

**ADJUSTMENT LENDING RETROSPECTIVE**

**FINAL REPORT**

**OPERATIONS POLICY AND COUNTRY SERVICES**

**JUNE 15, 2001**

## ACRONYMS

AFR	Africa Region	IMF	International Monetary Fund
ALCID	Adjustment Lending Conditionality and Implementation Database	I-PRSP	Interim Poverty Reduction Strategy Paper
AsDB	Asia Development Bank	LCR	Latin American and Caribbean Region
BIS	Bank for International Settlement	LIBOR	London Inter-Bank Offer Rate
BP	Bank Procedure	MNA	Middle East and North Africa Region
CAS	Country Assistance Strategy	OD	Operational Directive
CDF	Comprehensive Development Framework	OED	Operations Evaluation Department
CFAA	Country Financial Accountability Assessment	OP	Operational Policy Statement
CODE	Committee on Development Effectiveness	OPCS	Operations Policy and Country Services
CPAR	Country Procurement Assessment Report	PER	Public Expenditure Review
CPIA	Country Policy and Institutional Assessment	PPI	Private Participation in Infrastructure
CY	Calendar Year	PREM	Poverty Reduction and Economic Management Network
DEC	Development Economics Group	PRGF	Poverty Reduction and Growth Facility
DSL	Development Support Loan	PRSC	Poverty Reduction Support Credit
EAP	East Asia and Pacific Region	PRSP	Poverty Reduction Strategy Paper
ECA	Europe and Central Asia Region	PSAC	Programmatic Structural Adjustment Credit
EFF	Extended Fund Facility	PSAL	Programmatic Structural Adjustment Loan
EIAL	Early Intensive Adjustment Lending	PSD	Private Sector Development
ERDL	Economic Reform and Development Loan	PSI	Private Sector and Infrastructure Network
ERR	Economic Rates of Return	QAG	Quality Assurance Group
ESSD	Environmentally and Socially Sustainable Development (Network)	QEA	Quality at Entry Assessment
ESW	Economic and Sector Work	RAL	Report on Adjustment Loan
FIL	Financial Intermediary Loan	SAC	Structural Adjustment Credit
FINCR	Finance Credit Risk Group	SAL	Structural Adjustment Loan
FSAL	Financial Sector Adjustment Loan	SAP	Systems Application Program
FSAP	Financial Sector Adjustment Program	SAPRI	Structural Adjustment Participatory Review Initiative
FY	Fiscal Year	SAR	South Asia Region
GDP	Gross Domestic Product	SECAC	Sector Adjustment Credit
GNP	Gross National Product	SECAL	Sector Adjustment Loan
HD	Human Development (Network)	SNAL	Subnational Adjustment Loan
HIAL	Higher Impact Adjustment Lending	SOE	State-Owned Enterprise
HIPC	Heavily Indebted Poor Countries (Initiative)	SSAL	Special Structural Adjustment Loan
IBRD	International Bank for Reconstruction and Development	TA	Technical Assistance
IDA	International Development Association	TAC	Transition Assistance Credit
IFC	International Financial Corporation	WDR	World Development Report
		WID	Women in Development

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# ADJUSTMENT LENDING RETROSPECTIVE

## EXECUTIVE SUMMARY

1. In September 2000, the Development Committee discussed *Supporting Country Development: World Bank Role and Instruments in Low- and Middle-Income Countries*.<sup>1</sup> That paper suggested adapting adjustment lending in the Bank's country programming cycle for IDA borrowers to support country-led poverty reduction strategies. More recently, the Task Force on the World Bank Group and the Middle-Income Countries has discussed the role of adjustment lending as a vehicle for promoting growth and poverty reduction in IBRD borrowers.<sup>2</sup> These discussions reflect parallel evolutions: (a) as reflected in the Comprehensive Development Framework, the development paradigm has become a country-focused approach that recognizes the critical role of policies and institutions for development outcomes, especially growth and poverty reduction; and (b) adjustment lending has become a more flexible developmental instrument for partnering with others in supporting country programs.

