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Subfonds:	Moeen Qureshi files
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SVP QURESHI'S
SUBJECT FILES

Structural Adjustment Lending
general 1988-1991

Gillian

March 21, 1991

Messrs. Husain, Jaycox, Karaosmanoglu, Kashiwaya and Wapenhans

Attached please find a paper on the Inter-relation between adjustment and sector/investment lending which Mr. Qureshi proposes to discuss at the OVP meeting of Monday, April 1st. Thanks.

Ngozi Okonjo-Iweala

Ngozi Okonjo-Iweala

cc: Messrs. Bock
Grilli
Wyss

Pidgeon-holing conditions

You cannot get the same policy changes from investment lending that you can from adjustment lending

interlocutors are different,

Members have rights

910320019 1.

March 19, 1991

To: **Mr. Moeen Qureshi**

Re: Paper on the Inter-relation Between Adjustment and Sector/Investment Lending

The attached paper has been prepared at the request of Mr. Conable by a Bankwide team, under the coordination of DEC. The paper is part of the Annual Review of Development Effectiveness and is intended for internal use only. It is not a Board paper. The paper tries to draw on "best practices" from existing and past operations to provide a framework for thinking through the inter-relation between adjustment and sector/investment lending.

We would like to have your views on this paper before sending it on to the President's Council. I understand that a meeting of the OVPs, chaired by you to discuss this paper, has been scheduled for April 1. I look forward to receiving your views, and those of your colleagues, at that meeting.

Lawrence Summers

Lending strategy + instruments

Page 57. Synergies

conversion facilities

Attachment

cc: Messrs. W. Thalwitz
P. Isenman

– SUPPORTING POLICY CHANGE –

THE INTER-RELATION BETWEEN ADJUSTMENT AND SECTOR/INVESTMENT LENDING

March 18, 1991

This paper is part of the Annual Review of Development Effectiveness. It is being prepared by a team composed of Ajay Chhibber (DEC, Team Leader), Debbie Bateman (IEN), Thomas Hutcheson (PRD), Kathie Krumm (AF6), Gumersindo Oliveros (FRS), Roberto Rocha (CEC), and Steve Webb (CEC); under the general direction of Lawrence Summers, Johannes Linn, and Andrew Steer.

The paper benefitted from very valuable inputs from Carl Jayarajah (OED), Daniel Kaufmann (WDR), Millard Long (CEC), Malathi Parthasarthy (FRS), Andres Rigo (LEG), Enrique Rueda-Sabateur, Joanne Salop (COD), Sulaiman Wasty (OED), Michael Walton (DEC) and Al Watkins (PRD).

Research assistance was provided by Anna Maripuu, Toneema Haq and Heidi Zia.

Peer Reviewers: Amar Bhattacharya, Prem Garg, Gobind Nankani and John Page.

GLOSSARY

AL:	Adjustment Loans/Lending
IL:	Investment Loans/Lending
SAL:	Structural Adjustment Loan
SECAL:	Sector Adjustment Loan
FIL:	Financial Intermediary Loan
SECIL:	Sector Investment Loan
CSP:	Country Strategy Paper
CEM:	Country Economic Memorandum
CESW:	Country Economic and Sector Work

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EXECUTIVE SUMMARY

Introduction

(i) The World Bank has an array of lending instruments at its disposal to meet its development objectives and these can be tailored to fit into concrete country assistance strategies. The broad institutional goals of the Bank -- to be an agent for equitable, efficient and sustainable development while remaining a sound financial institution -- have not changed over time. What has changed is the strategy to achieve these objectives and, with it, the choice of lending instruments. A marked change in the Bank's lending program took place in 1979 with the introduction of quick disbursing, policy based lending. The oil shocks and the ensuing debt crises revealed that the development strategy then being pursued would not achieve "sustainable efficient economic growth". This conclusion also resulted from the growing realization that much project lending had not sufficiently addressed broad policy considerations and that the performance of parts of the Bank's project lending portfolio was suffering as a result. The immediate need was balance of payments support, but it was evident that this had to be accompanied by policy change to resolve the underlying structural causes of the imbalances -- hence adjustment lending.

(ii) This paper, coming roughly a decade after the inception of adjustment lending, attempts to provide a framework for discussing the appropriate balance between adjustment and sector/investment lending. While the appropriate mix of Bank instruments must obviously be decided on a country by country basis, it is nonetheless useful: (a) to clarify the criteria for using one instrument rather than another and (b) to disentangle the factors that cause the share of adjustment lending to vary over time. There are two levels at which such an analysis is useful: first, to assist management and staff in the preparation and review of country assistance strategy and the Annual Lending Allocation Review and, second, to shed light on the likely evolution of the share of adjustment lending for the Bank as a whole in the coming years.

(iii) The complementarity between policies and investment is a central idea for this paper. It was, of course, always recognized that national policies conditioned the overall development path and the choice of investment. Cost-benefit analysis was designed to allow public policymakers to make appropriate choices of investment in the presence of economic distortions, though it could never have much influence on private investment. Recent research for the 1991 World Development Report has highlighted the complementarity between policies and returns to investment. Using reappraised rates of return calculated by OED for over 1500 projects, this research finds a strong empirical relationship between the productivity of Bank- and IFC-supported investments and indicators of the policy environment, such as measures of exchange rate overvaluation, the degree of protection, biases against agriculture and real interest rates. Overall, rates of return under a "good" policy regime are about twice those under distorted policies. If Bank- and IFC-supported investments are representative, this translates into a difference in growth rates of the order of 2 percent per annum; for many countries this can make the difference between growing and falling per capita income.

(iv) It is important also to recognize that the Bank's earlier expertise in project preparation and aid coordination has been augmented by a third important expertise in the analysis, planning and execution of policy change. The Bank has developed a clear comparative advantage in the donor community in this third area over the 1980s and is expected to continue this role in the 1990s in the interests of overall aid effectiveness. An important instrument that has allowed the Bank to play this role is adjustment lending. Even after a decade's experience, the effectiveness of AL could be improved. Its use as spelled out here combined with appropriate investment lending -- both policy based and project -- should serve to meet the Bank's objectives better in the 1990s.

(v) This paper therefore focusses on the policy-support aspect of Bank lending (see Figure 1). It does not discuss the many important aspects and objectives of various forms of investment lending, such as technical assistance and project selection and design. The paper also does not attempt a discussion of issues related to staff/skills mix, as well as detailed budgetary implications of the use of different lending instruments.

(vi) The original intention of this paper was to simply lay out options to guide country assistance strategy. However, a few Bank-wide recommendations do appear to emerge boldly from the analysis. These are that the Bank needs to:

- Send a clear and meaningful signal to countries that the size of their overall lending program would be contingent on the pace of policy change.

Indonesia

- Restrict the use of ALs in the following cases:

  [illegible]

  (a) Where the adjustment cycle has been prolonged due to policy slippage.

  (b) By requiring prior actions before continuing AL in countries where the commitment to reforms is weak.

- Make ALs available if needed in the future (in conjunction with IMF assistance) to support policy reform for countries that have previously gone through an adjustment cycle or are currently unable to avail themselves of ALs due to fortuitous positive

Figure 1

RELATING BANK LENDING OBJECTIVES AND INSTRUMENTS

Objectives

Lending Instruments

	Quick Disbursing Balance of Payments Support	POLICY CHANGE			Material and Human Investment	
		Macro	Sectoral	Sub-Sectoral	Public	Private
Structural Adjustment	P	P	S		S	
Sector Adjustment	P	S	P		S	
Sector Investment			S*	P	P	
Financial Intermediary			S*	S		P
Specific Investment				S	P	
Technical Assistance				S	P	
Emergency Reconstruction					P	

P – Primary Impact
S – Secondary Impact

*Permission to tranche SECIL's and FIL's recommended in this paper would change this to Primary Impact.

Shaded areas denote the focus of the paper.

external shocks. The need for such ALs might arise in response to a negative external shock.

- o Permit the option to tranche sector investment and financial intermediary loans for the purposes of strengthening their policy content and effectiveness.

- o Require CSPs to specify clearly articulated lending scenarios based on the prospective pace of policy change except in countries that have successfully completed reforms. Require CSPs to specify project lending programs corresponding to these policy scenarios.

- o Reexamine ways to make CESW more policy-focussed, and improve its communication to the country. On the latter a recommendation in this paper is to develop and use a short policy focused document for dialogue between the Bank and the country.

Reasons to Re-examine the Lending Instruments

(vii) Discussions around the Bank on Country Strategy Papers and Business Plans, on Lending Allocation Reviews and on individual operations suggest the need to re-examine the interaction and synergy between our lending instruments in the context of country assistance strategies. The focus of this paper is on the interaction between adjustment lending and sector/investment lending as vehicles for supporting policy change. In this area three sets of concerns emerge.

(viii) First, adjustment (supported by ALs) has turned out to be much longer and more protracted than was envisaged. To date the Bank can count on only about five countries which have gone through successful adjustment with Bank assistance in the form of adjustment loans -- Chile, Indonesia, Mauritius, Korea, Thailand. Two countries, Botswana and Malaysia, have adjusted successfully but without adjustment loans from the Bank. In a number of cases adjustments have been sporadic or prolonged, although in some of these cases for example Turkey, Mexico, and Ghana substantial reforms have been undertaken.

(ix) Second, there is underway a significant shift in the content of conditionality within adjustment lending. This is characterized by a greater emphasis on the regulatory and legal environment and on longer term institutional issues. This shift has come about largely because a number of the Bank's early adjustors have gone through the early phases of their "adjustment cycle". These economies are now addressing the underlying institutional and long term factors that make their economic structures rigid. There is a growing sense of mismatch between some of the policy issues we are trying to address and the lending instruments as they have been used so far. This unease arises from two sets of factors:

- The quick disbursing feature of adjustment lending does not make it a suitable instrument to address longer term and institutional reforms.

- The procedures and perception surrounding Sector Investment Loans both in the Bank and in the country do not make them a suitable vehicle for engaging the government in a serious policy dialogue.

Sally Carlson

(x) Third, there is now a general recognition that traditional project of investment lending needs to be adapted so as to reflect greater emphasis on the private sector, and on the totality of government expenditure programs, as well as the importance of policy and institutional factors in general. It has proved difficult to "cocoon" projects from policy and institutional weaknesses, for example by using complex cost-benefit analysis for project selection in a distorted environment. In addition, an investment project is, in essence, an earmarked expenditure almost always in the public sector. It may often be the appropriate instrument to support development assistance (for example by helping transfer technology and strengthening program implementation), but there can no longer be a presumption that traditional project-specific investment lending is the "normal" instrument. While this paper does not evaluate investment lending in general, recent sectoral evaluations (e.g. the urban policy paper) draw attention to the need for instruments to better address sector policy and institutional issues through modified sector investment lending.

Alternate Instruments to Address Policy Change: The Tool Kit

(xi) How can these concerns be addressed? Adjustment lending as currently used is not the only way to engage countries in a policy dialogue although it is perceived to be the most direct and powerful instrument. In thinking through country assistance strategies, it is useful therefore to examine the other available methods to address policy change.

(xii) Extended-Tranche Adjustment Loans. Extended-tranche ALs are an available option to resolve the mismatch between the pace of reforms and the pace of policy change. These could be tranched in three or more slices and would indicate a medium term commitment by the Bank and the government to the planned reforms. They cost less in staff time than would preparing several smaller quick disbursing adjustment loans although, by itself, that is not a sufficient reason to choose this option. An extended tranche AL may be useful in addressing such policy issues as public expenditure restructuring, tax reform and trade reform. It would also allow for smoother disbursement and would reduce the syndrome of rapidly rising net disbursements that eventually lead to negative net disbursements. Several such loans have been used recently in the Africa Region, for example, the Fourth Structural Adjustment Credit in Togo.

(xiii) The viability and usefulness of extended tranche adjustment operations is a subject of debate in the Bank. One view is that extended tranche operations can only work where the government's commitment to reforms is strong and where it has the ability to plan and commit to actions over three to four years. Another view is that extended tranche operations serve the purpose of keeping the government reminded of the road-map to the agreed reforms. The Bank is conducting single-tranche operations in countries, for example in Indonesia, where both the commitment to reforms and the ability to plan ahead is relatively strong. And it is now pursuing extended tranche operations in countries where, with a few exceptions as in the Morocco Second Structural Adjustment Loan, the opposite holds -- that is where, the ability to plan into the future is limited. It is still too early to judge the performance of extended-tranche adjustment loans.

(xiv) Strengthening Policy-Conditionality in SECILs and FILs. There has been a significant decline in the share of Bank lending through FILs and SECILs in the latter half of the 1980s. This is not surprising since FILs and SECILs were originally designed as essentially loans to wholesale certain types of project loans -- not to conduct a policy-dialogue. However, these loans would appear to have considerable (neglected) potential. They have considerable operational advantages because they build on the Bank's comparative advantage in public expenditure oversight and sector policy analysis, allow regular review of institutional development programs and provide a ready linkage to other country assistance instruments and enhance their impact (such as ESW, technical assistance, aid coordination and cofinancing).

(xv) There is a growing need to put more policy teeth into sector investment lending in order that it can be used more effectively to address sectoral and sub-sectoral policy issues. The current guidelines for SECILs were prepared when this instrument was developed to wholesale project loans. A few recent loans, for example in the LAC region, are using mid-term reviews in SECILs to achieve policy conditionality but they still run the risk of being viewed as a soft option. Clearer guidelines are needed to strengthen the policy conditionality in SECILs and FILs. One way to strengthen conditionality would be to place the burden of proof on borrowers to demonstrate that conditions had been met, rather than the practice of placing the burden of proof on the Bank to demonstrate that conditions have not been met before it can suspend commitments. This can be done through explicit tranching of sub-programs of commitments of SECILs and FILs which should be permitted.

(xvi) Hybrid Lending. Hybrid loans were developed in the mid-1980s as a means to coordinate adjustment and investment lending into a single loan. A review of hybrid lending in 1990 showed that in general they have not worked well and have often been burdened by the problems of both AL and IL. They should therefore be used selectively when there are obvious advantages to combine investment and adjustment lending into a single loan. Hybrids could be used for addressing slower trade reforms and financial sector reforms where an accompanying investment component is needed to achieve the supply response. They would be an appropriate instrument in countries where:

- Adjustment lending has been prolonged not by policy slippage but because supply response has been slow.

- The adjustment cycle is in the declining phase during the transition from adjustment to investment lending.

- Hybrids could also be considered for social sector and environment lending with the policy based component of adjustment lending combined with an investment component.

The use of hybrid loans would avoid the problem of earmarking local costs under adjustment operations and the lack of high level policy dialogue under investment loans. This subject was discussed by a recent Task Force on Local Cost Financing specifically in the context of Education Sector Adjustment loans to Ghana and Nigeria.

Not a black or white issue

(xvii) "Leveraging" the Entire Lending Program. In countries where there is no immediate balance of payments problem but where there is clear need for structural reforms, AL is not the appropriate lending instrument. In these cases, one solution is policy based SECILs as discussed in para. xv. Another option is to "leverage" the entire lending program with lending program packages tailored to policy scenarios as described in para. xxvi. A few CSPs currently under preparation are attempting to prepare a country assistance program based on the idea of "leveraging" the entire program. This is not an easy option and will require considerable effort on the part of the Country team to design and execute it. The last India CSP, for example, has such a feature although the difference in the lending amounts between various policy scenarios was probably too small to have any significant impact. In any case, "leveraging" of the entire lending program should be more often explored as a good way to convince the country of the fundamental linkage between project performance and policy regimes.

(xviii) Country and Economic Sector Work (CESW). Adjustment Lending provided the Bank with a central role in the policy dialogue -- a seat at the table. How does the Bank maintain this dialogue without AL? How can CESW be reoriented to play this role? A model of good policy-oriented CESW is provided by Indonesia where the Bank has a broad-based dialogue on a wide range of issues even outside of ALs. To improve coherent dissemination of its CESW, the Bank should consider developing a shorter, more focused and policy oriented document. This document should form the basis of annual discussions between the Bank and the country, and should be discussed preferably by the Country Director with the government on an annual basis. It should convey in one concise document, such as the Indonesia CEM, the Bank's policy agenda. Other more thematic issues can be discussed in separate documents. The strong likelihood that the country may need AL in response to a future external shock should provide the impetus on both sides to conduct such a dialogue. It should also be made clear that this discussion would affect the size of the entire lending program.

CEM

SAL - SECAL

Country categories not analytically defined, (defined descriptively) but semi-stable,
Does not have to do with speed of adjustment, but rather with the speed - we like fast disbursing money for rapid policy action but not slow
In a certain phase of adjustment lending, a certain instrument is more useful

Table 1 Illustrative use of classification for guiding country assistance strategy

Category	Characteristics	Example	Proposed Strategy: Adjustment Lending	Proposed Strategy: Investment Lending
1. Quick-adjustor	Country has a balance of payments problem, and undertakes swift actions to address policies.	Korea, Thailand, Chile	Provide AL in future if external shock requires adjustment ment.	Continue investment investment projects if needed
2. Prolonged adjustor	Country has a balance of payments problem, is willing to undertake reforms but the process gets delayed because of			
	(a) political difficulties;	(a) Turkey, Philippines	(a) Rethink continued use of AL.	(a) Use alternative options -- policy based SECILs, 'leverage' entire lending program.
	(b) slow supply response and institutional weaknesses.	(b) Pakistan, Ghana,	(b) Use judicious combination of AL and IL including hybrids.	(b) Use policy based SECILS.
3. Repeat adjustor	Country has a BOP problem, states desire to undertake reforms but is not committed to it lending to policy reversals. This syndrome is repeated.	Cote d'Ivoire	Require prior actions to undertake reforms which were not undertaken in the past. Then use AL sparingly until good record established.	Composition of investment lending program based on pace of policy change as described in para. (xxvi).
4. Unwilling to Borrow through AL	Country has macro problem but BOP controlled through restrictions. Reforms needed but country unwilling to accept AL for political reasons or because they do not believe in a comprehensive reform program.	India, Ethiopia, Zimbabwe		'Leverage' entire lending program. Use selective policy based SECILs. Composition of investment lending program as described in para. (xxvi).
5. Policy reforms without BOP need	Country does not have a BOP need but institutional and policy reforms required. How severe	Not true Venezuela, Ecuador	Provide AL in future if external shock requires macro-adjustment. Use contingent AL during transitional uncertainty.	Use sector investment lending to address policies. Composition of investment lending program based on pace of policy change as described in para. (xxvi).

Countries' pasts are quick pasts are slow moving
Should not use them as quick posts

Gives a framework for the kinds of actions

The Use of Lending Instruments Country Assistance Strategy

(xix) Having discussed the various elements of the tool-kit available to assist countries and support policy change, it is useful to ask how all this affects country assistance strategies and the lending mix. The discussion is focussed on broad categories of countries (see Table 1), with the obvious qualifier that each country assistance strategy will naturally depend on its unique circumstances.

(xx) Dealing with Prolonged Adjustors. Evidence over the last decade indicates that in many cases, even when there is a broad commitment to reform, adjustment has turned out to be more prolonged than was anticipated. In these cases, there has been a sense of adjustment fatigue in the country which has caused concern in the Bank, suggesting the need to rethink the country assistance strategy. Where the delays are due to institutional weaknesses and slow supply response (for example, Ghana), hybrid loans (see para. xvi) and policy based sector investment lending (see para. xv) may be appropriate vehicles for country assistance. Where the delays in reforms are and remain due to political factors (as, for example, in Turkey or Brazil) and where AL is therefore likely to be ineffective, a suitable and modest investment lending program should be devised to show Bank commitment.

(xxi) An important prerequisite for AL is a balance of payments gap. This prerequisite is a subject of some discussion around the Bank, since, with a few exceptions, most Bank borrowers have a long term balance of payments gap that needs financing. It is important to note that AL was originally designed to meet the needs of countries that were under sudden, unanticipated balance of payments difficulties -- hence the quick disbursing nature of lending. Subsequently, its use has evolved and it is now used in countries, especially IDA countries, with a long term, perpetual balance of payments gap. This distinction is important because, in the latter case, it is not the quick disbursing nature of adjustment lending that is important. Rather it is the provision of free foreign exchange and the enhanced policy clout associated with AL that is important. In such cases, AL begins to look similar to the pre-1980 program loans but with explicit policy conditionality. Used in this manner, AL may continue to be a powerful instrument of policy change while providing financial assistance to countries with a long term balance of payments deficit.

(xxii) Repeat Adjustors. A more problematic set of countries are the repeat adjustors where the commitment to reform is not strong. The countries have received AL in fits and starts from the Bank, have agreed to undertake reforms with the prospect of AL but have reneged on those commitments or reversed actions taken earlier (for example, Cote d'Ivoire). In such cases, the Bank should require the country to enact reforms that were not undertaken in the past before embarking on any further AL. Until such time, a minimal investment lending scenario should be devised to maintain the Bank's presence in the country along the lines discussed in para. (xxvi).

(xxiii) Recurring External Shocks. It is important to recognize that with recurring external shocks, there may be a need for support from the Bank through adjustment lending, along with IMF support, even in cases where the country has completed an "adjustment cycle" in the past (as, for example, is discussed in the CSP for Chile). A country qualifies for adjustment lending from the Bank, even if it would have made policy changes in response to an external shock without Bank support. In this sense, the Bank should be prepared to provide adjustment lending as the need for it arises.

(xxiv) Addressing Policy Reforms Without AL. Where balance of payments needs have been eliminated but policy reforms are necessary, AL may have to be phased out even if it carries greater policy clout. In these circumstances, alternative means to continue a policy dialogue must be sought, such as hybrid loans (with a smaller AL component), FILs and policy based SECILs and of course policy-focussed CESW. Contingent adjustment loans (akin to a line of credit) may be prepared that would provide the country foreign exchange, if needed, and would help maintain the policy dialogue, but these should only be considered as a transitional solution.

(xxv) Countries Unwilling to Borrow through AL. In the case of non-adjustors where the country is unwilling to contemplate ALs, the Bank's options are more limited. Policy based SECILs and FILs are possible vehicles for addressing sectoral and sub-sectoral issues. Hybrid lending might be another more palatable option for the country. In any case, the Bank should convey its views on the policy issues through a well-articulated leveraged overall lending program -- containing specific lending levels for different stages of policy reform. In some past CSPs, for example on India, such a linkage has been stated but has been very weak.

(xxvi) The Composition of the Investment Program. A central element of the country assistance strategy is the project portfolio. The complementarity between project and policy loans has important implications for the size and composition of lending programs. In the "low case", when the country does not undertake reforms in the face of severe distortions, the project portfolio should at most be composed of a small set of projects for selected social sectors, environment protection projects and targeted infrastructure. Assistance for the social sectors helps to alleviate the adverse effects on the truly needy of the slowdown in economic growth that is likely in the "low case". In the "base case", where the government is willing to undertake limited policy change, the project portfolio could include both selected infrastructure and social sector projects. Infrastructure projects have long gestation lags and should be undertaken particularly if there is a reasonable expectation that the country would move into the high case. The "high case" can consist of a complete project portfolio including tradeable goods projects. A few CSPs, such as those for Kenya, Mexico, Morocco and Ghana, have used such an approach and it should be emulated in other parts of the Bank.

(xxvii) The proposed framework laid out in this paper provides a set of guideposts to think through country assistance strategies. Many other practical considerations enter into the formulation of the lending mix. Of these it is important to mention two which recur in CSPs and in Business Plans. These are:

- The role of AL as a catalyst for other donors in filling the financing gap. Often the Bank -- especially -- in IDA countries must play this role. This often leads the Bank to increase its share of AL, and is an important consideration in the Bank's efforts on the Special Program of Assistance in Africa.

- The management of disbursement profiles can affect both the choice of lending instruments and the volume of planned gross disbursements. High shares of AL in the past constrain lending choices in the future and are explicitly discussed in several CSPs, for example in Morocco.

I. THE SCOPE AND STRUCTURE OF THE PAPER

1.1 The World Bank has an array of lending instruments as well as other vehicles such as technical assistance and economic and sector work at its disposal to meet its development objectives. In translating and shaping these broad goals into concrete country assistance strategies it is useful to think in terms of three aspects of Bank lending. These are the provisioning of quick-disbursing balance of payments support, the facilitation of policy change, and the improvement in the quality of investment as well as its financing -- the last includes technical assistance and institution building and strengthening.

1.2 As is to be expected, different lending instruments are designed to deliver different types of assistance. Figure 1.1 summarizes the current primary and secondary impact of the existing Bank lending instruments. Their use and development has in some cases evolved over time -- for example there are growing pressures to strengthen the policy change supporting aspect of SECILs and FILs.

1.3 The focus of this paper is on supporting policy change and is consequently directed at the shaded areas of Figure 1.1. It draws upon "best practices" around the Bank, and on the results of previous evaluations of adjustment lending.[1] It is not intended to be a comprehensive discussion of the entire matrix of lending instruments and their objectives. Section II outlines the shifts in the composition of Bank lending in the 1980s. It also analyzes the projected composition of Bank lending into the 1990s, which shows a decline in the share of adjustment lending. Section III analyzes the inherent complementarity between adjustment and investment lending. It examines the concept of an adjustment cycle and then discusses real world problems that arise when the ideal or stylized conditions for adjustment lending do not hold. It also discusses the motivations behind the projected decline in the share of adjustment lending as stated in the latest CSPs.

1.4 Section IV examines the changing nature of conditionality and discusses the strengths and weaknesses of different instruments that are available to address policy change. It discusses various components of the tool kit that are currently available. Section V discusses other practical operational considerations -- such as the management of disbursement profiles, Bank exposure and aid coordination -- that might affect the choice between adjustment and investment lending.

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[1] See Report on Adjustment Lending I No. R88-199, August 8, 1988; Report on Adjustment Lending II: Policies for the Recovery of Growth, No. R90-51, IDA/R90-49, March 26, 1990.

Figure 1.1

RELATING BANK LENDING OBJECTIVES AND INSTRUMENTS

Objectives

Lending Instruments

	Quick Disbursing Balance of Payments Support	POLICY CHANGE			Material and Human Investment	
		Macro	Sectoral	Sub-Sectoral	Public	Private
Structural Adjustment	P	P	S		S	
Sector Adjustment	P	S	P		S	
Sector Investment			S*	P	P	
Financial Intermediary			S*	S		P
Specific Investment				S	P	
Technical Assistance				S	P	
Emergency Reconstruction					P	

P – Primary Impact
S – Secondary Impact

*Permission to tranche SECIL's and FIL's recommended in this paper would change this to Primary Impact.

Shaded areas denote the focus of the paper.

1.5 Section VI brings all these considerations -- the classification of country types discussed in Section III, the instruments for policy dialogue in Section IV and the practical considerations in Section V -- together to provide a framework to assist staff and management in thinking through country assistance strategies. It also outlines the implications of this paper for the future role of the Bank.

II. COMPOSITION OF BANK LENDING

II.1 Changes in the Composition of Past Bank Lending

2.1 The composition of Bank lending changed significantly in the 1980s with a marked shift from investment lending to adjustment lending (Table 2.1). This shift came in response to the severe balance of payments problems facing developing countries due to higher oil prices and rising nominal interest rates, as well as inadequate domestic policies. These problems intensified as real interest rates rose, a global recession developed and the debt crisis was recognized as such. The nature and content of the policy dialogue changed substantially with the introduction of quick disbursing adjustment lending. It changed from primarily dealing with project related issues to broader sectoral, intersectoral and macroeconomic issues.[2] With adjustment lending the policy dialogue was also conducted with a much wider range of policymakers in the government, and it involved much closer interaction with the IMF.

2.2 Besides this general shift from investment lending to AL, there were two distinct subsets of changes in the composition of lending in the 1980s. During the first half of the 1980s, there was a shift away from specific investment loans towards increased AL -- the share of sector investment and financial intermediary loans did not decline. During the second half of the 1980s, there was a shift from sector investment and financial intermediary loans to sector adjustment loans, while the share of specific investment loans and of structural adjustment loans (SALs) remained roughly unchanged.

Table 2.1 Commitments by main category of lending instrument: FY80-91 (percentages)

	Annual average FY76-80	Annual average FY80-85	Annual average FY86-90	FY88	FY89	FY90	FY91
Specific investment	56	47	46	40	50	49	51
Sector investment	22	24	16	19	7	19	12
Financial intermediaries	16	16	10	11	11	4	9
Sub-total investment	(94)	(87)	(72)	(70)	(68)	(72)	(72)
Sector adjustment	1	4	18	20	22	12	17
Structural adjustment and program loan	3	6	6	6	9	7	7
Debt reduction	0	-	1	-	-	7	-
Sub-total quick-disbursing	(4)	(10)	(26)	(26)	(31)	(26)	(24)
Technical assistance	1	2	1	1	1	1	1
Emergency reconstruction	1	1	2	4	1	-	2
Total	100	100	100	100	100	100	100
Memorandum item: Value of commitments (US$ billions)	8.7	13.6	19.1	19.3	21.4	20.7	24.2

Source: MIS.
Notes: FY91 based on pipeline as of October 11. Columns may not add to the totals because of rounding.

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[2] Broad macroconditions were discussed in the context of program loans in the 1970s. Discussions on the Country Economic Memorandum were also the occasion to have a dialogue on macroeconomic issues especially in the context of creditworthiness. However, the link between lending and policy change was very general and not tied to a specific laid out, program of reform - as is the case with current SALs and SECALs.

This shift reflects to a large extent the evolution of the policy dialogue from broad macroeconomic issues to sectoral concerns in a number of countries. The FY90 program, reflecting Bank support for the Brady Initiative, also contained a sizeable lending allocation for debt reduction deals. The share of lending through SECALs appears to have peaked in FY89 and the overall trend towards SECALs shows a reversal in FY90 and FY91.

2.3 There are a few important regional variations from the overall pattern of lending. In contrast to the overall pattern:

- In the EMENA region, sector investment lending increased in the 1980s whereas specific investment lending declined.
- In the LAC region, the share of specific investment lending in total lending continued to fall through the second half of the 1980s.
- In the Asia region, the share of specific investment lending increased substantially in the late 1980s, in comparison to the early 1980s. This, rather than the relatively smaller increase in adjustment lending, was the cause of the Asia Region's shift out of sector investment and financial intermediary lending.

In all cases, there was a marked increase in the volume of lending through sector adjustment loans.

II.2 Future Mix of Adjustment and Investment Lending

2.4 Projections indicate a clear shift away from adjustment lending in the 1990s.[3] Gross disbursements, which reached $21.3 billion in 1990 partly on account of adjustment lending in support of debt reduction operations in Mexico and Philippines, are expected to drop to $17.8 billion in 1991 and to increase gradually to $19.9 billion in 1994 (Figure 2.1). Adjustment lending is expected to drop from 39.5 percent of total disbursements in 1991 to 22.2 percent in 1994, while investment loans will increase correspondingly.

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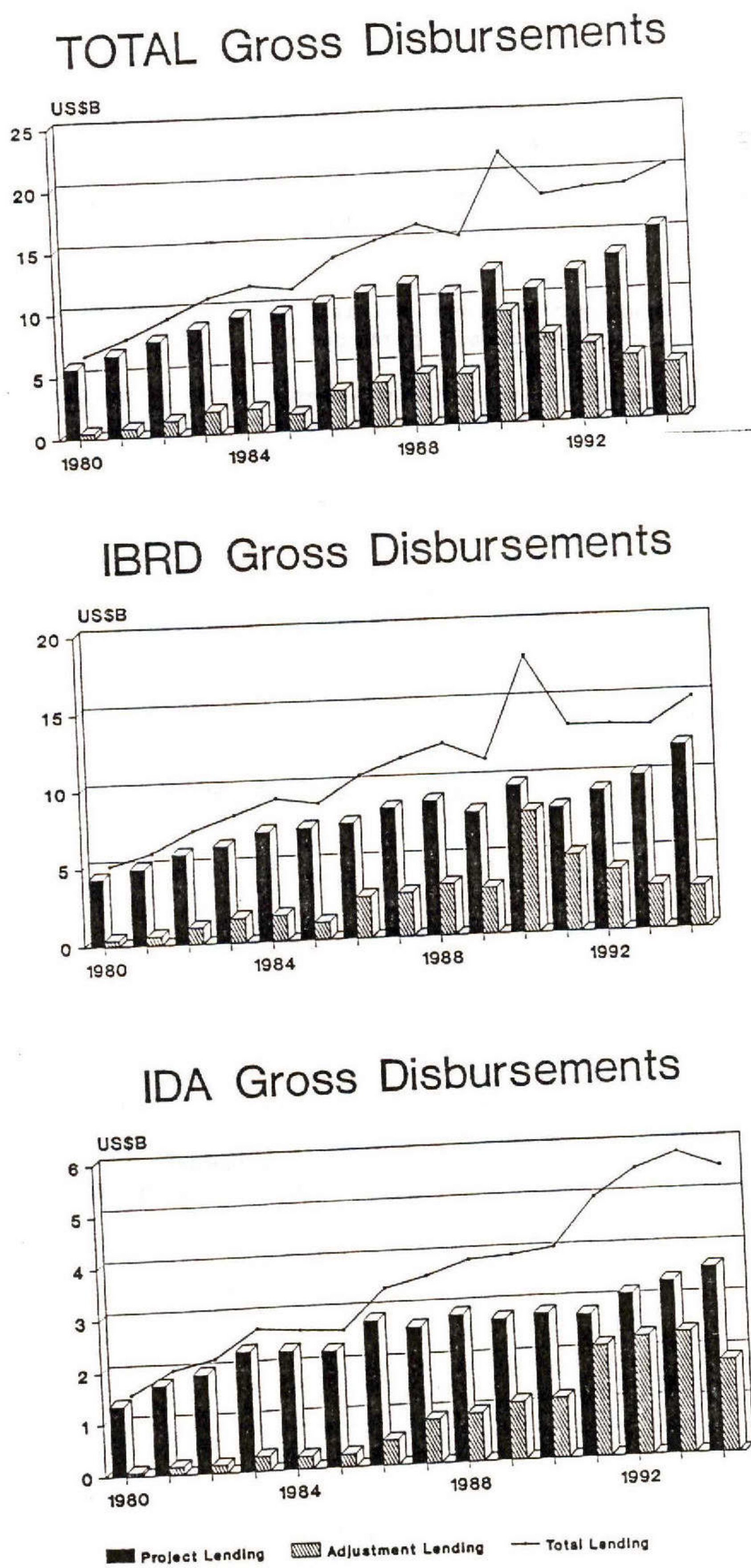
[3] These projections are based on preliminary estimates from the ongoing LAR exercises. Note that the decline from IDA AL comes only in FY94.

Figure 2.1

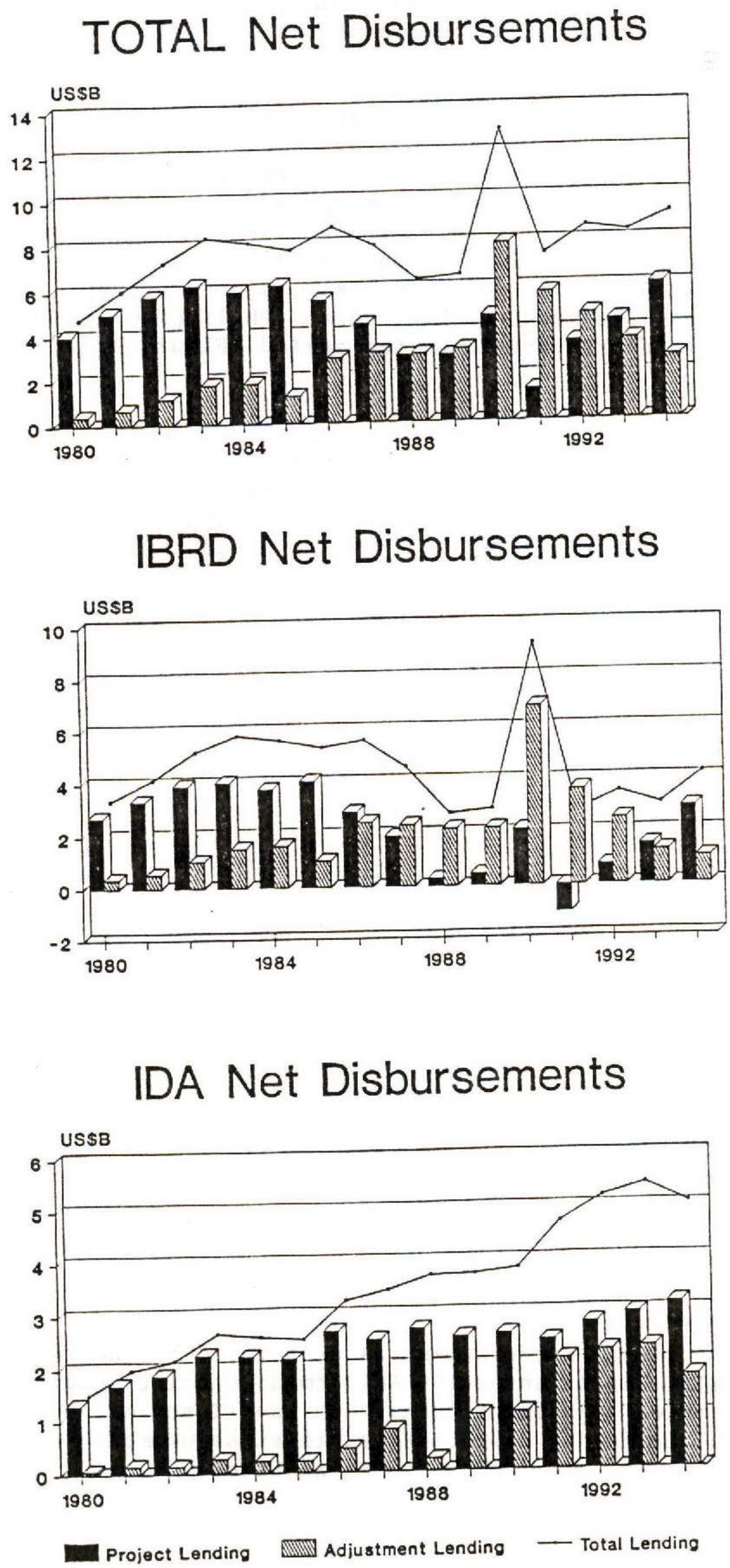

TOTAL Gross Disbursements
US$B
25
20
15
10
5
0
1980
1984
1988
1992
IBRD Gross Disbursements
US$B
20
15
10
5
0
1980
1984
1988
1992
IDA Gross Disbursements
US$B
6
5
4
3
2
1
0
1980
1984
1988
1992
Project Lending
Adjustment Lending
Total Lending

2.5 Countries that received adjustment loans from the Bank prior to 1988 are expected to receive most of the increase in gross disbursements through investment lending whereas disbursements to the Bank's new adjustors will increase slowly during that period. Net disbursements follow this pattern, increasing for countries that received adjustment loans prior to 1988, remaining approximately constant for non-adjustment lending countries (NALs) and decreasing significantly for new adjustors (NWLs).[4] Country groupings, however, disguise important differences among individual borrowers. For example, net repayments are relatively rare but are most prominent among Early Intensive Adjustment Lending (EIALs) countries (for example, Brazil, Turkey, Korea, and Thailand) which started early their adjustment cycle? However, other early adjusters like Morocco, Nigeria and Philippines are projected to receive growing net disbursements over the period (Figure 2.3).

2.6 These figures will undergo revisions in the coming months as country teams adjust to changing realities and are in any case not iron-clad lending targets. What is important is that the debate over these projections has raised important analytical issues about the composition of the lending mix and country assistance strategy. It is towards an analysis of these issues that we now turn.

[4] The information on disbursement is classified by the following categories: (a) EIAL: Early Intensive Adjustment Lending, countries that received at least three adjustment loans with the first loan before 1985; (b) NWL: New Adjustors, countries that received first adjustment loan after 1988; (c) OAL: Other Adjustors; and (d) NAL: Non-Adjustors.

Figure 2.2


TOTAL Net Disbursements
US$B
14
12
10
8
6
4
2
0
1980
1984
1988
1992
IBRD Net Disbursements
US$B
10
8
6
4
2
0
-2
1980
1984
1988
1992
IDA Net Disbursements
US$B
6
5
4
3
2
1
0
1980
1984
1988
1992
Project Lending
Adjustment Lending
Total Lending

IBRD NET DISBURSEMENTS

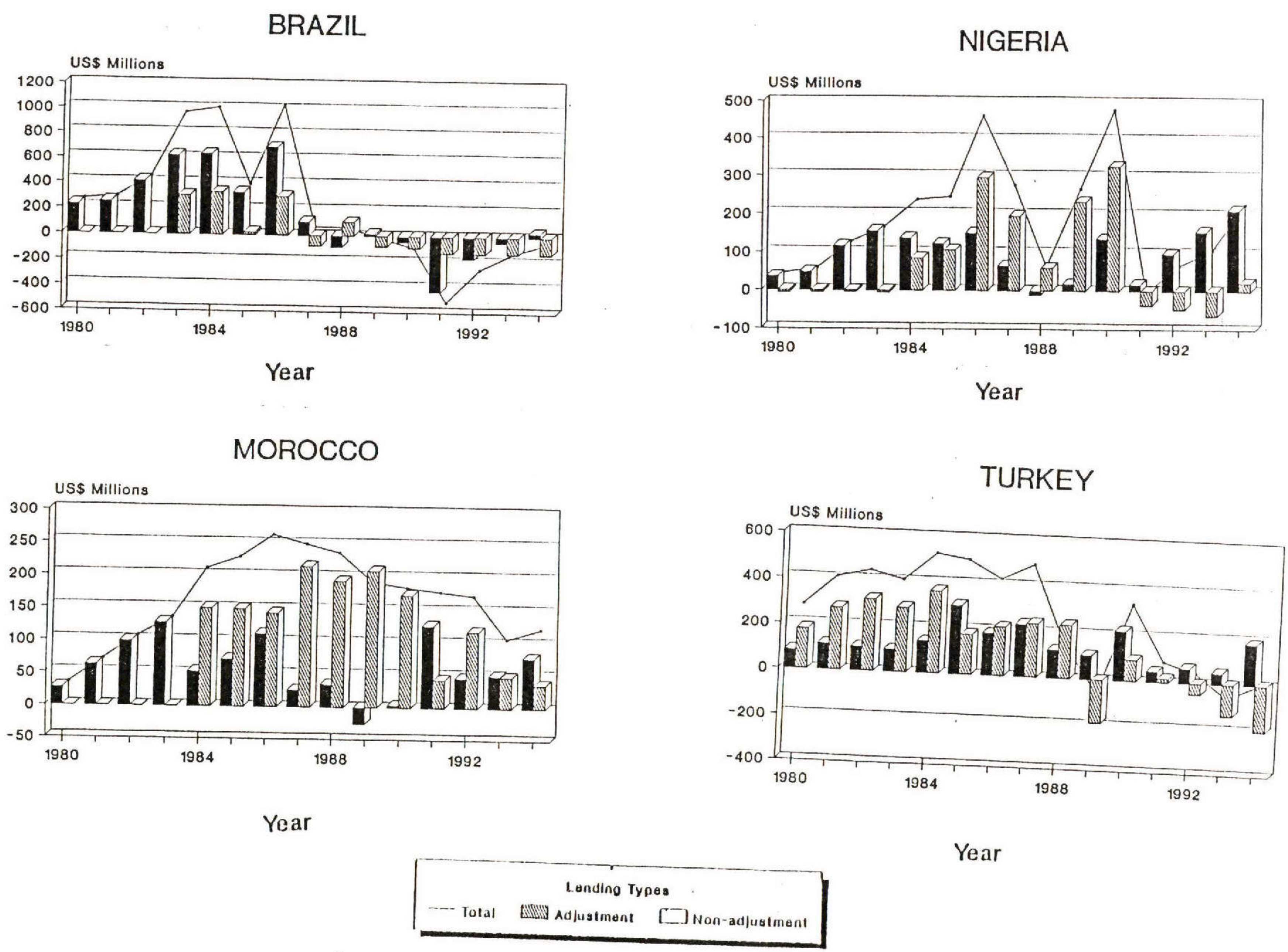


Figure 2.3

III. THE RELATIONSHIP BETWEEN ADJUSTMENT AND INVESTMENT LENDING

III.1 The Impact of Distortions on Investment Performance and the Returns to Adjustment Lending

3.1 In principle, the choice between investment and adjustment loans[5] would appear to be straightforward. If the returns on policy and project loans were independent, the procedure would be to calculate the relative rates of return, treating policy reform as simply another "project" with an associated time profile of costs and returns.[6] The marginal dollar should then be allocated to the activity with the highest return.

