Chapter 4 outlines the nature of the Bank's future operational product. It sets out a general framework, describes the characteristics of the Bank's "tool-kit" and provides some preliminary ideas for ways in which these tools may be used creatively. Chapter 5 highlights selected aspects of the Bank's product while Chapter 6 illustrates how the general framework established in the preceding chapters--the Bank's tool-kit--can be used under different circumstances in different groups of countries. Finally, Chapter 7 discusses issues of institutional coordination between the Bank and the Fund as the Bank's product becomes increasingly diversified.

^{1/} Papers other than this, in the subgroup defining the Bank's role, include defining the leadership role in research; the leadership role in aid coordination; the role vis-a-vis the commercial banks; the role vis-a-vis the private sector; increased differentiation in role by country group; and staff implications of the proposed future role.

2: BANK OPERATIONS:

THEIR EVOLUTION AND THE LESSONS OF EXPERIENCE

Introduction

2.1 The objective of this chapter is to place the current operations of the Bank into an historical perspective, particularly with respect to the economic development experience. This chapter will, therefore, briefly outline the Bank's accomplishments -- emphasizing its adaptability and evolution -- in order to set the stage for the role of the Bank in the next decade.

The Early Years

2.2 The overriding concern of those responsible for framing the World Bank was to address anticipated difficulties in reestablishing international financial markets after World War II. Based on the premise that private intermediaries could handle short-term financing, but would not be prepared to absorb the risks implicit in long-term international investment, the framers set out to develop an institution which would facilitate the flow of private capital to undertake such long-term investments. Consistent with this, most commentators on Bank history note that it was expected that a large part of the Bank's business would revolve around guaranteeing private investment through the guarantee facility included in the Articles. That this assumption did not prove accurate is one of the many examples of how a dynamic environment has led to modifications and new directions in the Bank group's operations. Indeed, the risk of changing circumstances was fully appreciated by the framers, resulting in the Articles of Agreement which give considerable operational discretion to the Bank's management to respond to new issues and priorities. A key theme emerging from any review of Bank group operations highlights the pragmatic use of this flexibility by successive Bank managements to ensure that Bank operations remained relevant to the borrowers' needs.

2.3 The early years of Bank operations were marked by a concern with Bank viability; in order to raise funds in the international capital markets for lending, the Bank had to establish itself as a secure credit risk. Reflecting this, the portfolio was initially heavily concentrated on the high-income countries of Europe and Latin America; diversification came slowly with increased lending to Asia in the 1950s. In the early years, lending for discrete investment proposals (traditional projects) was seen as a method which would allow accounting for the use of funds and would demonstrate a tangible contribution to reconstruction and development. In addition, lending concentrated on sectors where revenues could be generated; self-financing projects were seen as a way to ensure subsequent repayment. Reflecting this, almost 50% of Bank lending in the first 15 years was to power and railroad projects. There was no lending for social services, and agriculture lending accounted for less than 10% of the portfolio. 1/

1/ Various annual reports.

2.4 Long-standing Bank practices associated with the traditional project approach were developed in these years; Bank involvement with project preparation, refinement of the appraisal process, and the emergence of project supervision and ICB are examples. Yet, it would be incorrect to suggest that these developments were straightforward or the techniques used static. None of these activities were typical in normal commercial practices and refinements were continuous. For example, the increased Bank involvement in project preparation developed in parallel with the expansion of development lending as it became clear that lending proposals were not fully developed or analyzed. Also, increased technical assistance was provided as the weakness of project agencies became clear, in spite of the absence of any specific mention of this role in the Articles. The early loans also saw the introduction of conditionality at the project and sector levels. Initial efforts at institutional development were often aimed at the establishment of autonomous project entities, where such entities were found necessary, as in ports, power and railways. Early examples include the establishment of an autonomous railway authority in Thailand in 1951 and road and telecommunications authorities in Ethiopia in the early 1950s. Loan conditions reflected concern for the financial viability of these institutions, particularly in the power sector, but quickly expanded to include a broad range of project- and sector-related concerns.

2.5 At the same time, Bank management also focused on the broader issues of economic management, recognizing that broad macroeconomic policies provided the critical context for project implementation. A number of decisions were made on countries where economic management was weak; e.g. lending was refused to the Philippines in 1949 when a judgement was reached that economic management was weak. It must also be noted that when non-project lending was viewed as an appropriate response to borrower needs, the Bank undertook such lending. The first four loans the Bank made were for import support and subsequent import loans to the Congo (guaranteed by Belgium) and Italy were not linked to specific investments. Early loans to Australia, Norway and Yugoslavia were also for import support. In addition, a number of broader initiatives were proposed to respond to existing priorities and constraints; in 1955, the Bank established EDI to develop a capacity to provide operationally relevant training for its borrowers and IFC was subsequently established to provide a capacity to make available funds to the private sector without providing government guarantees.

The Expanding Focus of the Bank

2.6 Throughout the period discussed above, the increased focus on development issues was apparent. Yet, probably more than any other specific event, it was the establishment of IDA in 1960 that marked the maturing of the Bank as a development institution. This facility allowed far greater flexibility in lending; creditworthiness concerns alone would no longer determine lending programs and the Bank could build up and maintain lending programs in several countries. Moreover, with sustained growth in IBRD lending and larger IDA replenishments, country lending programs emerged, as opposed to discrete projects, as the basis for Bank's operations. This, in turn, provided an opportunity to work with government officials on the basis of a longer-term program, bringing broader policy issues more clearly into focus. Along with the stability resulting from fifteen years of operational progress, the IDA facility reduced the bias toward self-financing projects; the Bank rapidly

expanded agriculture lending and began lending to a number of social sectors (education, population and urban), leading to a remarkable transition in the composition of project lending.

2.7 Even at the disaggregated level, the emphasis of Bank work shifted. Lending to agriculture included work on rural development and support for extension and research; education lending broadened from an initial focus on technical/vocational education to secondary education and primary education; and work in the power sector became part of an expanded effort on energy development. Greater operational flexibility in Bank procedures also emerged. Increased local cost financing, greater reliance on LCB, a preference for local manufacturers and, in lower-income countries, for domestic construction firms, all reflect pragmatic responses to the development concerns of borrowing countries. The greater willingness to look at rehabilitation and maintenance investment is noteworthy and program assistance to lower-income countries was initiated. This trend began with the industrial imports support and other program loans to South Asia in the 1960s, continued with program loans in the middle 1970s after the first crisis and re-emerged after the second oil crisis and the subsequent international recession in 1980 with the development of the SAL program and the Special Action Program (SAP).

2.8 This broadening in the lending instruments reflects pragmatic responses to the needs and priorities of Bank borrowers. As a result, the options in designing a "project" now range from traditional project lending to a discrete investment package, through subsector and sector loans, through a variety of program loans/credits (e.g., industrial or agriculture import loans and export development funds) to more comprehensive SALs. In summary, what has emerged is a continuum of lending options where the type of loan/credit can be specifically related to the particular needs of the country/sector. While considerable work has been attempted directed at categorizing types of projects and, in particular, at distinguishing between project and non-project lending, this effort has become less meaningful as clear dividing lines have disappeared; traditional operations have broadened their focus while SAL operations have become more involved with sectoral issues. Moreover, recent legal reviews of the project/non-project distinction and its relationship with the Articles have emphasized that the reference to specific projects in the Articles implies essentially that lending should be related to specific productive purposes and does not prevent the Bank from developing new instruments in response to the needs of its member countries, even if these new instruments cannot easily be fitted in the project/non-project dichotomy. A current study ^{1/} indicates that the Articles of the Bank give the Bank all the flexibility it needs to develop appropriate instruments. Given this, it would appear timely to focus on which of the range of (actual or potential) instruments is most appropriate in the particular circumstances, rather than on characterization of loan instruments.

2.9 Along with the expanding focus on developmental needs, the Bank's policy interests expanded rapidly over the post-1960 period; the broader sectoral range of operations led to increases in sector work and the increased

^{1/} "Project and Non-Project Financing under the IBRD Articles," March 1, 1984. A note prepared by the Legal Department.

focus on country programs led to expanded macroeconomic work. More important, however, has been the realization that even with rapidly increased IBRD and IDA lending--a pattern that has now slowed down--the Bank's role in financing new investments would remain modest. Moreover, as will be discussed later, there has been increased recognition that investment alone cannot ensure efficient growth. Therefore, the impact of the Bank's work on overall performance will only increase if it can facilitate policy improvements as an integral part of the total effort. Indeed, this trend has come to the forefront of the Bank's work programs over the past four to five years as country economic and sector work (CESW) became the major vehicle for reviewing the necessary structural adjustment policies which would be required to accommodate the economic changes in the post-1980 period. As a result, CESW has risen to the point where it comprises 22% of the regional work effort.

2.10 Technical assistance and the Bank's focus on institution building also increased dramatically in the post-IDA period. The shift in the Bank's clientele to lower-income countries, where technical and administrative capacities were lower, necessitated greater attention to these issues. Bank involvement also increased in areas where the appropriate strategy for approaching project preparation and implementation was less clear. In particular, the traditional Bank approach of using autonomous entities was far less appropriate in the social sectors. Combined with the limitation of staff in existing line agencies, this involved the Bank in a much broader range of institutional issues. Finally, there was the magnitude of the growth in Bank operations. While Bank staff grew rapidly, the level of inputs required of governments also expanded. Given existing constraints, this forced the development of a number of alternative means of supporting the Bank in project preparation and implementation, including the emergence of cooperative programs with FAO, UNESCO, WHO and a variety of special programs of technical assistance, e.g. cooperation with UNDP as an executing agency and the development of the Agriculture Development Service (ADS) in Africa to name the most important. There has been a parallel expansion of field office staff in order to increase day-to-day contact with government officials. Finally, there has been a virtual explosion of discrete efforts at improving the capacity of agencies/ministries under ongoing projects.

2.11 The Bank's emphasis on aid coordination also matured with the establishment of the India Consortium in the mid-1960s and expanded rapidly with the setting up of a variety of donor meetings, particularly for the Asian and African members. With the growing emphasis on multilateral issues in the 1960s and the 1970s and the recognition of the administrative burden of multiple donors active in countries, the post-1960 period has also been marked by a general expansion of cooperation with aid agencies. Joint financing techniques were developed with the Scandinavian donors and the increased number of resident offices helped in establishing greater working-level contact with bilateral agencies. All this reflected a distinct change from the 1950s when the Bank was often a major competitor with the US Export-Import Bank.

2.12 In the mid-1970s, after the initial oil crisis, two new trends developed. First, the rapid increase in BOP surpluses led to an expansion in Arab aid and increased cooperation with the OPEC Fund and other Arab donors. Second, the explosion of commercial lending to oil importers led to a number of efforts in Latin America to more closely tie commercial lending with Bank projects. This trend then led to the development of the "B" loan technique.

More recent developments have indicated a return to bilateralism and greater emphasis on mixing aid and commercial funds, reflecting the commercial environment. To date, the Bank has tried to respond by establishing formal contact with the entire spectrum of agencies and develop case-by-case arrangements which would facilitate the flow of aid to appropriate projects.

The Lessons of Experience

2.13 The wide range of activities undertaken has permitted the Bank to learn from the lessons of its experience and affirm its evolutionary character. The activities characterized as traditional projects comprise the large majority of the loans and credits approved to date. When one attempts to review the experience of these projects, two themes emerge. The first is the flexibility of this instrument; there is almost limitless flexibility in what a project can now include. Within the overall framework of a number of general guidelines, projects officers have tremendous latitude to design an instrument responsive to the specific requirements of the sector and country in which they are operating. This flexibility has been central to the emergence of the continuum discussed above and has made it possible for the project instrument to remain an effective and viable response to the rapidly changing priorities and needs of the developing countries; this is a capacity that must be retained and enhanced. Second, the project instrument has become more complex. Perhaps the most important development has been the shift from a narrow project focus on specific hardware investments and autonomous entities to an increasing broad examination of investment programs, and the policy and institutional environment under which a particular investment will be made. This trend directly reflects the recognition that the impact of projects was often limited when broader issues were not addressed.

2.14 As one looks more closely at the lessons of experience, high rates of return have been a constant characteristic of traditional projects. The annual OED evaluations have consistently highlighted the overwhelming evidence that Bank projects have yielded high returns. While the record can be differentiated by country groupings--with Asia and LAC performing consistently well and EMENA and the Africas faring less well--the overall record is noteworthy in that the diversification of Bank lending into more difficult countries and into a wider range of sectors does not appear to have seriously weakened the overall quality of the Bank portfolio as measured by the rate of return of the projects.

2.15 There has also been a range of more subtle, but significant contributions of the project approach. The Bank has played an important role in getting governments to measure costs and benefits of their investment program more systematically and accurately. The broader Bank focus on the development of the project cycle is also noteworthy; i.e., the placing of projects within sectoral strategies, the work on project preparation and appraisal, implementation oversight and then evaluating performance. Finally, projects were used to test new approaches to development; e.g., through integrated rural development projects, urban projects, feeder roads, etc. These are important accomplishments which have provided the framework for the Bank's role in development today.

2.16 The project approach has also involved increasing attention to policy and institutional development. As listed above, in analyzing projects, the

recognition that an appropriate policy environment and an adequate institutional framework are necessary conditions for successful project implementation, has been a central lesson of past experience. The increasing sector work, the explosion of special studies under projects and the growth in project-related technical assistance and training underlie the importance staff have placed in trying to improve the borrowers' capabilities in these areas. Numerous successes have been recorded as a result of this increased attention: the Bank's early work in financial viability of the power and railroad sectors and its effort at stabilizing well-functioning entities in these sectors have been noted in all the reviews of Bank performance; more recent work on agricultural pricing policies and on education policies has had a large impact on government policies throughout the developing world, and work on institutional building in the urban sector is a consistent theme of projects in that sector.

2.17 Yet, increasingly there have been concerns raised about the applicability of the project instrument to addressing the broadening scope of Bank concerns in the policy and institutional areas. Recent OED reports have noted the problem that in the institutional area, project work inevitably focused on implementation capacity. As far as policy reforms are concerned, the crucial issue is whether project lending--with its associated project and policy covenants, combined with an economic policy dialogue based on the Bank's CESW--has proved to be an effective mechanism through which governments have been assisted in formulating and implementing agreed reforms. On this score, the Eighth Annual Review of Project Performance Audit Reports states that "on the basis of experience, it would be reasonable to conclude that individual projects, in general, are inefficient instruments for inducing policy change." The reasons for this are several: (a) at the preparation and implementation stage, the focus of the projects team is primarily on the technical, financial and economic (i.e., rate of return) analysis; (b) the momentum of what is a lengthy project cycle makes it difficult to either stop the processing or to suspend disbursements when the project is being implemented satisfactorily just because some policy conditions--which are often not related directly to project implementation--are not fulfilled; (c) the frequency with which policy-related covenants are agreed to, and subsequently not complied with reflects the expectation of the government that no credible action will be taken; the credibility of the institution as a non-enforcer of policy-related covenants is well established in the eyes of the governments; (d) the Bank, in many countries, is involved in only a limited number of sectors and, particularly in the smaller countries, once every three to five years. This is not conducive to a sustained effort to reform policies or develop institutions in that sector, particularly if inter-sectoral incentives are also important issues.

2.18 There is also the problem of different audiences; using the project vehicle for resolving broader policy or institutional concerns places issues in front of project management over which they have little control. At the same time, the policymakers tend to argue that it is inappropriate to use a discrete project investment to resolve broader sectoral or macroeconomic policies. For example, covenants related to power tariffs in power loans have been violated by the government--even if the power company is anxious to implement them--because of other reasons of domestic policy. This difficulty is greatly compounded if say, other energy prices (e.g., kerosene or diesel) are linked to power loans. Another example is when interest rate policy

issues are tied to DFC loans. A single DFC has no control over any aspect of financial policy--this being the preserve of the Ministry of Finance or the Central Bank--and, consequently, a DFC loan is often a totally inappropriate instrument to affect broader aspects of financial policy. The increasing use of conditionality and studies to accommodate this dilemma has not proven effective. OED reports have cited the general failure of the increasing resort to conditionality and regional reviews have cited at length the rapid growth of project-related studies which have not been adequately pursued.

2.19 Thus, the weaker the link between the policy issue and the project being financed, the greater will be the difficulty in reaching an initial agreement and, if reached, in subsequently enforcing it. The issue, therefore, is often not that Bank projects are weak on policy conditionality, but rather that there are maybe too many conditions--ranging from detailed to technical, administrative and financial issues relating to the projects to subsectoral, institutional, sectoral and macro-policy ones. The problem then becomes that of a dilution of conditionality with the narrower project-related conditions, only naturally, taking precedence in ensuring compliance with loan covenants; the supervision process is inevitably dominated by the more narrower project implementation concerns. Finally, and perhaps most important, the policy/institutional cycle operates in a much different way than the project cycle. Policy decisions tend to focus on a budget cycle or in response to political developments or economic crises; these typically do not match up with our project cycle. Institutional development is a much longer term process than the project cycle and needs to be recognized as such; this is a clear judgment of recent studies on institutional development.

2.20 The use of the project instrument, however, has not resulted in a neglect of broader economic and institutional issues necessary to understanding a country's development problems and policy options. Reflecting the priorities of broader institutional and policy analysis, the Bank's economic work has given increasing emphasis to institutional and subsectoral and sectoral policy issues covering, inter alia, public sector management and public enterprise efficiency, trade policy, industrial incentives, energy pricing policies, prices, taxes and subsidies in agriculture, resource mobilization and issues of urban and regional development. This increasing emphasis has been intensified with the changing environment in which the distorted policy framework of developing countries that were undesirable, but tolerable in the 1960s, have become unsustainable in the 1980s.

2.21 It has also become clear that the Bank's economic and sector work by itself was quite inadequate for the implementation of policy reform within countries. The best that could be said would be that the Bank's CESW, in some instances, influenced the direction of thinking of senior policymakers (Indonesia). The worst would be that Bank resources had been allocated to exercises now gathering dust on some policymakers' shelves (India, Egypt). Without a direct operational application or link, the Bank's CESW usually lacked the specificity in recommendations necessary for policymakers. Much CESW tends to speak in generalities (e.g., "liberalize the import regimes," "domestic prices must reflect scarcity values," etc.) without specifically suggesting the sequencing of the transitional steps that must be undertaken in moving from the distorted regime to a non-distorted one, the time phasing of these steps and the implications of such reforms.

2.22 Sector and subsector lending has, therefore, emerged as instruments to influence policy and institutional change. The OMS on sector lending sets out a number of detailed criteria for that instrument; i.e., a well-developed investment program, demonstrated ability to carry out the program, agreement on specific measures to strengthen management and improve policies. It goes on to confirm that few loans have met these criteria and even after encouraging greater use of the instrument, notes that in many countries and sectors most in need of help, the conditions for sector lending are "unlikely to be met". With this demanding list of criteria and the strictness with which they have been interpreted, these conditions have, in fact, not been met in most developing countries. However, in place of the formal sector lending instrument as defined in the OMS, a variety of initiatives have emerged which incorporate some aspects of sector lending while retaining some features of traditional project loans. These instruments (ranging from subsector loans to APEX loans and EDF loans) reflect the capacity of the Bank to develop appropriate instruments that match the needs of the borrowers and which focus on issues which cannot easily be addressed using the traditional project approach. Their emergence is too recent to warrant a proper evaluation of their effectiveness. Within the Bank, East Asia has expanded the use of this technique; a recent review of the lending program for the next three years reveals that almost half of the proposed program involves issues/concerns that are broader than those normally encompassed within the traditional project approach. While this trend toward transitional and flexible approaches should be encouraged, it is also important to ensure that too narrow a definition of sector lending does not preclude greater use of that instrument. Given the way the Bank has evolved, there may be a need to rewrite that OM statement.

2.23 The advent of structural adjustment loans (SALs) in 1980 marked a new phase in the use of lending for institutional and policy reforms. Though initially introduced to assist countries in their balance of payments problems due to the oil price shocks of 1978/79, they have provided the conceptual framework for broader policy-based lending. This conceptual framework provides the same discipline to both the Bank and the governments to implement and monitor policy reforms. Currently, structural adjustment lending is defined as a series of discrete lending operations over approximately five years. It provides quick disbursing funds for balance of payments support to a country prepared to formally represent to the Bank its commitment to undertake policy reforms. Such programs of reform consist of a statement of objectives to be achieved over a specified period (usually 5-10 years); a statement of the actions that will be undertaken to achieve these objectives; and a monitorable set of actions to be taken by the government. Moreover, the disbursements are often tranching to ensure timely implementation by the government.

2.24 The policy conditions in SALs include a set of measures designed to effect major changes in the pattern and production of goods and services covering a range of pricing, trade policy, investment and regulatory policy and institutional development issues. The major sectors include agriculture, industry, energy and financial. The social sectors (health, population,

nutrition, education) and infrastructure have not usually been included. ^{1/} The SAL process also has four important characteristics: comprehensiveness and consistency of the policy package; senior management attention in the country as well as in the Bank; a detailed articulation of the diagnosis; i.e., the medium-term strategy and short-term action program; and emphasis on policy reforms. The benefits of the SAL process include (a) enhancing the quality of the economic dialogue with countries; the need for agreement on a precise action program has improved the quality of arguments for policy reforms and forced both sides to think of specifics; this was not done before; (b) contributing to the increased pace of disbursement and enabling the Bank to play an important counter-cyclical role--a particularly attractive aspect for the governments involved; and (c) contributing to successful adjustment in the countries involved. Preliminary analysis shows that between 1979-81 and 1982-84, the SAL countries have performed better in terms of growth rates, than non-SAL countries, while at the same time reducing their reliance on foreign savings for financing their investments. ^{2/} Among the countries where the Bank has effectively contributed to policy reforms through the SAL process are Philippines, Korea, Turkey, Thailand and Ivory Coast. However, in the Bank's Board as well as in the borrowing countries, SALs have faced some problems and the future evolution of policy-based lending has to be designed to address them.

2.25 First, the action program on policy reforms as embodied in the Letter of Development Policy under SALs is often perceived as creating problems of confidentiality and of national sovereignty. If action programs on sensitive issues such as interest rates, energy prices and trade policy, are to be formulated in precise terms and in a medium-term framework, it is essential that they be kept confidential. However, with SAL documents, and the notion that SALs are "special instruments" outside the Bank's normal line of work, it has become difficult to maintain confidentiality from other governments or the media. Second, many of the SAL issues are issues of parliamentary decisions and the government may not have the authority to enter into agreement on these with an external agency such as the Bank. On the other hand, when many of the policy actions depend on future legislative support, it is difficult for the Bank to be absolutely certain about the commitments made by the government.

2.26 Third, the eligibility criteria for SALs are high; it is mostly the middle-income countries that have qualified for SALs so far. Many low- and middle-income countries that urgently need assistance and policy reforms have been left out of the process. More generally, the either/or approach of SAL has given it extremely high visibility and made it difficult for the Bank to administer assistance in policy reforms in small doses where appropriate. In addition, a breakdown of the SAL process has led to extra lending through other channels such as project loans. It could be that borrowers are not convinced that policy reforms are necessarily associated with an incremental lending program. This problem is compounded by the fact that the Bank has not

^{1/} The Kenya SAL is an exception; population and education policies were part of the total policy package.

^{2/} This, however, is only a correlation and does not, necessarily, imply causality.

yet adequately developed techniques for monitoring progress in adjustment policies or in adjustment performance. These are issues that the Bank will have to address over the next decade.

3. EMERGING THEMES FOR DEVELOPING COUNTRIES

Introduction

3.1 The post-war growth in the world economy has been unprecedented, not only in historical perspective, but also when measured against official goals and private expectations of thirty years ago. In this experience, it is possible to distinguish clearly between at least two broad phases. The pre-1970 period was one of uninterrupted expansion of the world economy, the emergence of many countries as sovereign states, and the rapid integration of the world economy. The post-1970 period, by contrast, was characterized by a slowing down of trade, especially with the shocks arising from sudden and high energy prices, and the emergence of an international debt problem. By the 1980s, the worst recession in 50 years interrupted the slowed down expansion of the world economy. A massive adjustment problem emerged as a consequence of significantly changed prices, lower real incomes and large new debt portfolios; recovery and adjustment is just beginning. Within this perspective, at least two broad themes can be recognized in the development experience of the Bank's member countries. These are the growing diversity among the member countries and the increasing global interdependence. These two themes have strong implications for the Bank's future role.

Diversity

3.2 Diversity among member countries is attributed to a number of factors and is apparent in different measures and dimensions. The most dominant indicator of this diversity is the level of income. However, there are other indicators of diversity such as social indicators, levels of institutional development and those of a physical nature such as size, population to land ratios, and being oil exporters or importers. In articulating the Bank's role, there is a need to recognize the many aspects of diversity among countries.

3.3 The growing diversity has been the result of a number of factors. First, there has been a doubling of the World Bank's membership between the late 1950s and the early 1980s; ^{1/} the most recent increases resulting primarily from the newly emerging nations of Africa. Second, differential rates of economic growth owing to different resource endowments and policy environments have increased the disparity in income levels and in levels of social achievements. Third, international events such as the oil price hikes, large and ballooning debt problems and the successful entry of some countries into manufactured exports, have led to even further diversity among the Bank's member countries.

^{1/} Bank membership rose from 60 in 1957 to 144 in 1983. In the 1968-78 period ten new members joined the Bank Group.

Interdependence

3.4 The second theme of importance in the evolution of Bank member countries is the growth of international economic interdependence arising from their increased integration of the world economy. This interdependence is simultaneously the cause and the result of the general economic expansion in the postwar period. This interdependence has been a major vehicle for a better international division of labor and increased specialization, transfer of technology and the driving force of rapid growth itself.

3.5 The global interdependence--between industrial countries and developing countries and among the developing countries themselves--arise from at least three different factors. First, was the improved environment for trade expansion created by the adoption of new rules of the game for trade and payments under the aegis of GATT and the IMF. Second, a revolution in transportation and communications technology has reduced the costs of trade in relation to its value, facilitating further specialization in trade and financial services. Third, demographic trends have increased labor endowments and led to labor-intensive activities to be located in countries according to changing comparative advantage and also promoted the movement of labor across frontiers. These factors together have created a global economic system in which indicators of interdependence straddle trade, financial flows, labor migrations and growth itself. As detailed below, the strength and nature of these links have important implications for the Bank's member countries.

Trade Linkages

3.6 Trade linkages arising from increasing specialization provide opportunities to pursue growth strategies and are not constrained by factors such as size, location and resource endowments. For the world as a whole, the increased trade linkages are revealed by the rapid rise in the share of exports in the world domestic product. This share increased from 12% in 1960 to 22% in 1980. It fell, however, to 19% by 1982 due to the overall decline in the growth of trade and the decline in the trade volume by 2%. 1/ While trade linkages increased, the nature of world trade changed with developing countries switching a part of their exports from primary products to manufactures. For example, the share of manufactures in non-fuel imports of industrialized countries from developed countries rose from 13% in 1963 to 51% in 1981. The opportunities for further expansion of developing countries exports remain formidable; a 1% growth in income of industrial countries would lead to an increase in exports of developing countries by 2% in volume. 2/

Financial Linkages

3.7 Financial linkages have been particularly striking following the oil price hikes and the recycling of petro dollars. But even prior to that,

1/ Development Cooperation, OECD, 1983 Review, Development Cooperation, pp. 32.

2/ Derived from the WDR 1983, the estimate refers to the 1982-85 period, p. 29.

financial flows had begun to rise concomitant with trade expansion and increased aid. Total flows of capital to developing countries increased from \$66 billion in 1973 to \$95 billion in 1982. ^{1/} An important feature of the financial linkages was the privatization of capital flows. By 1982, medium and long term capital flow from private sources financed 30-50% of current account deficits and reserve accretions of non-oil developing countries. ^{2/} The Bank has also contributed to the financial linkages via its intermediation role, with its lending increasing from \$1.0 billion in 1968 to some \$15 billion by 1983. These financial linkages are further enhanced through the Bank's co-financing and aid coordination functions.

3.8 With this growth, the international capital market has become extremely sensitive to interest and exchange rate movements. The current debt overhang further increases the sensitivity of asset portfolios to exchange and interest rate movements with profound implications for the adjustment problems faced by the high debtor countries.

Labor Market Linkages

3.9 With the tightening of labor markets in Europe beginning in the late 1960s, migrant workers replaced low paid workers in Europe. Following the large oil surpluses, a new phase of labor migration to Middle Eastern countries originated in South Asia. This gave rise to workers remittances becoming an important component of export earnings. These developments have increased interdependence and sensitivity of levels of employment and income beyond national frontiers. Despite the high unemployment levels presently confronting countries importing labor, workers remittances are expected to grow at 9.3% p.a. in the next decade while world trade is expected to grow at 5.6% p.a. over the same period.

Growth Linkages

3.10 Following from the trade, finance and labor migration linkages, strong growth linkages have evolved between industrialized and developing countries. The most visible manifestation of the growth linkages has been the 1980-82 recession in which the slowed down growth in industrialized countries spread to developing countries. While this linkage is neither fixed in its size nor in timing, it is a strong indicator of interdependence. It must also be noted that the growth linkage is a two-way relationship. In fact, the rate of recovery of industrialized countries will depend on the extent to which developing countries recover from the recent recession.

3.11 A measure of strength of the growth linkage is the relationship of imports of developing countries to growth in industrialized countries. In 1982, an 8% drop in the imports of developing countries resulted in a 0.5% reduction of GDP growth in industrialized countries. In absolute terms the resultant loss in GDP of industrialized countries amounted to \$36 billion. A similar relationship can be traced in the opposite direction between

^{1/} Expressed in constant 1981 prices and exchange rates.

^{2/} Development Cooperation, 1983 OECD Review, pp. 31-33.

industrialized countries' growth and the demand for exports of developing countries. It is estimated that a 1.0% increase in the growth of industrialized countries would increase demand for developing country exports by \$11.0 billion in the first year and if sustained, by \$30 billion by the third year. 1/

3.12 It is important to note that trade, finance and growth linkages are also intimately linked. The three together underscore the theme of interdependence even more than what can be demonstrated by indicators of one dimensional linkages. Two examples would suffice to reinforce this claim. First, the current debt service problems faced by a number of developing countries cannot be resolved without a recovery of trade since ultimately debt repayment takes place through export surpluses. Attempts to generate these surpluses by import restrictions would endanger the growth prospects of trading partners. Second, without a continuing flow of capital to ease the burden of debt service, it is unlikely that some countries could service their debt, raise their GDP growth rates or, in general, proceed with the adjustment of their economies. These linkages fundamentally impose a discipline on Bank member countries and on the Bank itself in its role as a financial intermediary and as an agent for institutional change and policy reform.

1/ Development Cooperation. 1983 Review. OECD, Paris, 1983, p. 32.

4. FUTURE DIRECTIONS FOR BANK OPERATIONS:

THE BANK'S TOOL-KIT

Introduction

4.1 Over the next decade, the world will not remain static and individual countries will be undergoing major economic changes. The preceding chapter has discussed how diverse and interdependent developing countries have become. In response to these changes, and in light of those that have occurred in capital flows and financing patterns worldwide, the Bank's operations over the future must continue to evolve and adjust. The purpose of this chapter is to discuss the style and nature of future Bank operations and policies. Before discussing Bank strategies in different groups of countries, it is useful to outline the Bank's product and some of its characteristics. This chapter, therefore, sets the general framework; it describes a "tool-kit" for such operations and provides some preliminary suggestions for ways in which the Bank's instruments can be used creatively. ^{1/} It outlines some future directions for the Bank and its product, focusing on the nature and flexibility of the product, the future evolution of the Bank's lending instruments, and some future orientations of project work. This chapter also raises issues about the evaluation of the Bank's product and describes the market for this product in different developing countries. The underlying theme of this chapter is that of continuing the adaptability and evolution of the Bank--and its lending instruments--in response to emerging economic development problems and experience; an approach that has been followed by the Bank in the past. As will be seen, in many ways, the Bank's future product is already here; several approaches and suggestions made here (and in the next chapter) are already under consideration or implementation in various parts within the Bank.

The Objectives of the Bank

4.2 There are two broad issues that are likely to be of major concern for the developing countries over the next decade. The first involves increasing the rate of physical and human capital formation, and the second, improving the productivity of investments and the efficiency of resource allocation. This framework represents a fundamental change in the view of the development process from one that dominated thinking in the 1940s and 1950s when the development literature placed an overwhelming emphasis on capital investment as a means of development. Over the last two decades, development experience has underlined the fact that the efficiency of investment is a major determinant of economic growth. For example, one study has shown that, for 31 major Bank borrowers which accounted for over 80% of GDP of the Bank's borrowers in 1980, growth performance in the 1970s was more closely related to the efficiency of investment than to investment rates or to domestic and

^{1/} Chapter 5 outlines selected aspects of the Bank's product and Chapter 6 discusses different Bank assistance strategies in diversified groups of countries to demonstrate how the general framework, the Bank's tool-kit, may be used.

foreign savings rates. ^{1/} Reflecting this judgement, Bank efforts to assist the developing countries over the next decade should address both the issues of increasing human and physical capital formation and that of increasing the efficient use of resources. The Bank's objectives, therefore, should emphasize both the provision of assistance to these countries in implementing institutional and policy reforms and financial transfers.

4.3 The Bank, however, no longer has the quasi-monopoly position it had in the long-term international capital markets of the 1950s and 1960s; over the last few years, these markets have changed dramatically. Currently, the size of the Bank's net financial transfers to developing countries is extremely small; in 1982, it was about 3% of these countries' total financing requirements and only 10% of official concessionary and non-concessionary flows. ^{2/} Unlike the Bank's position in the international capital markets in terms of financial flows, the Bank still retains a fairly dominant position in the market for information about developing countries. This situation reflects economies of scale, given the comprehensiveness of Bank coverage, and the fact that the Bank is also able to obtain confidential information that is not easily accessible to private commercial banks and others. This information base places the Bank in a unique position to assess the problems and prospects of countries involved. Using these assessments, the Bank is also well-positioned to identify policy/institutional weaknesses and encourage member governments to undertake much needed reforms. Furthermore, experience has also shown that institutional and policy advice cannot easily be separated from financial transfers, even though, in principle, it may be desirable to do so. Thus, the objectives of financial transfers and institutional/policy reforms are strongly interlinked, and the Bank delivers, in that sense, a "joint product."

4.4 In light of this situation, a number of roles emerge for the Bank. The first is to function as an efficient financial intermediary in the international capital markets to facilitate long-term investments in developing countries. The second is to promote the economic stability of these developing countries. The third is to provide an important forum in which developing countries can participate in influencing capital flows to them. The Bank's effectiveness can be enhanced only if its financial intermediary function is performed within a framework of policies and institutions designed to improve the efficiency of resource allocation. It should be noted that enhancing the Bank's focus on institutional development and policy reforms reflects primarily an acceleration of recent trends; it is not a new activity. This also does not suggest a changing emphasis on part of the Bank away

^{1/} R. Agarwala (1984), "The Future Directions of Policy-Based Lending: Development Policy Loans." A background paper prepared for Working Group #4 on the Future Operational Product of the Bank.

^{2/} World Development Report, 1983 (Table 2.12) and World Bank Annual Report, 1983 as cited in S. Please (forthcoming), The Hobbled Giant. The distribution of these funds, of course, varies significantly across countries; the relative importance of the Bank's financial contribution is much greater in the poorer countries of the world than in the middle-income ones.

from poverty alleviation and employment generation. It merely recognizes the fact that economic growth and equity considerations can be addressed through policy and institutional arrangements, in addition to the transfer of capital, using a variety of instruments--a flexible product--in different countries and sectors of the economy.

4.5 The Bank also has a catalytic role to play internationally in mobilizing various forms of external capital. In general, the principal method available to the Bank to fulfill its catalytic role is the influence it can bring to bear and the expertise it can apply to assist countries to restructure their economic policies in ways that will enhance the returns to investments and lower the risks associated with different types of external capital flows by increasing the creditworthiness of borrowing countries.

The Bank's Operational Product

4.6 To achieve its objectives over the next decade, the instruments that the Bank will have at its disposal will be many and varied; the "packaging" of these instruments in different combinations, in different countries, will be the Bank's operational product. The main components of this product will include:

- Bank loans (financing) and differential term of lending;
- technical assistance;
- policy/institutional advice;
- mobilization of external capital; and
- role in aid consortia. ^{1/}

4.7 In general, Bank operations in a country would incorporate all these components; thus, the product would be multidimensional. It would also be flexible as the weights (or the relative emphasis) attached to each component of the product could vary by country. The product would, therefore, be country-focused and country specific. The country's "place" on the product spectrum should be determined by its economic, financial and institutional capacity.

The Flexibility of the Product

4.8 Flexibility is inherent in the nature of the product; adjusting the relative emphasis of each component of the product permits a significant range of variations of the product. This, in turn, facilitates the design of a country assistance strategy as the product can be designed to fit the specific needs of any country. In Chapter 6, the design of Bank assistance strategies for five different groups of countries is discussed. The discussion illustrates the point just made, viz., that product diversification is essential and possible in a world of increasing country diversity. Even within each group, there will be significant variations and this will justify differing Bank strategies and a differing product in each country.

^{1/} The differential terms of lending, mobilization of external capital and the role in aid consortia are subjects of different papers on the future role of the Bank; they are mentioned here for the sake of completeness.

4.9 The assistance packages put together in countries, involving a mix of the various components in different proportions, could vary not only by country, but conceivably also within a country by sector (depending on the relative development of different sectors) and over time. For example, if the fundamental problem in a country is one of capital accumulation, a relatively greater emphasis will have to be placed on the financing component of the product and a relatively lower weight on the policy advice component (not necessarily zero). If, on the other hand, the problem is that of efficiency of resource allocation, then a higher weight will be given to the technical assistance/policy advice component. By adjusting the product to specific country needs, the Bank will be able to maximize the joint effect of increasing physical and human capital formation and the efficiency of resource allocation through institutional/policy reforms.

4.10 Against this background, understanding the development concerns of the country will be crucial to the operations of the Bank. Working closely with Governments to jointly develop a three- to five-year country assistance strategy will permit the specific tailoring of the Bank's product to the needs of the country. Also, such early and close collaboration with governments will be very important in building up the Bank's credibility in the borrowing countries. This credibility issue will be critical for the Bank's operations in the next decade as one focus of attention will be on institutional and economic policy reform. As will be discussed later, to a great extent, success in this area--and, thus, the market for the Bank's product--will depend on convincing the governments of the importance of policy change.

The Future Evolution of the Bank's Lending Instruments

Dimensions of the Lending Instruments

4.11 Over the years, four broad categories of Bank lending instruments have evolved. Spanning the range from the macro to the micro level, we currently have SALs, sector loans, sub-sector loans and project loans. Conceptually, all these lending instruments can be categorized in terms of three major components: a policy/institutional reform component; an investment component, or what is financed; and a disbursement component, or how funds are spent. In addition, a fourth element has been added with SALs--a tranche component. By modifying and/or combining these various components in different ways, it is possible to develop a range of lending instruments which are both appropriate to achieving the Bank's objectives in a particular country or sector and which are attractive to the country involved. The purpose in elaborating on these four components is to demonstrate that, in principle, the institution already possesses tremendous flexibility in responding to different issues of development. In addition, by examining other combinations of the various (existing) components, it might be possible to develop new instruments which could be considered in the future. As will be seen, SAL loans can be conceived of as a particular case of a more general class of loans which we define here as Development Policy Loans (DPLs) (see para. ____ below). Moreover, for the post-SAL era, the imagination and innovation of the regional staff (as in Turkey) are opening up the boundaries of these types of lending instruments. To the extent that these new instruments simply reflect a reformulation of existing approaches, they should be easy to justify. To the extent that additional flexibility is required, existing Bank policies may have to be reviewed.

4.12 The policy/institutional component of these instruments can range from the micro (project) level issues, to the sub-sectoral, sectoral levels to the multi-sectoral or the macro level. The investment component (or what the Bank can finance) has a number of dimensions: new capital investments; technical assistance, training or services; maintenance; and rehabilitation. ^{1/} Each of these can also span the range from the project to the multi-sectoral level. The disbursement component is most usefully subdivided into two sub-groups: slow-disbursing and fast-disbursing. ^{2/} Bank loans (so far only SALs) have also been tranced in a variety of ways; the number of tranches can vary, and they can be back-loaded (i.e., larger amounts released in later tranches), uniform or front-loaded; i.e., variable tranching is possible. Table 4.1 shows the taxonomy of instruments and their components and dimensions.

4.13 It might be useful to highlight how the taxonomy can be used to categorize possible operations. For example, the project lending instrument would typically focus on project level institutional and policy reforms and finance new investment and/or maintenance and rehabilitation. The funds would be normally disbursed slowly (e.g., for capital goods or civil works) and there would be no tranching. For subsector, sector or multi-sector instruments, the institutional and policy reforms would be targeted at the subsector, sectoral or multi-sectoral level; they could, in principle, finance new investments at the sub-sector, sector or multi-sector level (e.g., through time-slicing of investment programs); the funds, in this case, would typically be slow-disbursing. However, if there was only general import support or recurrent expenditures attached to these loans, the funds would be fast-disbursing. ^{3/} In addition, maintenance and rehabilitation could also be financed and the disbursements could be against any of the fast-disbursing categories shown in Table 4.1. Depending on the country circumstances and the nature of the reforms agreed to, flexible and variable tranching of these loans could take place when being disbursed against recurrent expenditures and general import support. Viewed within such a framework, a SAL is a special case of a multi-sectoral instrument (or a development policy loan); it has a multi-sectoral policy/institutional component, it typically (implicitly) finances new investments, maintenance/rehabilitation (and, perhaps,

^{1/} In this case, investments refer only to physical capital and not to human capital. The human resource development aspect is picked up in technical assistance, training or services (e.g., developing school curricula) unless it refers to physical structures (as building classrooms).

^{2/} The slow-disbursing subgroup may typically include items such as capital goods, civil works and consultants/trainers for which expenditures are reimbursed over a relatively long span of time. The fast-disbursing subgroup would include, for instance, recurrent expenditures and imports support (disbursed against a positive or negative list) for either public or private sector investment.

^{3/} It should be noted that, in general, under import support, production and consumption would be financed, unless restrictions were imposed.

TABLE 4.1:

A TAXONOMY OF LENDING INSTRUMENTS

Lending Instruments

Project Loan (PL)

Subsector Policy Loan (SSPL)

Sector Policy Loan (SPL)

Development Policy Loan (DPL)

The Components and Dimensions of Lending Instruments

Policy/Institutional Reforms

Project Level
Subsector Level
Sectoral Level
Multi-Sectoral (Macro) Level

Type of Investment

New Capital
Maintenance
Rehabilitation
Technical Assistance/
Training/Services

Disbursement

Slow-Disbursing
Fast-Disbursing

Tranching

Back-loaded
Front-loaded
Uniform
Number of
tranches can
vary.

consumption), the proceeds being disbursed against general imports, with at most two tranches. 1/

Development Policy Loans

4.14 A Development Policy Loan (DPL) is defined here as a lending instrument that explicitly addresses multi-sectoral policy/institutional concerns; there is a wide range of variation in what it could finance and how the funds would be disbursed (i.e., quickly, slowly, in tranches). A very interesting example of such a loan is the one being considered for Turkey in response to the need to find a way of maintaining the pace of disbursements reached under structural adjustment lending, once that form of lending stops. What is proposed is Public Investment Rationalization Loan (PIRL) based on a review of about 6,000 projects in the public investment program and on an agreed program of core projects to be financed. The Bank loan would focus, on a year by year basis, on a set of high priority projects in key sectors and help finance their completion. This loan would subsequently be supported by a number of sector policy loans (discussed below) linked to specific sectoral issues. Such an approach has the advantage that the concept of a macro loan can be easily retained and more clearly justified to the Board.

4.15 In general, the institutional and policy focus of such DPLs would be on the efficient allocation of resources for long-run development rather than on short-run adjustments to balance of payments problems. 2/ The sectoral focus of such reforms would, therefore, extend beyond the agriculture, industry, energy nexus and include the human resource and physical infrastructure sectors, in those countries where this may be necessary. 3/ This multi-sectoral focus of DPLs should extend to the financing of a time-slice of public expenditure programs including capital and recurrent expenditures. Indeed, given the nature of the economic problems in the next decade in Sub-Saharan Africa and in the middle-income, high-debt countries, relatively greater attention on the Bank's part to the nature of and relationship between capital and recurrent expenditures will be warranted. If the proceeds of such a loan can be disbursed against recurrent expenditures, such as essential raw materials, spare parts and salaries, it will give the Bank direct access to

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- 1/ It should, however, be noted that any lending instrument--including a project loan--which has policy conditions attached to it, can be defined as a policy-based loan. In fact, if one looks at the history of the Bank over the last ten years, the fraction of non-policy-based (i.e., pure bricks and mortar) loans would be quite small.
- 2/ One suggestion would be to reserve the term "Structural Adjustment Loan" for Bank operations designed to address "structural" balance of payments problems jointly with the IMF as suggested in Chapter 7. The term "Development Policy Loan" can then be used for those macro loans that emphasize efficient resource allocation independent of balance of payments problems and the IMF (see para 7.24).
- 3/ Encouraging institutional reforms using such instruments is discussed in Chapter 5.

the budgetary issues which have become so prominent over the past few years. Moreover, given clear policy and performance requirements as conditions of such loans, it should be possible to address Board concerns that these loans are not simply "throwing money down the tube." A general principle would be to disburse these funds on an agreed timetable. One would expect that for such policy-linked loans, the priority of most governments will often be on quick-disbursing funds. 1/ Moreover, rather than waiting for expenditure receipts, the option of disbursing the full amount of a particular tranche, the moment a government completes the implementation of agreed policy or institutional reforms, is also worth considering. 2/

4.16 For these loans, an aide-memoire can be used as an effective tool of policy conditionality; an example is provided by the Bank's strategy in Egypt. In that country, the Bank has major disagreements on some pricing policy issues, particularly in the energy sector. The Bank's suggestions for necessary reforms have been set out in a letter to the Egyptian Government from the President of the Bank. There is an understanding between the Bank and the Government that increased Bank assistance is contingent upon satisfactory progress in implementing policy reforms. As outlined earlier (para. ____), these loans can be tranching in many different ways, depending upon the circumstances of the country and the nature of the agreed reforms. If, for example, a series of steps is required and agreed upon, then a tranche could be released after each step is implemented. The size of each tranche may depend upon the difficulty associated with the policy step undertaken.

4.17 This approach has several advantages. First of all, it avoids the problem of passing judgement on the government's commitment to reforms; in this approach, seeing is believing, and subsequent tranches could be conditional on meeting agreed criteria. Second, it avoids the political embarrassment for the government of making advance commitments on sensitive policy measures that they may subsequently have to withdraw. Third, it keeps the issues between the management of the Bank and the government and avoids debates in public view. Finally, it provides a clear basis for linking the lending program to policy/institutional performance. In such an approach, when the loan is presented to the Board, the initial tranche is in support of policy/institutional reforms already made; subsequent tranche releases would also take place after agreed policy steps have been undertaken. When it is to be used to finance investment programs and essential imports, the benefits of the loan are the returns on investment and imports, which are now made higher by policy reforms already implemented.

Sector and Subsector Policy Loans

4.18 Another set of instruments would be sector policy loans (SPLs) and subsector policy loans (SSPLs). These loans would be different from sector loans as defined in OMS No.1.19; that approach is noteworthy primarily

1/ This has implications for the market for this product; i.e., there is a premium attached by governments to quick-disbursing funds.

2/ This is similar in concept to the approach taken by the IMF in its tranche releases.

for its very limited application in recent years as these loans are designed for situations where institutional capacity and the policy environment are reasonably satisfactory. SPLs, on the other hand, are designed to encourage institutional and policy reforms; SPLs (and SSPLs) would be made to governments to support policy reforms in specific sectors (or sub-sectors). Apart from their sectoral (or sub-sectoral) focus, these loans are conceptually no different from DPLs and much of the discussion above could apply to these loans as well. They could, therefore, be made available to support a time-slice of sectoral (or sub-sectoral) investment programs, and to finance equipment, credit, imports, etc; quick disbursements should also be possible, where necessary.