2. **Purpose of Retrospective.** Against this background, the plan to update Operational Directive (OD) 8.60, *Adjustment Lending Policy*, and convert it into the Operational Policy/Bank Procedures (OP/BP) format is timely. It will allow the results of the ongoing strategic discussions about lending instruments to be reflected in the review of operational policy issues. As a background paper to inform the discussion on Bank-specific issues related to adjustment lending—and as an input into determining how best to adapt adjustment lending to meet the development challenges ahead—this retrospective takes stock of the major trends and developments over the last two decades with respect to adjustment lending instruments. It also begins to frame issues for discussion about the direction of the Bank's operational policy for adjustment lending instruments, as a step in the process leading to the preparation of OP/BP 8.60. The retrospective was discussed by the Committee on Development Effectiveness (CODE) on March 7, 2001, and in a meeting of the Board of Executive Directors on May 9, 2001. An issues note that will inform the drafting of the OP/BP is under preparation; following its discussion with Executive Directors, it will provide the basis for external consultations.

3. **Overview of Findings.** The retrospective builds on earlier reviews of adjustment lending<sup>3</sup> as well as fresh research and analysis. It finds that (a) adjustment lending has been evolving in tandem with countries' broader reform agendas, becoming increasingly focused on long-run, structural, social, and institutional issues, with the 1980s' narrow focus on short-term stabilization and addressing distortions giving way in the 1990s to a more developmental perspective; (b) the quality of adjustment lending improved steadily and markedly throughout the 1990s—as measured, inter alia, by Operations Evaluation Department (OED) ratings for outcome, sustainability, and institutional development impact; but (c) further progress is needed in several areas, including poverty focus, fiduciary framework, and conditionality—especially if adjustment lending (or a variant thereof) is to play an expanded role in supporting country development.

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<sup>1</sup> See *Supporting Country Development: World Bank Role and Instruments in Low- and Middle-Income Countries* (DC/2000-19), September 8, 2000.

<sup>2</sup> See *Report of the Task Force on the World Bank Group and the Middle-Income Countries* (SecM2001-0204), March 27, 2001.

<sup>3</sup> See *Structural Adjustment Lending: A First Review of Experience*, Operations Evaluation Report No. 6409, World Bank, September 24, 1986; *Report on Adjustment Lending: Policies for the Recovery of Growth* (R90-51, IDA/R90-49), March 26, 1990; *The Third Report on Adjustment Lending: Private and Public Resources for Growth* (R92-47, IDA/R92-29), March 24, 1992.

## A. Quantity and Quality

4. Adjustment lending, originally conceived as a financing vehicle for short-term balance of payments support, has evolved to become an important developmental instrument for supporting social, structural, and sectoral reforms. Early adjustment lending had a mixed performance record, and concerns arose about the development effectiveness of this type of lending and its poverty, social, and environmental impacts. During the 1990s, the performance of adjustment lending improved sharply, as the lessons from OED and research evaluations were built into operations. Also over time, as described below, the Bank developed several types of adjustment loans to respond to changing borrower needs.

5. **Quantity.** In the 1980s, the Board approved 191 adjustment operations in 64 countries for \$27 billion, or 8 percent of total operations (2,357) and 17 percent of total Bank lending (\$156 billion). During the 1990s, adjustment lending increased to 346 operations for \$72 billion in 98 countries, or 13 percent of total operations (2,667) and 29 percent of total lending (\$245 billion). Until FY98 and FY99, when the demand for adjustment lending was greatest, the average share of adjustment lending in total Bank lending remained below the 25 percent benchmark established in OD 8.60,<sup>4</sup> averaging 23 percent from 1990-1997. In FY99, for the first time ever, adjustment lending surpassed investment lending in volume, but in FY00 the share of adjustment lending fell back to around one-third of all Bank lending. As of May 2001, the share of adjustment lending in FY01 was 33 percent. In terms of the number of operations, the share remains well below 25 percent.