3.2 In practice, an obvious problem in following such a procedure is the difficulty of estimating rates of return in the case of policy loans and some types of investment loans (for example, education projects). However, even if such calculations were possible, a serious problem is that the returns on adjustment and project loans are not independent. For most countries, adjustment and project loans are to a large extent complementary. If appropriately designed and implemented, adjustment loans can affect project rates of return by reducing policy distortions. The negative impact of policy distortions on project rates of return was a key reason, along with the balance of payments needs, for the shift to adjustment lending in the early 1980s.[7]

3.3 Until recently, evidence on the impact of policy distortions on project returns has been scanty and anecdotal. However, recent evidence based on ongoing work for WDR91[8] demonstrates the large and significant impact of policy distortions on the rates of return of World Bank and IFC projects. Table 3.1 shows the striking impact on the economic rates of return of both public and private sector projects of six indicators of macroeconomic

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[5] Assuming that adjustment loans carry a much higher level of policy conditionality.

[6] For this view, see Kanbur, Ravi: "Projects versus Policy Reforms", paper presented at the World Bank Annual Conference on Development Economics.

[7] For this view, see Stanley Please: "The Hobbled Giant: Essays on the World Bank", Westview Replica Edition, 1983; and Moeen A. Qureshi: "Policy-Based Lending by the World Bank" Paper presented for the "International Conference on Policy-Based Lending", Hulme Hall, University of Manchester, September 10-11, 1990.

[8] See Kaufmann, Daniel: "The Forgotten Rationale for Policy Reform: The Productivity of Investment Projects," Background Paper to this paper and to WDR91.

Table 3.1 Policies and the reappraisal economic rate of return of investment projects[a]

Policy distortion index	All public projects ERR	Agriculture ERR	Industry ERR	Non-tradable sectors ERR	Private[c] sector ERR
1. Trade restrictiveness index (Halevi/Thomas)					
Highly restrictive	13.6	12.6	INSF	14.6	9.2
Somewhat restrictive	15.4	15.5	INSF	16.0	8.7
Nonrestrictive	19.3	14.3	INSF	24.3	18.9
2. Index of exchange-rate overvaluation: black market premia					
High overvaluation	8.7	7.4	8.3	11.1	INSF
Medium overvaluation	14.7	11.5	11.8	16.9	11.7
Low overvaluation	18.1	17.2	17.9	19.1	14.7
3. Agricultural disprotection (Schiff/Valdes/Krueger)					
High disprotection	11.5	10.5	14.2	13.2	13.4
Medium/low disprotection	17.7	17.2	14.1	18.5	16.2
4. Price distortion index of tradable goods (Summers/Heston/D. Dollar ppp-based)					
High distortions	15.7	13.1	9.9	18.1	9.4
Low distortions	17.1	16.0	17.0	18.1	16.1
5. Real interest rate					
Negative	15.5	12.7	12.5	17.8	10.9
Positive	17.4	16.9	19.2	18.0	16.0
6. Inflation rate					
High ($I \geq 100\%$)	13.4	11.3	INSF	14.1	INSF
Moderate ($20\% \leq I < 100\%$)	14.7	11.5	12.5	17.1	11.9
Low ($I < 20\%$)	16.8	15.9	16.2	17.7	13.2

INSF Indicates insufficient number of observations (≤ 10) to make inferences.
a/ Results reflect work-in-progress, thus they are preliminary. Data on Reappraised ERR from OED data bank on 1,500 projects.
b/ Nontradable sectors include: transport, public utilities and energy, and urban projects.
c/ Based on 150 IFC projects evaluated after completion.
Source: Kaufmann, D.: "The Forgotten Rationale for Policy-based Lending: The Productivity of Investment Projects," background paper prepared for WDR91.

instability and inappropriate pricing policies. These results confirm very strongly the need to consider policy based adjustment lending as a necessary complement to investment lending. Conversely, when policy changes require investment to achieve a supply response, well designed investment lending can support adjustment lending (see Box 3.1 on Supply Response in Agriculture).

Box 3.1 Supply Response in Agriculture: Complementary Role of AL and IL

Adjustment programs usually involve major macroeconomic and sector specific policy changes that affect the structure of relative prices in the economy. A major objective of many adjustment programs has been to change the internal terms of trade in favor of agriculture. This is brought about either through changes in sector specific prices or through macroeconomic instruments, reducing the overvaluation of the exchange rate and protection to the industrial sector.

The results of various studies on agricultural supply response show that though changes in the incentive structure faced by farmers are an important component of a package to raise agricultural growth, they cannot in general be the only component. In many low income countries, growth in agricultural supply is held back by poor roads and transport facilities, lack of imported inputs, unimaginative and inefficient research and extension services, lack of assured water supply and power and poor health and education services. Price adjustments alone will not lead the economy to a higher equilibrium level of output. The provision of social and physical infrastructure -- nonprice factors -- must play a key role in the adjustment process.

It is important to emphasize this because adjustment programs are often undertaken during periods when public spending must be cut and foreign exchange is scarce. Such cuts are often made indiscriminately across the board, affecting the supply of critical public goods and services. The results of these studies show that if these cuts are large, they can prevent supply from responding to the improvements in price incentives initiated under the adjustment program. Moreover, increases in farm prices -- either through reductions in export taxes or higher procurement prices tend to lower public revenues, thereby necessitating larger cuts in public expenditure in order to maintain macroeconomic stability. The loss in revenue cannot be easily recovered from direct taxes (for example, land taxes), which are less distortionary but are often difficult to raise for administrative and political reasons. The tradeoffs inherent in these adjustment packages, therefore, need more careful scrutiny.

The importance of such tradeoffs will vary from one country to another. They do not arise in countries in which heavy and indiscriminate taxation of agriculture has been used mainly to transfer resources to other sectors of the economy. In these countries, improvements in the internal terms of trade of agriculture will obviously increase farm output. In some countries, too, improvements in the delivery of public goods and services to farmers do not necessarily require more resources; instead, reallocation within existing budgets and institutional changes can significantly enhance the infrastructure and services for farming. Nevertheless, since it is clear that in general farmers' response to prices depends heavily on structural conditions in agriculture, these conditions should undoubtedly be considered in the formulation of adjustment policy packages. These should contain a judicious blend of improvements in price incentives, the provision of free foreign exchange through adjustment lending and improvements in the delivery of necessary public goods and services through investment lending. The latter will often require measures to protect and sometimes increase certain components of the public expenditure program during adjustment.

III.2 The Stylized Adjustment Cycle

3.4 As is clear form the previous section, in a heavily distorted policy environment, project loans that do not demand simultaneous policy reform represent an inefficient lending strategy, because they do not address the major obstacle to growth -- the inadequate macroeconomic framework and sectoral policy distortions. Therefore, the Bank provides adjustment lending, which provides much needed balance of payments support and is accompanied by a set of policy reforms. As the policy distortions are addressed and the balance of payments requirements are reduced, the need for adjustment lending declines. In this sense, there is an adjustment cycle.

3.5 Over the stylized cycle, the lending pattern typically goes through three distinct phases (Figure 3.1). In the first phase, when policy distortions are prevalent, there is no adjustment lending and some project lending. In the second phase, when there is a balance of payments financing need and the government begins to address the policy distortions through an adjustment program, the size of total lending as well as the share of adjustment lending rises. The third phase is post-adjustment when the major reforms are completed. The volume of total lending declines, although typically, it remains higher than pre-reform levels.[9] The share of adjustment lending falls dramatically and eventually disappears.

3.6 The trigger points for the expansion in lending and the rising share of adjustment lending are (or should be) determined by the various scenarios in the Country Strategy Paper. The details of these trigger points depend on the particular policy agenda in each country. But, generally speaking, the "low case" represents unwillingness to take any policy reforms. The "base case" represents a willingness to take some policy reforms but not enough to get the economy on a path of efficient and sustainable growth. If a complete set of policy reforms were to be adopted, this would put the economy into the "high case". The "low case" would contain no adjustment lending, the "base case" some and the "high case" would contain a large share of it -- in some years exceeding 50 percent of total lending if there is a balance of payments need.

3.7 Four countries could be regarded as having followed the Bank's stylized adjustment cycle -- Chile, Korea, Mauritius and Thailand. In these countries, a well defined adjustment program was developed by the government with Bank assistance. The program was enthusiastically implemented by the government, and the Bank stepped in with limited doses of adjustment lending to cement a financing plan. In a few cases, such as Botswana and Malaysia, the Bank has

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[9] Except in Korea and Thailand where investment lending is currently well below the pre-adjustment lending phase due to their ability to finance any external resource needs from other sources.

Figure 3.1

THE STYLIZED ADJUSTMENT CYCLE

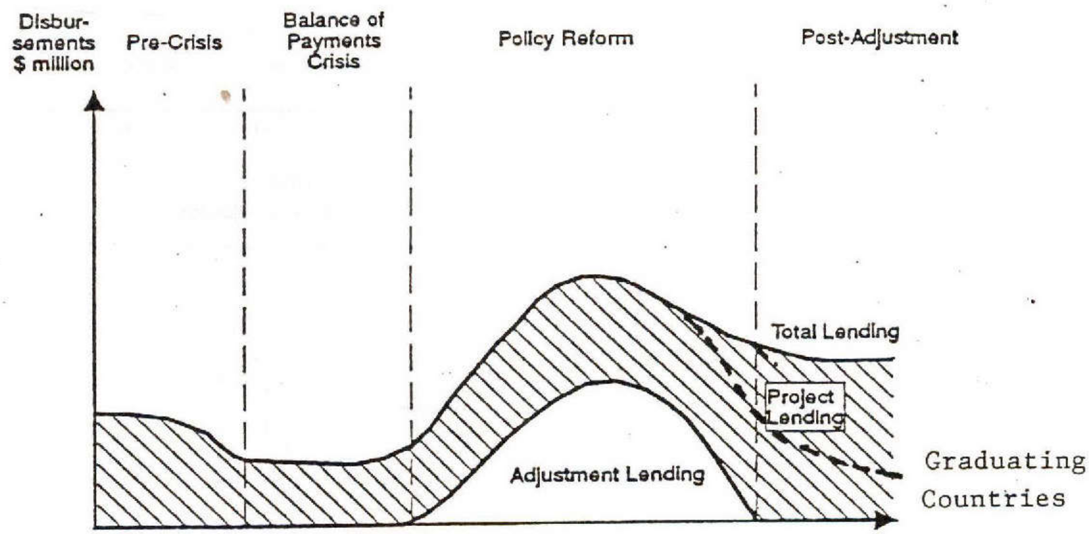
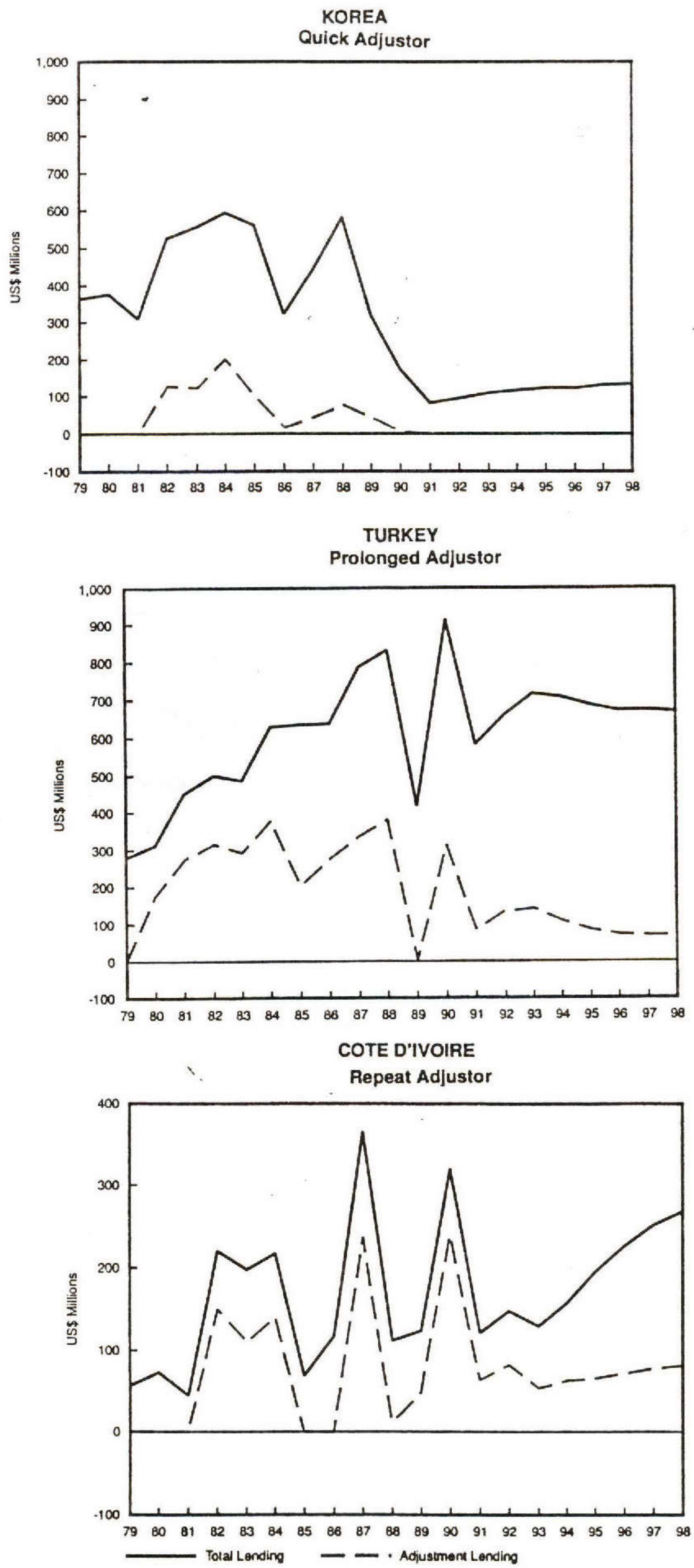


Figure 3.2

(EXPERIENCE WITH THE ADJUSTMENT CYCLE)
(GROSS DISBURSEMENTS)



never undertaken adjustment lending because the countries followed good policies and did not need balance of payments support. So much for the ideal cases. We turn next to some real world problems and ask how one might deal with them.

III.3 Policy Slippage and Prolonged Adjustment

3.8 Very few countries have undergone the stylized adjustment cycle described in Section III.2. In the real world, a number of complications may arise. The Bank often initiates adjustment operations amid considerable uncertainty about the outcome of the program. Very often, the Bank must begin operations in a sector in which the government is willing to make changes but has not yet established a full and comprehensive reform program. An example is Ghana's adjustment program, which might not have come about had the country department waited for the ideal conditions under which to initiate adjustment lending. The dilemma then is whether to go ahead in the expectation that positive changes in one sector will lead to increased willingness and ability to make changes in other sectors, or whether to wait for agreement on a comprehensive economy-wide program. Sometimes, lending decisions are based on unrealistic or over-optimistic expectations, and the Bank rushes into adjustment lending when in hindsight important prerequisites for success were missing and never materialized.

3.9 It is useful to try and classify these problems, to learn from past experience and to make better informed judgments in the future. These problems can be classified into five broad categories. It should be recognized that these are not rigid categories. Countries move from one to the other, not to mention, that in some cases a country may fall on the border of one or the other. They are discussed briefly here, leaving the issue of how they might be usefully applied to Bank assistance strategy for Section VI.

(a) Prolonged Adjustors. In several countries, the adjustment cycle has turned out to be much longer than had been originally anticipated. The government is broadly committed to a reform effort but adjustment has been prolonged. The Bank has made a series of adjustment loans, which, in some cases, are projected to continue into the future because the policy agenda is not completed. A very prolonged adjustment cycle can be due to political difficulties that delay reforms and slow their implementation, to the longterm nature or complexity of the adjustment problem (for example, in Eastern Europe or in general institutional reforms) or to slow supply response and institutional weaknesses which delay the benefits of reforms. Countries exhibiting a prolonged adjustment cycle due to political difficulties include Turkey (Figure 3.2), the Philippines. Countries in the second category where adjustment has been prolonged due largely to slow investment response include Ghana. In either case, a sort of "adjustment fatigue" has set in and the Bank must begin looking for alternatives to adjustment lending while pushing for the reforms to be completed. These issues are taken up in Section VI.

(b) Repeat Adjustors. A much more problematic set of countries are the so-called repeat adjustors. These are cases where the country typically comes to the Bank when it has an acute balance of payments problem. The Bank responds with one or two adjustment loans. The reform effort is short lived and is stalled or reversed as soon as the foreign exchange shortage is relieved. The country returns to the Bank for assistance again when the balance of payments deteriorates and the Bank makes more adjustment loans without lasting success. In these cases there typically is no deep seated commitment to the reforms in the country and the adjustment loans primarily allow the country to delay reforms. An example of a country that has exhibited this syndrome in the past is Cote d'Ivoire (Figure 3.2).

(c) Countries Unwilling to Borrow through AL. These are countries that have deep structural distortions but are unlikely to seek or accept adjustment loans for political reasons or disagreements on policy reform (for example, Ethiopia, India and Zimbabwe). In this group of countries, the policy distortions are large but past Bank efforts to prepare adjustment operations have been very contentious. However, the countries are prepared and willing to accept investment lending from the Bank, and are also eager for its economic and sector work. There have also been piece meal reforms at the project and sub-sector levels supported by investment lending.

(d) Addressing Policy Reform without Balance of Payments Needs. Adjustment lending is the most suitable lending instrument when a country needs to finance its balance of payments deficit and has policy distortions. What happens if the balance of payments need disappears due to an unexpected positive external shock but the policy reforms are not completed, such as happened, for example, Ecuador and Venezuela? A key raison d'etre for adjustment lending -- that there should be a balance of payments need -- is gone. How does the Bank engage the country in a serious policy dialogue without adjustment lending?

(e) Addressing Balance of Payments Needs When Reforms Have Largely Been Completed. The opposite problem might arise in a country that has gone through an adjustment cycle. It has undertaken a substantial set of policy reforms and the economy is on a path of efficient, sustainable growth. It is then hit by an external shock, say an oil price increase, resulting in a balance of payments financing gap. Should the Bank provide adjustment lending, if requested, to help finance the balance of payments gap? If the external shock is perceived to be temporary, should IMF support be sought? If the external shock leads to a permanent change in the country's terms of trade, requiring structural adjustment, should both Bank and IMF assistance be forthcoming?

3.10 Discussion of the issue of how to deal with these "deviations" from the ideal adjustment cycle is deferred until Section VI. We turn next to examining the changing nature of conditionality in adjustment lending. This is important because adjustment lending is not the only way to engage countries in a policy dialogue. As the nature of conditionality changes, the question of how best to address policy change becomes more important in determining the lending mix.

III.4 Shifts in conditionality

3.11 Detailed analysis of shifts in loan conditionality pre and post 1987 (Figure 3.3) indicates the following:

- Little change in the frequency of macroeconomic conditionality, in other words, fiscal, exchange rate and monetary policy.
- A decline in conditionality on trade policy -- due, to a large extent, to completion of trade policy reforms in many developing countries.
- A significant decline in conditionality in agriculture, again reflecting the fact that, in many developing countries, reforms in agriculture generally preceded reforms in other sectors.
- A noticeable increase in conditionality in the areas of rationalization of government finance and administration, social policy reforms, the financial sector and various sub-sector reforms.

3.12 With the very rapid expansion of SECALs since 1986 and their growing use to affect policy change on sectoral and sub-sectoral issues rather than across the whole economy, the shift is not surprising. However, the shift is apparent even in conditionality within SALs. The shift in conditionality appears to reflect a growing trend towards using adjustment lending to address a much broader set of policy and institutional changes than was originally envisaged.

3.13 As we should expect, these shifts are more pronounced in the case of the early and intensive adjustors.[10] The shift in the pattern of conditionality is very similar for IDA and IBRD countries, though somewhat more pronounced in the case of IDA countries. However, there are some differences in the type of conditionality between IDA and IBRD countries. The major differences are:

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[10] The so-called EIAL group -- countries that received the first adjustment loans before 1985 and have received at least three of them.

Content of Conditionality

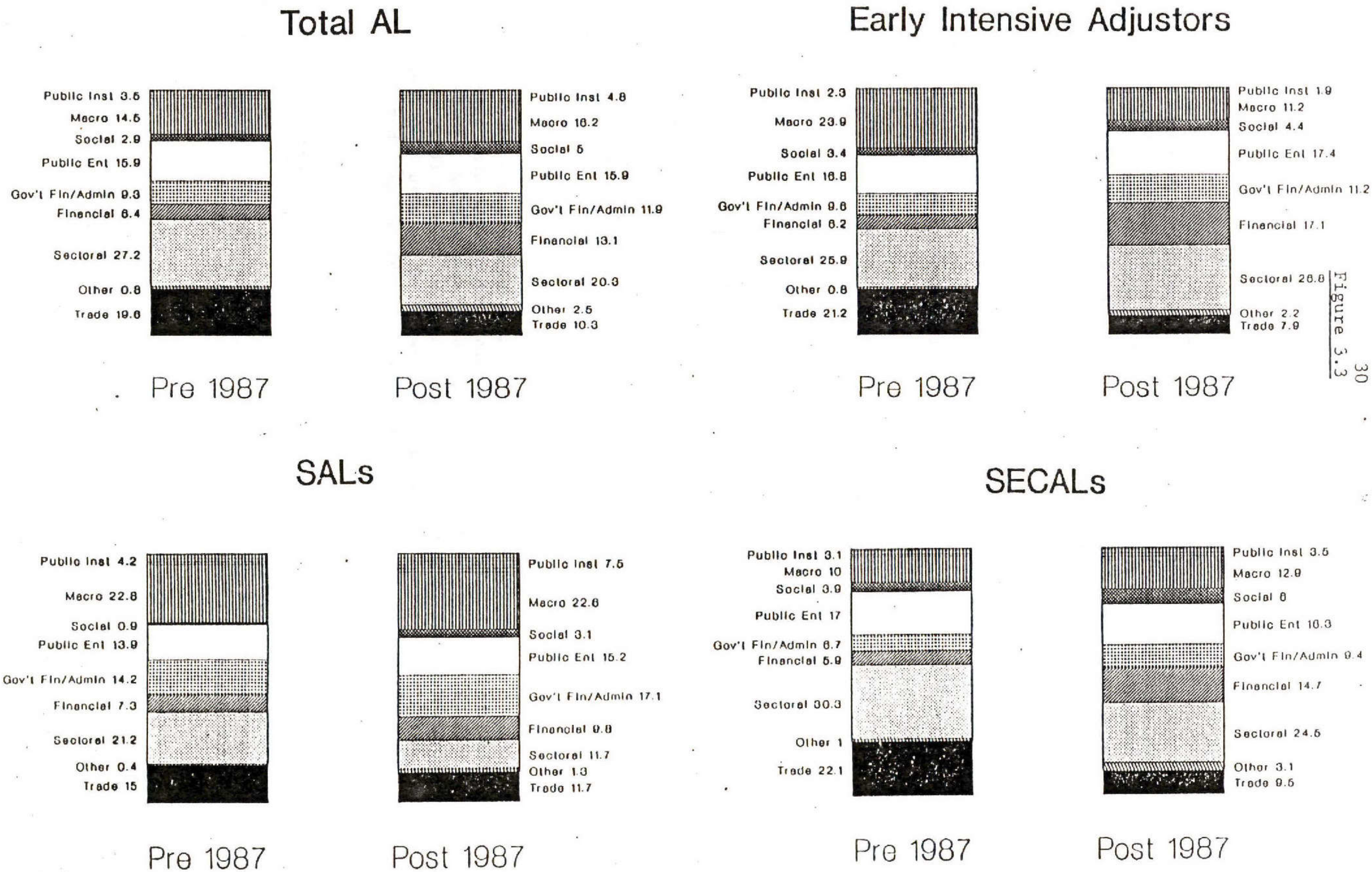

Figure 3.3

- IDA countries, on average, have somewhat higher shares of macroeconomic conditionality.

- IDA countries have lower levels of trade policy conditionality compared to IBRD countries, but the decline over time in the prevalence of trade conditionality mostly reflects a decline for IBRD borrowers.

- IDA countries also have higher levels of conditionality for social sector reforms and public enterprise reforms.

3.14 Broadly speaking, there is a shift in overall conditionality from trade to domestic policy issues and towards reforms that are typically of longer duration and require significant institutional change -- examples include, tax reform, financial sector restructuring and deregulation. These findings are more pronounced for the early adjustors and confirm results documented in recent papers.[11] These shifts, in most cases, reflect a deepening of the reform process and more attention to supply side policies. With the shift in the nature of reforms, a frequently articulated concern is whether adjustment lending is the appropriate instrument for supporting more long term, institutional reform, and whether the Bank should review investment lending procedures to develop them into effective instruments for supporting such reforms.

III.5 How CSPs Explain the Transition from Adjustment Lending to Investment Lending?

3.15 Having classified the deviations from the ideal adjustment cycle in Section III.3 and the changing nature of conditionality in the last section, it is useful to examine how the decline in the share of adjustment lending in projected lending strategies is explained in CSPs as it is here that the motivations behind the shift are stated. The explanations in about 19 Country Strategy Papers as well as current regional business plans can be summarized as follows:

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[11] Progress Report on the Private Sector Development Action Program, Report Number R90-43, March 13, 1990; The Design of Adjustment Lending for Industry: Review of Current Practice, Industry and Energy Department Working Paper No. 31; June 1990; Report on Adjustment Lending II: Policies for the Recovery of Growth, Report Number R90-51, March 26, 1990; Financial Sector Adjustment Lending: A Preliminary Assessment of the Bank's Experience, mimeo, CEC, November 1990.

Three Positive Reasons

(a) "Reforms are completed" is a common explanation for several intensive adjustors. Typically, these countries have received one or more SALs and several SECALs. Broad policy distortions and misallocations of resources in important sectors of the economy have been corrected. Mexico is a good example where this is the case.

(b) "Remaining policy issues are of a different nature". They are more sub-sectoral, involve changes in institutions and may require an extended period of time to carry out even when there is no question about the government's intention. In these cases, it is more appropriate to support policy reform with investment lending because it is a better vehicle (a) in terms of its interlocutors and (b) because it makes for a better fit between the project cycle and the pace of reform. A good example of this is Ghana and Indonesia.

(c) "Rectifying neglect of investment and important sectors during adjustment". Social expenditures have fallen or more needs to be spent on environmental or poverty alleviation. Economic infrastructure has often deteriorated during years of austerity or over an even longer period of time, and as a result funds are needed for maintenance, reconstruction, and enlargement of capacity. Both Ghana and Bolivia are good examples where this situation exists.

Negative Reasons

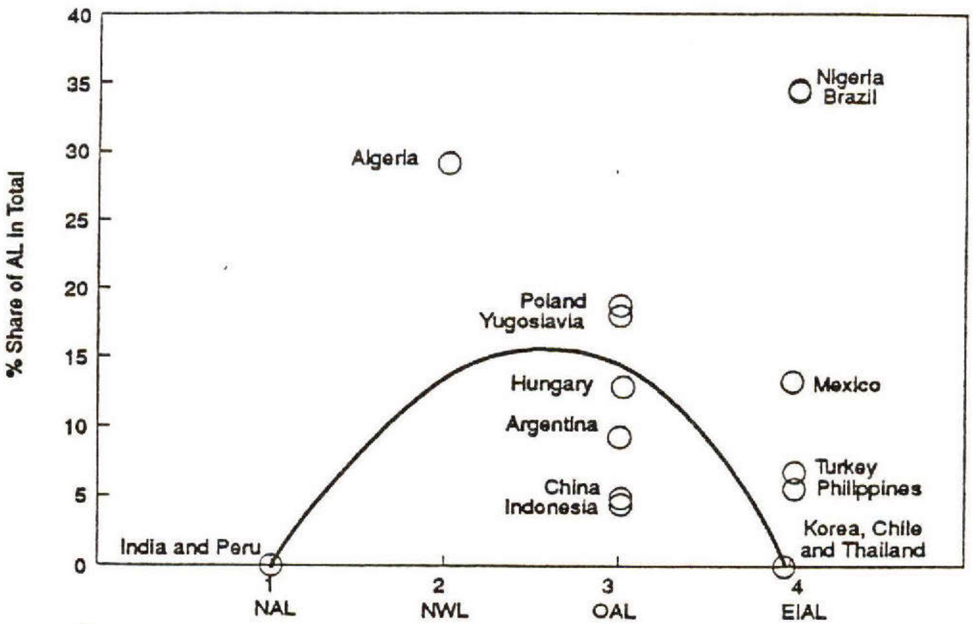
3.16 In contrast to these "positive" arguments for moving towards investment lending, many CSPs candidly acknowledge a prudential reason as well -- the need to slow down the rapid increase in Bank exposure that is the consequence of a series of quick disbursing adjustment loans. Exposure considerations have played an important role in the decision to scale back adjustment lending, for example, in Mexico, Turkey and Tunisia.

Reasons Not Discussed

3.17 In very few cases did a CSP identify a deterioration in the policy dialogue as the reason for terminating AL. The Congo CSP was the most explicit and the Philippine CSP came close to stating it. Only in hypothetical, policy related downside scenarios do CSPs link the interruption of AL to a breakdown in the policy dialogue. The Colombia CSP outlined a rationale for expecting AL to be difficult, but nevertheless found grounds for one last operation. No CSP considered that adjustment lending could be counterproductive by permitting reforms to be postponed rather than undertaken, although many observers outside the Region discussed this danger in Côte d'Ivoire. The likelihood that the country may not have a balance of payments financing gap was also never cited explicitly as a likely reason for a decline in future Adjustment Lending. In any case, the evidence from the latest CSPs shows that several of the Bank's EIAL countries are programmed to receive substantial doses of AL in the future, which would indicate that they have an unfinished policy agenda (see Figure 3.4).

Figure 3.4

PROJECTED SHARE OF ADJUSTMENT LENDING IN CSP's*



* Based on projected 5 year plans in the most recent Country Strategy Paper. These are mostly for the years FY 88-FY 91.

1) NAL : Non-Adjustors.

2) NWL : New-Adjustors, countries that received first adjustment loan after 1988.

3) OAL : Other-Adjustors.

4) EIAL : Early Intensive Adjustment lending, countries that received at least 3 adjustment loans with the first loan before 1985.

EK/W48670a

IV. PURSUING POLICY-DIALOGUE THROUGH ALTERNATE INSTRUMENTS

Elements of the Tool Kit

4.1 Adjustment lending was developed by the Bank in the early 1980s to provide balance of payments support and to respond to perceived inadequacies in the lending instruments then available for addressing economy wide policy distortions. However, quick disbursing adjustment loans are not the only way to engage countries in a policy dialogue. Whether involving project, sector, financial intermediary or adjustment lending, Bank loans and IDA credits have always been to some extent policy based. Linking lending with policy and institutional reforms (and, more broadly, the quality of economic management) has been done in several ways: (i) by the role given to performance in determining the size of a country's lending program; (ii) by the preconditions (for negotiation, Board presentation or effectiveness) associated with a particular operation; and (iii) by the preconditions for disbursement that may be applied even after a loan has become effective. Except for some project specific covenants, this third form of policy linking has normally been associated only with adjustment and program[12] lending. This is because once a specific desirable investment has been approved, the costs arising from delays in project implementation are likely to be greater than the benefits from tightening policy and institutional reform.

4.2 In thinking about the evolving pattern of conditionality and the appropriate lending strategy, five issues arise:

(a) The rate of disbursement and the pace of policy change.

(b) Policy conditionality through sector investment and financial intermediary loans.

(c) The use of hybrid loans.

(d) "Leveraging" the entire Lending Program.

(e) Maintaining macroeconomic dialogue despite reduced adjustment lending.

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12 A review of 19 program loans from 1976 to 1979 revealed that, in general, conditionality in program loans is quite vague. In most cases, the typical language on conditions for loan disbursement was as follows: "supporting economic and financial policies are put in place"; "there is an ongoing development program"; "the government will have a program of export promotion". In a few cases, the loans were in support of an IMF stand-by where, presumably, the conditionality was much stronger.

In order to address these issues, it is useful, first, to ask why it is necessary to provide financial support at all to persuade countries to undertake policy reforms. We then follow with a discussion of alternate instruments for pursuing policy dialogue.

IV.1 The Rationale of Financial Support for Policy Change

4.3 A typical CSP or an adjustment loan document contains macroeconomic scenarios that show the benefits from adopting a reform package -- such as higher GDP and export growth, better returns to investment and higher savings ratios. The benefits of reform are usually substantial. Why does the government seek or need financial help for reforms that are in the country's interest?[13] Several arguments can be made in favor of financial support to back policy reforms.

(a) The government is not convinced that the benefits will actually materialize. It does not believe in the Bank's economic framework and/or in our ultimate objectives. We need to "buy" reforms.

(b) Part of the government believes in reform; part does not. The believers use the availability of adjustment lending as an argument to get non-believers to accept the reform experiment. The Bank buys a "seat at the table."

(c) The government has a higher degree of risk aversion than the international agency. The government is convinced of the economic logic of the reform package but attaches a higher probability to its failure. As it has more at stake than the Bank does if the reforms do not work, adjustment lending is a reward for the risk taken by the government.

(d) There are substantial short run costs associated with policy change in return for long run benefits. Funds are needed to smooth these transitional short run costs of reform.

(e) Other creditors may wish to see the Bank supporting the reform program as a condition of their support.

4.4 The first argument has no validity as an attempt to "buy" reforms is a recipe for disaster. In this case, the government does not <u>own</u> the program but is implementing it because it desperately needs balance of payments support. In practice, however, the issue is not so simple. The lack of ownership is sometimes very evident, but often it is not so clear cut -- it requires judgment by the staff working on the country. Experience indicates that the second argument, that adjustment lending is useful to strengthen the

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[13] The country should instead be willing to pay for this advice.

hand of the reformers in government, has some validity. Very often, one group in the country is for reforms and another is not. A judgment must be made about the likelihood of the former prevailing over the latter and about whether the pro-reform elements need evidence of financial support from the international agencies to convince the nay-sayers.

4.5 The argument that quick disbursing adjustment lending is needed to assuage the short run costs of reform also has some validity. But here again, applying this logic to adjustment lending leaves some unanswered questions. For certain reforms, such as import liberalization, the need to provide import financing until export performance improves appears very logical. For others, such as tax reform or a provision for a safety net for the poor and unemployed, the need for temporary budgetary support[14] also has a straightforward rationale. However, in the case of some financial sector reforms, for example, the costs are not so large or cannot be easily identified.[15] Moreover, the size of the adjustment loan is not based on a calculation of the cost of the reforms. It is determined in the financing section of the balance of payments based on the share of the unfinanced gap that the Bank is willing to fill. There is no explicit connection between the size of the loan and the transitional cost of a reform package. This is not surprising, however, since the AL is not only to provide support for policy reform, but also to provide BOP finance to smooth out the consumption and investment path during a period of BOP crisis.

4.6 In summary, there is a widespread feeling and a common argumentation in adjustment loans, as well as in CSPs, that the "carrot" of adjustment lending is necessary to enable policy reforms. However, analyzing why it is needed does not provide very clear answers. Our current methodology on the impact and cost of reforms leaves an untidy or unquantifiable set of linkages between the size of adjustment lending and the magnitude of reforms. For the present and until such time as our understanding of this linkage improves, it would appear useful to get (as part of a CSP or an AL package) clarification from the country department on the following sets of questions:

(a) What and where is the constituency for reforms in the government? Is this constituency likely to prevail? In what way would the Bank's adjustment loan assist in this process? Why could similar results not be achieved with an investment loan?

(b) Has the government explained and publicized the reform program? Or is this a secret deal? What are the up-front actions the government is willing to undertake?

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[14] The budgetary support comes from the domestic currency equivalent of the foreign exchange.

[15] See "Financial Sector Adjustment: The Bank's Experience". Mimeo, October 12, 1990.

(c) What are the best estimates of the costs of the reform? Who would be affected? How will those affected benefit from the adjustment loan?

IV.2 The Speed of Disbursement and the Pace of Policy Change

4.7 The reforms supported by a loan often require institutional development or other measures that take longer than the six to 18 months between the Board date and the scheduled final tranche release. When the disbursement schedule of a loan calls for the first tranche to be disbursed immediately and the second in six months, the tranche release conditions can call for an action plan but sometimes cannot control whether it has actually been implemented. In countries with balance of payments problems that call for structural reforms with a long gestation period -- tax reform, financial and social sector reforms and public enterprise restructuring and privatization -- the Bank could usefully match the timing of its disbursements to the speed with which the reforms are introduced through extended-tranche adjustment loans. Assurance of a continued flow of financial support can increase the credibility and ultimate success of the reforms and bring the availability of financing more in line with the pace of implementing critical institutional reforms. Traditional quick disbursing loans remain appropriate for countries with balance of payment problems and with major distortions that can be quickly removed, such as price subsidies, excessive government spending and import quotas.

4.8 The appropriate composition of an adjustment lending program -- whether a series of quick disbursing adjustment loans, several adjustment loans running concurrently, a combination of adjustment and investment loans or, as suggested in RAL1 and RAL2, one big slow disbursing loan -- depends on the circumstances, including the speed at which major distortions can be removed, constraints on commitment levels and the timing of the need for balance of payments support. There is no need here for a new lending instrument, since adjustment loans (SALs or SECALs) with extended disbursement through multiple tranches, sectoral investment and financial intermediary loans with enhanced policy content and hybrid loans offer ways to establish continuity of support for adjustment. There is sufficient flexibility within and among the available instruments to tailor an adjustment program to the specific needs of the country. Loans such as this have been used recently in the Africa and EMENA Regions e.g. the Fourth Structural Adjustment Credit in Togo, and the Second Structural Adjustment Loan for Morocco.

4.9 Slowly disbursing adjustment loans have been suggested as an appropriate lending instrument in those cases where the policy and institutional reforms being supported are likely to be implemented only over a period of years and where the assurance of continued external support can increase the credibility of the reforms (and hence their chance of success). The same assurance may not appear so credible with a series of smaller quick disbursing adjustment loans. The fact that such loans provide readily fungible resources -- general import financing and, indirectly, budget support financing -- may increase their attractiveness to the central economic ministries and, consequently, may increase the government's capacity to adopt recommended reforms. As shown later in Section V.2, slower disbursing adjustment loans may also be preferred in order to avoid the swings in net disbursements associated with current adjustment loans. Slowly disbursing adjustment loans, however, have two preconditions that seem likely to limit their use:

(a) It must be possible to set out the proposed reform program in a series of specific time-bound steps, which can become the basis for tranche releases; when this cannot be done, a series of quickly disbursing operations would be more appropriate.

(b) The balance of payments situation must be sufficiently urgent that general import financing is needed, but not so urgent that the resources available for commitment need to be quickly disbursed.

4.10 The viability and usefulness of extended tranche adjustment operations is a subject of debate in the Bank. One view is that extended tranche operations can only work where the government's commitment to reforms is strong and where it has the ability to plan and commit to actions over three to four years. However, the Bank's existing operations appear to follow the opposite principle. The Bank is conducting single-tranche operations in countries, for example in Indonesia, where both the commitment to reforms and the ability to plan ahead is relatively strong. And it is now pursuing extended tranche operations in countries where, with a few exceptions as in the Morocco Second Structural Adjustment Loan, the opposite holds -- that is where, the ability to plan into the future is limited. It is still too early to judge the performance of extended-tranche adjustment loans. Cases where a slow-disbursing adjustment operation may seem appropriate would be, for example, trade reform in India and Pakistan, financial sector reforms in Turkey and tax reform in Argentina and Peru. Public expenditure restructuring where the governments needs a longer term commitment of Bank support may also be a good candidate for a slow disbursing adjustment loan.

IV.3 Policy Conditionality Through Sector Investment and Financial Intermediary Loans

4.11 Financial intermediary loans (FILs) and sector investment loans (SECILs) are intermediate between adjustment and project lending. This is true in four closely interrelated ways. First, in most FILs and SECILs, the design involves wholesaling. Accordingly, under FILs and SECILs, the Bank does not lend for a project; rather it lends for an institution which in turn selects the sub-projects to be financed and supervises implementation, while the Bank supervises the institution and the wholesaling mechanism. Second, associated with this wholesaling design concept, institution building tends to be an integral aspect of FILs and SECILs. Third, because sectoral rather than project issues are considered, there is more scope for addressing broader sectoral policy issues. Fourth, because discrete sub-projects are financed, it is far more credible to enforce policy undertakings by threatening to suspend disbursements because ongoing contract relations, which tend to be important for large single project operations are unlikely to be impaired if this should happen.

4.12 As noted earlier, for many countries, reforming sectoral policies and institutions is now the critical next step in the sequence of reform. Accordingly, FILs and SECILs are increasingly likely to be used in the 1990s, especially where agreement can be reached on a time-bound program of policy reform and institution building (see Box 4.1 on Changing Focus of Lending for the Urban Sector). In terms of instrument design, combining policy conditions with a mid-term review is a way to link disbursements to the fulfillment of policy conditions as well as to expenditures.

4.13 In the past, FILs and SECILs did not typically support adjustment type policies. SECIL conditionality mostly concentrated on institutional strengthening of the implementing agency (see Figure 4.2) comparing policy conditions in industrial SECALs versus SECILs). Many projects -- both SECILs and FILs -- financed studies designed to develop action programs on project related pricing or policy issues, although they were seldom specified as conditions when the findings of the studies were implemented. To some extent, SECILs may have excluded adjustment type conditions because of the availability of SECALs. SECALs were used, for example, to address education sector issues in Ghana and Nigeria, because it was felt that a SECAL would more effectively focus the governments' attention on policy issues (see Box 4.2 on Lending for the Social Sectors). As noted above, the largest shift in the composition of the lending program during the 1980s was from FILs and SECILs to SALs and SECALs. SECILs have tended to focus on major areas of public investment (power, rural infrastructure, transportation). On-lending for private sector activities in agriculture and industry has been addressed in FILs.

4.14 In recent years, however, the policy content of SECILs has grown. An increasing number of SECILs have included letters of sector policy. These are closely akin to the letters of development policy associated with adjustment lending. As in SALs, the letter of sectoral policy is generally referred to in the loan/credit agreement. The SECIL letter typically spells out the policy agenda for the sector, often including broader sectoral public expenditure issues, and provides a policy umbrella for the investment project. This innovation has been paralleled by a debate within the Bank about the desirability of transplanting to FILs and SECILs yet another technique of adjustment lending -- tranching.

Box 4.1 Changing Focus of Lending for the Urban Sector[1]

The need to give more policy teeth to sector investment lending arises both from the shift out of adjustment lending and from frustrations with traditional project lending. In the urban sector, the Bank's traditional lending has been largely in neighborhood level projects. There is a growing awareness in the Bank that we need to shift our focus towards city and national level policy reform and institutional development. Some of this shift is already underway, as, for example, in Brazil, Indonesia and Zimbabwe. This would require a re-focus of urban lending towards

(a) Reform of land and housing market regulations, centre/local financing relations and financial policies pertaining to housing and infrastructure.

(b) Institutional development to improve financial and technical capacities of national, regional and municipal organizations.

(c) Investments in city-wide infrastructure, housing and land development through financial intermediaries and improvement of slum areas.

Time-sliced sector investment operations and financial intermediation loans would appear to be the most suitable lending instruments to address these issues. The Bank has assisted the Indonesian government with an Urban Sector Loan in 1987 that helped the government revise and shift responsibility for planning, financing and maintaining local infrastructure from the Central to the regional and local level. The Bank has undertaken several projects in Brazil at the multi-city and state level such as the medium-sized Cities Project in 1979, the Market Towns Improvement Project in Parana State in 1983, which was designed to improve the access of municipalities to credit for local investments, and the Municipal Development Project in 1989. Since 1983, the volume of lending through housing finance operations has increased substantially. These have included reform of domestic resource mobilization for housing in Chile, Mauritius, Zimbabwe and Lesotho, improving the targeting and transparency of subsidies in Malawi and Mexico and improving the regulatory framework in Korea, Thailand, Nigeria and Tunisia.