4.19 One form of an SPL (or an SSPL) would be one where a multi-year sectoral development strategy--which includes institutional and policy reforms--is the basis of an agreement with the government. This strategy would be supported by a series of project loans without sector conditionality attached to each loan; only the relevant project-specific conditions necessary to ensure a viable project would be included. If the agreed sector strategy is not implemented by the country, lending in that sector would be curtailed. This could be done in several sectors within a country; the number and choice of sectors would depend upon individual country circumstances and agreement between the Bank and the country on the priority sectors. This type of an SPL is currently under active consideration in Pakistan.

4.20 Various other forms of SPLs are also currently under consideration. In Turkey, a tentative proposal is to have loans to finance the imports of a sector (raw materials, agricultural imports, spare parts and finished equipment such as tractors) over a two-year period, plus technical assistance in the implementation of key sectoral reforms and further analysis in return for an agreement on a detailed action program of reforms in the sector. The transport sector loans to Zimbabwe, the Industrial and Trade Policy Adjustment Loan to Morocco and the fertilizer sub-sector loans to Bangladesh, Pakistan and Nigeria fall under the categories of SPLs and SSPLs respectively.

4.21 SPLs (and SSPLs) have several attractive features to them. They can be more easily seen to be financing expansion, maintenance or rehabilitation of productive capacity and not providing pure balance of payments support as the IMF. Policy reforms would also be more manageable by being more narrowly focused than, for example, in SALs or DPLs. There would probably be many countries where SPLs would be the most appropriate vehicle for policy-based lending. These types of loans would draw from the Bank's sectoral expertise and be easier to monitor more closely.

4.22 Yet, there are some disadvantages to these instruments also. From a conceptual point of view, policy reforms can be most effective if they are a part of a consistent policy package. ^{1/} Many crucial reforms are about changing relative prices; e.g., the internal terms of trade of agriculture and

^{1/} For example, in the Philippines, while a SAL was focussing on trade and industrial policy reforms, the quality of public investment deteriorated during 1980-82, with seriously detrimental effects on the overall economic performance.

the non-agricultural sectors. These relative price changes cannot be brought about by reforms in one sector alone. Similarly, macroeconomic or multi-sectoral issues such as trade and financial policy would remain of continuing interest even after the phase-out of the SALs and when IMF resources are not being used. It is, therefore, important to retain a mechanism, such as DPLs, so that the intersectoral and the macro issues continue to receive adequate attention even though loans are made to a particular sector once every two or three years.

4.23 Given that funds are fungible in most circumstances, such DPLs and SPLs are efficient mechanisms to transfer resources to countries. But this is not to suggest that they be instruments whose sole objective is to provide balance of payments support. Their real advantage over traditional project loans lies in their being effective instruments for multi-sectoral and sectoral policy reforms. Their relatively faster disbursement characteristic, where used, can be particularly attractive when developing countries face unanticipated shocks and crises; in such cases, these loans, unlike traditional "project" loans, would be inherently counter-cyclical. Project loans, particularly for new investments, must be reduced during times of economic recession, when a country cannot afford its own share of a project's cost, and are expanded during boom periods. DPLs and SPLs can, on the other hand, contribute during periods of economic growth and, in times of recession, they can support the adjustment process and sustain much needed imports. Such loans clearly add to the flexibility of this institution to respond to the domestic policy and the international economic environment likely to face developing countries in the next decade. Consequently, arbitrarily determined ceilings on "non-project lending" (of 10% or any other amount) would only set up artificial constraints on the Bank's operations and, thus, restrict its flexibility and contribution to the development of the economy. ^{1/}

4.24 Since these are policy-based instruments, the loan amount should in some way be related to the costs associated with the reforms. Recognizing that this still remains more an art than a science, increasing use of such instruments will, nevertheless, require that the loan amount be related to the costs of adjustments; some assessments of such costs will, therefore, be necessary. In trade liberalization reforms, for instance, the short-run costs of increased imports are usually apparent very early, whereas there is some time lag before exports increase. Consequently, the loan amounts for SPLs or DPLs requiring such reforms must be at least as large as these economic adjustment costs, and, therefore, may be quite substantial. Clearly, some premium may have to be added to account for the "political costs" associated with such reforms and, for this component, judgements would have to be made and justified. In short, the Bank should begin to relate, in a more rigorous way than in the past, the loan amount and the costs of adjustments due to policy reform. This has an immediate implication for future CESW and the need to tie such CESW more closely to the Bank's operations (see Chapter 5).

^{1/} Currently, there is no clear definition of "non-project" lending; consequently, estimates of lending for "non-projects" vary from 9-10% (defining "non-projects" as only SALs and program loans) to about 40% (defining "non-projects" as all loans that do not conform to the "bricks and mortar" classification).

4.25 While policy loans should be large when the conditions merit and when governments are prepared to take significant actions, policy-linked lending does not necessarily imply large loans. One approach that may be worth considering is the design of small "policy implementation loans"--analogous to T.A. or engineering loans currently made--that could encourage the first steps on policy adjustments. The Bank could then offer to refinance them into larger loans aimed at physical measures (e.g., industrial rehabilitation) that need to follow the policy measures. This approach would allow the Bank a lot more flexibility in how it approaches countries which do not meet current SAL criteria. A variant of this approach has been attempted in Senegal and Mauritania.

Future Orientations of Project Work

4.26 Project lending will continue to be an important part of the Bank's future product, particularly in the low-income countries. The focus here is to draw on the main lessons derived from the Bank's experience with project work and to identify areas that require special emphasis. These lessons suggest that, in the future, project work should be adapted to the adjustment period ahead, to the technological changes that are likely to take place, and to the increased diversity among countries. Key dimensions are the importance of country commitment, project complexity, the macro/sectoral policy environment and project management, as these factors have often been cited as causes of project failure. This suggests that the Bank retain and enhance its current flexibility in the design of projects. Indeed, given that the nature of the project has changed, and its increased complexity, the importance of increased flexibility cannot be overemphasized.

4.27 Adapting project design and implementation to the special characteristics of individual countries raises some important issues. For example, in many middle-income countries and others with strong institutions, e.g., India and China, the sectoral perspective is indispensable for defining the policy framework under which projects will be designed, and for determining which policy elements need to be included as part of the project package. Also, an improper macro/sectoral policy environment often ensures project failure. Similarly, the beneficial impact of a project is likely to be lower if the project clashes with other macroeconomic or sector objectives. For countries with weak institutions, an appropriate sectoral perspective is essential for proper project identification. There could be many other sources of identification--as happens in the more advanced countries--but a weak institutional structure results in a sub-optimal choice of projects. Thus, sector work in Sub-Saharan Africa and other low-income countries is crucial.

4.28 In the middle-income countries where institutional capacity exists, the Bank, as a general principle, should concentrate less resources in identifying and evaluating projects; it should, instead, review evaluations undertaken at the country level. The Bank should also move in these countries towards financing time-slices of entire sectoral public investment or expenditure programs and the Bank should ensure that projects with low or negative rates of return are excluded and that ones with high economic rates of return, but with a low political pay-off, are given due consideration. In countries that lack the institutional capacity, a "project-intensive" approach to identification, including sector work, will still be required; but, the Bank

should also focus more attention on assisting these countries in evaluating their entire investment program with an emphasis on identifying the "white elephants" (i.e., those projects with negative rates of return) and on identifying projects which, because of their lower political appeal, may not have been considered and incorporated into the program by the government; these would normally be smaller projects benefiting less vocal groups such as the rural poor.

4.29 Project complexity is another issue that needs to be addressed. On the one hand, low-income countries with weak institutional structures would require projects which can address the fundamental economic problems and attempt to eliminate major bottlenecks that interfere with the goal of raising incomes. But their weak institutional capacity restricts the implementations and the successful operation of such projects. On the other hand, those countries that can afford more complex programs are those that probably need them the least. The Bank's experience suggests that the high-population countries in Asia (India and China) can undertake and implement projects as complex as the more advanced middle-income countries of East Asia and Latin America, but that care should be taken in not overburdening projects and programs in Sub-Saharan Africa and in many of the EMENA countries; in these countries, institutional and absorptive capacity will act as major constraints. The emphasis now should be on long-term efforts to develop capabilities in those countries that do not have it. An appropriate time perspective is essential; the Bank should not be bound by the constraints of the traditional project cycle, but must be able to take a long-term view of objectives and achievements in a sector.

4.30 The "blueprint," as opposed to the "process," approach to project design and implementation raises another set of issues. The former advocates detailed preparation and design of one specific solution, whereas the latter postulates the need for establishing a mechanism for the continuous review and modification during implementation of the original design, to adapt it to new developments during that period. The blueprint approach is more appropriate for "hard" infrastructure or engineering projects, and the process one for the social sectors. In addition, the argument has been made that in the low-income countries, the process approach should be applied more widely, because conditions are likely to change more during implementation, partly because they had been more difficult to predict initially. The process approach, however, assumes that some sort of functioning institutional structure can be established that will monitor implementation and propose changes in project design. The lower the income level, the lower is the institutional capacity, and the less likely that such an indigenous evolutionary process can be developed in the short run. Nevertheless, our own supervision efforts can be more explicitly geared to reviewing the need for design adjustments.

4.31 A rather general point regarding project design in developing countries may be made here. If projects in such countries require consideration of technological and administrative development, it might be appropriate to consider applying some of the principles developed in R&D work in the West to procedures of project planning, design and implementation. These principles differ sharply from conventional optimizing techniques applied to ordinary production processes in an environment of certainty. In general, these principles emphasize flexibility in goal setting, reliance on multiple and parallel approaches, flexibility in coordination of components, gradualism and

sequentialism. Pilot agricultural projects, therefore, are to be recommended in countries with poor institutional capacity so as to reduce uncertainty and to learn from gradual, incremental steps; similarly, it may be better to build cheap roads and let the ensuing traffic pattern decide which are to be upgraded and made permanent.

4.32 Regarding the nature of conditionality set by the Bank for a project, several conclusions also emerge from the Bank's experience. First, the number of covenants should be fewer for projects, particularly in low-income countries, and the nature of those covenants simpler and directed at the binding constraints. Second, in these countries, it is especially important to differentiate those objectives that are essential to the project and require a covenant that the Bank intends to enforce from the general policy statements that are desirable, but not essential for the achievement of the project's objectives. More broadly, the Bank should try to eliminate such general statement-type covenants in the context of individual projects. Experience indicates that these covenants have not been effective. ^{1/} Third, project conditionality will depend on the nature of the total package of activities of the Bank in a particular country. Experience has shown that the effectiveness of conditionality declines as it gets farther from the direct project objectives. If the Bank has a package containing other instruments, such as SSPLs, SPLs and DPLs, then conditions should be targeted to the appropriate instruments. As a general rule, the weaker the institutional structure of the country, the lower should be the proportion of non-project conditions attached to the project instrument. Furthermore, in those weaker countries, some set of formal "macro" conditions may become essential for ensuring the overall effectiveness of the program.

Evaluation of the Bank's Product

4.33 As the Bank's product becomes increasingly diversified, both the methodology and the procedures for assessing its product ex-ante (appraisal), monitoring the efficiency of the Bank's "production process" during implementation (supervision), and assessing the effectiveness and impact of the Bank's operations ex-post (evaluation) will need to evolve. The existing methodology and procedures have been developed and refined over the years primarily to determine the technical feasibility and incremental economic benefits of investments. The available methodology for dealing with the less tangible components of the Bank's product--such as institutional development or policy reform--is still primitive and unsystematic.

4.34 Recent work in the OED suggests some guidelines for those Bank products for which the rate of return concept is practically or conceptually difficult to apply. At the preparation/appraisal stage, four processes should be recognized as important. The first is defining objectives. Appraisal,

1/ See Operational Policy Review, Compliance with Loan Covenants; Report No. 4090; Operations Evaluation Department; September 1, 1982. The point made in this paragraph about the numerous covenants and conditions is just as relevant for SALs; the conclusions (i.e., fewer and simpler conditions) also apply. See Chapter 5 for a more detailed discussion on the approaches to policy reforms using DPLs and SPLs.

supervision and evaluation of non-investment products have frequently been difficult because the precise objectives of the Bank were not clearly defined at the design stage. For example, it is often unclear whether technical assistance attached to a project is intended to establish the self-reliance of an institution or is merely intended to provide short-term support for the institution to ensure successful project implementation. Similarly, in policy reform, it is important to establish at the outset the relevant linkage between a particular instrument and its objectives. Where the use of a particular instrument is likely to have multiple roles, it should be spelled out. The expected outcome deriving from the use of a particular array of instruments needs to be linked up at the earliest stage of the exercise.

4.35 The second is defining the expected product, particularly with respect to the "software" components which have often been less well prepared and appraised than the technical aspects. For example, training programs have often been left to consultants to define during implementation, and may never be implemented as a result. The preparation process should carefully define the product; i.e., specify the results expected from the Bank's intervention; e.g., the number of local staff to be trained each year, the policy changes or decisions to be targeted, the technological improvements to be introduced, and by whom and when. The preparation/appraisal process should also provide, whenever possible, indicators of performance during implementation as a rough guide to supervision, i.e., annual targets of time-specific events. To the extent possible, activity-specific monitoring systems should be built in to the operation.

4.36 The third is the choice of instruments. Any "product" can be produced by a variety of instruments used alone or in combination. The choice of instruments is an important design/appraisal decision and the range of choices should be made explicit. The "cost-effectiveness" of instruments may vary considerably. Partly because of the bureaucratic divisions within the Bank, there may be an inappropriate selection of instruments at the design stage; a Bank organizational unit will tend to choose the instrument most readily available to it, whether or not it is the most cost-effective way of producing the desired product. There may also be a short-term/long-term trade-off in the choice of instruments. These trade-offs need to be identified and resolved in close consultation with the borrower.

4.37 The fourth, and most difficult of all, is the assessment of the expected impact. All Bank products need to be justified ex-ante and ex-post in terms of their anticipated impact on the country's development goals. In investment projects, the rate of return can often serve as a proxy for overall impact. For other products, different concepts of impact are required. For institutional development, it will be necessary to assess what progress can be made in improving the capacity of an institution (at whatever level) to perform its functions efficiently. Indicators of performance can be drawn up; e.g., water supply losses, maintenance standards, number of farmers served, unit costs. In some countries, particularly in Africa, the progress towards indigenization may be an important criterion.

4.38 For policy reforms, calculating rates of return on loans designed to support a package of policy reforms is difficult. Currently, in most SAL reports, there are attempts at estimating medium-term macroeconomic scenarios "with" and "without" structural adjustment programs. These estimates are

fraught with difficulties. In these calculations, estimating, or indeed establishing, an empirical link between precise policy reforms and output growth or balance of payments is subjective. Also, many of the SAL "conditions" relate to "process" changes which cannot be monitored quantitatively; to estimate their effects on the GDP or the balance of payments in the short or medium term is, currently, not feasible. The issue of the "additionality" of policy reforms due to SALs or SAL-type instruments is also difficult. Policy reforms typically take place as a result of many influences of which the Bank's instrument may be only one. What reforms will be implemented "with" or "without" the Bank's involvement cannot be determined with certainty. It is also extremely difficult to evaluate the costs and benefits of policy change. Costs are not only economic, but also political and occur in the short run. The benefits usually occur in the long run. Furthermore, the benefits (or the impact of a policy change) may be affected by "exogenous," unanticipated factors such as the world environment, weather, etc. Consequently, it is difficult to identify the causal link.

4.39 The ex-post evaluation of the use of instruments such as DPLs, SPLs and SSPLs may be easier, particularly when funds are to be used directly or indirectly to finance development programs, and when the policy reforms are pre-conditions for such loans designed to improve the efficiency of resource use and the debt service capacity of the country. The rate of return on these loans can be calculated in the traditional way by estimating the addition to the GDP stream as a result of funding these programs "with" policy reforms, without guessing the situation "without" policy reforms. The policy reforms have effectively acted as eligibility and resource allocation criteria and need not be treated as "goods and services bought by the loans." In this approach, monitoring and evaluation has to concentrate on the evaluation of development programs supported by the loans; that would be more manageable than the evaluation of the impact of reforms "bought" by DPLs or SPLs.

4.40 A difficult aspect of monitoring policy changes is in determining whether the government is in compliance if it has undertaken some, but not all of the agreed reforms. Clearly, the Bank will have to make judgements here and it is inevitable that such situations will arise. But to minimize their recurrence, two issues must be borne in mind. First, the Bank must be very sure that what it is asking the governments to do is indeed essential; this is a special responsibility that this institution bears, particularly as it changes the nature of its product. Second, a "Christmas tree" approach to reforms should be abandoned. The Bank's project experience indicates that this is not a viable approach with project covenants and similar conclusions are being drawn from the SAL experience. This suggests that the required conditions must be direct, precise and limited; increased attention needs to be paid to the design of conditionality in the future.

4.41 The use of DPLs, SPLs/SSPLs and, currently, SALs also raises another set of issues. Most of the policy reforms required involve a change in the country's legislation. Often, because they are easy to monitor, these legislative changes are singled out as the main indicators of policy reforms under SALs. However, the true economic effects of concern are whether productive units are now facing more appropriate signals as a result of these reforms. The issue is whether--by monitoring legislation, instead of effective incentives faced by these units--the Bank, in fact, measures changes in the true economic effects of these reforms. In principle, and probably in

practice, there can be discrepancies between legislative changes and "effective" changes. For example, a legislative change may be compensated by a bureaucratic procedure; tariffs might be lowered, but now it may take more time to get the foreign exchange from the Central Bank. The true import costs to the firms may even have increased. Two examples in a particular SAL operation also highlight this issue. The agreed changes in import legislation were not clearly and expeditiously transmitted to regional customs officials around the country who kept using the old duty. Also, the lifting of beef export bans, which appeared in the official legislative bulletin, were not widely advertised to producers; interviews with producers showed that they were unaware of the change. In both these cases, there were legislative changes, but no effective changes as other actions were needed to transmit the changed signals from the legislative level to the firm level. This suggests that to monitor and evaluate the impact of policy reforms, even when all of them are ostensibly undertaken by the government, the direct surveying of randomly selected enterprises should be undertaken to document the net impact at the micro level. Monitoring legislated changes alone may not be enough.

4.42 Better preparation and appraisal will in itself facilitate better supervision and evaluation, since the objectives will be better defined, the inputs (costs) detailed, and a phased implementation schedule, with intermediate and final targets, will be available. The supervision process is mainly concerned with ensuring that the chosen instruments are used efficiently. The evaluation stage is concerned with assessing the effectiveness and the impact; evaluation can be more systematic and precise if the intended effects and impact of the Bank's operations are well defined ex-ante. Furthermore, ex-ante and ex-post evaluation of sectoral/sub-sectoral priorities will become extremely important. This suggests that the evaluation of operations will need to extend the focus from project specific to system-wide issues. It may also be useful to review a decade of Bank operations in a particular country, to draw lessons on the broader (systemic) issues of the Bank's country assistance performance. 1/

The Market for the Bank's Product

The Competitive Position of the Bank

4.43 As mentioned earlier, the Bank no longer operates in a quasi-monopolistic international capital market; the world has changed and the Bank is only one among many players in the market providing development finance. Furthermore, the Bank's product has changed, it has become more complex and continues to evolve. Consequently, the issue of client receptivity to the product of the Bank is crucial. The receptivity to the Bank's product will be a function of the nature of our relationship with a particular government and the competitiveness of the Bank's loans with policy advice, technical assistance, and conditionality relative to assistance provided by other donors and alternate sources of finance without these complementary components. In many countries, the lengthy project cycle is perceived as a cost relative to alternate sources of finance from institutions whose appraisal procedures are far more rapid. Put another way, over the next decade, the Bank's product

1/ OED has already begun the first of a series of such reviews.

will frequently be put to the market test; the Bank will, therefore, have to constantly evaluate its product in each country--particularly when the product fails the market test--in order to decide on the adjustments, if any, that should be made.

4.44 One study ^{1/} has shown that, in the past, the competitive position of the Bank--defined in terms of interest rate differentials--has been stronger in the low-income countries than in the middle-income ones that have access to alternate sources. However, in addition to interest rates, the competitive position of the Bank is also determined by the grace period, maturity of the loan and the rate of disbursement. Moreover, borrowers also place a value on Bank lending as a "seal of good-housekeeping," on project specific technical assistance and on the fact that Bank funds are untied.

4.45 In the future, the competitive position of the Bank will depend on the monetary environment, the political decisions with respect to the form and amount of capital that is available to the Bank, ^{2/} and the nature of the future product. While many countries may be willing to pay more for the non-financial services of the Bank--e.g., the seal of approval or technical assistance--the policy conditions attached to future loans may be regarded as negative elements which implicitly raise the cost of Bank loans to these countries and, thus, could put the Bank at a competitive disadvantage relative to alternate sources of funds.

4.46 The study mentioned earlier (para. ____) indicates that the provision of non-financial services adds to the administrative costs of the Bank. The costs of providing such services currently amounts to 0.75% of assets. If the change in the Bank's product were to increase these costs to 1% of assets, this would increase the lending rate by about 35 basis points and would begin to erode the cost advantage--of 50 to 100 basis points--the Bank has in countries where commercial lenders are active. If the nature of the new product imposes additional costs (political or economic) on the governments, the competitive position of the Bank would be further eroded. The flexibility of the Bank's product, however, suggests that this negative aspect where it exists, may be compensated by altering the other characteristics of the loan. For example, where increased policy conditionality may price the Bank out of a particular market, then such loans, in those countries, could be fast-disbursing; a characteristic for which most governments would pay a high premium.

Lending Terms

4.47 It is in the context of the specific terms of its loans that the Bank has considerable scope for becoming more consumer oriented. Adjusting the terms of loans to offer the borrower characteristics that it would find desirable would not only tend to create a more collaborative environment for

^{1/} A study on "The Competitiveness of the Bank" conducted by the Working Group #2 on the Future Role of the Bank.

^{2/} The paper on "The Competitiveness of the Bank" explains how these two variables affect the costs and interest rate structure of the Bank.

discussions of policy change, but would also provide opportunities for increasing the Bank's bargaining power and, hence, effectiveness as an agent of policy change. 1/ Some preliminary suggestions, that clearly warrant further scrutiny, include the following. For example, it might be possible to change the repayment profiles to offer the borrowers a constant payment/variable maturity loan instead of a constant principal/fixed maturity loan; this would resemble one of the B-loan co-financing options. Such a scheme would have the advantage of reducing the combined principal and interest payments in the early stages of a project and would provide more time for cost recovery mechanisms to mature and become productive as sources of loan repayments. Tailoring the loan terms more specifically to the needs of a particular loan or borrower is another option. Such an option might provide for cross-subsidization to reduce the financial burden on low-income or IDA/Bank blend countries. Without changing the average terms of Bank loans, terms could be varied with regard to grace periods, repayment periods (as already done) and profiles in such a way as to charge higher rates or offer shorter grace and repayment periods when appropriate to the nature of the loan and/or the borrower.

4.48 Another possibility that would induce countries to undertake policy reforms, and enhance the market for the Bank's product, would be to vary the terms of a loan according to the degree of performance and compliance with respect to policy conditions. For example, the flexibility could cover the amount of the loan and grace and repayment period. 2/ Varying the amount of the loan would be similar in concept to a "mini-loan" idea and to the tranche mechanism already used in some Bank loans. The objective would be to set the instrument up not as a single loan, but as a series of smaller, new loans phased in some agreed manner (annually?). In this way, the base of the policy dialogue would shift. Instead of refusing to disburse on a signed loan because a policy condition had not been met, the Bank would be in the position of negotiating new money, at regular intervals, on the basis of an ongoing policy dialogue. In most cases, the Bank probably has a stronger negotiating position when it is discussing new loans than when it is discussing disbursement conditions.

4.49 Increased variation of the grace and repayment schedules may also be possible. Now that the Bank has moved towards variable interest rates, the previous concern with the mismatch between borrowing and lending maturities should no longer be a constraint. Given the debt situation of many of our borrowers, they might be very interested in an option that would extend the grace period in exchange for making and/or maintaining policy reforms. It may also be possible to extend the maturity of the loan without extending the grace period. This would have the effect of reducing the repayments of principal in each installment. Conversely, the Bank could offer longer

1/ Any such changes are likely to have an impact on the Bank's income and would have to be carefully considered; some changes may also have the effect of providing an economic subsidy to the borrowers, and the justification for that would also need to be examined.

2/ Varying fees and charges is also possible, but it would raise numerous difficulties.

maturities, but add a feature allowing the Bank to premature the additional, later maturities if key policy conditions were not met. 1/

Policy Conditionality

4.50 One key characteristic that will obviously affect the marketability of the Bank's product is the attachment of explicit policy conditionality. In the past, there have been two situations when the Bank has been reasonably successful in having governments accept its policy/institutional advice. First, when governments have no choice but to accept; i.e., the alternative sources of funds are limited. The very low-income countries, possibly the middle-income, high-debt countries, and countries that have faced a sudden reversal in their fortunes due to, say, a commodity price drop (e.g., Indonesia, Nigeria during periods of declining oil prices), fall under this category. The second situation is when the Bank has convinced the governments of the logic of its position. This requires painstaking effort, but it can convert Bank conditionality from being a cost to becoming a perceived benefit and thus positively affect the marketability of the Bank's product.

4.51 Obviously, it is the second situation that the Bank should be moving towards. Yet, this effort will neither be easy nor straightforward. It should be recognized that governments will tend to ignore the Bank's advice during periods of "bounty." A time perspective is important, however, as many of these same countries search for advice during difficult periods. Often, in these cases, the Bank is one of the few institutions that has prepared the groundwork and laid the intellectual foundations for the needed policy reforms. The Bank must ensure that this avenue is always kept open for these countries so that a long-term presence in these countries can be maintained. 2/ In many other countries, the Bank's economic prescriptions may be unacceptable for a number of reasons. They may run contrary to the method of economic management (e.g., Tanzania, Algeria and Romania); they may be politically too risky to adopt (e.g., Indonesia); there may be an alternate source of much lower cost aid (e.g., Egypt); they may be disregarded because our leverage in the country is not significant enough (e.g., India) or scattered in too small amounts in too many sectors (e.g., Yugoslavia); or the country may simply disagree with them. Policy analysis is an area where our prescriptions tend to reflect a measure of economic liberalism that is unpalatable to many borrowers.

4.52 There are a number of implications of the potential for disagreement on economic policy. First, in view of the fact that economic policy advice is much more difficult to derive and contentious than technical advice or project design and management (where the Bank has considerable experience), the Bank needs to move cautiously in the area of policy conditionality in cases where there is room for genuine differences of opinion. Clearly, in using the

1/ It should again be emphasized that these options warrant further analysis particularly with regard to their impact on Bank income and the implicit economic subsidy inherent in some suggestions such as the extension of the grace period and repayment schedules.

2/ The use of the "core" program, discussed later, will permit this.

leverage to induce countries to make economic changes, the Bank bears a special responsibility to the borrower, or potential borrower, to avoid being arbitrary in its advice and to seek to understand the background to existing policies and constraints to future policy change. ^{1/} Second, in cases where the Bank and borrower cannot come to agreement on economic policy, the borrower may still be receptive to institutional reforms where it would have significance even in the absence of broader economic policy changes. And third, in the absence of a promising dialogue in either the areas of economic policy (macro or sectoral) or institutional reform, the Bank may have to recognize the existing constraints to achieving its objectives in a particular country or sector and allocate its resources accordingly; this outcome would be preferable to "diluting" our policy advice.

4.53 A crucial issue related to conditionality is whether the effectiveness of the Bank as an agent for policy change depends on the volume of resources available for lending. There is no generalized paradigm for determining the volume of resources that constitutes a critical mass for achieving policy change. The critical mass will vary from country to country and from sector to sector depending on the importance of the policy change sought, the expected benefits and the practical and political difficulties of implementing the change. At the one extreme, if the borrower accepts the need for policy change and the advice of the Bank with respect to the nature of the change, resource requirements may be limited to the funds needed to undertake a demonstration project and demonstrate the benefits of the change. In such cases, the Bank could be an effective agent for policy change for a modest resource input. At the other extreme, the borrower may be skeptical of the need for change, the nature of the change proposed by the Bank, and the political feasibility of implementing the change. In such a context, the Bank may need to offer a substantial volume of resources to ensure "a place at the table," to implement the change itself, and to implement other efforts (projects) to offset the negative political ramifications.

4.54 In the current world economic and financial climate, there will be a scarcity of resources available for development compared to the expanding needs of the developing countries. The Bank, however, may be able to increase its policy effectiveness by mobilizing other sources of funds. This could be achieved through an aid coordination role, and influencing the way in which other agencies apply their resources; it could be achieved through a catalytic role by increasing the volume of co-financing and joint financing with public and private entities; and it could be achieved through an agency role, with the Bank expanding its executing agency activities on behalf of other agencies (as we do with UNDP) and possible bilateral aid organizations. The common objective would be to convince the borrowers that good economic performance could lead to an increased flow of resources from other sources. This approach, however, is likely to prove effective only in specific countries and sectors. In most countries, the Bank will have to allocate its resources under constraints and that would involve maximizing the efficiency with which they are used and setting priorities for their application among countries and among sectors within countries. It is in this context that the "full-service Bank" issue arises. This issue is discussed in Chapter 6, in some detail

^{1/} See Chapter 5 for a discussion of the factors inhibiting policy reforms.

where the question of selectivity of countries, sectors and instruments is raised for different groups of countries.

4.55 The infrequency with which the Bank can undertake operations in low-income countries may also affect the market for its product in those countries and the effectiveness of the Bank as an agent for change. A small country may only have a few operations a year, with loans to a particular sector being much less frequent. How then can the Bank maintain a reasonable policy dialogue? It is true that dialogue takes place during supervision as well as at times of new lending operations. But, it is also true that policy dialogue is most effective when there is new money on the table. In such circumstances, the answer may lie, as suggested earlier (para. ____), in decomposing projects into smaller loans or tranches instead of combining them. For example, a project with a four-year execution period that called for a succession of policy actions could be re-formatted as a series of three or four sequential loans, each of which would be activated by evidence of the policy action.

The Market for Technical Assistance/Policy Advice

4.56 Ideally, however, the Bank should develop a relationship with its borrowers in which its policy advice is welcomed for its own sake, for its objectivity and sophistication, and may be provided whether it is lending or not in any particular year. If it could build further on its reputation for high-quality policy advice, the Bank may also be able to provide such advice (for a fee) to countries that have graduated out of IBRD lending, but continue to need policy advice on how to effectively manage their economies. Indeed, the provision of technical assistance/policy advice without lending to countries on a reimbursable basis is an issue that the Bank should address over the next decade. The market for this component of the Bank's product would probably be the more sophisticated borrowers who may prefer to "unbundle" the Bank's product, countries that have graduated out of the Bank and, as now, the capital-surplus oil-exporting countries.

4.57 Looking ahead over the next ten years, two factors can be seen as likely to influence future directions. The first is the Bank's own willingness to continue the present system of mixed reimbursable and non-reimbursable technical assistance and its satisfaction with the character and quality of the product. The second is the continued desire on the part of the countries themselves either to continue to pay the costs of reimbursable technical assistance or, in the case of non-reimbursable technical assistance, whether they will continue to be interested in seeking the Bank's help (and bearing the implicit cost). The demand for such assistance in these countries will depend on changing economic conditions and on their evaluation of its usefulness and quality. If the past is any guide, Bank assistance to the Saudi Government has resulted in significant cost reductions. Considerable success has also been achieved in detailed advice on procurement and supervision, while fundamental policy advice seems largely to have been confined to manpower planning and development. What could portend a disturbing shift is that the Saudi Government has turned to consultants rather than to the Bank for policy advice on economic strategies, even though this is an area in which the Bank considers it has a comparative advantage; clearly, the perceptions of the Saudi Government are different. The answer to why that government has turned to consultants rather than to the Bank, with whom it has had long

experience, would assist the Bank in developing a more marketable product, if this is a direction it wishes to pursue.

4.58 It is interesting to note that the demand for non-reimbursable technical assistance appears to be increasing from the oil-exporting group. So long as the financial conditions of these countries remain tight, it is likely to continue to increase. In the last two years, the Bank has provided assistance to UAE and Kuwait (general economic reviews), Bahrain (energy demand) and the Gulf Cooperation Council (food security). Requests have been received from all these countries for assistance in the next two years, up to the one staff year free limit. So long as the Bank confines this assistance to areas where its competence is strong and the demand is there, there can be little doubt that the Bank should be willing to respond. But in a world of increasing financial stringency, the arguments for providing these services for free, particularly to the oil-exporting group, are no longer obvious. The Bank should, therefore, begin to reconsider this position and develop an appropriate pricing structure for such services.

5. SELECTED ASPECTS OF THE BANK'S OPERATIONAL PRODUCT

Introduction

5.1 As discussed in the previous chapter, the Bank's operational product, over the next decade, will become more complex and will incorporate many components; the tailoring of these components to specific country requirements will be the key concern for the Bank if it is to have a significant impact on the development process. This chapter elaborates on some selected aspects of the Bank's product. It discusses the various factors that constrain policy change in developing countries; approaches the Bank may take to encourage policy reform; and the need for the Bank to develop flexible lending programs in order to maintain a long-term presence in countries while simultaneously addressing fundamental policy and institutional concerns. The chapter also outlines how the Bank's instruments can be used to stimulate private sector activity and ways in which the Bank may approach the difficult issue of institutional development. Finally, it highlights the increasingly important role of country economic and sector work for the future operational product of the Bank.

Factors Inhibiting Policy Reform

5.2 The evolution of the Bank's product will depend on convincing governments to address difficult policy issues. This, in turn, will depend, inter alia, on the institutional relationships developed between the Bank and the country. More importantly, the conviction of the Bank in the quality of its own advice and its willingness to provide long-term financial security to those countries willing to undertake and sustain much needed reforms will be pivotal factors. But, as experience has shown, there are considerable difficulties associated with convincing governments in undertaking policy reforms, much more so than in convincing them to incorporate technical (engineering) changes in project design. This implies a much greater effort on part of the Bank to overcome the constraints to policy change.

5.3 An important aspect of product diversification will, therefore, entail increased attention to the policy and institutional environment. This suggests that the Bank must have an increased understanding of the obstacles to any reform. If the Bank is to be involved in policy-linked lending, then it must address the question of why, if our policy advice is so good, are governments reluctant to take it? Clearly, there are many factors that inhibit policy reform; some of them are within the Bank's control and some are not. Furthermore, these factors will vary across countries and within countries, across sectors and over time. The most important ones are discussed below.

5.4 First, even if governments agree with the direction of reforms suggested, there is a lack of knowledge about how to implement them. In many circumstances--whether it is in trade policy reform, or eliminating agriculture and energy subsidies, or liberalizing the financial policy regime--the Bank has developed considerable expertise in analyzing the nature of the existing distortions. It can also provide the governments with a notion of what the non-distorted regime would entail and the economic reasons as to why such a non-distorted regime is superior to the existing one. However, while

governments may agree with the superiority of the non-distorted regime, they may be reluctant to shock the economy by a sudden change in the policy regime. At the same time, they often do not possess the necessary knowledge regarding the timing and sequencing of the intermediate steps that need to be undertaken to shift gradually from one policy regime to another. The ability of the Bank to advise governments on such steps is currently limited. This issue of the timing and sequencing of any policy change-- or the dynamics of policy implementation--is a much neglected area of analysis, both within the Bank and within academia.

5.5 The second reason stems from a misunderstanding of the potential benefits of policy reform. The level of economic sophistication, particularly in the poorer member countries, is modest; their understanding of the behavior of economic agents is often different from that of the Bank. Consequently, many suggestions for policy reform are resisted because the potential benefits, as articulated by the Bank, are not immediately obvious. For example, recommending the elimination of trade policy bias in favor of capital-intensive products, in order to reflect the country's long-run comparative advantage in labor-intensive production, is often perceived as a policy of de-industrialization rather than one that will promote efficiency in production and increases in employment. The preservation of industrial licenses is often officially justified to promote the private sector and protect the small entrepreneurs. Recommendations for their eventual elimination is, therefore, often viewed with suspicion. Or, less obviously, an increase in energy prices is often viewed as hurting the poor relatively more than the rich rather than eliminating subsidies that mostly accrue to the rich.

5.6 Third, on many occasions, even where there is general agreement on the broad directions of policy change and the intermediate steps required to initiate that change, such changes are inhibited by the fact that governments often place a very high premium on the short run as opposed to the long run. Specifically, the actual or perceived economic, and in many cases the political, costs associated with policy change must be confronted very shortly after the implementation of the policy, whereas the benefits accrue much later; in eliminating subsidies or undertaking tariff reforms, this is normally the case. The short-run costs are often weighted much more heavily in the government's objective function than are the long-run benefits; in economic parlance, the government's own discount rate is much higher than the social discount rate and this leads to sub-optimal policy choices. ^{1/} This would be perfectly understandable and rational behavior on the part of the government if it felt that its own welfare and political survival would be at stake as a result of this policy change; it would, therefore, be reluctant to undertake any change even if the net present value of that change (if measurable) would be positive.

5.7 Related to this is the issue of identifying the winners and losers of policy change. In some instances, governments may genuinely misjudge the winners and losers--e.g., their concern with rural households as a result of

^{1/} This is in direct contradiction of the traditional project evaluation literature which equates the government's discount rate with the social rate of return.

increasing kerosene prices in some countries--and this may lead to a reticence in undertaking reforms. In other instances, governments may correctly identify the winners and losers, but place a very different weight on them from what is implicitly assumed in the type of analysis made by the Bank. Politically powerful vested interests (usually urban as opposed to rural producers, consumers and labor force) may oppose such changes; so may bureaucrats in power to whom benefits and rents accrue from the status quo, as in the case of administrative controls. In addition, in some cases, there may be genuinely adverse income distribution effects. In all of these instances, the issue of the appropriate compensation of losers arises, i.e., the appropriate mechanisms for compensation, the amount of finance required, and the effectiveness of a policy designed to obtain the support of the losers in order to undertake the needed reforms. This is a vast and complex area and clearly a subject of concern to policy formulators in many developing countries.

5.8 The resistance to reforms in industrial licensing, trade protection, discrimination against agriculture and subsidized energy prices can be explained by many of the factors discussed above. For example, discrimination against agriculture can create virtual urban employment and lower food prices for urban consumers; this is done at very low cost from a fiscal point of view. The negative distributive effects are felt by the less vocal, less organized and more geographically dispersed groups. The efficiency costs--lower agricultural production--are felt only in the long run. Government behavior under a fluctuating external environment can also be similarly explained. Increased government revenues under boom periods are quickly spent in many countries; the effect of adverse fluctuations are postponed by maintaining current levels of expenditure through external borrowing or inflationary finance.

5.9 On many occasions, proposed policy reforms are interpreted as a means of forcing countries to continue their "economic dependency"; the ideological perceptions of governments, particularly those of recently independent countries, cannot be underestimated. They, therefore, view the Bank as ideological, representing Western economic thought and applying Western economic models to the complex problems of economic development. Whether or not the Bank agrees with these perceptions is not the issue; the fact that they exist, and can hinder policy change is, and must be explicitly recognized.

5.10 Related to the above, are the non-economic objectives of governments. Governments are not only interested in growth and equity, but are also concerned with other issues. For example, independence from foreign sources of supply and national prestige are non-economic objectives which often affect economic policy formulation and decisions in many countries. The arguments for self-sufficiency usually can be traced to a desire to be independent and national psychic income, in many countries, is enhanced from the construction of a steel mill or setting up a national airline, regardless of the opportunity costs.

5.11 The above suggests that the concrete components and dynamics of policy change, the clear exposition of the benefits of such change, and the political economy of public policy are crucial areas for Bank attention, particularly as it enters the domain of assisting governments through encouraging policy change. An understanding of these sets of issues, and an

explicit recognition of the constraints, should be important determinants of any Bank strategy that is designed to facilitate policy change, whether or not it is conducted in the context of a lending operation.

Approaches to Policy Reform 1/

5.12 The Bank can use its mandate as an international development institution to try to induce governments to establish appropriate institutions and undertake policies that are conducive to growth and equity. The Bank's objective here is to ensure, inter alia, that institutional development and economic reforms are being properly formulated and implemented by governments. It is in this context that the issue of the manner in which the Bank can use its financial resources to hasten such changes arises.

The Policy Cycle

5.13 To have a reasonable chance of encouraging governments to undertake reforms, the Bank must continue to take a long term perspective to the implementation of such reforms. Clearly, the time perspective will have to be longer in the low-income countries of Sub-Saharan Africa than in the middle-income group of say, East Asia and Latin America. From a practical point of view, policy reforms cannot be formulated and implemented overnight, and certainly not within the time frame of the traditional project cycle. The issues of economic policy have to be studied carefully and detailed and specific proposals for reforms must be formulated and legislated; in addition, implementation and effective monitoring procedures must be developed. All this suggests a more systematic and structured approach to policy formulation in the Bank than has typically been the case in the past when broader policy issues were often faced in the context of project loans.

5.14 One such policy formulating process--a "policy cycle" analogous to the project cycle--could be disaggregated into nine components: 2/

- (1) an understanding with the government of the country's development objectives;
- (2) an agreement with the government on the nature of the problems;
- (3) a diagnosis of the causes of the problems and delineation of directions for change;
- (4) an analysis of factors inhibiting change;

1/ Rather than constantly using the term "policy/institutional reform," the term "policy reform" in this chapter is used in its broadest sense to include economic policy reforms as well as policies to reform (develop) institutions. The context also makes it clear when only one (economic or institutional) aspect of reform is relevant.

2/ See Stanley Please, "The Institutional Dimensions of Economic Policy Management," April 10, 1984 (draft), where the steps of a policy cycle are discussed in some detail.

- (5) the formulation and ranking of alternative policy packages which take account of the constraints to change;
- (6) agreement with the government on a politically acceptable package of policy actions and a broad timetable;
- (7) the formulation of a detailed and specific program which articulates the nature, sequencing and timing of individual steps;
- (8) the implementation and monitoring of policy reform measures including feedback into the formulation of subsequent stages of policy reform; and
- (9) the evaluation of the impact of policy changes on the achievement of objectives and the derivation of the lessons of experience for the future.

5.15 Such a policy formulating process, or a variant of it, does take place in the Bank, but it tends to be more ad hoc than systematic, except when SALs are contemplated. It is in those lending operations that a more disciplined and structured approach is followed; this reflects the requirements of the developing countries and the need for the Bank to convince the governments of the importance of policy change. As the Bank increasingly diversifies its product and moves towards policy-linked lending, particularly in some middle-income countries, the demands of borrowing countries--which will determine the market for the Bank's product--will increasingly impose on the Bank the need for a more systematic and structured approach to policy formulation.

The Form and Nature of Policy Conditionality

5.16 The approach to policy formulation described above, is necessary, but not sufficient to induce change. Combining the Bank's financial resources with its policy advice can provide the Bank with the added "inducements" which may facilitate policy changes. ^{1/} As is well known, many governments, particularly those at the lower end of the income spectrum, are unable to formulate and/or implement policy reforms. In many cases, they may be unable or unwilling to commit themselves to the Bank to implement such reforms. There are many reasons for this, as discussed earlier (para. ____), but the Bank's role becomes critical here to support and encourage governments to undertake such policy reforms. This, however, raises the thorny issue of how the Bank should go about trying to bring about such changes. This, in turn, suggests that the form and nature of policy conditionality will be crucial to the success of any such forms of lending.

5.17 It is useful to distinguish between implicit and explicit conditionality associated with Bank lending as both types can potentially be used to further policy reforms. Implicit conditionality refers to understandings

^{1/} Chapter 4, on the market for the Bank's product, presented a more detailed discussion of this issue.

between the Bank and the governments on the need to undertake reforms without these being legal conditions of a loan. The understanding on the part of the government is that the Bank, in principle, could reduce its lending if adequate progress is not forthcoming. There is no explicit link between the level of lending and actions to be taken by the government. Such an approach may be useful in those countries that do not wish to be publicly associated with international agencies in implementing policy reforms and where such implicit understandings have a greater probability of being effective than explicit ones. The difficulty with this approach arises precisely from the fact that there is no direct link between a government's action (or inaction) and the Bank's lending operations. So long as there is satisfactory progress on the part of the government, this would be of no concern; but if there are unacceptable or unreasonable delays or no actions by the government, then judgements on progress (or the lack of it) will be required and the Bank's lending posture would have to be reconsidered. One would expect that this implicit conditionality (or parallel track) route is likely to be successful in few countries and only at specific periods in time. Explicit conditionality, on the other hand, is the more common form incorporated into a loan's legal agreements. In this case, once agreement on a realistic program has been reached between the Bank and a government on policy reform, the commitment and disbursement of Bank funds are tied to the government's ability and willingness to implement the agreed program.

5.18 The lending instruments to which policy conditions may be attached and which the Bank can bring to bear in designing and implementing a country assistance strategy can be categorized, as mentioned in Chapter 4, into four broad groups. These are: project loans (as traditionally defined); subsector policy loans; sector policy loans; and development policy loans or multi-sector/macro loans (e.g., SALs or SAL-type loans which can include two or more sectors). These span the range from the micro level to the macro level of the economy. To these loans, a variety of conditions that also span the spectrum from micro to macroeconomic concerns can be attached. The issue that the Bank faces is: which instrument is most appropriate for different types of policy reforms?

5.19 To be most effective, policy conditions linked to lending operations should be as precise as possible and directly linked to the object of the loan. As past experience has shown, a "Christmas tree" approach to economic reforms is neither in the interest of the country nor of this institution. Furthermore, for successful implementation (by the country) and monitoring (by the Bank), such conditionality must be limited. The design of conditionality--which is as important as that of a traditional (hardware) component of a project--and the policy objectives must be reflected in the ultimate formulation of the lending operation. As mentioned earlier (para. ____), the weakness or ineffectiveness of Bank lending in the policy reform area has not been due to the lack of conditionality, but instead, to too much conditionality.

5.20 The Bank's experience with its attempts at handling broad policy and institutional issues through project conditionality and policy dialogue suggests that where policy issues are directly related to successful project implementation or lie at the project level, then (policy-based) project loans would be the appropriate instruments for related policy conditionality; however, if subsector or sectoral policies are important, then subsector or sector policy loans (respectively) would be more appropriate. And if broader

policy issues that are multi-sectoral in nature or affect the macroeconomic environment (e.g., a public investment program) are critical, then SALs or similar forms of lending, such as development policy loans, would be appropriate. This suggests that there be increased "targeting" of policy conditions to lending instruments; i.e., the characteristic of the policy measure should be matched to the characteristic of the lending instrument. Tying sectoral policy changes, such as interest rate reforms or energy price changes, to a DFC loan or a power project, respectively, would not be an effective approach in most instances. Rather such conditions should be attached to sector policy loans. This suggests that the Bank use the strengths of traditional project work to do better project lending where necessary, and when project lending is an inappropriate instrument--say, to institute sectoral policy changes--then more appropriate instruments be used, such as sector policy loans.

5.21 Notwithstanding the importance of the initial linking of policy conditionality to appropriately pitched lending operations (i.e., at the project, subsector, sector or macro level), the Bank, in some instances, may wish to develop a hierarchy of conditions--project, subsectoral, sectoral and macro--and incorporate already agreed upon higher-level (macro) conditions, when necessary, into all "lower level" loans. For example, an initially agreed-upon "macro" condition--say, reducing import tariffs for all tradeables (agriculture, industry, and services) or raising interest rates--could be part of a "contract" with the borrower and could be incorporated by reference into all future relevant projects on the grounds that failure to achieve the targets would jeopardize those projects. Similar "contracts" could be developed for specific sectors (in SPLs). This would create a cross-default apparatus and increase the Bank's leverage in the policy reform area. These "contracts" should be revised periodically so that loans would not get locked into outdated conditions. This approach is currently being considered for Mexico with regard to interest rate policy.