6. **Adjustment Lending Instruments.** In response to changing borrower needs, new and varied approaches to adjustment lending evolved over the past two decades, mostly in recent years.<sup>5</sup> During the early 1980s, structural adjustment loans (SALs) were supplemented by sector adjustment loans (SECALs). There have been roughly equal numbers of SALs (255) and SECALs (233). Subnational adjustment loans (SNALs) are a more recent innovation. Since FY98, the Board has approved eight SNALs in support of social and structural reforms at the regional or state level in large federal countries; ongoing country program discussions indicate potentially increasing demand for SNALs. The needs of emerging markets affected by the East Asia crisis prompted the Bank to introduce special structural adjustment loans (SSALs) for countries with exceptional financing needs:<sup>6</sup> SSAL support for Argentina and Brazil helped them to maintain the reform momentum and safety net protection in the face of major external capital market shocks. And in FY99, the Bank introduced programmatic adjustment loans and credits (PSALs/PSACs) to

<sup>4</sup> OD 8.60, *Adjustment Lending*, states that “adjustment should not normally exceed 25 percent of Bank or IDA lending, aggregated over the Bank as a whole and averaged over a three-year period, and should not under any circumstances exceed 30 percent for IDA.” This guideline was adopted in the late 1980s as a pragmatic step based on the share of adjustment lending at that time. See also Ibrahim Shihata, *Authorized Purposes of Loans Made or Guaranteed by the Bank*, Memorandum of the Vice President and General Counsel (SecM88-517), April 8, 1988 for a discussion of the “special circumstances” under which the Bank’s Articles of Agreement authorize adjustment lending.

<sup>5</sup> The Bank offers two basic types of lending instruments: investment loans (which typically have a long-term focus of 5 to 10 years and finance goods, works, and services) and adjustment loans (which typically have a shorter time horizon of 1 to 3 years and provide quick-disbursing external financing to support policy and institutional reforms). For an overview of these two lending instruments, see *World Bank Lending Instruments: Resources for Development Impact*, Operations Policy and Strategy, World Bank, July 2000.

<sup>6</sup> See *Programmatic and Emergency Adjustment Lending: World Bank Guidelines* (R98-249), October 2, 1998.



support medium-term reforms.<sup>7</sup> In general, PSALs/PSACs consist of a series of annual operations under a unifying multiyear framework of policy and institutional reform. Building on a sound foundation of prior or parallel analytic and advisory work, they involve incremental phasing and close monitoring of progress. The PSALs/PSACs that have been approved by the Board to date provide integrated and sustained Bank and donor support for government reform programs, including institutional reforms and capacity building.

7. **Quality.** The mixed performance of adjustment lending in the 1980s has been well documented in internal and external evaluations.<sup>8</sup> Debates on the efficacy of adjustment lending centered on whether episodes of disappointing country economic performance and uneven progress in policy reform represented failures to adjust, or failures of adjustment. These debates in turn influenced the design of subsequent operations. Outcome ratings convey the fairly robust message that the overall quality of Bank adjustment lending improved markedly during the 1990s.<sup>9</sup> OED outcome scores increased from 60 percent satisfactory in the 1980s to 68 percent in FY90-94, and then rose to 86 percent in FY99-00. (Weighted by disbursements, the scores for outcomes increased from 73 percent satisfactory in FY90-94 to 97 percent in FY99-00.) As with investment lending, ratings for sustainability and institutional development impact were lower than outcome ratings, suggesting room for improvement; but throughout the 1990s, all three OED scores for adjustment lending rose sharply.<sup>10</sup> Meanwhile, the improvements for investment lending were far less pronounced.<sup>11</sup> Improvements in the ratings for adjustment lending can be traced to several factors: strong improvements in borrower performance in a number of countries, especially upper-middle-income ones; greater selectivity by the Bank in providing adjustment lending to better-performing and turnaround countries; and efforts to incorporate the lessons from previous adjustment experience that are highlighted in this retrospective—including increased attention to borrower ownership, and loan design that is more customized to country circumstances.<sup>12</sup> Bank performance has also contributed to these improvements in terms of quality at entry: the Quality Assurance Group (QAG) rated 10 of the 11 CY99 adjustment operations it reviewed, or 93 percent of total adjustment loan commitments, as satisfactory or better.<sup>13</sup>

<sup>7</sup> The term ‘programmatically lending’ encompasses both investment loans/credits (such as Adaptable Program Loans) and adjustment loans/credits (such as PSALs/PSACs). For PSAL/PSAC guidelines, see the Operational Memorandum *Guidelines for Programmatic Adjustment Loans/Credits*, February 11, 2000.