The Infrastructure and Urban Department has also argued for a new lending instrument -- city level lending. In some cases, slow disbursing adjustment loans could be considered to address important national urban policy issues but they would need to meet the strict criteria for those laid out in Section IV.2.

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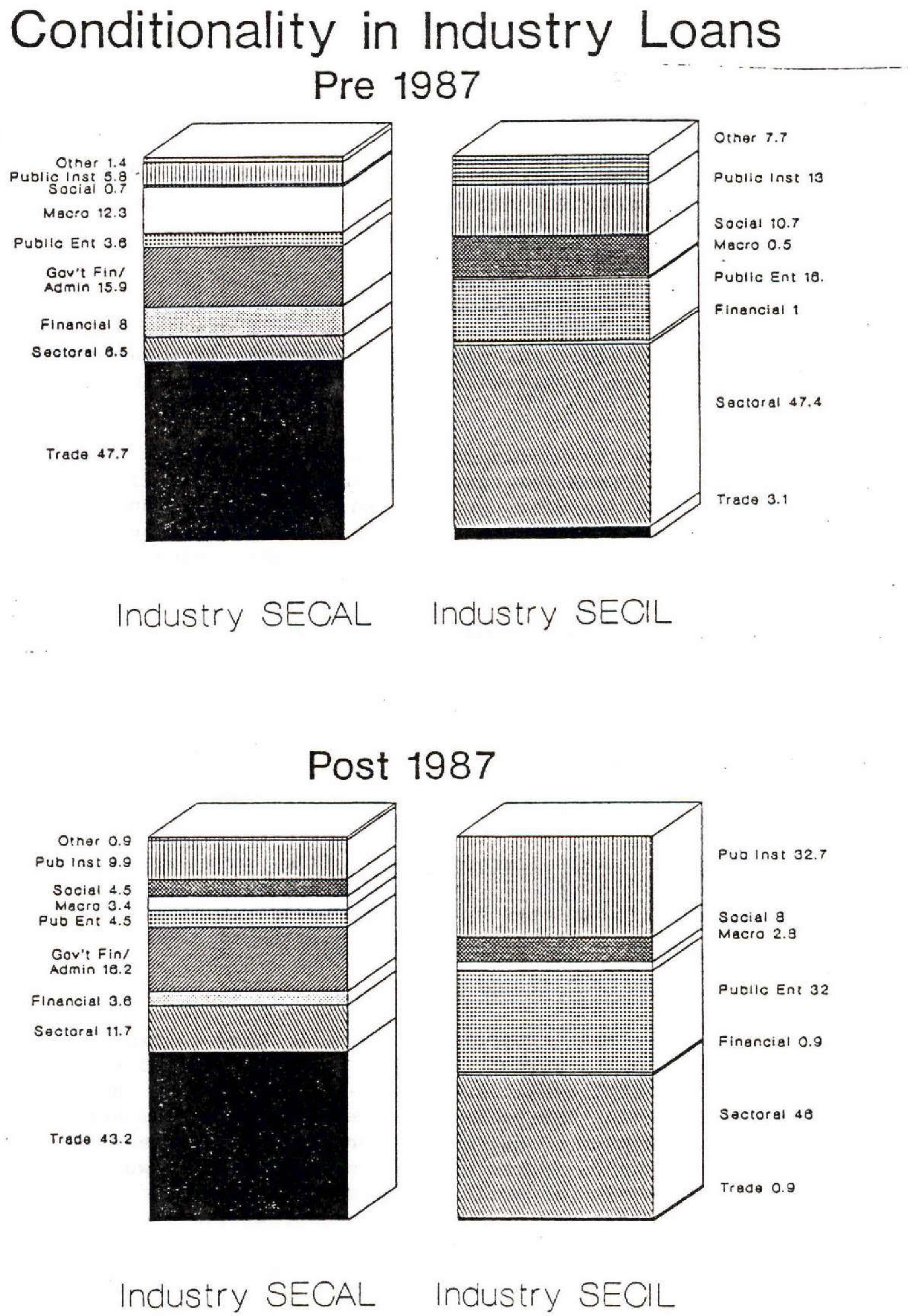
1 Based on "Urban Policy and Economic Development: An Agenda for the 1990s" September 4, 1990, Urban Development Division, Infrastructure and Urban Development Department.

Figure 4.1


Conditionality in Industry Loans
Pre 1987
Other 1.4
Public Inst 5.8
Social 0.7
Macro 12.3
Public Ent 3.6
Gov't Fin/
Admin 15.9
Financial 8
Sectoral 6.5
Trade 47.7
Other 7.7
Public Inst 13
Social 10.7
Macro 0.5
Public Ent 16.
Financial 1
Sectoral 47.4
Trade 3.1
Industry SECAL
Industry SECIL
Post 1987
Other 0.9
Pub Inst 9.9
Social 4.5
Macro 3.4
Pub Ent 4.5
Gov't Fin/
Admin 16.2
Financial 3.6
Sectoral 11.7
Trade 43.2
Pub Inst 32.7
Social 8
Macro 2.8
Public Ent 32
Financial 0.9
Sectoral 46
Trade 0.9
Industry SECAL
Industry SECIL

4.15 Two key issues in the debate about whether tranching is preferable to suspending disbursements are the appropriate approach to enforcing project conditionality and the state of relations between the Bank and its borrowers. The presumption in investment lending has long been that borrower obligations will be fulfilled. Therefore, the burden of proof has been on the Bank to demonstrate that obligations were not met before suspending disbursements. In addition, contractual relations under project lending tend to favor the continuation of financing under all but the most difficult circumstances. Over time, as a result, actual suspension of disbursements on grounds other than non-payment have been a relatively rare event in the Bank, which in turn raises the cost, in terms of country relations, of actually suspending disbursements for non-compliance with a project covenant. Even so, mid-term reviews have gained currency for SECILs -- as a way of signaling the Bank's willingness to consider suspending disbursements for non-compliance with loan covenants or lack of progress in the implementation of policy reforms.

4.16 Against this background and in the context of the Bank's internal debate, some staff members stress the importance of utilizing the existing remedies the Bank has under project lending -- in conjunction with mid-term or annual reviews to be conducted with the borrower to assess compliance with covenants and progress in the policy area. They argue that if these reviews show that obligations have not been fulfilled, or that progress in implementing the policy reforms included in the SECIL letter has not been satisfactory, then the Bank may, and indeed should, suspend disbursements.

4.17 Others within the Bank emphasize the difficulty that suspensions present for country relations, particularly during a time of transition when for many years suspensions were used only for the most serious infractions of project covenants. They argue that this remedy is too clumsy to be used effectively and that tranching is a more subtle instrument for securing compliance with policy undertakings. They stress that, with tranching, the burden of proof is on the borrower to establish compliance while, with suspension of disbursements, the burden of proof is traditionally on the Bank to establish non-compliance. Proponents of this position argue that to tranche SECILs is to provide an effective mechanism to ensure the implementation of agreed sectoral reforms.

4.18 It is clear that if SECILs/FILs are to play an expanded policy role, some clarification is needed, for Bank staff, for the Board, and for our borrowers, that will permit greater use/flexibility of the tranching/suspension instrument. But regardless of whether SECILs/FILs will be tranched or simply be subject to more frequent suspensions of disbursement in the event of non-performance, the overall approach would be the same. The agreed policy conditions would be placed in a letter of development policy and the future disbursements on the loan made conditional on the satisfaction of those conditions during mid-term reviews. Typically this would only be possible for FILs and for SECILs of the wholesale variety, in which individual project components are not closely related to each other and, except as individual parts of a broader investment program, stand on their own. Because of the discrete nature of the individual project components, disruption of contractor relations need not be a serious problem either in the case of suspensions of disbursements in the event of policy default or in the case of tranching. Preferably tranching of SECILs should be linked to the commitments for subprograms, rather than to disbursements within programs as subprograms, since this will provide the greatest leverage a least cost of disruption to investment programs once initiated.[16]

4.19 As and when adjustment lending in countries wanes, wholesale type SECILs, and their private sector analog, FILs, should increase in prominence (see Box 4.3 on FILs). Both instruments neatly combine a focus on investment (the capacity of sectoral ministries or agencies to design investment programs that satisfy agreed criteria), on institutional development (the capacity of financial institutions to appraise private investment prospects) and the scope for strong policy action programs grounded in mid-term reviews whether enforced by tranching or by more frequent use of suspension of disbursements.

4.20 Meanwhile, the transition must be carefully planned and managed. The Tunisia CSP discusses very explicitly the difficulties encountered in trying to shift quickly from adjustment lending to investment lending. Indonesia is a good example of those countries in transition that plan to use policy based investment loans as the major vehicle for maintaining dialogue. The Indonesia CSP not only announces its intention but also discusses in some detail how policy and investment will be put together. There are also important staffing and skills mix considerations involved in the transition that must be carefully planned.

IV.4 The Use of Hybrid Loans

4.21 In the late 1980s, a new instrument of lending -- hybrid loans -- emerged as an additional means for achieving the Bank's long standing goal to coordinate investment and policy adjustment. Hybrid loans were developed in response to the evidence that lack of investment has been one of the principal reasons that supply response has not been generally forthcoming in response to policy change.

4.22 Hybrid loans, which combine a quickly disbursing adjustment portion with a slowly disbursing investment portion, have become increasingly popular. Because they combine tranched BOP support (the release of which is based upon

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[16] For example, in the cases of an Irrigation SECIL, the required investments for say a canal network could be phased or time sliced. At each stage the commitments on new equipment or materials for the subsequent phase would be approved subject to satisfactory compliance with pre-agreed policy conditions.

Box 4.2 Choice of Instruments in Social Sector Policy Based Lending

The recent education SECALs in Ghana and Nigeria are examples of operations that fall near the border between adjustment and investment lending. The principal reason for making these loans was to support changes in policy in the education sector, and the Bank wished to disburse in tranches as the policy reform process proceeds. Since both countries had a need for quick-disbursing funds,[1] the operations appeared to be like other SECALs and they were so designated.

Under these loans the Education Ministry proposed to withdraw certain benefits from some of its clients (e.g., to reduce lodging subsidies in Ghana and introduce fees in and dismiss non-teaching staff from universities in Nigeria) and shift these resources to other uses such as elementary education. Both the Ministry and the Bank had a strong interest in ensuring that the Ministry's budget, especially for non-salary recurrent costs which were necessary to achieve the potential benefits, was not squeezed at the last moment, as often happens to social sector expenditures during adjustment.

In addition, even if budget systems could be relied on to provide funds, public sector entities in Nigeria and Ghana often suffer difficulties in converting local currency budget funds into foreign exchange for imports.

The desire to reduce uncertainty arising from budgetary and foreign exchange constraints on the sector led to linking disbursement of Bank funds directly to agreed expenditures implied by the policy reform program. Some of the agreed expenditures in Ghana and Nigeria were for items that were not directly imported and this led to disbursement for "local costs" of funds from a loan designated as "adjustment." This practice was questioned at the Board. On the other hand, the idea of "tranching" investment loans has also been questioned. Do loans such as those described fall between two stools -- is neither an AL nor an IL possible?

Not really. It would be more accurate to say that either instrument in principle could have been used. For the AL option to be chosen, the country would have to demonstrate a need for quick-disbursing funds and a macroeconomic program designed to deal with that need over the medium term, as with any other SAL or SECAL. The loan documentation would also have to explain why the social sector was a priority for adjustment (rather than one with more immediate impact on the macroeconomic balances, say) and justify the fit between the disbursement period and the time required to carry out the policy changes that are being supported.

If these questions, essentially no different from those asked of any other SECAL, are answered satisfactorily, there is no insuperable obstacle to linking the funds disbursed to agreed expenditures, even local expenditures. As suggested in the Report of the Task Force on Local Cost Financing in Adjustment Loans, although Bank funds provided under ALs cannot be disbursed against local costs, the government would be expected to make local currency and foreign exchange available for agreed purposes as part of a public expenditure program (as is being done in the Guinea Education SECAL) and this expectation could be reinforced by loan covenant. If, as in Ghana and Nigeria, the Ministry requires additional reassurance about its cash flow before undertaking fundamental reforms is needed, Bank funds could be held in a special account which could be drawn down only as resources are made available for agreed expenditures.

On the other hand, if a clearly identifiable list of goods and services needed to carry out the program of policy change can be identified, and the activities to be financed lead to increasing national income in the future, as does the education of people, then an IL may be the better choice. In this case the Bank and government can agree on annual -- or more frequent -- reviews of progress under the policy reform program and if progress is not acceptable, disbursements (or commitments to activities that will in due course lead to disbursements) can be suspended -- just as an unfavorable tranche release review stops disbursements is credible if policy changes do not come along as expected.

A third option would be a hybrid operation, with the adjustment lending component combined with an expenditure/investment component. This last option may offer the cleanest 'choice' an avoid the issue of local costs under adjustment loans and lack of 'high level' policy dialogue under investment loans.

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1 Although this need apparently was not spelled out in the Ghana loan.

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Box 4.3 Financial Intermediary Lending

Since the 1960s, the World Bank has been making loans to the private sector through financial intermediaries. The volume of such lending varies from year to year, but during the 1980s has accounted for roughly 15 percent of new commitments. The rationale for such lending has varied over time. In the 1960s and 1970s, the primary objective was to provide funds to fill perceived gaps in the financial markets. With regard to lending to agriculture and small business, the perceived gap was a general shortage of credit; in the case of larger industry and housing, the perceived gap was term finance. World Bank loans through financial intermediaries (FILs) were designed to do two things -- to provide some of the missing funds and to build institutions capable of handling such financing. In the early years, each FIL was earmarked for a single financial intermediary and over time a series of repeat loans were made to the same institutions.

Starting in the early 1980s and growing throughout the decade, FILs have become somewhat more policy oriented, though providing funds to fill financial market gaps has continued to predominate. Starting originally with concern over the level and structure of interest rates and later expanding to cover government intervention in credit allocation and other issues, a few FILs began to include a policy component. Some FILs also included elements covering nonfinancial policy issues affecting end-users of funds, such as trade policy in industrial FILs, pricing policy in agricultural FILs and the regulatory framework in housing FILs.

Beginning in the early 1980s, the Bank began to realize that many of the correspondent financial institutions that it had been funding were in serious financial straits and were no longer able to channel resources efficiently. This meant that the Bank had either to help restructure these institutions or to switch to sounder financial institutions to handle Bank funds. Both the increasing policy focus of FILs and the impaired condition of correspondent intermediaries led to a shift in lending strategy. Instead of using a single intermediary to handle Bank funds, more and more the Bank tended to use an apex structure for FILs. Bank funds went to the apex institution, in many case the central bank, which then on-loaned the funds to a number of second tier institutions. By switching to the central bank as its correspondent, the Bank was dealing with an agency responsible for policy. Also, with the apex approach, a broader array of intermediaries could be used to on-lend Bank funds.

The forthcoming operational directive on financial loans and the recent memorandum of the World Bank Group on Financial Intermediary Lending carries forward the evolution of FILs. Simply filling a perceived gap in the financial markets is no longer a justifiable rationale for a Bank loan. A Bank FIL must specify the reasons why the domestic financial market does not provide the required funds and a time-bound program of policy reforms designed to eliminate the financial market distortions and thus the financing gap. An alternative rationale for a FIL is to deal with policy issues affecting the end-users of funds in industry, agriculture and housing. Hence it is the intention in the future to make FILs in effect policy based. The operational directive also requires a careful selection of sound intermediaries to on-lend Bank funds and to ensure that the loan does not create distortions in the financial markets.

A number of factors will distinguish policy based FILs from FSALs and SECALs. First, while the specifics to be covered in FILs will not be limited, the range of policies and institutions included is likely to be less broad than in a sectoral adjustment loan. Second, in FILs the focus of the loan will be more on issues of development rather than adjustment. As well as policy issues, FILs are intended to develop the institutions of the financial and real sectors. Third, in contrast to a SECAL or FSAL, the funds from a FIL are distributed through financial intermediaries primarily to the private sector, not to government. Fourth, FILs will be preferred when the desired period of loan disbursement is somewhat longer. Fifth, FILs will be used in preference to adjustment loans when the policy changes covered are unlikely to eliminate the gaps in the financial markets during the period of loan disbursement. The funds provided by the Bank will help fill the funding gap. Even when the focus of the FIL is on the real sector, efforts will be made in the loan design to improve the functioning of the domestic financial market.

fulfillment of agreed conditions) with more traditional investment financing, hybrids seem a natural lending instrument in the declining phase of an adjustment cycle. Hybrids would also appear to be a useful instrument in countries such as Ghana where the adjustment cycle has been prolonged due to slow supply response. If a balance of payments need remains because of a slow supply response, investment lending would also be needed concurrently to rehabilitate the country's infrastructure. The appropriate use of hybrid lending is the subject of one of the papers in the FY90 Review of Development Effectiveness.[17] This paper showed that the actual experience with hybrid loans was not very favorable. It concluded that care must be used so that:

(i) hybrid loans do not become a soft option, in other words, a low conditionality way of providing general import and budgetary support financing;

(ii) the quickly disbursing adjustment component does not become a substitute for the cost sharing that would normally be required for the project component;

(iii) hybrids do not become the least common denominator of both investment and adjustment lending. That is, the investment component should not receive less attention than in a project loan while the policy framework should not normally be weaker than that of an adjustment loan;

(iv) the quick disbursing component is not simply added on to bring about a resource transfer, in cases where the policy change could have been achieved with nominal project conditionality;

(v) the procedures for approving hybrids should be similar to those for an adjustment loan.

IV.5 Leveraging the Entire Lending Program

4.23 In countries where there is no immediate balance of payments problem, reflected in a large current account deficit, but where there is clear need for structural reforms, AL is not the appropriate lending instrument. There are also cases where the country is unwilling to accept AL for political reasons. In these cases, one way to strengthen the policy dialogue is to use policy based SECILs and FILs as discussed in Section IV.3. Another option is to try and leverage the entire lending program with lending portfolio packages tailored to various policy scenarios. There would be a low case, base case and a high case with well specified triggers on the policy side that would activate higher levels of Bank lending through investment loans.

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17 "Hybrid Loans: A Review of Experience and a Framework for Their Use".

4.24 This is obviously not an easy option and will require considerable effort on the part of the country team in its design and execution. Moreover, if there were to be policy backsliding once projects were started, the Bank would have no option but to complete projects though, of course, the Bank would convey to the government the need to limit future lending in response to the backsliding. In any case, even if the government were unwilling to engage the Bank in a serious active policy dialogue, putting such a strategy to the government would make it aware of the extent of potential Bank support it could receive were it to change its mind and agree to undertake reforms.

4.25 The last CSP for India does have a discussion of the lending program along these lines. However, the difference in the lending amounts between various policy scenarios was too small to have any likely impact.

IV.6 Maintaining Policy Dialogue with Reduced Adjustment Lending

4.26 Adjustment lending has naturally emphasized the Bank's dialogue with country governments on both macro management and on the removal of major distortions affecting the efficiency of resource mobilization and allocation. The policy dialogue has been "raised to a higher plane" and given much greater visibility by the specific conditions attached to individual SALs and SECALs. It has also been conducted largely with a very different group in the government compared to discussions on investment lending. An important issue in countries where the Bank is shifting out of adjustment lending is how to maintain the effectiveness of our policy dialogue. This is necessary in order to monitor policy slippage and to remain prepared to resume adjustment lending to the country in the future.

4.27 Much of the intellectual work that might otherwise have been done in the course of preparing of AL can be programmed into CESW as AL is wound down. Different kinds of CESW are substitutable for different kinds of AL. CEMs take over some of the macroeconomic dialogue that otherwise would occur during SAL preparation. Public Expenditure Reviews can raise issues of public sector management and inter-ministerial resource allocation that are taken up in public sector SECALs. Several CSPs have recognized that CESW has to be of higher quality if it is to substitute for AL. Moreover, the style of CESW has to be different. It cannot stop at presenting governments with analytically sound reasons for adopting broad changes in policy. It must, like AL, continue the dialogue down to the stage of detailed execution. The FY92-94 Business Plan for LAC is most explicit in recognizing the substitutability of CESW and lending in promoting policy reform. As that Business Plan states,

> "Country dialogue rests on well-reasoned and clearly presented analyses that persuade governments. Even where not linked directly to lending programs, such economic and sector work can maintain the Bank's influence on country policy".

4.28 What is needed, however, is a concise regular CESW document that summarizes the country policy agenda of the Bank and that lays out the kinds of triggers for lending, related to policy performance, that are currently found in CSPs. This calls for a new-style CEM, similar to the Indonesia CEM. The profile of the CEM has also been downgraded. It is now, typically, viewed as a technical/economic document in the Bank and the country. One way to resolve this problem is to have a shorter, well defined CEMs with a standard set of guidelines defining what should be included in such a document. More thematic issues that are currently contained in CEMs could be discussed in separate reports.

4.29 This shorter policy oriented CEM should be discussed annually by a senior Bank official, presumably the Director, with country officials. It should be made clear that this document provides our central policy agenda with the country. It should also be the document that is used for aid coordination activities. It can also serve as the basis for discussions at the Annual Meetings. It should be emphasized to the government that it should take this document seriously if there is a prospect that the country might need Bank adjustment lending in the future. It might be argued that this would add yet another document to those to be produced by the Country Department. Instead, if it is planned carefully, this document could be used to avoid a lot of the duplication that one sees in the CEM, CSP, PFP (where applicable) and in loan documents. A good example of this is the Indonesia CEM.

4.30 In several countries, such as Sri Lanka, Bolivia, and Venezuela, Regions have planned to establish or to strengthen resident missions in order to carry out more effective dialogue during a transition toward more IL. Resident staff can provide some of the continuity in policy dialogue that is sometimes lost in CESW, which tends to be produced as discrete products in contrast to the more continuous preparation cycle, including tranche release and supervision, inherent in a series of ALs. A good example of this is the Indonesia resident mission.

V. OTHER CONSIDERATIONS THAT AFFECT THE LENDING MIX

5.1 The use of the elements of the tool kit into a proposed framework for thinking through country assistance strategies is presented in the final section of this paper. Before turning to that, it is important to discuss three considerations that affect the lending mix.

V.1 Fungibility of Funds and the Lending Mix

5.2 Providing financing to elicit a supply response in an economy suffering from foreign exchange shortages has a certain logic. This logic is more compelling when it is combined with policy change. The policy change ensures that the foreign exchange needs eventually decline. The foreign exchange is necessary to ensure that the economy will begin moving out of the "stabilization" phase and into the subsequent growth phase.

5.3 The provisioning of foreign exchange for necessary imports to elicit a supply response can be done through either adjustment or investment lending as money is, to an extent, fungible. But there is a difference in the degree of fungibility between the two types of lending instruments.[18] For a large country where the Bank typically finances a small proportion of the foreign exchange budget, the difference in specificity between AL and IL may not matter. If a country has a specified investment program and the Bank steps in with IL to finance a part of it, foreign exchange funds are released for general purpose imports. Foreign exchange is fungible, and funds that would have been used by the country for a project can be released for general purpose imports when the Bank decides to fund the project.

5.4 However, the distinction may be more important in the case of smaller countries (especially IDA countries) where the Bank finances a larger proportion of the foreign exchange budget. This is because the availability of free foreign exchange is much smaller, and the bulk of investment is financed through foreign assistance in any case (Table 5.1). There are very few investment projects that would have been financed by the country's available free foreign exchange where the Bank's decision to finance them would release foreign exchange elsewhere.

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[18] Adjustment lending disburses against a negative list that precludes certain types of imports. Investment lending disburses and are needed against a positive list that pre-specifies imports that can be authorized for the project.

Table 5.1 Donor Financing of Investment Budget
Non-Blend IDA Adjusting Countries

Country	Percentage Share of Investment Budget	Budget Year
Early Intensive-Adjustment Lending Countries		
Bolivia	55%	1989
Ghana	78%	
Kenya	67%	1989/90
Madagascar	73%	1989
Malawi	86%	1989/90
Mauritania	93%	1989-91 a/
Senegal	72%	1988/89
Tanzania	68%	1987 b/
Togo	62%	1989 c/
Zambia	68%	1990 d/
Average	72%	
New Adjustors		
Benin	92%	1989 g/
Chad	98%	1990
Mali	93%	1990
Mozambique	100%	1990
Average	96%	
Other Adjustment Lending Countries		
Bangladesh	67%	1988/89
Burkina Faso	90%	1990
Burundi	73%	1989 e/
Central African Republic	87%	1989
Guinea	83%	1989
Guinea-Bissau	92%	1990
Guyana	76%	1990
Niger	na	na
Sierra Leone	53%	1989/90 f/
Somalia	94%	1989
Sudan	na	na
Uganda	66%	1989/90
Zaire	61%	1989
Average	77%	

a/ 1989-91 Public Investment Program.
b/ 1987 Investment Program Review with adjustment for local counterpart funding of foreign-financed projects and local funded recurrent cost projects.
c/ Excluding phosphate countertrade contributions which have not been directed to investment.
d/ Including fertilizer counterpart funds.
e/ 1989 Public Investment Program.
f/ Share rises to 75% with inclusion of PL480 counterpart funds.
g/ 1989 Public Investment Program.

Source: Country Economists.

5.5 A classic example of these constraints is provided by Uganda. In Uganda,[19] "the collapse in coffee prices means that virtually all the free foreign exchange will go to meet petroleum imports and essential debt service, leaving the economy dependent on external financing to meet other import needs, including critical imports to rehabilitate Uganda's dilapidated economic infrastructure and to provide inputs for agriculture and industries". It should also be noted that almost two thirds of Uganda's development budget is financed from abroad.

5.6 The Uganda situation epitomizes, with some variations, the position of a large number of Sub-Saharan African economies in that the Bank's AL and, to some extent, purchases from the IMF are the only sources of free foreign exchange. The Bank becomes the lender of last resort in the financing package, with bilateral donors sticking to financing investment projects. This explains to some extent the need for, and the justification of, much higher shares of adjustment lending by the Bank in Sub-Saharan Africa. In order to reduce the Bank's high share of adjustment lending, an obvious solution is to try to convince other donors to convert or add to their assistance program to help with balance of payments support. It is in this context that the Bank coordinated the Special Program of Assistance (SPA) in late 1987 for three years. This was extended into SPA II for FY91-93. For the 20 core countries under SPA1, quick disbursing cofinancing and coordinated financing other than from the Bank represented 47.5 percent of total if the Fund contribution is included and 62.5 percent if it is excluded.[20] Strong donor support is expected to continue in the context of SPA2 (1991-93), but the share of total is not expected to change significantly.[21]

V.2 Disbursement Profiles and the Composition of Lending

5.7 The low degree of specificity in the use of foreign exchange is one distinguishing feature of adjustment as against investment lending. The second distinguishing aspect of AL is that it disburses much faster than IL. It, therefore, provides the flexibility to respond quickly to a country's unanticipated balance of payments needs. It is this flexibility that makes AL a powerful tool in designing country assistance strategies. However, it also carries risks, one of which is that it leads to a rapid increase in net disbursements that must eventually decline and turn negative. This pattern

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[19] According to "Special Program of Assistance: Proposals for the Second Phase", Africa Region, World Bank, May 1990.

[20] SPA meeting, October, 1990.

[21] See "SPA: Growth, Aid, Debt -- Proposal for the Second Phase", World Bank, 1990. If the Fund increases its financing of the core 20 countries to $1.5 billion, the share from non-Bank donors would be about 50 percent including the Fund and 61 percent excluding the Fund.

also prevails for traditional loans, but in that case usually takes many years, providing a country with the opportunity to develop its capacity to service its Bank debt gradually. This pattern is apparent in a number of the Bank's borrowers who have received adjustment lending since the early 1980s. Negative net disbursements can be a source of concern as they can lead to a liquidity crunch, to a deterioration in relations between the country and the Bank and to changes in the Bank's exposure. It can also lead to the temptation to undertake defensive lending to maintain positive net disbursements. This does not mean that the Bank's overriding objective should be to smooth net disbursement profiles. For example, the sharp increase in the disbursements to Mexico as part of the recent debt agreements have considerably improved the country's future repaying capacity and are therefore justified.

5.8 Negative net disbursements are projected in many of the Bank's early intensive adjustors. The exceptions are Nigeria, Mexico, Morocco and Pakistan. These are all countries where adjustment lending is expected to continue although at declining levels. In most of the Bank's early intensive adjustors, a substantial volume of investment lending is projected into the future. This is a logical outcome of the "adjustment cycle" discussed in Chapter III. The negative disbursements then typically arise from repayments on past adjustment operations. They are an issue of prominence in some CSPs. The Morocco CSP, for example, devotes considerable attention to discussing how to avoid future negative net disbursements.

5.9 The net disbursement profile to a country changes with a change in the share of adjustment lending. For purposes of illustration, Figure 5.1 shows the pattern of net disbursement for Nigeria and the Philippines. If the required policy changes can be brought about through investment lending rather than adjustment lending, it is preferable to use investment lending from the perspective of the long run management of net disbursements.[22] In practice, this choice might arise between a sector adjustment loan, or a sector investment loan, especially as the agenda for reform in a country moves into sectoral and sub-sectoral issues. In the case of health, education, transport, sewerage and other urban sector issues, we might consider whether the policy agenda can be negotiated through sector investment and project loans rather than through SECALs (these choices were discussed in Chapter IV). Slower disbursing adjustment operations would also serve a similar purpose. A good example is a financial sector loan in Nigeria tranched over three to four years. A longer term arrangement can also be helpful in keeping a program on track if there is a change in government.

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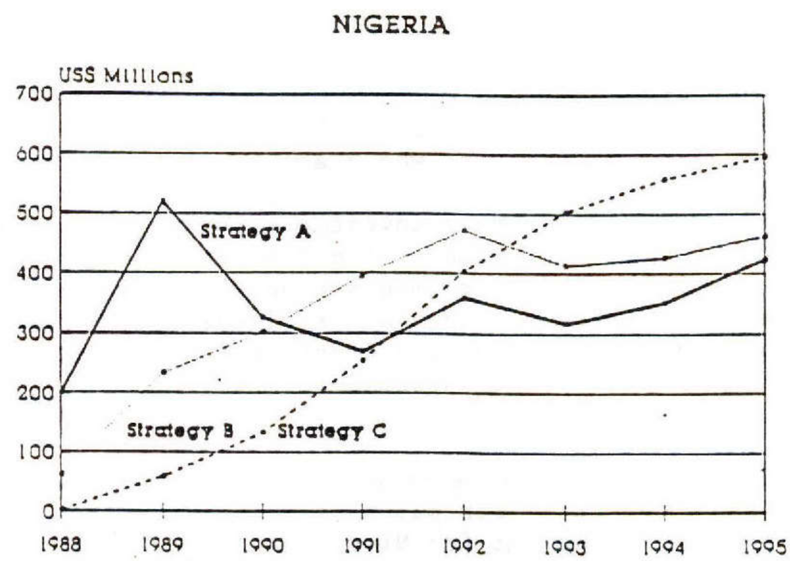
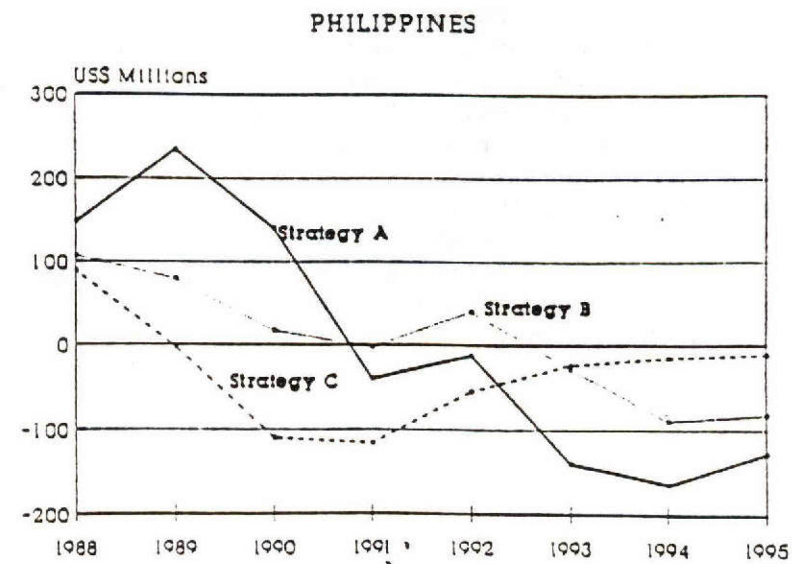
22 Assuming, of course, that other lenders could be persuaded to come in to fill the financing gap, which may not always be possible.

Figure 5.1 1/

COMPARISON OF NET FLOWS UNDER DIFFERENT LENDING STRATEGIES





A: Current Strategy B: Multi-year Adjustment C: Project Lending Only

1/ From the 1988 Creditworthiness Report this type of scenarios are being prepared by FRS.

V.3 Private Sector Development and the Lending Mix

5.10 Bank lending operations can support the private sector in three different ways: (i) increasing the resources available to the whole economy while supporting policy reforms that enhance the business environment (through balance of payments support); (ii) alleviating constraints related to social and physical infrastructural bottlenecks; and (iii) providing investment financing to enterprises through financial intermediaries.

5.11 The first two kinds of indirect support may be generally perceived as enhancing the public (as opposed to the private) sector, but in many situations they may actually represent the most efficient way of fostering private sector development too.

5.12 When significant distortions are present, the policy reforms supported by adjustment operations are often the highest Private Sector Development (PSD) priority. What may also be required is greater involvement by the Bank in the choice of mechanisms for economic absorption of the Bank loan/credit which is the crucial determinant of its impact on the private sector (for example, the Indonesian and the Tanzanian Open General License which has been supported by two adjustment operations).

5.13 Infrastructure investments can also be critical for the private sector, even if they fall in the public domain. Here the main issues concern the composition of investment (and thus Bank lending programs) and the design of the project. Ensuring that constraints to private economic activity influence the determination of public expenditure priorities is a key Public Sector Development Loans issue, not only because of the reduced competitiveness that derives from poor infrastructure but also because, in the absence of basic infrastructure, there are greater economies of scale than otherwise (and, thus, less competition). A classic example of this has emerged from recent research on Nigeria.[23] The other key PSD factor in public investment financing is the need for project designs that maximize the participation of the private sector in financing and/or managing infrastructure and social services. Elements such as contracts, concessions, BOTs and procurement mechanisms need to be considered in the design so as to attract private agents and thus reduce the State's burden.

5.14 The rule could be that the project identification and design should bear the burden of proving that no preferable private alternative exists when involving public agencies. But this is not a question of instrument mix in the lending program but of its contents. And, it should be noted, much progress is being achieved in this sense -- Bank lending programs are now

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[23] Manufactures' Response to Infrastructure Deficiencies in Nigeria, Infrastructure and Urban Development Department, Report INU50, July 1989.

financing almost no undesirable parastatals and are incorporating private sector components in more and more projects.

5.15 Direct support is provided through financial intermediation operations. These have been the subject of a recent Task Force Report and of a PSD Working Group.[24] Implementation of the recommendations of the Financial Operations Report has so far resulted in a reduction in the number of new financial intermediation operations, and the recommendations of the PSD Working Group should clarify the division of labor between the Bank and IFC. The main implication for the Bank's lending mix is that financial intermediation operations will continue to be a significant feature, but will have to be justified in connection with well-defined policy and institutional reform strategies.

5.16 In summary, the lending mix has to be responsive to the specific circumstances of each country. The deciding factor is whatever constrains efficient private activity. In some countries (or at some stages), it may be policies or resources and this may argue for adjustment lending (whether quick or slow disbursing may depend on the nature of the needs and of the reforms to be implemented). In other countries, at other stages, key constraints to private sector development may only be relieved through public investment, even if that may sound paradoxical.

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[24] See January 17, 1991 Memorandum to the Executive Directors and the Board of Directors on the World Bank Group on Financial Intermediary Lending; and Report of the Task Force on Financial Sector Operations (see R89-163) July 1989.

VI. THE IMPLICATIONS FOR COUNTRY ASSISTANCE STRATEGY

6.1 The previous three sections have dealt with various issues regarding the inter-relation between adjustment and investment lending. Section III classified the problems that we have seen emerge over the 1980s in the course of adjustment. Section IV discussed how to pursue policy change and the various lending instruments available to do so. Other considerations that affect the lending mix, such as the management of disbursement profiles and the fungibility of foreign exchange provided under alternate instruments, were discussed in Section V. This final section brings it all together by providing a way to match the problems with the tool kit. It is important to reiterate that the framework provided in the next section provides a way of thinking through the lending strategies but that, in practice, individual country issues and structure will determine the actual approach taken. It is also important to mention that country situations will evolve. A repeat adjustor may decide to seriously initiate reforms, a non-adjustor such as Egypt or India may negotiate ALs. The classification should be used as a guidepost.

VI.1 A Typology for Thinking-Through Assistance Strategy

6.3 Table 6.1 provides a framework with five categories. These are:

(1) Quick Adjustors. In the case of countries that have either taken swift adjustment in the past or where there was no need for balance of payments support or policy reform, the lending strategy is clear cut. The Bank should be prepared to continue investment lending if it is needed. The country should be provided with the Bank's expertise in project appraisal, design and supervision through investment lending or free standing technical assistance.

The Bank should also be prepared to provide adjustment lending in response to future external terms of trade shocks. This assistance should be forthcoming even if the country has in place institutions and a flexible policy framework that will lead to adjustment to the external shock without conscious efforts by the Bank to engage the country in a policy dialogue. In this sense, AL from the Bank should be available to a country in the case of an external shock even if it has gone through an adjustment cycle in the past. Adequate burden sharing between the Bank and other lenders would be an important consideration in determining the extent of Bank support.

The CSP for Chile explicitly discusses this issue in the following manner:

> "...when domestic policies remain quite appropriate but the international environment deteriorates, creating weaker demand for Chilean exports, export prices or high interest rates. In this

Table 6.1 Illustrative use of classification for guiding country assistance strategy

Category	Characteristics	Example	Proposed Strategy: Adjustment Lending	Proposed Strategy: Investment Lending
1. Quick-adjustor	Country has a balance of payments problem, and undertakes swift actions to address policies.	Korea, Thailand, Chile	Provide AL in future if external shock requires adjustment ment.	Continue investment investment projects if needed
2. Prolonged adjustor	Country has a balance of payments problem, is willing to undertake reforms but the process gets delayed because of			
	(a) political difficulties;	(a) Turkey, Philippines	(a) Rethink continued use of AL.	(a) Use alternative options -- policy based SECILs, 'leverage' entire lending program.
	(b) slow supply response and institutional weaknesses.	(b) Pakistan, Ghana,	(b) Use judicious combination of AL and IL including hybrids.	(b) Use policy based SECILS.
3. Repeat adjustor	Country has a BOP problem, states desire to undertake reforms but is not committed to it lending to policy reversals. This syndrome is repeated.	Cote d'Ivoire	Require prior actions to undertake reforms which were not undertaken in the past. Then use AL sparingly until good record established.	Composition of investment lending program based on pace of policy change as described in Section VI.2.
4. Unwilling to Borrow through AL	Country has macro problem but BOP controlled through restrictions. Reforms needed but country unwilling to accept AL for political reasons or because they do not believe in a comprehensive reform program.	India, Ethiopia, Zimbabwe		'Leverage' entire lending program. Use selective policy based SECILs. Composition of investment lending program as described in Section VI.2.
5. Policy reforms without BOP need	Country does not have a BOP need but institutional and policy reforms required.	Venezuela, Ecuador	Provide AL in future if external shock requires macro-adjustment. Use contingent AL during transitional uncertainty.	Use sector investment lending to address policies. Composition of investment lending program based on pace of policy change as described in Section VI.2.

situation, we recommend that the Bank help consolidate the policy framework by accelerating its net disbursements.... However, the Bank alone could not (and should not) absorb the likely additional financing needs Chile would face under this scenario. We would need to gear up to join a coordinated response among all creditors".

(2) Prolonged Adjustors. These are countries where there is a willingness to undertake reform but where the process gets delayed either because of political difficulties or because of slow supply response and institutional weaknesses. The Bank's response would depend on the reasons for the prolongation.

In the case of countries where adjustment policies have been implemented but where supply response has been weak, it is necessary to reevaluate the country assistance strategy to enhance supply response. In cases where the weak supply response is due to a lack of adequate infrastructure, the Bank assistance should include a coordinated set of investment and adjustment lending. Carefully crafted hybrid loans could prove extremely useful in this situation as they were, for example, in Ghana, Pakistan and Nigeria.

Often the slow supply response is not due to inadequate public investments in infrastructure and support services but due to very poor delivery of services and to the regulatory system. To a large extent, these are reflections of institutional weaknesses and of the slower pace of certain types of reform, such as the regulatory system and the restructuring of public expenditure. Free standing technical assistance loans provide one vehicle to address these issues. But often countries are unwilling to accept free standing technical assistance.[25] Policy based sector investment loans would provide an important vehicle to address these issues, as long as they have a heavy institution building focus as discussed in Chapter IV.

In some cases, the prolongation of the adjustment cycle is primarily due to political difficulties. The overall commitment to reforms is still there and many fundamental policy changes, such as the trade regime, exchange rate policy and in some cases tax reform, have already taken place, but problems persist. However the country is unwilling to push reforms into the subsequent phase. The unwillingness to pursue key reforms can sometimes lead to macroeconomic imbalances as has happened in Argentina where delays in addressing public enterprise reform have affected the fiscal deficit.

Turkey provides a good example of a country that has these characteristics. Philippines also exhibit similar features, although the reforms undertaken in this case are much less extensive than in Turkey.

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[25] It is important to recognize and acknowledge that developing countries are usually unwilling to pay for technical assistance. Even when they accept it, they prefer to fund it out of UNDP funds or bilateral grants rather than through Bank loans.

In any case, the Bank must rethink the use of adjustment lending. Again policy based sector investment lending (SECILs) may prove useful in some cases. The necessary policy changes are not going to come any easier with SECILs and it is wise to recognize this fact. But at least the pace of reforms and the pace of disbursements would be more compatible and the Bank would avoid skirting the precipice of a break or deterioration in relations which is likely with AL. The size of the overall lending program should also be made contingent on the pace of reforms, with well-defined triggers specified in the CSP.

(3) Repeat Adjustors. A more problematic set of countries are the repeat adjustors where the commitment to reform is not strong. The countries have received AL in fits and starts from the Bank, have agreed to undertake reforms with the prospect of AL but have reneged on those commitments or reversed actions taken earlier e.g. Cote d'Ivoire.

In such cases, again, the Bank must rethink its country assistance strategy. Each episode leaves a legacy of greater mistrust and a feeling of being let down. One solution is to require up-front actions, in other words, to require prior actions on the part of the government that can then be used to justify adjustment lending. One important benefit of this approach is that the government does not appear to be undertaking reforms under duress. It also results in more open working relations between the Bank and the country. The composition of the investment lending program should be based on the suggestions in Section VI.2.

(4) Countries Unwilling to Borrow through AL. These are countries that are unwilling to accept adjustment lending for political reasons or because they do not agree with the overall reform program.

Since the attempt to initiate adjustment lending may be counterproductive and the reforms are likely to be protracted, one solution is to try and leverage' the entire investment lending program with a process of policy change. The levels of overall lending would be related to broad structural and macroeconomic reform with clearly specified projects in a low case, base case and high case scenario. Such an approach is obviously difficult to manage and would require a period of learning on both sides and a build-up of mutual trust. If it worked, it would be preferable to the contentious relationship that is sometimes generated with adjustment lending. In any case, there should be a clear signal to the government that the Bank intends to make a serious linkage between policy change and project lending, especially given the new results of this shown link in Table 3.1.

Policy based sector investment lending can also be pursued because there may be selected areas of policy agreement even where there is disagreement on the overall reforms.

(5) Policy Reform Without a Balance of Payments Need. The issue of how to design a lending strategy when there is uncertainty about future balance of

payments needs has arisen in a few countries including Ecuador, Venezuela and Indonesia. The balance of payments is strongly influenced by the price of oil whose outlook is uncertain. The question is, should the Bank switch to a combination of hybrid and investment lending and hold back adjustment lending for subsequent use, when and if the balance of payments deteriorates? Or instead, should the Bank pursue contingent adjustment lending (see Box 6.1: Contingent Adjustment Lending: Dealing with Balance of Payments Uncertainty) since it allows the Bank to continue the policy dialogue with the country at the highest levels, but keeps open the option not to use the funds if the balance of payments need does not materialize.