5.22 Also, historically, flexibility and enforcement in policy-based lending has been handled through the size of the new lending commitment and disbursement of tranches conditioned on policy reform. These two would continue to remain important, but the Bank's leverage could be increased by an additional enforcement feature to the Bank's policy-linked "macro" instruments. Standard practice in medium-term corporate lending is to include covenants so that when certain commitments are not met by the borrowers, the lender, after consultation with the borrower, has the right to call the loan. Given that what is often required are sensible policies over the life of a loan and not only reforms at the time of disbursement, on some crucial or important occasions, more explicit reference to the circumstances under which the Bank would require prior consultation and consider invoking the call provision ("the Acceleration of Maturities," Article 7 in the General Conditions Applicable to Loan and Guarantee Agreements) may be useful, particularly as the product becomes more diversified and the relative share of

policy-based lending increases in some countries. ^{1/} When it is felt that this approach would not be effective, the proper tranching of loans should, of course, be undertaken.

5.23 Conditions, whether they are implicit or explicit, can be attached to specific loans, as discussed above, or to the entire lending program; these two approaches to conditionality are not mutually exclusive. In the case of loan conditionality, as described above, institutional and policy reforms should be targeted to specific loans that are part of an agreed Bank assistance package. Under lending program conditionality, once an understanding has been established between the government and the Bank on (a) its total assistance package over a specified (three to five years) time period, and (b) the actions to be undertaken by the government, over the same time period, then all or part of the Bank's assistance package and the government's actions could be made dependent on one another. Whichever approach is taken, a credible and effective policy dialogue, based on substantive and detailed economic analysis, will be a sine qua non. The dialogue must also be flexible and realistic in reaching agreements on policy reform with governments; but once agreement has been reached, the Bank, to retain its credibility, must be inflexible in its insistence on compliance barring, of course, major environmental changes. In the final analysis, the flexibility required can only be achieved if the consequences of non-compliance, once an agreement has been reached, are unequivocal.

5.24 A crucial issue relates to IDA countries. These are not only the most in need of the Bank's financial resources, but also most in need of fundamental policy and institutional reforms. Furthermore, except for some countries like India and China, Bank lending as a share of each such country's development budget is quite significant; thus Bank leverage is not trivial. This is particularly true for Sub-Saharan Africa. How should the Bank approach reforms in such countries? One approach would be to allocate IDA funds, as now, to the group of countries who make up the poorest of the poor, but within this group, reward those who undertake reforms at the expense of those who do not (subject to a "core" lending program discussed later). The rationale for this approach is that once a total allocation (of IDA) has been made to this low-income group (on humanitarian and charitable grounds), within this group there are no a priori reasons to be indifferent to reforms; on the contrary, since many of these countries desperately need to change their economic policies, the Bank should use all of its instruments and influence to encourage such reforms. An alternate approach, suggested by some, would be an equi-proportionate distribution on some principle so that every country gets a

^{1/} It should be recognized that this acceleration clause is the Bank's biggest "stick." If there is any expectation of using it, then two conditions would need to be made explicit: first, the inclusion of a default in the performance of specified "macro" covenants in the list of events giving the Bank the right to accelerate (this is not the case now); and second, upon such a default, a decision on the part of the Bank to exercise its right of acceleration.

certain amount. ^{1/} However, in the next decade, when policy adjustments will be even more critical than the past, such an allocation principle would rob the Bank of an important instrument and convert the Bank into essentially a pure resource transfer institution with questionable prospects for improving the plight of these countries. The first approach suggested above clearly implies increased selectivity of countries on part of the Bank; this theme is picked up again in Chapter 6.

5.25 Increased focus on policy and institutional reforms will make the Bank's product more labor-intensive than in the past; this will require efficiency gains in the Bank's operations, particularly in a low- or no-growth situation. These gains may come about through a variety of mechanisms, e.g., streamlining the internal operations of the Bank (e.g., document processing requirements) to permit scarce resources to be used more effectively. This shift will also require the development (clearer articulation?) of country performance criteria to judge progress towards policy reform. Furthermore, country teams should be held responsible to make explicit their approaches to conditionality at the lending program, sectoral, subsectoral and project levels. The resulting product, so formulated, should be justified and evaluated with reference to the overall country assistance strategy.

Maintaining the Flexibility of Country Lending Programs

5.26 In order for the Bank to maximize its impact on a country's development using its lending program, key development investments, institutions or policies would have to be identified which would benefit substantially from Bank lending. The Bank would, therefore, lend for activities which the governments might not have undertaken or which it would have undertaken less, or where the Bank's involvement would beneficially affect the way in which the activity is carried out (e.g., technological design or institutional improvements) or which would bring about policy changes which might not have occurred without Bank lending, whether at the micro, subsectoral, sectoral or macro level. Bank loans can, in principle, have all these aspects, but it is indispensable that they have at least one of them. However, with increased product diversification, the Bank's objective of transferring resources to the developing countries may be, at least partly, compromised under the increased conditionalities that accompany lending operations designed to bring about policy and/or institutional changes. To some extent, this will be inevitable if the Bank is to maintain its credibility regarding its commitment to fundamental policy and institutional reforms. On the other hand, since the Bank is involved in the long-term development of its member countries, it must maintain a long-term relationship with these countries; this, however, is a position that may, at times, conflict with increased conditionality. Also, an on-again/off-again lending policy within a country will neither be in the interest of this institution nor enhance its effectiveness and credibility within the country as a long-term development institution. While this dilemma is not easily resolved, considerable flexibility exists to develop different approaches to ensuring

^{1/} E.g., per capita basis with ceilings for India and China.

the Bank's long-term presence and simultaneously encouraging countries to undertake necessary reforms.

5.27 One approach would be the following. A judgement (made by senior management) would be necessary to determine the minimum level of annual total financial transfers that must be undertaken by the Bank to be consistent with its role as a development institution. The distribution of this minimum level across countries would constitute a "core" lending program--made up of various types of loans--for each country. The "core" level would have to be explicitly derived for each country taking into account country-specific considerations, including some judgement on the minimum amount of financial transfers necessary for the Bank to maintain its long-term presence in that country; this would be some percentage of a country's annual total lending program and would be allocated to operations not expected to encounter difficulties or delays due to policy-related issues. The level of the "core" could change from year to year depending upon country circumstances and conditions; in each year, the "core" would constitute a ceiling. The balance of the program--the "non-core"--would consist of operations (of various types) with implicit or explicit conditionality, where it is made clear to borrowers that funds would not be provided if agreement on appropriate policy or institutional measures cannot be reached. Thus, this amount would constitute "pure" additionality. The Bank could, therefore, continue to maintain a long-term presence in the country with its "core" lending program and still retain some ability to credibly influence policy change. This "core" concept, or a variant of it, is currently being applied in some parts of the Bank as in Egypt and Tanzania. 1/

5.28 The above approach could be combined with the existing multi-year (regional/Bank-wide) lending forecasts. Under the system described, the Bank would have increased flexibility; an annual "core" program would be firm and relatively predictable, but the "non-core" would be flexible and could be adjusted across countries and over time depending on individual country progress in implementing institutional and policy reforms. Depending on the circumstances, it may be appropriate to shift these funds to future policy loans in the country, if there are encouraging prospects of fulfilling conditions in the near future. Or, more generally, as happens now, the unused funds could be allocated to other countries which have undertaken the necessary policy reforms. The Bank can, therefore, project total multi-year lending levels; however, it is in the distribution of that aggregate amount--across countries and over time (three- to five-year horizons?)--that the Bank will retain the flexibility that will be essential as the Bank's product becomes more diversified and the institution moves towards more policy-related lending. One implication of such an approach is that annual lending programs in individual countries may experience wide swings; this, in turn, would have an effect on the programming and budgeting process.

1/ It can (and has) been argued that if the only objective is to maintain a long-term presence in countries, then this does not necessarily require financial transfers from the Bank. To the extent that this is true in particular countries, and there is no acceptable movement on policy change, the "core" lending program can be zero (as will, presumably, be the "non-core" program).

5.29 Some guiding principles may be useful in differentiating the "core" program from the "non-core" program. One suggestion, that would build on the principle of flexibility, would be to let managers determine the types of loans and sectors that would constitute the "core;" their responsibility would be to meet the agreed level of "core" lending. In this way, the manager would make the judgement of what is feasible or not regardless of whether it is a project loan or a multi-sectoral development policy loan with already agreed upon policy/institutional reforms. Another suggestion would be that the "core" program, in general, emphasize increases in physical and human capital formation and be "soft" on policy conditionality. This suggests that the "core" program consist of traditional project loans with conventional covenants to ensure project viability in the physical and human infrastructure sectors such as transport, water supply, power, telecommunications, education, population, health and nutrition. The "non-core" program would then emphasize better resource use and allocation through policy and institutional changes. 1/ One implication of this would be that there would be an inverse relationship between the size of the "core" program and the income level of a country; i.e., in high income countries, the "core" program would be relatively smaller than in low-income countries (and vice versa). This would be consistent with the view that at the low-income end, relatively greater attention should be placed on improving the physical and human infrastructure of the country, whereas at the other extreme, the focus would be on policy and institutional reforms. It would also reflect the importance of a relatively predictable resource transfer to the low-income countries. 2/

Instruments to Stimulate Private Sector Development

5.30 The role of economic policy reform will be critical in encouraging the private sector in developing countries. Given that in many developing countries--such as those in Sub-Saharan Africa and those in the Middle East and some in Latin America--the public sector is a dominating force, the Bank, in the next decade, will have to pay increased attention to involving the domestic and foreign private sector in the development process. The reason for this is that the governments in these countries have limited financial resources and a scarcity of skilled manpower and managerial resources. These

1/ The practical aspects of institutionalizing such an approach within the Bank requires further thought.

2/ One implication of increased conditionality and the resulting possibility of decreased total lending within a country, is the need for the Bank to develop some organizational flexibility for its staff; this is particularly true if there are anticipated long-term declines in the lending program and associated CESW down to the "core" level. In such cases, one approach would be that the released staff resources on individual countries could be temporarily transferred to ERS and OPS to provide Bank-wide services--in support of operations and policy work in different countries--for agreed and specified time periods. This would facilitate much needed cross-fertilization between the central and regional staff of the Bank. There are probably several other ways of addressing this problem and a detailed analysis would be necessary to determine the best solution.

cannot be spread thinly if they are to be effectively utilized. Simultaneously, the private sector is constrained by a variety of rules and regulations and disincentives to expand. Total investments, the productivity of these investments and the efficiency of resource use--and thus growth--would increase if there was a better allocation of both public and private skills and investment resources.

5.31 To stimulate activity in the private sector, policies that affect both domestic and foreign entrepreneurs need to be reformed in many cases. ^{1/} The Bank clearly has a role to play in this process, yet it has limited instruments at its disposal for this purpose. This is partly due to the fact that the Articles of Agreement require government guarantees for Bank loans; most governments, understandably, are reluctant to guarantee Bank loans made directly to the private sector.

5.32 The most frequently used Bank instruments for reaching the private sector are DFC loans--and more recently, SALs and EDF loans which have policy reforms attached to them--and the policy discussions and advice given to the governments through our CESW. Bank loans also assist in the development of the private sector through support to investments in physical and human infrastructure, which act as catalysts for private sector activity. However, in many developing countries, it is the unavailability of credit that acts as a major constraint to private sector activity. The difficulties that planners have had in identifying growth areas suggests that, in many countries, it would be much better to create a financial system that is responsive to market opportunities than to attempt to direct credit through the planning process. The Bank can play a major role in stimulating private activity through the development and the organization of developing countries' financial markets.

5.33 In recent years, the Bank has begun to pay greater attention to countries' financial systems, but thus far the effort has been primarily in the form of studies. Only in a few cases has financial development become a central issue in the policy dialogue and in even fewer cases have projects been designed to develop the financial system. In fact, the Bank's loans for agricultural credit and industrial and housing finance, though passed through financial intermediaries, have had a limited impact on developing an efficient financial system.

5.34 The one aspect of financial policy with which the Bank has been deeply concerned has been interest rates. In order to mobilize funds, the Bank has argued that countries should pay an interest rate on deposits at least equal to the rate of inflation; but in terms of loan conditionality, the Bank has only insisted on positive real interest for the on-lending rate for Bank funds. Hence, while Bank studies have discussed mobilization, the Bank in its policy dialogue and lending program has focussed primarily on allocation. Furthermore, by targeting on-lending to specific subsectors, as has been done with many loans, the Bank has fostered government intervention in credit allocation and the fragmentation of the financial markets. There is now sufficient evidence that using credit allocation mechanisms to channel

^{1/} The details of this issue are being addressed by the Working Group #7 on the Bank's Role vis-a-vis the Private Sector.

funds to investments with high social or economic, but low financial, rates of return is inefficient and can be "successful" only in countries with highly fragmented financial markets. Other issues, such as financial sector regulation, structure of financial markets, competition, efficiency, cost of intermediation, and primary and secondary market development are occasionally mentioned in financial sector studies, but seldom enter into the policy dialogue. In terms of institution building, the Bank has in the past focused on development finance companies, not on the commercial banks and non-bank deposit intermediaries responsible for the bulk of mobilization and credit allocation, nor on the non-depository institutions and markets which provide essential financial services.

5.35 The Bank's sectoral analysis, policy advice, institutional focus and loan design would all have to change if the Bank were to shift its primary focus from using finance to develop various sectors of the economy to the development of an efficient financial system. Analysis would need to be focused on identifying the particular reasons a country's system had failed to mobilize an adequate quantity of financial savings and to allocate these savings efficiently among competing investments. The Bank's lending instruments would include both DPLs and SPLs. Policy advice and loan conditions would be based on economic analysis and would be aimed at eliminating market imperfections in order to build an efficient financial system. The institutions assisted would not be limited to DFCs but would include the entire gamut of intermediaries and markets which comprise the financial system. Fewer Bank loans would be tied to investments in specific subsectors, but would be predicated upon changes in policies designed to make investments in those subsectors profitable. If such investments were made profitable through policy changes, credit allocation would no longer be necessary, and the Bank's institutional efforts could be concentrated on building an efficient financial system that would enhance private sector activity rather than developing institutions whose primary function was to channel government and Bank money to preferred subsectors.

5.36 Consequently, one key issue that the Bank will face in the future is: what should be done with the DFCs? The answer hinges upon the extent to which non-commercial lending to "priority" sectors will continue. In most countries, the Bank should aim to reduce the quantity of priority lending, so that the DFCs can become, over time, multi-purpose institutions providing a range of financial services to the private sector on a commercial basis. The approach suggested above does not rule out all directed lending, particularly in countries with poorly developed financial markets. However, it does represent a change in focus for the Bank and a new agenda for the next decade; i.e., away from using allocated credit to develop various sectors of the economy to improving the efficiency of the financial system itself.

5.37 Concurrently, to stimulate private sector activity, the Bank should continue to address issues of the incentive regime--such as investment licensing, price controls, trade policy biases, export and import controls and regulations, agriculture and energy prices, taxes and subsidies, disincentives through price and regulatory mechanisms that deflect foreign investment, and transportation, distribution and marketing regulations--through a series of DPLs and SPLs covering the relevant sectors in countries where the bias against private sector activity is particularly strong.

5.38 Other actions that the Bank may wish to consider include: urging developed countries to revise protectionist trends and open world markets further; providing advice to countries on the legal structure required, within which the private sector can operate efficiently; taking leadership in establishing a code for foreign investment; assisting in developing mechanisms to insure foreign investments against political risk; developing with the IMF, a standardized debt-reporting system for all countries receiving loans, and providing this information to other lenders of development finance; use of the Bank's guarantee authority; and increasing co-financing. ^{1/} Also, the international market has considerably less information about investment opportunities in developing countries because investments in these countries represent a small share of most foreign investors' portfolio and because of poor quality or restricted data from the countries themselves. This suggests that through information dissemination (for a fee?) the Bank could mitigate some of the perceived risks to potential investors. ^{2/} One reason that it is important for the Bank to pay attention to its impact on foreign private investments is that these flows are large and in the future, private foreign investment will become even more important in a developing world facing financial constraints on the part of commercial and official lending.

Approaches to the Development of Public Sector Institutions

5.39 The previous section has focused primarily on issues of economic policy reform. But as development experience has demonstrated, institutional development is an important corollary of policy reform. There are several symptoms of institutional failure in developing countries. For example, individual projects often fail to achieve their qualitative and quantitative goals because implementing institutions fail to perform the tasks expected of them; e.g., roads and irrigation canals deteriorate because of lack of maintenance; cost overruns because of implementation delays in staffing, procurement and management of finance; and production goals are not met because of delays in the delivery of imports. In addition, the high costs and unavailability of services intended to be provided by public sector institutions--such as health, education, housing and transportation services--and the fiscal drain imposed by many public sector enterprises, all point to various forms of institutional failure. The causes of such failure are fairly similar across countries and, inter alia, include inadequate funds, lack of skilled staff, lack of management systems and experience, insufficient incentives for managers, public sector pathology, ^{3/} and an inappropriate policy environment.

5.40 This last reason is important because it is not a factor "internal" to the institution, but rather an external factor--government policies--and

^{1/} Most of the issues in this paragraph are being addressed in detail by other working groups on the Future Role of the Bank.

^{2/} This would have to be done with the approval of the governments involved in order to avoid breach of confidentiality.

^{3/} Public enterprises tend to work under management systems which favor the control of processes over that of outcomes and which often lead to inefficiency.

because it highlights the relationship between institutional development and policy reform. It is often stated that a strong institutional base is a necessary condition for policy reforms. This proposition is clearly true as economic policy reforms cannot be sustained in an environment of weak institutions. However, the effects of the policy environment on institutional development should not be underestimated; an improper policy environment can hinder institutional development and cause institutional failure. For example, in the agriculture sector, an institution will not be successful in enticing farmers to adopt a new technology (through extension) if producer prices are not attractive; or a parastatal will not minimize costs if it is given a monopoly position in its market or if it is protected heavily by restricting private sector activity through legislation or investment licenses or by restricting competing imports through trade policy. Similarly, public and private sector financial institutions, in many countries, are hampered from developing by a policy environment that provides disincentives to these institutions to mobilize resources and to develop longer term financial instruments; thus, the financial intermediation process, of which institutional development is an integral part, is retarded. These examples indicate that the causality between institutional development and policy reforms runs both ways. The implications of this are that institutional and policy reforms must accompany one another. On one hand, this makes the task of institutional development--which by its very nature is a long term proposition--even more difficult. On the other, creating a proper policy environment may assist the development of institutions, if the appropriate incentives to grow are there.

5.41 The complexity of the task ahead for developing countries and the Bank in this area cannot be underestimated. Despite its experience, the Bank is ill-prepared; it currently has very few people specialized in these matters and even fewer working exclusively on them. More importantly, there are no clear and effective approaches to institutional development either within the Bank or outside; there are no models which can be evaluated and which can be used as a reference for measuring progress. This problem reflects the fact that institutions are extremely diverse and complex and cannot be treated as a homogeneous group. There is no "theory" that explains the efficient development of institutions (though there are several theories on the growth and behavior of bureaucracies). However, given the importance of this issue, particularly in low-income countries, the Bank has little option but to keep trying new ways and experiments; there is no alternative to a trial-and-error approach. Clearly, progress will only come if the lessons of experience derived from this approach are incorporated into future measures the Bank may take.

5.42 The Bank, currently, has a panoply of instruments for achieving institutional development at the project and the sector level: pilot projects, free-standing TA projects, and sector policy loans. While these instruments have generally not been systematically used in the context of institutional development, experience indicates that through project lending, the Bank has been relatively successful in developing project implementing institutions (e.g., PLN, the state electricity company in Indonesia; PUSRI, the state fertilizer company in Indonesia; and TANESCO, the Tanzanian electricity company). This suggests that in countries that are weak institutionally (Africa and some in Asia and EMENA), institutional development should continue to be the focus at the project and sector level much along present lines, i.e., of operations combining investments and institutional development

components, but with a much greater emphasis on the latter and a more explicit strategy for institutional development efforts.

5.43 Nevertheless, as discussed earlier, the Bank's capacity to develop institutions has remained limited. Part of the reason may lie in the limited use of the range of instruments the Bank has used in the past. Since institutional issues arise at various levels of the structure, a more flexible use of instruments may help. Thus, the suggestion made earlier (para. ____)--that the Bank target its policy reform conditionality to specific lending instruments--can apply equally to specific issues of institutional development. Thus, if the concerns are at the project level, then project loans would be the appropriate instruments; if they are at the subsector, sector or multi-sectoral level, then SSPLs, SPLs or DPLs, respectively, would be the appropriate instruments. These types of instruments should be increasingly used to make "free standing" institutional development loans. 1/

5.44 The "macro" aspects of institutional development or public sector management--i.e., the institutional and managerial aspects of economic and financial management and traditional public administration--deserve special attention from the Bank. Until about 1980, the Bank had had relatively little experience in lending for improving institutions that have country-wide responsibilities. The major exception was planning, for which Bank or Bank-executed assistance has been provided in more than 20 countries since 1970. The picture has been changing very rapidly over the last four or five years; the portfolio in public sector management has become much larger and is growing fast. 2/ Structural adjustment lending has been one important force behind this growth. SALs have produced a very large increase in Bank support for institutional reforms in recipient countries. 3/ The second major factor in the growth of public sector management lending is the African economic crisis, and the long-standing decline of African institutions. 4/

1/ Chapter 6, discusses the use of these instruments for institutional development in more detail within the context of countries in Sub-Saharan Africa.

2/ A preliminary estimate shows at least 40 current lending operations with a substantial public sector management component, in the sense defined above, in over 30 countries. Most of these have been approved since 1980, and there is every indication that the pipeline is continuing to build.

3/ All 16 SAL countries to date, and 27 out of 28 SAL operations, have incorporated institutional improvements in economic and financial management. Five countries (7 operations) have included public administration reforms in SAL programs.

4/ Twenty African countries (25 operations) are, or soon will be, recipients of lending in this field. However, public sector management lending is neither confined to SAL-related operations nor to Africa. There are also free-standing operations underway or in preparation, for example, in Peru, Chile, Bangladesh and Papua New Guinea.

5.45 Despite these advances, there is not yet a fully satisfactory lending vehicle for supporting public sector management. Technical assistance is the main mode, and often suffers from the general problem of "institutional" as against "engineering" technical assistance, i.e., problems of government commitment, inadequate design, a tendency to plug holes rather than think through institutional development strategies and widely differing estimates of feasible objectives. Technical assistance projects which have emerged have severe limitations, particularly given their small size--(can we really expect governments to take difficult decisions in the area of administrative reforms for \$5 million to \$10 million?)--and have, therefore, been quite inadequate as a means to address the large problems of performance of the core institutional system. Where public sector management reform has been directly supported by SALs, similar problems have sometimes been encountered with the lack of clear procedures for securing SAL counterpart funding for management reform initiatives.

5.46 There is also evidence that inexperience is a problem; the staff and the Bank, in general, are at an early stage in the learning process in this area. ^{1/} Furthermore, it is also the case that careful preliminary CESW specifically addressed to these issues pays off in designing assistance. Some innovations were made in Thailand, where the major institutional initiatives in the two SALs were built upon detailed institutional reviews carried out by the Bank. The same holds true, to a degree, for the Jamaica SALs and the second technical assistance loan in support of public sector management reforms in Papua New Guinea which, while still in the very early stages, is built on a thorough review of development administration problems.

5.47 One approach for the future would be to integrate public sector management lending with economic policy-based loans such as DPLs, where possible; this would develop and strengthen the emerging pattern under SALs. This would place public management reform within a policy framework, and also within a context of substantial resource transfer. At the same time, it might well increase the acceptability of policy reform by offering a package in which the Bank was also explicitly supporting the development of national capacity for policy analysis, formulation and execution. The major justification for this approach, however, is that improved public institutional capacity is important to the sustainability of policy change over the longer term.

5.48 In principle, such "policy and institutional reform loans" could be sectoral or macro in character (as appropriate) and could include rapid as well as slower-disbursing investment elements (e.g., in the context of public sector financial restructuring), which would be on a time track closer to the pace of institutional change; this would partly deal with some of the time disparities experienced in SALs. The starting points for Bank support to (macro) public sector management are, first, policy analysis and second, economic and financial management, including the budgeting process, public

^{1/} It appears, for example, that the newest batch of projects in this field in West Africa--e.g., in Niger, Mali and Guinea Bissau--have a broader scope, somewhat clearer focus and more integrated design than some earlier technical assistance efforts in this field in the Region.

sector investment program management, accounting and the public enterprise financing and control systems. This would permit the Bank to proceed in lending operations in the public sector management field from what it knows, towards newer areas and, at the same time, to retain the major emphasis on the importance of an appropriate policy environment to promote efficiency and institutional capacity and foster economic growth.

5.49 Although there will be some role for free-standing public sector management projects, the major challenge seems to be to fashion these policy/institutional hybrids with the flexibility of SALs, but incorporating much more systematic and carefully designed support for institutional reform. This also requires more, and more professional, attention to public sector management in CESW and in the design of operations than has generally been the case in the past. The Bank is at an early point in that task with demand for work in this field outstripping present capacity.

5.50 The discussion, so far, has implicitly assumed that public sector involvement and strengthening is desirable and necessary. Clearly, this is true in many cases and, therefore, for all practical purposes, institutional development means the strengthening of the public sector. To the extent that the public sector is considered necessary in certain functions (e.g., public utilities, roads, ports, etc.), the argument for the support of institutional development is obvious. There may, however, be certain areas where the participation of the public sector may not be necessary or desirable. In those circumstances, one could argue for the reduction of the public sector. In many countries (such as several in Sub-Saharan Africa), and in many functions, the public sector has grown to be so large and/or inefficient as to be a hindrance to economic development and growth. This suggests that a central element in country or sector institutional development strategies is the need for selectivity. An effective strategy should identify not only those institutions that ought to be strengthened, and how, but also those that need to be reformed, and those that should be reduced, merged with others, or eliminated. Until now, these issues have received relatively less attention by the Bank, which has concentrated on those institutions that need strengthening. But, given the financial, managerial and administrative constraints facing many governments, one of the Bank's most effective contributions could be to help countries in achieving a restructuring or even a dismantling of selected institutions, such as some marketing boards in agriculture and certain public enterprises in industry, where public sector involvement is either unnecessary or even a hindrance to the smooth and efficient functioning of the economy. This is already being done for certain marketing boards in some African countries.

5.51 There are a wide range of alternatives to strengthening and expanding public sector institutions. Over, the next decade, when many governments will be facing financial constraints and will be under increased pressure to reduce their deficits, the Bank can be an effective catalyst to support such reforms. For example, in many countries, the privatization of delivery of selected services is a viable and effective way to reduce the fiscal burden. This can be done by deregulating and allowing the private sector to compete with public institutions. Such a strategy may be particularly effective in the areas of urban transport, agricultural input supply and output marketing, primary and secondary school education, and health care. It will free up scarce budgetary and personnel resources for use in more pressing tasks that can only be performed by the public sector.

5.52 Contracting-out of services is another possibility. Rather than attempt to deliver various services itself, the government can contract with private firms. For example, municipal bodies in many countries have experimented with several contracting arrangements and rely heavily on this general mechanism; the services that can be contracted out range from garbage collection to road maintenance. Successful contract experience can be cited in several developing countries such as Senegal (transport sector); Argentina (trash collection in Buenos Aires); Yugoslavia, Brazil, Nigeria and Argentina (road maintenance).

5.53 Divestiture of public enterprises and commodity producing parastatals is a third possibility. This may be difficult to accomplish, in practice, for the simple reason that governments do not generally wish to sell profitable enterprises while private parties do not wish to buy unprofitable ones. The arguments for such divestiture, however, arise from the finite limits to the states financial resources and managerial abilities and from the fact that this policy makes available funds which can be used to invest in the social and infrastructure sectors in which the private sector is unlikely to enter. This policy has been adopted by several countries such as Argentina, Brazil, Japan, Korea and Singapore in the belief that the continued efficiency of production would be better ensured by private investors using their own resources rather than by managers of public enterprises. The difficulties associated with the mechanisms of divestiture are many and the Bank has not had sufficient experience in advising governments in this area. The Bank's recent experience in Peru should be instructive. Where such a policy is not feasible, Bank efforts should be directed at improving the performance of public enterprises through sectoral policy loans. This could include substantial capital support to selected public enterprises, policy conditions for release of funds, as well as provision for technical assistance and training.

5.54 The above suggests that the Bank's own project work be guided by the broader principles of systemic reform rather than the establishment or the proliferation of numerous new project-level entities and institutions designed specifically to ensure the success of Bank projects. To the extent possible, existing institutions should be used. An alternative approach would be to design projects so as to minimize the involvement of public sector institutions and to economize on scarce technical and managerial resources; this could imply an emphasis on small-scale decentralized projects rather than large, centrally administered ones and the incorporation of private sector units into project design. Finally, future Bank lending to large-scale public enterprises, when undertaken, should be in the context of participation (in the sector or the enterprise) by private investment and finance and to increased competition from domestic producers and from foreign trade.

The Role of Country Economic and Sector Work

5.55 The country economic and sector work (CESW) program of the Bank forms the underlying intellectual basis for and constitutes a major input into the Bank lending operations. As has already been discussed, the Bank's inputs into policy analysis and formulation will be of crucial importance, particularly as this institution moves towards a more diversified product. This increased emphasis imposes a special responsibility on the Bank to ensure that its policy analysis and recommendations are of high quality. Furthermore, the quality of research institutions and policy advisers in certain developing

countries is rapidly increasing; in some, the technical quality of individuals may even exceed that of the Bank's staff. This increased domestic competition places an added responsibility on the Bank to retain superior quality staff to ensure high quality advice; the receptivity and the credibility of the Bank's advice on policy and institutional reforms will depend critically on this quality issue. In fact, high-quality analytical work will be a sine qua non for the Bank's future operational product. The current erratic quality may constitute a significant constraint to the future evolution of the Bank.

5.56 With the worsening of the international economic environment after the second oil price increase and the increasing difficulties faced by developing countries, more and more countries have undertaken a serious reappraisal and reorientation of economic policies and institutions and have turned to the Bank and the Fund for specific advice and support in carrying out structural reform. These changing needs have influenced CESW in several ways, such as the shift away from "basic" reports to more policy-relevant analysis; a sharper focus on policy issues relevant to medium-term structural adjustment at the macro and the sector level; and finally, a more sharply defined audience with increased priority to reaching policymakers.

5.57 While pragmatic responses to the changing needs of the situation supported by the measures indicated above have improved the relevance, effectiveness and efficiency of CESW, there is still scope for significant progress. One major problem is that, in the elaboration of a country assistance strategy, the relative roles of lending and CESW and their inter-relationship are often not addressed. 1/ While CESW without close integration with operations tends too often to result in polite debate on broad issues, the SAL operations, introduced in 1980, have provided an effective medium; they brought CESW into the forefront to provide the needed underpinnings for programs of specific measures and policy changes. With the availability of this medium, the message has to be elaborated, sharpened and focused, particularly if policy-linked lending is to be broadened.

5.58 Indeed, such a program should not only support an active policy dialogue and policy-based lending, but also monitor the policy changes and their effects. Furthermore, the worsening of the international economic environment in recent years and the increasing difficulties faced by developing countries suggests a need for CESW to provide the basis for specific (rather than generalized) measures of reform. This is crucial if the Bank is to effectively channel its conclusions and recommendations through an active policy dialogue and policy-based lending into actual policy reform.

5.59 On a country level, the Bank's overall policy effectiveness is probably first and foremost a function of the quality and timeliness of the Bank's CESW and of its capacity to convince governments in a politically acceptable manner. While there may be good reasons for differences between the

1/ A three-year rolling Country Work Program (CWP) translating the medium-term country assistance strategy into an adequately budgeted set of country specific tasks and operations, including CESW, lending, aid coordination and other work is being experimented with as a way to deal with this problem.

regions in the nature and direction of their CESW, there are three areas requiring Bank-wide improvement if the Bank is to increase its policy effectiveness through CESW. First, the Bank must learn how to better "sell" its CESW. This often requires special skills and the drafters of a report are not always the best salesmen. This is a little recognized, but widespread problem in the Bank which underlies a lot of frustration and failure; this is the issue of economic diplomacy which the Bank needs to address more consciously. Second, as mentioned before, there remains an urgent need for stronger links between CESW and effective conditionality. Only for SALs and similar operations is the link clearly established (although effectiveness is not assured by this). For most traditional operations, however, conditionality remains largely the responsibility of project officers, loan officers and lawyers who are frequently not in the best position to place such conditionality into proper country or sectoral perspective. Third, the management and supervision of project-financed (CESW-type) studies, which are often a multiple of Bank-financed CESW, should be clearly linked to the Bank's CESW. This is an area where much remains to be done, and the scope for reduction in waste and duplicative effort may be large.

5.60 In determining the appropriate "mix" of the assistance package and the right focus of CESW, the emphasis should be on specific country capacities and needs. However, relevant in most member countries would be issues relating to improving the efficiency of resource use, through the elimination of major price and trade policy distortions, including costly subsidy programs; reductions in government deficits, particularly through rationalizing public sector investment and expenditure programs and public enterprises; and the development and strengthening of institutions and, particularly, improving public enterprise management and public sector administration.

5.61 The issue of subsidies warrants special attention. Currently, most adjustment programs supported by SALs involve an increase in the relative price of exportables and importables and/or a decline in the general level of government expenditures so as to bring aggregate demand in line with aggregate supply. The effect of these actions is usually an increase in the relative price of foods (particularly cereals, which is the main traded good) and a reduction in the degree of subsidization in the economy, either of food commodities or public services. An important part of the Bank's future analytical work should be to minimize the distributive impact of these measures by retargeting and phasing the new (lower) level of aggregate subsidy in the economy. This work should identify specific foods which are basically consumed by low-income groups or specific programs directly targeted to the most vulnerable groups (e.g., school feeding programs). Regarding public services, the objective should not be to cut the provision of services across the board to maintain the present levels of per capita subsidization; cross-subsidization should be attempted. For example, user charges should be implemented for urban-curative medicine while the per capita subsidy is maintained for rural preventive health; or, charges for higher education should be implemented so that the educational subsidy can be concentrated on primary education. The sector departments in OPS should develop a capability to evaluate quickly these options in the design of new policy-based loans.

5.62 Furthermore, developing stronger links between CESW and the Bank's lending operations suggests that the economic analysis undertaken must identify and place greater emphasis on the factors inhibiting policy reform.

Consequently, greater attention needs to be placed on: (a) the political economy of policy change; (b) the economic (and, if appropriate, the political) implications of policy reforms; (c) identification of more efficient ways of achieving non-economic objectives of the government; (d) the adjustment costs during the transition period; (e) how to implement policy changes during the transition period; (f) transmitting the lessons of successful and unsuccessful approaches to policy reform to decision-makers in borrowing countries; (g) the relationship between short-term stabilization and adjustment and long-term growth; and (h) careful reviews of public expenditure programs with a view to identifying marginal projects and the "white elephants."

5.63 Addressing many of these areas will be difficult. In many cases, no research has been done, even in academia; in some cases there are no theoretical foundations and in others there is no empirical basis. Where research has been done, it is too general, abstract and not easily amenable to giving detailed and specific policy advice. Thus, the task ahead for those on the "front lines" will not be easy, particularly given the every day demands on their time. It is, therefore, evident that CESW is unlikely to show much progress in adequately addressing some of the indicated issues in a systematic fashion for some time. Consequently, to ensure that the proper groundwork is laid, Bank research has a major role to play in providing the intellectual foundations for the Bank's product and for policy formulation and implementation. By providing useful analytical frameworks, deriving lessons of experience of countries that have undertaken effective and sustained policy and institutional reforms, and developing alternate designs of specific policy packages, the reorientation of research to address the sorts of issues raised in the previous paragraph and to support CESW in this endeavor is of pivotal importance.

5.64 Dissemination of the Bank's CESW to a wider audience--other than governments and official aid agencies--is an issue that also requires consideration. The Bank's CESW has a special character that distinguishes it from work done by other institutions. While noting short-term developments, it typically aims at a medium-term perspective. Also, the background material derived from the Bank's operational experience in many countries with different economic and social systems and problems, enables the Bank to provide an articulation of the relationship between macro, sector and project analysis and to provide some useful advice. Furthermore, the resources devoted to CESW have increased significantly since the 1970s and so has the output of formal and informal economic and sector reports; about 20% of the recorded time of operational staff and about 13% of the total budgeted resources of the institution are at present absorbed by CESW. While comparable data would be difficult to come by, it should be possible to state without contradiction that no other bilateral or multilateral development institution devotes the same volume of staff resources to undertaking such work.

5.65 All of this suggests that the Bank, through its CESW, can play a major catalytic role in influencing the flow of external capital from private investors, commercial banks and official sources to the developing countries. An analysis of the economic state of the Bank's major clients and more importantly, of the major borrowers in the international capital markets would be a significant instrument. In this capacity, the Bank could evaluate and provide information on a country's development strategy and economic policies being pursued as well as on the implications of these policies. The Bank could,

thus, act as a disseminator of information relating to the country's credit-worthiness and, in this way, influence external capital flows; it would support or provide caution to institutions providing finance to developing countries. 1/ Such an approach would have some bearing on the Bank's competitive position, particularly in those middle-income countries that have access to alternate sources of finance without strict policy conditionality and need to restructure their economies. Currently, and for the next few years, this may not apply to the middle-income high debtor countries (e.g., Brazil) where the competition from other sources of finance will be limited; however, this could be very relevant to the middle-income countries of East Asia, e.g., Thailand or Korea, where the Bank funds with conditionality have to compete with private and official sources of external capital. 2/

5.66 There are, however, numerous issues that need to be resolved if the Bank wishes to influence the flow of external capital in this manner. First, can the Bank perform this function while still protecting the confidentiality of information it receives on the basis of a privileged relationship with a member government? Second, is our present system of providing semi-public access to Bank documents adequate to influence capital flows? And third, what are the implications of the above for the Bank's relationship with its borrowers? Addressing these issues is clearly beyond the scope of this paper and warrants further consideration.

1/ For a view of the private banking community on the credibility of Bank analysis, see Chapter 6.

2/ The issue of the market for the Bank's product was discussed in more detail in Chapter 4.

6. ELEMENTS OF THE BANK'S ASSISTANCE

STRATEGIES IN DEVELOPING COUNTRIES

Introduction

6.1 This chapter outlines the elements of different Bank strategies for different groups of countries along the lines of a country typology discussed below. The use of a country typology is designed to facilitate a discussion of common development problems. The purpose here is not to be prescriptive, but rather illustrative as to how the Bank's product--its tool kit, which was discussed in Chapters 4 and 5--can be used under different circumstances which may arise due to country differentiation, sector differentiation or changes over time. Though it has been mentioned earlier (para. ____), it bears repeating that within any particular group of countries--say, Sub-Saharan Africa--there will be considerable variation across countries. Thus, the Bank's product will have to be specifically designed for each individual country setting and will also have to evolve over time. A country-focused approach is, therefore, expected to remain the cornerstone of the Bank's assistance strategies.

A Country Typology

6.2 The diversity and interdependence themes discussed in Chapter 3 make the use of the country typology outlined below a useful organizing framework to discuss the role of the Bank in different groups of countries. The need also emerges in the context of the increasing diversity in the Bank's operations and the product it sells as demanded by the diverse membership of the Bank. For that purpose, a manageable number of country groups has been chosen. The country typology selected for the purpose of this paper divides countries into five groups: Sub-Saharan Africa, China and India, other low-income countries, middle-income high debtors and other middle-income countries. 1/ This particular typology satisfies a number of criteria. First, it follows closely the different development issues related to the level of income. Second, it recognizes the particular and more pressing needs of Africa. Third, it recognizes the large, more populous and relatively closed economies of China and India as special cases. Fourth, it identifies the debt ridden middle-income countries as those with special adjustment problems that are expected to last for at least a decade. Finally, the other low-income and middle-income countries are residual categories, differentiated more by income than location, level of debt obligations or size.

1/ Sub-Saharan Africa, throughout this chapter, refers only to the low-income countries of Sub-Saharan Africa. Annex I provides the criteria and the list of individual countries by each country grouping. In the extreme case, there are obviously 144 country "groups" as each member country has its own unique set of developmental issues and problems which the Bank needs to address in a specific way.

6.3 The major issues, germane to each typology, can be categorized under the following general headings: the maintenance of a stable macroeconomic environment; appropriate pricing policies, including import protection and export promotion policies; the nature of government intervention and public sector management; development of infrastructure; the expansion of the human resource base; and institutional development. It is within this general framework that the principal challenges facing country groups can be examined. A review of the nature and relative importance of these issues for the various country groups is provided in Annex II.

The Bank's Assistance Strategies

6.4 In pursuing growth with equity in the developing world, as was mentioned before, the developing countries and the Bank will jointly have to address ways of increasing physical and human capital formation and improving the productivity of investments and the efficiency of resource use. To address the first problem, domestic resource mobilization, both from the public and the private sectors will be important, as will external capital flows. The second problem would require that attention be paid to institutional reform, the policy environment and the public/private sector mix. It is the solutions to these problems that provide the "entry points" for the Bank's assistance strategies.

6.5 A crucial consideration for the Bank, over the next decade, will be whether it should be a "full-service" institution in every country. The position taken here is that it should not; the Bank may have the capability in the aggregate of providing a full range of services, but it should be selective in the provision of services and in the focus of attention in each country. Consequently, the underlying theme here is that of selectivity of issues/sectors and selectivity of instruments in different countries. Suggestions regarding the choice of issues and sectors suitable for Bank involvement across the many different types of borrowers are difficult to make a priori, in view of the relatively wide variability among countries, even within the illustrative groups, in terms of the relative importance and the nature of particular sectoral problems and issues. Moreover, what differentiates countries in our typology, and is central to the focus of this paper, is more the fashion in which the Bank's product will vary across country groups (even in cases where the same sectors are addressed), than the sectors or issues that will dominate our attention for particular groups. Nevertheless, it will be important that the Bank exercise selectivity in the choice of sectors and issues focused on in individual countries, in order to avoid dissipating its energies and resources and losing the benefits of critical mass, in terms of both leverage and experience. Among the considerations which would naturally figure into the choice of issues and sectors to be addressed in a specific country are: the perceived receptivity of the client to our initiatives in a given sector or issue area, the activities of other donors and financial institutions in a particular sector, the resources we have at our disposal, and the Bank's likely comparative advantage over the planning period. It will be important in the selection process to take a relatively long-term view, recognizing that we may be better off addressing a range of issues in sequence rather than simultaneously.

6.6 Against that background, it is useful to discuss the choice of instruments for different country groups, where it is possible to develop

indicative scenarios regarding the instruments likely to be most relevant and effective for the various groupings. Because of the acute problems facing Sub-Saharan Africa and the middle-income, high-debt countries, relatively greater attention is paid to the Bank's strategy in these two groups than in the other three. Since these two groups also represent the two ends of the income spectrum, and since the purpose here is to be illustrative, not prescriptive, the general principles outlined can be translated to the other three groups.

6.7 As a general rule, for the lower-income countries, all of the Bank's instruments will have to be utilized, while for those at the higher end of the income spectrum, the Bank's activities can focus more on the macro and sectoral levels than on the micro (projects) level. It should be noted that we are dealing here with a continuum along which country groups are arrayed. As one moves along this continuum, the suggested mix of appropriate instruments will change, but one would not expect sharp distinctions between groups at the margin. In Sub-Saharan Africa, for instance, all the Bank's instruments will be required; in the other low-income group, the distribution of lending instruments will shift towards the subsector and sector level; it is suggested that this shift in distribution continue for India/China. For the other middle-income group, the suggested distribution becomes increasingly skewed in favor of sectoral and macro instruments while for the middle-income, high-debt group, the sectoral and macro instruments strongly dominate the project instrument. The discussion that follows outlines the role of different Bank instruments within each country group.

6.8 In Sub-Saharan Africa, over the next decade, both physical and human capital formation and increased efficiency of resource allocation will be extremely important. Also, in this group of countries, more than anywhere else, the Bank must convey the message that getting the prices right is obviously not the end of the development process, but getting them so wrong often is. Given their weak capacity to manage institutional and policy changes, the full flexibility of the Bank's product will have to be called upon--from the project level to the subsector, sector and macro level. Our activities will span the entire product spectrum in order to support individual investments and institutional and policy reform, provide technical assistance, and mobilize external capital from commercial banks as well as from foreign direct investments. Clearly, the Bank's activities in these countries will be extremely labor-intensive and will, over the next decade, require the highest concentration of our staff resources per dollar lent.

6.9 At the project level, these countries will require strong support for design and appraisal, technical assistance in implementation and institution building and training for future cadres; project lending should be directed to alleviating their long-term constraints. It is also essential that projects be redesigned in accordance with the lessons of experience. To a great extent, this applies to intra-sectoral project choice and particularly to agricultural projects; agriculture and livestock projects have not done well in Sub-Saharan Africa and it is important that the causes of failure be analyzed and, if necessary, new approaches be considered. For example, to economize on scarce administrative resources, it may be time to abandon the area-wide agricultural development approach and settle for a progressive farmer-oriented one which encourages innovation and risk-taking and focuses on a smaller number of farmers; i.e., we may want to abandon large extension

efforts and concentrate on the demonstration effects of progressive farmers; similarly, more resources may need to be allocated to basic and adaptive agricultural research since the technical packages available at present are not suited to African conditions. Project experience in Africa has been so disappointing and the nature of the African development problem is so severe that bold innovation is called for.

6.10 Project design should also take into account the fact that implementing institutions are poorly developed in Sub-Saharan Africa and that there is a scarcity of managerial and technical resources; projects should, therefore, be relatively small, simple in design and decentralized, economizing on the scarce resources. The Bank could, for example, alter its portfolio of education projects towards more frequent, smaller, more Bank staff-intensive ones. To curtail delays in project implementation, the principle of project revolving funds could also be established. Experience in many African countries has also shown that a sequence of relatively small projects in the urban sector directly related to policy and institutional issues provides an effective forum in which the advice is more readily accepted.

6.11 In cases where considerable use of public sector institutions is necessary, the project design should include measures to strengthen these institutions or, at any rate, to analyze them to see if they can bear the weight of the project; it may be necessary to pay as much attention to the institutional component of the project as to its physical, production component. Such an effort may even need to span a sequence of projects as a typical project cycle is not long enough to adequately address long-term institutional issues. In many cases, efforts could also be made to incorporate private sector units into project design. Such units may be reasonable substitutes for parastatals in such areas as input supply and output marketing in agricultural projects, urban transport in urban projects, solid waste collection, pharmaceutical management in the health sector, and small and medium enterprise lending (through private commercial banks) in industrial finance projects; such institutions will be increasingly important in the next decade given that the public sector in Sub-Saharan Africa is very large and inefficient and creates serious distortions in the domestic labor and capital markets, distortions which currently continue to hamper development.

6.12 Where necessary, project lending will continue to be the basic vehicle for building local institutions. The Bank's projects, however, should be so designed to enable full use of existing institutions and facilities rather than on creating new ones; this will, in part, entail a greater emphasis on maintenance and rehabilitation. For example, in education, the Bank could focus on rehabilitation and/or subsector maintenance programs where significant proportions of the education sector are deteriorating and endangering economic prospects as in Sierra Leone, Uganda, Ghana, Tanzania and Sudan. This shift from autonomous PMUs to existing institutions is already under way in some countries.

6.13 The Bank can also become more flexible in its disbursement procedures, particularly in the area of local and recurrent costs. The low tax base of most Sub-Saharan Africa countries--especially if they are to be denied revenue from the excessive taxation of agriculture as a consequence of policy reform--makes it difficult to meet local and recurrent costs of projects.