<sup>8</sup> See the studies cited in footnote 3, and also Paul Mosley, Jane Harrigan, and John Toye, *Aid and Power: The World Bank and Policy-based Lending, Volume 1—Analysis and Policy Proposals* (New York: Routledge, 1991); Vinod Thomas, Ajay Chhibber, Mansoor Dailami, and Jaime de Melo, eds., *Restructuring Economies in Distress: Policy Reform and the World Bank* (Washington, D.C.: Oxford University Press for the World Bank, 1991); and *Adjustment in Africa: Reforms, Results, and the Road Ahead*, World Bank Policy Research Report (New York: Oxford University Press, 1994).

<sup>9</sup> OED defines satisfactory outcomes at exit as projects that have efficiently met or exceeded their major relevant objectives. See *1999 Annual Review of Development Effectiveness: Toward a Comprehensive Development Strategy*, No. 23, World Bank, Operations Evaluation Department, December 9, 1999, available at [www.worldbank.org](http://www.worldbank.org).

<sup>10</sup> In FY99-00, OED’s ratings were higher for SECALs (95 percent satisfactory) than for SALs (86 percent satisfactory), but comparisons of OED outcome ratings for SALs and SECALs over a longer period do not show a clear trend.

<sup>11</sup> OED notes that there are limits to the conclusions that can be drawn from a comparison of adjustment and investment loan outcomes. OED’s current methodology does not capture the long-term outcomes of adjustment lending programs, especially when evaluations are done soon after disbursements are completed; and work is under way to augment and refine it. Nonetheless, these ratings are broadly indicative of a steady improvement in the quality of adjustment operations.

<sup>12</sup> See *2000 Annual Review of Development Effectiveness: From Strategy to Results*, Report No. 21550, World Bank, Operations Evaluation Department, January 9, 2001, available at [www.worldbank.org](http://www.worldbank.org) (search ARDE).

<sup>13</sup> QAG’s quality-at-entry assessment evaluates the internal quality of Bank operations at the time of Board approval and the likelihood that these operations will meet their development objectives. The results reported are based on QAG’s third quality-at-entry assessment (QEA3) for a total of 80 projects approved by the Board in CY99; see *Quality at Entry in CY99—A QAG Assessment* (CODE2000-63), June 16, 2000.

8. **External Criticisms.** The Bank's approach to adjustment lending also has been shaped by the concerns raised by the development community, which have centered around three themes that largely relate to the content and focus of the programs supported by adjustment lending rather than to the instrument itself. First, many critics of adjustment programs maintain that the social costs are high, even while they accept that the costs of not adjusting can also be high. Several studies point to specific country experiences, particularly in Africa, with such adverse effects as increasing unemployment, real wage reductions, and deteriorating social indicators.<sup>14</sup> They also suggest that adjustment is often associated with growing inequalities,<sup>15</sup> and that many adjustment programs have neglected the distributional consequences and non-income aspects of poverty. In particular, some studies find that adjustment programs have not taken adequate account of constraints on women's ability to benefit from market opportunities.<sup>16</sup> On the other hand, analyses by OED and the Bank's research group, the Development Economics Group (DEC), have shown that poverty has been reduced and social conditions have improved in countries with well-implemented adjustment programs and sound policies for sustainable growth.<sup>17</sup> In particular, policies such as openness to international trade, low inflation, moderate government size, and strong rule of law generally benefit the incomes of poor people as much as those of anyone else; and some policies, notably stabilization of high inflation, may benefit the poor disproportionately.<sup>18</sup> A new World Bank research report on gender and development finds that when structural adjustment leads to renewed economic development, this can contribute to gender equality; for example, resulting increases in household income and firm-level demand for labor are commonly associated with the closing of gender gaps in human capital investments and in employment.<sup>19</sup> There also is evidence that adjustment lending and the associated economic policies do not have significant long-term effects on gender equity—either positive or negative— independent of their effect on income growth.<sup>20</sup> Second, the export promotion focus of many adjustment programs has raised concerns about unsustainable exploitation of forests and other natural resources. However, a recent study finds no consistent relationship between adjustment

<sup>14</sup> See, for instance, Kevin Watkins, *The Oxfam Poverty Report* (Oxford, U.K.: Oxfam Publishing, 1995); Esbern Friis-Hansen, *Agricultural Policy in Africa after Adjustment*, Center for Development Research (Copenhagen) Policy Paper, September 2000; and Pauline Peters, *Failed Magic or Social Context? Market Liberalization and the Rural Poor in Malawi*, Harvard Institute for International Development, Cambridge MA, November 1996.