This idea should be pursued further though the suspension or release of Bank funds should be based on precisely specified outcomes such as the oil price rather than BOP outcomes. It should also be understood that such an instrument can only serve a transitional purpose until the uncertainty is resolved. Finally, the focus should be on the strength of the proposed reform -- if the reforms are strong the Bank should not be unduly concerned about making an AL into a situation where a BOP need may not materialize.

VI.2 The Investment Lending Program

6.4 Although in general the returns on all projects are affected by the extent of the existing economic distortions, the degree to which project returns depend on the policy framework can be expected to vary depending on the type of project under consideration. It is difficult to generalize, because in practice the specific policy environment will determine the extent to which particular projects can lead to increased resource waste.

6.5 In deciding on the project portfolio, there are two key issues: (a) the impact of policy distortions and institutional weaknesses on various Bank sponsored projects and (b) whether the capital stock generated by a Bank project can be reallocated once the policy regime changes. More generally, in thinking about the composition of the project portfolio, we can group projects into three broad categories: first, social sector and environment protection projects; second, infrastructure projects; and third, agricultural and industrial projects.

6.6 First of all, investments in the social sectors (for example, health, education and urban services such as water supply and sewage) add to the human capital stock, which is relatively less use-specific than most forms of physical capital. Many social sector investments (for example, in health or education) provide very basic services and can be targeted towards the poor. Projects for environmental protection should also be put into this category since they are designed to repair or alleviate the impact of poor economic policies.

Box 6.1 Contingent Adjustment Lending: Dealing with Balance of Payments Uncertainty

In the Ecuador Trade Policy SECAL, the Region proposed a novel way of dealing with the uncertainty over Ecuador's need for a fast disbursing loan. Under the Bank's base case assumptions about the price of oil at the time, Ecuador still had a balance of payments need for AL but, under alternative scenarios, it did not. The Region proposed to proceed with loan processing, disbursing it "as usual" even if the projections at the time of Board presentation showed no balance of payments need, but to include an accelerated prepayment clause that would become effective if oil prices stayed above a trigger level for a certain period of time.

This proposal led to the formation of an inter-complex group to examine the question of dealing with balance of payments need in adjustment lending under high levels of uncertainty about oil prices. The following alternative new instruments are under consideration:

(a) Loans with tranche releases based on a BOP contingency.
(b) Lines of credit drawn down according to a BOP contingency.
(c) Loans with accelerated repayment contingent on the BOP or an oil price indicator.

Whatever form is used, the critical distinction is between: a) countries that, on current best estimates, have a balance of payments need but would not have if estimates turn out wrong, and b) countries that do not have a need on current best estimates but would have if these estimates are wrong. The first case calls for an instrument that allows an up-front disbursement but also provides a way to defer disbursement (even if program compliance conditions are met) and even to recover the amounts disbursed if the balance of payment need disappears. In the second case, the Bank may wish to make a commitment to the reform program by preparing, negotiating and signing an AL, but stands ready to make a disbursement if a balance of payments need develops during the period of reforms.

The cloudy outlook for oil prices, even as it makes the balance of payments need for AL uncertain, also increases the need for Bank involvement in dialogue on macroeconomic policy. Having available alternative ways of tailoring loan disbursements to the balance of payments need has the advantage of permitting loan processing and the accompanying policy dialogue to proceed with greater assurance that some form of adjustment lending will be possible. It should be recognized that the Bank need not be overly concerned about disbursing to a country even if the balance of payments need disappears mid-stream, as long as the country's policies are moving in the correct direction.

6.7 The second broad group comprises infrastructure projects, which raise the profitability of private sector activities by reducing costs such as those of transportation. Their objective is to raise the relative price responsiveness of private allocation decisions -- in other words, the "supply elasticity". Their returns are likely to be strongly affected by the policy environment as their effectiveness depends more closely on the configuration of relative prices and on the macroeconomic framework.[26] For example, the construction of port facilities primarily for (say) exports will have a minimal impact on export supply if the real exchange rate is grossly overvalued or if the trade regime has a strong anti-export bias. As argued above, in such cases infrastructure projects represent an inefficient use of resources, as they do not address the primary obstacle to the supply response -- the policy framework. The typical gestation lag for an infrastructure project is also likely to be long.

6.8 The final group would include most industrial and agricultural[27] projects and credit operations. Although they focus on specific productive sectors, their impact on aggregate real income and growth depends in a complex manner on the configuration of relative prices and economic policies. In a very distorted economy, they can have very low or negative returns. For example, an industry loan in an economy with an overvalued real exchange rate and negative real interest rates may result in excessive investment in the nontradable industry, along with the adoption of techniques that are too capital-intensive. In both cases, the result is a distorted investment decision with a low social return. Even worse, the return will become negative if, in the future, the realignment of relative prices makes the investments unprofitable.

6.9 As noted above, the supply effects of policy loans can also be enhanced by certain types of project loans, especially in the case of infrastructure projects. For example, consider the case of a policy reform that corrects a real exchange rate overvaluation and/or removes barriers to trade with the objective of promoting export oriented growth. However, the export supply response may be limited by the lack of adequate port or transportation facilities and also, possibly, by the lack of technical assistance or credit lines to the export industry. Loans for projects of this type can contribute to enhancing the supply response to changes in the incentive structure, thereby reducing the short run social costs of the adjustment and thus increasing its net return.

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26 Note that in Table 2.1 the economic rates of return for non-tradable sector projects are affected by the policy environment. These are projects in transport, public utilities, energy and urban.

27 Note that many projects in the so-called agricultural sector are basically infrastructure projects. These should be treated as projects in the second category.

6.10 In general, it is difficult to say that one category of projects is affected more strongly by the policy environment. Nevertheless, it is useful to think through the design of the size and composition of lending programs as laid out in the Country Strategy Paper in terms of these categories. For those countries where the inadequate policy framework still impairs the achievement of acceptable returns on project loans, the lending strategy should be centered around alternative lending scenarios, characterized by different degrees of policy reform. The alternative lending scenarios should show a positive association between the size of the lending program and the share of adjustment lending in the program. With the degree of Bank involvement and support depending on the country's willingness to enlarge the scope and quicken the pace of policy reform, the "high lending" scenario should be characterized primarily by augmented adjustment lending.

6.11 However, because of the complementarity between adjustment and investment lending, the "high case" scenario should also include additional investment lending, as the increased adjustment would make more projects profitable. In this case, there should be no restrictions on the composition of lending. In contrast, the "base case" scenarios associated with more limited policy reform should not only show a significant decrease in the share of adjustment lending, but also a decrease in the volume of investment lending. These should primarily concentrate on investments whose return is not likely to be too adversely affected by the inadequate macroeconomic framework. They could include infrastructure type projects with longer gestation lags in cases where it is highly likely that the country is moving towards the high case. This is necessary if it is perceived that the supply response to the policy reforms may be affected by the lack of necessary infrastructure when the economy moves into the "high case". They would also include projects in the social sectors and on the environment if the institutional structure exists to execute and maintain them. The "low case", where there is no evidence of willingness to undertake policy change, should concentrate on a core lending program in the social sectors and on environmental protection. The latest CSP Update on Mexico, for example, has a clear statement on this that says:

"....In case an agreement on adequate adjustment response cannot be agreed, the Bank would, in addition, revise its lending strategy with a view to:... Withholding the processing of adjustment and sector operations and changing the composition of lending, in order to intensify the Bank's assistance for the social sectors thus helping alleviate the adverse effects on the truly needy of a slowdown in economic growth; looking into the possibility of continued limited lending for basic infrastructure within the ceiling of reduced overall lending."

6.12 The latest CSPs on Kenya, Morocco and Ghana also provide a discussion of investment lending strategies under different degrees of policy reform. To summarize, the suggested investment lending portfolio in each CSP scenario would be:

"Low Case"	:	Social Sector, Environmental Protection
"Base Case"	:	Social Sector, Environmental Protection and some Basic Infrastructure
"High Case"	:	No restrictions.

9103 2 8013

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 28, 1991

TO: Mr. Moeen A. Qureshi

EG

FROM: Enzo Grilli

EXTENSION: 81934

SUBJECT: OVP Discussion of PRE Paper on Adjustment Lending

1. The OVP's are scheduled to discuss the PRE paper titled "The Inter-Relation Between Adjustment and Sector/Investment Lending", at their regular meeting on Monday, April 1. The paper was circulated to you and the OVP's under cover of a note from Mrs. Okonjo-Iweala dated March 21. The paper has a long history, and we have been following it closely in EAS with some concern over the past year. We sent detailed comments on the draft just prior to this one; copies of these comments are attached. Unfortunately, most of our concerns were not taken into account, and none of the key ones were.

2. Although there are some positive aspects to the paper, we remain extremely concerned over the following:

(a) The basic approach of the paper remains one where there is an attempt to establish a categorization of all borrowers into one of five categories: Quick-Adjustor, Prolonged Adjustor, Repeat Adjustor, Unwilling to Borrow Through Adjustment Lending, and Policy Reforms Without Balance of Payments Need. The Bank's lending stance would then be determined by which "pigeon-hole" the country has been placed in. It is not at all clear how the appropriate categorization would be determined (perhaps a PRE analytical study?), plus there are fundamental conceptual problems. For example, how does one determine at the <u>beginning</u> of the process whether a country will be a Quick-Adjustor, Prolonged Adjustor, or Repeat Adjustor? And what does one do about countries that might shift between the five categories (Venezuela could probably have been counted in three of the categories, plus Non-Adjustor, at some point over the last 2 1/2 years). Such a categorization system over-simplifies the complex situation we in fact face, and although the paper refers to the need for flexibility, we are worried that such an approach is by its nature designed to constrain the flexibility of Management in Operations to determine the appropriate lending stance in a particular country situation.

(b) The underlying theme of the paper remains that adjustment lending is over-used and mis-used, and should therefore be cut back. It recommends that one should instead make greater use of such instruments as Sector Investment Loans or Financial Intermediary Loans, with both now including also strong policy conditionality of the type associated with adjustment lending. Use of such SECIL's or FIL's might of course be appropriate in certain circumstances, and further development of such instruments would be desirable. However, before recommending a generalized shift from adjustment loans to such loans, the PRE paper should have examined some of the implications. For example, the budgetary implications will be extremely important. Although adjustment lending and project lending each require about the same amount of staff-time per operation for processing and supervision, the cost per dollar of commitment is three times larger for project loans than for adjustment operations. Unless PRE is recommending a sharp drop in Bank/IDA commitments, the implication would therefore be that if adjustment lending is to be cut from about 30% of total lending to, say, 10%, there will be a need for increased staff resources in lending equivalent to the staff now working in lending in the entire LAC or EMENA Regions. This is not small.

3. There is much that is good in this paper. However, the central themes mask this. Our basic recommendation had been that the approach should not have been one of trying to arrive at a rigid categorization of countries, which would then be used to determine where adjustment loans are or are not warranted. Rather, the paper should have followed a more positive approach, which would have presented the alternative lending instruments Bank staff have (or should have) available, and would lay out the advantages and disadvantages of each. This would have been more in keeping with the original directive of Mr. Conable (of June 23, 1989), which said the paper "should examine to what extent the present investment and sector lending supports the ongoing adjustment lending effort".

FJLysy:

cc: Messrs/Mmes: Husain, Jaycox, Karaosmanoglu, Kashiwaya, Wapenhans, Bock, Wyss, Okonjo-Iweala

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 15, 1991

TO: Mr. Lawrence Summers

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: Paper on "The Inter-Relationship Between Adjustment and Investment Lending

1. Mr. Frank Lysy presented the views of EAS at Thursday's meeting to discuss this draft paper. Given its importance, I thought that it may still be useful to express to you in a more precise form what are our main concerns on the paper. Mr. Lysy will be directly in touch with Mr. Chhibber on a number of more specific comments EAS has on the current draft of the paper.

2. This (February 7) draft of the paper is much improved over the draft dated January 22, with regard to the operational conclusions drawn. However, the paper has still moved significantly away from the original request of Mr. Conable, in his directive of June 23, 1989, to prepare a paper within the next six months that "should examine to what extent the present investment and sector lending supports the ongoing adjustment lending effort". The paper had moved far from this in the draft outlines that had circulated last Fall, where much of the discussion was on a notion of a transition away from adjustment lending.

3. The current draft, while much improved, still suffers at points from this heritage. The underlying premise is still that adjustment lending is over-used or mis-used, and that its use should therefore be cut, with some other type of lending instrument then utilized instead. This is an essentially negative approach. Much preferable would be an essentially positive approach, where the paper lays out the considerable range of lending instruments the Bank has (or perhaps should have) available, where different instruments are most appropriate in different situations. The authors have the material for such an approach, and the current draft of the paper indeed contains much of this material already in various places (which is what makes it such interesting reading for many), but the paper would have to be reorganized for it to serve this very useful purpose.

4. A key flaw of the paper, however, as it is currently structured, is its attempt to arrive at a typology of countries, where the Bank's lending posture (particularly as regards adjustment lending) would depend on where the country is placed. The paper recommends that countries be classified as "Quick-Adjustors", "Prolonged Adjustors", "Repeat Adjustors", "Non-Adjustors", or "Policy Reforms Without BOP Need". The problem with any such system of classification is that one still has to recognize that there is great variety in specific country situations, that the appropriate lending posture for the Bank must take

into account this variety, and that in the end, Senior Management must make decisions on the case specific situation presented to them. The paper does recognize this in places with suitable qualifying statements 1/, but still it makes the case for new guidelines, which in our view would do much more harm than good.

5. Dividing lines are always blurred, even if one agreed that the classification system proposed is the relevant one. Furthermore, where a country should be placed within such a classification system will vary over time. The example of Venezuela illustrates this.. Over just the last two years (about the period of a normal lending cycle), Venezuela would have moved under such a system, from Non-Adjustor, to Quick-Adjustor, to Policy Reforms Without BOP Need. Given the movement of petroleum prices over the last few weeks, Venezuela may soon be re-classified back to Quick-Adjustor. It is not clear, in such a volatile situation, how such a classification system will be of much use to Management in determining the proper lending posture for the Bank.

6. More importantly, it will not be clear at the <u>beginning</u> of the adjustment process, what category the country will later be assigned (with hindsight). It will not be clear whether the country will end up as a Quick-Adjustor, Prolonged Adjustor, or Repeat Adjustor, but yet the lending posture to be taken will depend on the choice made.

7. Finally, even if one could agree on the proper categorization, the country specific special factors that always exist will have to enter into the decision of Management on the lending posture to take. Two countries, even if agreed to be in the same category, will often (almost always) have to be treated differently, depending on factors specific to the case at hand. To conclude, when one takes all these factors into account, the proposed categorization of the paper says, in effect, little more than that the Bank should not provide adjustment loans in situations where they will fail.

8. On the specific operational recommendations made in the current draft of the paper (para. xxvii on page 9), we have the following comments:

(a) Relating size of lending program on the pace of policy change: In general, we would agree.

(b) On restricting use of adjustment lending for a "Prolonged Adjustor": For the reasons discussed above, we believe one cannot be rigid.

(c) On requiring "prior actions" in countries classified as "Repeat Adjustors": Again, one cannot be rigid. We would note,

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1/ For example, in para. 6.1 on page 57, it is noted that "in practice, individual country issues and structure will determine the actual approach taken".

however, that adjustment loans in general require the bulk of their conditionality to be completed up-front (i.e. by Loan Effectiveness, and often by Board Presentation). On the proposal to couple this "prior action" conditionality with single-tranche (rather than the normal two-tranche) operations, we would note that while we are not at all opposed to this (it would provide a very useful degree of flexibility in particularly difficult situations), the Board has normally been opposed to such operations, for reasons that are not altogether clear to us. The Board, in fact, has only approved the use of single-tranche operations in precisely the opposite type of country: those with an excellent track record, such as Indonesia.

(d) On "introducing procedures" for strengthened policy based sector investment and financial intermediary loans: We would like to know precisely what is meant by "introducing procedures". The current draft does not have a description of this. An earlier draft of this paper proposed introducing clearance procedures similar to those now used for adjustment loans; if that is meant, we would be strongly opposed, but since that was dropped in the new draft, presumably something else is now meant. If it is basically to encourage Bank staff to utilize this lending instrument more broadly (for example, through the provision of suitable budgetary and staff resources), then the proposal is a good one. In our experience, the lack of budgetary and staff resources has been a principal constraint on the use of these lending instruments in the past (for example, in Venezuela). Such SECIL's would require all of the staff effort currently required for a policy-based adjustment operation, plus more (for the assessment of the specific investments being supported, for the institutional development efforts, and so on).

(e) On the proposal to introduce the possibility of tranche-type conditionality in suitable SECIL's and FIL's: Adding this option would be useful; there are certain situations where this could be of help. We would note that if tranching is used in such an operation, then it should be defined in terms of the commitment authority of the financial intermediary or the sector authority, not in terms of Bank disbursements.

(f) On requiring CSP's to specify three clearly articulated scenarios (base, high, and low), with three corresponding project portfolios: We do not see how this particular recommendation fits in this paper. On its merit, one can only say that scenarios are generally useful, but there is not an optimal number and we should not be too rigid. In certain situations, one should perhaps have two scenarios (or even just one), while in others there should perhaps even be four. It all depends. In this regard, we would also note that the proposal of the paper to define the "base" case as one where the policy framework is insufficient to generate "sustainable" growth (para. 3.6 on page 26), seems rather odd in concept and not very useful in practice. Again, we see in this "propensity to regulate" a very basic problem with the paper.

(g) On the proposal to "reexamine" ways to make CESW more policy-focussed, including the use of shorter, more policy-oriented, CEM's: It is again not clear precisely what is being proposed. There is a good deal of such policy-focussed CESW now, although much of it is not officially recorded as a formal CESW task that appears in the MIS on the computer. It should be, and changing the system to allow this would be useful. More fundamentally, we would agree with the implication in your proposal that Bank staff need to have the flexibility to respond quickly to rapidly changing country situations, with this taken into account as budgets are drawn up and the staff member's work program for the fiscal year are set. You will perhaps be amazed to know that under the current budget system, a staff member's time is often allocated down to 1/2 week increments for up to a year ahead of time! Major CESW tasks are supposedly programmed up to three years ahead of time. This of course makes it difficult to respond to rapidly changing country situations, where Bank staff are most effective when responding to a specific Government request for an assessment of some specific policy proposal, and to provide such input soon so a decision can be made. Bank staff usually do try to respond, but they must do so by using their ingenuity to find a way to by-pass the current work programming system. We would therefore welcome the proposal of the paper to "re-examine ways to make CESW more policy-focussed", and would suggest that a prime area that should be examined is the current system that attempts to program the work of Bank staff tightly in a budget context.

9. Please consider these rather extensive comments as a sign of the importance that we attach to this paper and of the efforts that we would like to see made to improve its usefulness. Frank Lysy and I would be happy to sit down with Ajay to discuss what is said above, if you would find this of use.

FJLysy:

cc: Messrs.\Mmes: Qureshi, Bock, Wyss, Salop, Hasan, O'Brien, Selowsky, Yenal, Isenman, Linn, Chhibber, Levy, Ray, Okonjo-Iweala

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 21, 1991

TO: Mr. Ajay Chhibber

FROM: Frank J. Lysy, Economic Adviser, EAS FJL

EXTENSION: 81945

SUBJECT: Paper on "The Inter-Relation Between Adjustment and Investment Lending"

1. As you know, we in EAS have a number of concerns on this paper. The main concerns were covered in the memo from Mr. Grilli to Mr. Summers of February 15, which you were sent a copy of. The purpose of the present memo is to focus on several, more specific, issues. I am also enclosing a marked-up copy of the paper.

The Paper's Recommendations on the Use of Specific Lending Instruments

2. We welcome very much the discussion at various points in the paper of the wide variety of lending instruments that the Bank has available to use. I indeed believe this is the primary contribution of the paper, and why many find it of such interest to read. We would in fact strongly recommend that the discussion of these various instruments be brought out more clearly and amplified; this point is discussed in the memo of Grilli to Summers referred to above.

3. However, we still have certain concerns on some of the specific statements and recommendations made on several of the instruments discussed. The basic problem is that the discussion is not balanced. Whereas the underlying theme is that adjustment loans are often misused, the discussion on the other instruments (i.e. SECIL's, FIL's, Hybrid Loans, and Slow-Disbursing Adjustment Loans) is almost uniformly positive and laudatory. There should be a better balance of the pro's and cons of each, with a description of the type of situation where each would be most appropriate. The disadvantages in the use of these instruments should be brought out; what follows are some of the points that we believe should be made.

4. Slow-Disbursing Adjustment Loans: This is perhaps the most problematic of the alternative lending instruments the paper recommends. The fundamental problem is that it ignores the impossibility of forecasting the future path of an adjustment program with any certainty, especially over a three or four year time horizon. There is then the grave danger that even though we might be quite pleased with the course of the adjustment program (where the progress might even be better than had been planned), the program as implemented might in fact fail to meet the letter of one or more of the tranche release conditions designed three or four years earlier. We would then not be able to release the tranche. Indeed, to release the tranche we might in fact have the perverse result of requiring a back-tracking in some area.

5. An actual example of this type of problem occurred in the Venezuela SAL, although the issue related to a dated covenant rather than a tranche release condition (where covenants are fortunately much easier to change as conditions change). In order to encourage the Government to move to better targeted food subsidies, the SAL contained a covenant requiring that there be a study of the use of inferior goods (e.g. low grade flour that to a large extent only the poor would buy) as a vehicle for such subsidies. However, the Government then moved much more quickly than expected, and removed all of its general food subsidies, substituting for them subsidies that provided direct monetary or in kind support for low income people. Once this was done, we did not want to encourage them to return to any general food subsidies, even for inferior goods, and a study such as that mandated under the SAL would have provided support for those that wished to see such a return to general subsidies. Fortunately, as a covenant, it was relatively easy to change this condition. This change in Government policy occurred within only a six-month period; one can imagine the changes to be expected over a three or four year period.

6. Much preferable, we believe, is to use a series of adjustment loans in such situations, rather than one, large but slow-disbursing, operation. This is in fact what the Bank has done in the past. For example, the norm in the area of trade policy has been to utilize a series of Trade Policy Reform Loans to support the various phases of the reform program. Finally, we would note that the experience we have had with stretched-out three-tranche operations has not been exceptionally good.

7. Hybrid Loans: We would be wary of extensive use of this instrument. It is appropriate in certain cases, but the conjunction of factors required is not common. These factors include:

(a) The Government is following an overall policy reform program, and this program is being supported by the Bank with quick-disbursing assistance.

(b) There is a need for Bank-financing of investment in the area of the proposed Hybrid.

(c) The investment required in that particular area (to be covered by the Hybrid) will not, however, be done efficiently, unless some area of the Government's overall policy reform program is implemented first, or is implemented in conjunction with the investment. It might also be the case that the policies will more likely be implemented, if it is recognized that Bank support for specific investments in the area will soon follow. The key is that there must be some clear linkage.

(d) Finally, it must be the case that it would not be more efficient, in terms of loan processing or in the use of Bank Staff resources, to deal with the issues in two separate operations, a SECAL for the policy-based part and a SECIL or regular investment loan for the investment part.

If these four factors hold, then a Hybrid might be appropriate, but it is probably fairly rare. In addition, one must recognize that a Hybrid will be more complicated as an operation, than either of the two parts separately would be as separate loans. And the more complicated something is, the more likely something will go wrong.

8. <u>SECIL's and FIL's with strong policy content</u>: Greater use of such instruments is perhaps warranted. They combine support for policy change, institutional reform and development, and financing of specific investments. However, such operations can soon become quite complex, and perhaps overly complex. A break-down into component pieces might be appropriate in many cases. Such operations also differ from the original conceptions for the instruments carrying these names; perhaps you should coin a new name for what you are now proposing. SECIL's and FIL's were originally conceived as "wholesaling" operations, which would be applicable in precisely the opposite type of situation you describe, i.e. in a situation where policies are good and the institutions strong, so the Bank can use these institutions to "retail" the funds the Bank provides.

9. But probably the most important constraint on the use of the type of SECIL's and FIL's you describe is budgetary. Operations that combine policy reform, institutional reform and development, and support for specific investments, can be very complicated and difficult to put together. In my own experience on Venezuela, the lack of sufficient staff resources in the Sector Operations Divisions was, I believe, the primary reason these Divisions were reluctant to proceed with such operations, even though we were trying to encourage their use.

<u>Projections of Future Adjustment Lending</u>

10. The paper expends a good deal of effort in attempting to project the future share of adjustment lending in the Bank's portfolio, and draws conclusions from the trends in the projections it reports. There is a fundamental flaw in this, however. One simply cannot project the use of such an instrument in any reasonable way.

11. Quick-disbursing adjustment loans are provided in response to some crisis, where balance of payments support from the Bank is required and requested. One cannot, however, predict when such a crisis will occur in the future, much less predict when the country's Government will respond with an appropriate adjustment program that the Bank can support. One cannot, therefore, predict on a country specific basis what the future level of adjustment lending from the Bank should be, at least not past a three or perhaps four year time horizon.

12. Two very simple examples illustrates this point:

(a) Imagine what the results of such a projection exercise would show if you had requested a projection (by country) of Emergency Reconstruction lending by the Bank (as for floods or hurricanes). Except for perhaps the next year or two, such lending would be projected at a level of zero. We should not then jump to the conclusion that Emergency Reconstruction lending by the Bank will be zero in, say, 1995, even though none of the country projections show any. I am sure there will be some; we just do not know where. The same applies to adjustment lending.

(b) Similarly, imagine what the results of such an exercise would be if one forced IMF staff to do it for future IMF lending. IMF programs are supposed to succeed, and no further Fund resources are projected to be used in any Fund-supported program after three or four years at most. Such a projection would therefore show no further IMF lending (purchases) after about four years. Should we therefore expect the Fund to be shutting down by around 1995? Some might look forward to such an outcome, but I would not count on it. Similarly for adjustment lending; there will certainly be a substantial need for it in 1995, but we cannot predict in 1991 where that need will be.

13. It should therefore be no surprise that one observes a decline in adjustment lending in the current country specific lending plans. But it is not logically correct to generalize from these current country specific plans, to the Bank as a whole. Quick-disbursing assistance is in response to the unexpected, and one should expect the unexpected to happen somewhere, we just do not know where.

14. Finally, you should note that the projections of future lending commitments (and specifically the share of quick-disbursing assistance) you report in the paper, comes from FRS. The projections you use are those developed by FRS for the purposes of the 1990 Creditworthiness Review. These projections were based on the FY91-93 Business Plans submitted by the Regions. Projections to the year FY98 were then developed by FRS (not the Regions) by:

(a) First assuming the FY91-93 average share of adjustment lending reported by the Region in its Business Plan for each specific country, would then hold for FY94-98.

(b) And then adjusting these shares in certain specific cases, based on the judgement of FRS staff.

This approach is perhaps suitable for the Creditworthiness Report. However, in your paper you report these projections as if they were the plans of the Regional staff, for the period to 1998, where no such plans exist. It is therefore totally incorrect to draw conclusions on the trend in "planned" adjustment lending from this; you are defining a trend based on a methodology that starts by assuming the FY91-93 shares will remain constant to FY98, and is then only adjusted based on FRS staff assumptions.

15. You should therefore delete the discussion of all this from the paper. The approach used is flawed, both logically and in practice. Page 17 to 22 can be dropped, as well as portions of page 65 and certain other phrases scattered around the paper.

The Desired Net Disbursement Profile

16. A major section of the paper (Sec. V.2) argues that Adjustment Lending is bad for the Bank, since it increases the country risk the Bank is exposed to because of the resulting net disbursement profile. It is taken as a given that a flat net disbursement profile (for Bank operations in the country as a group) is best for the Bank, from a risk management point of view. Yet it is not clear why this should necessarily be so. Two point should be considered:

(a) One should consider Bank net disbursements not in isolation, but in the broader context of what the country needs, and what other creditors are doing. The country's need for balance of payments support is high early in the process, and adjustment lending is designed to provide this support. The policies being implemented will require some time until they can have the effect of reducing the need for such balance of payments support. This is precisely the stylized "adjustment cycle" you discuss earlier in the paper (Figure 3.1, on page 27). That earlier discussion is basically ignored here. One should also consider what other creditors are doing. This point is also made elsewhere in the paper, but seems to be ignored here. It should be expected in a normal adjustment cycle that the Bank and the Fund will provide a large share of the financing required in the early stages of the process, while bilateral financing (mostly supplier's credits guaranteed by an export credit agency) and voluntary commercial finance will be more important later.

(b) Consider also what is viewed as the "ideal" net disbursement profile for the IMF in support of this process. The support of both the Bank and the Fund has similar objectives here, that is, to assist the country to get through a balance of payments crisis through the adoption of suitable macro and structural adjustment reform policies, and the provision of balance of payments support until those policies can have an effect. Yet even though the objectives are similar, the view of the Fund's "ideal" net disbursement profile in support of this is precisely the opposite of what you consider the ideal for the Bank. The Fund provides a very high level of financial support quickly, and then after three or four years begins to be re-paid, and has negative net levels of purchases. That is, there is a very strong peak in the pattern considered to be the "ideal" for the Fund. Why should the view of the "ideal" be so different?

17. For these reasons, we would therefore recommend that you cut Section V.2 (pp. 52-55) and related references scattered through the paper.

Budgetary Implications

18. The paper currently contains little on the budgetary implications of its recommendations, and in particular on the effect of a generalized shift away from adjustment lending. There is only a table in the back (Annex Table 2), and I do not recall any discussion in the text. This table shows the staff-weeks required per project (through to the Board Presentation stage, i.e. excluding Supervision required I believe, although this is not explicitly noted). The table indicates that the staff-weeks required per project (excluding supervision) is roughly the same for investment loans as for adjustment loans, and in fact somewhat lower.

19. This is misleading, however. It ignores the fact that SAL's and SECAL's are on average much larger in size than regular investment loans. Expressed per dollar of commitment, adjustment loans require less than one-third the staff-weeks input of an investment loan, on average. This is because adjustment loans have been, on average, about three times the size of investment loans. This is carefully documented in a memo of Mr. Satish Mannan to Mr. Vinod Dubey of April 17, 1990, 1/. Mr. Mannan calculated the total staff inputs (including supervision, as is proper) required for all Bank projects approved during FY80 to FY89 and fully disbursed by February 28, 1990. He found that the total staff inputs required per project through the entire project cycle was roughly the same for adjustment loans as for investment loans (the total requirements for adjustment loans were in fact somewhat less, about 12% less, since the total supervision required for investment loans is greater). About 137 sw were required for adjustment loans and 155 sw for investment loans. However, per million dollars of commitments, only 1.01 sw were required for adjustment loans vs 3.08 sw required for investment loans, i.e. investment loans are three times as expensive.

20. The implication of this should be clear. Unless a fall in World Bank lending commitments is being recommended, there will be a need to increase substantially World Bank operational staff resources if there is to be a substantial shift out of adjustment lending into investment lending. The paper should make this point clearly.

1/ Copies of this memo are available from Mr. Mannan or myself.

Other Issues

21. Role of CESW: CESW is obviously important and should be policy-focussed. However, as the memo of Grilli to Summers cited above notes, there is much policy-focussed work that Bank staff do now that does not get recorded in the computer as the system is now set up, and thus does not get recognized in the bureaucracy. The key point should be that there is a need for flexibility in the way staff work is programmed. With tight budget constraints, there is an attempt to program staff work in excessive detail and years in advance. Under such a system it becomes more difficult to be responsive and focussed on the policy issues as they develop.

22. An additional point I wish to make here is in response to the suggestion made in the paper that CESW and adjustment lending should be viewed as substitutable: that with more of one there can be less of the other (as in para. 6.29 on page 48). This is totally wrong. Policy-focussed CESW and adjustment lending are best viewed as complementary rather than substitutable. Adjustment lending can be disastrous if not backed-up by proper CESW. And policy-focussed CESW will be most effective (perhaps only effective) if there is a follow-through by means of some specific Bank lending operation. The lending operation might be an adjustment loan, if that is appropriate for the situation, but could also be by means of some other operation, if such an operation is most appropriate for the situation. The follow-up could be, for example, by means of a SECIL or a regular investment operation. But unless there is some follow-up, there is the strong possibility that the CESW report will just be put on some shelf and ignored. For this reason also, choices among CESW tasks should be made so that in general there is a means of follow-up.

23. Counting Conditions: The paper attempts to draw conclusions on trends in conditionality in adjustment operations, by means of counting the number of legal conditions required for effectiveness and tranche release. It is well known that this is fundamentally meaningless. Sometimes one condition is more important than the rest combined, and often the most important conditions are not even listed at all in the legal loan documents since they were required as conditions of Board presentation or even appraisal. Discussion of this and the associated tables should be cut from the paper (pages 31-33, 42, and Annex Tables 3.1 and 3.2).

24. Opening Paragraph of the Executive Summary: The opening paragraph of the Executive Summary contains a number of mis-leading statements, and sets the wrong tone for the paper. The opening sentence, for example, states that adjustment lending was "originally expected to be a short-lived diversion" for the Bank, but does not say who expected this. Although I am sure some may have, I doubt that reasonable people who understood the purpose of the new instrument had such a view. There is, for example, no reference to the view that SAL's would be a "short-lived" instrument for the Bank in the first Annual Report of the Bank (1980) that makes reference to it. Rather,

in that report SAL's are treated as a new instrument available to the Bank, that have evolved out of the Bank's long-standing Program Lending (the first two loans made by the Bank made were Program Loans). There is no hint that they should be viewed as only temporarily available.

25. Much preferable as an introductory paragraph would be what is now used as the introduction to the main text (paragraph 1.1 on page 10).

26. Length of the Paper: The paper is too long as it now stands and is repetitive. The Introductory Section I, for example, is largely another Executive Summary; it could be dropped. The paper also uses the approach of setting-up "straw men" at various points, which it then knocks down. There is no need for this. An example of this is on pages 37-38, where it first sets out a number of supposed rationales for financial support of policy reform programs (e.g. to "buy" reforms), which it then knocks down. These should be cut. Finally, we have noted above several sections of the paper where the arguments are faulty (for example, on the projections of adjustment lending), which should be cut. More fundamentally, as noted in the memo of Grilli to Summers, there should be a basic re-casting of the paper from its current negative approach (where it is argued that adjustment lending is often over-used or mis-used), to a basically positive approach that lays out the range of lending instruments the Bank has available, where certain ones are most appropriate for certain situations.

27. Backing for "Accusations" Made: Finally, a number of accusatory statements are made at various points in the paper, that are not backed-up by any evidence. This naturally gets people in Operations upset, and since specific examples or backing are not given, they are difficult to defend. For example, on page 13 there is a reference at the top of the page to "adjustment lending addiction" and at the bottom of the page to "defensive adjustment lending undertaken only to reduce negative net disbursements". Yet nowhere in the text is any specific case cited of this, nor is any other backing provided. The people implicitly "accused" of this should be given the specifics of "where and when", so that the issue can be discussed and hopefully resolved. As it stands, the reader will assume that everyone agrees that such statements are generally accepted as they stand.

FJLysy:

cc: Messrs.\Mmes: Summers, Linn, Isenman, Picciotto, Stoutjesdijk, Kilby, Yap, Grilli, Levy, Ray, Bock, Wyss, Salop, Hasan, O'Brien, Selowsky, Yenal, Bhattacharya, Garg, McCleary, Nankani, Page

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 6, 1991

TO: Mr. Lawrence Summers, Chief Economist & Vice President DEC

FROM: Enzo Grilli, Director, EAS EG

EXTENSION: 81934

SUBJECT: Adjustment/Investment Lending Paper

1. I received Mr. Linn's note of February 25, 1991, concerning the written comments that we sent to you on the paper after the working level review that you chaired. This is clearly an important paper that deserves everybody's close attention. For this reason, Mr. Qureshi had already decided to have the paper discussed by the RVPs. A review is now scheduled for Monday, April 1, by which time the paper will have been revised to account for the comments received so far.

2. While the areas of disagreement over the paper are being progressively reduced, we still have a number of concerns over it, some general and some specific. The concern about the overtaxonomic approach being followed is one of them, which Mr. Dubey, former Director of EAS, had already expressed at the time the outline was being discussed. Such an approach may be of analytical interest, but does not translate, in our view, into helpful operational criteria for decision and action, at either the country or the instrument's levels.

3. Finally, I wish to address the point made in Mr. Linn's memo, that favorable comments and inputs were received from selected individuals in Operations. It is true, and indeed normal, that some colleagues in the Operations' complex provided background input for the paper, and several commented on it. However, the inputs were on specific parts of the paper, and comments were made in a personal capacity. Neither can be taken as a substitute for the views of the Operations' complex. As for EAS, given the importance that we attributed to it, we twice commented on the outline of the paper (last April and again in the memo of Mr. Dubey of October 2), and we recently sent you two sets of written comments on the draft. We cannot do much more than this, even for our friends in PRE!

cc: Messrs. Qureshi, Bock, Wyss, Isenman, Michalopoulos, Linn, Lysy,
Ms. Okonjo-Iweala
Regional Vice Presidents
Regional Chief Economists

EGrilli:eg

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 21, 1990

TO: Members of the Operations Committee

FROM: Moeen A. Qureshi MAQ

EXTENSION: 82006

SUBJECT: Adaptation of Adjustment Lending in Response to Recent Oil Price Volatility

1. The attached paper is the product of a Task Force created to examine whether adjustment lending repayment terms should be modified in the wake of the Gulf Crisis. Specifically, with the sharp rise in petroleum prices last August, the question has arisen on several occasions whether accelerated repayment terms (or some other mechanism) should be utilized in adjustment loans for certain oil exporters. The Task Force was made up of representatives of FPR, Legal, PRD, IEC, COD, CFS, and EAS.

2. The report is being circulated to the members of the Operations Committee for their comment. If members of the Committee feel that the paper raises issues that require further discussions, or there are concerns over what is recommended, a meeting of the committee can be held. Please provide any comments you might have to Mr. Enzo Grilli by January 9, 1991.

Operations Committee

Messrs. Shihata, LEGVP
Wood, FPRVP
Rajagopalan, PREVP/Linn, Acting DECVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

cc: Messrs./Mmes Goldberg, Wyss, Isenman, Stoutjesdijk, Picciotto, Burmester/Thahane, Okonjo-Iweala, Parmar, Pfeffermann, Rao, Kavalsky, Sandstrom, Liebenthal, Kilby, Robless, Khanna

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 21, 1990

TO: Mr. Moeen A. Qureshi EG
(Through Enzo Grilli, Director, EAS)

FROM: Frank J. Lysy, Economic Adviser, EAS FJL

EXTENSION: 81945

SUBJECT: Adaptation of Adjustment Lending in Response to Oil Price Volatility

1. The attached paper, sent to you under cover of a memorandum from Mr. Stoutjesdijk dated December 10, is the product of a Task Force created to examine whether adjustment lending repayment terms should be modified in the wake of the Gulf Crisis. Specifically, in mid-October the Operations Committee considered the Initiating Memorandum for a Trade Policy Reform Loan for Ecuador, in which the Region had proposed to include a contingent early repayment clause for the loan. Early repayment would be triggered in the event oil prices remained high. The Bank had been discussing trade policy reform with Ecuador for several years, and the Government was finally starting to move and with quite a strong program. However, with the August rise in petroleum prices, the balance of payments justification for the operation was brought into question. Based on the oil price projections from IEC of the time, the Region felt there was still a balance of payments justification for the loan, but that this was obviously highly uncertain and dependant on the path future oil prices would take. The Region therefore proposed that we proceed with the operation, but include an early repayment clause to be triggered should oil prices remain above some benchmark level for some period of time.

2. The Operations Committee (with Mr. Jaycox in the Chair, acting for you) felt the proposal was not unreasonable, but that it should be considered in a broader context. Other options should be considered (such as a revolving line of credit), and whatever was approved for Ecuador would obviously have implications for other borrowers as well that would be faced with a similar situation. Mr. Jaycox therefore requested (on the recommendation of EAS) that Finance (under Mr. Wood) head a task force to examine the various options. The attached paper is the product of that task force.

3. The paper reflects a consensus of the Task Force members, where the Task Force included representatives of FRS (which carried out the drafting), Legal, PRD, IEC, COD, CFS, and EAS. We believe the report is a good one, and we agree with the recommendations made. In essence, the report points out that Operational staff have a number of alternatives when faced with a situation such as that of Ecuador, and the choice they should make will depend on country specific circumstances. Some of these alternatives are obvious and have always been available; these include, for example, the option of having no loan or of scaling down the size of the loan. Other alternatives have never been used, but Legal believes there is no legal prohibition to their use; these include, for example, use of early repayment clauses,

of a line of credit structure, or disbursement into an escrow account. Legal stated it does not believe special Board approval would be required for Operations to proceed with such structures. The main concern Legal had was whether we could proceed at all if balance of payments need was not clear. This would apply to adjustment lending with traditional terms as well.

4. Assuming you agree with the recommendations of the Task Force, the issue now is how should we proceed. There are basically three options:

(a) The Task Force paper could be circulated to staff as is, with a covering note from you stating they may proceed with what is recommended in the paper.

(b) The paper could be circulated to the Operations Committee for comment.

(c) An Operations Committee meeting could be called to discuss the paper.

We would recommend proceeding with option (b). Although we believe the OVP's will have no problem with what is recommended, they have not had the opportunity to review the paper. And although the paper reflects the consensus view of the Task Force members (mostly at Director level), the most senior management in each complex may not have been advised of the content. However, it is also not clear that a meeting on it will be necessary, if everyone is in agreement on the recommendations.

5. In the event you do agree that we should proceed with option (b), we have attached a draft covering memo from you to the members of the Operations Committee that could be circulated with it.

6. Please indicate what approach you would like us to take.

cc: Bock, Okonjo-Iweala

FJLysy:

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

cc: Mr. Bock
Mr. Dubey

900601034

RECEIVED
90 MAY 30 AM 10: 20
AND SECRETARY

DATE May 29, 1990

TO Mr. Timothy Thahane

FROM Eduardo Wiesner E.W.

EXTENSION 72233

SUBJECT Chairman's Summing Up of Discussion on "Adjustment Lending II"

As per our conversation, I would like to confirm my concern about the language used in paragraph 4 in connection with the conditions for quick disbursing adjustment lending. I do not believe the Board approved such strict and rigorous language such that this type of lending will "only be provided if (a country) has a balance of payments gap..."

Surely, the Board felt that a "balance of payments need" was a major factor in making a judgement, but I do not believe that there was unanimity on a language so exigent as to state that "only if" a gap is anticipated there would be disbursing.

My impression is that the sentiment of the Board was for a less inflexible policy posture. This may be in the best interest of the institution and of the borrowers.

Chai
Send copy to Mr. Qureshi
and Stan Fischer.
T.T. 5/31

Please send a copy also to Mr. Shihata.
MAQ 6/5
sent

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

MOEEN A. QURESHI
nior Vice President, Operations

May 21, 1990

Mr. Conable

Re: Adjustment Loans - Financing Local Cost

Barber:

Further to your note of May 7, I have set up a task force chaired by Mr. El Serafy of EAS with members from COD, PRE, Legal and the Regions to look into the policy issue. Due to prior work commitments, the task force will report to me in about two months.

Moeen,

cc: OVPs, Messrs. Thalwitz, Shihata, Dubey, and Bock

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 21, 1990

TO: Messrs. Thalwitz, PPRSV, and Shihata, LEGVP

FROM: Moeen A. Qureshi, OPNSV MAQ

EXTENSION: 73665

SUBJECT: Local Cost Financing Under Adjustment Operations

In response to the concern over financing local costs under adjustment operations, as expressed in Mr. Shihata's memorandum to me of May 3, I am setting up a task force, to be headed by Mr. Salah El Serafy of EAS, which will also include representatives from the Regions and the Central Operations Department. I would appreciate your nominating a representative each from PRE and Legal. I would expect the task force to complete its work and issue its report by the end of July 1990.

cc: Messrs. Husain, Jaycox, Karaosmanoglu, Wapenhans, Dubey, Bock, Lee

ESerafy:sb

May 11, 1990

Mr. Qureshi

Moeen,

I checked this with Vinod and Marianne. EAS had looked at the substance of the report carefully and were satisfied that it was a faithful reflection of the meeting and did not create any major operational problems. Marianne tells me that Barber's concern centered on the last section on areas for further study, which committed management to a whole series of further papers. Apparently, this same approach was taken on the occasion of the last round.