Though this is currently being done, in the future, it may be even more important to finance some of these costs in order to ensure the successful completion of projects and to achieve the maximum benefits. Clearly, this can be done only on a case-by-case basis so as not to commit the Bank to permanent support of the budgets in these countries. This, however, also suggests that increased attention be paid by the Bank to the cost recovery aspects of projects and that the Bank be prepared to experiment in these countries with alternate financing mechanisms, such as user charges, community contributions or voluntary labor.

6.14 The Bank may also consider lending through other institutions such as the African Development Bank and regional organizations such as ECOWAS or the World Food Program. A regional approach may be effective if significant externalities are involved, such as in the case of soil erosion. Several Sahelian countries are affected by soil erosion and a coordinated effort would help all countries, whereas independent strategies may work at cross-purposes. In the past, however, the record of regional cooperation and the experience with regional organizations has been disappointing. Any significant effort in this direction should, therefore, ensure that the expected benefits are likely to exceed what may well be a high-cost effort for the Bank. The use of NGOs may prove to be a superior alternate channel in Sub-Saharan Africa to the formal regional institutions, and increasing use of that avenue should be actively pursued.

6.15 For those Sub-Saharan countries with a few relatively strong sectoral ministries, Sector Policy Loans which, for example, finance time-slices of sectoral or subsectoral public expenditure programs in return for institutional and policy reforms may be more appropriate. For example, in countries like Malawi, Ethiopia and Lesotho, where education policies are generally sound, but could be improved, and where past implementation justifies confidence, sectoral investment programs could be financed. ^{1/} In many countries, the restructuring of sectoral expenditure programs may be necessary and should focus not only on capital expenditures, but also on the recurrent cost components. In some countries, reforms in a particular sector may also be implemented through an overarching sectoral or subsectoral conditionality--which involves an agreed sectoral (or subsectoral) strategy for institutional and policy reforms--combined with the financing of discrete projects with traditional project covenants to ensure project viability; failure to abide by the agreed sectoral strategy would result in reduced or no further project lending.

6.16 In those countries with relatively stronger central institutions--such as in Kenya, Senegal and Malawi where several SAL programs are currently being launched--the use of macro loans, such as Development Policy Loans may be effective instruments to cover a broad range of policy issues addressing the macroeconomic environment; these could include trade policy reforms, public expenditure reforms, and a variety of multi-sectoral issues--such as those in agriculture, education and transport--where the urgency for reform is very high. For example, in agriculture, the functioning of marketing boards,

^{1/} For sectors with competent management and sound policies, transport sector programs, or slices of them, have been financed in Ethiopia and Kenya.

export taxes, and domestic pricing policies would be the major issues. In education, unsound practices which significantly constrain economic efficiency would be priority areas for reform. Deregulation, combined with the easing of import restrictions on purchases of spare parts, handling equipment and vehicles, and the alignment of fuel prices would be examples of transport policy reforms.

6.17 In many Sub-Saharan African countries, the Bank may also consider using Development Policy Loans or sector policy loans to encourage institutional reforms. Disbursements for these loans could take place against any necessary activity that would improve the functioning of the economy; e.g., recurrent costs, local costs, increases in salaries, imports, etc. Within a sector, a sector policy loan can be used to reform a particular sectoral institution, such as a cotton or tea authority or the Ministry of Agriculture. For example, consultants may be financed to set up a management information system or restructure the financial, accounting and auditing systems. There would not necessarily be a production component to such loans; they could focus only on the key changes needed to be made in the institutions; i.e., they would be specific loans for institutional reform. This has been done with a succession of loans with cotton growing, processing and marketing institutions in Sudan.

6.18 There are, however, two caveats. First, it should be recognized that the Bank is entering into uncharted territories here. The Bank does not have much experience with such loans and that it is less well equipped to deal with institutional reforms than with policy reforms. The situation in Sub-Saharan Africa, however, does warrant some moves in this direction from the Bank. Second, there are approximately 80,000 technical experts working in Sub-Saharan Africa under various ODA programs. Sub-Saharan Africa is suffering from "TA fatigue;" some resentment appears to be developing within the countries over this issue. Clearly, there is an absorptive capacity question that the Bank must address. Can Sub-Saharan Africa absorb so much TA? And is it being used effectively? This is an area in which the Bank should re-examine its strategy very carefully, particularly when various forms of TA are viewed as the solutions to institutional development.

6.19 The efficient allocation of resources in Sub-Saharan Africa requires that attention be paid to the policy environment, particularly for the major tradeable sectors, industry, agriculture and energy. The industrial sector, where the public sector in most of these countries is overwhelmingly dominant, requires close examination. The Bank's role in this sector should not be to encourage new public investments, but rather to encourage policy reforms to stimulate private sector activity, both domestic and, to the extent possible, foreign. This may be best accomplished through its CESW and policy dialogue, providing the necessary assistance to enable this group of countries to formulate and implement the needed sectoral development strategy, by tying industrial policy and institutional reforms to development policy loans/sector policy loans which support restructuring the governments' public expenditure programs and investments in infrastructure, and through financial sector loans. The financing of large, capital-intensive, public sector industrial projects does not appear to constitute an appropriate part of the Bank's assistance strategy in most of Sub-Saharan Africa.

6.20 In encouraging policy reforms to alter the economic environment and stimulate the private sector, the Bank also faces some difficult decisions regarding its role in the financial system that provides the much needed credit for private activities in agriculture and industry. The record of many development banks in these countries is not very good and many will have to be restructured during the next few years. This is not merely a question of refinancing, but of rethinking the role of development banks in these countries' financial systems and the proper model for Sub-Saharan Africa. Should the Bank move away from the DFC approach and reorganize the DFC or should it channel its funds through the commercial banks? One body of thought believes that the Bank's funds should continue to be channelled through development banks, which will continue to have high costs and high arrears, on the grounds that directed credit remains the best option for Africa; this implies that those responsible for the management of the development banks are most suited to direct the credit. Another school believes that the lack of availability of credit for private activities due to government preemption of credit for public enterprises is the problem; the solution, therefore, lies not in directing credit selectively, but in making it available to those activities that have the highest rates of return, whether they be in the public or the private sectors. Accordingly, channelling credit through development banks is not the answer, but rather encouraging development banks to become more like commercial banks and allocate credit to the most efficient activities. Clearly, the Bank must resolve such issues to enhance the financial intermediation process.

6.21 The provision of assistance in various forms will also be crucial in the energy sector, where special features make the management of this sector more complex. Here, the Bank should assist governments in strengthening their management and policymaking capacity by providing assistance directly or through consultants. The need for some assistance is almost universally true for most countries in this group; in its absence--and to the extent that it is not available to these countries from other sources--there is some question as to whether the Bank should be involved at all. Also, as the creditworthiness of these countries improves, mobilizing cofinancing--through export credit agencies and commercial banks--will become an important Bank activity. For projects that involve considerable infrastructure hardware and those that involve early production of oil and gas, the Bank will have to pay very close attention to cofinancing possibilities, and given resource constraints, to the encouragement of private foreign capital through the provision of information and the restructuring of domestic incentives.

6.22 The countries in Sub-Saharan Africa are also by and large extremely vulnerable to the vagaries of the external environment which, in turn, has an impact on these countries' ability to implement and sustain a program of economic reforms. Consequently, some of the more macro loans--such as Development Policy Loans and Sector Policy Loans--should have the fast-disbursement characteristic incorporated into them, subject to proper tranching to ensure policy implementation, so that they can be counter-cyclical. Such loans may also have their disbursements linked, not only to the quality of the implementation of an agreed program of reforms, but also to the countries' terms of trade and export earnings fluctuations.

6.23 Sub-Saharan Africa will also require the highest concentration of IDA lending. The importance of high levels of ODA from all donors also needs to

be emphasized because: (a) Sub-Saharan Africa contains many of the poorest people in the world today; (b) Sub-Saharan Africa's foreign exchange earning prospects are bleak over the medium term because its major exports will face slowly rising prices, and little private commercial money can be expected on account of the limited creditworthiness of the region; and (c) increased aid should increase the prospects of policy reform; conversely, decreased aid, and IDA in particular, will reduce the prospects of much needed reform. The other donors of external capital (private and official) should also be encouraged to associate themselves with Bank loans designed to support macroeconomic and sectoral policy changes. ^{1/} Given the shortage in IDA funds, the Bank should concentrate its financial assistance on those countries within Sub-Saharan Africa that are prepared to undertake the fundamental measures necessary to stimulate economic growth; this implies much greater selectivity of countries on the part of the Bank than in the past.

6.24 The above discussion suggests that the general institutional weakness in low-income Africa should not deter the Bank's involvement in the crucial area of institutional and policy reform, but rather the instruments to achieve such changes would be tailored to the level of institutional development in the country. The importance of this gets magnified if one recognizes the interdependence between institutional development and policy reform; i.e., even though institutions are required to implement policy change, an appropriate policy environment is necessary, though not sufficient, to induce institutional development. What this implies is a more collaborative effort between the Bank and such countries and increasing attention on the part of the Bank to use its lending instruments to support the necessary changes.

6.25 In the recent past, a number of countries have accepted the Bank's advice and taken action in such areas as producer price incentives, reform of marketing parastatals and exchange rate policies. The results, however, have not been, as positive as hoped because: (i) Sub-Saharan Africa countries have been hit by a sharp decline in prices of commodities in the last two years, just as they were liberalizing their policies; (ii) some of the reforms have been piecemeal, insufficient and superficial reflecting, among other things, the political opposition; and, as suggested earlier (para. ____), (iii) some governments simply do not have the technology and administrative capability to develop and implement programs of policy reforms as yet.

6.26 This suggests that the manner in which the Bank carries out its economic work is as important as the work itself. Working closely with our counterparts (a form of institution building) will be essential, not only for them, but also for the Bank in developing a greater understanding of the factors inhibiting reforms. Progress will be slow and time horizons must be longer in Sub-Saharan Africa than in the other groups of countries. Given the generally low level of skills and education, more than in any other region, the Bank will have to invest significant resources to convince policymakers of the potential benefits of policy reform, assist them in the implementation of such reforms and transmit the lessons of successful experiences from other countries.

^{1/} The exact mechanisms by which this could be done will vary by country and warrants additional thought.

6.27 The use of Bank instruments in the other low-income group will also have to span the full range, from the project to the macro level. The institutions, in some of these countries, are stronger than those in most of the countries of Sub-Saharan Africa, and this may permit greater flexibility in using subsector and Sector Policy Loans (e.g., as in Pakistan). These instruments can be used to increase producer incentives in agriculture, enhance exports, and assist in correcting management and institutional deficiencies in selected sectors. Most of the issues raised regarding the use of different types of Bank instruments in Sub-Saharan Africa can be translated, with suitable modifications, to this group and does not warrant repeating; the principles are clear.

6.28 In India and China, the institutional structures are far better developed than in the previous two groups; this suggests the potential feasibility of using macro instruments such as Development Policy Loans to bring about policy and institutional changes. However, neither China nor India has expressed any interest in SALs and, given the size of their economies and their sensitivity to any broad conditionality, it is clear that the multi-sector Development Policy Loan approach is not likely to be employed, at least in the near future.

6.29 However, the logic of moving to broader subsector and sector instruments in order to properly address the crucial policy and institutional issues--which should provide the major focus of our work in these countries--is strong. The issue, therefore, is the willingness on the part of these borrowers to move to discuss these broader issues and accept subsector and Sector Policy Loans, initially on the institutional side, but, over time, to include issues of economic policy reform. For example, State-wide sector and Subsector Policy Loans would be very effective instruments to bring about policy and institutional changes in the agriculture sector in India. Accomplishing this will, however, require an ability to provide appropriate incentives to China and India. If the approach suggested for Sector and Subsector Policy Loans offers the feature of more flexible use and rapid disbursement of financing and it is clearly established that funding can be awarded on the basis of past performance--as opposed to the incremental actions which are typically required in present lending operations--these instruments might become more attractive to these countries.

6.30 Project lending would continue to be a suitable instrument for the development of physical and human infrastructure. Power investments, in particular, might be highlighted, but other investments in the energy sector would also be an appropriate focus of Bank attention. The one issue that does arise in the energy sector is the importance of ensuring proper coordination of the Bank and the private sector in oil and gas development. Human infrastructure investments have, in the past, played a modest role in India; the proposed China program is not dissimilar, except in education. Clearly, population, health and nutrition issues are important in the two largest countries in the world. However, the fact that formal education lending to India has not been done in the past reflects Indian priorities; this is a clear case where a sectoral specialization decision has been made. In China, a large program of education lending is under development as they have welcomed our technical views and our comparative experience. Overall, the consistent message in this sector would appear to be that, given the modest levels of investments proposed, an ability to provide some policy and insti-

tutional leadership on a particular issue or area should be a necessary condition for Bank involvement. Discrete "one-off" projects would not appear to be a productive use of Bank staff or financial resources. Also, in the general area of human resource development, it should be recognized that there are other donors involved and that the large size of these countries suggests that the Bank locate a few critical areas where its instruments can have sector-wide influence.

6.31 The industrial and financial sectors present interesting challenges in these two countries as efficient industrialization has the potential of being a dynamic source of growth. A major industry and DFC program is proposed for China as a critical element of our effort at opening up that economy and increasing the reliance on markets and pricing. To the extent that this objective is maintained, and a program of projects can be developed to facilitate this, this effort has high priority. In India, where the thrust of our advice has been towards making the industrial sector more competitive internationally, various forms of subsector and Sector Policy Loans would be effective instruments here, but a wide variety of policy issues--spanning the range from administrative and price controls to trade policy reform to credit allocation mechanisms--would need analysis and resolution. Moreover, except when clear and overwhelming policy/institutional objectives are identified, Bank support for large public sector investments may now be inconsistent with a strategy to facilitate the efficient expansion of the industrial sector.

6.32 Related to policy and institutional reforms is the issue of CESW. The CESW programs of both China and India are large, and a continued focus on macroeconomic updating is essential given the importance of these borrowers to the Bank's portfolio; greater selectivity is probably required on sectoral work. If a movement to policy-based lending at the sector or subsector level proves feasible, an expanded sector work program will, obviously, be warranted. If this does not emerge, then the issue of whether significant resources should continue to be allocated to these areas must be reconsidered. While interesting work can no doubt be done, in a constrained Bank environment the priority of such work will be the issue.

6.33 As noted earlier (para. ____), India and China are massive and diverse by any measure. Therefore, even though India has maintained its position as the largest individual borrower for longer than two decades and the China program is projected to expand rapidly to a size similar to that of India's--in FY84 the China program will exceed \$1 billion in commitments--it must be appreciated that programs of this size will represent a very small percentage of the overall resource needs or even the resource requirements of specific sectors and subsectors. This situation underlies the importance of both a clear sense of priorities and well developed strategies for having an impact on government policies and institutions. This concern is particularly relevant in light of the current IDA situation. Given the increased credit-worthiness of India--and assuming that it can be maintained through the future--and the borrowing flexibility available to China in light of its past conservative borrowing practices, the maintenance of large IDA flows to India and increased IDA to China will be critically dependent on an ability to trace the impact of such aid on these countries' future growth prospects. In that context, an additional issue which might also be raised is the extent to which the relative level of IDA funds should be conditional, as suggested for the other groups of countries, on progress in moving towards broader policy and institutional reforms.

6.34 For the middle-income, high-debt group of countries of Latin America, Southeast Asia and the Middle East, improving the macroeconomic environment and policies at the sectoral levels will be much more important than capacity expansion at the project level; this will require a relatively greater use of the Bank's macro instruments such as multi-sectoral Development Policy Loans or Sector Policy Loans, particularly those with fast disbursement characteristics and which address crucial sectoral adjustment issues, rather than micro instruments such as project lending. In some countries, particularly those of the Middle East--where the institutional structures are less well developed than those in East Asia or Latin America--the entire spectrum of instruments may be required, both to address policy issues in the tradeables sectors to support the adjustment process and to enhance institutional reforms and human resource development to lay the foundations for longer-term growth.

6.35 Fast-disbursing Development Policy Loans or Sector Policy Loans can complement the other Bank instruments by playing a counter-cyclical role. This will be an important consideration for these countries since the level of economic activity over the next decade is quite uncertain, and there may be likely economic downturns given the size of the necessary adjustments, future world economic cycles and "humps" in the debt profile. The Bank should, however, only use such instruments when evaluation indicates that the accompanying funds, in combination with the required policy measures, would enhance the quality of their existing and future assets of the country; i.e., increase the country's ability to service debt. This is clearly a crucial point for this country group.

6.36 The policy component of Development Policy Loans would involve encouraging governments to continue with difficult, but necessary policies already undertaken or to undertake specific new changes in their public expenditure programs (investment as well as recurrent expenditures), cost-effectiveness in the social services, reforms in public sector pricing, improvements in public sector efficiency, and the encouragement of private domestic and foreign sectors through changes in trade, financial and fiscal incentives to the tradeable sectors of the economy such as agriculture, industry, energy and services. In addition, such loans could also focus on the "macro" prices of the economy such as the interest rate. Naturally, the focus would vary depending on the precise nature of the problem in each country, but the underlying need to minimize the short-run costs of macroeconomic stabilization and achieve long-term structural adjustment will require coordinated policies in all these countries.

6.37 Various kinds of Sector Policy Loans can be used at the sector and subsector levels to facilitate sectoral/subsectoral changes. As in the case of Development Policy Loans, this type of wholesale lending, in return for sectoral policy reforms, would be increasingly appropriate for the more sophisticated countries of this group such as Argentina, Brazil, Chile, Korea and Mexico where the necessary technical competence exists. For countries such as Turkey, Yugoslavia and the Philippines, Sector Policy Loans could be made only in specific sectors that have substantial institutional capability. In such cases, there should be more emphasis on making use of existing institutional strengths than on developing new institutions. Over the next ten years, the competence of these countries and of their sectoral and project institutions to manage such Sector Policy Loans must increase. This suggests

that though macroeconomic stabilization and adjustment issues will continue to be important, in some countries such as Turkey, Indonesia and Morocco, the Bank also has a role to play in support of institutional and human resource development programs; the longer-term impact of these programs to the adjustment process should not be underestimated.

6.38 The financial sector provides a good example of how a Sector Policy Loan may be used. A crucial aspect of improving the macroeconomic environment relates to these countries' financial systems. In most of these countries, there are important structural problems in these systems. The Bank must, therefore, make sure that it understands the lessons that are to be learned from the recent chaos, e.g., the dangers of inflation; excessive leverage in corporate finance; the problems created when financial institutions are owned by industrialists (as in Chile and Turkey), and how deposit insurance reduces caution (the moral hazard problem). In these countries, the Bank needs to develop new programs and policies--which can be attached to the Sector Policy Loans--to refinance and/or restructure bankrupt corporations. This will, however, require an improvement in the business and financial climate, which makes the Bank's effort dependent on the success of macroeconomic reforms. In the longer run, the Bank could attempt new approaches by lending through investment banks, which would function as apex institutions to review the "deals" and manage the money. This approach would develop a new segment of the financial markets: the investment banks.

6.39 Traditional project lending will remain important in countries such as Indonesia and Egypt where institutions are less well developed and where the debt problem is less pressing. In general, however, the demand for new traditional Bank-financed physical projects in many of the high-debtor countries will be weak over the next five years and will recover only gradually. Fiscal programs are likely to be under tight financial discipline; the return to active new investment programs, thereafter, will depend critically on the speed of domestic adjustment and the resolution of the external financing and trade situation. Thus, in the medium term, the use of Development Policy Loans and Sector Policy Loans, rather than project loans should dominate in this group of countries. Loans at the project level cannot, of course, be totally ruled out. Where necessary, such loans should be for working capital and to support the completion, rehabilitation or maintenance of projects already begun, but have been halted midstream due to fiscal constraints; this, in effect, would be "reverse co-financing" where Bank funds would be used for projects originally financed from some other official or private source.

6.40 The need for increasing flexibility in the use of the Bank's lending instruments also suggests a need for the Bank, in this group of countries, to develop flexible disbursement and repayment schedules. There is sufficient institutional flexibility to permit a phasing of the disbursement schedules and the tranches of Development Policy Loans/Sector Policy Loans to meet the objective of increasing financial transfers subject to appropriate domestic policy adjustments. It is the repayment schedule which warrants further exploration; one approach may be to move to flexible repayment periods in which nominal repayments for periods remain constant; this is, in effect, automatic rescheduling. The implications of this suggestion, however, require further examination.

6.41 A related issue--the dilemma of refinancing--is likely to emerge in the future. The question of whether to refinance, i.e., to lend to ensure that the servicing of previous obligations continues in order to avoid rescheduling on defaults, cannot be resolved here. If unilateral rescheduling on default is likely, the Bank may choose to engage in some lending if it is expected to help resolve the problem. However, significant leverage may be lost with other countries if it is perceived that the Bank will lend simply to avoid write-offs. It is not clear which strategy satisfies the dual goals of promoting economic development and maintaining a strong financial position. The Bank should, however, be in a better position than it is now to analyze the implications--to its member countries and to its own financial standing in the international capital markets--of the low probability outcome of an aborted world economic recovery that may precipitate debt repudiations. Contingency planning for this outcome should not be ignored.

6.42 Within this group of countries, building policies formally into the Bank's lending process would require more monitoring of the constantly changing circumstances and timely review of performance. This suggests more regional staff dealing with policy issues and more active and low-key communication channels. In addition, private commercial lending has become a very important source of external financing, particularly for the Latin American countries; in such cases, the Bank's incremental financial contribution will be small. While external commercial banks and other private lending sources are likely to be more cautious in expanding exposure, they are expected to stay in a big way, both to protect existing assets as well as to realize continuing profits in their traditional banking business in the region. The Regional Development Banks (the IDB and the ADB in particular) will continue to be important sources of alternate finance with, at most, minimal policy conditionality. Thus, the Bank would continue to be only a marginal lender to the most industrialized countries such as Mexico and Brazil. Its leverage would be greater only in those countries where commercial lenders are expected to back off.

6.43 The success of a policy-linked lending program would, therefore, vary, across countries and over time and depend on the level of agreement on policy directions between the Bank and the country. One way to increase the probability of agreement on policy directions would be to put more resources into developing links with the groups that provide technical support to the country policymakers. This will, however, take time to develop, particularly in those countries with a poor human resource base. Most importantly, the use of policy-linked lending would have to rely very heavily on a convincing policy dialogue.

6.44 This has major implications for country economic and sector work in this set of countries. Increasing attention should be paid to debt-related problems, the analysis of public expenditure programs--particularly on the inter-sectoral allocation of cuts in such programs--financial sector analysis, the links between financial policy instruments and the exchange rate, and most importantly, the timing and sequencing of a liberalization policy in the goods and (domestic and external) capital markets. A lack of understanding of this last issue, in both the countries and the Bank, has caused severe economic problems, particularly in some Latin American countries. Also, a closer link between alternative global analyses and the projections and reviews undertaken at the country level would make the Bank more able to provide an "early

warning" of potential problems and, perhaps, be a step ahead in developing programs to prevent further crises. Sector work should also put much attention and focus on anticipating problems (as opposed to reviewing the past), evaluating alternative policy positions and making detailed and specific recommendations. Judgements would have to be made as well about the policy priorities on an inter-sectoral basis, requiring more resources in country economic work and incentives for collaboration among those doing work on different sectors. Major benefits would also accrue to the countries and the Bank from increased collaboration with local institutions, developing informal links with key policymakers and their staff and making use of and encouraging technically sound policy analysis. This process would avoid duplication, improve access to data and institutional insights and catalyze further domestic capability for policy analysis. This should become widespread for the more sophisticated borrowers, and be encouraged, on a selective basis, with the others.

6.45 In the case of the other middle-income countries--a heterogeneous group which includes countries of Latin America, Southeast Asia, Africa and the Middle East--the Bank should focus on improving macroeconomic management and sectoral policies. As with the previous group, policy-linked loans at the macro and sectoral level rather than loans at the micro (project) level could, in general, be the major lending instruments; as before, economic and sector work will continue to play a major role in providing the intellectual foundations for the Bank's involvement.

6.46 The suggested strategy above would require that the Bank become much more a wholesaler of projects, in that it would finance a small share of a large number of projects rather than a large share of single projects. This is not entirely new to some of these countries, but it does require a greater degree of sophistication on the part of the borrowers than is available in some of these countries--particularly those in Africa and the Middle East. As before, this implies a greater focus in those countries on institutional development, training of staff and managers, and increasing the education level in general. Thus, the Bank's expertise in project design, appraisal and supervision will have to be adjusted to transcend the "micro" concerns and to address the broader issues of sectoral policy and organization.

6.47 There are two reasons for the suggested approach: (i) as sectoral issues and constraints are likely to be the key to the development prospects of these countries, more broadly based lending instruments will be more effective in addressing these issues and constraints; and (ii) as the level of Bank funds relative to the overall government investments in a sector will be modest (and are likely to decrease over the next decade) moving towards such lending will provide a framework to remain involved in a reasonable proportion of government investments in a sector. It should, however, be recognized that there will be significant start-up costs in moving to more broadly based lending in this group; for example, reaching agreement with governments on sector policies, and strengthening key entities will be time-consuming activities, much more so than with the previous group.

6.48 In this heterogeneous group of countries, two caveats must also be borne in mind. The first is the recognition of the need for careful phasing in using the more macro loans such as Development Policy Loans and Sector Policy Loans. In some countries, it will take time to identify and resolve

important constraints, reach agreement with governments on a new type of instrument and develop our capabilities in these areas. A transitional lending approach (incorporating a focus on sector issues into a traditional style of project operation) is being attempted broadly in East Asia; this effort requires close monitoring. The second point is that there will be no simple format for policy-linked lending across sectors or countries. Given the nature of the problems, the Bank should clearly focus on the broader issues in these countries. For the moment, the exact focus of lending would depend on the country and may range from broad Development Policy Loans and Sector Policy Loans to Subsector Loans to traditional projects with (project-specific) policy packages attached to them; however, as countries in this group develop, this distribution should become increasingly skewed away from traditional project loans.

6.49 Through the use of Development Policy Loans and Sector Policy Loans, the Bank can assist this group of countries in the necessary structural transformation. For example, in the energy sector, which will become increasingly important as these countries industrialize, the Bank can assist in promoting international investments in exploration and development and in strengthening the institutional and management capacity in these countries through the introduction of new technologies in countries that may be capable, but are shut off from recent developments (as in Romania in enhanced oil recovery), the establishment of new institutions when a new energy source is introduced to the country (as in natural gas in Thailand) and assistance in formulating and implementing sector strategies and energy demand management policies. In the industrial and agricultural sectors, the Bank can assist in bringing about the necessary changes in the trade policy regime and the incentive structures. Lending to large state-owned enterprises deserves much lower priority than in the past; policy considerations should take central place in the Bank's lending operations and be the motivation for the Bank's interest in these groups of countries. In the financial sector, the use of Sector Policy Loans, such as past APEX loans (used in East Asia), could assist in altering various aspects of financial policy; e.g., interest rate policy. In all these cases, the implications for economic and sector work are enormous as it will provide the framework for such forms of lending. The ways in which policy and institutional reforms can be incorporated into Development Policy Loans or Sector Policy Loans and the manner in which aggregate supply can be increased, particularly in the tradeable sectors, are similar to that in the previous group. The material difference lies not so much in the type of policies, but in the degree of adjustments that must take place.

6.50 As these countries gradually move to the upper end of the income scale, they will also have increasing access to external capital markets. The willingness of these countries to accept Bank loans with strict conditionality will then depend upon their willingness to accept the Bank's advice and the extent other sources of funds without conditionality are available to them. Some of these countries, over the next decade, may become intermittent borrowers from the Bank, while for others, particularly those at the upper end, the net resource transfers from the Bank may decline. As mentioned in the case of the high-debtor countries, this may affect the Bank's leverage. Consequently, for this group of countries, high-quality economic and sector work and the ability to "sell" it through its specificity, timeliness and a convincing policy dialogue will be increasingly important, as will be the willingness of the borrowers to improve their economic management. Where the

responsiveness of the borrower is low, as currently in Romania, Algeria and Syria, the Bank should be less willing to respond to the country's need for external funding (subject to a "core" program). Where the willingness is high, as currently in Nigeria and Colombia and the Ivory Coast, the potential for a much more diversified product will open up. Thus, for these countries, the Bank, building on the confidence of its policy analysis, would need to incorporate flexible enforcement features into its various lending instruments, and then have the will to use them.

Bank Assistance Strategies and the Fund in Different Country Groups

6.51 During the 1970s, low-income countries had limited access to commercial flows. ^{1/} In the aftermath of the external shocks, a large number of low-income countries, particularly in Sub-Saharan Africa, have entered into high conditionality programs with the Fund. Effective adjustment of their external accounts still remains an overriding constraint in many of these countries. A clear symptom of this is that many countries, even those which have successfully met the requirements of Fund programs, will face difficulties in meeting the schedule of repayments that comes due to the Fund in the mid-1980s. The necessary growth in exports and domestic production of other tradeables that would have been required to meet these repayments without an undue burden has continued to elude these countries.

6.52 With the benefit of hindsight, it seems difficult to avoid the conclusion that, in many of these programs, the Fund has been excessively optimistic about the ability of these countries to adjust their balance of payments in a manner that is compatible with reasonable levels of economic activity within the time horizon provided for by existing Fund facilities. This is a reflection of several factors. Many of the low-income countries do not have the domestic capacity to identify the types of adjustments that are required on the supply side in order to complement Fund programs that deal primarily with demand management and a small number of key relative prices. Non-price factors, such as inadequate marketing institutions, have held back production, particularly of agricultural products. In the industrial sector, many countries are weighed down by highly inefficient public enterprises that respond extremely sluggishly, if at all, to changes in market signals. Finally, in coping with the immediate effects of external terms of trade shocks, many of the low-income countries have resorted to extremely restrictive trade regimes that have resulted in mounting inefficiencies in the allocation of resources.

6.53 These supply factors result in a production structure that does not adequately reflect comparative advantage, is highly inflexible and very unresponsive to alterations in relative prices. As a result, the loss in economic welfare associated with balance of payments adjustment policies that rely primarily on aggregate demand and exchange rate measures, has tended to

^{1/} This section differentiates the relative roles of the Bank and the Fund between low-income and high-income countries; the high-debt group is treated as a subset of the middle-income countries. The five country groups used earlier were not considered useful in discussing this issue. Various aspects of institutional co-ordination (areas of responsibilities, Bank/Fund cooperation etc.) are addressed in Chapter 7.

be relatively high and disproportionately concentrated on certain key economic groups.

6.54 An effective external adjustment strategy in the low-income countries, more than anywhere else, requires a package of measures that deal with both macroeconomic policies and a wide range of reforms on the production side of the economy. There is a recognition within the IMF that external imbalances in low-income countries are not amenable to correction in a short period of time and do require extensive changes in the pattern of production. However, the Fund has been constrained in the design of programs by the limited expertise available to it. Nor has there evolved an adequate mechanism by which the Fund can tap and channel the expertise within the Bank in order to assist it in the design of adjustment programs. A growing Bank role in assisting governments in formulating and implementing reforms on the production side, as described earlier (para. ____) is, therefore, critical.

6.55 The Bank can muster the sectoral knowledge and expertise that is required to formulate and implement policy changes in areas such as agriculture, transport and industry in order to design reform programs on the production side that can complement Fund programs; the instruments by which this may be accomplished has been discussed. The major danger is that such adjustment packages may be viewed by the country as a substitute for Fund programs rather than complementary to Fund programs; as a result, the Fund has been acutely sensitive about independent Bank initiatives that it feels may undermine its negotiating position. The most striking recent example of such a danger is in Tanzania. An increased Bank role in the design of adjustment programs will require more than the usual degree of consultation with the Fund.

6.56 For those countries likely to face severe debt problems in the next decade, the Bank, the IMF and other donors must now also begin to identify the mechanisms--which may be unique to Sub-Saharan Africa because of the relatively inflexible structure of their economies--to handle debt rescheduling payments; flexible rescheduling schemes tied to the fluctuations in the country's terms of trade may be one approach. Some schemes may implicitly increase the economic subsidy to these countries. Nevertheless, given that political structures are fragile, and that the external environment can exact a heavy toll on these countries, they should have access, not only to subsidized funds, but also to medium- and long-term financial security. Such support should be made explicitly clear to those countries prepared to take bold steps in instituting reforms. To such countries, the Bank should be ready to provide the necessary financial security and, as mentioned earlier (para. ____), at least temporarily, disengage itself from those reluctant to undertake the much needed adjustment measures.

6.57 Most of the middle-income countries have had good access to commercial flows. During the 1970s, many of these countries were able to use private capital markets to finance both temporary balance of payments deficits and increased levels of investment. Very few turned to the IMF for finance, except when serious payments disruptions had occurred and their creditworthiness had been impaired. While the private capital market has substituted for the Fund in providing counter-cyclical finance to the middle-income countries in the normal course of events, there are increasing concerns voiced among

policymakers in the international financial community that such an arrangement has a somewhat fragile basis.

6.58 The experience during the 1970s has indicated that the private capital markets cannot be relied upon on their own to impose a prudent ceiling on the international indebtedness of individual countries; this is most visible in the case of the high-debt group. Private international capital markets do not have adequate mechanisms for monitoring and assessing emerging problems of economic policy in time, or for establishing the necessary discipline for countries to strike the right balance between adjustment measures and financing. There is, therefore, a growing demand for the Fund to play more of a preventive role in regulating external borrowing policies of the less developed countries so as to prevent cycles of "excessive" borrowing from emerging, rather than only becoming deeply involved when a payments crisis has occurred. The ways in which the Fund is likely to expand its regulatory role in this area are unclear. Nevertheless, it is probable that the IMF will begin to make a much more explicit evaluation of the appropriateness of the size, composition and rate of its members' external debt in the context of its Article IV consultations.

6.59 The analytical basis for determining what constitutes the appropriate current account deficit and/or a sustainable debt capacity is still not well developed. It is, however, well recognized that the criteria that are relevant in making judgements about external borrowing policies and in identifying cases of excessive borrowing must include considerations related to long-run trends in GDP, the efficiency of investment and prospects for export growth. Assessments of external borrowing policies cannot, therefore, be conducted except within the context of a comprehensive evaluation of medium-term growth prospects--including the quality of public investment, the appropriateness of the structure of relative prices and the nature of economic returns to the resulting pattern of private investment. If the Bretton Woods institutions are to play some sort of role in shaping and managing external borrowing policies, this cannot be done satisfactorily except as a joint exercise.

6.60 The Bank and the Fund will, therefore, have to both bring to bear their respective expertise in arriving at a synthetic judgement about the appropriateness of external borrowing policies in the middle-income countries. Given the difference in orientation of the two institutions, there will inevitably be differences of opinion. The Bank is likely to place a greater emphasis on growth while the Fund is likely to press for greater conservatism so as to reduce the risks of future debt problems. Some sort of procedure for ironing out these differences and for arriving at a joint decision will be necessary if cooperation is to be effective.

6.61 The quasi-regulatory role outlined above for both the Bank and the IMF is designed to be preventive. However, under the present circumstances, the two institutions will continue for the next few years to be preoccupied with the task of managing middle-income, high-debt economies that are in throes of major balance of payments crises. These crises have generally, but not always been associated with a major rescheduling of commercial debt or a sequence of such reschedulings. The role of the IMF in the aftermath of such crises has been twofold. It has negotiated and agreed upon the broad parameters and targets of macroeconomic policy--e.g., the ratio of the budget deficit to GNP, the rate of inflation, changes in the exchange rate. In

addition, particularly in the most recent crises in Latin America, it has acted as an arbitrator between debtors and creditors in striking some sort of balance between austerity on the part of debtors and increased finance from creditors.

6.62 The ability of the Bank to play a role in assisting these countries to manage the transition period following a payments crisis has varied from country to country. Nevertheless, various initiatives have been taken by the regions and from these the broad outlines of a possibly more activist role for the Bank have emerged. This role is primarily one of supplementing Fund programs with a more detailed agenda of reforms in key areas. On the fiscal side, Fund programs define a set of highly aggregate targets, which, while they provide a disciplining force on the total level of public expenditures, do not necessarily ensure that this is achieved in the most efficient manner. Similarly, with regard to the external accounts, while the Fund does focus on developments in both the nominal and the real exchange rate, it generally does not submit tariff import control policies and export incentive policies to the same degree of rigorous scrutiny. As a consequence, there is little assurance that adjustments in the pattern of demand and supply of imports and exports is achieved in an efficient manner. Thus, where the Bank has played a more activist role, the two main areas of focus have been in the evaluation public investment policies (including the operations of public enterprises) and in the design of trade policy adjustments.

6.63 Because macroeconomic stabilization and structural adjustment must be pursued simultaneously and in a unified way, closer coordination between the Bank and the IMF in the middle-income group, in general, and in the high-debt countries in particular, is of importance. As mentioned above, the IMF has a comparative advantage in aggregate demand policies, but it is not ideally suited to address issues of aggregate supply, which is the Bank's strength; the Bank as several instruments which it could use to affect aggregate supply over the long term. It is the integration of such adjustment policies with short-term stabilization efforts that is essential to ensuring the long term of growth of these countries. But this integration is not easy, as demonstrated by the experiences of Argentina, Brazil, (Chile) and the Philippines; here, trade liberalization programs designed to increase aggregate supply and facilitate long-term adjustments are being slowed down or reversed as governments attempt to stabilize their economies through credit restrictions and import limitations.

6.64 Turkey, Yugoslavia and Morocco provide examples of economies in need of a fundamental structural change that have also gone through balance of payments crises requiring stabilization programs from the IMF. The IMF intervention has included standby arrangements and purchases under the compensatory financing facility, major changes in the financial and fiscal policies, a drastic reduction in their public investment programs and debt rescheduling with commercial banks. This suggests that countries that face severe problems are prepared to accept conditionality providing the funds are fast-disbursing. In such countries, the Bank and the Fund have a complementary role to play because the required economic analysis conducted by both institutions covers much common ground and because the financing provided by each institution, under such strict conditionality, is part of a common package from the borrower's point of view.

6.65 The beginnings of what could become a relatively new and different role for the Bank in this group of countries, vis-a-vis the IMF, are emerging from the various attempts which have been initiated in some of them. The IMF, in each case, has negotiated and agreed to the broad outlines of a stabilization program. The complementary role of the Bank would be to work with the governments to restructure their public expenditure (not just investment) programs, support their resource mobilization efforts in the public and the private sectors, and reform their trade and incentives regime in the industrial, agriculture and (where necessary) the services sector. These adjustment policies could be undertaken through a series of development policy loans/Sector Policy Loans that would provide suitable packages of longer-term financing to assist the governments in implementing the policy changes necessary to meet the IMF targets. Such joint "Economic Adjustments Programs" would require much more explicit, though not necessarily formal, coordination between the Bank and the Fund.

6.66 The recent Moroccan experience is a good example of the demonstration of the complementary roles of the Bank and the Fund. To implement the IMF agreement, the Bank has assisted the government in a reduction of its public investment program and in reforming trade and related financial and fiscal policies. The loan made through an Industrial Trade Policy Adjustment Loan--a form of an Sector Policy Loan--will be used to finance current imports, not the investment program, and will be released in tranches as and when a specified action program is carried out. This is expected to be followed by a series of loans to pursue additional trade and financial policy changes, and reforms in agriculture, education and the public enterprise sectors.

6.67 A related area where a more activist role for the Bank can develop is in its relationships with commercial banks. In the immediate aftermath of a typical balance of payments crisis, particularly in the high-debt countries, the preeminent concerns have been to devise an appropriate rescheduling agreement and then ensure that total expenditures in the crisis country are curtailed in line with resource availability so as to maintain service payments on the restructured levels of debt. Fund programs are the critical component at this stage. Once this has been achieved, the objective of implementing effective long-term adjustment policies becomes one of establishing a basis for restored free access to private capital markets; this is where the Bank can play a major role.

6.68 Conventional wisdom also suggests that coordinating the Bank's activities with commercial lenders would also aid in directing and shaping such flows, particularly to the middle-income high-debt countries and, incidentally, increase the Bank's leverage; this is an issue the Bank can ill afford to ignore. However, there appears to be some question within the banking community about whether a larger Bank financial role would necessarily influence commercial bank flows to these countries. According to some members of this community, even increased access to Bank analysis or increased policy conditionality in Bank lending instruments would have only a marginal effect on the commercial banks' decision-making processes. There also appears to be some skepticism in the banking community about the credibility of the Bank and thus the usefulness of its analysis; the Bank is often perceived as an advocate of increased capital flows rather than as a provider of independent assessments of the nature and quality of economic management. A change in the private market perceptions of the Bank is, therefore, important. Developing

closer links with this community through co-financing, the World Bank's Bank and participating in syndications may alter that perception, particularly as the comparative advantage of the Bank in formulating long-term adjustment programs for these countries is better understood and appreciated.

Bank Strategies and a Changing World Environment

6.69 One important concern is how should the Bank's product change, in different regions, in response to a changing international environment. This aspect has been addressed in a separate study ^{1/} which investigated the implications for the Bank's product under alternative growth scenarios for the different regions of the world. The study concludes that the most plausible low-growth scenario would not imply any significant changes in Bank assistance strategies, except in the case of the middle-income, high-debt group. For these countries, reductions in export growth will lead to difficulties in meeting their debt servicing obligations unless there is widespread restructuring of their outstanding debt. The Bank's role, in this case, would be characterized by even more attention to domestic adjustment measures and this would imply more policy-related lending and resource transfers than in the Central case. In some countries, this may imply that the Bank's portfolio limits have to be exceeded. This may, however, have adverse implications for the Bank in the international capital markets. Consequently, alternative financial arrangements may have to be considered and increased priority be attached to approaches to mobilizing other sources of external capital including the use of Bank guarantees. ^{2/} This analysis, however, refers only to average growth rates in different regions. There are bound to be significant variations around that average necessitating the tailoring of the Bank's product to individual country needs.

6.70 A related issue is how the Bank should respond to unanticipated crises and instability in the world environment. In such circumstances, in most countries, the resource transfer objective will have to dominate the policy reform one. Consequently, some possible Bank approaches include: increasing total level of Bank lending (if possible); increasing disbursements out of existing commitments, i.e., extending and expanding SAPs, if necessary; increasing total lending to the more severely affected countries, at the expense of the less severely affected ones, within a constant level of aggregate Bank lending; creating a refinancing facility which would service country debt service obligations to the Bank; creating a jointly administered Bank-Fund refinancing facility, not limited to refinancing the amount of debt service owed only to the Bank; and providing guarantees to commercial lending. The probability of significant instability in the world environment is currently low, but the fact that this probability exists underscores the need for the Bank to maintain its flexible character over the next decade.

^{1/} "The Future Role of the Bank - The Global Environment to 1995", May 18, 1984. A paper prepared by Working Group # 1 on the Future Role of the Bank.

^{2/} Op. cit. p. 26.

7. INSTITUTIONAL COORDINATION BETWEEN

THE BANK AND THE FUND

Introduction

7.1 The preceding chapter has outlined a variety of areas where issues related to the balance of payments are inextricably linked to issues of economic efficiency and growth. As the Bank's product becomes increasingly diversified, it will become vitally important for the Bank and the Fund to cooperate in the formulation of the policy advice and prescriptions that they provide to their members. Until the early 1970s, the Bank and the Fund had relatively clear and separate identities and responsibilities. The Fund was designed to be an adjustment institution whose short-term loans were specifically directed to the financing of temporary balance of payments deficits and whose major policy focus was the adoption of effective balance of payments adjustment policies. The Bank was conceived of as a development institution whose long-term loans and policy focus were directed to the promotion of growth and the efficient development and use of a country's resources. In and of itself, the future product of the Bank as described in Chapters 4 and 5 would not breach this distinction. As the fundamental purpose of Bank lending would be to increase physical and human capital formation and to improve the efficiency with which resources are used, the focus of Bank lending would, therefore, be mainly on the production and investment aspects of the economy. Since the objective of Fund programs remains the achievement of external adjustment, the emphasis in Fund conditionality would primarily be on the management of aggregate demand. The boundaries between the two institutions have tended to become more blurred primarily because of the profound changes that have occurred in the international economic environment since the mid-1970s. These changes have eroded the analytical distinction between issues related to balance of payments adjustment and issues that are central to economic growth, and thus have made the traditional division of responsibilities between the institutions less clear cut. This chapter, therefore, discusses the possible evolution of the institutional relationships between the IMF and the Bank over the next decade.

The International Environment

7.2 The international economic climate, since the mid-1970s, has been characterized by a succession of shocks. These have included the two oil price increases of the 1970s, the high real interest rate of the last few years and the impact of the global recession on the volume and prices of developing country exports. The large changes in relative prices that have occurred have made it necessary to restructure the economies of many developing countries in a manner that would permit the expansion and diversification of exports and efficient import substitutes. A long-run solution to both the constraints on growth and on the balance of payments has not only required measures to reduce expenditures in line with lower incomes, but a combination of policies to restrain the growth of consumption, raise savings, accelerate investment particularly in such areas as exports, domestic energy production and conservation, and improve the efficiency with which existing resources were used.

7.3 A second factor that has eroded the distinction between short-term balance of payments problems and long-term development problems has been the emergence of commercial banks as a major conduit through which international flows are intermediated. Prior to the 1970s, there was a reasonably clear distinction between finance for trade and development--that was provided by relatively autonomous flows from the international capital market and official sources of long-term credit--and balance of payments finance. The most immediate and obvious symptom of balance of payments difficulties was a loss of foreign reserves. With the dramatic rise in private bank lending to finance the balance of payments deficits of middle-income oil-importing countries, the private banking system effectively took control over the growth, distribution and composition of a large part of international liquidity. The private capital market has, in effect, begun to provide both temporary balance of payments assistance and long-term development finance particularly to the middle-income countries. As a result, issues related to the short-term balance of payments position of a country have become inextricably linked to issues of long-run creditworthiness.

7.4 The expansion in commercial bank lending also resulted in an alleviation of public sector borrowing constraints and thus fed a rapid growth in public investment programs among a large number of the developing countries. Balance of payments crises have therefore generally been associated with fiscal crises as the curtailment of foreign capital inflows has resulted not only in a shortage of foreign exchange, but also a shortage of resources available to the public sector. The process of balance of payments adjustment has, in many situations, necessitated fundamental changes in the scope of public sector activities and the establishment of a much greater degree of oversight and control over public spending agencies. In such circumstances, perhaps more than anywhere else, the activities of the Bank and the Fund have coalesced.

Bank/Fund Cooperation

7.5 While these changes in the international environment have eroded the distinction between balance of payments problems and fundamental problems of economic growth and development, there continue to remain areas where the primary objectives of each institution are quite distinct. The Fund remains the primary institution concerned with providing assistance and devising solutions to cope with temporary balance of payments deficits associated with excess demand pressures and/or cyclical declines in exports. Similarly, the Bank is the lead organization on issues related to investment and resource allocation, especially when these do not impinge directly on the short-term balance of payments situation. Nevertheless, in between these two extremes, there now exist numerous situations where the concerns of both institutions overlap to a much greater degree.

7.6 In these situations, rigid distinctions between the objectives of the Bank and the Fund cannot continue to be made. Thus the Fund, in prescribing lasting balance of payments adjustment measures, is having to broaden the scope of its concerns into areas of resource allocation in which the Bank has traditionally had greater expertise. By the same token, the Bank in its policy prescriptions has had to emphasize those components of resource allocation and investment policy that can have the greatest impact in alleviating the balance of payments constraint to accelerated growth. The fundamental

distinction between the role of the Bank and the Fund is, therefore, not one of objectives, nor that one institution is concerned with the short term and the other with the long term. Rather the distinction is becoming a matter of the inherited experience, expertise and comparative advantage that each institution can bring to bear on the economic problems confronting a large number of the developing countries.