<sup>15</sup> See Tony Killick, "Making Adjustment Work for the Poor," Overseas Development Institute Poverty Briefing 5: May 1999.

<sup>16</sup> See, for instance, *Women and Structural Adjustment*, Commonwealth Economic Papers 22, Commonwealth Secretariat, Economic Affairs Division, 1991; and Nilufer Catagay, Diane Elson, and Caren Grown, "Gender, Adjustment and Macroeconomics: Introduction," *World Development* 18(5):695-705, 1995; Diane Elson, "Gender Awareness in Modelling Structural Adjustment," *World Development*, Vol. 23, No. 11, 1995; Ingrid Palmer, "Public Finance from a Gender Perspective," *World Development*, Vol. 23, No. 11, 1995; Pamela Sparr, *Mortgaging Women's Lives: Feminist Critiques of Structural Adjustment*, (London: Zed Books, 1994); and Kevin Watkins, *The Oxfam Poverty Report*, op. cit.

<sup>17</sup> See Carl Jayarajah, William Branson, and Binayek Sen, *Social Dimensions of Adjustment: World Bank Experience 1980-93*, Operations Evaluation Study (Washington, D.C.: World Bank, 1996).

<sup>18</sup> See David Dollar and Aart Kraay, "Growth is Good for the Poor," *International Monetary Fund Seminar Series (International)*, No. 2000-35: 1-44, March 2000; Jan Vandemoortele and Enrique Delamonica, *Growth is Good for the Poor: A Comment*, UNICEF, New York, June 2000; and Kevin Watkins, *Growth with Equity is Good for the Poor*, Oxfam, June 2000.

<sup>19</sup> See *Engendering Development: Through Gender Equality in Rights, Resources, and Voice*, Policy Research Report (New York: Oxford University Press for the World Bank, 2001). On balance, there is evidence that adjustment lending and associated economic policies do not have significant effects on gender equity—either positive or negative— independent of their effect on income growth. See, for example, David Dollar and Roberta Gatti, *Gender Inequality, Income, and Growth: Are Good Times for Women?* Policy Research Report on Gender and Development, Working Paper, World Bank, Washington, D.C., 1999; and Nancy Forsythe, Roberto Korzeniewicz, and Valeria Durrant, "Gender Inequalities and Economic Growth," *Economic Development and Cultural Change* 48 (3), April 2000.

<sup>20</sup> See, for example, David Dollar and Roberta Gatti, *Gender Inequality, Income and Growth: Are Good Times Good for Women?* op. cit.; and Nancy Forsythe, Roberto Korzeniewicz, and Valeria Durrant, "Gender Inequalities and Economic Growth," op. cit.

lending and increased extraction of timber resources.<sup>21</sup> While recognizing that many adjusting countries suffered from economic mismanagement, critics suggest that adjustment programs have not fully addressed external factors such as terms of trade deterioration, barriers to exports, or debt accumulation. Some critics conclude that the growth and export performance of “non-adjustment lending” countries was superior to that of the countries that received loans.<sup>22</sup> At the same time, empirical studies generally find that openness to trade has beneficial effects on per capita incomes.<sup>23</sup> Third, some critics have stressed the importance of public discussion of trade-offs, as part of a larger discussion of public sector accountability and transparency of governments,<sup>24</sup> an issue that has received much prominence in the ongoing consultations on the Bank’s disclosure policy.<sup>25</sup>

## B. Content and Coverage

9. The content of adjustment lending has evolved in line with the changing development context. Created to help developing countries adjust their balance of payments after the 1979 oil shock, it focused in the 1980s on fiscal adjustment in response to external shocks and on removing obstacles to growth, with the idea of enabling countries to grow out of debt. The first decade of adjustment lending raised concerns that the emphasis on getting relative prices right paid too little attention to the social impact of countries’ economic adjustment and to institutional constraints in adjusting countries.<sup>26</sup> Reflecting these concerns, the Bank’s adjustment operations in the 1990s changed along a number of dimensions, with increased attention to poverty reduction, institutions, and complex social and structural reforms.