I suggested to Marianne that this last section be rewritten to emphasize the agreement that there should be a RAL III in about 18 months and that it should cover the subjects listed in this section. This would eliminate the appearance of commitment to separate papers.

She agreed with this approach and said that she would follow up with Stan Fischer accordingly.

David
David R. Bock

cc: Mr. Dubey, Ms. Iweala

THE WORLD BANK

May 29, 1990

Mr. Bock:

Thanks. I hope you will keep an eye on this. We should not be saddled with a shole new slew of papers.

Mr. Bock

Thanks. I hope you will keep an eye on this. We should not be saddled with a whole new slew of papers.

[illegible]
5/23

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

DATE: 10-May-1990 06:40pm

TO: See Distribution Below

FROM: Stanley Fischer, DECVP (STANLEY FISCHER)

EXT.: 33774

SUBJECT: Real Interest Rate in Adjustment Programs: II

It went without saying in the previous note that no stabilization program will succeed unless it attacks the fundamental underlying source of macroeconomic disequilibrium, which is usually the budget deficit. In the Egyptian case a devaluation is also needed.

In case it needed saying, it has been said.

DISTRIBUTION:

TO:	Moeen A. Qureshi	(MOEEN QURESHI)
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CC:	Everardus Stoutjesdijk	(EVERARDUS STOUTJESDIJK)
CC:	Andrew Steer	(ANDREW STEER)
CC:	Vittorio Corbo	(VITTORIO CORBO)
CC:	Kate Oram	(KATE ORAM)

cc, Mr Bock
Mrs Lwoolay

The World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: 10-May-1990 03:59pm

TO: See Distribution Below

FROM: Stanley Fischer, DECVP (STANLEY FISCHER)

EXT.: 33774

SUBJECT: Real Interest Rate in Adjustment Programs.

As you know, the issue of the appropriate real interest rate in the early stages of a stabilization program has come up on several occasions, most recently in connection with a possible Egyptian program. I would like to set out a few considerations that should be taken into account.

1. Experience and empirical evidence establish that highly negative real interest rates distort the allocation of resources by reducing the proportion of savings that is intermediated through the financial system. They probably also reduce the rate of saving. Thus it is important that real interest rates be brought to positive levels.

2. There is no convincing evidence that raising a positive real interest rate to higher levels increases saving or improves the allocation of resources. In addition, theory suggests that the effects of an increase in the interest rate on saving is ambiguous. There is therefore neither empirical nor theoretical reason to want to have very high real interest rates.

3. It should be part of the goal of any stabilization and structural adjustment program to raise the real interest rate to a positive level. The question remains though of the speed at which this should be done. Typically price level adjustments at the start of a stabilization program mean that the measured inflation rate is very high for a few months, especially in the first month. Attempting to set a nominal interest rate that matches those inflation rates means that the nominal rate is raised very sharply, and thus that a large increase in real interest costs (since real rates were negative before) is imposed on firms just at a time when they are expected to respond to new price signals, a tougher macroeconomic environment, etc. In addition, because it is difficult to forecast the relevant inflation rate, the actual real interest rate ex post may turn out quite unrelated to the intentions of the policymakers. There are, for instance, large differences between month over month inflation rates and point-to-point inflation rates (e.g. the inflation rate from May 1 to June 1). It is the latter that are relevant in estimating the real interest rate, e.g. the real interest rate implied by a one-month nominal rate fixed on May 1.

4. Analytically, one can say the following. The real interest rate functions as an allocator of new resources, and in this role should typically be raised at the start of a stabilization program. But because there is an existing structure of debt contracts, any change in the interest rate also creates costs (in effect taxes) that are based on past decisions. These cost changes can precipitate bankruptcies and other disruptions, without at the beginning haveing any useful allocative role.

5. Considering the conflict between these two effects of a chanhe interest rate, and the problems raised in para 3, there is no strong case for attempting to get a positive real interest rate from the start of the program. Rather a gradual adjustment of the real rate -- such as can be obtained for example by an initial small rise in the nominal rate, followed by a gradual rise until it meets a declining inflation rate -- makes a lot of sense. This could take place over a period of 6-12 months.

6. This leaves one argument to be dealt with. Those in favor of a rapid increase in the interest rate argue that helps bring back capital flight immediately, and therefore provides strong backing to the currency. This is true. However in a context in which devaluation has been anticipated, the initial devaluation will bring in money that has been parked abroad right up front. Thereafter the rising real rate will bring money in gradually.

7. Please call me if you want to discuss any of this further.

DISTRIBUTION:

TO:	Moeen A. Qureshi	(MOEEN QURESHI)
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CC:	Vittorio Corbo	(VITTORIO CORBO)
CC:	Kate Oram	(KATE ORAM)

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 9, 1990

TO: Mr. Moeen A. Qureshi

FROM: Vinod Dubey, Director, EAS

V. Dubey

EXTENSION: 78051

SUBJECT: Adjustment Loans Financing Local Cost

Mr. Bock has passed on to us Mr. Conable's note to you on the above subject asking when a paper will be ready.

Our review of the issue indicates that the issue raised is not a substantive one if one accepts the assumption that such loans should only be made in situations where the preconditions for adjustment lending are met. The "thorny issues" raised by local cost financing through adjustment loans hinted at in Mr. Shihata's memorandum to you of May 3 are presumably legal in nature.

I suggest that you set up a task force to be led by Mr. El Serafy, with members from COD, PRE and Legal to report to you in about two months. This amount of time is reasonable given that

(a) we need to develop a consensus with PRE and Legal
(b) no IMs for SECALs with local cost financing are imminent (to the best of our knowledge)
(c) a report on Cost Sharing (and local cost financing) is in the final stages of completion under COD leadership
(d) other work commitments of Mr. El Serafy

If you agree we will prepare a short memo from you to Messrs. Thalwitz and Shihata informing them about the task force and asking them to nominate a staff member to it.

cc: Mr. David Bock
Mr. Ducksoo Lee
Mr. Enzo Grilli
Mrs. Okonjo-Iweala

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

May 7, 1990

Mr. Moeen A. Qureshi

Moeen:

Re: Adjustment Loans Financing Local Cost

Further to my note (see attached) and Mr. Shihata's note of May 3, I agree with Mr. Shihata's recommendation to neither prepare nor finalize additional Adjustment Loans financing local cost before the policy issue is resolved.

Please let me know when this paper will be ready.

Barber Conable

Attachment

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 3, 1990

TO: Mr. Barber B. Conable

FROM: Moeen A. Qureshi

EXTENSION: 73665

SUBJECT: Re: Adjustment Loans Financing Local Cost

We have processed and completed negotiations on two Education Sector Adjustment Loans in Ghana and Nigeria. Mr. Shihata has raised a question with respect to these two loans, i.e. whether the proceeds of quick disbursing loans can be used in part to finance local cost expenditures.

There is a precedent in the past where an adjustment credit included financing of local costs but I agree that this is an issue which we need to look at carefully from a policy point of view.

However, I do not wish to delay the issue of these loans to the Board. These loans are very important to the countries concerned. The issue flagged by Mr. Shihata was not raised at earlier stages of loan processing and we have now completed the negotiations. The Government of Nigeria has shown great courage in pressing ahead with education reforms (despite serious student demonstrations).

I would like therefore to go ahead with these two projects to the Board. I hope you agree. Mr. Shihata does not object to the submission of the projects to the Board but would like a Working Group to be established to look into this issue, and make recommendations. I agree with his suggested approach and will set up such a Group. In the meantime, we shall not put forward any adjustment loans to the Board that include local cost financing.

OK
BBC

cc: Mr. Shihata

My understanding is that we are proceeding on an exceptional basis only, and will make this clear.

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Correspondents / Participants
To: Mr. Moeen A. Qureshi, OPNSV
From: Ibrahim F.I. Shihata, LEGVP

Subject / Title
Adjustment Loans Financing Local Cost

Exception(s)
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Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

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cc. Mr. Conable
Mr. Dunberg

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

May 7, 1990

Messrs. Qureshi, Stern, Thahane & Shihata

Re: Draft President's Summary of RAL-II Board Discussion

Could we discuss please.

Barber Conable

Mr. Bock.
David - Please check this
Jim.

Attachment

THE WORLD BANK

May 9, 1990

Mr. Bock:

David:

Please check this.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 7, 1990

TO: Mr. Barber B. Conable

THRU: Mr. Wilfried Thalwitz

FROM: Stanley Fischer SF

EXTENSION: 33774

SUBJECT: **Draft President's Summary of RAL-II Board Discussion**

I am enclosing a draft of the President's Summary of RAL-II Board Discussion for your clearance.

Attachment

SUMMARY OF BOARD DISCUSSION OF

"REPORT ON ADJUSTMENT LENDING II: POLICIES FOR THE RECOVERY OF GROWTH"

April 17, 1990

To summarize the Board discussion of the "Report on Adjustment Lending II," (RAL-II) this note discusses major areas of general agreement, other major topics of discussion, and areas needing further study and follow-up.

A. Areas of General Agreement

1. **Value of Adjustment Lending.** Adjustment lending has proven to be a valuable instrument for providing temporary balance of payments financing to countries that are committed to reforming their economic policies. The design and implementation of adjustment lending continues to improve as we gain experience; RAL-II is an important part of that learning process.

2. **Sequencing.** Structural adjustment programs, typically supported by several loans, should focus first on large reductions in the largest distortions. In countries that start with high inflation or a large current-account deficit, structural reforms aimed at restoring macroeconomic balances should be emphasized first. The sequence of sectoral reforms should take account of the linkages among sectors. A country should not receive adjustment lending unless it is willing to undertake measures to remove the largest distortions.

3. **Ensuring Macroeconomic Stability.** The Bank should support adjustment programs only if there is either already a broad measure of macroeconomic stability and assurance that it will continue, or if the program itself focuses on measures to promptly restore macroeconomic stability on a sustainable basis. Supervision of SECALs should include a thorough assessment of the macroeconomic situation.

4. **Balance-of-Payments Needs.** A country should receive quickly disbursing adjustment lending only if it has a balance-of-payments gap or if a gap is expected to emerge as a result of the reform measures adopted (i.e., if there is a repressed gap).

5. **Increasing the Priority of Public Sector Reforms.** More of the reform effort should focus on the management of the public-sector itself. Reforms aimed at reducing fiscal deficits in a permanent way and increasing the efficiency of taxation and public expenditures should have high priority in most adjustment programs. This is clear in countries with major macroeconomic imbalances. Public sector reforms are also important in countries with inefficient regulation and taxation and where the efficiency of public expenditures leaves much room for improvement. Public-sector reforms should be part of structural adjustment programs also in countries that need to make room in their budgets to spend more for education, health, and basic infrastructure.

6. **Protecting the Poor.** Although the available statistics are weak, they do not generally show a deterioration in the indicators of social welfare for

early intensive adjustment lending countries. However, central government spending on the social sectors declined on average, which is a negative sign for the long term. In order to protect the poor in the short-term and to ensure the improvement of living standards in the medium-term, most adjusting countries need to increase social investments and target these investments towards the poor. Thus adjustment lending operations should be designed with the poverty consequences of policies firmly in mind.

7. **Lending to Support Prior Actions.** Adjustment lending primarily in support of prior actions should be regarded as exceptional and normally confined to countries with already good policies and a strong track record of sustaining policy reform.

8. **Increasing Investment.** While reform programs often need initially to reduce public investment, because it is either inefficient or unsustainable, some recovery of investment in infrastructure and social sectors is usually required for efficient growth. In countries that have already removed major policy distortions, adjustment programs should give special attention to inducing a recovery of private investment. This should not be stimulated through special subsidies, but rather through improvements in the overall macro and microeconomic climate for business. Hybrid operations and SECALs that address the main obstacles to private investment can be particularly useful in this regard.

9. **External Financing.** To assure financing over a multi-year horizon, adjustment loans should be supported, where possible, by an appropriate

combination of co-financing, Consultative Groups, contingency financing arrangements, and debt-reduction packages.

10. **Political Economy.** The full support of the government is a prerequisite for a successful adjustment program, as recommended in RAL-1. Furthermore, countries need to design their adjustment programs with an awareness of the need to mobilize the requisite domestic political support. For instance, when a crisis has temporarily mobilized popular support for fundamental reform, the government should try to accomplish as much as is technically feasible, while there is enthusiasm for reform. While taking account of these elements in program design, the Bank should not itself get involved in the domestic politics of member countries.

11. **Institutional Development.** Although adjustment programs often call for a reduction of total resources going into the public sector, it is equally important to strengthen public institutions in selected areas, through improved policies, organization, and management. Institutional development is essential for both the implementation and the ultimate success of many of the reforms the Bank supports. Public sector reforms, including privatization, usually require institutional development and training -- and therefore need to be phased. Privatization needs to be done on a flexible schedule, in order to take advantage of market conditions.

12. **Timing of Disbursement.** In countries that need structural reforms with a long gestation period (tax reform, public enterprise restructuring and privatization, financial sector reform), the Bank should try to match the

timing of its disbursements to the speed at which the reforms can be introduced. Adjustment loans should have multiple tranches when the program requires extensive institutional development or when a step-by-step introduction of reforms, such as trade liberalization, would reduce adjustment costs. In these cases, the assurance of a continued flow of financial support would enhance the credibility of the program. The appropriate choice from the menu of currently available options -- one large multi-tranche loan, a sequence of smaller two-tranche loans, or policy-based sector investment loans -- should depend on the particular circumstances of the country.

13. **Share of Adjustment Lending in total Lending.** The current guidelines for the limits on overall adjustment lending should remain in place -- 25 percent for IBRD and 30 percent for IDA.

14. **Transition to Investment Lending.** It is expected that in the course of the early 1990s, the total share of adjustment lending will decline and that most current recipients of adjustment lending will phase down their use of it, the exceptions being primarily in Sub-Saharan Africa. To smooth the transition to investment lending, the Board could expect to see increasing numbers of hybrid loans and sector-investment loans with broad policy conditionality.

15. A version of the Report revised to take into account the comments made at the Board discussion, with recommendations about Bank procedures deleted, should be published promptly, and its findings should be disseminated to Bank staff and to the international development community.

B. Other Major Topics Discussed

1. **Monitoring Adequacy of Macroeconomic Framework.** Although there was general agreement on the importance of a supportive macroeconomic framework for the success of adjustment lending, there were varied opinions on how to insure the maintenance of this framework. The Board has already approved several adjustment loans with specific targets for macroeconomic variables mentioned in the loan agreements or Letters of Development Policy as indicators of the adequacy of the macroeconomic framework. Some speakers welcomed the idea of making this practice universal, and some of them said that the indicators should be spelled out in the loan agreements. Other speakers expressed concern about the division of responsibility between the Bank and the Fund on this issue. Most speakers felt that the Bank should retain the competence to assess for itself the macroeconomic situation in countries receiving adjustment lending. One speaker felt that the operational responsibility for macroeconomic monitoring should be clearly assigned to either the Bank or the Fund, but that the Bank should not increase its responsibility in this area just because there was no Fund-supported program in place.

2. **Bank-Fund Collaboration.** The Bank should continue to share information and ideas with the Fund and to avoid duplication of staff effort. There was agreement that dialogue between the Bank and the Fund should ensure that there is no conflict in the policy signals from the two institutions. Several speakers stressed the importance of avoiding cross-conditionality in lending agreements made by the two institutions. There was general endorsement of the

PFP process and some speakers suggested that it be extended to middle-income borrowers.

3. **Priority of Financial Sector Reforms.** Some speakers pointed out that some aspects of financial reforms could facilitate the stabilization effort. Other speakers emphasized that some aspects of financial sector reform require macroeconomic stability to be credible and sustainable. Such measures should not be supported prematurely.

4. **Specificity and Number of Loan Conditions.** Some speakers felt that, since an increase over time in the number and specificity of conditions in loan agreement had been associated with an increase in the implementation rate, continuation of the trend would be beneficial. Other speakers felt that, while greater specificity of conditions was useful, the number of conditions per loan should be reduced.

5. **Debt Overhang and Debt Reduction.** Several speakers felt that debt overhang was often a serious impediment to successful adjustment and that adjustment lending in these circumstances should only be undertaken when accompanied by an appropriate debt-reduction plan. One speaker felt that adjustment lending should proceed in support of a well-designed programs, even when a desirable debt-reduction plan proved infeasible.

C. Areas for Further Study and Follow-Up

There was general agreement on the need for further work in several areas.

1. **Effectiveness of Adjustment Lending.** Further work on the effectiveness of adjustment lending should analyze the sustainability of adjustment with special attention to improvements in creditworthiness. As more information becomes available, studies of effectiveness should also address the long-term effects on economic growth and income distribution.

2. **Long-term Growth.** Since the recovery of growth requires a sustainable increase in saving and investment, more research on how to get an increase in investment is required.

3. **Social Costs of Adjustment.** More information needs to be collected and an appropriate methodology developed in order to determine better the social effects of adjustment and to understand how adjustment programs can most effectively benefit the poor.

4. **Environment.** More work is needed on how Bank-supported adjustment programs can be designed specifically to enhance protection of the environment. Research will also need to develop methods to assess the environmental impact of measures supported by adjustment lending.

5. **Political Economy.** Further research is needed on how to design and

present an adjustment program in order to enhance the prospects for receiving domestic political support. This includes the issue of involving local authorities in the development of programs, so that they have full ownership.

6. **Other issues for further analysis include:** the proper size of individual adjustment loans, the downside risk of underfunding, and reciprocity of trade concessions.

7. **RAL-3.** Another Report on Adjustment Lending should be presented to the Board in two years. There should be an interim annual statistical up-date on adjustment lending.

5/4/90

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

MOEEN A. QURESHI
Senior Vice President, Operations

May 4, 1990

Mr. Shihata

Re: The Nigeria Federal Universities Development Sector Adjustment Credit and Ghana - Second Education Adjustment Credit

While I agree with the need to look at the policy issues raised by these two loans, I should like to dispel the impression that a high proportion of the proceeds of these loans was destined for local cost financing. The share going to local cost financing was not 90% as implied in your note but much smaller. In the case of the Nigeria loan only 3% of the loan is for local cost financing and the proportion is 40% for the Ghana loan.

Please refer to schedule 1 of the Development Credit Agreement for Nigeria and para. 90 of the President's Report which reflects the procurement table 6. Although the credit would finance 90% of local expenditures and 100% of foreign for equipment, vehicles, and materials, these local costs amount to only 3% of the credit. The bulk of credit proceeds, about US$116 million or 97% would in fact be used to finance foreign exchange costs of goods and services for the sector. With respect to Ghana at least 60% of the credit proceeds in any one year would be used for foreign exchange costs and 40% or less for local cost financing. The region will enforce this through a Board condition for the first tranche funds (which has been satisfied) and through second and third tranche release conditions per schedule 1 of the credit agreement.

Moeen Qureshi

cc: Mr. Conable and Mr. Jaycox

Record Removal Notice

The World Bank Group Archives & Records Management

File Title	Barcode No.
Structural Adjustment Lending - General - 1v	1663033

Document Date	Document Type
May 3, 1990	Memorandum

Correspondents / Participants
To: Mr. Moeen A. Qureshi, OPNSV
From: Ibrahim F.I. Shihata, LEGVP

Subject / Title
Adjustment Loans Financing Local Cost

Exception(s)
Attorney-Client Privilege

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	July 26, 2023

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 3, 1990

TO: Mr. Barber B. Conable

FROM: Moeen A. Qureshi MAQ

EXTENSION: 73665

SUBJECT: Re: Adjustment Loans Financing Local Cost

We have processed and completed negotiations on two Education Sector Adjustment Loans in Ghana and Nigeria. Mr. Shihata has raised a question with respect to these two loans, i.e. whether the proceeds of quick disbursing loans can be used in part to finance local cost expenditures.

There is a precedent in the past where an adjustment credit included financing of local costs but I agree that this is an issue which we need to look at carefully from a policy point of view.

However, I do not wish to delay the issue of these loans to the Board. These loans are very important to the countries concerned. The issue flagged by Mr. Shihata was not raised at earlier stages of loan processing and we have now completed the negotiations. The Government of Nigeria has shown great courage in pressing ahead with education reforms (despite serious student demonstrations).

I would like therefore to go ahead with these two projects to the Board. I hope you agree. Mr. Shihata does not object to the submission of the projects to the Board but would like a Working Group to be established to look into this issue, and make recommendations. I agree with his suggested approach and will set up such a Group. In the meantime, we shall not put forward any adjustment loans to the Board that include local cost financing.

OK
BBC

cc: Mr. Shihata

My understanding is that we are proceeding on an exceptional basis only, and will make this clear.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

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cc: Mr. Shihata

Record Removal Notice

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Exception(s)
Attorney-Client Privilege

Additional Comments

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Withdrawn by	Date
Shiri Alon	July 26, 2023

9004 27003 2.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 26, 1990

TO: Distribution

FROM: Stanley Fischer, DECVP SF

URGENT NOTICE

EXTENSION: 33774

SUBJECT: Adjustment Lending Conference: April 30, 1990, **Room Change**

I am pleased to inform you that our RAL2 conference will be held in the H Building Auditorium, **H-B1-201**, rather than in H-1-200. The availability of this larger facility permits us to expand the invitation list to include all Division Chiefs as well as Principal and Lead Economists. Hope to see you there!

Attachment: Agenda

Distribution:

Senior Vice President, Operations
Senior Vice President, Finance
Senior Vice President for Policy, Research, and External Affairs
Vice President, Development Economics
Vice President, Sector Policy and Research
Vice President, Cofinancing and Financial Advisory Services
Vice President, Financial Policy and Risk Management
Regional Vice President, Africa
Regional Vice President, Asia
Regional Vice President, Europe, Middle East, and North Africa
Regional Vice President, Latin America and the Caribbean
Vice President and General Counsel
Executive Vice President, IFC
Director-General, Director, Division Chiefs, Operations Evaluation
Regional Chief Economists, Department Directors, Division Chiefs, Principal and Lead Economists
PPR Department Directors, Division Chiefs, Principal and Lead Economists
PRE Department Directors, Division Chiefs, Principal and Lead Economists
IFC Investment Department Directors and Director, CEI
EAS Director, Chief Economist, and Senior Adviser

CONFERENCE ON SECOND ADJUSTMENT LENDING REPORT

April 30, 1990
Room **H-B1-201**

Agenda

0900-0910	Welcome and Call to Order by the Conference Chairman, John A. Holsen, Director, Country Economics Department
0910-0920	General Remarks on Adjustment Lending by Wilfried P. Thalwitz, Senior Vice President for Policy, Research, and External Affairs
0920-0945	Overview of Principal Findings by Stanley Fischer, Vice President for Development Economics and Chief Economist of the Bank
0945-1045	Measuring the Effectiveness of Adjustment Programs by Vittorio Corbo, Division Chief, Macroeconomic Adjustment and Growth Division, Country Economics Department
1045-1100	Coffee Break
1100-1200	Measuring the Social Impact of Adjustment Programs by Jacques van der Gaag, Division Chief, Welfare and Human Resources Development Division, Population and Human Resources Department
1200-1300	On the Design and Implementation of Adjustment Programs by Steven B. Webb of the Macro Division
1300-1430	Luncheon (by invitation)
1430-1530	Saving, Investment, and Growth by William R. Easterly of the Macro Division
1530-1545	Coffee Break
1545-1715	Panel Discussion on the Implications of the Report for the Bank's Development Assistance Strategies in Three Major Regions of the Developing World; Chairman, Moeen A. Qureshi, Senior Vice President for Operations; Panelists: Edward V.K. Jaycox, Regional Vice President for Africa; Willi A. Wapenhans, Regional Vice President for Europe, Middle East, and North Africa; S. Shahid Husain, Regional Vice President for Latin America and the Caribbean; Stanley Fischer, Vice President for Development Economics and Chief Economist

900402019

FORM NO. 75
(6–83)

THE WORLD BANK/IFC

ROUTING SLIP	DATE: 3/30/90

NAME	ROOM NO.
Mr. Moeen A. Qureshi	
Mr. Heinz Vergin	
Mr. David Bock	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
X	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		**URGENT**

REMARKS:

FROM: Vinod Dubey	ROOM NO.:	EXTENSION:

Pl file

Conditions / Adjustment lending

March 29, 1990

Mr. V. Dubey

Macro Conditions for Tranche Release

Following our conversation this morning, I thought you might be interested in the attached. It attempts to distill what we are trying to suggest.

Andrew Steer

Attachment

<u>MACROECONOMIC CONDITIONALITY IN ADJUSTMENT LENDING</u>

Two principles should guide the Bank's approach to this issue:

- First, the Bank must ensure that its own adjustment lending and technical assistance actively contributes to the removal of the <u>structural</u> causes of macroeconomic imbalances.

- Second, the Bank (and the borrowing government) must assure themselves that the macroeconomic situation is not such as to undermine the efficacy of the structural measures (e.g., financial or trade policies, institutional reforms). In this regard, the Bank may specify a minimum "enabling environment" as a condition of tranche release. These conditions would always be consistent with IMF conditions and should be discussed in the risk section of the loan documents.

Under these two principles, two cases need to be distinguished: (i) when the IMF is present, and (2) when the IMF is not present.

(1) In countries where there is an IMF program, the presence of the Fund provides a presumption that actions are being taken that would contribute to the restoration of macroeconomic stability. Two situations have to be distinguished: (a) When there are significant structural causes of macroeconomic disequilibrium, the Bank's loan itself would include actions to

remove such causes. For example, to the extent that a chronic, long-term budget deficit is a major cause of the macroeconomic instability, the Bank would direct its loan conditionality upon tax and expenditure measures and upon the institutions responsible for their implementation. Concern for the macroeconomy would therefore be embedded in the loan itself as part of the conditionality -- in the form of covenants relating to public pricing policies, public enterprise reform, government expenditure plans, specific tax policy changes, and the like. These components would in and of themselves make a crucial contribution to the restoration of balance. (b) Where the macroeconomic imbalances are moderate and where there is not judged to be a need for complementary Bank conditionality directed towards the removal of such imbalances, the Bank may provide a SECAL directed exclusively towards growth-oriented structural reforms (sectoral policies in agriculture and energy, financial policies, trade policies, and the like). In such situations the Bank will still need to assure itself that the macroeconomic situation will be such that it does not undermine the efficiency of the structural reforms being implemented. For this purpose the Bank would specify in the Loan documents or in the Letter of Development Policy, the macroeconomic conditions required to facilitate a material impact for the adjustment measures supported under the SECAL. This "enabling environment" would always be consistent with the Fund program, but would remain operational in the event that the Fund program ends either through expiration or breakdown. The choice of these macroeconomic indicators would vary according to the type of SECAL. As an example, in the case of an FSAL, the rate of inflation may need to be a condition of tranche release, since an acceleration of inflation would seriously undermine the entire effectiveness of the financial reforms supported under the SECAL. Other types of SECALS may require other measures of macroeconomic stability to ensure their efficacy.

(2) In the absence of a Fund program, the Bank needs to ensure the improvement and maintenance of the macroeconomic situation. In a situation in which substantial improvements are required in the macroeconomic situation, adjustment operations would need to contain specific actions under the control of the authorities that will ensure a restoration of macro stability. Where no major macro imbalances are present, it is still necessary to ensure at least the maintenance of the macroeconomic situation in order that the efficacy (materiality) of the structural measures are not jeopardized. In such a situation, "enabling macroeconomic conditions" would be specified as requirements for tranche release. These may include, for example, the inflation rate, real exchange rate, real interest rate, etc.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Roo Yo 2004 L

DATE: March 30, 1990

TO: Mr. Vittorio Corbo, CECMG

FROM: Vinod Dubey, Director, EAS

V. Dubey

EXTENSION: 78051

SUBJECT: Macroeconomic Indicators

1. On the basis of your note, I had a meeting on Tuesday with the Chief Economists (or their representatives) on the use of macroeconomic indicators in the monitoring of the macro program in an adjusting country. There was a remarkable degree of consensus among the participants.

2. While there was agreement among all that a satisfactory macro economic situation was an important element in making decisions on tranche release and that, therefore, an evaluation of the macro situation was needed at the time of tranche release, many concerns were expressed about the approach proposed by your note based on prespecified indicators, as a generally useful tool for making such decisions. Our concerns are in three general areas: (a) the circumstances under which such indicators were to be used; (b) the role they played in the design of conditionality and decisions on tranche release; and (c) the indicators themselves. The views expressed included the following:

(i) the approach smacked too much of the discredited approach in the 1960's towards developing indices of country performance as a basis of allocating aid. In the 1980's the Country Policy Department again failed dismally in an effort to develop formulae for determining country performance ratings;

(ii) there was no substitute for good analyses of the macroeconomic situation; tranche release decisions cannot be based merely on whether prespecified values of certain indicators were attained. A judgement that a country has "a satisfactory macroeconomic framework" can only be made in the context of a macroeconomic analysis of that country's internal or external imbalances and constraints on growth. Good loan conditions would specify monitorable indicators of government undertakings. These indicators arise from the macroeconomic analysis and complement it. They cannot replace the macroeconomic analysis. On the one hand, performance may be affected by exogenous factors; on the other, the indicators may be within agreed values while the underlying situation was developing very unfavorably, thus supporting withholding rather than release of a tranche;

(iii) the approach would encourage a mechanical rather than an analytical approach to tranche release. For example, the inflation index may be higher than agreed because the government eliminated price controls more rapidly than anticipated or moved more rapidly on the exchange rate. This would be a desirable development, not an undesirable one. The movements in the indicators need to be interpreted and understood, not just monitored (point (ii) above);

(iv) the medium- and long-term indicators listed are usually available with a lag and often only as preliminary estimates, which are often revised and altered as better information is available. Thus there would be practical difficulties in using them as suggested;

(v) the paper shifted around between referring to the indicators as being used for monitoring progress and as being used as conditions. It was felt that the levels of the macroeconomic indicators could not be conditions for tranche release. They could only be part of review and a dialogue with the country on the macroeconomic situation. Such a dialogue may be either periodic (e.g., quarterly) or may be triggered by the breach of specified levels of agreed indicators. The outcome of such a review would be the basis of the tranche release decision;

(vi) one of the participants reminded us of the following statement in the Moshin Khan et al paper on Adjustment with Growth: Relating the Analytical Approaches of the IMF and World Bank: "While the principle of having a more general framework that links the various policy measures contained in Fund and Bank programs to their ultimate objectives is hardly disputable, the actual task of designing one is no easy matter and will undoubtedly occupy researchers for the foreseeable future. It may also be that these efforts do not yield a unique framework. The very diversity of developing countries in terms of, inter alia, production structures, degrees of financial development, trade and exchange regimes, and the type of the existing disequilibria, argues for a flexible approach in the design of programs...". That is also true in the design of models and indicators that purport to establish precise relationships between policy measures and outcomes.

3. Despite the strong concerns expressed, there was agreement that

(i) in every case of tranche release the Bank has to make its own independent judgment on the macroeconomic situation. It cannot rely mechanically on the Fund's assessment;

(ii) such a judgment requires monitoring of the macroeconomic situation; such monitoring necessarily would focus on a number of key items, but not necessarily those covered by the indicators suggested;

(iii) it would be useful <u>in some cases</u>, particularly where there is no IMF program, for the Bank to specify in the loan documentation the macro scenarios and expectation and any associated conditionality. However, such a specification should not be a requirement in all cases. It was suggested that the set of countries for this requirement will probably be those which will have adjustment loans without an IMF program or a PFP in place at the time of loan negotiation. In countries which have a PFP, that will provide the basis for agreement between the Bank, the government and the IMF and all that is needed may be a reference to it in the loan document and linkage to tranche release;

(iv) there should be no attempt to legislate what the indicators monitored or targeted should be in each case. Normally the short-term indicators (which were the crucial ones) would be those typically contained in IMF programs. But flexibility should be retained;

(v) PRE should collaborate with the Regions in developing and testing, on a pilot basis, a set of macroeconomic management performance indicators. Guidelines should be prepared only on the basis of the experience with such macro indicators and a demonstration of their added value in helping avoid tranche release in inappropriate conditions. After all, during the past two years in no case have tranche releases been made in inappropriate macro situations. (Argentina was sui generis; agreement on macro indicators would not have led to a different decision in that case.).

cc: Messrs Qureshi (o/r), Vergin/Bock, Hasan, O'Brien, Yenal, Selowsky, Armstrong, Barandarian, Michalopoulous

Fischer

Agreement: Importance

(1) Centrality of a Good Macro economic situation

(2) ~~[illegible]~~ Timing of adjustment Lending. Staying with Countries -

(3) Selectivity in Adjustment Lending - Willing to do it only when the Country is ready.

(4) Primacy of Fiscal Policy - Micro - Structural aspects of fiscal reform -
Poverty - Fiscal Issue - How do you get the rich to contribute

(5) Do we do Adjustment lending when there is no current b.o.p problem.
Not subsidizing for the Fund.

Shahid

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INTERNATIONAL FINANCE CORPORATION
MULTILATERAL INVESTMENT GUARANTEE AGENCY

(and the one to be targetted)

(1) Fiscal Issue is the heart of the problem. Domestic debt problems more important

Domestic transfer issue ~~be~~ more important than the external transfer issue.

(2) Adjustment programs that have succeeded have been home grown.

(3) Gradualism vs Drastic Mexico: Reforms:
(Issue is in fact a philosophical one)

(4) Policy ~~relations~~ dialogue are based on both adjustment + non-adjustment loans.

(5) Macro Economic Issues are not different from Sectoral Issues.

(6) Can sharp declines in incomes by avoided. Beneficiaries of Crisis — upper income group.

P-1852

Machiavelli
grant final absolution — Priest.

Father, this is not the time
to make enemies.

What are you ~~getting~~ going
~~to~~ to forswear.

Willie Wappenhans — prepared to
consort with the Devil.

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INTERNATIONAL FINANCE CORPORATION
MULTILATERAL INVESTMENT GUARANTEE AGENCY

Deterioration of income.

If we say that the burden has also to be borne by the poor – then ~~not care~~ when on line –

3 tranches – Sector Inv

Kim Jaycox

Written a long Bank
Multiplicity Operational Summary.

THE WORLD BANK
INTERNATIONAL FINANCE CORPORATION
MULTILATERAL INVESTMENT GUARANTEE AGENCY

1. Nature of Reform - Focus on Fiscal
Domestic resource transfer issue more important
than external issue

2. Gradualism vs Drastic Reform
Philosophical Issue.

3. Can we protect the poor - Not
entirely but we must try valiantly
Must ~~be~~ be politically & socially
manageable.
Not just humane good.

(4) LAC - problem of transition -
Africa - Clear institution building
Some different reasons - Supporting
Consumption as well as Investment
Poverty Issue

P-1852

Nature of Reform

(1) Rectification of the problems ~~reform~~ must focus on the fiscal system ~~domestic~~

Domestic resource transfer more important than external transfer issue

Focus of Policy Advice much more on domestic distortions + domestic resource mobilization ~~than on external issues - although clearly exchange rate continues to be~~

Earlier much greater emphasis on monetary + credit controls + on the external sector

(2) Gradualism vs Decisive Reform

RAL II: A VIEW FROM THE OPERATIONS COMPLEX

(Talking Points)

An ounce of practice is worth more than tons of preaching

Introduction

- An important report, on an important subject. One that is very close to us in the Operations complex.

It blends judgement and analysis indicators

- The report itself is a high quality product as seen in its level of analysis and coverage. Special Operational significance (Part I - chapters 2-5) and of significance to all economists who are interested in development (Part II - chapters 6, 7 and 8).

- At the same time, we would be the first to recognize that the subject matter is difficult. In part I, for example, there are difficulties in measuring performance. Second, there are analytical difficulties in keeping initial conditions and external factors constant to measure the results of policy reforms in the adjustment programs.

- We in the Operations complex welcome this effort, because rigorous analysis is the mettle of policy improvement. We are grateful to the authors for this help.

Central Challenges

- We agree with the main recommendations. Some of us might quibble about certain nuances or their lack - mainly because we cannot reduce the nexus between reforms and outcome to a single formula. Qualitative differences in initial conditions, external factors and program implementation cannot be easily measured.

- We fully concur with the five main recommendations - removing distortions, increasing the priority of public sector reforms, increasing investment, tailoring disbursement to the pace of reforms, and ensuring macroeconomic stability. These are of course general principles. In actual design of lending programs we need to calibrate the reform packages in different countries to different circumstances. This issue can be cast in the form of four challenges - for deliberations today and for future work.

- First, we do not have yet a sufficiently good and adaptable macro-framework that can explicitly recognize different country conditions and circumstances to define policies and measure performance with sufficient precision. Thus the practice of counting conditionalities alone becomes more a form of indicative "bean counting" than a strong indicator of achievement. So we need a framework to define conditionality, that is economically meaningful and capable of producing the desired result.

Second, with respect to timing and disbursements, we have to consider the best combination of lending instruments given a whole lending program. Some of us believe that the lending program in its totality is a fine instrument -- tying one instrument to one policy goal for the sake of time consistency may not produce as good a result as a whole lending program which has a continuous time dimension, focus, size and qualitative nuances to support reforms. Such an approach may be more of a challenge than the one to one match. For example, in Sub-Saharan Africa institutional reforms, have to be combined earlier and more strongly with incentive reforms then in say South Asia. Similarly, macroeconomic stability would take precedence over long-drawn out public sector reforms in Latin America. Thus we have a challenge in designing
and the type of lending instruments that we use
lending programs that respond to different priorities in different settings. The research challenge is how to recognize these differences ~~with precision~~ and how to help translate them into actual responses.

Taking account of

Third, now a days, everybody seems to recognize that growth does not automatically follow adjustment - (winter comes but spring seems to be far behind!) Some countries that have taken strong adjustment measures have seen

Supply Response

little or no growth. While Malawi is a good example - there are other countries in Table 2.1 that also qualify - Mexico, Nigeria and Cote d'Ivoire. The challenge for us is to ask why? What are the competing hypotheses? Is it a lack of credibility of policies? Lack of fast enough reactions by the various agents in the economies undergoing adjustment? Difficulties of getting out of a stabilization mode without a rekindling inflation? Institutions that cannot coordinate or direct?

Fourth, the last challenge in fact is derived from the earlier three challenges. This is the challenge to design programs which get at the nub heart of reforms without overwhelming the administrative machinery - which rewards the front runners who save, repatriate their foreign assets and invest; penalizes the procrastinators; protects the poor and gets growth going based on increased productivity. This is a tall order. But one we must strive for, together.

Conclusion

- Congratulate the authors for a fine report. Operations complex grateful for their efforts.

- While we do not have all the answers - we seem to be on our way.

- Deliberations today should reaffirm your commitment to seeking solutions to the important challenges for us.

SR

April 30, 1990.

900307010 1.

March 6, 1990

Mr. Moeen A. Qureshi

Moeen,

RE: RAL II on Tranche Releases

1. This memo will give you an idea on where we are in the tug-of-war with PPR on this issue.

2. What is coming out that, as you predicted, they have been quite cavalier on the data and judgements made and now they have a "face problem" in backing out of the shaky statement on the subject that they have made.

3. We are keeping at it.

Enzo Grilli

Enzo;
Thank you — I want you to indicate to PRE that they are damaging our credibility and integrity with the Board!

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

MOEEN A. QURESHI
Senior Vice President, Operations

March 7, 1990

Mr. Grilli:

Enzo:

Thank you. I want you to indicate to PRE that they are damaging our credibility and integrity with the Board by citing statistics that are terribly misleading, and thus needlessly muddying the dialogue on such issues as tranche releases. This is the second report -- therefore I would like to see separate statistics:

(i) since the Reorganization;

(ii) since the last report RAL I, to establish where there is a single instance when we have released the second tranche without either (a) (in our view) fulfillment of tranche release conditions, or (b) obtaining a waiver from the Board. I believe there are none.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 6, 1990

TO: Mr. Vittorio Corbo, CECMG

FROM: Salah El Serafy, EAS

EXTENSION: 78072

SUBJECT: RAL II on Tranche Releases

1. Many thanks for the various explanations you (and Mr. Webb) gave me, and for the table you faxed to me on your calculations of the incidence of fulfillment of tranche release conditions. From the table, which comprises 92 loans/credits approved in the period FY79-FY88, you calculate the percentage of "fully and substantially" observed conditions by loan and by unweighted annual average, showing an improving trend for observance of conditions. While I understand from you that these numbers are not exactly the same as those yielding the 83% record mentioned in RAL II, I accept your assurance that they are very close.

2. I understand also that the 83% applies to the average for the whole period i.e. FY79-FY88. Fulfillment in respect of the operations approved in FY87 earns a 90% rating and for FY88 a 91% rating. Since the FY88 operations are the only ones in your sample that have followed the Reorganization I focused on the operations of that year. You list five loans in your sample: for Chile, Malawi, Mexico, Tunisia and Uganda. You give us a 100% mark for "full or substantial" fulfillment of conditions for the Chile, Mexico and Uganda loans or credits, and it is only on account of a lower rating (75%) for Tunisia [SAL I (Loan 2962)] and (80%) for Malawi [Industrial and Trade Adjustment (Credit 1920)] that you lower the FY88 rating, showing an average of 91%.

3. I looked in detail at these two operations and have to report the following. For the Tunisian loan, the second tranche has not yet been released, but release of the first (effectiveness) tranche was delayed on account of non-fulfillment of a condition that a draft law on direct taxation should have been submitted to the National Assembly. This could not be done because the national elections were advanced. Tranche release was authorized only after this condition had been transformed into a dated covenant to be observed prior to second tranche release. As I said earlier, the second tranche has not been released. A rating of 100% is therefore warranted.

4. As to the Malawi credit, the Notice to the Board (IDA/SecM89-288 dated September 13, 1989) clearly states that all second tranche release conditions (of which six were listed) had been fulfilled. The last paragraph of this document (para. 13) specifically mentions "the complete fulfillment of second tranche release conditions." This again should earn us a 100% rating.

5. As I said to you on the telephone today, I wonder if the data base for the evidence you cite is really reliable.

6. I mentioned to you before that in a number of cases we have gone to the Board for a waiver or notified the Board that we had waived certain conditions for good reasons. So far we have identified seven cases which, if they fall in your sample, should be excluded from the negative record of compliance. I shall be communicating these to you presently.

cc: Mr. Grilli
Mr. Dubey (o/r)

SESerafy/lcu

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

MOEEN A. QURESHI
Senior Vice President, Operations

February 20, 1990

Mr. Dubey:

I am distressed that this kind of statistical fallacy is still being perpetuated (Shihata's response to Chapter 1, p. 3). This is exactly the kind of nonsense that gave rise to the whole tranche release debate with the Board. I would like to make sure that we don't shoot ouselves in the foot again by making statements that endeavour to count what percentage of conditions are, or are not, met. I think it should be clear that in no case do governments implement every program in the way in which they formulate it. This should be said already because conditions change. - We should also make a clear distinction between tranche release conditons and other aspects of the program.

cc: Mr. Grilli

Record Removal Notice

File Title	Barcode No.
Structural Adjustment Lending - General - 1v	1663033

Document Date	Document Type
February 13, 1990	Memorandum

Correspondents / Participants
To: Mr. Stanley Fischer, DECVP
From: Ibrahim F.I. Shihata, LEGVP

Subject / Title
New Draft of RAL-2

Exception(s)
Attorney-Client Privilege

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	July 26, 2023

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

MOEEN A. QURESHI
Senior Vice President, Operations

February 9, 1990

Mr. Jaycox

Kim:

Regional SALs

As I mentioned to you, there are serious questions concerning the scope, shape and structure of a Regional SAL that we must resolve and agree upon internally within the Bank before undertaking discussions on this matter with institutions and individuals outside the Bank. I would also like to be sure that the approach and the concept has been fully discussed and agreed with me prior to being floated with others.

Moeen

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 22, 1990

TO: Mr. Stanley Fischer, DECVP

FROM: Ibrahim F.I. Shihata, LEGVP

EXTENSION: 74945

SUBJECT: Second Report on Structural Adjustment Lending - Comments of the Legal Department

We have discussed in the Department your interesting draft on Structural Adjustment Lending and have prepared the attached note. The note is divided in two parts. The first part deals with the major policy or legal issues raised by the report. The second part contains detailed suggestions and comments which you may find useful in preparing a new version of this draft.