7.7 The resulting need for close Bank/Fund cooperation has, in fact, been accepted by the two institutions for a long time. Periodically, the Bank and the Fund have made joint statements on how to make cooperation effective. The last complete statement was contained in a memorandum on Bank/Fund collaboration prepared in February 1970, the main points of which were incorporated in the Operational Manual Statement No. 5.10 issued in 1971. In these guidelines, it was recognized that the Bank had primary responsibility for the composition and appropriateness of development programs, while the Fund had primary responsibility for exchange rates and restrictive systems, for adjustment of temporary balance of payments disequilibrium, and for the evaluation and design of stabilization programs. In between these two areas, there is a broad range of matters that were recognized as falling within the purview of both institutions.

7.8 In addition to the demarcation of responsibilities, the guidelines outline a comprehensive set of procedures for the exchange of information and documents. Following the introduction of structural adjustment lending by the Bank in 1980, a further review of the agreements on collaboration was conducted. Both institutions agreed that the 1970 understandings continued to be broadly applicable, although the procedures were somewhat modified so as to provide for a more detailed exchange of views in countries where lending for structural adjustment was being considered.

7.9 Some demarcation of responsibilities between the Bank and the Fund is clearly needed in order to avoid problems of conflict which might lead to contradictory or inconsistent advice to member countries. However, except with regard to the nominal exchange rate--which is the only policy instrument, as opposed to policy objective, that is explicitly singled out in the guidelines--the categories outlined in the guidelines are too vague to make them very useful from an operational point of view. Furthermore, the actual content of the policy dialogue and supporting economic work undertaken by the IMF and especially by the Bank do not fit readily into the categories outlined in the guidelines. For example, the Bank's growing involvement in issues of trade policy have inevitably implied that it has taken the lead in policy discussions related to "restrictive systems," a category that is identified as falling within the jurisdiction of the Fund. It needs to be recognized that no simple criterion of demarcation will do justice to the complexities of a relationship that owes a lot to historical circumstances. At a conceptual level, however, the most useful distinction is between the Fund, which as a consequence of its inherited experience, has an expertise in issues related to demand management, and the Bank which, for similar reasons, has more of an expertise on the supply or production side of the economy.

7.10 In operational terms, such a distinction would imply that certain policy instruments--e.g., monetary policies, budget deficits--would clearly fall within the rubric of the Fund while others--e.g., the composition of public investment, pricing policy--would fall within the rubric of the Bank.

The nominal exchange rate impinges both upon the demand side and the supply side. Nevertheless, since exchange rate policy is of particular significance at the time of balance of payments crises when Fund involvement tends to be at its height, there are important and substantive reasons why the nominal exchange rate should fall within the jurisdiction of the Fund.

7.11 While a division of labor is necessary in order to facilitate relationships with our member countries, this should not be allowed to obscure that fact that many policy issues will cut across any boundaries of responsibility. In addition, there are important differences in the nature of each institution's operations and the vehicles by which its policy dialogue is conducted. The Fund, theoretically, does have a continuous relationship with its member through its annual consultation process. However, its impact on policies tends to occur mainly in the context of its lending operations. Fund support is usually required either when there is a major balance of payments financing need and/or when policies have deteriorated beyond a certain critical level. Its ability to provide amounts of finance at a time of crisis will often give it a degree of leverage over policies that are unavailable to the Bank to the same degree. By contrast, the Bank's role in effecting policy change is far less dramatic and more continuous. It, therefore, has a wider range of instruments and more opportunities to play a preventive role in influencing policies prior to the development of a crisis. As a result of these different opportunities for influencing policies, it would be productive for the institution best placed to extend the scope of its policy discussion to areas that are recognized to be, under normal circumstances, the primary responsibility of the other.

7.12 A typical example would be in reference to developments of the real exchange rate in countries which face temporary improvements in their terms of trade. The Bank should clearly be concerned about such developments, particularly as they can have profound effects on the evolution of the balance between the tradeable and non-tradeable sectors of the economy. In such situations, the Fund may have a limited influence and capacity to exercise its responsibility for nominal exchange rate policy. An example where such an arrangement has proved to be useful is in the case of Nigeria.

7.13 The success of current efforts to ensure coordination and cooperation vary considerably from region to region and even within regions between countries; some of this was discussed in Chapter 6. Much depends on both the personalities involved and on the nature of country dialogues. This is inevitable, given the need to retain as much flexibility as possible in the modes of cooperation. In attempting to improve collaboration, it seems counterproductive to dwell too long on efforts to delineate finely each institution's responsibilities. Exactly how the Bank and the Fund approach specific country problems and agree upon a division of labor should be determined at the working level in order to allow for the wide variety of country situations and not be imposed rigidly and uniformly from the top. 1/

1/ See S. Please (forthcoming), op. cit. for a view that a lead institution be nominated in each country.

7.14 Country experience demonstrates that the vital keys to effective collaboration are good relations at the working level and the development of a continuous, informal exchange of information and news. In order to foster such an exchange, the following steps should be emphasized:

- (i) The views of the other institution should be sought - and seriously considered - at an early stage in policy formulation before positions have become frozen as a result of deadlines or management clearances.
- (ii) The current practice of holding periodic joint seminars and workshops to discuss major issues of policy at both regional and country level should be encouraged.
- (iii) The exchange of information should cover both policy discussions in member countries and, in order to facilitate planning, the future work programs of country desks and the timings of future missions. When it is found to be useful, joint missions--which goes beyond merely participating in each other's missions--should be encouraged.

7.15 In addition to these more general procedural measures, a variety of additional steps to improve cooperation in economic policy formulation need to be established. For that purpose, it is useful to break up the areas into three categories: (a) where the Fund's policy discussions impinge upon areas of Bank expertise; (b) where the Bank's policy discussions need to be coordinated with issues under Fund jurisdiction (primarily exchange rate policy); and (c) cooperation in areas of joint responsibility.

The Fund and Areas of Bank Expertise

7.16 In developing its conditionality on supply side issues, the Fund has looked to the Bank for its views on such issues as the size and composition of the investment program, recurrent outlays, pricing policy and other measures of the overall efficiency of resource use. The extent of Bank assistance in this regard has varied from case to case. In situations where the Bank has had a history of involvement in the sector, the formulation of Bank views was relatively easily accomplished. In other cases, however, the Bank's views have been formulated and presented in a very general and perfunctory manner. Managers within the Bank have often not had the incentive to devote the necessary staff resources to developing a well articulated Bank position for what is perceived to be the product of another institution.

7.17 The main difficulties in coordinating Fund involvement in areas of Bank expertise have, therefore, primarily arisen as a result of programming and staff allocation problems. The solution, therefore, lies in the establishment of a more effective mechanism by which the countries, where the Fund is likely to require Bank assistance, can be identified in time and the necessary staff resources deployed. It is, therefore, recommended that the Bank and the Fund conduct periodic joint reviews at the regional level (possibly at the time of the indicative statement) to agree upon a group of countries in each region where the necessary issues such as those related to public investment, pricing and trade policy do require further analysis, and the resources and time horizon for Bank work in support of the Fund.

The Bank and Areas of Fund Jurisdiction

7.18 There is general agreement within both institutions that there are policy issues (e.g., trade policy or agricultural pricing policy) which are of primary concern to the Bank and where it has taken the lead, which have to be closely coordinated with exchange rate policy. However, the Fund, concerned as it is that prescriptions regarding exchange rate policy should not be inconsistent, has resisted the notion that the Bank should take the initiative in policy discussions with the Government on exchange rate policy (except in those cases where Fund involvement in a country is marginal). Thus, there has emerged a recurring conflict between the objective of avoiding inconsistent advice and the equally important objective of ensuring that policy advice to members is both comprehensive and well integrated.

7.19 In establishing a modus operandi which can reconcile these two conflicting objectives, it is important that a distinction be made between analytical work done within the Bank which has an informal status and the official views of the institution as expressed in its official economic documents (i.e., Grey Cover Reports) or in its negotiating position. In those cases where it is felt that exchange rate policy does impinge in a significant way on issues of central importance to the Bank policy dialogue, a study outlining these linkages and tracing out the implications for exchange rate policy should be undertaken. Such studies might be initiated by the Bank separately or jointly with the Fund, but would only be available for internal use and would not be given to the Government. The advantages of such a procedure are twofold. Informal studies would help to sharpen and focus issues more clearly and thus would add an element of rigor that is sometimes lacking during informal exchanges of views between the Bank and the Fund. In addition, joint analysis would facilitate a less doctrinaire approach to the division of labor between the two institutions and thus permit a more flexible approach to policy dialogue in member countries.

Areas of Joint Responsibility

7.20 There exists a large area of economic policy that is recognized to be of mutual concern. The sorts of issues include foreign borrowing policies, interest rates, financial sector policies and tax policies. The degree of coordination in these areas is particularly dependent upon initiatives at the working level. At its best, coordination has involved the writing of joint reports (e.g., the Philippines Financial Sector Report) and informal agreements as to which institution is best placed to take the lead in guiding the dialogue related to a certain policy area. In other cases, however, particularly when the two institutions have widely differing views, countries end up receiving very mixed and confused signals.

7.21 While efforts should be directed at facilitating cooperation at the operational level, there will inevitably exist situations where fundamental differences in policy prescriptions divide the staff of the two institutions. Differences in the organizational structure of the Bank and the Fund complicate the matter. In the Bank, country policy issues are resolved at the level of the Regional Director, Vice President, or Senior Vice President. By contrast in the Fund, the Central Department plays a more critical role, e.g., the Exchange and Trade Relations Department. Regional counterpart relationships, while useful, have not always been an effective channel for the

resolution of deep policy differences. In such situations, it may be useful to have some sort of high-level machinery for the resolution of such policy differences.

Coordination in Lending Policies

7.22 Both the Fund and Bank introduced new forms of lending arrangements in response to the economic shocks of the 1970s. The Fund established the Extended Fund Facility in 1976, under which financing was provided for a longer period of time and under which the scope and time horizon of policy commitment were also expanded. Similarly, the Bank introduced its Structural Adjustment Loans in 1980. SALs provided quick disbursing resources that were linked to the recipient country undertaking a program of "structural adjustment" designed to reduce the current account deficit. As these new lending instruments, both of which focused on very similar objectives, were introduced, there was considerable discussion about their implications for Bank/Fund coordination. It was recognized that they would place new demands on the collaborative mechanism, although how precisely these new demands might be met was not the subject of formal discussion between the two institutions.

7.23 In order to establish more effective complementarity between Fund programs and Bank policy-based lending, a much clearer conceptual distinction must be made within both institutions between (a) different types of programs. In particular, a distinction has to be made between those situations where the two institutions are providing resources for what is, in effect, a single need of their members and (b) those situations where the institutions are providing resources to support distinct objectives. The present arrangements fall between two stools. They neither provide the sort of highly orchestrated and sustained approach necessary to deal with balance of payments problems that are deeply rooted, require much longer adjustment periods and involve a package of policy measures dealing in detail with both aggregate demand management and resource allocation and investment issues. Nor does the present de facto link between SALs and Fund programs provide the Bank with an adequate set of arrangements for supporting policy changes to achieve efficiency gains in situations where the balance of payments position does not pose a major constraint.

7.24 For the Fund, this implies a much clearer differentiation between balance of payments difficulties associated with excess demand pressures and/or temporary changes in the terms of trade, and "structural" balance of payments difficulties. Similarly, for the Bank, a clearer distinction must be made between policy-based lending that is, in essence, supportive of Fund programs to achieve external adjustment (as SALs were originally conceived), and policy-based lending which attempts to achieve efficiency gains that are independent of the particular balance of payments adjustment policies that the country needs to pursue--as SALs have in some respects become--and which do not require Fund involvement.

7.25 The design of adjustment programs for countries facing "structural" balance of payments difficulties should be conceived and planned as a joint product. The criteria relevant for identifying such "structural" payments difficulties are in the final analysis likely to be qualitative in nature. However, in keeping with the objectives originally outlined at the time of the introduction of the EFF, they should include cases where: (a) major changes

are necessary in the size and composition of export-producing and import-competing sectors requiring a substantial acceleration in investment in order to reconcile the objectives of external adjustment with a reasonable level of economic activity; (b) quantitative restrictions and other price distortions have resulted in a structure of production that is highly distorted and thus where the requirements of external adjustment are intimately linked to reforms in a wide spectrum of trade and pricing policies (e.g., Tanzania, Ghana); and (c) improvements in the efficiency of resource use and productivity of investment can have an immediate and direct bearing on access to external private capital flows (e.g., high-debt countries).

7.26 A greater degree of integration in the lending activities of the Bank and the Fund in order to deal with "structural" balance of payments difficulties will have several implications. There is, first, a need to dovetail appraisal procedures more closely. Fund support is often required in a hurry in order to forestall a crisis. On the other hand, effective adjustment policies will require time to identify and appraise. In order to be able to meet the short-term liquidity needs of the situation while providing the necessary interval for the appraisal of medium-term policy measures, the Fund should be encouraged to provide a standby arrangement as a prelude to negotiations for longer-term facilities under the EFF.

7.27 Second, in the Bank component of such adjustment programs, there has to be a much more explicit link between policy reform measures and the external accounts and a much more focused analysis of the time horizon over which such impacts are likely to occur. Third, it has to be recognized that such adjustment programs do inevitably embody an asymmetric relationship between the Fund component and the Bank component. Effective aggregate demand management and exchange rate adjustments are a necessary ingredient in any program of balance of payments adjustment. By contrast, the policy focus of the Bank component is essentially designed to facilitate the adjustment process. This would imply that while the Bank component may be made contingent upon the Fund program, the converse would not be necessary.

7.28 In general, to make effective use of the various instruments at the disposal of the Bank, as discussed earlier (Chapter 4, para. ____), the Bank will have to develop a coherent long-term (three to five years) country assistance strategy in its borrowing countries, which goes beyond generalizations to clear and specific articulation of lending amounts, sectors of focus, instruments to be used and policy/institutional reforms to be undertaken. Also, as suggested before, this will require a clearer articulation of country performance criteria, and country teams should be held responsible to make explicit their approaches to conditionality at the lending program, sectoral, subsectoral and project level.

7.29 To the extent possible, the Bank's assistance strategy should complement that of the Fund. Also, to the extent that this is possible, the strategies of the Bank and the Fund should be negotiated, if not simultaneously, then at least back-to-back with the relevant governments. In so doing, potentially divergent policies between the Fund and the Bank can be avoided. Moreover, the Bank, with full knowledge of the Fund's strategy, can commit itself to a lending program that consists of the different specific instruments, their objectives and mechanisms for monitoring and evaluating their effectiveness, particularly with respect to policy and institutional reforms.

7.30 Prior informal discussions with the IMF should be undertaken to ensure that the strategies of the two institutions complement one another. In those countries where commercial banks play a relatively large role, e.g., as in many middle-income countries, these banks should be brought into the picture after agreement with the Bank and the Fund has been reached. The strategies of commercial banks should be discussed and, if necessary, redirected in a manner conducive to the long-term benefits of the country. In this way, such a three-part relation may influence the flow of long-term capital from private banks to these countries. The Bank should also strive for a "compact" between these countries and the major international financial institutions so that an understanding is established on the amounts of capital transfers to these countries and the major policy/institutional reforms that will be undertaken over a three-year horizon. Such a "compact" will be most crucial for the middle-income, high-debt countries where the imperatives to restore creditworthiness and long-term growth are very strong.

ANNEX I: THE COUNTRY TYPOLOGY

The country typology used in this report was devised according to the following criteria.

1. Countries 1 to 94 listed in Table 1 of the WDR (1983) were first selected. Botswana and Gabon were added to increase the representation of Sub-Saharan Africa, even though they have populations under 1 million.
2. Countries with a population less than 1 million have been excluded, unless otherwise stated as above.
3. Non-borrowers from the Bank were excluded; they were Mozambique, Angola, Cuba, Mongolia, Democratic Republic of Korea, Islamic Republic of Iran, South Africa, Venezuela, Greece, Hong Kong, Israel, Singapore.
4. Sub-Saharan Africa includes countries in Africa with GNP per capita less than or equal to US\$460 per capita (1981). Kenya, Senegal and Mauritania have also been included in this group because their economic problems are considered to be similar to other countries in this category as opposed to those in other categories. One low-income country in Latin America, Haiti, shares many of the problems of Sub-Saharan countries and is added to that list.
5. Low-Income Asia includes countries in Asia with GNP per capita less than US\$460 per capita (1981).
6. India and China are in one separate category.
7. High-Income Debtors includes countries with medium- and long-term debt outstanding of US\$13.5 billion at the end of 1982. Philippines with US\$12 billion MLT but US\$7.1 billion short term, and Morocco with US\$9 billion but over US\$3 billion committed were also included.
8. All other countries are in the remaining category--Middle Income Other.

The Country Typology

51 Sub-Saharan Africa

Chad
Ethiopia
Mali
Malawi
Zaire
Uganda
Burundi
Upper Volta
Rwanda
Somalia
Tanzania
Guinea
Benin
Central African Republic
Sierra Leone
Madagascar

Niger
Sudan
Togo
Ghana
Kenya
Senegal
Mauritania
[Haiti]

52 India, China

53 Low-Income--Other

Kampuchea
Bhutan
Lao, PDR
Bangladesh
Nepal
Burma
Afghanistan
Viet Nam
Sri Lanka
Pakistan

54 Middle-Income, High-Debt

Brazil
Mexico
Argentina
Chile
Indonesia
Philippines
Korea, Republic of
Egypt
Turkey
Yugoslavia
Morocco
Algeria

55 Middle-Income--Other

Ivory Coast
Zambia
Liberia
Lesotho
Nigeria
Zimbabwe
Cameroon
Congo, PR
Botswana
Gabon
Bolivia
Honduras
El Salvador

Nicaragua
Guatemala
Peru
Ecuador
Jamaica
Dominican Republic
Colombia
Uruguay
Costa Rica
Paraguay
Panama
Trinidad and Tobago
Thailand
Papua New Guinea
Malaysia
Yemen, AR
Yemen, PDR
Tunisia
Syria
Jordan
Iraq
Lebanon
Portugal

ANNEX II: MAJOR ISSUES FOR DEVELOPING COUNTRIES

The emerging issues for developing countries over the next decade are outlined here. They are intended to be illustrative, not exhaustive.

Among the Bank's borrowers, Sub-Saharan Africa faces the most acute development problems. At the time of independence, most of these countries were very deficient in the skills and institutions required for rapid development. Experience since then illustrates that human and institutional development are long and slow processes in an environment of low life expectancy, high fertility and slow agricultural growth. The major long-run economic problems of this group of countries relate to the low growth of agricultural output, which is primarily, though not exclusively related to the policy environment; rapid population growth, with its resultant impact on urbanization; the low level of human resource development; energy development; and the inefficiency and dominance of the public sector. The institutions in most of these countries are weak, their capacity to manage change is low, the indigenous private sector is small and of recent origin, and last, but not least, they have limited access to non-concessional flows (loans or equity). The reductions in the total real levels of IDA funds available to the Bank may present even further difficulties for these countries.

The production crisis facing these countries can trace its roots to the inappropriateness of the policy and institutional environment, particularly in agriculture. Prices are set at levels unrelated to production costs, indigenous marketing activities are supplemented or stifled by inefficient government parastatals, devaluation of exchange rates is resisted, and the rural/urban terms of trade are set at levels unfavorable to rural producers. The distorted producer prices and the restrictions on the marketing and input distribution systems in this sector have been of overriding importance in affecting the success of agriculture projects. The inappropriate trade and "exotic" exchange rate regimes have also contributed to the growth of an inefficient manufacturing sector. Economic growth, in general, has been restricted by policies that have created large public sectors replete with marketing boards, transport monopolies and other parastatals. Such policies have, in turn, discriminated against the private sector. The external environment has also contributed to situations in these countries, but poor macroeconomic management has exacerbated debt problems in many countries such as Sudan, Zambia and Zaire. Consequently, stabilization programs, in combination with world recession, have caused serious financial problems of high arrears for many banks in these countries. But this problem has a secular component as well, reflecting a history of poor policy and management. As a result, policy and institutional reforms will deserve at least as large a share of the Bank's attention as infrastructure and human resource development.

Other low-income countries, particularly those of South and Southeast Asia (excluding India and China), are confronted with pervasive poverty and limited social sector achievements. The severe strain on social services and human resources makes developing countries in this group among

the poorest in the world. But unlike Africa, countries in this group have relatively more and better trained people and greater administrative capacity. Moreover, countries in this group have been able, to some extent, to eschew the distortive pricing policies that have plagued Sub-Saharan Africa. More rational agricultural pricing policies over the last decade have led to increases over the past couple of years of foodgrain production in some countries. Although price distortions in the agricultural sector have been reduced, but not yet eliminated, price distortions in other sectors remain pervasive. Agriculture is the predominant sector in most of these other low-income countries, accounting for the largest share of output, jobs and exports.

A fast-growing population is also a concern and will exacerbate the growing problem of landlessness. This has established an enormous need for off-farm employment for which opportunities need to be provided with new policies and within the extremely limited investment resources of these countries. The weak political and institutional situation of these countries makes it impossible to look toward land reform as a solution to the problem. The key solution will be to establish the right incentives for the functioning of private initiatives and non-governmental organization for employment generation.

While several low-income countries possess considerable economic infrastructure, growth in all sectors will continue to be impeded by serious weaknesses in public administration, and in the management of state-owned facilities which in turn have resulted from excessive government intervention. These deficiencies must be corrected so as to improve the countries' capacity to absorb new investment and increase the efficiency of existing facilities.

India and China each represent strong potential for economic growth, particularly in completing a recent robust agricultural phase. In the past few years, bottlenecks in key areas of infrastructure have caused major problems for both economies and have constrained growth. Although their respective institutional structures are certainly not weak compared to other low-income developing countries, given the sheer size and diversity of both, such structures are inadequate.

In India, transport and communications infrastructure represents the most serious resource constraint. Given the lack of regional impediments, a substantial level of interregional trade has developed. Such trade is, however, hindered by road congestion, inadequate railways and limited port and shipping facilities. As in India, China faces serious development constraints due to inadequate infrastructure. This discourages interregional arbitrage, at a time when the scope for trade has been vastly increased by policy reforms. Recent easing of shortages and bottlenecks in both countries has come primarily from better utilization of existing facilities. Future improvements in both countries will require added capacity and the ability to absorb technological changes in transport.

The need to conform to international standards and advanced technologies will become more apparent as both countries intensify their export promotion efforts. With this objective in mind, the Government of China has undertaken significant structural changes aimed at improving incentives for

efficient economic and public sector management; but there is much that remains to be done. In a similar effort to promote a more efficient industrial structure and accelerate industrial growth through export expansion, the Indian Government has initiated a partial liberalization of the trade regime which will increase efficiency. In both these countries, general economic reforms aimed at improving the overall efficiency of the economic system, particularly through greater reliance on economic instruments and less on administrative directives, are required. Given the tremendous export potential for both India and China, infrastructure and industrial policies require considerable attention if either country intends to better mobilize external resources to sustain a high rate of economic growth.

For the middle-income, high-debt countries of Latin America, Southeast Asia and several countries in the EMENA region, the most important concerns over the next few years will continue to be those related to the adjustment to their economies in a difficult external environment. The international recession, the steep rise in interest rates on international lending, and the slowing down of world inflation, have had a major impact on the economic prospects of these countries. The inability to adjust to global economic changes has resulted in an unstable macroeconomic environment in many of these countries.

Several measures recently undertaken, such as debt reschedulings, reduction in public expenditure, and tighter control of monetary aggregates, have assisted this group to manage their immediate economic problems. Nevertheless, they are expected to have continuous difficulty in servicing their debt over the medium term. It is expected that the next five years will bring continuing international reserve difficulties and repeated reschedulings connected, for example, with the bunching of maturities in 1986-88 in Latin America. The demand for foreign exchange from these countries is expected to rise sharply as they will be faced with high incremental debt service obligations. The prospects for increased commercial lending necessary to support efficient, phased adjustments are also not promising. Furthermore, the maturity of the loans--particularly those linked to "involuntary lending"--is such that the restructuring of these economies will be essential to repay them. In the later part of the decade, as voluntary lending resumes, a major emerging issue will be the establishment of appropriate mechanisms to ensure that future debt crises do not reoccur. Thus, on the external financing side, even though the attention devoted to debt renegotiation may not be as intense as in the recent crisis period, with no resumption of smooth external financing in sight over the next five years for most countries, the relationship with the external lending community will continue to be of major importance.

On the domestic side, attention in the next ten years will focus on orienting these economies to generate additional foreign exchange and, at the same time reactivating them after the recent recessionary years; this is by no means a short-term task. The external shocks to these economies, and the incomplete policy responses of the recent past, mean that significant policy adjustments are still required in the trade, financial and fiscal areas. Because of its importance in servicing the debt, the tradeables sectors will have to be promoted. Under the expected tight financing situation, ways to improve fiscal performance--particularly that of the public sector--will also have to be sought, but political forces against budgetary rationalization will

also reappear once the balance of payments situation eases. Also, the private capital flight characterizing the recent crisis, particularly in Latin America, and the potential continuing lack of confidence will raise doubts about the amount of investment forthcoming from the domestic private sector. A recently completed study by the Bank on debt and adjustment in twelve countries indicates that with the exception of Morocco, most of the debtor countries will be able to restore their creditworthiness by the end of the decade (under certain assumptions of the external environment), provided that they are able to undertake appropriate domestic policy reforms. ^{1/}

The key development problems for the high debt countries in the EMENA region are those related to population growth, human resource development, employment and urbanization. These problems will be even more difficult to deal with given that massive shifts in employment from agriculture to industry and services continue to take place. Population growth and changes in social structure will not only put a severe strain on government resources, they will also require a major strengthening of the management of government institutions at all levels.

Other middle-income countries form a heterogeneous group which includes middle-income developing countries of Latin America, Southeast Asia, Africa and the Middle East. These countries, while distinct and varied from one another, share common economic development characteristics and issues. The industrial sectors of these countries, especially those of Southeast Asia, have expanded significantly, mainly as a result of deliberate policies to promote exports. Because many of these middle-income countries are highly integrated in the international economy, several experienced the full force of the world recession. Export growth will remain vital for these countries' future economic expansion and will depend both on international economic conditions and domestic policies.

New agricultural technologies have also had a significant impact throughout the regions of South and Southeast Asia, and the institutions in those regions are relatively well developed; the countries in the EMENA region do not share the other two regions' strength of institutions nor the vigor of their private sectors. The latter countries require a sustained effort at improved macroeconomic and public sector management, stimulation of the private sector and improvements in the capacity and effectiveness of sectoral and project organizations. It is, however, difficult to generalize about the productive sectors of these countries because they form such a large and multifarious group scattered across several continents. One common thread is that many of them are at a stage in their development where significant reductions are possible in the absolute numbers of people engaged in agriculture. This implies accelerated change in the fundamental economic structure which puts a premium on the effective management of the transition process involving massive shifts in employment to other sectors.

^{1/} "Debt and Adjustment in Selected Developing Countries" (mimeo). Date. This study states that Ivory Coast will also have difficulty in restoring its creditworthiness through appropriate reforms.

The major challenge for all these middle-income countries will be in sustaining the growth and reform momentum, as well as maintaining, and in some cases restoring, creditworthiness; this implies a stable macroeconomic environment. Contrasted to the high-debt countries, many of these countries have been characterized by outward-looking strategies, high domestic savings rates, small current account deficits, and therefore, low levels of debt. Given this continued emphasis, the reduction of official capital flows should not be a constraint on growth when proper incentives and a predictable policy environment have been provided.

ANNEX III: THE BACKGROUND PAPERS

This document has drawn on the following background papers and notes prepared for this exercise:

1. The Future of the Bank: Emerging Sectoral Issues in PHN for Developing Countries. J. Warford (PHN).
2. The Bank's Future Operational Product: Education Sector. G. Pscharopoulos (EDC).
3. The Future Product of the Bank in the Transport Sector. E. Bennathan (TRP).
4. Recent Sectoral Developments: Agriculture. G. Donaldson (AGR).
5. World Industry and the World Bank. Some Selected Suggestions. K. Dervis (IND).
6. Future of the Bank: Emerging Sectoral Issues. - Urban. H. Dunkerly (WUD).
7. The Bank's Future Operational Product: Energy: D. C. Rao (EGY).
8. From Development Finance to Financial Development. M. Long (IND).
9. The Future Product of the Bank in the LAC Region. K. Krumm (CPD).
10. The Future Product of the Bank: A South Asia Region Perspective. S. Chernick and H. Pilvin (ASA).
11. The Bank's Future Operational Product in the EMENA Region. P. Naylor (EMNVP).
12. The Future Role of the Bank in Sub-Saharan Africa. F. Iqbal (CPD).
13. The Future Development Assistance of the Bank and the Articles of Agreement. L. Forget (LEG).
14. The Role of Technical Assistance in the Future of the World Bank. F. Lethem (PPDPR).
15. The Bank's Experience with Project Lending. A. Israel (PPDPS).
16. Selected Lessons from Project Experience. F. Iqbal (CPD).

17. Growth, External Financing and the Bank. D. McCarthy (CPD) and K. Meyers (CPD).
18. The Link Between the Bank's Effectiveness and the Volume of Resources for Commitment. P. Watson (FPAFS).
19. The Bank and the Fund in the 1980s. L. Ahamed (CPD).
20. Bank/Fund Collaboration. A. Humm (consultant).
21. Country Economic and Sector Work - Objectives and Characteristics. V. Dubey (CPD).
22. The World Bank: Conduit for Aid or Financial Intermediary. A. Virmani (DRD).
23. Future Directions of Policy-Based Lending: Development Policy Loans. R. Agarwala (CPD).
24. The Fungibility of Project Lending. Some Implications for Bank Operations. M. Selowsky (OPSVP).

ANNEX IV: MEMBERS OF THE WORKING GROUP #4 ON THE FUTURE ROLE OF THE BANK

The Working Group for this exercise consisted of the following:

1. J. Adams, AENVP
2. J. Burrows, OEDD2
3. A. Choksi, CPDST, Chairman
4. F. Colaco, EMENA
5. L. Forget, LEGVP
6. C. Jansen, PBD
7. P. Meo, LC1DR
8. S. O'Brien, WANVP
9. S. Rajapatirana, VPERS
10. D. Ritchie, PMD
11. A. Shakow, IRDDR
12. P. Watson, FPAFS

OFFICE MEMORANDUM

DATE February 10, 1984

TO Advisory Group on the Strategic Planning Model

FROM Daniel G. Ritchie, PMD

EXTENSION 69133

SUBJECT Review Meeting - Wednesday, February 15, 9:30 a.m. - 12:30 p.m., Room I-11-223

1. Our second meeting as a group is set for the morning of February 15. Please advise Ed Rodriguez (Ext. 61927) whether or not we may look forward to your participation.

2. The agenda is:

- o Review and completion of the "future product" specification in model terms, based on what was accomplished in our February 2 meeting;
- o Review and agreement on a formulation of an index for "development impact", based on concerns raised last meeting;
- o Review of preliminary model simulations reflecting assumptions to-date about the "future product".

Distribution: Messrs. Koch-Weser (AGRME); Pouliquen (TRP); Richardson (OPSVP); Ruddy (SVPOP); Scott (LCPUR); Wessels (LCPDR); West (ASNVP),

cc: Messrs. Wood (FPBVP); Vergin, Asanuma (PBDDR); Choksi (CPDST); Jansen, Imam, King (PBDCP); Kaji, Dyck, Thint, Kieser, Wilkinson (PMD); Voight (OPD).

ERodriguez:cmj

I told them you couldn't go last wk -
Strategy Planning Model WG.

STAFFING IMPLICATIONS OF PROPOSED FUTURE ROLE OF THE BANK

Meeting on Use of the Strategic Planning Model
Thursday, February 2, 1984, Room I-11-223

Agenda

1. Introduction and review of the Model 9:30 - 11:00 a.m.
(Pugh-Roberts Associates)
2. Review and Discussion of the current Base Case 11:00 a.m. - 12 noon

Some specific questions:

- o Acceptability of projected staff growth, FY84-88
- o Implications of reduction in share of program lending; increase in policy content and supporting CESW for sectoral lending

3. Base future product scenario 12:00 - 2:30 p.m.

Some specific questions:

- o Discussion of initial attempt by the task force to characterize the "future product", and corresponding model results
- o Review of assumptions going into characterization of the future product
- o Required changes in staff discipline mix to support the future product
- o Revisiting model assumptions on development impact

4. Attempt to define more radical characterizations of the future product 2:30 - 3:00 p.m.

Possible alternatives:

- o Larger shifts in sector mix
- o Alternative ways of delivering the Bank's product

5. Internal/external constraints on implementation of the future product 3:00 - 3:30 p.m.

ERodriguez:cmj

OFFICE MEMORANDUM

JAN 30 1984

DATE: January 30, 1984

TO: Advisory Group for the Pugh-Roberts Model

FROM: Daniel G. Ritchie, PMD

EXTENSION: 69133

SUBJECT: Meeting on Use of the Strategic Planning Model - Thursday, February 2, 9:30 a.m. - 3:30 p.m. Room I-11-223

How much of his
shall I be able to attend?
about 2 hr! 1/30

TF 2/2

1. Many thanks for agreeing to continue to serve on - or to join - the Advisory Group on the Pugh-Roberts Strategic Planning Model. We are particularly interested in seeing how the model might be used to assist in the work on the Bank's Future Product (a copy of Mr. Stern's November 23 memorandum is enclosed). Specifically, we have been asked to prepare a paper on the staffing implications of the Bank's Future Product. We think the Pugh-Roberts model will be a useful tool to look at, among other things, the number and skill mix of staff required and the Bank's capacity to adjust staff mix over time.

2. We would like the Advisory Group to revisit some of the basic assumptions of the model and offer advice on the future product scenario.

3. At this stage, we envisage a total of three meetings of the Group. The first will be next Thursday, February 2. We would appreciate your blocking off a good portion of the day, if possible.

4. An annotated agenda for our meeting this Thursday, February 2, is attached. We shall start the day with an overall presentation and review of the Strategic Planning Model, a computer-based simulation model of the Bank's budget, work and personnel flows. Any of you who were in the advisory group for the development of the model itself may wish to skip this initial part of the meeting (scheduled to last 1 1/2 hours), unless you wish to refresh your memory on key model assumptions, etc. Particularly for those of us gaining exposure to the model for the first time, I have enclosed the Executive Summary of the Final Report (February 1983) on the development of the model. I would encourage you to read it before the meeting. (Please note that since the model was developed the "base case" has changed; indeed the current base case is one of the major discussion topics for the day.)

5. Following the review of the model, which will be given by the senior consultants of Pugh-Roberts Associates who helped develop the model, will be four consecutive sessions in which your fullest participation will be of principal importance:

- o Discussion of the current base case
- o Basic future product scenario
- o More radical future product alternatives
- o Internal/external constraints on implementation of the future product.

To help you prepare for these discussings, I have attached a third document, a copy of the Future Product Preliminary Analysis discussion note prepared by Pugh-Roberts Associates after an initial application of the model.

6. Please call me or Ed Rodriguez (ext. 61927) if you have questions on the above, or if you need additional information before the meeting.

ATTACHMENTS

Distribution: Messrs. Pouliquen (TRP); Koch-Weser (AGRME); Richardson (OPSVP); West (ASNVP), Wessels (LCPDR), Ruddy (SVPOP)

cc: Messrs. Wood (FPBVP); Vergin, Asanuma (PBDDR); Jansen (~~XXXX~~ ^{PBDCP}), Imam (PBDCP); Rischards (FPAFA); King (~~PBDCP~~); Kaji, Dyck, Ritchie, Thint, Kieser, Wilkinson (PMD).

DRitchie/ERodriguez:cmj

OFFICE MEMORANDUM

TO: Managing Committee

DATE: November 23, 1983

FROM: Ernest Stern, SVPOP *ES*

For MC Consideration

Nov. 28, 1983

Mr. Poljanec

A-1100

SUBJECT: Bank's "Future Product"*file date bank Nov 28*

Attached is a discussion paper on the Bank's "Future Product". As you know, we agreed that Operations would prepare an initial "think" piece, as a contribution to the work program on the Future Role of the Bank. The framework and schedule for the overall exercise was discussed by Mr. Wood on November 21.

Although we have changed our distribution rules, November 28 is the only time before mid-January that Mr. Clausen and I will be here together. Moreover, the weekend is exceptionally long. I am requesting your indulgence for this early violation of our new principle. I suggest we have an initial exchange of view on Monday, November 28. This will be helpful to the overall work schedule and there will be ample opportunity for us and our staff to have more detailed discussions as the work proceeds. In any event, we are only concerned with the relevance and appropriateness of the indicated directions, not the details.

The "future product" discussed is the product, broadly conceived, delivered to the borrower by Operations. This "product" depends on the contribution of all Bank units and is not, of course, the exclusive work or prerogative of Operations. But in addition, there are many other "products", both internal and external, which are not treated in this paper, including such vital components as our resource mobilization work, the maintenance of public understanding and support, our global analysis of prospects, and our research.

The original draft, prepared by OPS, was discussed with the OVPs but only in a very preliminary way because of time limitations. The present draft is substantially revised and reflects that discussion, but is in no sense a fully agreed document.

Attachment

cc: Mr. Southworth

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ABSTRACT

The paper:

- discusses the evolution of the Bank's current "product"* and concludes that the choice among different instruments of Bank lending will be affected increasingly by the fact that the policy environment is at least as significant as the projects themselves;
- briefly reviews the unpromising near-term international environment for development, notes the growing differences among developing countries, and concludes, that the changes in the global macro-economic aggregates are less relevant to the future product of the Bank than the evolving technical, analytical and managerial capacity of its borrowers and that its operations must be tailored more explicitly to take account of these growing differences;
- indicates ways in which the Bank's policies and operations might change in response to these developments.

*To avoid the inelegant phrase operational product or, worse, operational output, the term "the Bank's product" frequently recurs. But pace -- it is intended to refer to the operational output and not the full range of the Bank's functions.

I. INTRODUCTION

The Bank's operational "product" is a set of relations with a developing member country designed to support its development by providing economic analysis of and advice on its major policy issues, the management of the economy and the design of its development strategy; by providing technical assistance and by lending.

Over time the Bank's product has become increasingly complex, responding to changing economic circumstances and changing perceptions of the issues of economic development. In the past ten years, its operations have been affected by:

- the growing recognition that the development of human resources and institutions are as important as, and in some countries a prerequisite to, rapid expansion of the productive capacity. Growing emphasis has been placed on the development of institutions, training and education.
- the realization that sustained development also requires a concern with the distribution of the benefits of growth. Hence, the concern with employment generation and alleviation of poverty. The Bank's emphasis on agriculture and rural development stems from the fact that in practically all developing countries increased food supplies are an essential concomitant of development, and that a large portion of the population depends on the growth of the rural economy.
- the severe impact of oil price increases and subsequent economic developments which have focussed attention on the need for adjustment of economies and have heightened the policy content of the Bank's work and its conditionality. This led to structural adjustment loans and sectoral adjustment loans, with a heavy accent on policy and institutional changes.

Because of the increased importance of the policy environment to the viability of the economies and to the success of individual projects, the Bank, in order to make an effective contribution to development, has to broaden and deepen its understanding of the sociological and political factors that impinge upon economic policies and institutions. While lending remains the centerpiece of our relationship with developing countries, what is associated with that lending, formally or informally, has become more complex and immerses the Bank deeply in many aspects of policy. This role is further enhanced by the need to assist countries in mobilizing sources of external finance.

II. ELEMENTS OF BANK'S OPERATIONS

A Bank loan or IDA credit provides part of the financing for a project or program. Whether a country receives a Bank loan, an IDA credit or a blend depends on its creditworthiness and level of income. The maturity and grace period of Bank loans are related to per capita GNP.^{/1} Until the 1970s, maturities and grace periods were tailored mostly to projects. Since then country terms have been adopted, and essentially the average terms have hardened to accelerate repayments and permit a higher level of sustainable lending. While Regions have authority to modify terms, the range of discretion is limited.

Project and Program Loans

For any operation, detailed plans are agreed upon between the Bank and the borrower for achieving specific physical, institutional and policy objectives. The breadth and coverage of these plans varies with the nature of the loan and the country. At one end of the spectrum is a "traditional" infrastructure project where most of the funds provided by the Bank are associated with civil works or equipment. While the centerpiece of such projects is the creation of physical facilities, they usually also include improvements in organization or administration, technical assistance during implementation, and training. Sector policy issues, particularly pricing issues generally are also included. Typically, such projects are completed, and Bank funds disbursed, over seven years. Often a series of such loans are made to the same institution, in the course of which a wide array of institutional and skill training objectives of increasing sophistication are addressed.

At the other end of the spectrum is the structural adjustment loan with its focus on improvements in macro-economic policy and management. Disbursements against a broad list of imports are completed in 6 to 12 months. The policy conditions typically cover changes in prices and subsidies, tariffs and tax policy, public investments programs, and incentives for private investments, and are the culmination of extensive economic and sector work. The policy conditionality of these loans seeks to complement that of project loans.

Between these two poles, there is an almost limitless variety of loans with different combinations of "hardware" and policy and institutional content. "Sector loans" typically support the investment program of a sector or subsector such as highways, power distribution or higher education. Here the entire sector or subsector program is reviewed and the borrower and the Bank agree upon the criteria for selecting projects within the program by the borrower. Such loans are made to relatively experienced borrowers with sectoral institutions whose appraisal capability is proven. The relationship strongly emphasizes the improvement of sectoral policy and management. There are loans for "time slices" of agreed investment programs, such as in irrigation. There are loans for credit

^{/1} Borrowers are grouped into four categories defined by per capita GNP levels (in 1982 prices) of up to \$805, \$806-\$1670, \$1671-2910, and over \$2910.

for private farmers or entrepreneurs, for both investment and the purchase of current inputs, channeled through different types of financial institutions. There are "apex" loans embracing several different types of financial institutions. There are loans which finance the creation of new assets and loans which finance rehabilitation, maintenance or working capital. A loan can finance only imports or only technical assistance. What is clear is that the "traditional" project loan - e.g. a loan for infrastructure with only project-related conditions - is as rare as a structural adjustment loan. The old bipolar distinction of project and non-project loans is today as much of an anachronism as fixed exchange rates.

The concept of a project and the issues which projects address have evolved constantly. Today, a project is a flexible instrument -- a combination of physical, institutional and policy objectives and technical assistance to address specific development needs.

Assistance in Preparation and Implementation of Projects and Programs

While it is normal for lenders to appraise and supervise projects, the Bank as a development institution is commonly associated with projects before a loan is made and helps to define the physical, institutional, financial and policy aspects. However, the process of identifying projects differs widely among countries and sectors. In countries with relatively developed sector and planning institutions, the initial idea for a project often comes from the government, though in many instances, projects result from Bank sector work. In less advanced countries, more projects are first identified by Bank staff. The Bank has continued its efforts to improve the preparation of all its projects, on the premise that a well-prepared project is also likely to be well implemented.

Because the Bank is concerned with development over the long-term, and with the distributional aspects of growth, it is not neutral on the choice of sectors it operates in. While guided by the country's development strategy, the Bank seeks to affect change through selection of sectors and the design of projects. Such choices have costs. It is more expensive to work in sectors such as education, urban development and small-scale agriculture. The growing attention to the institutional and policy environment of projects, as well as the priority accorded in our lending to questions such as increasing the productivity of small farmers, poverty alleviation and job creation require Bank association throughout the preparation and implementation of projects. The analysis required for such operations often is not available in the country and policy-makers as well as managers at all levels must be persuaded of the merits of new approaches and educated in how to implement them. And the risks are greater because the technology may be uncertain, the institution new and weak, the commitment episodic or oratorical, or the changes involved in the socio-political structure generate tension and impair effectiveness.

The Bank remains associated with a project during its implementation. The original purpose was to ensure that the loan proceeds would be used only for purposes for which the loan was granted, but it has become an essential ingredient in the basic structure of our relationship. It is an important channel for the transmission of knowledge. Supervision helps to identify and solve implementation problems by working with the borrower. It provides continuity for the Bank's participation with the borrowing agency, the supervising ministry, and the government more generally. Supervision work is a fertile source for new project ideas and for sector issues to be addressed in the country dialogue. Patterns of problems in the country's portfolio, addressed systematically in implementation reviews, involve the Bank with full range of line agencies and their administrative problems. Supervision is an exercise in cooperative problem-solving and one of the most effective ways in which the Bank provides technical assistance to its member countries. It is also one of the unique elements of the Bank's service to its members.

The Bank, as a development institution with global coverage, also is in the unique position of being able to gather and systematically record experience related to different types of countries, projects and development strategies. This experience not only provides useful insights on how to improve the preparation and design of projects, but is also being disseminated among member countries to serve as a basis for planning new development efforts.

Country Economic and Sector Work

Country economic and sector work provides:

- a) the analysis of macro-economic and sector policy issues which constitute the basis of our policy dialogue;
- b) the framework for formulating the Bank's assistance strategy;
- c) the basis for assessment of creditworthiness, design of projects, identification of conditionality;
- d) information to other lenders and donors about development prospects and issues in individual countries.

The resources devoted to country economic and sector work have increased significantly during the past few years and the output takes a wide variety of forms (formal economic and sector reports, economic and sector sections of CPPs, informal memoranda, discussion papers, aide-memoires and policy briefs) reflecting the multiplicity of objectives and audiences.

The combination of features of the Bank's CESW distinguishes it from similar work done by other institutions. First, our analysis typically has a

medium-term perspective. ^{entirely} Second, the objective is not ~~only~~ to understand characteristics and trends but to identify necessary policy and institutional actions and to analyze these issues (macro, sectoral and subsectoral) in sufficient depth to enable us to define specific policy actions. The combination of these factors, plus the background material derived from our experience in many countries with different systems and problems, enables us to provide an explicit articulation of the relationship between macro, sector and project analysis and to provide consistent and specific advice which emerges from the different levels of analysis. CESW is increasingly done in close collaboration with policy-makers and technical staff in the developing countries. This facilitates the policy dialogue.

Changing needs have influenced CESwork in several ways. There has been a shift away from "basic" reports which, while thorough, were expensive and took years to prepare. They proved unsuitable to a rapidly changing environment. Second, there is a sharper focus on policy issues relevant to medium-term structural change. The analysis is increasingly action-oriented - i.e. relevant to policy-makers and sufficiently detailed to help illuminate alternative courses of action. Third, the composition of CESwork has been made flexible, at the discretion of the Program Division Chief, so its content can be adjusted to reflect emerging needs. This has led to the current increase in work on structural change, energy and creditworthiness. Finally, the audience has been more sharply defined and we focus increasingly on the decision-makers in the developing countries who need our analysis on a timely basis. This is responsible for the increase in informal reports, to the despair of the monitoring system which is designed to record achievement only with the issuance of a formal report.

The more sharply focussed CESW is essential for an active policy dialogue with our borrowers, and is the device by which we can monitor that policy change occurs and what its effects are. Structural adjustment loans have proved to be an important vehicle for doing this in several of the countries in which they have been made. Sector and subsector lending with broad policy conditionality is also an appropriate approach for an active policy dialogue. A stronger link between project lending and policy change also is developing.

Coordination and Co-Financing

Because the Bank provides only a small portion of the external financing needs of most countries, coordination with other sources of finance is essential.

Borrowers and lenders need to exchange information and views on a country's development effort, the associated policies and institutional changes, and the requirements for external capital. Consultative groups and consortia are an important instrument for these exchanges. With some exceptions, these meetings are chaired by the Bank; the discussion is based mostly on reports and presentations by the Bank. There is a strong demand for increased coordination, particularly for Africa.