Attachment

cc: Mr. Holsen

Record Removal Notice

File Title	Barcode No.
Structural Adjustment Lending - General - 1v	1663033

Document Date	Document Type
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Correspondents / Participants

Subject / Title
Comments of the Legal Department on the draft Second Report on Structural Adjustment Lending (Chapters 3, 4 and 5)

Exception(s)
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Additional Comments

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 22, 1990

TO: Moeen A. Qureshi

FROM: Enzo R. Grilli, Chief Economist, EAS EG

EXTENSION: 78061

SUBJECT: Regional Integration and Regional SALs

1. The Africa Region is working on at least two Regional SALs (for Eastern and Southern Africa and for Central Africa). There may be other Regional SALs on the drawing board in other Regions. Given these developments, I thought it appropriate to start thinking in more general terms of the rationale for these loans, their usefulness and their possible modalities. The following are my first thoughts on the first two points.

2. The Regional SALs are typically envisaged as supporting ongoing efforts at regional integration. The two already worked on have in fact to do with the countries belonging to the Preferential Trade Area of Eastern and Southern Africa and the countries of Central Africa belonging to the UDEAC customs union. Neither of these two trade arrangements has had a particularly successful past. This lack of success is indeed a common trait of the current (and past) efforts at discriminatory trade liberalization and economic integration at the regional level among developing countries. The experiences of regional integration are almost uniformly negative in both Africa and Central/Latin America.

3. Regional integration generally involves two phases: the setting up of discriminatory trade arrangements among the partner countries -- such as free-trade areas and customs unions -- and the establishments of common policies -- sectoral or general -- towards the goal of an economic union. At times the passage from trade to economic integration is seen as an evolutionary process, while in some cases the objective of a common market is set out at the very beginning and trade arrangements as well as common sectoral policies among members are pursued simultaneously.

4. The net benefits of discriminatory trade arrangements have to do with the creation of trade due to the price effects of liberalization among members and the diversion of trade originating from tariff discrimination in favor of member countries. They have to do with the reallocation of existing patterns of production through trade. The static benefits of regional trade arrangements are not thought to be very important for developing countries, since they depend on the height of existing trade/production ratios and on the amount of intra-trade that exists among member countries. Generally trade already accounts for a fairly large share of domestic production in small and relatively open economies, and thus the benefits of substituting less efficient domestic production with more efficient foreign production are not high. Similarly, as trade is mostly with

non-members (generally industrial countries), regional trade discrimination does not increase intra-trade. The problem is that, in general, the economic structures of most developing countries involved in regional integration are largely competitive. These countries produce often the same primary products and exchange them for manufacture produced in industrial countries.

5. If the benefits deriving from reallocation of existing production patterns are quite small among developing countries, what about those that might derive from the creation of new productions? In general, regional integration is predicated on the dynamic benefits deriving from the incentives that larger markets, keener competition and learning by doing afford to new productions. Economies of scale and specialization are thought to permit efficient new production, while larger markets -- cum external tariff protection -- are expected to attract new investments (local as well as foreign). These dynamic benefits, however, are neither automatic nor always sufficiently large to make a sizeable difference. Moreover, they apply in the main to industrial activities. Regional integration is in this respect predicated on the same assumptions that guide "infant industry" protection at the national level. The silver lining is that, if done regionally, i.e. in larger and more competitive markets, protection of infant industry should be less costly and have better chances of success. Latin America followed this logic and pursued regional integration as a complement to infant industry protection in the 1960s and part of the 1970s, but with poor results.

6. As previously observed, the dynamic benefits of regional cooperation stretching into sectoral -- generally industrial and ancillary -- policies are not automatic. They cannot be assumed to materialize simply as the results of regional efforts in this direction. Past experience illustrates this point quite clearly: disillusionment with the paucity of effects in the area of diversification of production in member countries has often doomed regional economic cooperation in Africa, Central and Latin America. Suffice here to think of the Eastern African Community, the Central American Common Market and the Andean Group.

7. Support by the Bank of regional integration efforts must, therefore, be "proved" in terms of its economic benefits. Such benefits cannot simply be assumed. This seems to be quite clearly the first lesson that comes to us from both theory and experience. Before supporting regional integration efforts, at least beyond first steps (e.g. rationalization of external tariff structures, harmonization of national taxes), the Bank needs to ascertain its actual scope, that is the existence of net allocative benefits and the extent of regional comparative advantages. Without a clarification of the objectives being pursued and a preliminary determination of the expected benefits -- either from the reallocation of trade or from new and better investments or from both -- the risks of failure in regional integration appear to be so high to cast doubt on the wisdom of offering it sizeable and deep-reaching forms of Bank support.

8. Moreover, the dynamic benefits of regional integration can be seen to depend critically on the policies followed by the countries

concerned, at both the regional and national levels, particularly in the areas of investments in regional infrastructure and industry. Regional specialization and investment rationalization are the key tasks of regional integration policies. Here one can follow the road of "complementary agreements" in the fields of trade and industrial policies (offering incentives and assistance at a fairly broad level of industry) or that of direct promotion of those regional investments that hold the greatest promise (picking the winners in a narrow sense). Both avenues have clear pitfalls, and the effectiveness of investment planning is being strongly doubted in many quarters. Here again, the key point is that the effectiveness of policies cannot be assumed. It has to be ascertained in the specific cases, before specific forms of Bank support can be predicated on it. Conditionality of SAL lending would also seem to depend on a priori evaluation of policies. Without it, expectations about them could be wide of the mark and negatively affect SAL conditionality.

9. Finally, equity issues loom large within regional groupings. The equitable distribution of costs and benefits of regional cooperation is particularly tricky. The reasons are many. In the area of tariffs, for example, the costs of protection are born by the consumers of import substitutes, while the benefits are reaped by the national producers of import-competing products. When strong distributional differences arise across member countries, compensation becomes necessary. This is very difficult within groups of developing countries lacking the resources -- and at times the will -- to implement regional compensatory schemes. The same is true of location of new investments. The advantages of industrialization accrue in direct proportion to the creation of production capacity. Thus the location of new investment becomes contentious and tends to be based on political instead of economic considerations. Therefore, in supporting regional integration, attention needs to be focused on equity and regional balance issues. Bank support of regional integration efforts must be made to depend, after a certain stage, on the existence of the appropriate ways to ensure a measure of equity in the distribution of its costs and benefits among members. Fiscal compensation is one possible way. The other is the regional allocation of investments. Investment planning, however, needs to be comprehensive, if efficiency and equity objectives are to be successfully meshed. And this is difficult in the best of circumstances as the experiences of both the Eastern African Community and the CACM show.

10. There are other important issues and problems that need to be tackled in supporting regional economic cooperation. One of them has to do with the exchange rate arrangements being followed within the group and vis-a-vis the rest of the world. There are significant, if not always obvious, interactions between exchange rate regimes and commercial policies that are heightened within regional groupings. Another relates to the degree of political homogeneity among the perspective partners that is necessary to sustain in time what is in effect a non-linear and bumpy process.

11. In the light of the above, to establish a proper and effective process for the evaluation of Bank loans in support of regional integration the following steps may be considered: 1) require the sponsoring Region to prepare an approach paper, detailing the integration strategy for which support is being contemplated, its phases and the scope of Bank assistance in each of them. This document should accompany the first IM and be discussed at the OC; 2) require the sponsoring Region at the IM stage to indicate the areas of expected benefits from integration that are being pursued with Bank support in order to establish a prima facie case for it. The analysis of the benefits is to be pursued during appraisal of the Bank loan; 3) direct the sponsoring Region to include in the President's report a clear and, whenever possible, quantified explanation of the benefits deriving from the Bank loan.

cc: Messrs: Vergin, Dubey, Levy, Rajapatirana
Mrs. Okonjo-Iweala

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

MOEEN A. QURESHI
Senior Vice President, Operations

June 5, 1989

TO : Chief Economists:

I found the attached paper by Marcelo Selowsky simple in exposition and very much to the point. I suggest you distribute it to the economists in your Region.

Distribution:

Messrs. O'Brien
Yenal
Hasan
Selowsky
Dubey/Grilli

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 17, 1989

ECONOMIC NOTE #5

TO: LAC Economists

M.S.

FROM: Marcelo Selowsky

EXTENSION: 39006

SUBJECT: A Framework to Assess Adjustment Programs and the Role of External Financing and the Bank

In both our strategy papers and adjustment operations documents we are asked to discuss how external financing, and in particular the Bank, complements domestic policies in the context of an adjustment program. In other words we search for the "value added" of external assistance, and the Bank in particular. As expected, this becomes central, and also more complicated, when the country has a high debt overhang already. This is the case of most LAC countries.

This note presents a set of building blocks or organizing principles that might help the systematic discussion of the different components of the adjustment program and where external financing can play a complementary role. Obviously a particular adjustment operation will typically "intervene" in complementing a particular component of the adjustment program; in that case the discussion should focus on the most relevant "building block".

The Context of our Assistance

Most LAC countries are characterized today by low growth, low levels of investment and imports, an over-expanded public sector resulting in fiscal deficits financed by inflation or domestic borrowing, room for a significant increase in the efficiency of resource use both in the private and public sectors, and a high external debt burden that is preventing access of countries to (voluntary) lending.

Our objectives are (a) the restoration of growth while allowing a minimum increase in consumption per capita so that the adjustment can be sustained; (b) an eventual reduction in external debt burden indicators; (c) a reduction in short-term macroeconomic instability as reflected in high inflation rates as well as high and volatile domestic interest rates, i.e., a reduction in the domestic sources of financing the fiscal deficit.

Because these issues cannot be solved overnight - and also because there are some significant trade-offs among them, trade-offs that change as time passes - the adjustment program must be discussed in an intertemporal context, actions and outcomes must be related over time. Most important is identifying the role that external financing (including the Bank) plays in the adjustment program. We have to be able to answer the question: Why do we want to pile additional external debt on countries already having a high level of indebtedness?

Because we usually argue for higher levels of new financing - at least in the short run - we have to be able to explain thoroughly why this additional financing adds more to growth than to debt accumulation; in other words, why this financing - including the Bank's own contribution - allows the country to recover growth while eventually reducing its external debt. This is the acid test we have to pass.

The Adjustment Program, Recovery of Growth and External Financing

External financing potentially can add to the country's savings - thus allowing a higher investment rate - as well as to its availability of foreign exchange - allowing more imports of capital goods and inputs to make better use of capacity. (We have used the word "potentially" because that financing might end up in higher consumption or capital flight, rather than investment and imports.) When this borrowing is repaid in the future it must come at the expense of lower levels of expenditures and lower availability of foreign exchange. Thus a cost benefit analysis must be able to defend why the benefits of foreign borrowing today are larger than the "pain" of repaying it in the future; and particularly why this can be the case in a country that is already highly indebted.

It is here that the intertemporal analysis becomes crucial. To increase the growth rate we need a higher level of investment, imports and efficiency of resource use (lower ICOR). But a decline in the debt burden (debt/GDP, interest/GDP etc.) requires a gradual reduction in the current account as a fraction of GDP; given the high level of external interest payments this requires a gradual increase in the trade or resource balance, i.e., an excess of exports over imports, X-M, and a corresponding excess of domestic savings over investment, S-I. 1/ How then do we balance the positive effect of additional debt on growth with its adverse effect on debt accumulation? How do we make compatible the required increase in (X-M) and (S-I) with the higher levels of M and I required to recover growth? How do we reduce the need for domestic financing of the public sector deficit - thus lowering inflation and the crowding out of the private sector - if the government has to service large external interest payments?

In our discussion we must be able to pinpoint how a temporary acceleration of external financing (and World Bank adjustment financing) permits a "breathing time", so that the improved policies eventually allow the economy to sustain that higher growth and stability with a declining current account deficit as a fraction of GDP. Because of the quick disbursing nature of adjustment lending of the Bank it might well be the case that Bank exposure quickly increases in the country in question, beyond limits considered as prudent from a portfolio point of view. However, if this situation is to be transitional - to be complemented afterwards by slow disbursing investment loans - we must again be particularly explicit about what the Bank is supporting with the adjustment operation. In the next sections we identify four major "building blocks" where external financing has a role to play during this transition. A fifth section addresses the need to protect the adjustment from external shocks.

1/ A positive resource balance is required for the external debt to grow at rates smaller than the interest rate. Recall that external debt grows at the rate of interest if all interest is refinanced with new money.

#1. Foreign Financing to Support the External Adjustment

To lower the rate of external debt accumulation countries will have to increase their trade surplus, (X-M), so that a higher fraction of foreign interest payments becomes financed with a country's own resources. 2/ Because imports must be kept at levels sufficiently high to allow for a recovery of growth and because it takes time for exports to expand, one could argue for some temporarily high levels of external financing. But it must be temporary, and only justified if exports (or efficient import substitution) can grow and gradually substitute external financing. More rigorously, we are implicitly assuming that the shadow price of foreign exchange is higher in the short run than in the long run and thus foreign financing helps redistribute better that scarcity over time, i.e., the price or value of foreign exchange is higher when obtaining the funds than when repaying them. That is, in rigor, the justification of the "balance of payments support" argument for adjustment lending. 3/

Nevertheless, this argument must be defended. Somebody could say the opposite, namely that we are hurting exports by increasing foreign financing, i.e., we are bringing down the real exchange rate below the level that would have existed otherwise. It is not enough to argue that today we are experiencing a scarcity of foreign exchange: We have to make a case as to why that relative scarcity will decline as time passes and in spite of a reduction in foreign financing that is required to lower the rate of debt accumulation. Consequently, a case has to be made that either the country is experiencing a temporary decline in terms of trade and/or that we expect an improvement in the system of incentive conducive to an expansion of exports and efficient import substitution, in spite of accelerated foreign financing in the short run. This bring us to the importance of trade reform as an integral part of the external adjustment, particularly if supported with additional external financing.

Eliminating import QRs and reducing the variance of import protection has two effects: First, it increases the demand for foreign exchange and neutralizes the short run effect of external financing on the exchange rate and, second, it increases the relative incentives for export and efficient import substitution. Only if such mechanisms are clearly discussed can we justify an accelerated level of lending in the short run.

#2. Foreign Financing to Support the Internal Adjustment

In order to service an increasing fraction of external interest payments we not only need a trade surplus. We also need a corresponding excess of domestic savings over domestic investment, S-I. But again, we need to generate this savings surplus while we assure a level of investment compatible with the recovery of growth, in particular private investment. In

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2/ Basically what is needed is an increase in the non-interest current account surplus. For simplicity I call it trade surplus.

3/ If the external financing is devoted entirely to investment the condition is less strict: foreign credit will have a benefit if the rate of return of that investment is larger than the (real) dollar cost of external credit plus (minus) the rate of increase (decline) in the shadow price of foreign exchange.

many countries generating this surplus is more difficult than generating the trade surplus. When per capita income has fallen for many years it is more difficult to increase the savings rate quickly.

Foreign financing can again fill the gap temporarily between investment requirements plus external interest payments and the domestic savings rate, while we wait for the latter to increase. We can only make such an argument if we are explicit about what type of domestic reforms will encourage the necessary growth of domestic savings.

This brings us to the key role that financial deregulation and the elimination of interest ceilings may have on private savings. Improvements in the overall macroeconomic environment and political stability will probably be as important, although it is not easy to predict these developments in the future. This has been one of the most difficult and elusive areas, particularly as far as the adjustment of the public sector is concerned, a topic to which we now turn.

#3. <u>Foreign Financing to Support the Fiscal Adjustment</u>

The fiscal adjustment is a particular component of the internal adjustment. However, it is so important and it has so many ramifications that it deserves special treatment.

The public sector holds most of the external debt and thus it has to generate the domestic resources required for its servicing, i.e., it has to solve its "own" internal adjustment problem. However, the public sector can also borrow from the private sector and from the Central Bank to obtain resources, generating further macroeconomic conflicts and trade-offs. In order for the fiscal adjustment to be compatible with the overall adjustment program, the public sector must find an external debt servicing strategy compatible with (a) maintaining a critical level of public investment required to complement private investment in the recovery of growth; (b) tax reforms that increase government revenues without imposing new distortions incompatible with the recovery of growth; (c) maintaining a critical level of subsidization to protect the poorest groups of the population during the adjustment; (d) a reduced level of borrowing from domestic capital markets so as to avoid crowding out the required private investment; (e) a level of inflationary finance compatible with a "reasonable" level of inflation, one which does not generate uncertainty and misallocation of resources; (f) a time profile of refinancing of external interest compatible with an eventual reduction of the external burden.

This is a difficult agenda - probably the most difficult one in the majority of countries - and central to the adjustment program. The key issue is again: In what way can external financing assist the fiscal adjustment? What are the key transitional element to be supported?

The fiscal adjustment requires first an increase in public savings, by efficiently increasing tax revenues and cutting government consumption that cannot be defended on efficiency or equity grounds. The proper mix between tax increases and government consumption reduction obviously will depend on the country in question. A second component is to cut quickly the domestic financing of the deficit so as to stop crowding out the private sector and to reduce the inflationary pressures stemming from borrowing from the Central Bank. This will reduce the overall level of uncertainty and unpredictability in the economy and thus help in the recovery of private investment. It will also assure that the external financing ends up in additional investment instead of capital flight.

The key transitional issue is that it takes time to increase public savings efficiently, while domestic borrowing must be cut immediately so as to restore confidence and encourage private investment quickly. It is here where external financing can play a critical role: It can help finance the gap between the progress being made in increasing public savings and the need for a quick reduction in domestic borrowing. As time passes and public savings increases, further external borrowing can be reduced so as to avoid an unsustainable build-up of external debt. Consequently, external financing helps the fiscal adjustment by allowing all progress made in fiscal savings (and thus on the primary surplus) to be fully translated into lower domestic sources of financing the deficit. Afterwards that progress must also be translated into lower external borrowing.

The above discussion shows clearly a relationship between the external debt burden on the budget and the short term macroeconomic instability stemming from the fisc borrowing from private capital markets and the Central Bank. This is a major link between the long run and short run which is not explicitly incorporated into our RMSM modelling. Such links require a model to determine real domestic interest rates (i.e., demand for assets) and also specifying a demand for money. Because of the importance of these issues in some specific countries (Brazil, Mexico) our economic and sector work has started to incorporate these links more formally. 4/

#4. Foreign Financing To Support Improvements in ICOR and in the Overall Efficiency of Resource Use

It is obvious that the overall adjustment becomes easier if the program incorporates measures to improve the efficiency of resource use and the productivity of investment. It allows a higher growth rate out of the same level of investment, thus allowing a faster recovery of consumption and creditworthiness.

Many of the reforms discussed earlier will have such effects. Trade reforms move resources into sectors which can generate or save foreign exchange more efficiently. Financial sector reforms allow resources to move where the productivity of capital is higher. The same is true for eliminating regulations that prevented entry into specific sectors and activities. Eliminating quantitative allocation and licenses move resources devoted to rent seeking into true productive activities. Lowering inflation improves the informational content of prices and thus improves resource allocation.

The same is true regarding reforms to increase the productivity of investment in the public sector. "Prestige" or "national security" arguments for inefficient investments cannot be accepted anymore, particularly if the Bank is involved in adjustment lending. In summary, our discussion of the adjustment should elaborate on how the different reforms will influence ICORs

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4/ "Brazil: An Assessment of the Current Macroeconomic Situation", Grey Cover, 1988. "Mexico: Towards Growth, Structural Reform and Macroeconomic Stability", Volume II, December 6, 1988, Green Cover.

and the efficiency of resource and how, in turn, this might influence the recovery of output and growth.

There might be situations in which external financing influences the overall adjustment through contributing to the implementation of reforms rather than through financing the three adjustments (external, internal, fiscal) described earlier. External financing might help the adjustment more through supporting reforms than through the financing of a temporary gap in resources. This will be particularly true if foreign financing helps to redistribute better the gains, losses and risks of the policy reforms so that they become more feasible politically. There are many examples. Decontrol of agriculture or food prices to improve producer incentives might generate strong adverse reactions in urban consumers. However, they may be counteracted quickly by targetted food programs supported by external financing. Trade reforms involving reduction of quantitative restrictions and tariffs sometimes may generate fears of unsustainable bursts of imports (particularly in durable goods), to be controlled only by very large devaluations. External financing complementing that reform may prevent the need for such an overshooting of the exchange rate and allow a smoother transition. To the extent these links might be important in the specific operation or country being discussed, they should be explicitly addressed.

#5. Protection Against Shocks

All adjustment operations and strategy papers should have a short section on this topic. Terms of trade and external interest rate shocks may derail the adjustment and a strategy should be devised to cope with them, both for the country and the Bank.

Of crucial importance is the choice of the base projection for the terms of trade of the country. That base projection anchors the overall adjustment program insofar as export commodity prices largely determine the external and fiscal component of the adjustment. The issue is to protect the adjustment program from fluctuations around that trend.

A mechanism has to be found to sterilize gains around that trend so as to build reserves for the bad years. This prevents unsustainable burst of expenditures (particularly public sector ones) that later call for a sharp contractionary policy. Ways have to be devised so as to condition the overall Bank relationship with the country on commitments to build up these stabilization funds. Obviously this is not easy to the extent we never know whether a deviation from the predicted trend is a temporary or a permanent one.

The second strategic issue is the role of the Fund. If a country has an outstanding debt with the IMF - due to its participation in EFF or Stand-by Programs - the amount of funds it has available from the Compensatory Facility is reduced in case of an adverse shock. A country should graduate as fast as possible from these programs when the adjustment is progressing so that it can maximize the funds it gets from the Compensatory Facility under an eventual adverse shock. Thus, by graduating faster it can "buy" more insurance against risks that may derail the program. However, graduating too early might also be a problem to the extent it may endanger the initial progress of the adjustment programs. This issue should be clearly discussed.

A GRAPHICAL EXPOSITION OF THE ADJUSTMENT.

The attached note (Attachment 1) was used as background for a lecture on adjustment in LAC countries. At the end we find three graphs that are useful in summarizing the building blocks discussed earlier. It can also be used to identify a checklist of issues to be covered in the macroeconomic discussion of our adjustment operations and in our strategy papers.

Figure 1: The External and Internal Adjustment

Figure 1 shows the adjustment required in order to eventually lower the ratio of external interest payments/GDP while maintaining a minimum growth of output and consumption.

The analysis starts by specifying a growth rate of output that can be achieved given the past history of the country and given a restoration of investment and imports as well as an improvement in the efficiency of resource use. In the Figure this growth rate is assumed to be 5% per year. Given the ICOR - which can be lowered if domestic policies improve - we set the investment requirements as a fraction of GDP.

In order for the current account/GDP to decline (for a given external scenario) the economy has to generate a critical level of savings surplus (domestic savings over investment) and a matching export surplus (export over imports). Given the level of investment, the savings surplus will increase only if the savings rate goes up. For this consumption has to grow at a slower pace than GDP, but sufficiently high to allow for some growth in per capita consumption. On the other hand, because GDP growth requires a minimum growth of imports (equal to 5% if import elasticities are one) exports will most probably have to grow faster than GDP.

We have here a razor edge problem: If output growth is set too high in order to allow for consumption growth the current account may become too large, and the convergence toward a lower interest/GDP ratio will become difficult or even impossible. If we set GDP growth too low it will be difficult to achieve an increase in the domestic savings rate while simultaneously achieving some growth in per capita consumption.

As mentioned earlier, all the adjustment path is critically affected by our assumptions regarding external variables (world interest rates and terms of trade) and domestic policies (the level of ICOR). On the other hand, all the projections should in rigor be "stochastic", they are all subject to a probability distribution of events, particularly on the external side.

Checklist

- Is the projection of the domestic savings rate, the trade surplus and the current account consistent? How sensitive is the eventual reduction in debt burden indicators (interest/GDP in the Figure) to different assumptions on external and domestic developments?

- How do we assure the extra external financing does not end up in capital flight?

- What are the policy reforms behind the increased savings rate?

- What are the assumptions and policy reforms behind the increase in the trade surplus?

- What are the reforms required to validate the implicit ICOR used in the projection? What are the reforms that will improve the private sector ICOR and which one will improve the public sector ICOR? (ICOR determines the required investment rate needed for the recovery of growth.) How does it compare with past ICOR and the past relationship between investment and growth? How are we projecting short term output growth? What are we assuming about capacity utilization and imports? What are we assuming regarding the relationship between an anti-inflationary program and capacity utilization and thus short term output?

- If consumption growth is constrained in order to obtain a sharp increase in the savings rate, what are we assuming about the retargetting of subsidies?

<u>Figure 2: The Fiscal Adjustment</u>

Figure 2 is a replica of Figure 1, but for the public sector. However, there is an important difference: The public sector can also borrow domestically to finance its deficit, both from domestic capital markets and from the Central Bank. Such domestic borrowing creates new problems and new trade offs: They crowd out private investment and generate inflation. The objectives of the adjustment are not only to lower the external debt service, but also, and <u>much faster</u>, to lower domestic borrowing from the public sector.

Figure 2 shows the public investment rate necessary to achieve the "5% growth" and the initial levels of external and domestic interest payments that have to be served. That defines the "resource requirement line" for the public sector. To finance it the government generates a surplus of revenues minus consumption (excluding interest payments). As long as those requirements are higher than that surplus the public sector has a deficit (the overall grey area) which is financed by borrowing externally (shaded area) and domestically ("clear" dotted area).

The adjustment shown in Figure 2 aims at quickly eliminating (by year T*) all domestic borrowing on the part of the public sector. For that purpose government revenues must increase sharply and government consumption reduced quickly, using external borrowing to finance the "transition" (i.e, all progress in public savings is translated into smaller domestic borrowing). This transitional role of external financing allows the public sector to increase its savings efficiently, particularly if this calls for institutional changes requiring time (i.e., a good tax reform).

Checklist:

- Do we have consistency between the public deficit projection and its financing and the projection of the current account?

- Is the projected domestic financing of the deficit consistent with a decline in inflation and a reduced crowding out of private investment? What do we assume about the demand for money?

- Do we have a view on what the critical public sector investment program that is necessary to recovery growth is? Does it compete with or complement private sector investment?

- At what speed can the revenue minus consumption line growth so that external borrowing can be reduced?

- What are the most efficient ways to increase revenues? Pricing of public services, tax reforms, tax collection efforts, etc.?

- What cuts in government consumption can be carried out?

Figure 3: Identifying Cases for (External) Debt Reduction

Figure 3 shows a situation where the current account/GDP ratio cannot be reduced if the country wishes to recover a minimum GDP growth. It can result because the initial conditions are too severe, i.e., too high debt/GDP ratio, savings cannot increase because the country has been in recession for too many years and per capita incomes are too low, complete collapse of foreign exchange earnings, etc. It can also result because, given a high debt burden, the adjustment is extremely sensitive to movements in world interest rates and export prices. In this case a reduction in the stock of debt or interest payments relief is necessary to allow the current account/GDP ratio to converge eventually to a lower level.

Checklist:

- Are there reasonable external scenarios under which the debt burden indicators keep growing?

- What are we assuming about domestic savings? Are we not too ambitious about consumption growth?

- Why can't ICOR be reduced further? Can further domestic policy reforms have a significant effect on ICORs?

- What are the benefits of reducing the stock of debt versus interest forgiveness in helping the adjustment. What is the cash flow effect of these alternative vehicles of forgiveness?

ATTACHMENT 1

BACKGROUND NOTES FOR THE LECTURE OF MARCELO SELOWSKY

April 1988

ADJUSTMENT WITH GROWTH IN LAC HIGHLY INDEBTED COUNTRIES

Requirement for a Successful Adjustment

GDP and Consumption Growth: They have to recover and become sustainable; consumption growth must exceed population growth, i.e., it must reach 2-3% per annum. Because domestic savings rates must increase (a condition for the adjustment), GDP growth must exceed consumption growth. Thus GDP must at least grow at a sustainable rate of 4 percent per annum.

Exports and Imports: The trade surplus (exports minus imports) will have to gradually increase and finance an increasing fraction of external interest payments. This reduces the current account deficit and gradually reduces the accumulation of new external debt. But the way in which the trade surplus increases is important. It must do so through increasing exports rather than reducing imports. Exports will have to increase more rapidly than GDP. This has implications for exchange rate policy and a good incentive system for exports and efficient import substitution.

Problems with Past Experiences

GDP growth averaged 1.6% during 1982-87. Per capita income today is lower than in 1980-81.

Because of the abrupt cut in external financing during the 1982-86 period, countries had to generate quickly a significant trade surplus in order to pay their interest obligations (in 1984 Brazil and Mexico generated a trade surplus equal to its interest payments). However, in the short-run, the only way to quickly increase that surplus is by compressing imports and GDP growth. It takes time for exports to expand. In addition, countries had to use expedient but inefficient instruments to cut imports, like additional tariffs and quantitative restrictions. (Imports in the region were reduced by about 20 percent in 1982 and in 1983.)

Domestic Savings

The gradual increase in the trade surplus will have to be matched by a gradual increase in the savings surplus (savings minus investment) so that a higher fraction of interest payments can be served. Because the investment rate will have to increase to sustain a higher GDP growth, the domestic savings rate will have to increase even faster. But again this takes time, particularly if consumption levels cannot be compressed further. Thus, additional external credit will be required in the interim. Reforms in the capital markets, positive domestic real interest rates and increases in public savings are required.

The sharp cut in external financing in the 1982-86 period forced countries to generate a sharp increase in their savings surplus. Because it is hard to compress consumption sharply, the increase in the savings surplus came largely through cuts in investment. During 1982-87 gross investment as a fraction of GDP was reduced to 18% (from a pre-debt crisis level of 23.5%).

The Public Sector Adjustment

Because in most countries the foreign debt is public, governments will have to gradually generate the resources needed to serve a higher fraction of external interest payments. Because inflation must be reduced and private investment must increase, public deficit financing from domestic sources (the Central Bank and private capital markets) must be eliminated. Consequently, public savings will have to increase sharply. But this increase in public savings will have to be achieved efficiently and obtained through reforms that are perceived as permanent. It will require tax reforms and reductions in the transfers to public enterprises and regional governments; this calls for institutional reforms in regional government/-central government relationships, reforms in the operation of public enterprises and privatization. But, again, this will take time; during the transition foreign

Because of the sharp decline in foreign financing governments had quickly to generate significant domestic resources to service interest payments. They resorted to trade taxes, credit from the Central Bank and crowding out of the private sector through reserve requirements and higher real interest rates. Since 1983 the money supply and domestic prices have grown by more than 100% per year. In most countries uncontrolled domestic real interest rates reached levels above 20% per year.

financing will have to cover part of the external interest payments, allowing governments to translate increases in public savings into lower domestic sources of deficit financing (lowering inflation and promoting private sector investment). Thus, external financing during the transition has an important role in helping countries to stabilize their economies, i.e., there is an important link between the debt problem and stabilization issues.

Overall Improvement in the Efficiency of Resource Use

Such an improvement will allow countries to achieve a higher growth rate out of a given investment rate. It calls for public investment to concentrate in high rate of returns project and to eliminate "prestige projects". Improving the allocation of private investment will be achieved by eliminating forced allocations of credit, unifying exchange rates, eliminating price controls and regulations and moving toward a less protective trade regime.

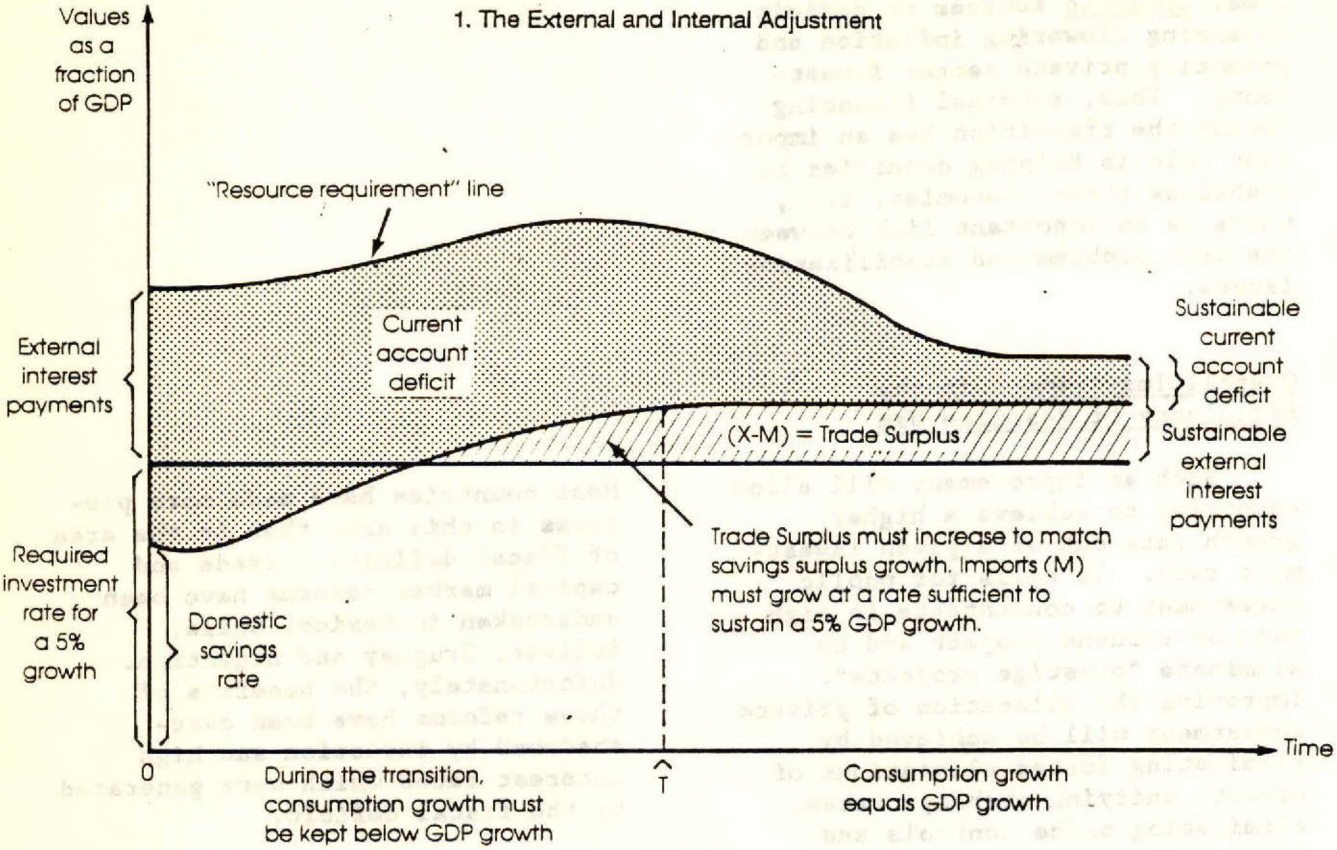
Most countries have made more progress in this area than in the area of fiscal deficits. Trade and capital market reforms have been undertaken in Mexico, Chile, Bolivia, Uruguay and Argentina. Unfortunately, the benefits of these reforms have been overshadowed by inflation and high interest rates which were generated by the fiscal deficit.

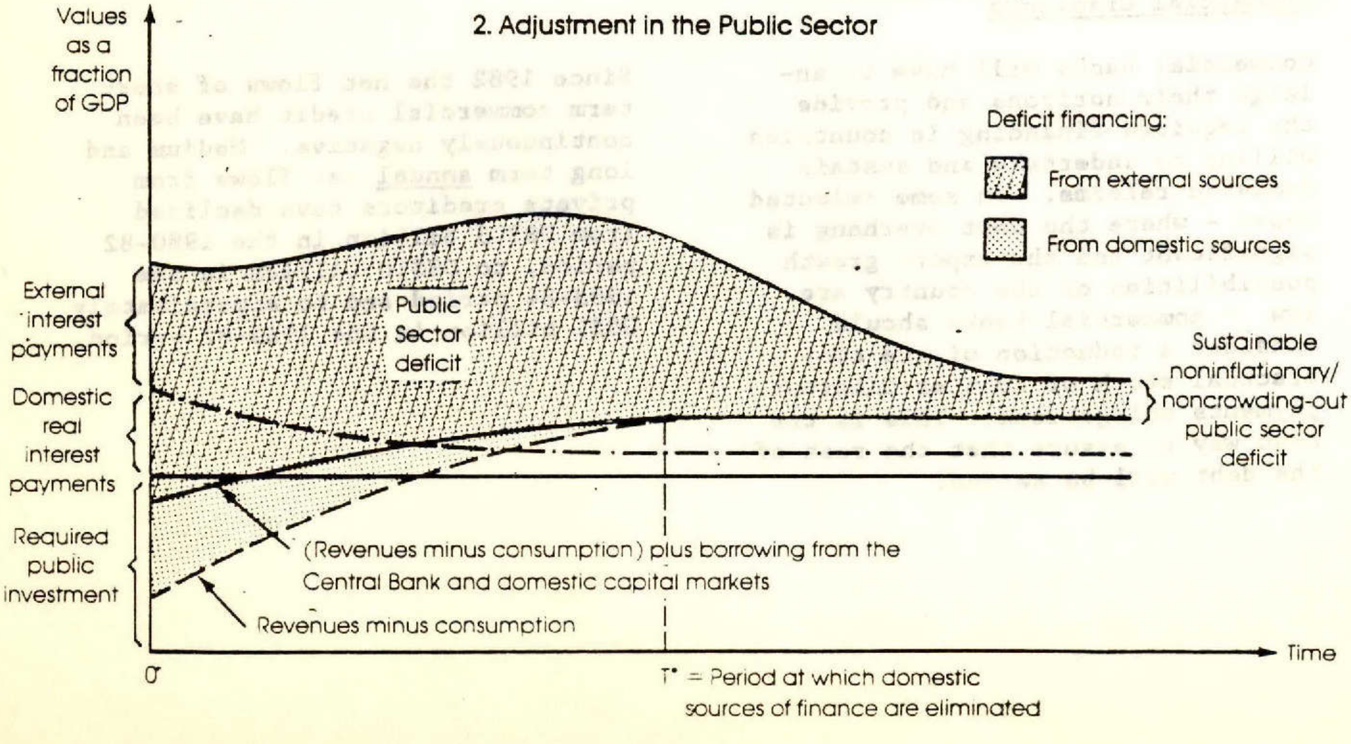
External Financing and the Role of Commercial Creditors

Commercial banks will have to enlarge their horizons and provide the required financing in countries willing to undertake and sustain domestic reforms. In some selected cases - where the debt overhang is significant and the export growth possibilities of the country are low - commercial banks should consider a reduction of the contractual stock of debt or interest payments obligations. This is the best way to assure that the rest of the debt will be served.

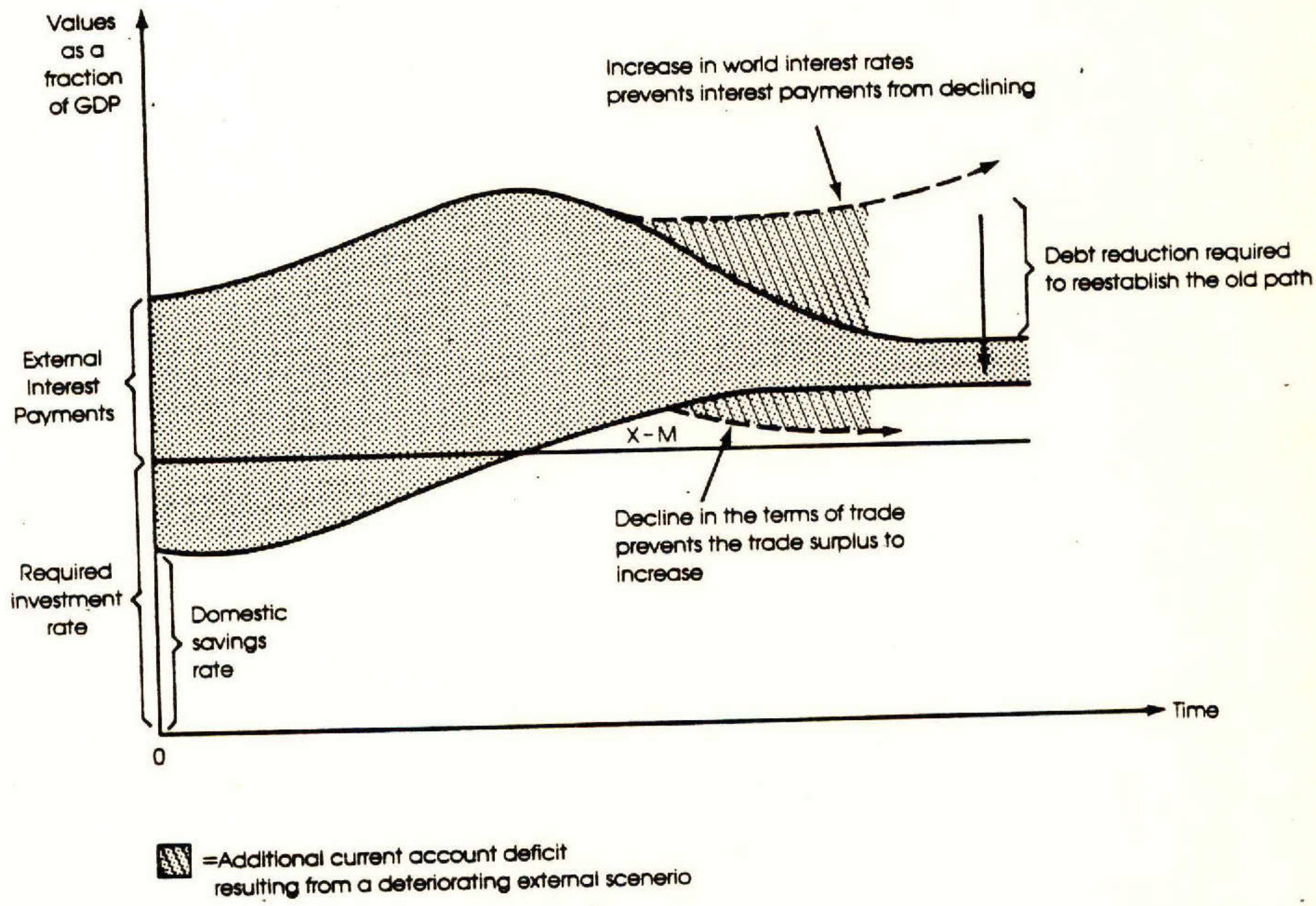
Since 1982 the net flows of short term commercial credit have been continuously negative. Medium and long term annual net flows from private creditors have declined from US$25 billion in the 1980-82 period, to US$10 billion in the 1983-84 period and to approximately US$1 billion in the 1985-87 period.

EXTERNAL AND INTERNAL ADJUSTMENT WITH A " 5% " GDP GROWTH





THE NEED FOR DEBT REDUCTION RESULTING FROM ADVERSE EXTERNAL EVENTS



Record Removal Notice

File Title	Barcode No.
Structural Adjustment Lending - General - 1v	1663033

Document Date	Document Type
January 27, 1989	Memorandum

Correspondents / Participants
To: Mr. Murray A. Sherwin, EDS
From: Heinz Vergin, Acting SVPOP

Subject / Title
Structural Adjustment Lending - Tranche Conditions

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Shiri Alon	July 26, 2023

FORM NO. 1599
(8–80)

THE WORLD BANK

ROUTING SLIP	DATE August 10, 1988

OFFICE OF THE SENIOR VICE PRESIDENT, OPERATIONS

NAME	ROOM NO.
Hilda	

	To Handle		Note and File
	Appropriate Disposition		Note and Return
	Approval		Prepare Reply
	Comment		Per Our Conversation
	Full Report		Recommendation
	Information		Signature
	Initial		Send On

REMARKS

Could you please give this to Mr. Steckhan as material for his visit to Congressman Lafalce tomorrow. I spoke to him about it earlier on and said I would get it to him before he left work today.

Thank you.

FROM Nicola x73665

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

Mr Conable

For your info.
I have had the figures typed.

Stern.

P-1852

IMPLICATIONS OF LIMIT OF 50% FOR ADJUSTMENT LENDING

IDA FY87 - 89

(SDR M)

	EXCESS OF ADJ. LENDING OVER 50% LIMIT	% BY WHICH FY89 ADJ. PRGS. HAVE TO BE REDUCED TO KEEP WITHIN 50% LIMIT.
50 - 75%		
Burundi	7	18%
CAR	11	65%
Madagascar	-	-
Mauritania	3	10%
Mozambique	3	2%
Uganda	5	4%
Above 75%		
Tanzania	118	52%

File: 87-89IDA

IMPLICATIONS OF LIMIT OF 50% FOR ADJUSTMENT LENDING

IBRD FY87 - 89

($ M)

	EXCESS OF ADJ. LENDING OVER 50% LIMIT	% BY WHICH FY89 ADJ. PRGS. HAVE TO BE REDUCED TO KEEP WITHIN 50% LIMIT.
50 - 75%		
Cameroon	5	3%
Gabon	7	20%
Mauritius	7	70%
Philippines	205	59%
Tunisia	142	59%
Argentina	18	2%
Chile	54	20%
Honduras	10	13%
Jamaica	7	16%
Uruguay	34	18%
Above 75%		
Costa Rica	37	37%
Panama	50	all committed

File: 87-89IBRD

June 20, 1988

Mr. William Stanton

Limits on Structural Adjustment Lending

Bill:

I hope that we can persuade Congressman LaFalce to express his concerns about Bank operations in a different form. The concern, if I understand it correctly, is that the Bank should not allow its involvement in adjustment financing to distract it from its area of proven expertise; namely the support of productive investment.

The best way to express this concern is, in my view, to focus on what is happening in the borrowing country rather than on the specific instrument that the Bank happens to use to support the country's development efforts. There are two main reasons for this: one negative, the other positive.

The negative reason is that a cap on the use of a particular instrument is likely to lead to anomalies that invite ever more complex limits. For instance, what happens if we issue a guarantee of commercial bank loans as part of a debt workout. Should that count as adjustment lending? What do we do about the growing volume of hybrid operations that have some of the characteristics of adjustment lending and some of investment lending? A cap on adjustment lending will, I am afraid, unintentionally encourage re-allocation and/or relabelling of Bank operations that would be unfortunate and could lead to quite unnecessary recriminations later. Judging from my brief exposure to Congressman Lafalce, I would not think he has any appetite for this sort of "micro-management" by the Congress.

On the positive side, if the aim is to encourage support for productive investment, why not say so directly? Why not ask for a policy statement indicating that the Bank would only engage in adjustment lending when, over a multi-year period, this is projected by the Bank to be associated with an increase in the level, and improvements in the efficiency, of public and private investment. This way of expressing the goal happens, by the way, to offer some comfort as well to those who fear that adjustment lending may only serve to sustain interest servicing on commercial bank loans. That is not what we are after. Our adjustment financing is used only in the context of efforts to restore or to sustain growth over the medium-term and that in turn requires growth in investment as well as improvements in efficiency.

Joe

Mr. W. Stanton:

Bill:

Re: Structural Adjustment Lending

It would be very unfortunate in my view to have an amendment such as the one supported by Congressman J.Lafalce become a reality. In fact, such a move on the part of the US legislature would unnecessarily reduce our flexibility to respond to countries' needs without alleviating the concerns which seem to be driving Congressman Lafalce.

This is so because in many countries, especially small ones in Africa and Central America, we often have only one operation per year (or even sometimes one every other year). Applying a ceiling of 50% on adjustment lending, which I take as meaning in any given year, would de facto prevent us from doing any policy-based lending at all; as the attached table illustrates, this 50% ceiling was exceeded at least once in 16 countries during FY86-88, but the total proportion of adjustment lending over that entire period in each of these countries remained well below 50%; similarly, our lending plans for FY89-92 indicate that this limit could be exceeded in about 20 countries at some point during the upcoming 4-year period, but not over the entire period in any of the countries concerned.

More importantly, the application of mechanical rules across the board without any consideration for the diversity of country situations would prevent the Bank from supporting effectively the adjustment with growth process and responding adequately to crisis situations where our catalytic role has often proven to be essential; this danger would be particularly acute in the case of major borrowers in Latin America and elsewhere.

We should also reafirm to Congressman Lafalce that the scope, content and share of our policy-based lending in any given country is part and parcel of a multi-year country assistance program which is carefully designed to maximize the contribution the Bank can make to the development process of its borrowers. It would therefore be counterproductive to try to impose quantitative constraints on any lending instrument that the Bank is using to fulfill its development objectives.

Moeen A. Qureshi

Countries with IBRD adjustment lending exceeding 50% in any one year

	FY86-92 (in %)							Total % of adjustment lending over the period
	86	87	88	89	90	91	92	
Cameroon	0	0	0					27
Congo	0	0	82					45
Cote d'Ivoire	73	0	0					37
Mauritius	0	100	0					23
Nigeria	0	72	0					40
Korea	0	0	0					6
Philippines	0	88	50					39
Hungary	53	0	62					41
Morocco	65	42	66					40
Pakistan	15	0	42					26
Tunisia	0	90	51					47
Yugoslavia	0	0	0					21
Argentina	64	52	61					42
Chile	55	68	100					28
Colombia	36	0	62					22
Costa Rica	0	0	0					38
Equador	39	0	62					33
Guatemala	0	0	0					17
Jamaica	0	57	0					41
Mexico	0	29	52					29
Uruguay	0	76	0					28

Macroeconomic Conditionality and Adjustment Lending

Need of a Macroeconomic Framework

Adjustment, whether structural or sectoral, needs a robust macroeconomic framework for it to succeed. As the aim of adjustment is to restore balance to the economy without, to the extent possible, sacrificing growth, the framework should offer both a stabilization plan and a set of policies that would be hospitable to growth-oriented adjustment over a realistically short time span during which exceptional finance must be mobilized. Without an adequate macroeconomic framework supported by a realistic but adequate financing plan, the sought-after adjustment is unlikely to materialize. This is a point particularly emphasized in the Report on Adjustment Lending [The Fischer Report, which recommended that the Bank make its own independent assessment of the macroeconomic situation of the adjusting countries, discussed by the Board on September 13, 1988 (R88-199)].

Over the years we have come to rely on the IMF for providing reassurance that such a macroeconomic framework, at least in its stabilization phase, was in place before we embarked on a SAL. This arrangement has, on the whole, worked smoothly, with only few exceptions where we thought the Fund's stabilization goals contradicted our adjustment-with-growth objectives. More recently we have departed from that pattern. Thus the structural adjustment loan for Honduras was approved in August 1988 without the advantage of a Fund program. Needless to say a medium-term macroeconomic framework was projected for Honduras and agreed with the Government prior to the loan, with estimates made of the necessary financing. A shorter term focus was also agreed on the consolidated public sector deficit, public investment, total public expenditures, domestic credit ceilings, credit to the public sector, and the discount rate. A second tranche condition of the Honduras SAL is that the entire 1988 adjustment program be carried out and the necessary preconditions be established for the continuation of the macroeconomic program afterwards.

Is a Fund Program Necessary?

More commonly the Bank has avoided making a SAL without a Fund program, sometimes converting the elements of a prototype SAL into a sector loan if a Fund program was judged not to be forthcoming. However, a close juxtaposition of SALs with broad-front sector adjustment loans such as the ITPAs for Morocco and Tunisia (respectively in FY84 and FY87), or Colombia's Trade Policy Loan (FY85), would show little difference in substance between a SAL proper and such a sector adjustment loan. Some SALs in fact have focused on one or two areas of reforms such as in the Philippines (FY81 and FY83), while some sector adjustment loans, like financial sector and trade policy adjustment loans, have dealt with the whole gamut of macroeconomic policy and institutions. In the past the Bank has not hesitated to undertake sector adjustment operations in the absence of a Fund program, provided, of course, that a macroeconomic program agreed between the borrower and the Bank was in place, and continued on track during the process of adjustment.

Turkey stands out as a case where we have mounted four sector adjustment loans without a Fund program [an Agricultural Sector Adjustment Loan (FY85); two Financial Sector Adjustment Loans (FY85 and FY88); and an Energy Sector Adjustment Loan (FY87)]. Five SALs had been made to Turkey between FY80 and FY84, and all these had overlapped with Fund Stand-by arrangements, the last of which ended in 1985. Since 1985 Turkey has eschewed Fund programs while seeking Bank adjustment operations in conditions of high inflation, budget deficits and high real interest rates. As always under adjustment lending, an overriding condition for initiating a Bank adjustment operation, and later for tranche releases, has been the existence and continued implementation of an acceptable macroeconomic program, and this is spelled out in the President's Report for every operation. In Turkey, such a program was worked out closely with the Government, but also with Fund staff despite the absence of a Fund program (see below). Adherence to the agreed macroeconomic program is always taken as a condition that must be satisfied before tranche releases are approved, even if this is not explicitly stated in the loan/credit agreements.

While Fund staff continued to visit Turkey twice a year to perform a kind of surveillance similar in fact to Article IV Consultations, i.e. without targets or limits, in early 1986 the Bank instituted a program of quarterly assessments of key macroeconomic variables in order to monitor the agreed macroeconomic program in the absence of Fund formal arrangements. The Turkish economy continued, however, to suffer from budget deficits, high inflation and high real interest rates, as well as an external current account deficit -- all of which had to be brought under control in order for the adjustment process to succeed. Monthly reporting on certain key indicators was also undertaken as these became available. In reviewing the progress of the adjustment programs, such indicators have proved invaluable, and complemented economic work carried out by missions visiting Turkey from Headquarters to prepare CEMs, and more recently by the Resident Mission. It will be recalled, however, that the Fischer Report refers to the Bank's attempt at monitoring the agreed macroeconomic program in Turkey in the context of adjustment lending as having produced "mixed" results.

Pakistan is another case where failure by the Government to reach agreement with the IMF for the final tranche release of the Extended Fund Facility arrangement (November 1980-November 1983) led to an agreement with the Bank that sectoral lending for Energy (FY85), and for Export-Development (FY86) should proceed without a Fund program. Instead, an agreed macroeconomic program was set up and monitored through a system of annual consultations between the Bank and the Government in the context of annual economic reports. This approach was not entirely successful, largely because the budget deficits could not be adequately curtailed. Again the Fischer Report classifies this experience in macroeconomic surveillance by the Bank as having been "mixed."

In Colombia, neither the Bank's Trade Policy Adjustment Loan (of FY85) nor its Trade and Agricultural Sector Adjustment Loan (of FY86) was undertaken with a Fund program, though with IMF "enhanced surveillance" in the background. A robust macroeconomic program was certainly required in order to arrest the imbalances created by worsened terms of trade and inadequate domestic policies. A comprehensive macroeconomic program was thus agreed between Colombia and the Bank, and carefully monitored during the adjustment. Apart from measures specifically addressing trade and agricultural policy under the Trade and Agricultural Policy Loan, adherence to the macroeconomic program was built into loan conditionality. A condition of Board presentation (March 1986) was that the Bank had to reach a "satisfactory assessment of 1985 performance and 1986 plans in fiscal, public investment, monetary, exchange rate and overall trade, and external borrowing policies." It was agreed that the program would be monitored by the Bank and that the second tranche would not be released before a satisfactory review of the same variables was made for 1987-88. The second year of the program would also be monitored, and a three-year investment program reviewed. Before releasing the second tranche of this loan [Notice to the Board dated July 1, 1987, SecM87-780] the progress of the macroeconomic program was carefully assessed and the conclusion reached that:

> "The Bank is satisfied with progress made in carrying out the Program of macroeconomic and trade policy reforms and with the updating of the medium-term public sector investment program and financing and borrowing plan. Macroeconomic adjustment targets for 1986 regarding balance of payments, reserves, real exchange rates, fiscal deficit and monetary indicators were fully met, and trade policy reforms envisaged under the Trade Policy and Agricultural Loan were satisfactorily implemented. The Bank has assessed as satisfactory the public sector investment program and associated financing and borrowing plans for 1987-90."

Bank-Fund Division of Labor

In working on adjustment, Bank and Fund staffs have come together in a way that had not been envisaged before. The Bank's interest in adjustment has clearly directed its focus to issues of budgetary deficits, exchange rate policies, tariffs and trade regimes, and many other areas which the Fund has traditionally considered to be its turf. Some Fund staff had previously looked upon the Bank as an institution with comparative advantage only in project financing, whereas the IMF did "macroeconomics." The more tolerant among Fund staff would acknowledge a macroeconomic role for the Bank only in terms of vetting public sector expenditure (with its usual component of project expenditures, and would perhaps credit us also with expertise in analyzing certain aspects of external debt as well as such drives as export promotion. The exchange rate, though a powerful policy tool for export promotion and rationalizing imports, has traditionally been the reserve of the Fund, and we have been very careful not to tread on Fund's sensitivities in this regard. Thus we would refer both in discussions with our borrowers and in our written work to the objective of maintaining "export competitiveness" (a euphemism for proper exchange rates). We would talk of adequate exchange rate policies rather than the exchange rates themselves. Great resources of tact and diplomacy have always been necessary in order to paper over differences of opinion with Fund staff. In many situations, however, common sense and a real spirit of cooperation have led to an amicable division of labor between the two institutions in macroeconomic matters. The Bank's concern for development makes it imperative for its staff to be on top of macroeconomic policy in all its ramifications, including the exchange and interest rates, monetary policy, fiscal and trade policy, investment, pricing, as well as all the longer-term structural issues of population, poverty, institutions and many others. We certainly do not regard macroeconomics as the preserve of the Fund. While acknowledging their short-term focus, our focus in macroeconomics is much more on the medium and longer terms. While the Fund attends to short-term balance through demand management measures, our concern is more on coaxing medium-term supply response from the available resources. Both approaches are needed and complement each other. True, conflicts can arise from the divergence of short- and long-term interests, but this is a fact of life where compromise has to be attempted.

Two cases of successful cooperation based on a sensible division of labor over macroeconomic policy may be cited: that of Thailand and that of Nigeria. It cannot be claimed that total harmony has prevailed, but it can be asserted with justification that the arrangements worked out have been quite successful and reflected an implicit recognition by the Fund of the Bank's macroeconomic role. In fact, Fund staff have come not only to acknowledge a macroeconomic role for the Bank, but have increasingly and in a practical way lent substance to a collaborative relationship on macroeconomics based on the comparative specialization of the two institutions.

In Thailand SAL I (FY83) was made under the umbrella of a sizable two-year Stand-by arrangement, starting in June 1981, as well as a Compensatory Financing Facility arrangement made also in 1981. Fiscal policy was specifically an area under the first SAL, where the two institutions carefully and closely collaborated. Resource mobilization and improved expenditure programming were divided rather neatly into short-term concerns to be addressed by the Fund and longer-term adjustments by the Bank (see President's Report P-3201-TH, page 27). The Fund had over several years provided technical assistance to reform the organization and administration of the Internal Revenue Department, and was then reviewing administrative practices in the Customs Department. Fiscal policy had also traditionally been a concern of the Bank, especially for resource mobilization and efficient public resource utilization. Under the SAL the Bank supported a stronger link between overall development planning and medium-term fiscal policy, with emphasis on medium-term resource mobilization in an attempt to reduce budget deficits while safeguarding development expenditure. For rationalizing public expenditure, prospective patterns of expenditure were married to multi-year investment programs, with stress placed on the institutional interfaces between planning, budgeting, programming and monitoring of the development process. While the Bank addressed the development of a medium-term fiscal strategy and the improvement of tax policy, the IMF contributed to the formulation of the medium-term strategy for the whole of the public sector.

An increase in the budgetary deficit in FY82 led to the violation of the agreed sub-ceiling on net credit to the Government and the Stand-by arrangement gave way to another, approved in November 1982, with cooperation between the two institutions proceeding along the same lines, based on intensive consultation and exchange of information at the staff level.

In <u>Nigeria</u>, the Bank began discussions in April 1983 regarding elements of a possible medium-term adjustment program. The Bank had prepared numerous sector studies of the Nigerian economy and these were drawn upon by the Fund for designing an Extended Fund Facility arrangement. During 1983-85 discussions between Nigeria and the Fund made little progress, but the Bank's efforts at adjustment continued, especially to rationalize public expenditure. In FY84 the Bank made a Fertilizer Import Adjustment Loan, and this was followed (in FY87) by a Trade Policy and Export Development Loan which was made at a time when agreement was reached between Nigeria and the Fund on a program for 1986 and 1987. Both institutions worked in tandem to provide technical assistance in managing adjustment. The Fund concentrated on developing a second-tier exchange market, and in monitoring fiscal and monetary policy. The Bank assisted in designing and monitoring the agreed trade liberalization measures, including the tariff and incentive policies, the public investment program and sectoral policies. Throughout the period covered by the Trade Policy Loan, both institutions continued to share and exchange information and coordinate actions and recommendations.

<u>Conclusion</u>

In sum, collaboration with the Fund has provided assurance for the Bank regarding the policies supported by adjustment lending, and has brought to the process of adjustment another view of great value. However, in many instances Bank judgment has had to be made independently from the Fund on practically all aspects of macroeconomics even those traditionally claimed by the Fund as their own preserve. The division of labor, largely in terms of a short-term focus for the Fund and a longer term one for the Bank, has worked well in some situations, but the responsibilities of the two institutions have more often overlapped. For it is a well known fact that short term or demand factors are not easily separable from longer term or supply factors as suggested by the textbook model of supply and demand. In many situations, as the above record shows, the Bank has supported adjustment without a Fund program and has worked out with the borrowers a macroeconomic program which it has monitored and whose results it has had to evaluate.

October 14, 1988

SES

SESerafy/lcu

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

MOEEN A. QURESHI
Senior Vice President, Operations

October 13, 1988

Mr. Conable

Re: Review Procedures for Adjustment Lending Operations

I am sorry that David Hopper has expressed his disquiet to you concerning what he perceived to be a departure from normal procedures on adjustment loans for Argentina, Mexico and Morocco. Had he conveyed his concerns to me, I would have clarified that these procedures are, and will continue to be, strictly followed.

With respect to Argentina, meetings of the Operations Committee took place under my chairmanship to discuss both the Banking Sector Loan, and the Trade Policy Loan. These meetings gave full opportunity to all Bank units to express their views on these operations. Furthermore, an additional meeting chaired by me took place on August 5 to discuss more specifically issues associated with the macro-economic framework in Argentina and the specific conditions under which the Bank would be prepared to make the Banking Sector loan effective and to invite the Argentine Government to formally negotiate the Trade Policy Loan. Stanley Fischer attended all these meetings. At no point did I, or any of my associates, ever state that we would only proceed to the Board after a commercial bank's package had been agreed upon. A condition for the January tranche releases is sufficient progress in obtaining external finance. Insistance on prior agreement with commercial banks would be unrealistic and tactically wrong because it would merely give leverage to commercial banks and may, in fact, delay an agreement.

The two other loans forming part of the Argentina "package" are investment operations (Low Income Housing and Power Sector) which are being processed and reviewed according to the procedures in force for such loans. Their viability would naturally be strengthened under the improved macro-economic framework to be put in place by the Argentine Government.

In the case of Morocco, also, the established procedures were also closely adhered to: first, the Initiating Memorandum for the SAL was reviewed in a meeting of the Operations Committee; all bank units were represented and did express their views at that time; second, after appraisal of the operation, the "Green Cover" report was circulated to all Operations Committee members on a no-objection basis (this was immediately before Berlin), which is also customary in those cases where no new issues have emerged between the "Initiating Memorandum" and "Green Cover" stages of the loan process; we actually received comments from most members of the Operations Committee (including PPR) and the consolidated comments were relayed to the Region by my Economic Advisory Staff. These comments are being taken into account. You should also know that according to established procedures, any member of the Operations Committee could have asked for a formal meeting (instead of written comments), and none did.

As far as Mexico is concerned, the Operations Committee will meet on specific and detailed loan proposals - these are not there yet. You are well aware that this matter was raised with us during the Berlin meetings. I have planned a brief restricted meeting with members of the Operations Committee on Friday, October 14, essentially to brief them on the request and to indicate to them the guidance given to the mission that is proceeding to Mexico. In view of your schedule, this meeting could not be held prior to our briefing for you on Mexico. You will see therefore that we fully intend to adhere to the established procedures, but equally it is not appropriate for this institution to ossify into a bureaucratic body that is unable to respond flexibly and quickly to its members' needs.

In order to alleviate your concerns about the integrity of and compliance with the processing procedures on adjustment lending, I would suggest that we meet at your convenience to discuss the issue in more depth. Vinod Dubey and his colleagues of the Economic Advisory Staff have done a superb job since the Reorganization in that respect, and would be delighted to give you a first hand account of the situation.

Moeen

Moeen A. Qureshi

cc: Mr. W. David Hopper

THE WORLD BANK

Office of the President

October 12, 1988

Mr. Moeen Qureshi

Moeen:

I share David's concerns and hope we can follow the established procedures.

Barber Conable

Barber B. Conable

Attachment

1101

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 88/10/11 DUE DATE : 00/00/00
LOG NUMBER : 881011001 FROM : WD Hopper
SUBJECT : Memo--- Re-establishment of Normal Procedures for Reviewing Structural Adjustment Proposals.
OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

	APPROVED
	PLEASE HANDLE
	FOR YOUR INFORMATION
*✓	FOR YOUR REVIEW AND RECOMMENDATION
	FOR THE FILES
*✓	PLEASE DISCUSS WITH BBC
	PLEASE PREPARE RESPONSE FOR ______ SIGNATURE
	AS WE DISCUSSED
	RETURN TO ______

COMMENTS :

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 11, 1988

TO: Mr. Barber B. Conable, EXC

FROM:: W. David Hopper, SVPPR

EXT: 75678

SUBJECT: **Re-establishment of Normal Procedures for Reviewing Structural Adjustment Proposals**

1. I was disquieted, and my staff shared my disquiet, at the lapse from the normal procedures for reviewing structural adjustment proposals that occurred in Berlin. The usual practice for reviewing these actions is to have a detailed document setting forth the proposed conditions and expected course of negotiations that is discussed in the Operations Committee, with the attendance from all the relevant Bank units. If considered necessary, an appropriately amended paper is then sent to the President's Council for review with you. This procedure has worked well in the past. Mr. Qureshi has given strong and fair leadership to the Operations Committee and has opened a full opportunity for all Bank units to place on record their concerns with the structural adjustment proposals.

2. My disquiet arises because these procedures were not followed in Berlin. The final outcome of our previous discussions on Argentina differed in substantial measure from the assurances members of the President's Council received in our earlier review of the Argentian action. [For example, we have been informed that the Bank would not commit to Argentina until the commercial banks agreed to be full partners. In Berlin, I learned that this important condition was being dropped because it would give the commercial Banks veto power over our actions--hardly a convincing reason for ignoring an important condition of our lending.] In the case of Mexico, there were no discussions and, to my knowledge, no paper detailing the proposals. I also learned in Berlin that a Moroccan adjustment loan was to go forward without an Operations Committee meeting or review by the President's Council.

3. With the pressure of the Berlin meetings now behind us, I hope it will be possible to return the discipline of our normal procedures. In other words, let us not make what occurred in Berlin a precedent for future structural adjustment approvals.

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

July 26, 1988

Messrs. Moeen A. Qureshi and Stanley Fischer

Re: Adjustment Lending Policy Paper

Congratulations on a first-rate report. This is an extremely useful document.

I support, in principle, the focus, frank tone, and conclusions of the report. It should be seen as a guide and a reminder to all of us to improve the management of adjustment lending. Following Board discussions, I expect OPS to internalize the implications of the report and to transform the recommendations into operational guidelines. I expect PPR to proceed with the evaluation and research on structural adjustment outlined in paras. 50-51 and to provide conceptual guidance on the design and implementation of appropriate macro-economic conditionality and adjustment programs.

When finalizing the Board report, I would like you to reflect the following points and make adjustments as necessary:

(a) Agreement on a medium-term framework to address the major macro-economic imbalances and bring about the structural changes needed, both at the economy-wide level and in specific sectors, is the basis for (quick disbursing) adjustment lending. Bank management (on all levels) must be stricter, more specific and consistent in the design and implementation of the medium-term framework supporting SALs and SECALs. Management must take greater care that the "three prerequisites" outlined in paras. 23-24 are met in form and substance. Specifically, I support the more consistent way of recording an understanding on overall structural adjustment programs as detailed in paras. 45-46.

(b) To the extent that measures are adopted to systematically strengthen the design, recording and monitoring of the underlying medium-term framework and structural reform program for SALs and SECALs, it might not be necessary that individual SECALs explicitly "include as conditions for disbursement the implementation of reforms which will contribute directly to overcoming macro-economic imbalances in the medium-term." Clearly such direct linkage is justified on equity grounds and in practice, if an adequate medium-term framework is neither adopted nor implemented satisfactorily in conjunction with SECALs.

At this time, I do not insist on the direct inclusion of macro-economic conditionality in SECALs, but expect OPS to adopt a stricter approach to the design, recording and monitoring of the medium-term framework. I would like to revisit this decision at the end of CY1989. To this end, I request PPR to follow and evaluate the design, conditionality and implementation of SECALs, in collaboration with OPS, and prepare a report in 18 months. The Board report should present the issues and my decision.

(c) As a general rule, adjustment lending in a given country should not exceed 50% of lending to that country over a 3-year period. However, this should be used as an internal management guideline and not as a yardstick for the Board. I agree that the Board document should contain specific guidelines on the overall share of adjustment lending for IBRD and IDA; it is important to develop the logic of such limits carefully in the report.

(d) Other lending instruments such as successive sector loans with time slice disbursements, as well as slower disbursing adjustment loans, merit a prominent discussion as important alternatives to balance of payment support adjustment loans. Staff should be encouraged to make effective use of the various lending instruments available.

Barber B. Conable

cc: President's Council

Mr. W. Stanton:

Bill:

Re: Structural Adjustment Lending

It would be very unfortunate in my view to have an amendment such as the one supported by Congressman J.Lafalce become a reality. In fact, such a move on the part of the US legislature would unnecessarily reduce our flexibility to respond to countries' needs without alleviating the concerns which seem to be driving Congressman Lafalce.

This is so because in many countries, especially small ones in Africa and Central America, we often have only one operation per year (or even sometimes one every other year). Applying a ceiling of 50% on adjustment lending, which I take as meaning in any given year, would *de facto* prevent us from doing *any* policy-based lending at all; as the attached table illustrates, this 50% ceiling was exceeded at least once in 16 countries during FY86-88, but the total proportion of adjustment lending over that entire period in each of these countries remained well below 50%; similarly, our lending plans for FY89-92 indicate that this limit could be exceeded in about 20 countries at some point during the upcoming 4-year period, but not over the entire period in any of the countries concerned.

More importantly, the application of mechanical rules across the board without any consideration for the diversity of country situations would prevent the Bank from supporting effectively the adjustment with growth process and responding adequately to crisis situations where our catalytic role has often proven to be essential; this danger would be particularly acute in the case of major borrowers in Latin America and elsewhere.

We should also reafirm to Congressman Lafalce that the scope, content and share of our policy-based lending in any given country is part and parcel of a multi-year country assistance program which is carefully designed to maximize the contribution the Bank can make to the development process of its borrowers. It would therefore be counterproductive to try to impose quantitative constraints on any lending *instrument* that the Bank is using to fulfill its development objectives.

Countries with IBRD adjustment lending exceeding 50% in any one year

	FY86-92 (in %)							Total % of adjustment lending over the period
	86	87	88	89	90	91	92	
Cameroon	0	0	0	100	0	90	0	27
Congo	0	0	82	0	100	0	63	45
Cote d'Ivoire	73	0	0	60	55	0	0	37
Mauritius	0	100	0	0	0	0	0	23
Nigeria	0	72	0	39	48	12	8	40
Korea	0	0	0	0	0	0	100	6
Philippines	0	88	50	60	67	0	0	39
Hungary	53	0	62	0	80	60	0	41
Morocco	65	42	66	36	47	16	25	40
Pakistan	15	0	42	52	27	18	51	26
Tunisia	0	90	51	63	20	60	0	47
Yugoslavia	0	0	0	55	0	50	0	21
Argentina	64	52	61	33	70	24	20	42
Chile	55	68	100	0	0	0	0	28
Colombia	36	0	62	0	26	0	0	22
Costa Rica	0	0	0	100	0	0	0	38
Equador	39	0	62	34	0	43	34	33
Guatemala	0	0	0	60	0	0	0	17
Jamaica	0	57	0	83	0	33	36	41
Mexico	0	29	52	57	15	25	26	29
Uruguay	0	76	0	51	0	0	0	28

June 16, 1988

Moeen
Mr. Qureshi:

re: Structural Adjustment Lending

1. Secretary Baker appeared yesterday before the House Banking Committee to support the Bank's General Capital Increase. Congressman John J. LaFalce said the following:

> "I am concerned about the growth of structural adjustment lending. I am thinking of an amendment that would limit bank loans for structural adjustment to a 50% limit in any one country and a 25% limit overall."

2. The ~~Senate~~ House Committee mark-up is scheduled for Tuesday next week; perhaps, before the end of this week, you would let me know your reaction to the Congressman's statement.

Bill Stanton

Bill

Adjustment Lending

Issues and Country Experience

A World Bank Symposium

April 6 – 7, 1989

Country Economics Department
Policy, Planning, and Research
The World Bank

ADJUSTMENT LENDING: ISSUES AND COUNTRY EXPERIENCE

The World Bank introduced structural adjustment lending in 1980 as a response to the severe balance of payments problems facing many developing countries. These problems had their origins in the global shocks of the early 1980s, including higher oil prices, higher interest rates, and recession in OECD countries, as well as inadequate domestic policies. Initially, adjustment lending in most countries was expected to last three to five years and the balance of payments was expected to reach a sustainable level in five to seven years. But adjustment lending has intensified rather than disappeared. The reason is that as the 1980s progressed, the terms of trade for most developing countries deteriorated further, real interest rates increased, and the debt crisis and slow growth persisted. In addition, the sources of domestic inefficiencies proved to be more intractable than previously thought. Thus, the scope of adjustment operations has widened, and the Bank has increasingly undertaken sector adjustment loans.

In 1988, almost a decade after the first structural adjustment loan was prepared by the World Bank, the Country Economics Department prepared a report evaluating the Bank's experience with adjustment lending. The report was discussed by the World Bank's Board in September 1988. A study, "Adjustment Lending: An Evaluation of Ten Years of Experience," based on the findings of this report was published in December 1988. In preparation for this report a number of papers were put together dealing with particular issues and countries. This symposium, which is organized around 17 papers prepared by staff of Policy, Planning, and Research (PPR), provides a forum for a more detailed and in-depth discussion of the issues connected with structural adjustment lending -- how it has worked and how it can be improved.

As external uncertainties and internal problems continue, adjustment issues remain relevant. It is hoped that the focus will shift from short-term crisis management and stabilization, which have dominated in the last decade, to the more fundamental issues of long-term growth, development, and poverty alleviation.

The symposium program and abstracts of the papers follow. The full papers will be subsequently available from the authors, after they incorporate comments from the symposium.

A handout will be available at the beginning of each session.

SYMPOSIUM ON ADJUSTMENT LENDING
H Building B1-201, APRIL 6-7, 1989

DAY I

Thursday, April 6

8:30 am — Registration and Coffee

9:00 - 9:30 — Adjustment Lending: Evolution and Issues - Chairman: John A. Holsen

Ernest Stern

SESSION I. **TRADE AND FINANCE** 9:30 - 11:00 - Chairman: Vinod Dubey

9:30-10:15 — 1) Trade Policy in Adjustment - Vinod Thomas
Discussant: John Williamson (IIE)

Open Discussion and Chairman's Conclusion

10:15-11:00 — 2) Financial Sector Policies - Alan Gelb & Patrick Honohan
Discussant: Maxwell Fry (University of California, Irvine)

Open Discussion and Chairman's Conclusion

SESSION II. **PUBLIC SECTOR POLICY** 11:00 - 12:30 - Chairman: Murray A. Sherwin

11:00-11:45 — 3) Public Finances in Adjustment - Ajay Chhibber & J.K. Shirazi
Discussant: Mario Blejer (IMF)
Peter Heller (IMF)

Open Discussion and Chairman's Conclusion

11:45-12:30 — 4) Public Enterprises in Adjustment Programs - John Nellis
Discussant: Leroy Jones (Boston University)

Open Discussion and Chairman's Conclusion

12:30-2:00 — **PROGRAM PARTICIPANTS' LUNCH** - Speaker: W. David Hopper

2:00 — **Coffee at H B-201**

SESSION III. **LATIN AMERICAN EXPERIENCE** 2:30 - 4:00 - Chairman: S. Shahid Husain

5) Chile: Cristian Moran
Discussant: Sebastian Edwards (UCLA)

6) Mexico: John Nash
Discussant: Vittorio Corbo

Open Discussion and Chairman's Conclusion

SESSION IV. **EMENA EXPERIENCE** 4:00 - 5:30 - Chairman: Hans-Eberhard Kopp

7) Turkey: Faezeh Foroutan
Discussant: Dani Rodrik (Harvard University)

8) Pakistan: William McCleary
Discussant: Mohsin Khan (IMF)

Open Discussion and Chairman's Conclusion

SYMPOSIUM ON ADJUSTMENT LENDING
H Building B-201, APRIL 6-7, 1989

DAY II

Friday, April 7

8:45 Coffee

SESSION V. **POLICY IMPACT** 9:00 - 10:45 - Chairman: Pedro S. Malan

9:15-10:00 9) Macro Comparisons - Jaime de Melo
Discussants: Peter Montiel (IMF)

Open Discussion and Chairman's Conclusion

10:00-10:45 10) Social Costs of Adjustment - Elaine Zuckerman
Discussant: Dennis de Tray

Open Discussion and Chairman's Conclusion

SESSION VI. **SECTORAL ISSUES** 10:45 - 12:15 - Chairman: Visvanathan Rajagopalan

10:45-11:30 11) Agricultural Policy and Performance - Odin Knudsen & John Nash
Discussant: Nurul Islam (IFPRI)

Open Discussion and Chairman's Conclusion

11:30-12:15 12) Structural Adjustment and Industry - James Tybout
Discussant: Mieko Nishimizu

Open Discussion and Chairman's Conclusion

LUNCH (Own Arrangements)

1:15 **Coffee at H B-201**

SESSION VII. **AFRICA EXPERIENCE** 1:30 - 3:00 - Chairman: Edward V.K. Jaycox

13) Zambia: Mohsen Fardi
Discussant: Ben King

14) Ghana: Chad Leechor
Discussant: Lyn Squire

15) Cote d'Ivoire: Christophe Chamley
Discussant: Shanta Devarajan (Harvard University)

Open Discussion and Chairman's Conclusion

SESSION VIII. **ASIAN EXPERIENCE** 3:00 - 4:30 - Chairman: Attila Karaosmanoglu

16) Korea: Mansoor Dailami
Discussant: Larry Westphal (Swarthmore College)

17) Philippines: Gerardo Sicat
Discussant: Isabel Guerrero

Open Discussion and Chairman's Conclusion

SYMPOSIUM ON ADJUSTMENT LENDING
H Building B-201, APRIL 6-7, 1989

DAY II

Friday, April 7 (Cont.)

SESSION IX. **PANEL DISCUSSION** - Chairman: John A. Holsen 4:30 - 5:45

Opening Remarks: Moeen A. Qureshi

Joe Abbey (Ghana High Commissioner in UK)
Stanley Fischer
Manuel Guitian (IMF)
Gerald K. Helleiner (University of Toronto)
Arjun Sengupta (IMF)

ADJUSTMENT POLICIES AND IMPACT

DEVELOPING COUNTRY EXPERIENCE IN TRADE REFORM

Vinod Thomas

During the 1980s developing countries have made greater efforts in trade reform than in the past. Their policy improvements also contrast with the lack of progress in trade liberalization during this time in the industrial countries. One reason for reform by the developing countries has been the tough external conditions of the 1980s. External shocks and economic instability have made adjustments of trade policies necessary. An important finding of this paper is that trade reform has been helpful in reviving growth and stimulating exports.

The paper considers the experience of 40 countries that have carried out reforms supported by trade-related adjustment loans and IMF programs during 1980-87. These countries have addressed export and import reforms in varying degrees. The main components of reform have been the following:

- Exchange rate reform;
- Export policy, including reduction of restrictions, increased access to imports for exporters, and provision of special incentives;
- Import policy, including reduction of quantitative restrictions, reduction of tariffs, substitution of tariffs for quantitative restrictions, and greater uniformity of tariffs;
- Studies on protection; and
- Institutional changes and domestic reforms.

Overall, the extent of actual implementation of trade reform has been moderately significant in 24 countries for which data are available. The major improvements have comprised a more realistic and flexible exchange rate policy and reductions in impediments to export. There has also been a liberalization of policy affecting imports needed by exporters. Import regimes have been improved by substituting tariffs for quantitative restrictions, although the lowering of quantitative restrictions has been modest in the face of foreign exchange constraints, except in selected cases (for instance, Chile, Korea, Mauritius, and Mexico). Effective rates of protection and anti-export bias have been reduced in some cases (for example, Mexico, Morocco, and the Philippines). Internal reforms, however, have lagged even in some of the major trade reformers (for example, Mexico), and institutionalization of reforms and reductions in protection levels have been limited.

For a sample of 80 developing countries, the paper gives evidence of relative improvements in performance associated with trade reform. In the short period under review (the 1980s), the evidence is modest, however. Moreover, most of the improvement is associated with the contribution of additional imported inputs in situations of severe foreign exchange constraints. But there is also a statistically significant impact of policy reform on performance. Countries that have implemented policy reforms under trade adjustment lending have experienced a stronger growth impact from additional imports than have others. The evidence supports the need for continued and stronger efforts to reform trade regimes as part of adjustment.

While evidence is provided of the benefits of reform, factors that constrain reform are also underscored. Reviews of 24 cases highlight four constraints: macroeconomic instability, inadequate conviction concerning the benefits of reform, vested interests against reform, and weak implementation capacity. Institutional reform has been found to be particularly slow, while price reforms have also not always been sustained. These issues are important because sustainable price changes and effective institutions are vital to achieving meaningful supply responses.

Factors other than trade policy also influence the sustainability of the positive effects of trade reform. In successful East Asian cases, for example, factors complementary to trade reform and export development have included stability and a sound macroeconomic framework, sectoral and institutional reforms, and supportive improvements in areas such as marketing, information dissemination, and technology. Country experiences illustrate that not only has implementation of trade reform varied but that the impact of trade reform on performance has also differed according to how favorable complementary factors have been. The implications of the findings are that greater efforts in trade reform will be beneficial for adjustment and growth and that their impact will be stronger if attention is paid to complementary policies.

FINANCIAL SECTOR REFORMS IN ADJUSTMENT PROGRAMS

Alan Gelb and Patrick Honohan

The recent surge of concern with financial sector policy issues in developing countries arises primarily from three characteristics of their financial systems:

- Many of the financial institutions in developing countries are extremely unsound.

- There is often excessive control over interest rates and the direction of credit, amounting to repression of the financial systems.

- Domination by banks of the financial system in many countries has led to a need for institution building to enrich the range of services offered by the financial sector.

The typical financial sector reform package involves policy changes to increase the power of centralized decisionmaking in some areas and to reduce it in others.

In the area of prudential regulation and supervision, reforms seek strengthened information systems, stronger and more detailed regulations, and closer credit supervision. At the level of the intermediaries, reforms seek improved procedures, some of which, such as credit policies, loan review, and management information systems, are natural complements to improvements at the central level.

Insofar as the relative cost and availability of credit are concerned, the typical reform program calls for a reduction in government control and a wider range of options for finance. Increases in and eventually liberalization of interest rates are called for, as is a reduction in the scope and severity of restrictions on bank lending and financial innovation generally. A reduction in the tax burden, implicit and explicit, of the financial system is often required, and this has fiscal consequences.

Many needed financial sector reforms are of an institutional nature, requiring the acquisition of scarce skills. For instance, development finance institutions may need to reconsider their fundamental objectives and their entire method of operation. Such changes take time to become effective, and it is not clear that the typical quick-disbursing policy-based operation is the ideal medium for effecting them.

Experience has shown the importance of the links between financial sector policies, performance, and the macroeconomic situation. The implementation record of most financial sector reform operations has been reasonably good, and in some cases governments have taken actions that go beyond those mandated. But without an adequate degree of macroeconomic stability, some financial sector reforms have failed, with serious consequences. Therefore, financial sector reform operations must be predicated on an appropriate macro-policy framework, especially since countries receiving adjustment support are likely to be in difficult macroeconomic circumstances.

PUBLIC FINANCES IN ADJUSTMENT PROGRAMS

Ajay Chhibber and Javad Khalilzadeh-Shirazi

Fiscal adjustment and reform are by nature difficult to design and implement, given the complexity of the underlying economic and institutional factors as well as social and political sensitivities. This paper points to several broad conclusions concerning the nature and extent of fiscal adjustment in developing countries in this decade:

- Fiscal policy reforms have often been triggered by actual or impending budgetary and balance of payment crises. Under such circumstances, short-run considerations have dominated the policy measures introduced.

- For a number of countries, considerable adjustment has occurred with respect to reducing fiscal and external deficits, although several countries experienced a reversal on the budget side after 1985. As expected, the short-run impact of budgetary retrenchment has generally been recessionary, with a fall in investment and growth.

- Reduction of the fiscal deficit has been achieved primarily through expenditure cutbacks, particularly in public investment.

- Expenditure cutbacks relative to GDP have been accompanied by a more focused public investment program, often in the form of a "core" set of projects and activities in high priority areas, such as infrastructure. Improved allocation for recurrent expenditures has also been achieved, although the reduction and elimination of some subsidies (fertilizers) have proven to be more difficult.

- With a few exceptions, revenue enhancement has not been very significant because the tax systems often lack sufficient elasticity and reductions of imports due to foreign exchange constraints have resulted in losses of tariff revenues, a main component of tax receipts. Indeed, to maintain or modestly increase their tax-to-GDP ratio, many countries have introduced ad hoc tax measures that are undesirable on efficiency and incentive grounds.

- Fundamental tax reform, except for tariffs, has not been a significant aspect of fiscal adjustment.

Growth-oriented adjustment programs entail fiscal reforms that go considerably beyond the traditional stabilization approach, which emphasizes measures to reduce aggregate demand. By definition, fiscal policy changes aimed at augmenting aggregate supply take longer to bring about the desired results. Consequently, adjustment policies accenting fundamental fiscal reform require a medium-term perspective. Countries suffering from severe macroeconomic imbalances need to restore a reasonable degree of stability before structural measures can be expected to elicit the desired response. But what constitutes a "reasonable degree" of macroeconomic correction depends on a number of factors, including the availability of external finance. Countries committed to fundamental fiscal reform -- as well as to reform in other key policy areas -- should be provided the necessary financial support within a time frame that allows them to initiate and sustain the process of change. In this context, the tradeoff between a rigid focus on stabilization and adjustment should be recognized and considered.

In the case of the Bank, structural adjustment lending remains the most appropriate vehicle for supporting fiscal reform because of its economy-wide approach. In principle, there is no reason why a series of fiscal-based structural adjustment loans (SALs) could not be designed for a country willing to undertake structural and institutional reforms in taxation expenditure policy and public sector pricing. Considerable preparation in the form of studies would need to precede such lending operations, however. The Bank has in recent years carried out many "Public Investment (Expenditure) Reviews," some of which have served as inputs into SALs. More sharply focused studies of this type, including examination of the revenue side, are necessary to underpin the adjustment programs and lending. Loan conditionality would need to be geared toward reform actions as opposed to necessarily short-run improvements in key macro targets (for instance, the budget deficit). In countries with an acute stabilization problem, aggregate demand reduction measures would need to precede structural reforms. In any event, multiyear financing commitments would be required to help persuade governments to undertake the reforms and to sustain them.

PUBLIC ENTERPRISE REFORM IN ADJUSTMENT LENDING

John Nellis

The performance of public enterprises in developing countries has not usually lived up to expectations. Too many public enterprises incur losses and operate inefficiently. Piecemeal attempts at improvement have been numerous but generally ineffective, thus setting the scene for systemic reform through World Bank-supported adjustment operations. Through 1988, public enterprise-related reforms have featured in 100 structural and sectoral adjustment operations. Sub-Saharan Africa has been a main locus of activity.

Reform packages have comprised four main elements:

- Reforms of the macroeconomic policy and financial frameworks affecting public enterprises performance;

- Reforms of the institutional framework (ways in which the government guides, supervises, and evaluates public enterprises);

- Issues of divestiture; and

- Restructuring, financial and physical, of individual key enterprises.