Coordination with the IDT has always been of particular importance, but has become far more so during the last five years. As long as the Bank's lending was essentially project lending and loan conditionality related to project questions and related sectoral issues, the issues of coordination arose largely in relation to broader judgments on a country's economic prospects and performance. The Bank would generally accept the Fund's analysis of near-term balance of payments and demand management. Even then, however, there were areas of common concern on which cooperation and coordination was essential. The Bank has always tried to ensure that stabilization programs are as consistent with development priorities as possible. With the Bank's growing concern with the overall policy and institutional environment in borrowing countries, and with the development of structural adjustment loans and other instruments of dialogue on broader policy issues, questions of coordination and overlap with the Fund have become significant. In the current economic crisis, particularly in the high debt countries, it becomes increasingly difficult to distinguish between questions of short-term stabilization and medium-term development.

Much of the impetus for co-financing with official lending agencies came from the fact that many bilateral and some multilateral agencies had funds but little experience and expertise in preparing, appraising or implementing projects. Through co-financing the borrowers and lenders could be assured that funds would be used for well-designed, high-priority development projects. In number, co-financing arrangements with official agencies predominate, especially in low-income countries. In volume, however, the greater part of co-financing investments flows has been with export credit agencies and private lenders. Creditworthy countries benefit from co-financing because it helps to mobilize additional funds and ensures that foreign financing is associated with sound economic plans and institutions. All forms of co-financing have increased significantly during the last ten years.

III. Developments in the World Economy

There are many aspects of the world economy which bear on our borrowers and, consequently, on their need for external capital and policy action. These include economic policies and performance in the OECD countries, the behavior of commercial banks and the consequent volume of capital flows, the evolution of international trade policies and the sense of international commitment which underpinned concessional capital flows in the last 40 years. Projections of these and other factors were presented in the 1983 WDR and will be revised in 1984. That general framework is taken as given. Variations are unlikely to have a major impact on the Bank's future "product" as discussed below. Changes in the global economy can make the task easier or harder; they will influence decision on lending volume at the margin; they may influence the degree of political support and hence the resources available; and they undoubtedly will affect the frenetics of our daily life. But the conceptual nature of the product is, we believe, relatively insensitive to possible variations in our projections of the macro-economic environment in the medium-term because the "product" should evolve largely in response to other factors. The most important among these are:

- the continuation of the adjustment process in industrialized and developing countries alike to a more fluid, rapidly changing economic environment;
- rapid technological changes -- in industry, transport, communications, agriculture and other areas -- the absorptive capacity for which will be an important determinant of the differential performance among countries, and
- the rapidly increasing diversity among developing countries.

Neither the content of, nor the rate of change in, these areas is easily predictable. It is essential therefore that we recognize the importance of flexibility -- in our policy analysis and advice as well as in our project design -- and that we strengthen and expand our ability to keep up with current and prospective developments in all areas relevant to our borrowers.

The increasing diversity among developing countries is the clearest of these factors, and has important implications for the substance and organization of our work. It is discussed in further detail below.

Middle- and High-Income Countries

Considerable regional differences have emerged among the middle-income countries. In the depth of institutions and the vitality of economies they range from the countries of East Asia to those of North Africa.

East Asia

Countries of East Asia have grown most rapidly in the last decade. Their economies are about the most open in the developing world and, apart from Indonesia, they have expanded their industrial base and industrial exports.

Their agricultural production has increased rapidly.
The Philippines no longer imports rice and Indonesia has stabilized its rice imports. Their project and planning institutions have improved. They have strong private ~~institutions and inflows of foreign capital~~ ^{institutions and inflows of foreign capital} largely from private sources. All these countries are affected by the current crisis and face difficult issues in managing the balance of payments and domestic resources, but none of them, apart from the Philippines, is a crisis case.

Their recent performance notwithstanding, these economies face difficult issues in the years ahead. Except in Malaysia, governments in East Asia have a narrow political base, and in some of these countries political change may be violent and disruptive. In Indonesia, Malaysia, the Philippines, and Thailand poverty and unemployment remain major problems and progress on this will be gradual. A number of countries also have serious regional imbalances. Their institutions of economic management are among the most effective in developing countries. Macro-economic management has improved in recent years, although in Indonesia, Malaysia and the Philippines important distortions still affect the mobilization and use of resources.

In the next decade most of these countries are expected to continue to grow rapidly. They will have the benefit of the substantial expansion and diversification of their economic base, the growing skills of their labor force and the depth of their institutions. This region will also benefit from the growth of the Japanese economy, as well as the opening up of the Chinese economy. Private loan and equity capital is likely to be readily available.

Latin America

The pace of growth of the middle-income countries in Latin America has been similar to that of the East Asian countries, but there are important differences. In natural resources, these countries are the richest in the developing world. Latin American economies have strong sector and project institutions but they also have economic structures which are subject to considerable strains. The initial impetus for industrialization in countries such as Brazil and Argentina was import substitution behind protectionist barriers, and most Latin American economies remain much less open and competitive than those of East Asia. On economic management, national consensus or even near consensus has eluded economic managers for decades, in part because their societies are more open and pluralistic than those of East Asia (with some important exceptions). Over time, governments have acceded to competing claims and

instituted a mixture of protective practices, subsidies, government services and prices which in aggregate have become tenable. Inflationary finance is ingrained in most of the larger economies in the region. The external debt crisis is partly a manifestation of these problems.

Traditionally, much of the external funds for Latin American development have come from private loans and equity. However, in the wake of the current debt crisis, the resumption of voluntary lending by private institutions will require the resumption of sustained growth in the world economy and major adjustments in the economies of many of these countries. The heavy burden of debt servicing and the delicate task of managing debt in these countries will persist, even in the best of circumstances, for at least a decade. Countries such as Argentina, Brazil, Chile, and Mexico will have to generate sustained export surpluses to service the debt and to reduce it. Economic development and successive short-term economic and financial adjustments will remain intertwined, and economic policy measures constrained by the need to develop a broad-based political consensus.

Other Middle-Income Economies

The other middle-income economies, principally in EMENA, are a diverse group. They share some of the problems of the Latin American economies but have neither the sophistication and depth of their sector and project organizations nor the vigor of their private sectors. For example, Morocco has an untenable debt burden, and simultaneously an economic structure and sector and project institutions which are weak. Turkey and Egypt remain saddled with large and ineffectual public sectors. These countries require a sustained effort at improved macro-economic management, stimulation of the private sector and improvements in the capacity and effectiveness of sectoral and project organizations. With the exception of Egypt and Morocco, most of them also depend heavily on private capital flows. Yet the maintenance of their credit-worthiness, and in some cases the restoration of credit-worthiness, will require painstaking and sustained adjustments in macro-economic policy as well as in important sectors.

Low-Income Countries

India and China

India and China together have more than half of the population of developing countries. Both countries have made major strides in economic development -- they are largely self-sufficient in food; have developed large industrial sectors and large reservoirs of skilled manpower; and their capacity for economic management is comparable to that of many middle-income countries.

Financial management in India and China has been conservative. In relation to many low-income countries, levels of domestic savings are high. For external funds, India has depended heavily on concessional official sources; China so far has borrowed little. In both countries, external trade is small relative to the economy. While both should increase their recourse to private capital, the long haul of development, and the quick build up of debt which high interest rates can lead to, would require moderation in borrowing on commercial terms. Both countries will need sustained assistance in improving the use of resources and in raising their still very low standards of living.

Other Low-Income Countries Outside Africa

In overall economic performance and institutional development, the other low-income countries have lagged substantially behind China and India. At one extreme is Bangladesh whose problems of poverty and lack of economic opportunity are among the most severe in the world. In Pakistan -- mainly because of the remittances from migrant workers in the Middle East, as well as improvements in agriculture -- the standard of living has improved perceptibly in recent years. In all these countries, however, the political and economic structures remain fragile. Domestic resource mobilization is low and public sectors -- which are deeply involved in manufacturing and trade -- are large and inefficient. Sector and project institutions are weak, and a sustained effort is needed to improve these countries' absorptive capacities. These countries are dependent largely on public capital, much of it concessional, and most will remain so during the coming decade.

Sub-Saharan Africa

Sub-Saharan Africa has stagnated for the last twenty years and its problems are the most serious and intractable. During the 1960s and 1970s, per capita income in 19 countries grew by less than one percent a year and in another 15 it declined. During 1980-82, conditions in the region worsened: the volume of output per capita declined by five percent, and because of the decline in the terms of trade, real per capita incomes declined even more sharply. As to the future, given present trends in trade and capital flows, real per capita income in Sub-Saharan Africa in 1995 is likely to be lower than in 1970 -- representing a quarter century of further stagnation. The prospect is one of increases in poverty, unemployment and underemployment.

The political, social and economic infrastructure of African countries is still very fragile. Nearly all of these countries are at an early stage of development. They all inherited inadequate infrastructure inadequate to cope with the complexities of today's economic problems. Political instability has added to these complexities. The African economies are particularly vulnerable to fluctuations in international trade and commodity prices; most of them are heavily dependent on the export of a few commodities. Volatile movements in the prices of these commodities have made the planning and implementation of development particularly difficult. Economic stagnation and decline has led to a serious deterioration of the already inadequate physical infrastructure in many countries. There is an urgent need to arrest this trend and to stimulate a process of institutional reform, policy change and rehabilitation of infrastructure. All African countries will need to make a sustained effort in practically all aspects of economic development, particularly in improving human skills and institutions and in macro-economic management. With the exception of countries such as Ivory Coast, Nigeria and Cameroon, they will need sustained concessional assistance.

IV. THE BANK'S FUTURE OPERATIONAL PRODUCT

Under any plausible scenario of the expansion of the Bank and IDA, total lending will remain a small proportion of the capital flows to developing countries. The effectiveness of the Bank as an institution therefore will depend on its impact on development strategies, institutions and policies in developing countries, on the improvement in the quality of life for the populations in our borrowing countries, and on its ability to help mobilize larger flows of external capital.

Country Assistance Strategies

Increasingly, we shall have to consider lending, technical assistance, economic analysis and policy dialogue as an integrated package. And with the growing diversity of the developing countries, we shall need to vary the contents of the package to match it more closely to capacities and needs of specific countries. Different approaches to country assistance strategies for broad groups of countries are sketched below. In practice they need, of course, to be tailored to individual countries to allow for the substantial differences among countries within each group.

Middle-Income Countries

Countries in this group, particularly in Latin America and East Asia, have a good base of human resources and well-established private and public institutions. Most of these countries have had good access to commercial flows; however, net external capital flows have dried up for many countries, mostly in Latin America, and future growth of external capital is expected to be modest. Given the size and vigor of their private sectors, investment has not been a constraint on growth when proper incentives and a predictable policy environment have been provided.

Growth will come mainly from the private sector. The institutional capacity is sufficiently well developed so that an appropriate policy framework can elicit the necessary responses in savings and investment, and permit monitoring to assure that benefits are broadly distributed and depressed areas are not neglected. Consequently, the Bank should use instruments to support policies that provide appropriate and predictable incentives to this sector. Policy reforms will be needed, particularly in trade, energy and agriculture. These reforms must be designed so as to minimize the short-term costs of undertaking them, so that they become more acceptable to governments. This requires phased programs, a long-term involvement in policy issues, new approaches to increase the relevance of our relatively modest financial contributions to policy change, and the assurance of adequate and stable financial flows during the transition period.

Many of these countries' long-run problems, particularly though not exclusively in Latin America, have been caused by short-term macro-economic policies, which tend to expand activity in the short-run in a manner that is unsustainable in the long-run. Excessive external borrowing has made it possible to postpone adjustment. The stabilization programs that such policies made necessary have caused long-run losses that were much more costly than expected, particularly in terms of new investment. Other countries have sought to adjust to temporary external shocks by reverting to inefficient policies which then remain.

In middle-income countries the Bank should thus focus on improving economic management and policies at the macro and sectoral levels rather than at the micro (project) level. Policy-based lending--sector-oriented loans and SALS--should be the major instruments. A large part of the Bank's activities in this group of countries will involve helping to coordinate short-term with medium-term macro policy, in collaboration with the Fund and commercial sources of credit. Of importance is an increased policy dialogue on the long-run cost of "stop-go" macro-economic policies, and its sustained adverse effect on investment and external capital flows.

Middle-income countries at the upper end of the scale will increasingly have access to external financing, independently of the Bank. They may be expected to become intermittent borrowers from the Bank, turning to it in times of crisis. The Bank's financial contribution, through additional funding or better terms, may often be small. A major factor to consider will be the extent to which countries wish to maintain a policy dialogue with the Bank, and have access to its advice, in periods when its financial contribution is marginal.

Sub-Saharan Africa and Other Low-Income Countries (Other than India and China)

These countries have a poor human resource base and rapid population growth; agriculture is the most important source of growth and employment. Their institutions are weak and in many the indigenous private sector is very small and of recent origin. They have limited access to non-concessional flows, either loans or equity. Their main feature is a low capacity to manage change and an overstretched public sector. Our activities in these countries need to span the full range -- from the project to the macro level -- and will require the highest amount of staff resources per dollar lent. They also require the maximum concentration of IDA lending.

At the project level, these countries require strong support for design and appraisal, technical assistance in implementation and institution building, and training for future cadres. Projects need to be simply designed but also clearly conditional in basic areas of performance. Project lending will be an essential vehicle for building local institutions. Technical assistance and training will need to be major components of the Bank's assistance programs.

It will not be possible to use sector lending approaches, leaving detailed project preparation and appraisal to their institutions. Since the more effective use of domestic capacity is a major problem, exacerbated by current economic conditions, Bank operations must be flexible enough to deal with that issue rather than concentrating on providing new capacity. This will entail continued emphasis on maintenance and rehabilitation, including a willingness to finance the recurrent costs of operations, and restructuring programs for public enterprise.

Investments in human resources are crucial for a more self-sustaining growth in the future. To increase their medium- and long-term absorptive capacity these countries must develop education and training as fast as possible. Although investments in human resources, including health, can have high rates of return, their benefits take them to be felt and are hard to recoup.

The policy dialogue and policy-based lending in Africa will be substantially different from that in the middle-income countries. In many African countries and some other low-income countries, the capacity of institutions for studies and analysis is limited and is likely to remain so during the next decade. Here the process of carrying out the Bank's economic and sector studies is as important as the studies themselves: it helps to resolve emerging issues, and also helps to educate and develop the skills of our counterparts. From the Bank it will require a much deeper understanding of the factors inhibiting policy change.

The process of change is more difficult in Sub-Saharan Africa because of the relative absence of domestic analytical capacity, the fragility of the political process and the limited channels for developing compromises. The policy dialogue also is more difficult because the solutions are much less clear. The relevance of macro-economic tools is more limited in these economies, markets are fragmented and hence monopolistic and volatile, and market incentives more narrowly effective. The policy issues themselves are fewer and professionally less complex but they involve more basic issues of strategy - hence they are more political. They include the role of the public sector, pricing, the respective roles of primary production and processing, realism in investment priorities in face of great expectations for rapid progress, conflict between basic social objectives such as universal literacy and a relatively inflexible tax base, and how to develop and nurture the private domestic sector.

While progress in all these areas will be slow, and our expectations must be realistic, we must continue to identify these issues, put them before policy makers, insist on their consideration and analysis and push for action. But this will require quite different presentation of analyses and personal approaches than are involved in the policy dialogue with middle-income countries. And we continue to be hampered by the lack of intellectual challenge these small countries pose in attracting our top policy-oriented analysts. Not only are the middle-income countries professionally more complex but the policy changes yield

results more quickly and the linkages are predictable. In African countries, a better policy framework is only a first step in a very long process and the uncertainty of what the right approaches are compound the problem.

China and India

As far as the Bank's instruments are concerned, the situation of these countries suggests an approach somewhere in between the two groups just discussed. At the macro-economic management, sector, and project levels, these countries have some institutions as strong as those in many middle-income countries. Hence while project lending will continue some sector lending will be feasible. But sectoral lending on a national level often is difficult because of the sheer size of the investment requirements, the diversity of sectoral problems across these countries, and the delegation of responsibilities to the States and provinces.

In these countries our approach to policy change must be placed in the context of our overall lending program and pursued through sector, sub-sector and project lending. In both these giants the belief in an entitlement to Bank/IDA lending is strong and the link between the level of lending and policy action is not an accepted proposition. And, as in all large countries, "satisfactory policy performance" covers so wide an array of issues, at so many levels, that it is neither easy to define with precision nor to monitor consistently. Our policy dialogue can identify issues for attention but in these countries the actual implementation of change rests more heavily on the link with specific operations. Moreover, while an improved policy and incentive framework is essential, the response of the economic and social system to general incentives is much less clear, and the need for government intervention to attain progress towards many social and political objectives much stronger, than in the middle-income countries. In addition, although there are some strong financial and central institutions, the institutional structure, when compared to the task posed by the size and diversity of these countries, is still weak. Their need for investment in infrastructure and human resource developments is still immense.

A promising approach is support for policy reform and efficient resource utilization in major (sub) sectors. Sector loans through a suitable intermediary may increasingly become an appropriate vehicle. A good example is the role of the Bank in improving the control and maintenance of the large irrigation and drainage systems through State-wide sector loans in India--which will be vital to the success of agriculture. Sectoral adjustment loans may also be an effective instrument where sectors are under the control of the central government. But we shall have to continue to be flexible in devising operations which can include effective policy discussion on sector or general issues with the appropriate level of authority.

The effectiveness of our dialogue with these countries will also be affected by the relatively small scale of our lending, and limited IDA availability. Although only about 40% of IDA VII funds are notionally allocated to these two countries, compared to 40% for India alone in the past, unless the climate for IDA improves substantially in the future even this share will have to be reduced. This will become an even more acute issue if bilateral concessional flows to Sub-Sahara Africa continue to stagnate or decline. This may be offset to the extent that the Bank has a role as a catalyst for other lending, through co-financing or otherwise. But large-scale non-concessional borrowing would increasingly raise questions of creditworthiness, particularly in India. An increasing capacity to service debt would require a major acceleration of the shift towards a more export-oriented economy which may not be feasible. At present, our ability to increase Bank lending to India is already constrained by portfolio limitations and this policy should be reviewed; in China the same constraint may emerge eventually but for now Bank lending is limited by the Government's view about the appropriate blend between Bank and IDA.

Common Issues and New Directions

Economic and sector work will increasingly be required to provide the intellectual underpinning for our lending and policy dialogue. Much of this work will have to be done in close collaboration with the client countries. There are four specific areas which will merit special attention. We need, first, to recognize that many of the policies we regard as distortive are maintained because they serve non-economic objectives. Country economic work should provide more information on the economic costs of these policies, and should help to identify more efficient ways of achieving these non-economic objectives.

Second, we need a much deeper understanding of the factors inhibiting policy reforms. These will widely vary across countries. Reforms may be inhibited by lack of knowledge of how to implement them, or of their potential benefits. Frequently, they may be inhibited because, although beneficial in the long run, they involve important and visible political and economic costs in the short run. Designing the implementation of reforms so as to minimize these short-term costs, and planning the use of lending to finance transitory costs, will be key aspects of country economic work.

Third, adjustment on the current scale and need for urgency is a new experience for many countries. Most policy-makers tried to deal with the changed circumstances with the help of lessons learned in an environment of sustained growth of the global economy. The new experience and the new lessons learned are bound to have an impact on the decision-making process and on policies for the future. They will also have an impact on the social and political developments in most countries. In our future work we must also distinguish between countries which have drawn the right lessons from the recent experience and others where we need not only suggest the appropriate approaches to economic management but also must spend additional efforts to show the causal relationships between policies and outcomes.

The fourth area concerns the relationship between short-term adjustment and long-term growth. It has become clear that repeated short-term macro-economic imbalances and the associated stabilization programs have reduced the utilization of productive capacity for long periods. This has caused standards of living to remain below their potential. It has also depressed new investment and therefore the rate at which productive capacity itself expands. Country economic work needs to pay more attention to the relationship between short-term adjustment and long-term growth.

To increase the effectiveness of project lending and maximize its developmental impact, we should step up two activities. First, we should increase the dialogue regarding the balance between consumption and investment; our lending should not result primarily in greater government consumption. Second, we should analyze more closely the composition of public expenditures, and the "marginal" projects or other expenditures that are added in the public sector when more resources become available because of the fungibility of our loans.

We will also need to consider the way in which we are to provide analytical services. They are costly and even allowing for streamlined processes, better managers and management, more careful programming and other efficiency improvements, it is unlikely that an expansion of this work can be accommodated in the medium-term budget framework. There are three choices: Increase overall allocations; substitute for other work; or reallocate between groups of countries. The first is not likely to be feasible in the short-term; the second is impractical because the other changes discussed below are also not costless and technical analysis and quality control already is stretched thin. If that assessment is correct, we must develop sharply different support levels for different groups of countries if we are to devote the necessary resources to the low-income countries. This will require more reliance on local institutions to do analyses and studies required by us for sector and country economic work underpinning our policy dialogue. A collaborative approach will be essential but the potential conflicts of interest are obvious. The extent to which it will be possible in practice remains to be tested; to the extent this cannot work, we will have to consider lesser analytical support for middle-income countries and this will pose the difficult choice whether that will be in the areas necessary for our lending operations or in the area of macro-economic management.

← Very serious
explanations!
It is not like
income level
comparisons!

As to lending instruments, we should continue the present trend of adapting to the specific institutional capacities and economic needs of different types of countries. In countries with more developed project and sector institutions, we should move to sectoral and sub-sectoral lending and concentrate on improving sectoral policies and institutions, delegating the selection and implementation of sub-projects to national institutions. In a growing number of middle-income countries and in China and India, we should be using this approach during the next five years.

As we discuss the Bank's role as a stimulant for policy and institutional change, the underlying assumption is that Bank and IDA resources would be commensurate with this role. The current lag in IBRD's commitments is temporary and is the product of the economic crisis where the needs of countries are largely for funds to complete ongoing programs and current activities. This should change as adjustments proceed and new lending instruments are initiated. But in Africa, despite the relative shift of IDA funds to the continent, IDA's ability to maintain a credible dialogue will be compromised unless availabilities increase substantially over what now seems likely. Equally important, institutional support and technical analysis are all staff-intensive and will make heavy demands on our staff.

There are a number of other issues which require attention. The first relates to the perception of the Bank as a "project" institution which knows how to build highways (or ports or power stations) but should stay out of policy issues and management (except for equity, population, etc). Unless we can successfully educate our Board and the wider audience it represents, that the role of the Bank has changed dramatically and that it is our function to be involved in these matters, we will not be able to implement the changes that are proposed -- at least not effectively. An understanding of the importance of policy to development success, and the role of the Bank in the evolution of policy, is a prerequisite to getting away from the anachronistic polarity of project/non-project.

A second related issue concerns our relationship with the Fund. An important theme is that in many countries there is no analytical distinction between the issues of short-term adjustment and those of long-term development. The areas of concern of the Fund and the Bank will be complementary and often common. The recent cooperation between the Bank and the Fund has been reasonably good. But if we are to address effectively the issues that developing countries face, we shall need to develop more common and complementary approaches. Joint economic work may be an important feature of this; as will be making the financing packages of the two institutions more explicitly complementary instead of merely avoiding conflict.

A third issue concerns our relationship with borrowing countries. Increasing the emphasis we put on policy dialogue and conditionality will not be costless. As our visibility in areas of macro-economic policy increases, strains will inevitably appear in our relations with borrowing countries. So far we have largely avoided this through the continuity of our dialogue (as distinct from the Fund, whose standby operations are pervaded by a sense of crisis) and the depth and extent of our economic and sector work. We shall have to depend upon these, but we should also sharpen our skills at economic diplomacy. We should re-examine the balance between field and headquarters staff, and explore the extent to which dialogue and cooperative economic work would be facilitated by placing more of our staff in the field where the interaction is continuous against the costs -- not so much administrative but the inevitable difficulty, in most countries, of having the field staff become excessively influenced by the constraints on change.

Fourth, aid coordination is of increasing concern and the Bank is looked to as a natural leader in this effort. Obviously, avoidance of duplication, optimal use of resources and clear identification of priorities are important. We should be prepared to play a larger role. But we also must recognize the limitations. Aid coordination should not be allowed to become a substitute for increased aid flows and we must not be caught as leading the substitute effort. We also must be sure that aid coordination will work both ways. More effective policy influence and clearer priorities by the developing countries is the aspect usually addressed with the greatest fervor. But equally important is the commitment by the donors to rely on joint analysis, to streamline procedures, to reprogram when necessary and to forego pressing capital-intensive, premature projects for the sake of sales. On this side enthusiasm is more limited. Finally, we must avoid giving credence to the expectation that bank-led coordination efforts, particularly in low-income countries, will eliminate all problems. It won't -- though it may improve matters somewhat.

Other
does
ble
revised

There are many other issues which bear on the operational product of the Bank such as expanding private and official capital flows, and even more broadly, improving the climate for development. The Bank will need to consider what it can and should do in these areas. This would include consideration of our role as an opinion-leader and source of analysis and information on development and global and economic issues and in research, including participation in international programs such as CGIAR and TDR. Much could be done but it will cost money. These issues are not discussed in this paper, which has focussed only on the changes in the major elements of our operational product. Further discussions over the next several months are expected to sharpen these preliminary ideas, generate others and add the issues which involve the other elements of the Bank's work.

It is important, as we proceed, to clarify the Bank's role, to keep in mind our limitations and the constraints on us. The argument of this paper is that the Bank's lending is an integral part of our policy analysis, assistance in institution-building and development of local capabilities, research on development and global economic issues, and progress towards better conceived, more effective development strategies. The Bank's role is a combination of money and brains.

But the definition of our future role requires us to address the appropriate balance between the two to retain our leadership in the overall development community and to maintain an effective relationship with increasingly diverse borrowers.

PUGH-ROBERTS ASSOCIATES, INC.

PROGRAMMING/PERSONNEL/BUDGETING
PLANNING MODEL

FINAL REPORT
EXECUTIVE SUMMARY

February 1983

A. Project Objectives

The next ten to twenty years will involve many changes, uncertainties, and challenges for the World Bank, such as shortages of capital, shifts in lending mix, and increased borrower difficulties and needs. The Bank's success in adapting to new priorities and making efficient use of scarce resources will depend on the effectiveness of its planning. This is another major challenge facing the Bank, for its planning needs are large and complex.

The World Bank is a complicated human, technical, and financial system. By "system" we mean a set of interrelated, interacting flows (e.g., personnel, projects, cash); decisions (e.g., staffing levels, lending targets, loan terms); and activities (e.g., recruitment, project appraisal, supervision of outstanding loans). This system is difficult to steer because it has considerable momentum. Because of the time required for project initiation, appraisal, and approval, it takes years to substantially alter the Bank's lending mix. Excessive acceleration of changes in the lending mix will cause reduced staff productivity, project quality, and ultimately, project performance. These difficulties are, in part, a result of the dynamics of the project "pipeline" and, in part, a result of the rate at which the Bank's personnel structure can adapt to desired changes in the operational work plan. Changes in the work plan must recognize the rates at which the Bank can recruit, train, and reassign personnel, and the rate at which the staff can acquire experience in a new area.

Many of the most urgent planning issues now facing the Bank involve the interaction between its operational work flow and its personnel structure. These issues include:

1. ability of the project flow to respond to changes in lending objectives;
2. ability of the personnel structure to respond to changes in the operational work plan;
3. effects of a shortage of capital on the volume and pattern of Bank assistance;
4. consequences of graduation by various member countries from eligibility for IDA or IBRD financial assistance;
5. interactions between productivity, work quality and development impact; and
6. maintaining the vitality of the Bank staff.

To assist the Bank in its planning efforts, Pugh-Roberts Associates, Inc., in conjunction with a Task Force from both the Personnel Management Department (PMD) and Programming and Budgeting Department (PAB), has developed a planning tool for addressing issues such as the ones listed above. The tool is a computer simulation model using the same techniques and approach as in the Administrative Strategic Planning Model. (See "World Bank Administration Strategic Planning Model: Phase II Final Report", October 29, 1981).

The project during which this model was developed has had three inter-related, but distinctly different, objectives:

1. to develop a tool for planning of the Bank's personnel structure and operational work flow;
2. to engage Bank managers in a process of policy development and evaluation, through performing analyses with this tool; and
3. to transfer this new analysis/planning capability from Pugh-Roberts Associates to PAB and PMD.

These objectives can be viewed as developing a tangible product, influencing how the Bank plans, and implementation.

B. Process by Which the Project was Carried Out

The computer simulation model has been developed in a two-phase project. During Phase I, over the four months from February 1982 through June 1982, a prototype model was designed, programmed, and used for preliminary analyses of alternative strategies. The purpose of the Phase I model was to demonstrate the use of the model as a planning tool; to identify possible weaknesses in the model's relationships, quantitative assumptions, and level of detail; and to pinpoint additional or more detailed data requirements. During Phase II, extending from July 1982 through December 1982, the model's relationships and assumptions were refined, additional detail added, and then a range of strategy alternatives analyzed. The model has been installed on the World Bank's computer system, and Bank personnel trained to use the management tool on an on-going basis.

The modeling project has been conducted in very close collaboration with a Task Force of personnel from the sponsoring departments and an Advisory Group from operations. The Task Force consisted of approximately fifteen people from PMD and PAB who are concerned with the issues of the work program and personnel strategies for the World Bank, and with budgeting for projects and personnel. Task Force members participated in all steps of the project. The Advisory Group consisted of one representative from each of the organizational units within operations. The Advisory Group joined the project after Phase I. Their review of the Phase I model and participation in Phase II contributed significantly to the project.

The philosophy of the project, from the beginning, has been one of the World Bank's managers developing and analyzing strategy alternatives with the help of outside consultants. It distinctly was not a philosophy of

"having consultants analyze the situation and tell us what to do." We recognize that in an exercise of this type, the outside consultants can contribute techniques, experience and objectivity. However, in the end, the client "owns" the problems and must implement solutions.

The project was organized to engage senior managers in the process of defining assumptions, designing the computer simulation model, evaluating the model, specifying policy and sensitivity experiments to be performed, interpreting the results, and formulating alternative strategies for lending and personnel. Throughout the project, the Task Force and Advisory Group also served as a source of detailed information about the World Bank.

Every three to four weeks, the Task Force met to review and discuss aspects of the project. These meetings typically lasted for four to six hours. In addition, members of the Task Force and Advisory Group were individually interviewed several times during the project.

These interviews were an important source of information for the model. They provided information about how the Bank works, and also served as sources of estimates for the strengths of many model relationships (e.g. the effect of staff experience on productivity). In addition to the Task Force and Advisory Group, information and data for the model was drawn from a number of sources: Bank budgets, PAB time recording data, and PMD personnel data.

Participation in the project by Task Force members was a very important source of on-the-job training with respect to the model, its use, and its continued refinement. In addition, three separate training sessions were given to those Bank personnel who will use the model on an on-going basis.

D. Overview of the Model

The model is organized into a series of sectors, each representing an important "subsystem" of the Bank. The sectors are:

1. planning, programming, and budgeting;
2. the work program;
3. personnel management; and
4. expenses.

We refer to them as "building blocks" because the equations of each sector are reproduced many times within the model to create a disaggregated representation of the work program and personnel. This building block approach yields a very flexible, modular model. Detail may be added or subtracted in each sector to adapt the model to various planning uses.

The model represents the entire Bank, but not at the same level of detail -- the focus is on operations. The programming, budgeting, and execution of the operational work program are modeled explicitly, in terms of "product" pipelines, economic sectors, and groupings of beneficiary countries. The representation of operational staff mirrors how the work program is modeled. Hiring, advancement, reassignment, and attrition are explicitly represented. Calculations are performed by sector, country group, and professional discipline.

Outside of operations, the model treats both the work program and personnel in a far simpler way. Several categories of non-operational staff-years are included in the model (see Annex). In some instances, they are calculated as a function of an aspect of the operational program; e.g., finance staff-years depend on the volume of loan disbursements. In other

cases (e.g., external relations), assumptions about staff-years are an external input to the model. Higher-level non-operational positions and headcount are calculated from the staff-years, using assumptions about working hours per year (allowing for overtime, leave, etc.), mix of permanent and temporary staff (including consultants and contractors), and fill ratios. Assistant-level and secretary/clerical personnel are proportional to higher-level staff.

During the course of the project, there was much discussion of what constituted an appropriate level of detail within the model. A compromise is always required between simplicity, for the sake of clarity and ease of use, and complexity, for the sake of realism. For the current model, we chose an intermediate level of detail appropriate for addressing many important strategic issues which confront the Bank. Specifically, the operational work program is disaggregated by

- o Country Income Groups:

1. IBRD only
2. BLEND
3. IDA only

- o Sectors:

1. Agriculture
2. Telecommunications and Transportation
3. Industry (including Development Finance)
4. Urban, Education, PHN, Water Supply and Sewerage
5. Energy and Power
6. Program Lending

Operational Staff are disaggregated by country and sector as above, and further by

- o Regular and Fixed Term versus Consultants
- o Grade Levels
- o Discipline

1. Program Economists
2. Loan Officers
3. Technical Specialists
4. Financial Analysts
5. Project Economists
6. Other

The building blocks of the model are replicated for each of the disaggregations.

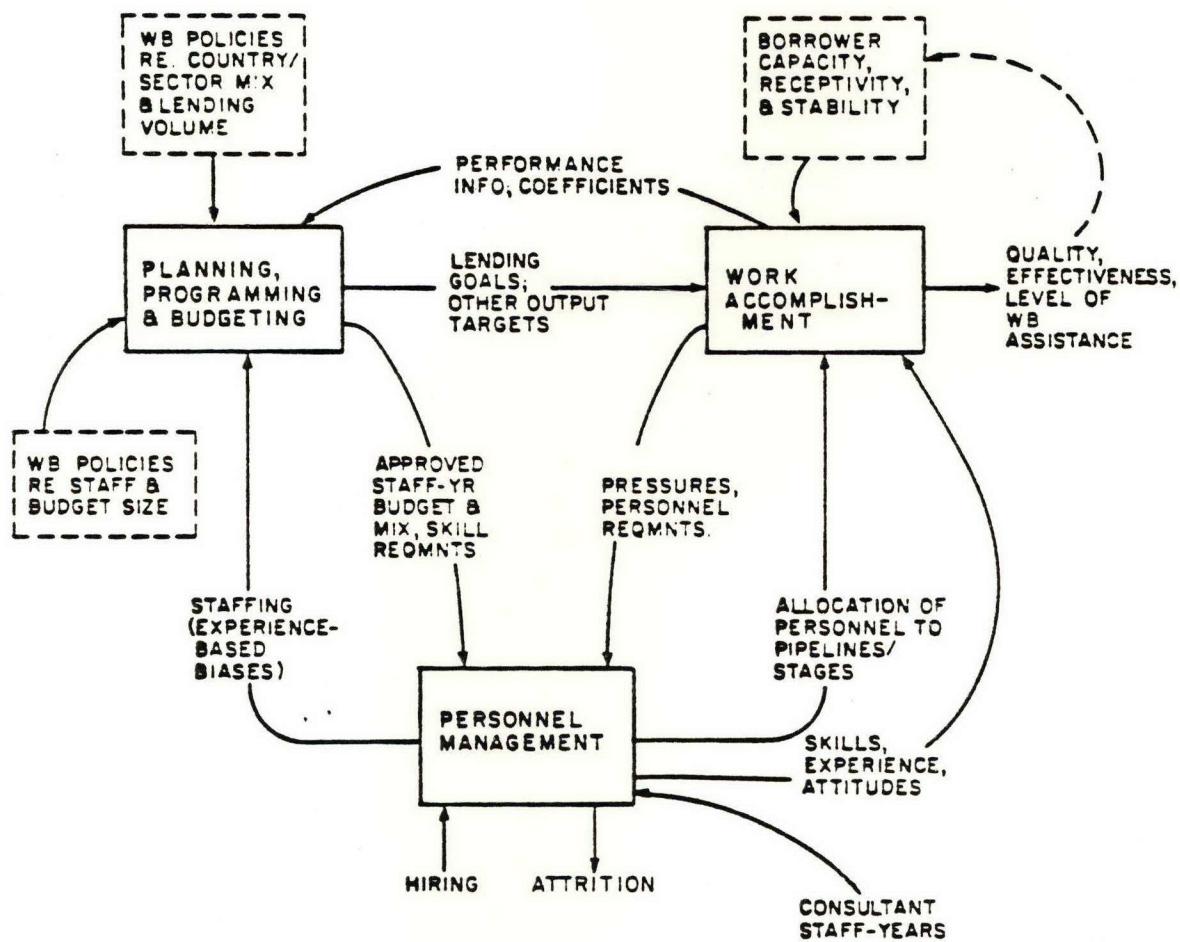
Each building block, or sector, of the model represents one of the Bank's major "subsystems". The functions of these building blocks are summarized below:

1. Planning, Programming, and Budgeting Block -- determines lending goals and other output targets (by country-income group and sector); reconciles Bank-wide assistance objectives with the capabilities and interests of present staff; calculates approved staff-years budgets.
2. Work Program Block -- represents the flow of projects through a series of multi-stage pipelines, from initiation to supervision (there is a separate pipeline for each combination of country-income group and sector); allocates available staff-years to project work, economic and sector work, and other direct work; calculates staff productivities for each stage of each pipeline; determines measures of the "technical quality" and potential "development impact" of Bank outputs (these terms are defined below).
3. Personnel Management Block -- represents the hiring, advancement, reassignment, and attrition of personnel (by country-income group, sector, and discipline); calculates various institutional and individual measures of experience; determines the allocation of personnel to all elements of the work program.

The building blocks are highly interactive in the model, just as the processes they represent interact in the "real world". The most important interactions are shown in Exhibit 1. The Planning, Programming, and Budgeting Block performs its calculations based on: overall Bank policies regarding country/sector mix, lending volume, staff size, and budget growth (these are external inputs to the model); the experience-based biases of the Bank's present staff regarding what are appropriate projects to under-

EXHIBIT 1

HOW THE KEY BUILDING BLOCKS INTERACT



take (these come from data on staff experience and specialization in the Personnel Management Block); and perceptions of productivity and Bank performance, e.g., the budgeting coefficients (these arise from the Work Program Block).

The Work Program Block operates based on: lending goals and other output targets (from the PPB Block); the capacity, receptivity, and stability of borrowers (this is determined by a combination of Bank effectiveness, calculated within the model, and user-defined scenario inputs); and the numbers, skills, and experience of personnel allocated to each element of the work program (which are outputs of the Personnel Management Block).

The Personnel Management Block hires, advances, allocates, and loses staff based on: approved staff-year budgets and associated skills mix (from the PPB Block); personnel requirements and priorities of the work program (these arise from the Work Program Block); Bank policies regarding the mix of permanent and temporary staff (external inputs to the model); and labor market conditions (another set of external inputs).

There are hundreds of assumptions built into the model, but the most critical ones have to do with the determinants of staff productivity and the quality and impact of the Bank's products. For lending projects, the model calculates four "stage productivities" for each country-income group/sector pipeline: pre-appraisal, appraisal, negotiation and approval, and supervision. These productivities are dynamic, and can vary significantly over time. The model represents many effects on productivity. They describe how, and why, productivity at any point in time differs from productivity in the reference year (which is 1981). The factors in the model which can affect productivity are:

1. staff experience;
2. world-wide Bank experience in a sector;
3. Bank experience in a particular country and sector;
4. adequacy of economic and sector work;
5. policy content of projects;
6. workload pressure;
7. quality of work at the preceding stage;
8. adequacy of support services; and
9. sub-sector mix and other factors.

The first seven are calculated inside the model. The final two are external inputs.

The model contains several important measures of the quality and effectiveness of Bank products. These are:

1. Policy content of projects -- refers to the amount of policy dialogue, training, technical assistance, and other similar activities incorporated in lending projects; the policy content increases with Bank experience, adequacy of ESW, and availability of staff time.
2. Technical quality of projects -- is defined in terms of the correctness and completeness of the technical work; it is measured on a scale of 0 to 10, with the index normalized for conditions in 1981; technical quality, like adequacy of ESW, depends on staff experience, Bank experience, and workload pressure.
3. Development impact -- denotes the potential effect of Bank assistance on economic growth in borrower countries; in the model, the magnitude and effectiveness of both the Bank's lending and "intellectual activities" (i.e., policy content of projects, ESW, other direct work) combine in an indicator of development impact; technical quality, sector mix, adequacy of ESW, and adequacy of supervision are important factors determining the effectiveness of Bank programs.
4. Beneficiary impact -- defines whether the development impact is targeted according to Bank objectives; in the model, success in targeting is measured by the congruence between the actual country and sector mix and the Bank's desired mix.

The above measures certainly are not perfect. They do, however, provide a useful framework for discussing, analyzing, and projecting how the various components of the Bank's "product" complement one another, and the consequences of changes in the magnitudes or mix of those components. The Programming/Personnel/Budgeting Model has not attempted to capture the very complex process of economic development in borrower countries.

E. Historical Performance of the Model

For several important reasons, the first use of the model was to simulate the period from FY71-FY83. This facilitates: (1) the comparison of simulation results with actual historical data; (2) evaluation and refinement of the assumptions in the model; and (3) diagnosis of the causes of past trends.

Exhibits 2 through 6 show model simulation output for a number of important performance measures, and plot some actual historical data for comparative purposes. The historical data are not used by the model in any way to produce this simulation. The simulated output is produced solely by the structure, and assumptions in the model; quite specifically, the model is not reinitialized during the course of a simulation to bring it back into line with the historical data.

In general, for the variables shown, and for most other simulated variables, model output is within $\pm 5-10\%$ of actual Bank performance. This index serves as an important check on model validity, and indicates that model relationships -- which seemed reasonable when examined one at a time -- collectively produce behavior which is consistent with past realities.