Adjustment operations have required or requested the sale or liquidation of public enterprises; changes in pricing and other policy regimes; financial rationalization; reduction of costs, including labor; improved guidance and evaluation by the state; and rehabilitation at the level of the firm.

There has been an acceptable degree of compliance with conditionality on public enterprise issues, even on the difficult themes of divestiture, labor retrenchment, and price increases. Experience confirms the importance and the intractability of institutional reforms; progress on these issues is slow and variable. It appears that a perceived improvement in the financial situations of many enterprises is attributable to across-the-board investment cuts and price increases in monopoly public enterprises, not to efficiency gains. There is little information on the post-privatization performance of divested firms.

The following changes characterize adjustment-related public enterprise reform programs in nine countries reviewed in detail in the study (and there is no reason to think this is an unrepresentative sample):

- A freeze on employment in public enterprises and, in several instances, a reduction in numbers of employees, sometimes substantial;

- A freeze in the creation of new public enterprises and, in many instances, a reduction in their number through divestiture and amalgamation into the regular line administrations;

- A general but not universal reduction in the budgetary burden posed by public enterprises;

- Increases in the quantity, quality, and transparency of information on public enterprise performance;

- Widespread experimentation with institutional mechanisms to better monitor and manage public enterprises;

- Equally widespread experimentation with private sectors as alternate users of the resources previously invested in public enterprises.

Nevertheless, greater effectiveness requires a long-term perspective, more flexibility in conditionality, and intensive supervision. Thus, despite some early positive signs, institutional development has a long way to go.

AGRICULTURAL SECTOR ADJUSTMENT LENDING AND AGRICULTURAL POLICY

Odin Knudsen and John Nash

In an effort to modernize economies, industrial growth has often been promoted at the expense of agriculture. Industrialization policies have created biases against agriculture by directing protection to industry, taxing agricultural exports, depressing the price of food in cities, and overvaluing domestic currencies through external borrowing and protectionist policies.

Increasingly governments have recognized that this policy has failed. Industries that were to lead growth remained inefficient and uncompetitive, often becoming increasingly dependent on protection. Because of depressed conditions in rural areas and subsidization of food in urban areas, cities have come under siege from rural poor seeking employment and higher income. Food imports have increased as domestic production has faltered. While subsidies on fertilizer and food consumption rise, public investment and expenditures on agricultural infrastructure decline.

In the early 1980s, the Bank attempted to assist governments in redressing the policy bias against agriculture while providing foreign exchange to buffer the adjustment costs. Conditions related to agriculture in policy-based loans accounted for well over 10 percent of all conditionality. Furthermore, agricultural sector loans began to dominate project lending for agriculture in several important borrowing countries. Conditionality on pricing and trade, which had been peripheral parts of project lending, set the tone of Bank and country dialogues and became integral to the Bank's lending operations for agriculture. Meanwhile, international prices fell below their historical trend levels because of subsidies in industrial countries, further complicating reform efforts.

One of the principle conclusions of the paper is that agricultural reform is a long-term process that will not necessarily yield results immediately once prices are adjusted or wasteful subsidies reduced. Agricultural growth is contingent not only on corrections in relative and absolute commodity prices but also on nonprice factors. The paper recommends that lending operations adopt a longer-term perspective that includes not only price and trade adjustments but also measures that address both the quality and the level of public investments and expenditures.

A second conclusion is that governments will continue to pursue the objective of insulating producers and consumers from fluctuations in international prices and exchange rates. Unless alternative marketing means are available, states will intervene via parastatal marketing organizations, ad hoc export taxes, quantitative restrictions, and untargeted food subsidies. Sector lending must focus not only on redressing the price bias against the sector but also on developing less intrusive, more transparent, and less costly means of improving price stability and subsidizing the consumption of the poor.

Third, the paper draws some conclusions regarding the design of agricultural trade liberalization. Reduction of trade barriers for agricultural commodities should be preceded by, or at the minimum conducted in conjunction with, overall cutbacks in protection for industrial products. Officials must proceed cautiously in establishing government programs and subsidies to promote exports of agricultural and agroindustrial products. Agricultural export promotion should focus on eliminating disincentives to export. Experience suggests that refraining from active intervention and export subsidies may be the best way to promote these exports. Finally, when the exchange rate is unstable, it may be necessary to accept short-term quantitative restrictions on agricultural imports to support minimum domestic prices, at least when the government is purchasing.

Last, the paper addresses the depth of the reform program. An examination of loan conditionality shows that reforms have been easily reversible in most countries. Few institutional and regulatory mechanisms have been dismantled. Rather, agricultural pricing and trade largely remain subject to the same political forces and mechanisms that caused distortions and biases in the past. As long as reforms are superficial, it will remain difficult to generate private investor confidence in the credibility of the changes. The need to deepen reforms means that Bank lending for agricultural adjustment has just begun to scratch the surface of what needs to be done. It would be wrong and naive to retreat from policy-based lending for agriculture because price and trade policies have improved or because some initial efforts have been unsustainable. Superficial policy changes can be swept away by changes in governments or deterioration in the macroeconomy. Sustainability in agricultural reform requires a vision that extends beyond a decade, along with a persistent commitment to redress biases against agricultural growth.

INDUSTRIAL PERFORMANCE AND STRUCTURAL ADJUSTMENT: SOME STYLIZED FACTS

Jim Tybout

This paper examines manufacturing sector performance in countries which received structural adjustment loans during the 1980s. Measures of manufactured output growth and trading patterns are constructed for these countries and compared with regional norms. In a sample of adjustment lending countries, an attempt is made to link patterns of import substitution and export expansion with policy reforms.

Growth in manufacturing value-added dropped in 1982-83 in the developing countries as a result of debt crises and world recession. It rebounded in 1984-86, but in Africa the recovery was so slight that growth rates remained negative. Compared with regional averages, the sample of adjustment lending countries fared slightly better in terms of manufacturing value-added growth during this period, when most adjustment programs were under way. But these same countries had done better than the regional average during 1978-81, before the crisis. Similar comments apply regarding rates of industrialization: the sample tended to outpace regional averages both before and after 1982-83. Hence if adjustment lending had much impact on growth, it was that it allowed countries to maintain their positions in the world economy.

An examination of demand-side sources of growth shows that global recession and the debt crisis led to substantial reductions in imports of manufactures in the developing countries, particularly in Latin America and the Caribbean and Africa, where demand contracted dramatically. Import reductions took place on a more limited scale in the Europe, Middle East, and North Africa region and in Asia during 1982-83. Especially rapid import substitution began in Africa during this crisis period and continued into 1984-86 as domestic markets for manufactured products remained stagnant. In countries in Latin America and the Caribbean and (especially) in Europe, the Middle East, and North Africa, however, import substitution was reversed during 1984-86 as domestic market growth resumed.

Many adjustment lending countries followed the regional patterns. The African adjustment lending countries, however, did not exhibit continued import substitution during 1984-86. Moreover, domestic markets in three of the five African adjustment lending countries grew considerably faster than the regional norm (Cote d'Ivoire, Ghana, and Kenya). Finally, several countries deviated from these norms by exhibiting unusually rapid import substitution (Jamaica and Pakistan) or unusually low domestic market growth (Jamaica, Malawi, and the Philippines).

Adjustment lending conditionality tended to be relatively weak. Nonetheless, except in Asia, trade liberalization and exchange rate devaluation were stressed relatively frequently. While it is unclear what the countries would have done in the absence of this conditionality, most did devalue and liberalize trade somewhat. Examination of industrial performance indicators for possible correlation with these regime changes showed weak evidence during the adjustment period of increased imports in countries where trade liberalization or devaluation have been important.

When conditionality was specific to industry, the focus was on restructuring, followed by pricing policies, investment incentives, and redirection of public investment from the manufacturing sector to encourage private investment.

MACRO-PERFORMANCE UNDER ADJUSTMENT LENDING

R. Faini, J. de Melo, A. Senhadji-Semlali, J. Stanton

This paper applies simple statistical methods to measure the effect of adjustment lending on economic performance. The study relies on traditional comparisons of the periods before and after initiation of adjustment lending and between recipients of adjustment lending and a control group of nonrecipients. With respect to their own past performance, adjustment lending countries improved their external position by generating a sufficient trade balance surplus to service their external debt. However, fiscal (and inflation) indicators deteriorated, a sign of remaining macroeconomic imbalances. Growth rates also fell, a reflection of deteriorating terms of trade and of the difficulties in achieving the required reduction in absorption.

With respect to performance vis-à-vis nonrecipients of adjustment lending, nonparametric statistics for the selected group of eight economic indicators show that, overall, recipients improved relative to nonrecipients. But the share of indicators showing an improvement (the average of the number of countries -- over all indicators -- showing an improvement) varied between 53 and 63 percent, depending on classifications. Statistical tests of difference of means for individual indicators suggest that these improvements were often statistically insignificant. However, improvements are stronger for a group of 12 recipients that received three or more adjustment loans. The evidence is that some mild relative improvement occurred.

Results are stronger when an attempt is made to control for the potentially negative effects of the external environment on performance. When controlling for this effect, adjustment lending recipients appear to do better than nonrecipients, now defined as countries that received neither Bank nor Fund adjustment lending. But the control group is small (only 14 countries), so these results are not statistically robust. Furthermore, when the influence of Bank-IMF support is entered as a continuous variable, it is found for most indicators that intensity of Bank-IMF involvement contributes significantly to better performance. The most notable exception was investment as a share of GDP, with which intensity of Bank-IMF lending is negatively (and significantly) correlated. Given the positive correlation of lending intensity with GDP growth and import growth, it would appear that the positive contribution of Bank-IMF lending to economic performance occurred mostly by relieving the foreign exchange constraint and allowing for the purchase of crucial foreign intermediate goods.

Adjustment lending is intended to elicit a supply response. This implies that for a given expenditure-switching policy, a greater improvement would be achieved in the trade balance. Alternatively, adjustment lending recipients would be expected to achieve a given trade balance improvement (controlled for changes in the terms of trade) at less cost in terms of foregone growth than nonrecipients. Correlations for a group of 30 countries that received their first Bank adjustment loan by

1984 show that adjustment lending recipients had higher average growth and greater trade balance improvement than nonrecipients. However, the tradeoff between growth and external balance improvement was the same for both groups of countries. Both the higher growth and the higher trade balance improvements confirm results that are discussed in the paper.

ADJUSTMENT PROGRAMS AND SOCIAL WELFARE

Elaine Zuckerman

The paper describes how concern for the social impact of recession and adjustment evolved, which income groups are most affected, how to obtain data for monitoring the social effects of adjustment, which policy measures have the most adverse social impact, and what actions can be taken to mitigate them.

The impact of recession and adjustment on the poor in any given country depends on the structure of production and consumption among and within households. While a specific adjustment measure, for instance, increased agricultural prices, may benefit some groups, such as farmers and traders, the same measure may worsen the welfare of others, such as poor landless and urban consumers. Furthermore, the poverty costs of adjustment are not simply a short-term problem. Adjustment is taking longer and proving far more arduous than originally expected. Ideally, adjustment should spur growth and an improved standard of living for the poor over the long term. Even with growth, however, the poor would gain only to the extent that trickle-down and expenditure switching benefited them. Trickle-down has not proved to be a reliable solution to poverty, and adjustment entails greater time lags than envisaged. Adjustment programs therefore need to be designed to increase the productivity of the poor so they will contribute to economic recovery and growth.

Adjustment programs also must be designed to protect the poor's living standards from the negative impacts of recession and needed austerity policies involving cutbacks in public social expenditures and in public and private sector employment. Three broad groups of poor may need protection: the "new" poor, who are the direct victims of recession, such as retrenched employees; the "borderline" or vulnerable poor on the brink of poverty, who are pushed over by austerity policies; and the "extreme" or structural poor. Short-term targeted public interventions are necessary to compensate the new poor and to cushion the vulnerable and structural poor. Public expenditures should be redirected from programs that benefit better-off groups to those affecting poorer constituents. Private social services and programs involving cost recovery are options for those who can afford to pay for services. Social bureaucracies need to be made more efficient. Tax reform, a typical adjustment measure, can help the poor if tax rates are progressive. Severance payments, retraining, public works schemes, and short-term, multidonor-financed compensatory programs directed to the new poor are becoming popular complements to adjustment programs, but much more needs to be done, particularly for the extremely poor.

In the long term, the extremely poor must become involved in the growth process through employment generation, human resource formation, the redistribution of assets such as land, and participation in designing and implementing development programs. These measures would contribute to adjustment's principal objective of realizing long-term growth and obviate the need for program targeting, which should only be used in the short term. Involving the poor in the growth process will also make adjustment more sustainable.

There is a clear case for including measures to offset the impact on the poor in adjustment programs. Measures to mitigate the social costs of adjustment are feasible and need not dilute the main objectives of adjustment. Without them, the sustainability of adjustment programs may be jeopardized.

COUNTRY STUDIES

CHILE

Cristian Moran

Domestic policy mistakes and negative external shocks combined to generate a severe economic and financial crisis in Chile in the early 1980s. Domestic policy decisions in four areas made the economy particularly fragile: (1) simultaneous adoption of a fixed exchange rate and a wage indexation formula linking nominal wages to past changes in inflation, (2) a privatization process that facilitated the emergence of highly leveraged financial conglomerates, (3) financial liberalization with excessively permissive banking legislation, and (4) delayed response to the events that preceded the crisis because the government believed that adjustment would be "automatic." Worsening terms of trade, increases in international interest rates, and the virtual cessation of commercial bank lending in 1982 in the wake of the debt crisis were the negative external shocks that then triggered an enormous economic and financial crisis. Real GDP fell 14 percent in 1982 and another 1 percent in 1983, and unemployment reached 28 percent of the labor force in 1983 (including those enrolled in the government's emergency programs).

In 1985 the government put in place an adjustment program that was supported by the IMF (through a three-year Extended Fund Facility arrangement) and the World Bank (through three consecutive structural adjustment loans). The program emphasized three key areas: (i) export incentives and the balance of payment; (ii) domestic resource mobilization; and (iii) a rehabilitation of the financial and corporate sectors. It was also complemented with an orthodox stabilization package, and an explicit attempt to restructure the external debt. Since then, the economy has responded to the adjustment program, with GDP, exports, and investment increasing at a substantial pace. Growth averaged about 4 percent in per capita terms during 1985-88, while unemployment declined to about 9 percent in 1988 -- a figure substantially below that prevailing in the late 1970s. Improvements in efficiency and targeting of social programs probably ameliorated the negative effects of the economic recession on the poor, but a drastic deterioration in health infrastructure and an increase in poverty-related health problems -- especially among adults -- could not be avoided. Moreover, the deterioration of real wages (particularly of minimum wages) and the heavy subsidization that occurred during the process of financial rehabilitation and the reprivatization of the economy -- favoring U.S. dollar debtors and wealthy individuals -- may have worsened the distribution of income.

Despite some concerns over the pace of implementation of social sector reforms, Chile's adjustment program has been successful. Four major factors have contributed to this success: (1) the introduction of a sound macroeconomic program, (2) the elimination of major microeconomic distortions prior to implementation of the adjustment program, (3) the government's commitment to policy change, and (4) the timely financial assistance provided by the IMF and the World Bank when no other credits were available. Because of its still-heavy debt burden, however, and the need to increase investment even further to sustain its economic expansion, Chile will require a continued effort to increase domestic savings -- a difficult task in the face of strong pressures to increase present consumption and expenditures in the social sectors.

MEXICO

John Nash

The foundation for the crises of 1982 and 1985 was laid in the late 1970s with the discovery of substantial new oil reserves in Mexico. In response to this discovery the government ended an incomplete stabilization program and embarked on an expansion of spending financed by internal credit expansion and external borrowing against prospective oil revenues. By 1982 public sector outlays reached 45 percent of GDP and parastatal enterprises dominated the economy. The 1982 crisis was marked by a severe foreign exchange shortage and the eventual adoption of a drastic stabilization program to cut the fiscal deficit and run a substantial trade surplus. The program was initially successful and the economy began to recover. The recovery, however, took place in an economic environment distorted by decades of protectionist policies, so import substitution sectors were the most affected. These sectors drew resources away from export producers, contributing to another deterioration in the balance of payments and to another crisis in 1985.

Before the 1985 crisis, the World Bank had made only one policy-based loan to Mexico, a 1983 export-development operation that achieved mixed success. The loan package negotiated between Mexico and its creditors in 1985 thrust the Bank into a central role in the policy dialogue, since the release of much of the commercial bank money was linked to various prospective policy-based Bank loans then under discussion. Between late 1986 and early 1988 the World Bank Board approved lending operations based on policy reforms in the agriculture, fertilizer, and steel sectors; another export development loan; and two loans based on changes in the import regime. These loans totaled over US$2.2 billion.

Mexico's structural adjustment program has been far-reaching in trade policy reforms, were progress has been excellent. Import protection has been dramatically reduced and the system has become more transparent. Nonoil exports have expanded rapidly, although much of this expansion has been due to the redirection of output from the domestic market rather than to new investment in export sectors. A recent study concluded, however, that although adjustment has been slow, due partially to overregulation of the economy, the hoped-for resource reallocation is beginning to occur. In nontrade areas reforms have been more modest but still significant. A large number of parastatal firms have been divested, although few of the most important ones. Agricultural pricing policies have been improved, with global food subsidies largely replaced by subsidies targeted to the poor and plans to flexibly link support prices for some crops to international price levels. (Recent developments, particularly the price freeze associated with the anti-inflationary program, threaten these reforms, however.) Pricing of state services has been oriented more toward cost recovery, although this effort has been impeded by high inflation, and some important state-owned enterprises have been made more efficient. Rules governing foreign investment have been made clearer and less restrictive.

Familiar arguments suggest the difficulty of sustaining other structural reforms before stabilization is achieved. Mexico's experience in 1983, on the other hand, underscored the difficulty of stabilizing an economy before a highly distorted incentive structure is improved. The ongoing stabilization effort, begun in late 1987, appears to be reducing inflation, and this effort has been aided by the reduction in the distortion of incentives brought about by the trade policy reforms.

TURKEY

Faezeh Foroutan

In 1977 Turkey's foreign debt crisis put an end to an era of high economic growth based on protectionist policies. By January 1980, after three years of economic and political instability following the debt crisis, the newly formed government embraced a new economic program.

The program represented a radical departure from previous policies and convictions. It effectively paved the way for support from the IMF, the World Bank, and private lenders. The long-run objective was to restore economic growth and transform Turkey from a regulated, highly protectionist, and inward-oriented economy to one that was market-oriented, outward-looking, and more liberal. In the short run, the program aimed at stabilizing the economy by controlling inflation and public sector and foreign trade deficits. Import policy liberalization and export promotion were key points of the program.

Turkey has made enormous progress in achieving some of these objectives, most notably in the areas of export promotion and high economic growth. The spectacular rise in exports has been the main factor in restoring Turkey's creditworthiness, thereby enabling it to resolve its debt crisis and resume high rates of economic growth. Turkey's performance in other key policy areas is more mixed. In particular, sustainability is being questioned by the emergence of high public sector deficits since 1985 and the consequent steady build up of domestic and foreign debt and inflationary pressures; the depressed level of private investment in key tradable sectors, primarily as a result of very high real rates of interest; the unstable structure of the finance sector (again related to high interest rates); and the unequal income distribution pattern.

What are the lessons to be learned from Turkey's experience? First, the Turkish government was committed to the adjustment program, and its ability and willingness to carry out the necessary reforms have been the key to progress. Second, the financial assistance of the international community was essential because it gave officials the opportunity to spread over time the burden of the necessary adjustment measures. Third, the examination of areas where the adjustment program has been less successful (such as finance sector reform) was useful for the light it shed on the question of how much sectoral reform is feasible in the face of severe macro imbalances.

Turkey has implemented outward-oriented policies over the past decade. Its economy has undergone a remarkable structural transformation toward a more efficient, market-oriented system. At the same time, present economic conditions point to a serious concern that the progress achieved so far may not be sustained. The threat to sustainability is fundamentally related to the large public sector budget deficit and the negative impact of the deficit on inflation, interest rates, private investment, and the stability of financial institutions. Sustainability is also threatened by the sharp deterioration of the purchasing power of wage earners and rural residents over the past decade. In retrospect, it seems clear that the government has not paid sufficient attention to the importance of macroeconomic stability, particularly since 1985, as a prerequisite for sustainable growth, nor did the Bank structural adjustment loan program incorporate any mechanisms for guaranteeing the maintenance of stability. In particular, the structural adjustment loan program focused more on liberalization than on stabilization and remained largely silent on income redistribution. Liberalization has borne substantial results. Decisive actions on the macroeconomic front are now required to preserve these hard-won benefits.

PAKISTAN

William McCleary

Pakistan began the 1980s recovering from poor policies of the previous decade that had involved nationalizations, heavy investment in large-scale industry, widespread government regulations, and fiscal and monetary indiscipline. Despite some early success in accelerating growth and controlling inflation, the economy was still suffering from important weaknesses at the start of structural adjustment efforts: low savings and investment rates, inward-looking trade policies, dependence on migrant worker remittances, and heavy reliance on price controls and entry restrictions in industry and energy. These problems were exacerbated by the second oil shock and the war in Afghanistan.

The government's adjustment program, supported by the IMF and World Bank structural adjustment loans and sector loans (energy, export development, agriculture), emphasized improved resource mobilization by the private and public sectors, a more balanced set of incentives between export and domestic market production, and a loosening of government controls. In a number of areas the pace of reforms has been quite rapid. Flexible exchange rate management has been introduced and the real effective exchange devalued by about 40 percent. Government controls on private investment have been substantially reduced and a better set of price incentives introduced in agriculture, oil, and gas. Medium-term planning has been restored and a substantial reorientation of public expenditures toward essential economic and social infrastructure accomplished. On the other hand, progress has been very slow in mobilizing additional public sector resources, liberalizing import policy (tariff reform), and phasing out agricultural input subsidies (irrigation water, nonphosphate fertilizers).

The result has been rapid growth with moderate but recently accelerating internal and external imbalances. Growth has averaged over 6 percent a year and has been rapid in both traded and nontraded goods-producing sectors. Budget deficits have been larger than expected and growing, leading to greater inflation and balance of payments pressures. While export performance has been quite good, rising imports and falling migrant worker remittances have reversed the decline in current account deficits. The questions of stabilization and appropriate incentives for continued progress in structural adjustment are being addressed in government programs covering FY 1989 to FY 1991, supported by IMF and Bank resources.

The dialogue between the government and the Bank has contributed to Pakistan's progress. A number of lessons can be drawn from this process. Progress has been easier in areas where dialogue was specific and concrete (for instance, a least-cost investment program for power, pricing arrangements for power, oil, and gas). Reforms have been sustained because of the government's incremental and flexible approach and because strong economic performance has reduced pressures for reversals. In areas in which understandings had been reached about the direction and elements of needed change, considerable progress was possible without specific conditionality (for instance, deregulation). There are payoffs to sensitivity about sequencing (for instance, securing better private sector performance in oil and gas before attacking the same issue in power). And last, it has proven difficult for the Bank to monitor and hold the government to high levels of macroeconomic performance under a program of sectoral adjustment loans only, that is, without the express conditionality of a structural adjustment loan or an IMF program.

KOREA

Mansoor Dailami

In many respects the goal of structural adjustment, pursued with alacrity by so many indebted developing countries in the 1980s, finds its clearest expression in the experience of South Korea. Over the course of this decade, the Korean economy has undergone a fundamental transformation. The aspects of this transformation that relate to improvements in internal macro conditions and external balance are most visible and hence most commonly appreciated. The extent of these improvements can be gauged by a comparison of the crisis situation in 1980 with the present state of vigorous economic growth, contained inflation, and a hefty surplus on current account.

Korea's structural adjustment experience is most notable, however, with respect to the broad and far-reaching policy reforms in the various aspects of the economy, including trade, industry, energy, and finance. Progress in these areas has been impressive. Successive efforts to enlarge the range of import policy liberalization for industrial products achieved the targeted 95.4 percent import liberalization ratio by 1988. The tariff system has been simplified, and the average tariff has been reduced from 31.7 percent in 1982 to 18.1 percent in 1988, with a further decline to 7.5 percent planned by 1993 -- a level corresponding to that in OECD countries. In the area of energy, significant advances have been made both in reducing the country's energy consumption propensity and in diversifying energy sources.

In the financial sector the government has followed a cautious liberalization strategy geared toward deregulation of interest rates, enhanced competition, and a gradual shift from direct intervention in credit allocation and the conduct of monetary policy to indirect intervention through reserve requirements, open-market operations, and market-determined interest rates. Bearing on the pace and scope of these reforms have been two important considerations: the high degree of corporate indebtedness and the emergence since 1986 of a substantial balance of payments surplus (amounting to $13.0 billion in 1988).

The Bank's involvement in Korea's adjustment process dates from structural adjustment loans in 1981 and 1983 that were important vehicles of policy dialogue, financial support (US$550 million), and cooperation. Given the government's strong commitment to policy reform and its success in macro management, the loan agreements were free of specific conditionality. This yielded a certain degree of policy flexibility and maneuverability which proved useful in the volatile world economic conditions of the early 1980s. Thus, for example, the government's firm policy of continuing to support the expansion of the automotive industry despite the Bank's earlier reservations led to handsome returns as exports of vehicles grew more than four-fold between 1980 and 1985.

The Bank's policy dialogue with Korea continued in the context of two industrial finance projects in June 1983 and May 1985. These projects laid the foundation for initiatives and reforms in the financial sector, which were shaped by the assessment of Korea's new role in the international financial system and the understanding that the reforms are as crucial to Korea's transition to the 1990s as export expansion strategies were to the economic growth of the 1960s and 1970s. In this perspective the decade of 1980s has been the era of adjustment, which has been a remarkable success because of two general factors. First was the sequencing of policy measures. Stabilization efforts laid the foundation for the implementation of subsequent industrial restructuring and trade liberalization reforms, which in turn facilitated financial sector liberalization. The second factor was the rapid economic growth, low inflation, high savings rates, and vigorous capital formation that characterized the 1981-85 period of structural adjustment loan program formulation and implementation. Balance of payments adjustment during this period was facilitated by favorable external conditions, notably the decline in the real price of oil and the appreciation of the Japanese yen. Consequently, the adjustment on the external account relied on export promotion rather than on import compression.

PHILIPPINES

Gerardo Sicat

The Philippine economy, which grew at a real rate of 6.0 to 6.5 percent a year in the 1970s, slowed toward the end of that decade. Dependence on external finance for investment, structural problems related to industrial and trade policies, and an expansionary fiscal policy contributed to a buildup of external debt. From 1974 to 1981 external shocks represented an average of 4.4 percent of GNP, climbing to 5 percent in 1980 and 11.6 percent in 1981. These shocks were generated by changes in the terms of trade, transmitted recession from the industrial market economies, and increases in international interest rates.

The Philippines received its first structural adjustment loan (SAL) in 1980, followed by another in early 1983. These loans, which paralleled IMF programs, were designed to address trade and industrial policies in addition to supporting macroeconomic reforms.

Two distinctive episodes describe the Philippine experience with respect to Bank adjustment loans. The first, which coincided with the period of the first two SALs, revealed inadequate adjustment at the macroeconomic level. The second episode, from 1983 to the present, coincides with a period of economic crisis, stabilization, and recovery. A stabilization program during the 1983-85 period helped bring reductions in deficits and inflation, but fundamental structural reform in finance, trade, and agriculture was not sufficiently addressed and the economy suffered severe recession. At the same time, the onset of a political crisis contributed to uncertainty, thus delaying recovery and leading to an economic crisis which required a readjustment in the Bank-supported program.

Since the change in government in February 1986, significant new steps have been taken to address structural weaknesses in trade, finance, and agriculture. A major tax reform included introduction of a value-added tax in 1988, and the public investment program has been reduced in size and refocused. Trade liberalization has significantly reduced the number of items subject to quantitative restrictions. The two largest government banks have been restructured and put on sound financial and management footing. Privatization of government-owned assets has begun, resulting in significant sales of acquired assets and public corporations. The Bank supported this adjustment effort with an economic recovery loan in 1987 and a public corporation reform loan.

Last year GDP growth averaged 6.6 percent and the inflation rate was 9 percent. But many unresolved problems remain. Unemployment and poverty, exacerbated by the stabilization program, remain significant problems without easy solutions. Political instability has slowed recovery in the past and continues to discourage private direct investment, although political uncertainty has been substantially reduced over the last year. Rapid population growth is putting increasing pressure on scarce land resources, with increasing environmental consequences. And finally, debt reschedulings have provided only a temporary solution to the heavy debt burden. The flow of new concessional assistance in the form of the so-called "mini-Marshall" plan is currently being worked out and could provide much needed external relief.

ZAMBIA

Mohsen Fardi

The economic crisis facing Zambia in the last decade has its roots in a rigidly structured economy that has had to adjust to a rapid decline in the terms of trade. During 1973-80 wide fluctuations and general decline in real copper prices and production led to an average annual decline of 6.0 percent in gross national income. In addition, policies supporting a fixed exchange rate, low agricultural prices, and extensive price controls created a strong bias against noncopper exports and high import and capital intensity in domestic production. The public sector became overextended because of the government's unsustainable expansion of the parastatal sector and its effort to provide basic education, health, and other public services for a rapidly growing urban population. As copper exports declined and the economy worsened, the government relied on large foreign borrowing, including the use of large IMF resources, and growth in payments arrears to stave off the need for retrenchment and restructuring.

Zambia's restructuring program began in 1983 with World Bank and IMF participation. The program moved into high gear in October 1985, with the adoption of an auction market for setting the foreign exchange rate, and lasted until May 1, 1987, when it was officially abandoned. The program was never fully and comprehensively implemented. While the adjustment program was in effect, the government adopted policies for rationalizing the foreign trade and exchange rate systems and for rehabilitating and restructuring the mining, industry, and agricultural sectors. Consumer prices were decontrolled and agricultural producer prices were raised. A substantial real depreciation in the effective exchange rate took place. Interest rates were also raised, although the real rate remained negative.

Despite some early gains from this program, the economy's overall response to the adjustment program remained tenuous. Initial successes included rapid expansion of nontraditional exports (albeit from a very low base), increased capacity utilization in targeted sectors as a result of greater availability of inputs and capital goods, and expansion of agricultural output because of high producer prices and favorable weather. Overall, however, GDP grew by only 0.5 percent in 1986 because of the continuing decline in the mining industry. Despite repeated rescheduling of some external debt, arrears continued to accumulate, including those to the IMF. The net inflow of external assistance fell short of expected amounts in part because of inadequate performance relative to fiscal targets. Although public sector wages were reduced in real terms, rapidly rising interest-payment and foreign-exchange-related expenditures led to a budget deficit exceeding 35 percent of GDP.

This failure to achieve fiscal targets led also to inconsistencies with other aspects of the adjustment program. The current account deficit increased to 24.5 percent of GDP in 1986. A rapid decline in real wages and increasing unemployment led to the erosion of political support for the adjustment program. The removal of maize subsidies and the raising of fuel prices triggered strong public protests, leading to reinstatement of the subsidy and a rollback of the price increases.

Since May 1, 1987, the government has tried to implement its own adjustment program. The new program includes reinstating the fixed exchange rate system and limiting debt-service payments to 10 percent of export receipts less payments for mining sector, petroleum, and fertilizer imports. Foreign exchange earned from exports is allocated through an administrative system. Initially, a price freeze for consumer goods was enforced, but subsequently controls have been enforced only on a much smaller group of key consumption items. Despite the sharp and unexpected increase in copper prices since the second half of 1987, marginal improvements in copper production, and a good agricultural harvest, the economy is yet to show any signs of growth. Wide shortages of consumer goods and an inflation rate of over 50 percent have been reported despite government efforts to control the prices of basic consumer goods.

The agenda for Zambia remains the same as before, that is, finding ways to stop (or slow) the decline in the per capita income; to diversify the economy's production base, especially given the expected declines in copper reserves and production over the long-run; to better manage public resources; and to resolve the external debt problem. In retrospect, it appears that the adjustment program failed both because of a shortfall of external funds, due largely to unrealized projections regarding copper receipts, and because of the difficulty of reducing the fiscal deficit. The resolution of the present impasse is dependent on finding innovative ways to reduce the external debt to a manageable size and on getting back on an economic reform track that is workable, politically feasible for Zambia, and acceptable to international donors. Now more than ever Zambia needs to implement a vigorous and comprehensive economic restructuring program.

GHANA

Chad Leechor

The standard of living in Ghana had been falling since independence in 1957, except for brief periods of cocoa boom. The national economy had followed a faltering and erratic course. The most recent and precipitous decline occurred between 1978 and 1983, as virtually all modern infrastructure ceased to function and real per capita income fell by 25 percent. The principal cause appeared to be the failure of economic policies in dealing with an overextended public sector, terms-of-trade deteriorations, and extensive administrative controls. The protracted drought of 1983 added to the severity of the economic decline. External debts, however, neither caused nor greatly aggravated the downturn.

In April 1983 the current government introduced the Economic Recovery Program (ERP), a set of adjustment policies that represented a radical break with traditional practices. The new approach emphasized improving incentives, freeing up private sector activities, and increasing public sector discipline. The centerpiece of the ERP was a massive exchange-rate realignment, from 2.75 cedi per U.S. dollar in April 1983 to 128 cedi per dollar in September 1986, a magnitude of change seldom seen elsewhere. In addition, government programs were streamlined, including reductions in the workforce and commercial roles, to reduce expenditures. Liberalization of trade, production, distribution, and price control was gradually implemented.

Initially the ERP faced considerable resistance at home. Devaluations and spending cuts, in particular, brought hardship to large segments of the population. An earlier adjustment effort, including an 80-percent devaluation in 1971, had been extremely divisive and ultimately brought down the incumbent administration. Against this background the introduction of the ERP was a testimony to the government's political will. The continuation of the program over the years showed a commitment to change, but two factors favorable to the ERP were at work as well, however. First, the Ghanaians had been through so much trouble for so long that they were willing to put up with considerable suffering in support of change. Second, the international community, including the World Bank and the IMF, firmly endorsed the ERP and provided the substantial foreign exchange needed for recovery.

The new policies worked. The economy rebounded, with real GDP growth of 26 percent in four years. The standard of living improved dramatically. Moreover, the gains were widely shared within the population, as the changes helped mainly the rural areas where the country's workforce was concentrated. Government services were restored and expanded as more revenue was mobilized. Much remained to be done, nonetheless. Inflation was still very high (40 percent each year), despite success in fiscal control. Nontraditional exports were yet to emerge. The financial sector remained a bottleneck hampering structural change and growth.

Developing countries have much to learn from the Ghanaian experience. Above all, it shows that the approach underlying the ERP does work. In addition, the experience challenges widely held assumptions concerning the political feasibility of certain adjustment measures, including large corrective devaluations, increased resource mobilization, and drastic reduction in expenditures, all of which were successfully implemented in Ghana. The same measures may not work as well in other countries, however. Public support may dry up before the program begins to pay off. The government's commitment may waiver under pressure. Finally, country-specific conditions might call for different measures.

COTE D'IVOIRE

Christophe Chamley

Until 1975, growth in Cote d'Ivoire was impressive, with an average annual real growth rate of 8 percent over the previous decade. Between 1975 and 1977 CFA prices of cocoa and coffee (which together constituted 16 percent of GDP and 40 percent of exports) increased more than three-fold. The windfall revenues were largely captured by the government through taxation. The temporary commodity boom and the concurrent macroeconomic policy had two major impacts. First, the windfall revenues were used to expand expenditure programs, and these programs were not scaled down at the end of the boom in 1978. The resultant fiscal gap was financed by external borrowing. Second, the domestic price level increased significantly during the boom and did not decrease after 1978. Given the fixed exchange rate, Ivorian competitiveness suffered. As a result the ratio of foreign debt to GDP had reached 35 percent by 1981, and the government budget and current account deficits were equal to 12 and 17 percent of GDP, respectively.

An adjustment program was initiated in 1981 and lasted until 1988. This program was supported by three World Bank structural adjustment loans (December 1981 to December 1982, August 1983 to November 1984, and February 1987 to February 1988) and by the IMF through a multiyear arrangement under the Extended Fund Facility from 1981 to 1983 and two one-year stand-by arrangements in 1984 and 1985.

The main tasks of the program were (1) to restore internal equilibrium by reducing public expenditures and instituting administrative reform of the budgetary process, and (2) to restore external equilibrium in the short term by reducing the fiscal gap and in the medium-to-long term by introducing economic incentives for the diversification of the economy from the main cash crops.

The adjustment process can be divided into three periods. In the first period (1981-83) the gravity of the situation was not perceived, and the program was insufficient. Some reduction of public expenditures took place as a result of improvements in the expenditure decisionmaking process and management of public enterprises. However, while expenditures on investment were reduced from 18 percent of GDP in 1980 to 11 percent in 1983, current expenditures during the period increased from 22.6 percent of GDP to 29.6 percent, in part because of higher debt-service obligations (from 3.2 percent of GDP to 8.2). The modest reduction of overall expenditures was offset by the worsening of the terms of trade, the increase in interest rates, and the drought. By 1983 internal and external deficits were at about the same level as they had been in 1981. In the essential area of export diversification, the need for some incentives was recognized but no related conditionality was attached to the first structural adjustment loan.

The combination of increases in coffee and cocoa prices and cuts in expenditures substantially reduced external and internal deficits. During this second period in the adjustment process (1984-86) public expenditures declined significantly, but most of the cuts fell on the public investment program (which fell from 11.3 percent of GDP in 1983 to 7.2 percent in 1985). The reduction of current expenditures, particularly the wage bill, was small. Adjustment was fragile, however, for several reasons. The prices of cocoa and coffee were higher in this period than their trend values, and subsequently fell sharply. Government current expenditures were inconsistent with long-term revenues, and real public sector wage rates stayed at relatively high levels. The real exchange rate did not depreciate to its pre-1975 value (or to a value compatible with the increased debt) due to price rigidities and other factors. Implementation of export premiums, which were included in the structural adjustment loan program to circumvent price rigidity and the fixed exchange rate, was delayed. Finally, domestic investment was significantly below the level needed to achieve long-run growth targets.

The problems of the current crisis period (1986-88) began as external and internal balances were again disrupted by falling cocoa and coffee prices at the end of 1986. Their present international level is at a historic low. Domestic producer prices have not been decreased, leading to substantial subsidies. Prospects for export prices do not appear optimistic, and the economic situation in Cote d'Ivoire is now worse than at the beginning of the adjustment program. The structural changes necessary for resumption of growth have not been made. Meanwhile, the country has acquired an enormous debt, and debt-service payments are now in considerable arrears.

NOTES

THE WORLD BANK

March 20, 1989

Mr. Baudon:

Thierry:

I think participation in the closing panel would be O.K. What do you think ?

You could also deliver the closing statement or chair the closing panel. I would suggest you do the former (less time consuming)
Thierry

MOEEN A. QURESHI
Senior Vice President, Operations

8903170181

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 15, 1989

TO: Mr. Moeen Qureshi

FROM: John A. Holsen

EXTENSION: 6-1755

SUBJECT: Symposium on Adjustment Lending

As you know, we are sponsoring a symposium on "Adjustment Lending: Issues and Country Experience," to be held at the Bank, during April 6-7.

As I mentioned some days ago, we very much hope that you can participate in the symposium. The attached draft program envisages your participation in a closing panel discussion on April 7. Alternatively, as I mentioned when we talked about it, you might wish to make a statement at one of the other sessions. For example, you might open the second day of the symposium--which is when we take up the theme of the policy impact of adjustment lending. Your reflections on this subject would be most welcome.

Please let me know if you will be able to join us and, if this is possible, how you would like to participate.

Attachment: Program

Thierry:
I think participation in the closing panel would be ok.
What do you think?
M.

Q to join closing panel
at 4.30 pm 4/7

SYMPOSIUM ON ADJUSTMENT LENDING
H Building B-201, APRIL 6-7, 1989

DAY I

Thursday, April 6

8:30 am	Registration and Coffee
9:00 - 9:30	Adjustment Lending: Evolution and Issues - Chairman: John A. Holsen
	Ernest Stern
SESSSION I.	**TRADE AND FINANCE** 9:30 - 11:00 - Chairman: Vinod Dubey
9:30-10:15	1) Trade Policy in Adjustment - Vinod Thomas Discussant: John Williamson (IIE)
	Open Discussion and Chairman's Conclusion
10:15-11:00	2) Financial Sector Policies - Alan Gelb & Patrick Honohan Discussant: Ronald McKinnon (Stanford University)
	Open Discussion and Chairman's Conclusion
SESSION II.	**PUBLIC SECTOR POLICY** 11:00 - 12:30 - Chairman: Murray A. Sherwin
11:00-11:45	3) Public Finances in Adjustment - Ajay Chhibber & J.K. Shirazi Discussant: Mario Blejer (IMF) Peter Heller (IMF)
	Open Discussion and Chairman's Conclusion
11:45-12:30	4) Public Enterprises in Adjustment Programs - John Nellis Discussant: Leroy Jones (Boston University)
	Open Discussion and Chairman's Conclusion
12:30-2:00	**PROGRAM PARTICIPANTS' LUNCH** - Speaker: W. David Hopper
2:00	**Coffee** at H B-201
SESSION III.	**LATIN AMERICAN EXPERIENCE** 2:30 - 4:00 - Chairman: S. Shahid Husain
	5) Chile: Cristian Moran Discussant: Sebastian Edwards (UCLA)
	6) Mexico: John Nash Discussant: Vittorio Corbo
	Open Discussion and Chairman's Conclusion
SESSION IV.	**EMENA EXPERIENCE** 4:00 - 5:30 - Chairman: Hans-Eberhard Kopp
	7) Turkey: Faezeh Foroutan Discussant: Dani Rodrik (Harvard University)
	8) Pakistan: William McCleary Discussant: Mohsin Khan (IMF)
	Open Discussion and Chairman's Conclusion

SYMPOSIUM ON ADJUSTMENT LENDING
H Building B-201, APRIL 6-7, 1989

DAY II

Friday, April 7

8:45 **Coffee**

SESSION V. **POLICY IMPACT** 9:00 - 10:45 - Chairman: Pedro S. Malan

9:15-10:00 9) Macro Comparisons - Jaime de Melo
Discussants: Marcelo Selowsky and Peter Montiel (IMF)

Open Discussion and Chairman's Conclusion

10:00-10:45 10) Social Costs of Adjustment - Elaine Zuckerman
Discussant: Dennis de Tray

Open Discussion and Chairman's Conclusion

SESSION VI. **SECTORAL ISSUES** 10:45 - 12:15 - Chairman: Visvanathan Rajagopalan

10:45-11:30 11) Agricultural Policy and Performance - Odin Knudsen & John Nash
Discussant: Nurul Islam (IFPRI)

Open Discussion and Chairman's Conclusion

11:30-12:15 12) Structural Adjustment and Industry - James Tybout
Discussant: Mieko Nishimizu

Open Discussion and Chairman's Conclusion

LUNCH (Own Arrangements)

1:15 **Coffee** at H B-201

SESSION VII. **ASIAN EXPERIENCE** 1:30 - 3:00 - Chairman: Attila Karaosmanoglu

13) Korea: Mansoor Dailami
Discussant: Larry Westphal (Swarthmore College)

14) Philippines: Gerardo Sicat
Discussant: Isabel Guerrero

Open Discussion and Chairman's Conclusion

SESSION VIII. **AFRICA EXPERIENCE** 3:00 - 4:30 - Chairman: Edward V.K. Jaycox

15) Zambia: Mohsen Fardi
Discussant: Ben King

16) Ghana: Chad Leechor
Discussant: Lyn Squire

17) Cote d'Ivoire: Christophe Chamley
Discussant: Shanta Devarajan (Harvard University)

Open Discussion and Chairman's Conclusion

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DAY II

Firday, April 7 (Cont.)

SESSION IX. **PANEL DISCUSSION** - Adjustment Lending: Issues and Country Experience 4:30 - 5:45 -
Chairman: John A. Holsen

Moeen A. Qureshi*
Stanley Fischer
Arjun Sengupta (IMF)*
Joe Abbey (Ghana High Commissoner in UK)
Manuel Guitian (IMF)
Gerald K. Helleiner (University of Toronto)

* To Be Confirmed