EXHIBIT 2 BANK-WIDE LENDING SUMMARY

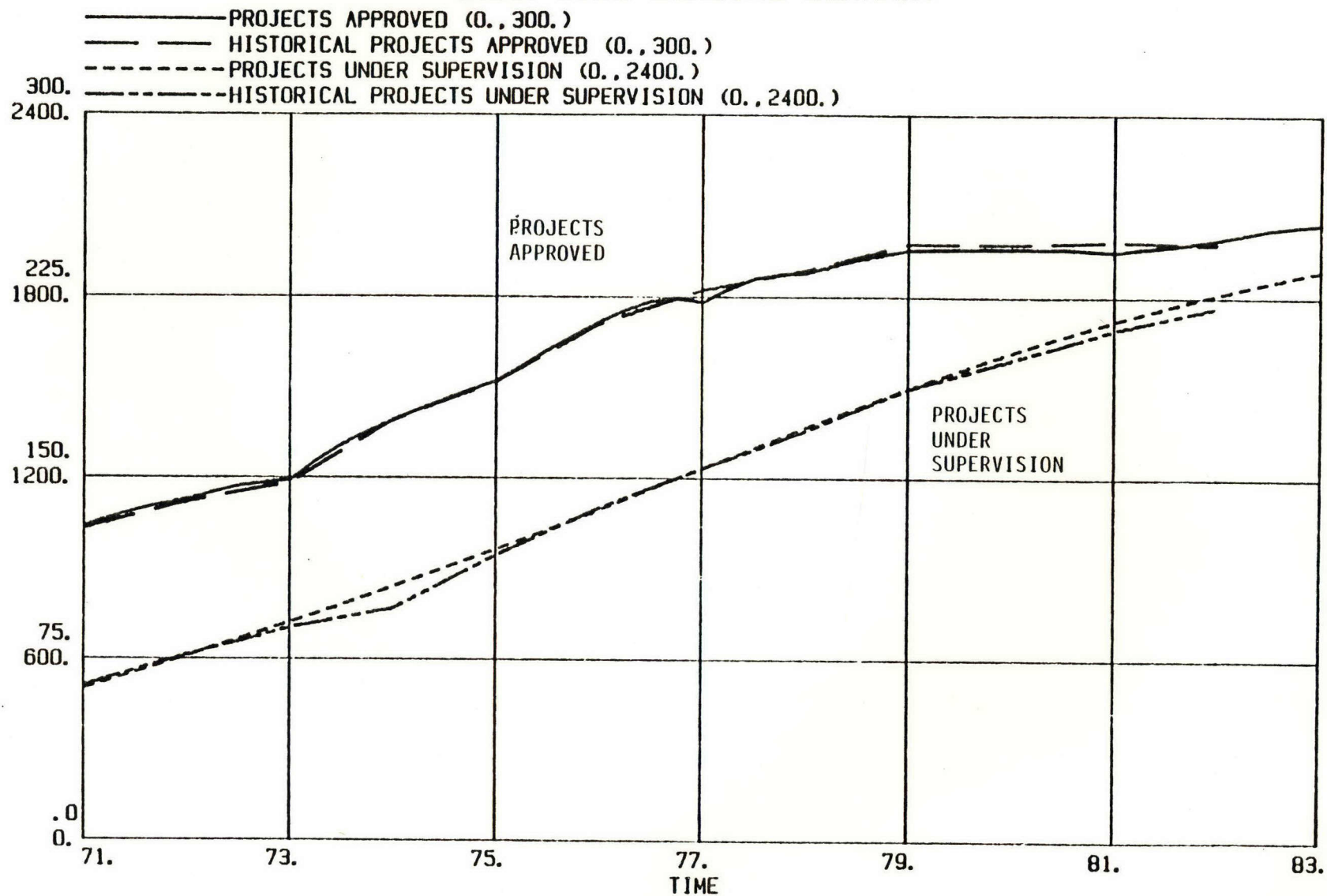


EXHIBIT 3
OPERATIONAL WORK PROGRAM

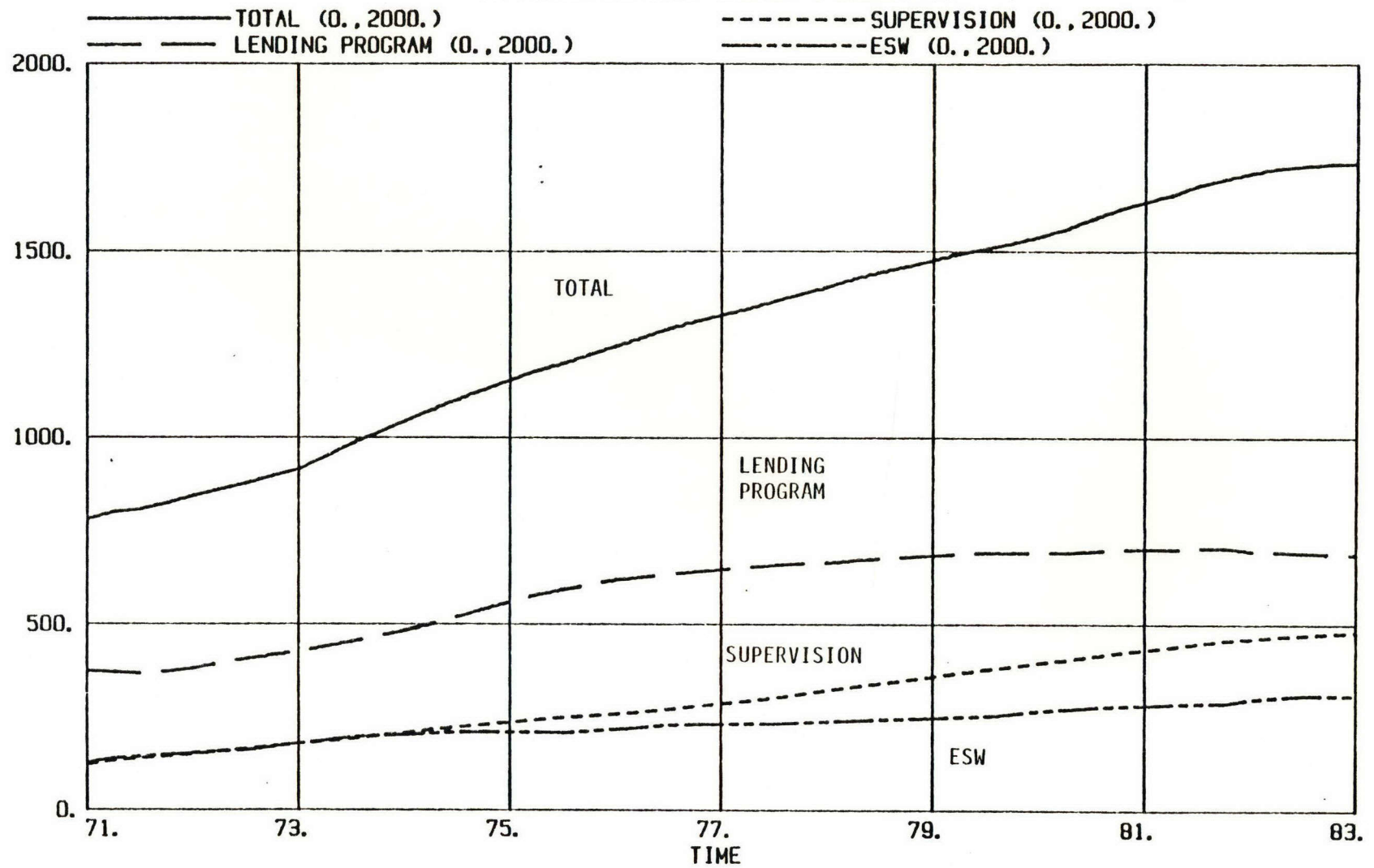


EXHIBIT 4
BANK-WIDE OPERATIONS STAFF

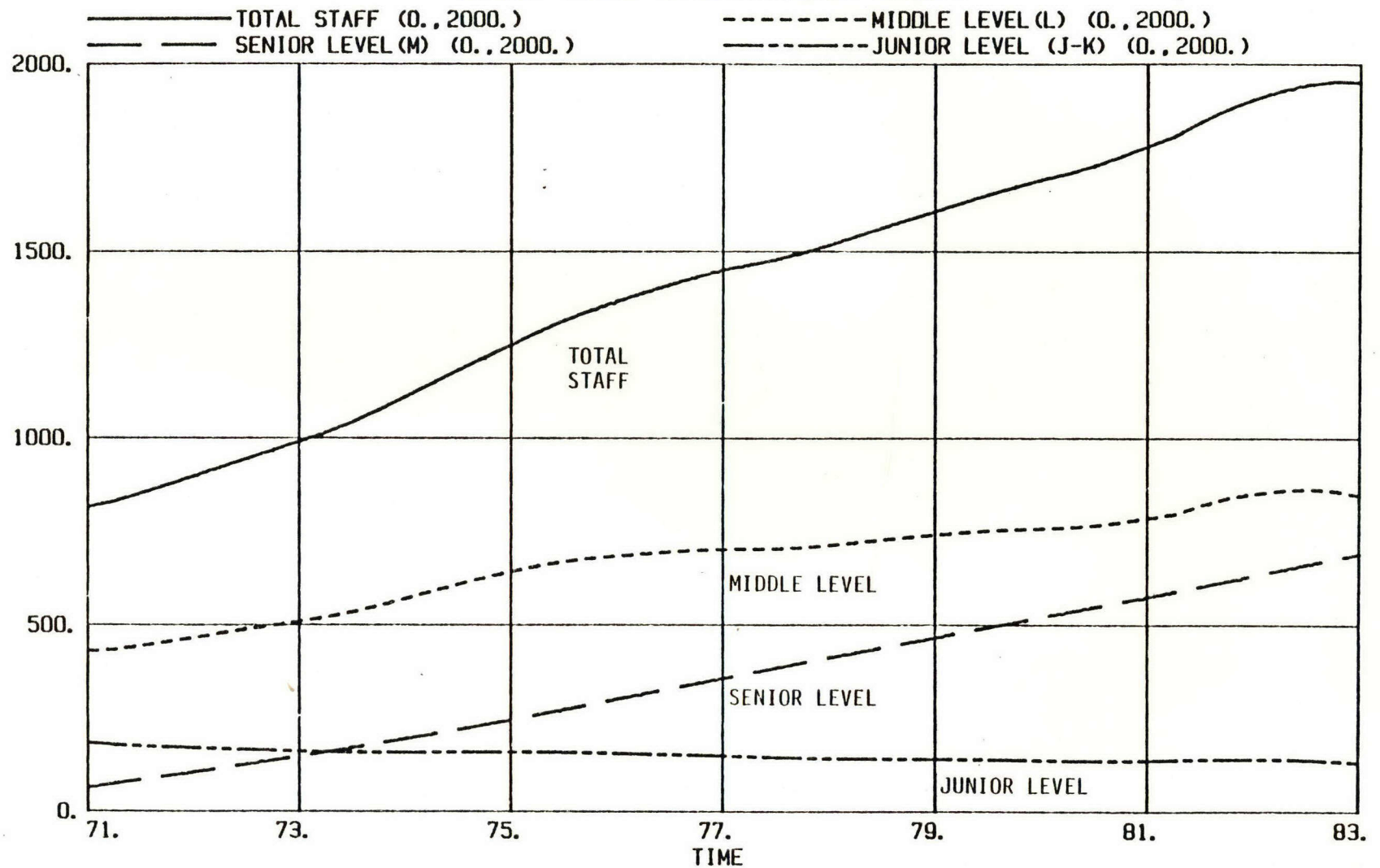


EXHIBIT 4 (continued)
MODEL FIT TO STAFF

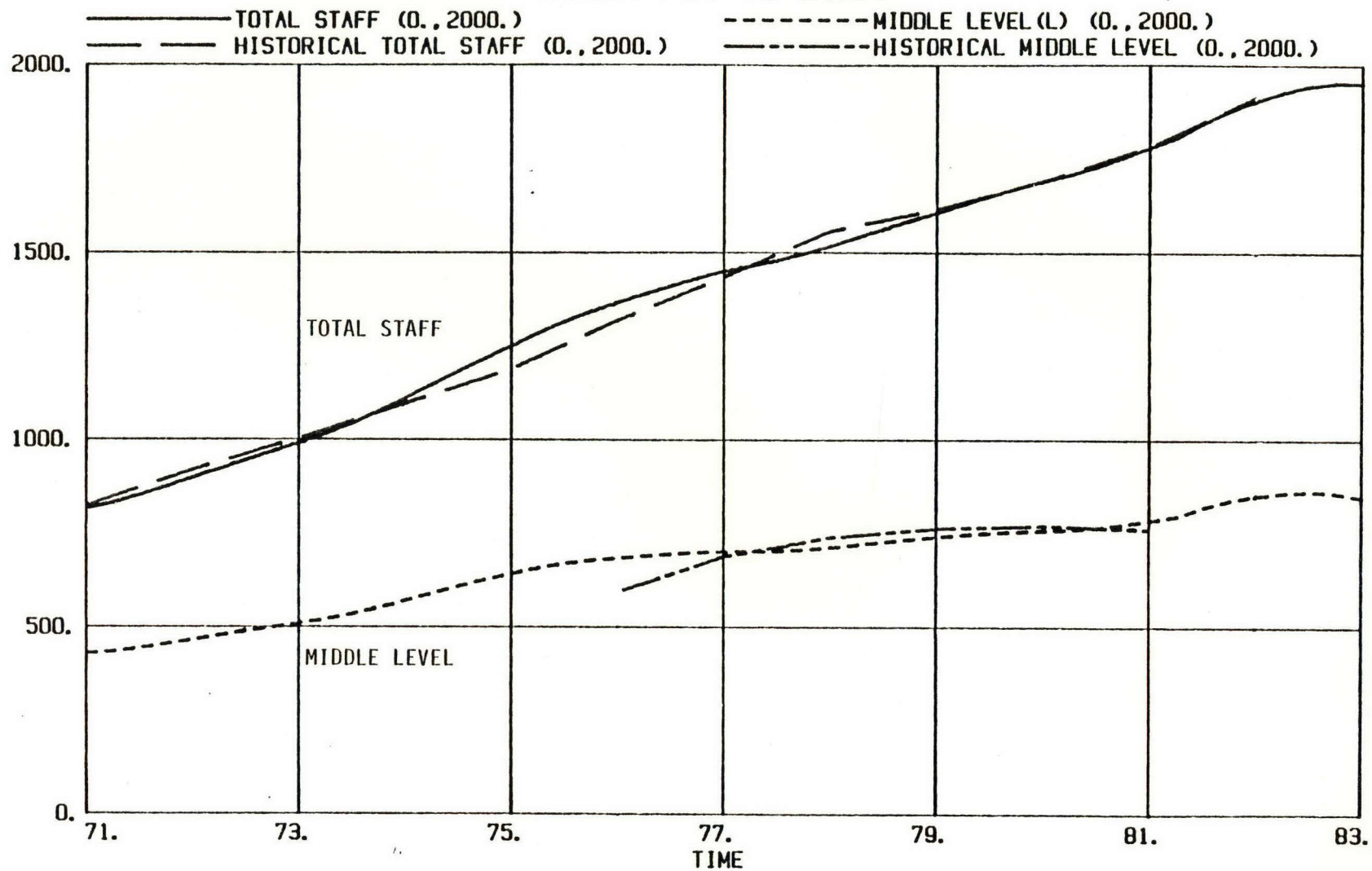


EXHIBIT 5 LENDING COEFFICIENT

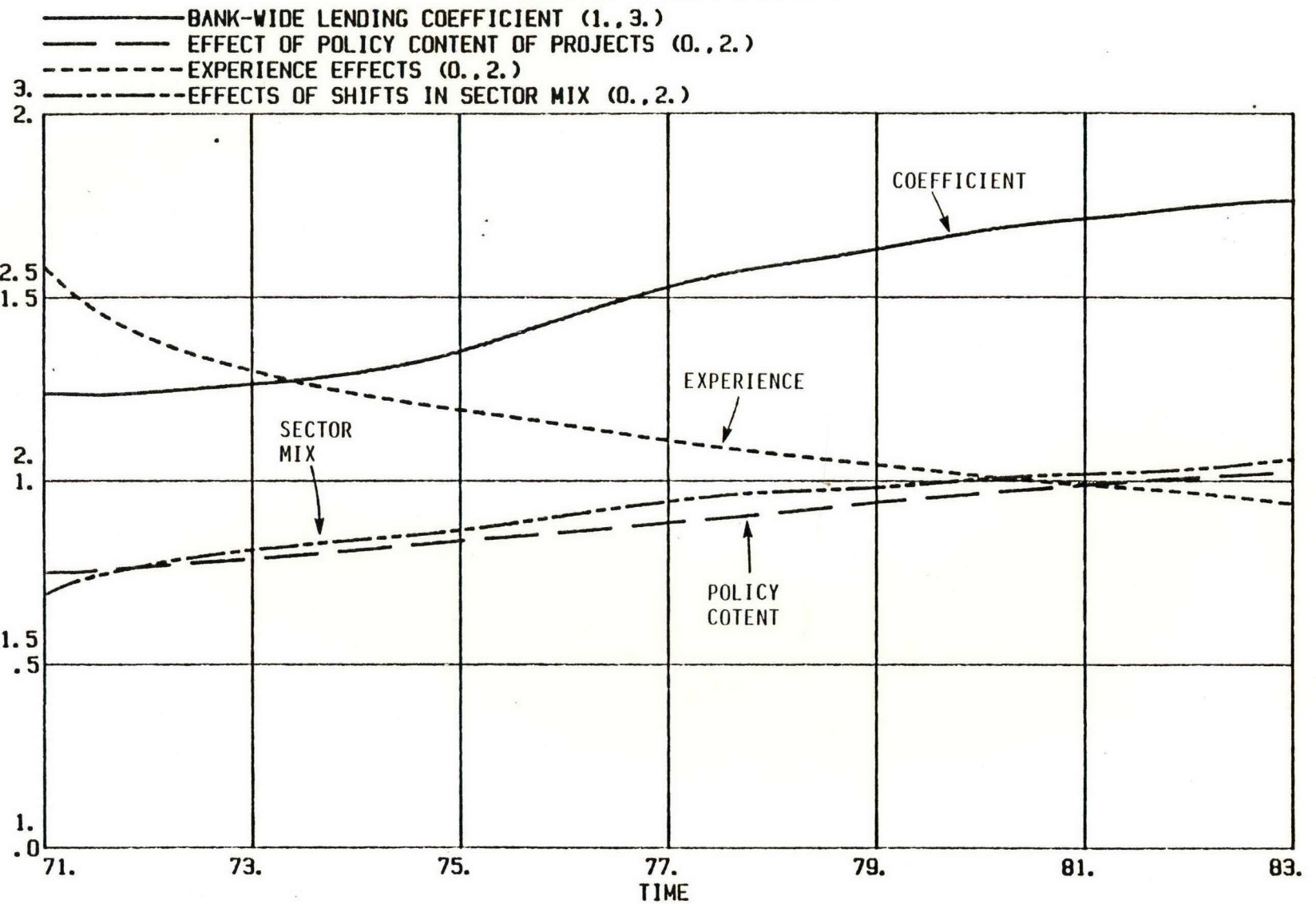
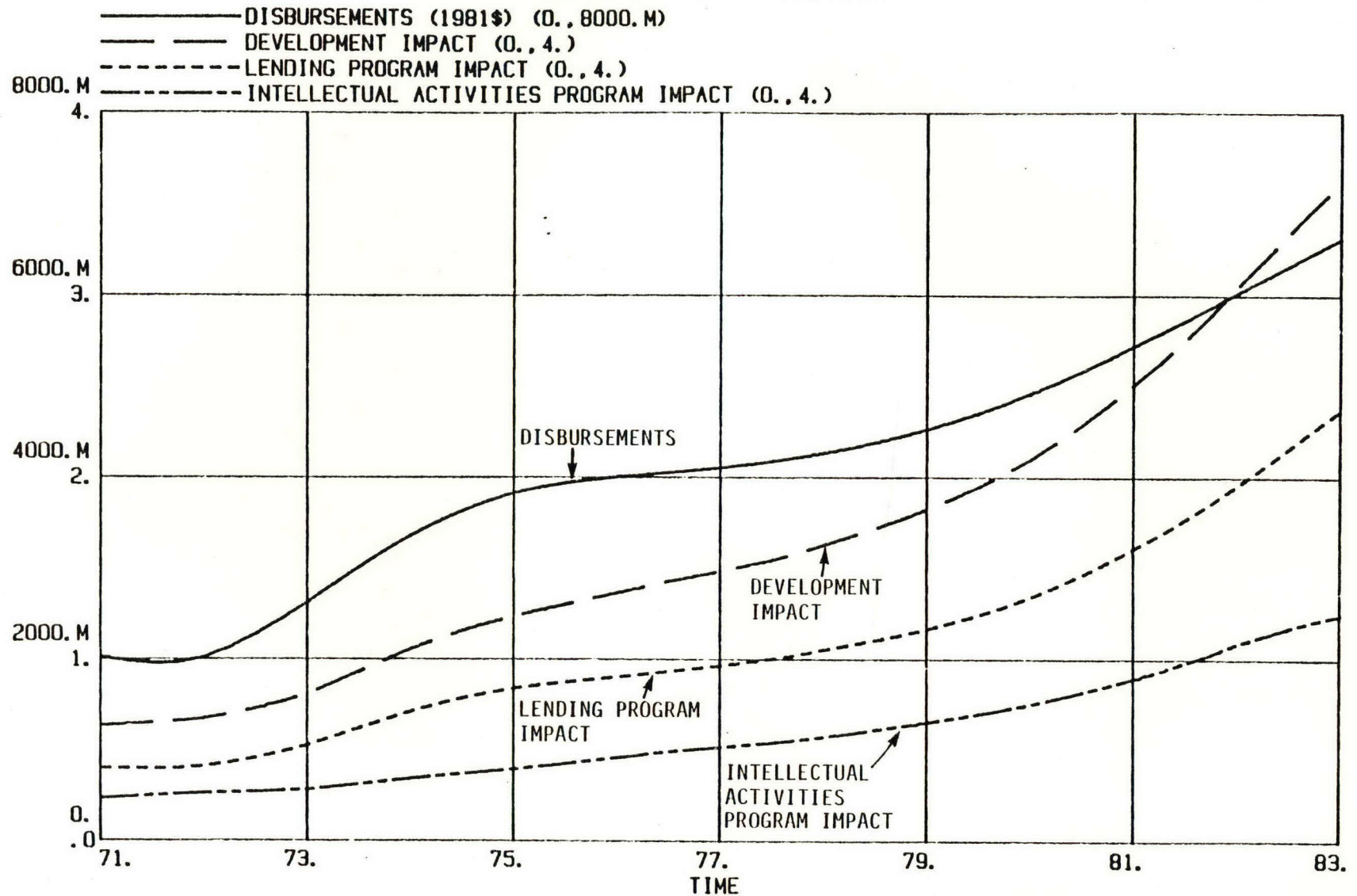


EXHIBIT 6 DEVELOPMENT IMPACT



The correspondence between output and actual performance also reduces the likelihood that important relationships which existed over the historical period were omitted from the model. This increases our confidence that the model will be useful in projecting Bank performance into the future. In each figure, "time" flows from left to right along the horizontal axis, from 1971 to 1983; the scales for each variable are given to the left of the vertical axis.

A number of important historical trends can be noted in the historical output from the model:

1. The rapid growth in projects, work program, and staff between 1971 and 1977, and the subsequent leveling from 1978 onward.
2. The increase in the Bank-wide lending coefficient, caused by:
 - o shifts in sector mix, and
 - o reinvestment of potential productivity gains (from experience) into the policy content of projects.
3. Large increases in the Bank's development impact, caused by:
 - o growth in the magnitudes of both lending and intellectual activities, and
 - o cross synergies, where intellectual activities increase the effectiveness of lending (via "capacity") and lending increases the effectiveness of intellectual activities (via "receptivity").

F. The Base Case Projection

What is the likely evolution of the Bank assuming a continuation of present management policies and current planning assumptions (as of 12/82)? Exhibit 7 lists these assumptions. Lending will grow slowly over FY82-FY84, spurt in FY85, then stabilize starting in FY86. Economic and sector work and other direct work will take big jumps between FY82 and FY83, but

EXHIBIT 7 BASE CASE ASSUMPTIONS

OPERATIONAL WORK PROGRAM

1. Lending Volume:

	BANK		IDA	
	Billions 1982\$	Operations	Billions 1982\$	Operations
FY82	10.4	153	2.7	94
FY83	11.2	157	3.0	95
FY84	11.9	159	3.0	99
FY85	12.9	165	5.0	115
FY86	13.6	167	5.3	118
FY87 & after	15.1	167	5.7	118

2. Lending Mix (Fraction of Projects):

	<u>BANK</u>	<u>IDA</u>
Agriculture	.30	.36
Transportation and Tele-communications	.13	.15
Industry	.18	.12
Urban, PHN, and Water Supply and Sewerage	.19	.14
Energy	.12	.10
Program Lending	.08	.13

3. Supervision Based on Pipeline

4. Economic and Sector Work: 310 Staff-Years/Year (versus 287 staff-years budgeted, FY82)

5. Other Direct Work: 259 Staff-Years/Year (versus 217 staff-years budgeted, FY82)

EXHIBIT 7 (cont'd)

BUDGETING

FOLLOWS TRADITIONAL PROCEDURES

PERSONNEL

1. ATTRITION RATES WILL REMAIN AT HISTORICAL LEVELS, EXCEPT WHERE AGING INCREASES SENIOR-LEVEL ATTRITION
2. FRACTION OF STAFF BY DISCIPLINE IN A GIVEN SECTOR WILL REMAIN AT HISTORICAL VALUES
3. OTHER STAFF-YEARS ON THE OPERATIONAL WORK PROGRAM:

YPP -- 20 (45 IN FY82)

COOPERATIVE -- 65 (80 IN FY82)

then remain flat. Personnel policies will remain as they are now. Other staff years will drop from FY82 values, but remain constant thereafter. The Base Case, therefore, is one of modest growth in the the next fiscal year, a spurt of lending in FY85, and then no growth thereafter.

Exhibits 8 through 14 show model simulation output for a number of key performance measures for 15 years into the future. A number of important trends can be noted in these exhibits:

1. Except for the brief spurt in FY85, the lending program remains flat. Projects under supervision, however, continue to grow until FY95. Work program staff-years grow in FY85, then level off. Slight declines in lending are offset by increases in supervision.
2. Operations staff also will grow over the next five years, but thereafter remain nearly constant. As a result, staff experience increases substantially, as does the proportion of senior level staff.
3. With the shift from growth to a stable lending program, the various experience factors have a downward effect on the coefficients. But these are nearly offset by continued improvements in the Bank's product -- i.e., the reinvestment of potential productivity gains into increases in the policy content of projects.
4. As a result, the apparent surplus of staff bank-wide is minimal. If policy content were maintained at FY81 levels, however, the surplus of staff would be about 13%. The historically faster-growing sectors experience a greater surplus, because they have greater productivity improvements.
5. Development impact continues to improve until FY95. But continued population growth in borrowing countries gradually causes impact to level (and to decline after FY97).

G. Planning Issues Raised by Model Use to Date

The Programming Personnel/Budgeting Planning Model provides the Bank with a powerful tool for asking "What If" questions. It specifically provides the Bank with the capacity to (1) analyze the consequences of different trends in the external environment; (2) develop contingency

EXHIBIT 8 BANK-WIDE LENDING SUMMARY

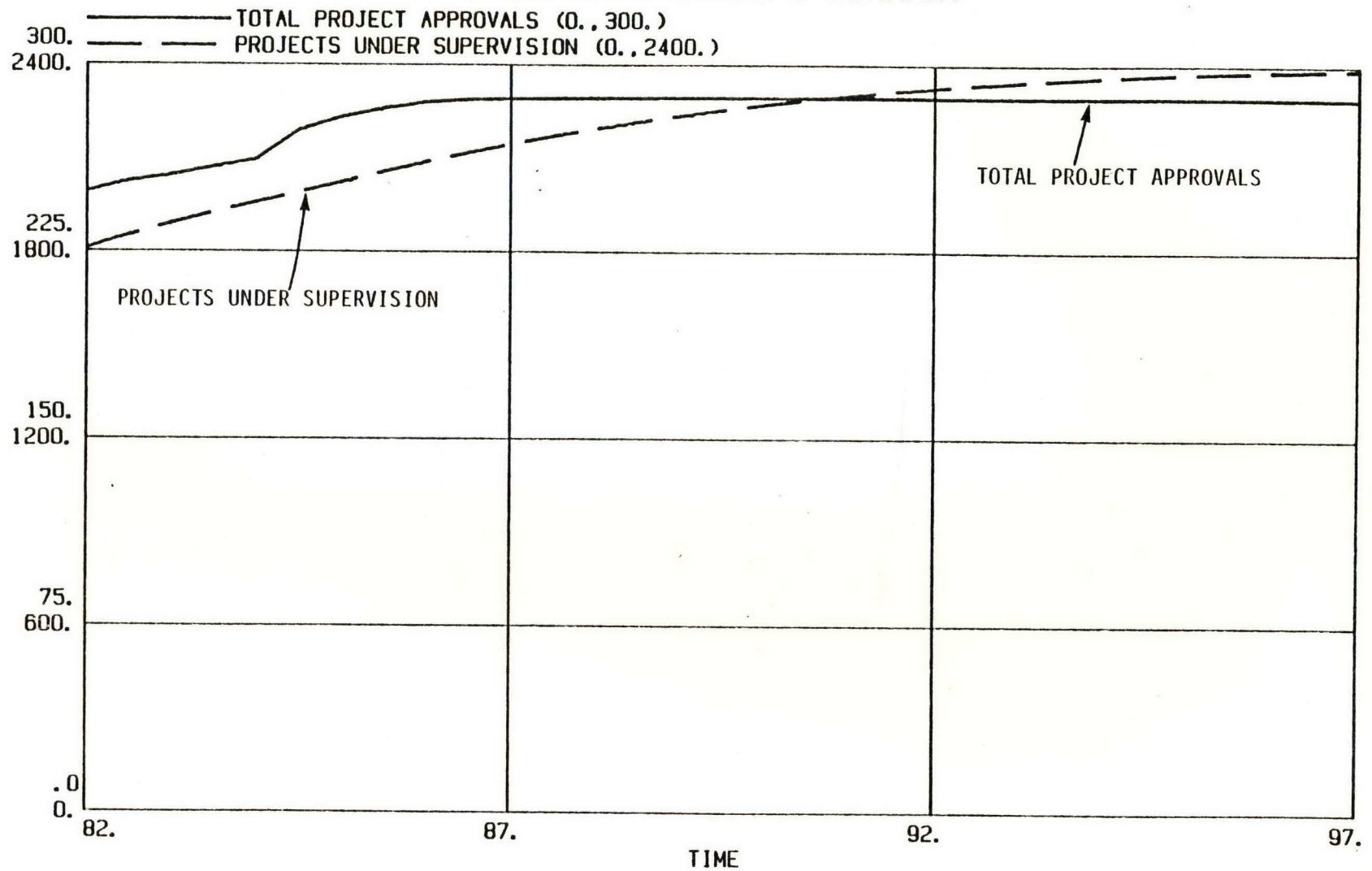


EXHIBIT 9
OPERATIONAL WORK PROGRAM

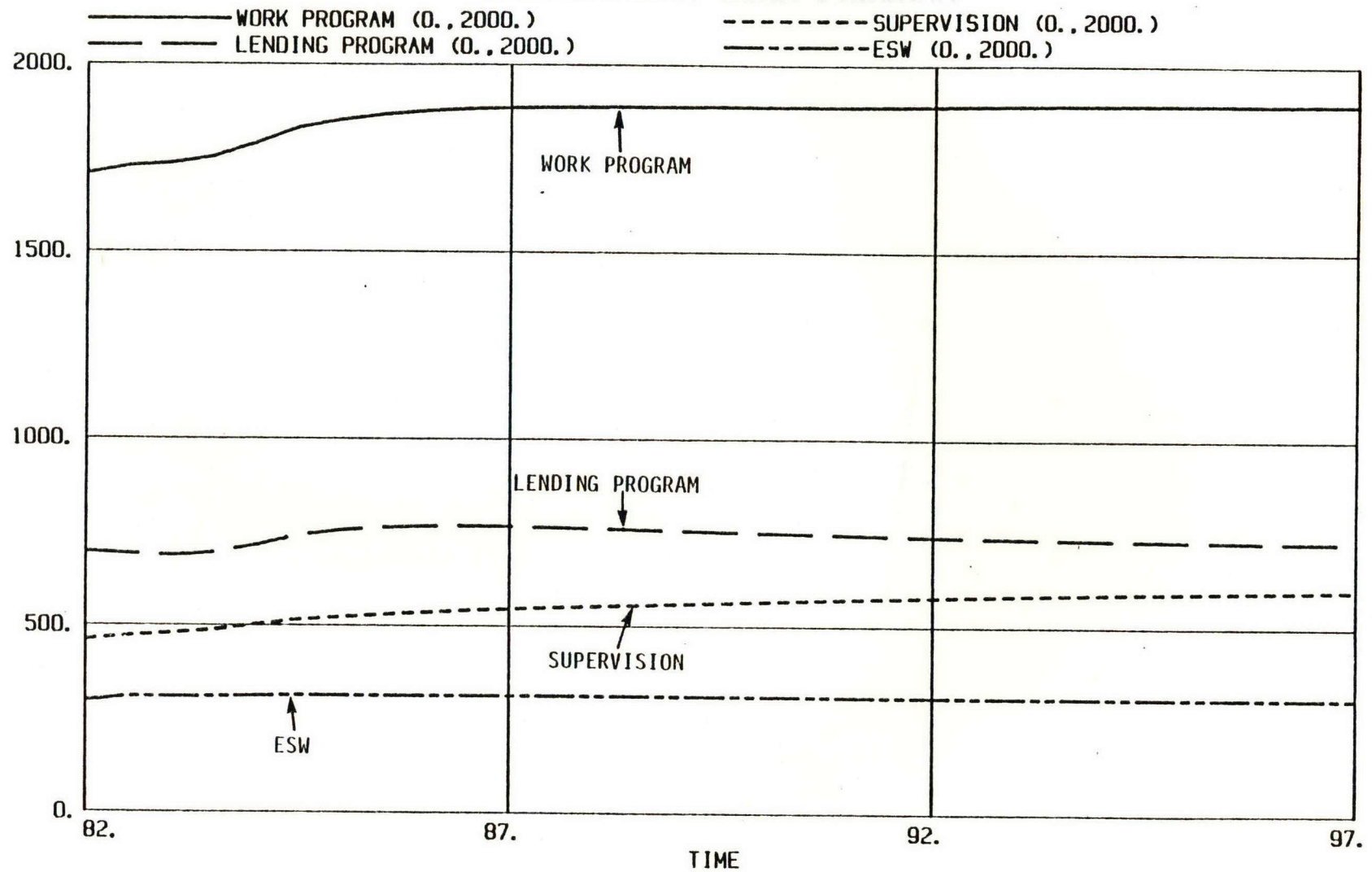


EXHIBIT 10 BANK-WIDE OPERATIONS STAFF

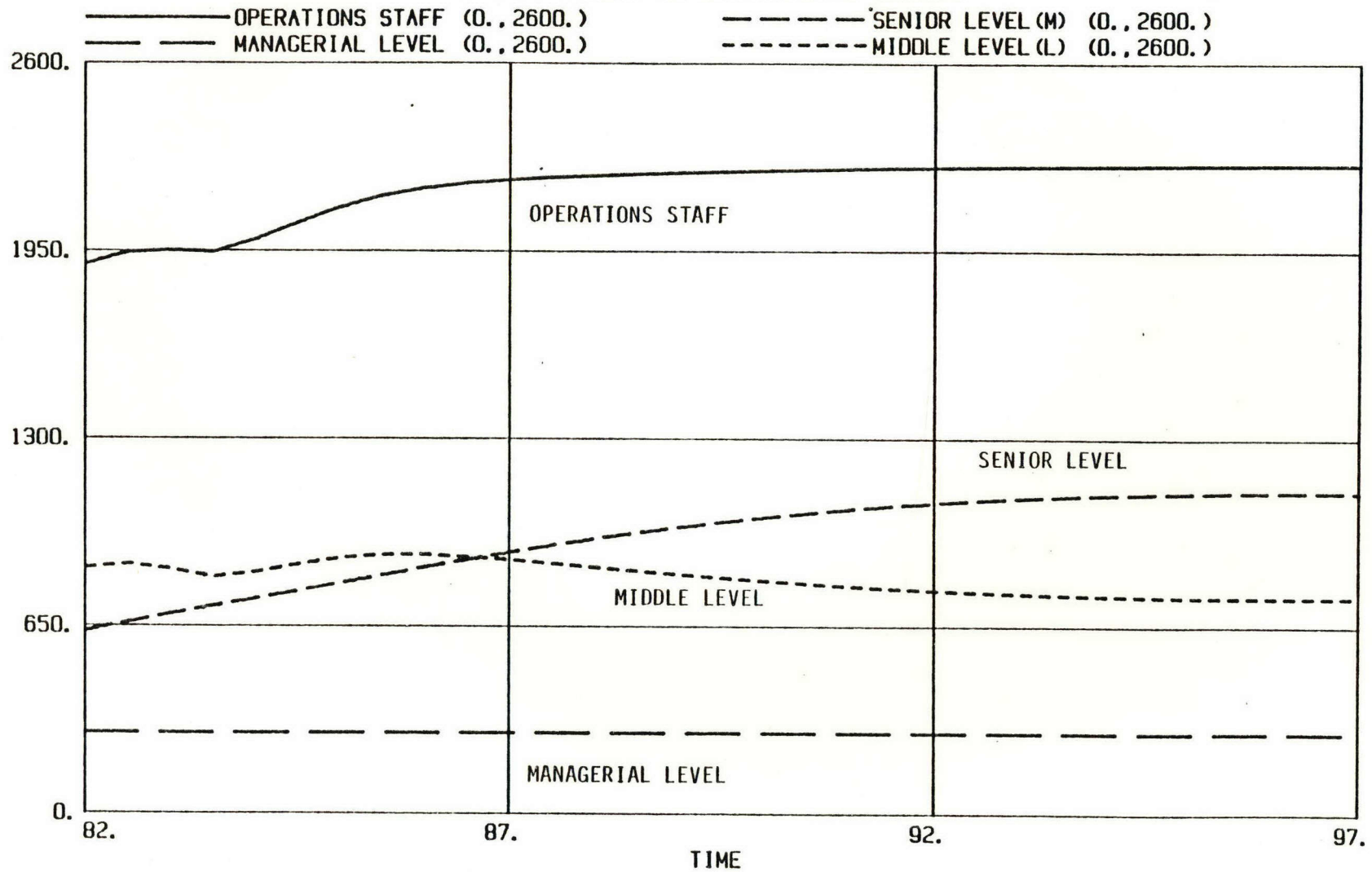


EXHIBIT 11

PERSONNEL

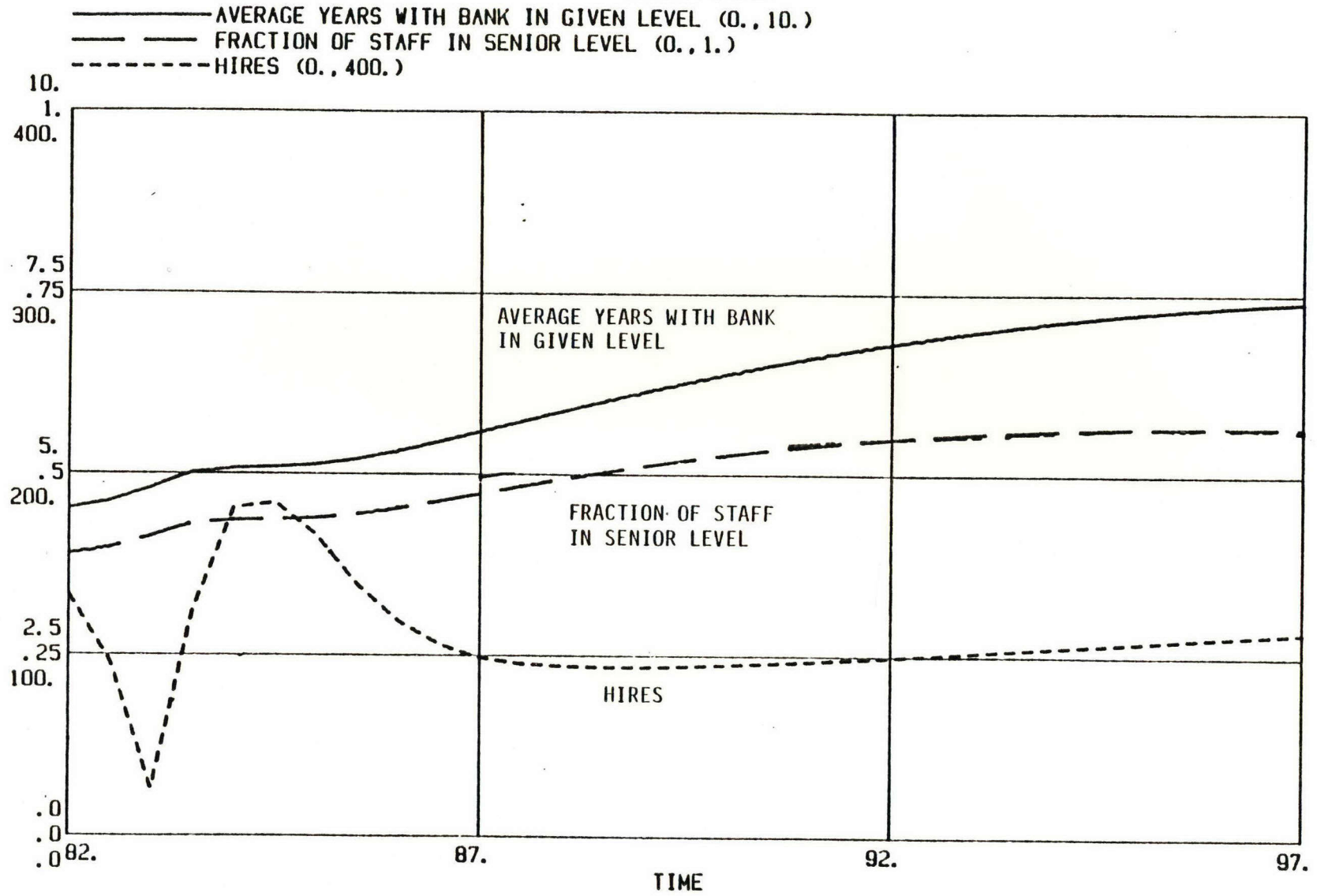


EXHIBIT 12 LENDING COEFFICIENT

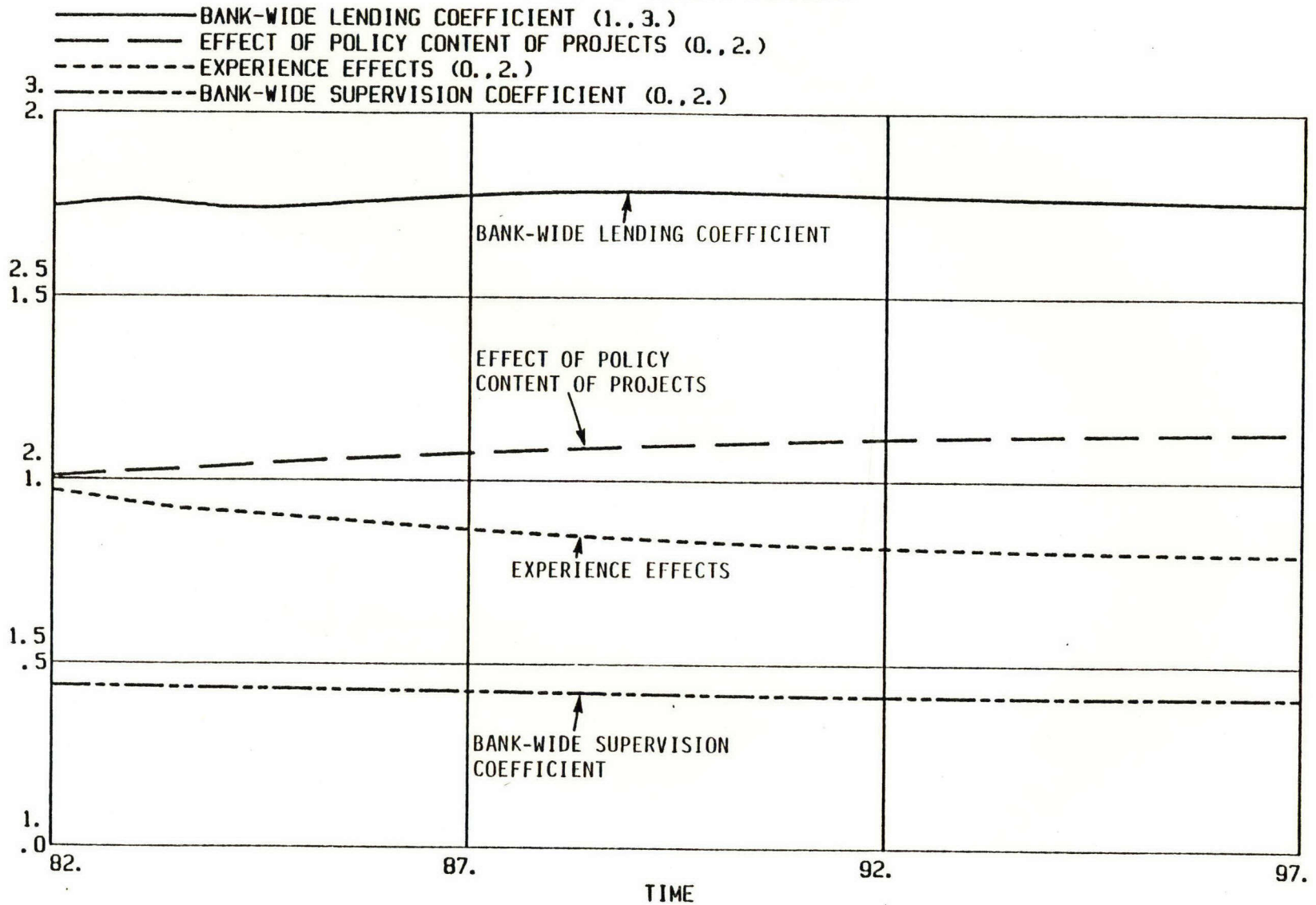


EXHIBIT 13
STAFF AVAILABILITY INDEX

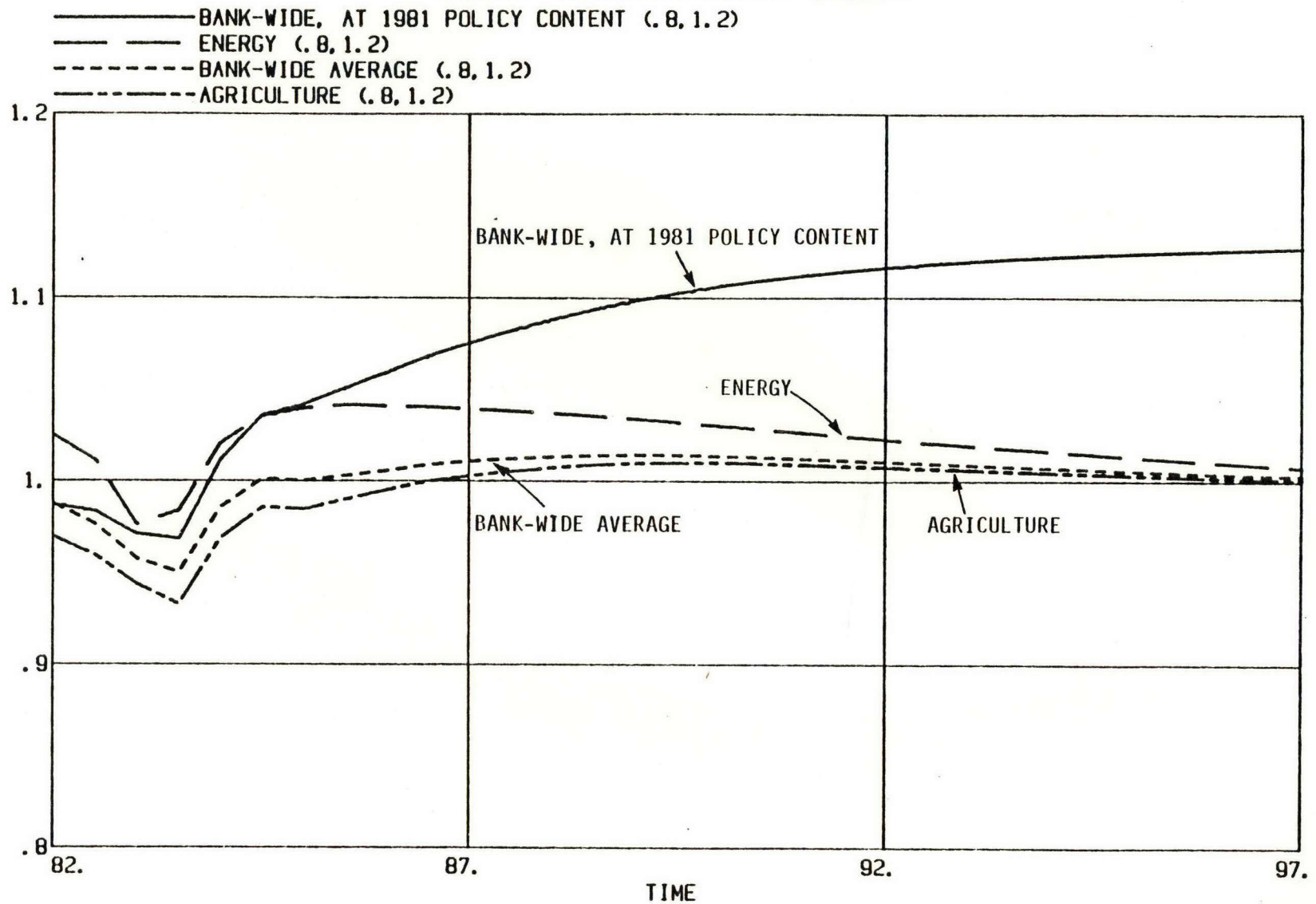
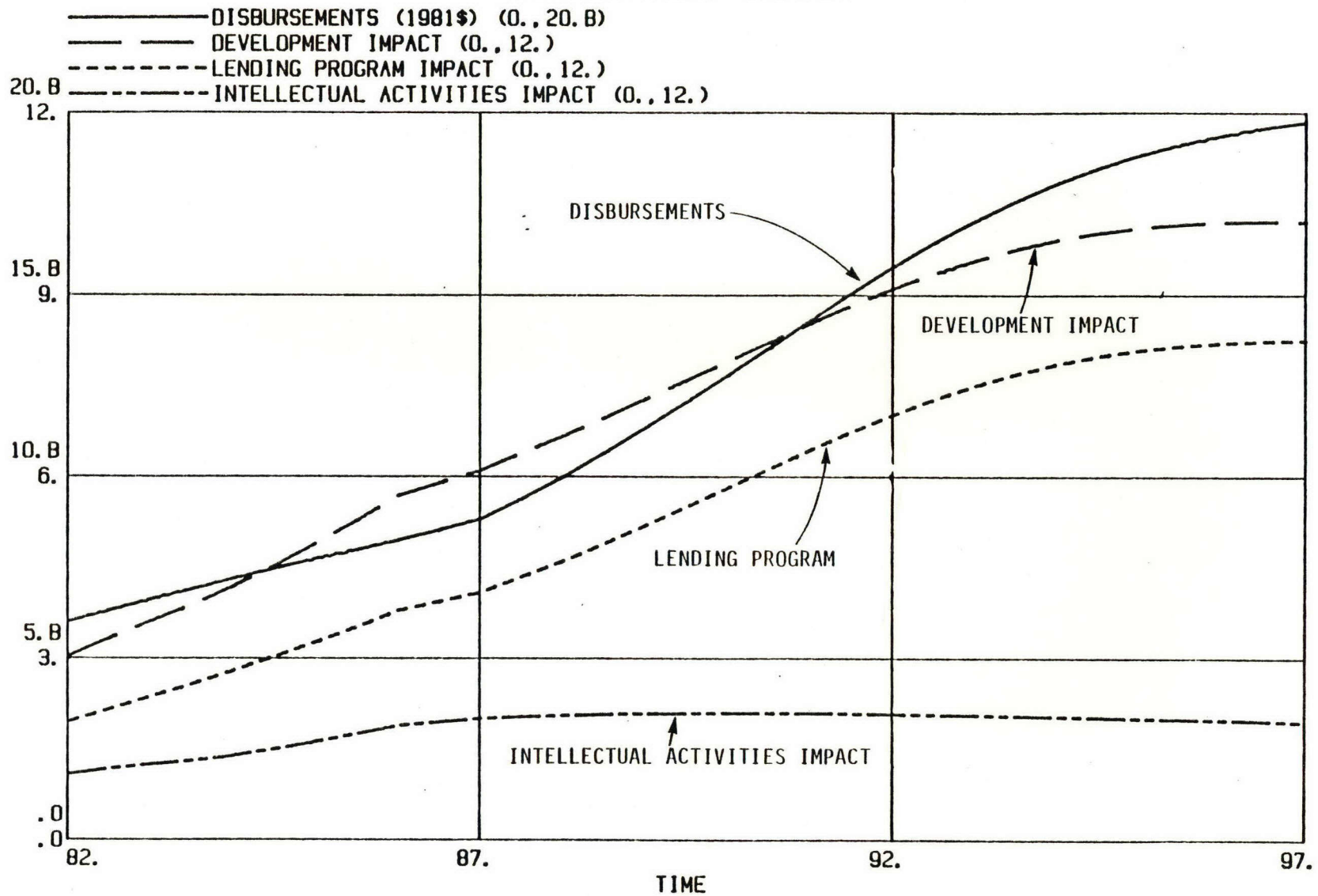


EXHIBIT 14 DEVELOPMENT IMPACT



plans; and (3) identify and evaluate changes in the Bank's strategies and policies which might improve performance.

A number of illustrative policy and strategy experiments have been performed to date. They are reported on in the main body of this report, and revolve around the problem of coping with a more difficult lending environment (defined as an increase in lending coefficients, more dropped projects, and reduced borrower capacity to utilize Bank loans). The consequences of a number of Bank actions to mitigate the impact of this more difficult environment were tested, including increased program lending and ESW, changed budgeting and personnel policies, increased lending volume, and faster disbursements.

As an example of using the model in this "What If" capacity, Exhibits 15, 16 and 17 show the changes in Bank performance as a result of first a change in the external environment (more difficult lending environment described above), and then of a change in Bank strategy designed to mitigate the impact of the environmental change (a temporary doubling of program lending and associated ESW). As a result of the more difficult environment, the Bank's development impact falls short of Base Case levels (Exhibit 15); increased program lending improves the situation, but the lead times involved in gearing up for appraising, and disbursing at a higher level mean that development impact is below Base Case levels until FY87. By definition, the more difficult lending environment results in an increase in the lending coefficient (Exhibit 16); greater program lending reduces the magnitude of the increase because loans in this sector are less staff intensive. The increased lending coefficient causes an increase in operations staff (Exhibit 17); with more program lending, operations staff eventually fall below Base Case levels because of reductions in supervision

EXHIBIT 15 DEVELOPMENT IMPACT

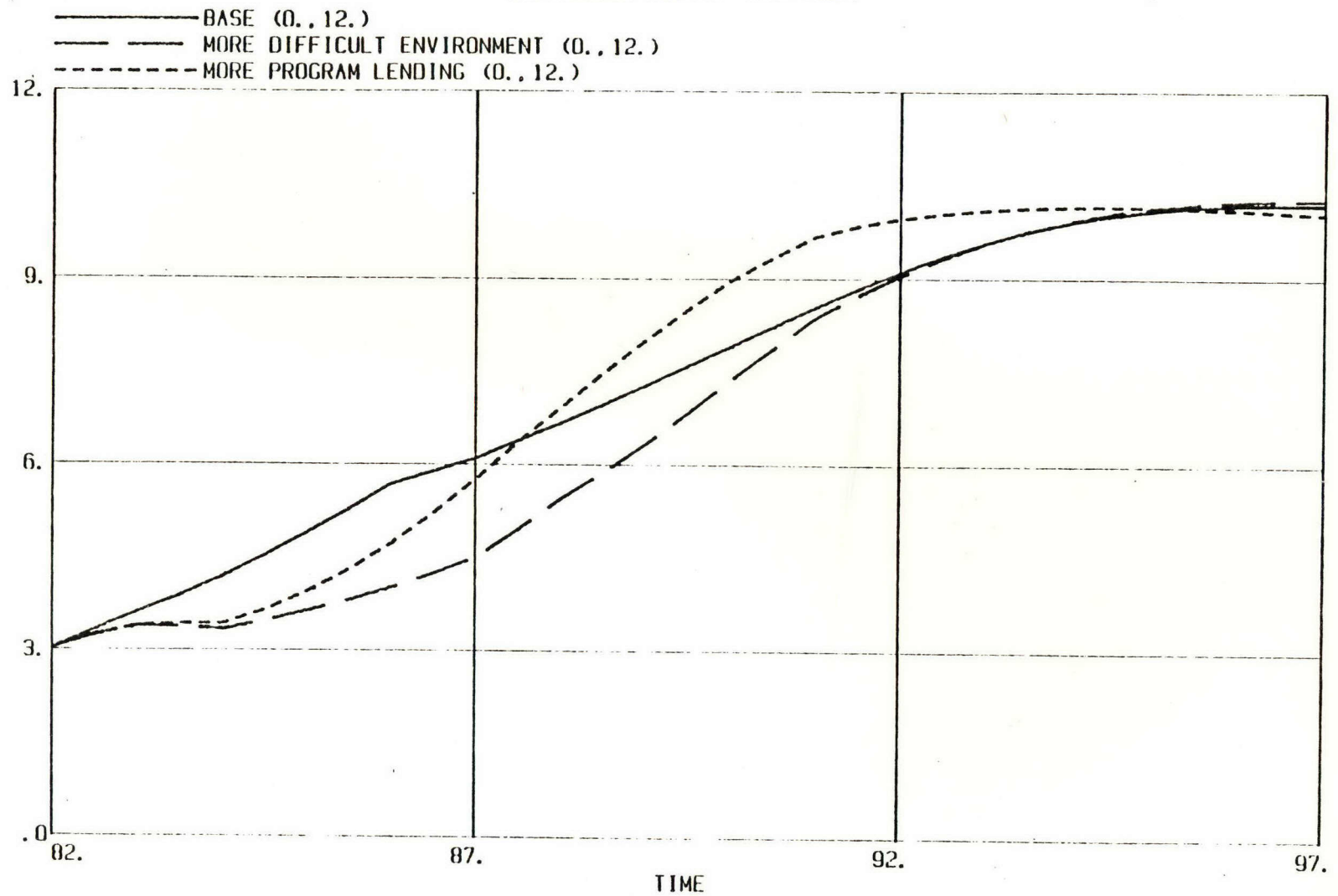


EXHIBIT 16
BANK-WIDE LENDING COEFFICIENT

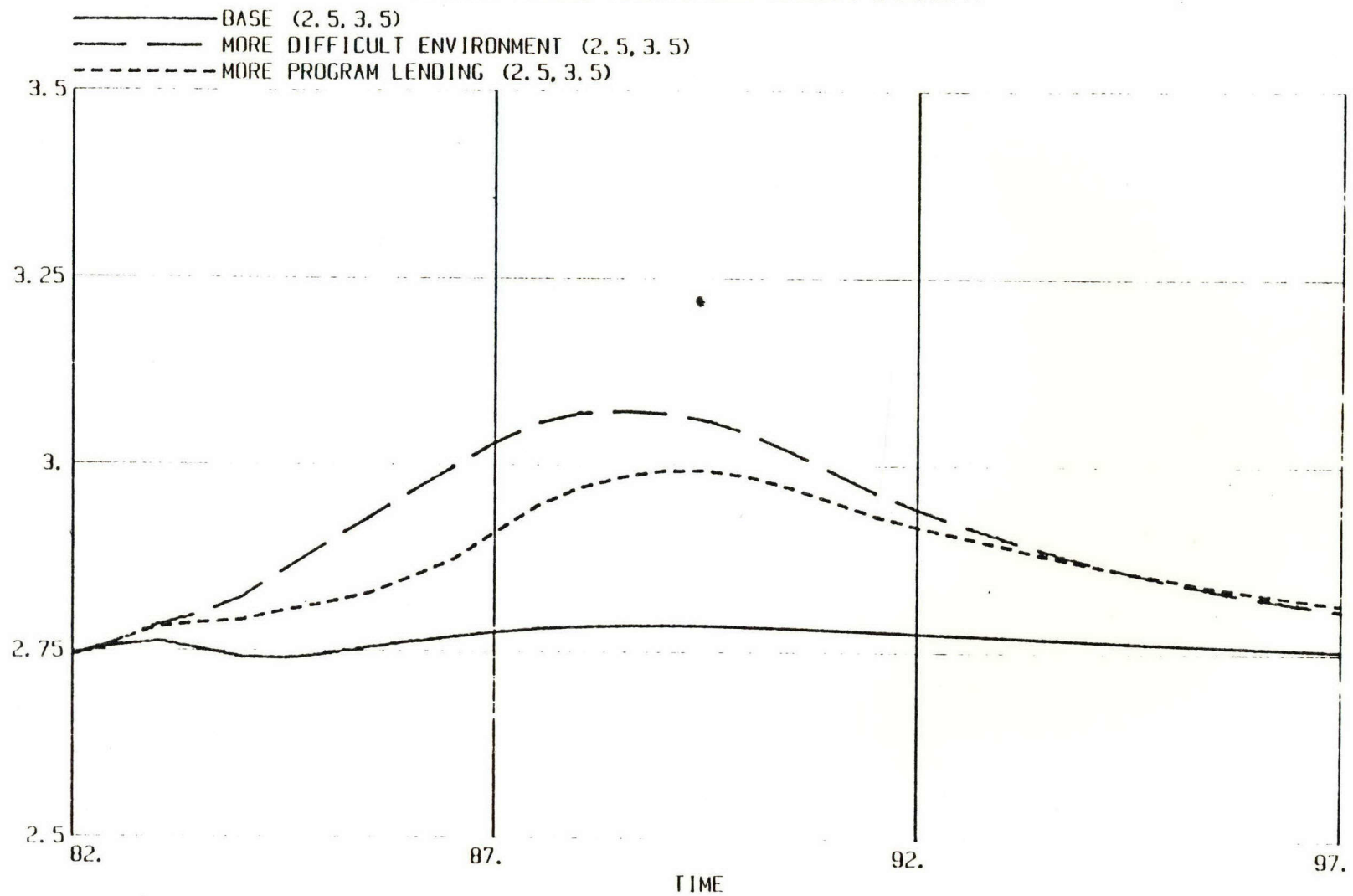
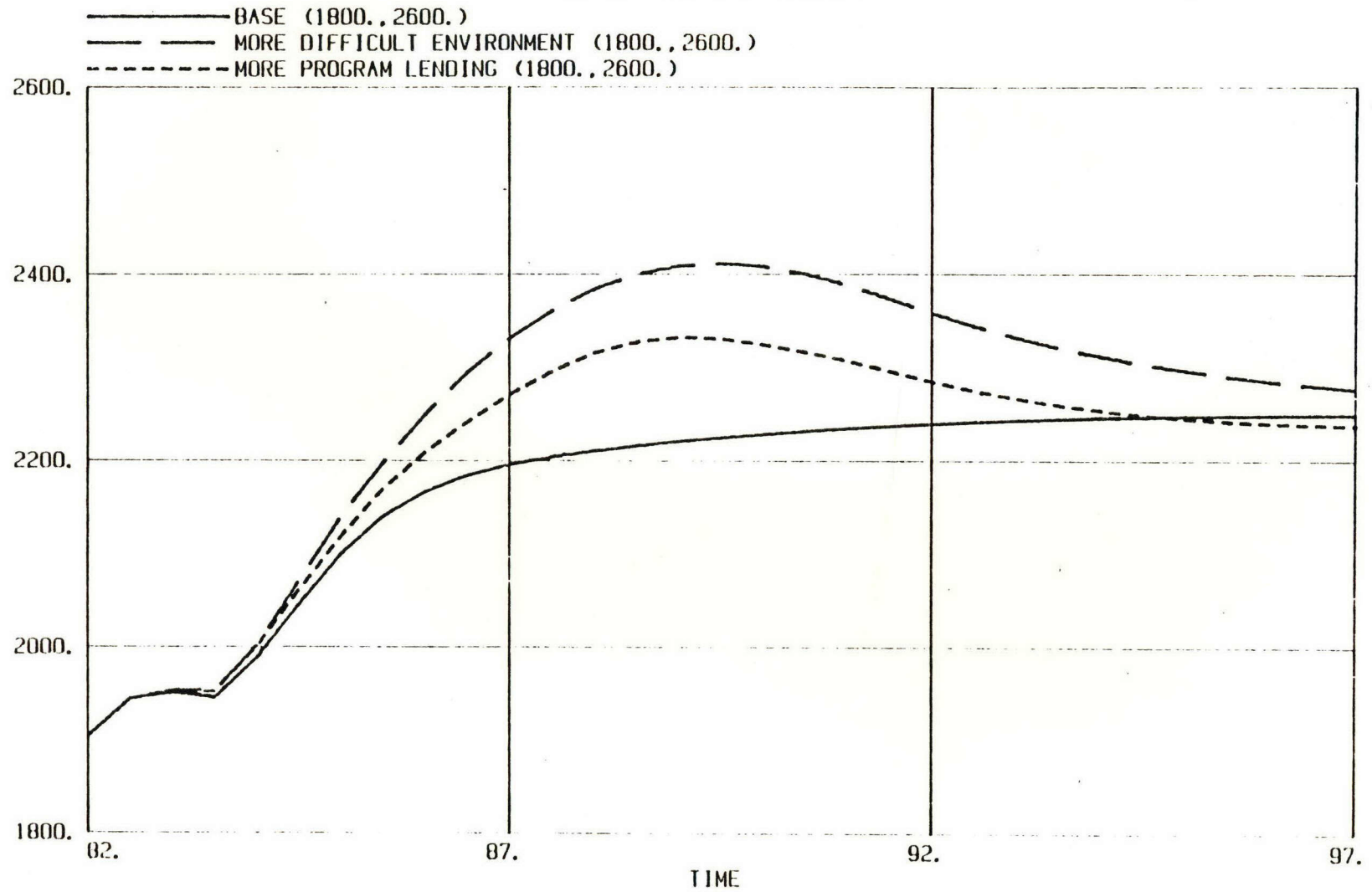


EXHIBIT 17 OPERATIONS STAFF



staff-years. Additional policy changes can further improve the situation, as described in the body of the report.

The results of the Base Case simulation and these policy and strategy experiments raise a number of important planning issues for the World Bank:

1. Reinvestment of potential productivity gains -- To what extent should future potential gains in productivity be reinvested into improvements in the Bank's product, or used to reduce costs? Where, in particular, should investments in the Bank's product be made (in terms of elements of the work program, country-income groups, and/or sectors)? And, what is the best way to control this process?
2. Enhancing the Bank's Responsiveness -- The rate at which the Bank's output can be changed is significantly increased by greater use of consultants, aggressive reassignment of staff, and faster changes in budgeting coefficients. Do the benefits of greater responsiveness offset the costs of achieving it?
3. Institutional Stability -- to what extent should the Bank's mix of output, or its development impact, be allowed to change in response to changes in the environment.
4. Maintaining Per Capita Assistance -- should the Bank's assistance program keep up with population growth in borrower countries in order to maintain per capita development impact?
5. The Bank's Product in the Longer Term -- What will be the balance between lending and intellectual activities? What will be the balance between project and program lending? Should the Bank "unbundle" its product, for example, set up a separate consulting bureau which charges fees for services? How will the product differ by country-income group?
6. Effect Planning and Control -- to what extent should the present planning system, involving "top-down" and "bottom up" forces, be changed to meet the planning needs of the future? What performance measures, capturing effectiveness as well as efficiency, are needed to control decentralized and dissimilar operations?

PUGH-ROBERTS ASSOCIATES, INC.

PROGRAMMING/PERSONNEL/BUDGETING
PLANNING MODEL

FUTURE PRODUCT
PRELIMINARY ANALYSES

23 JANUARY 1983

CONTENTS

1. BASE CASE ASSUMPTIONS
2. BASE CASE HIGHLIGHTS
3. FUTURE PRODUCT ASSUMPTIONS
4. FUTURE PRODUCT IMPLICATIONS
 - WORK PROGRAM
 - STAFFING
 - IMPACT
5. NEXT STEPS

BASE CASE ASSUMPTIONS

	<u>Planned Lending Volume (\$B)</u>				<u>Planned Operations</u>			
	IDA	Blend	IBRD	Total	IDA	Blend	IBRD	Total
FY85	1.6	5.0	10.6	17.2	65	73	138	276
FY86	1.5	5.9	11.6	19.0	58	84	147	289
FY87	1.7	6.5	12.4	20.6	64	81	147	292
FY88 onward	1.7	6.5	13.4	21.6	68	78	150	296

	<u>Staff-years On</u>	
	<u>ESW</u>	<u>ODW</u>
FY85	334	293
FY86	339	297
FY87	344	302
FY88 onward	349	306

Lending Volume Sector Mix (FY87-88)

	<u>IDA</u>	<u>Blend</u>	<u>IBRD</u>
Agriculture	.37	.33	.27
Trans. & Telcom.	.12	.12	.12
Industry	.11	.16	.18
Social Sectors	.23	.17	.25
Energy & Power	.13	.17	.14
Program Lending	.04	.05	.04

POLICY ASSUMPTIONS

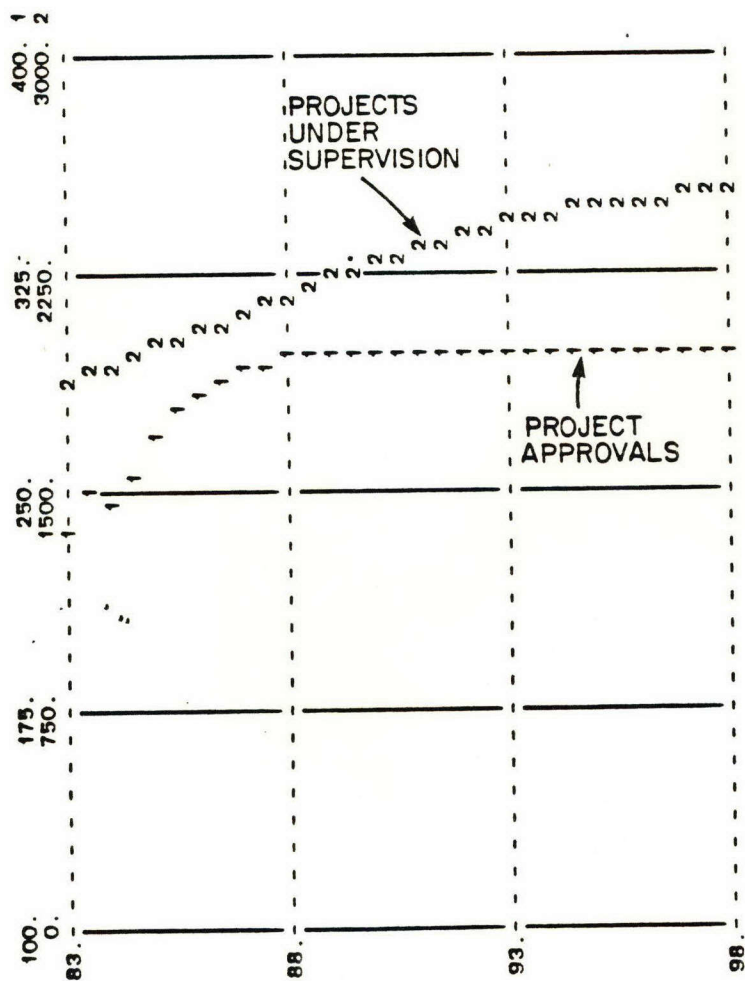
1. Lending and supervision staff-years devoted to "policy content" are held at FY83 levels.
2. A combination of multi-year programming and reduced coefficient averaging time (one-year) is adopted, in order to detect productivity improvements and adjust staff accordingly.
3. Allowed consultant usage ranges from a minimum of 8% to a maximum of 15%.
4. The fraction of staff by discipline in a given sector of the work program will remain at recent levels:

	Program Economist	Project Economist	Loan Officers	Financial Analysts	Technical Specialists	Other
Agriculture	0	.24	.12	.10	.36	.18
Trans. & Telecom.	0	.31	.13	.10	.33	.13
Industry	0	.14	.46	.13	.15	.12
ocial	0	.15	.12	.13	.47	.13
Energy & Power	0	.21	.17	.20	.33	.09
Program Lending	.62	.01	.18	.02	0	.17

5. The Bank does not terminate or reassign people, beyond recent levels, as a result of redundancies.
6. Other staff years in the operational work program will be 20 YPP and 65 cooperative for FY84 on.

BANK-WIDE LENDING SUMMARY

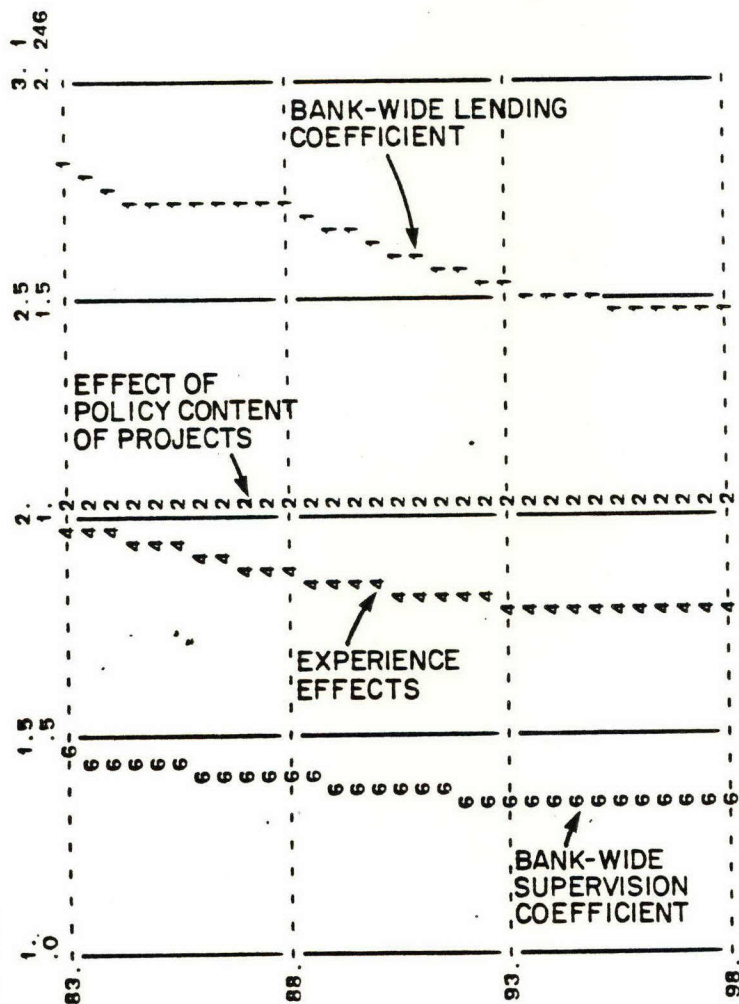
TOTAL PROJECT APPROVALS=1, PROJECTS UNDER SUPERVISION=2



LENDING COEFFICIENT

LENDING COEFFICIENT

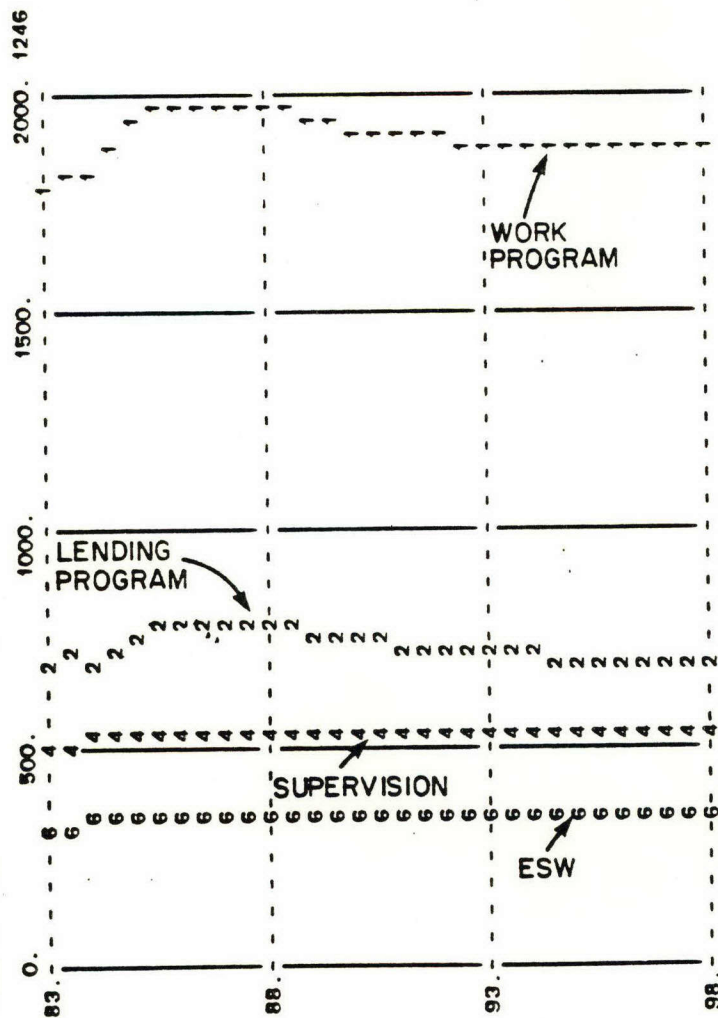
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EXPERIENCE EFFECTS=4, BANK-WIDE SUPERVISION COEFFICIENT=6



OPERATIONAL WORK PROGRAM

OPERATIONAL WORK PROGRAM

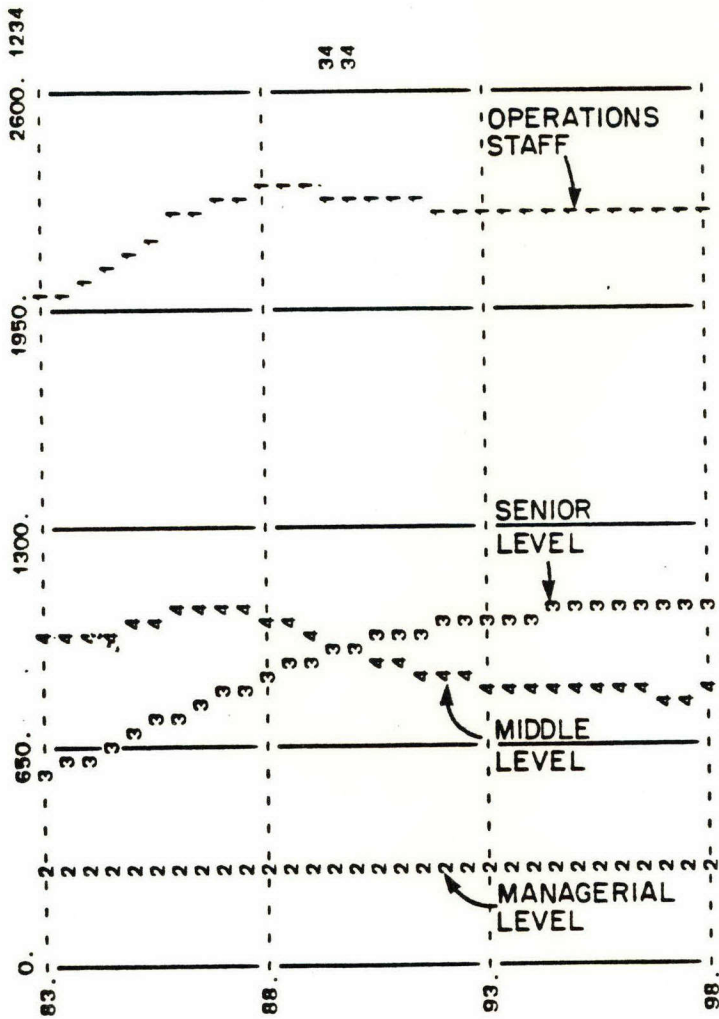
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PAGE 23 PAB/PMD STRATEGIC PLANNING MODEL, BANK70 1/13/84 14:32 RUN:BASE

BANK-WIDE OPERATIONS STAFF

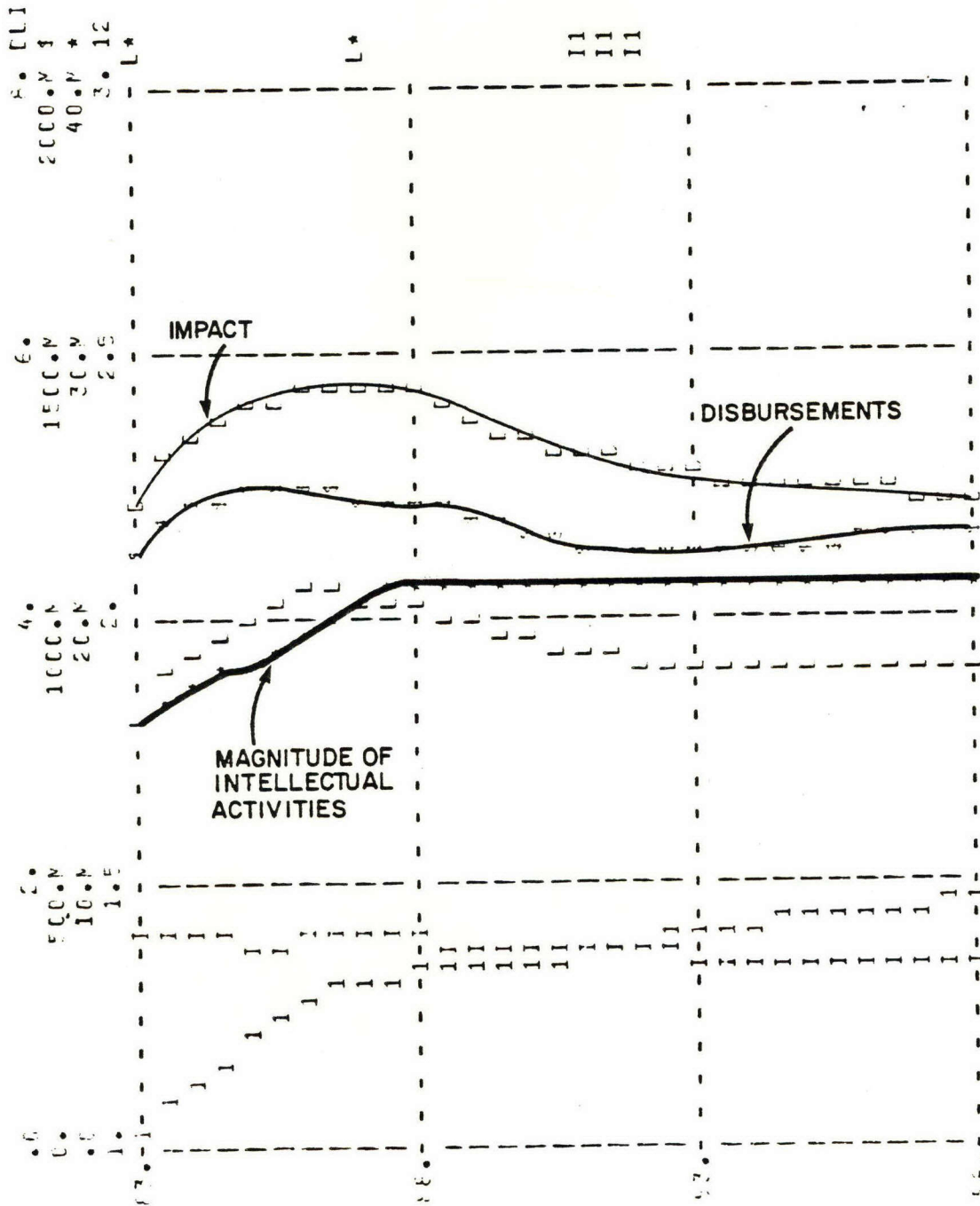
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DEVELOPMENT IMPACT IDA

PAGE 12 PAR/FMD STRATEGIC PLANNING MODEL, BAP70 1/17/84 11:04 RUN:PASS

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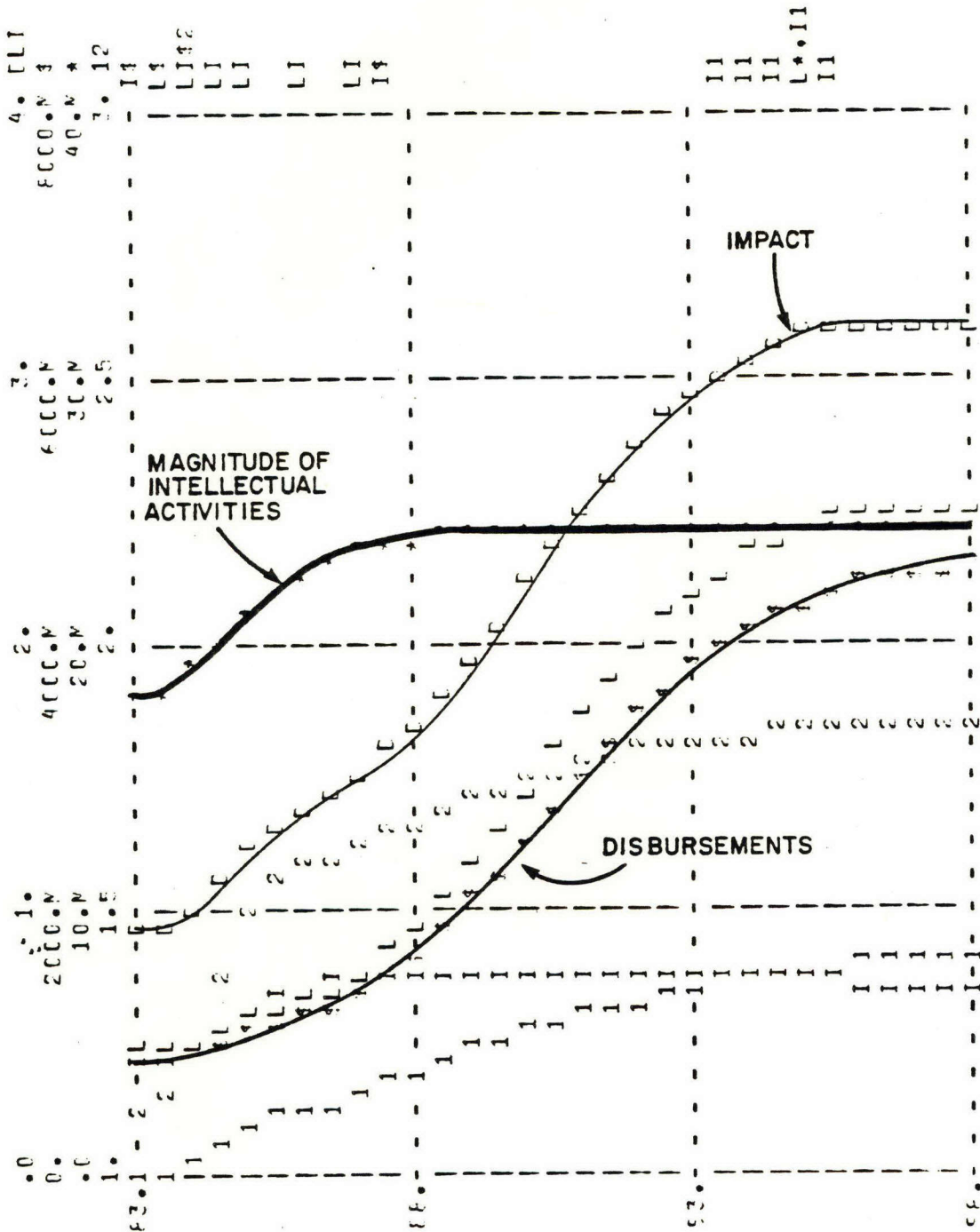
DEVELOPMENT IMPACT BLEND

PAGE 54 FAE/FMD STRATEGIC PLANNING MODEL, BANK7C 1/17/84 11:04 FUN:FAE

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DEVELOPMENT IMPACT IBRD

FILE 05

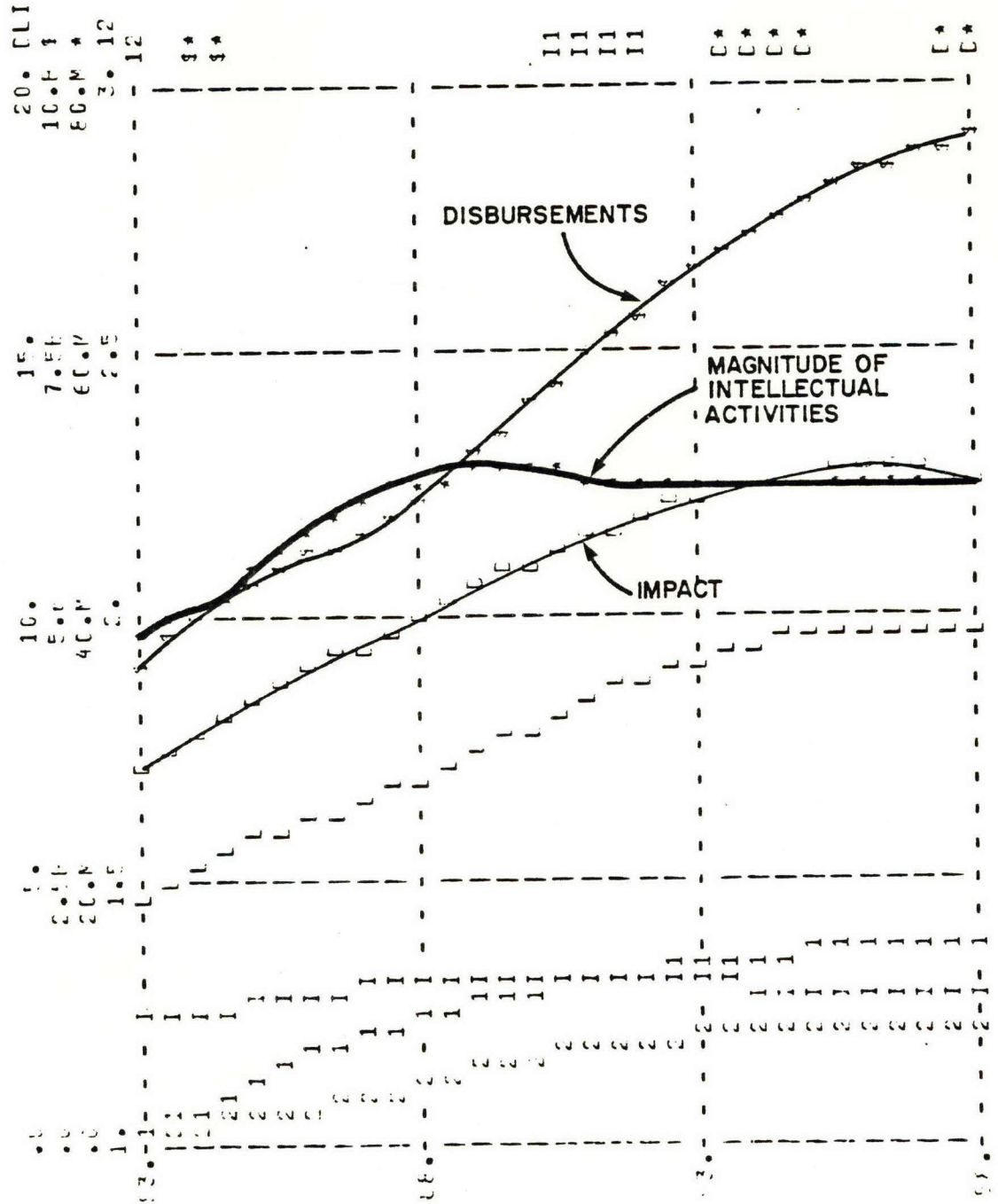
1/17/84 11:04

PAN#70

STRATEGIC PLANNING MODEL, PAN#70

FILE 05

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LEFIF(IEF)=L,EFIF(IEF)=L



BASE CASE HIGHLIGHTS

1. The number of operations increases from 249 in FY84 to 295 in FY88 and remains level thereafter. Projects under supervision, however, continue to grow through FY98.
2. Lending and supervision coefficients decline as experience improves productivity, and these gains are translated into reduced staff budgets (i.e. not reinvested in policy content).
3. The operational work program increases between FY84 and FY88 with the greater number of operations. Thereafter, it declines slightly as a result of: (a) falling lending coefficients; and (b) supervision effort remaining nearly constant because the growth in projects under supervision offsets productivity gains.
4. Operations staff growth averages 3.0%/year FY83 to FY88; financial staff growth averages 4.1%/year over the same period.

During the subsequent 10 years, operations staff declines at a rate of 0.35%/year. Financial staff continue to grow because disbursements increase.

Over the 10 years between FY83 and FY93, the staff mix shifts quite significantly toward senior level (i.e., grades M -).

5. Higher level and lower level support staff growth maintains parity with growth in operations and financial staff.
6. Staff required for the work program and staff available are quite well balanced in all sectors and disciplines except program lending, because of the drop in number of operations.
7. In IBRD and Blend countries, development impact continues to improve until FY93; impact in IDA countries peaks in FY86 and then declines about 15% by FY93.

NEW STAFFING REQUIREMENTS - BASE CASE

	Program Economist	Project Economist	Loan Officers	Financial Analysts	Technical Specialists	Other	Totals
FY84 - FY88 Total							
New Positions	43	55	37	36	110	26	307
Total Hires	97	142	109	34	316	97	855
FY84 - FY93 Total							
New Positions	44	49	27	31	91	19	261
Total Hires	153	224	172	150	514	164	1377

SUMMARY OF FUTURE PRODUCT ASSUMPTIONS

IBRD: The Bank substantially expands Industry and Program Lending at the expense of Agriculture and Transportation.

Those Industry projects become much more heavily "policy-oriented", and therefore increase in average size, policy content, and coefficients.

BLEND: The Bank increases lending in the Industry, Energy, and Transportation sectors while cutting back in Agriculture and Urban, et. al.

Industry and Agriculture projects become much more heavily policy-oriented.

IDA: The Bank expands its lending in the Urban, et. al. and Energy sectors at the expense of all other sectors.

The Urban projects become increasingly policy-oriented; coefficients in the Energy and Agriculture sectors increase for other reasons.

SECTOR MIX (\$)
(NO CHANGE IN COUNTRY MIX)

	IBRD	BLEND	IDA
AGRICULTURE	Down	Down	Down
TRANSPORTATION	Down	Up 33%	Down
INDUSTRY	Up 50%	Up 33%	Down
SOCIAL	Same	Down	Up 50%
ENERGY & POWER	Same	Up 33%	Up 25%
PROGRAM LENDING	Up 50%	Same	Down

NATURE OF PROJECTS

	IBRD	BLEND	IDA
AGRICULTURE	APS: Same PCP: Same COEF: Same ESW: Same	Same Up 25% Same Up 25%	Down 15% Same Up 25% Same
TRANSPORTATION	APS: Same PCP: Same COEF: Same ESW: Same	Same Same Same Same	Same Same Same Same
INDUSTRY	APS: Up 30% PCP: Up 50% COEF: Up 20% ESW: Up 30%	Up 30% Up 50% Up 50% Up 30%	Same Same Same Same
SOCIAL	APS: Same PCP: Same COEF: Same ESW: Same	Same Same Same Same	Down 25% Up 25% Up 25% Up 25%
ENERGY & POWER	APS: Same PCP: Up 10% COEF: Up 10% ESW: Same	Same Same Same Same	Up 10% Same Up 25% Same
PROGRAM LENDING	APS: Same PCP: Same COEF: Same ESW: Same	Same Same Same Same	Same Same Same Same

APS: PROJECT SIZE PCP: POLICY CONTENT COEF: COEFFICIENTS ESW: ESW AND ODW

FUTURE PRODUCT ANALYSIS SUMMARY

	<u>FY88</u>		<u>FY93</u>	
	Base	Future Product	Base	Future Product
Operations				
Agriculture	88	73	90	67
Trans.	38	35	36	33
Industry	46	42	46	49
Social	60	57	65	73
Energy	44	42	43	44
Program	20	18	16	13
<u>Total</u>	<u>295</u>	<u>266</u>	<u>296</u>	<u>279</u>
Lending Coefficient	2.7	3.0	2.55	3.4
Operations Staff				
Program Econ.	290	297	287	302
Project Econ.	416	422	408	468
Loan Officers	362	383	353	451
Fin. Analysts	242	249	237	287
Tech. Spec.	692	703	678	796
Other	297	302	289	338
<u>Total</u>	<u>2298</u>	<u>2355</u>	<u>2251</u>	<u>2642</u>
Impact				
IDA	5.7	5.3	5.1	4.6
Blend	1.7	1.8	3.0	3.1
IBRD	10.1	10.3	12.2	12.8
<u>Average</u>	<u>4.7</u>	<u>4.8</u>	<u>6.0</u>	<u>6.2</u>

FUTURE PRODUCT ANALYSIS HIGHLIGHTS

1. In total, the number of operations drops from 295 per year in the Base Case to around 275 in FY88. Almost all of this decline occurs in the Agriculture sector.
2. The Bank-wide lending coefficient is up significantly (approximately 30%), as is operations staff. This increase results from the combination of greater policy content, reduced productivity, and sector mix shifts.
3. The greatest shortage of staff occurs in the Industry sector (averaging 5% through FY93) with smaller shortages in Energy and Urbanization.

These shortages are the most severe in the Technical Specialist, Financial Analyst, and Project Economist disciplines (i.e. those with the lowest fungibility).

4. The greatest surplus of staff occurs in the program lending sector (5%) with a lesser surplus in the Transportation sector (2%).
5. The future product scenarios entail significant increases in hiring. Total hires over the period FY84 - FY93 increase 35%.
6. Development impact decreases by nearly 10% for the IDA countries, even though the magnitude of intellectual activities increases by nearly 50%.

This decline in impact occurs partially because of a reduction in disbursements (reduction in fast-disbursing program loans), but more importantly because of a decline in the adequacy of ESW. Adequacy of ESW is based on the ratio of ESW staff-years to lending staff-years. By assumption, lending staff-years increase substantially without a commensurate increase in ESW.

7. Development impact in the Blend countries increases by only 5%, even though the magnitude of intellectual activities increases by 18%. Lower staff experience causes a reduction in the effectiveness of these activities. But more importantly, the improvement in impact is limited because intellectual activities directly contribute only one-third to impact, and because the leverage effect of intellectual activities on the effectiveness of lending has saturated.
8. Development impact in the IBRD countries increases by only 5% as well, for almost an identical set of reasons. Further, the increase in intellectual activities in the IBRD countries is less than 10%.

NEW STAFFING REQUIREMENTS

	Program Economist		Project Economist		Loan Officers		Financial Analysts		Technical Specialists		Other		Total	
	Base	FPD	Base	FPD	Base	FPD	Base	FPD	Base	FPD	Base	FPD	Base	FPD
FY84 - FY88														
New Positions	43	55	55	63	37	53	36	43	110	121	26	31	307	366
Total Hires	97	116	142	160	109	137	94	110	316	348	97	111	855	982
FY84 - FY93														
New Positions	44	78	49	112	27	104	31	80	91	212	19	68	261	654
Total Hires	153	191	224	299	172	267	150	211	514	661	164	222	1377	1851

DEVELOPMENT IMPACT ANALYSES

What would be the consequences if the Bank ...

1. Increased ESW by 50% in the IDA countries in the Agriculture, Social, and Energy sectors.
2. Assumed that the effect of the magnitude of intellectual activities on the effectiveness of lending does not saturate.
3. Both (1) and (2) together.
4. In addition to (1) and (2), shifted \$5B in IDA funds from Blend to IDA countries, and shifted \$2B in IBRD funds from IBRD to Blend countries.

DEVELOPMENT IMPACT ANALYSIS SUMMARY

		1.	2.	3.	4.
	Base	Future Product	More ESW in IDA	No Saturation	3 and Shift Lending
Operations Staff	2251	2642	2667	2642	2667
Lending Coefficient	2.55	3.4	3.4	3.4	3.5
Development Impact:					
IDA	5.1	4.7	5.2	5.5	6.2
BLE	3.0	3.1	3.1	3.4	3.4
IBRD	12.2	12.8	12.8	13.6	13.6
Total	6.0	6.2	6.3	6.73	6.8

WHAT IF ...

An important capability of the model is to examine "What If ..." questions.

As an example of this capability, the following simulations start with the future product implemented by FY88 and ask:

1. What if PMD hiring capacity were only 150 staff per year?
2. What if, in addition, maximum usage of consultants were increased to 25% (from 15% in the Base Case)?

'WHAT IF' ANALYSIS SUMMARY

	<u>FY88</u>				<u>FY93</u>			
	Base	FPD	Hiring Limit	Hiring Limit and In- creased Consult- ants	Base	FPD	Hiring Limit	Hiring Limit and In- creased Consult- ants
Operations: Total	295	266	263	266	296	279	274	279
Lending Coefficient	2.7	3.0	2.85	3.0	2.55	3.4	3.15	3.4
Operations Staff: Total	2298	2355	2167	2168	2251	2642	2314	2362
Bank-wide Consultant Fraction	10.4	13.0	15.0	19.8	9.6	10.8	16.5	22.0
Bank-wide Overtime	1.09	1.12	1.15	1.13	1.08	1.10	1.13	1.10