10. ***Poverty and Social Focus.*** The ultimate objective of adjustment lending, as of all Bank support, is to reduce poverty by establishing or restoring the conditions for equitable growth and sustainable development, and by preventing economic-financial crises or reversing unsustainable economic conditions that hurt the poor.<sup>27</sup> A careful assessment of available evidence suggests that the poverty and social focus of adjustment lending has increased over time, but still needs to be improved further. This is a major priority for our work going forward.

<sup>21</sup> A correlation between adjustment lending and increased extraction of timber is only found for currency devaluations, which are not normally part of World Bank conditionality. See David Wheeler and Kiran Pandey, “Structural Adjustment and Forest Resources: The Impact of World Bank Operations”, Development Economics Research Group, World Bank, January 2001, processed.

<sup>22</sup> See Paul Mosley, “Decomposing the Effects of Structural Adjustment: The Case of Sub-Saharan Africa,” in R. Van De Hoeven and F. Van Der Kraaij, *Structural Adjustment and Beyond in Sub-Saharan Africa* (Portsmouth, NH, and London: James Currey and Heinemann, 1994), pp. 70-98.

<sup>23</sup> See Jeffrey Frankel and David Romer, “Does Trade Cause Growth?” *The American Economic Review* (US); 89: pp. 379-399, June 1999.

<sup>24</sup> See T. Mkandawire, “Adjustment and Democratization” in Giovanni Andrea Cornia and Gerald Helleiner, eds., *From Adjustment to Development in Africa* (St. Martin’s Press, New York, 1994).

<sup>25</sup> See [www.worldbank.org/html/pic/disclosure/](http://www.worldbank.org/html/pic/disclosure/). On May 31, 2001 the Executive Board approved the public disclosure of the President’s Report for the first Poverty Reduction Support Credit—to Uganda—which in due course will be available in the Infoshop.

<sup>26</sup> See Giovanni Andrea Cornia, Richard Jolly, and Francis Stewart, eds., *Adjustment with a Human Face*, UNICEF (New York: Oxford University Press, 1987-88).

<sup>27</sup> Economic crises can be devastating to the poor. See Nora Lustig, *Crises and the Poor: Socially Responsible Macroeconomics*, Sustainable Development Department, Technical Paper Series, Inter-American Development Bank, Washington DC.; Francisco Ferreira, Giovanna Prennushi, and Martin Ravallion, *Protecting the Poor from Macroeconomic Shocks: An Agenda for Action in a Crisis and Beyond*, World Bank, Policy Research Working Paper 2160, PREM, Poverty Group, and Development Research Group, Poverty and Human Resources, August 1999.

- ***Trends in the 1980s.*** Early adjustment loans in the 1980s included little explicit poverty focus and consideration of the social impact of countries' economic adjustment—in part because of the widespread view at that time that getting relative prices right would on balance help the poor, and that social measures should be primarily addressed by parallel investment operations. In the event, the first-round reforms such as price and trade liberalization were not always accompanied by lasting reductions in poverty or improvements in social conditions.<sup>28</sup> There also was often insufficient analysis of the incidence of expenditure reductions as part of fiscal austerity programs, leading to cuts in health and education spending relative to other expenditures. In 1987, to strengthen the integration of social and poverty concerns in the structural adjustment process in Sub-Saharan Africa, and to foster the capacity of regional governments to do the same in the design of their own programs, the Bank—in collaboration with the United Nations Development Programme, the African Development Bank, and other multilateral and bilateral agencies—launched the Social Dimensions of Adjustment Project. Within five years, more than 30 countries had formally requested to take part in the project, which responded to the dual concern in countries for immediate action and for long-term institutional development.<sup>29</sup>
- ***Trends in the 1990s.*** Beginning in the late 1980s, and increasingly following the 1990 *World Development Report* on poverty, adjustment operations included measures to protect the poor and vulnerable through social expenditures and safety nets.<sup>30</sup> This is reflected in the increase in the share of explicitly poverty-focused adjustment operations as measured by the Poverty Reduction and Economic Management Network (PREM), from 47 percent in 1995 to 75 percent in 1999—though it is important to note that this measure focuses on the poverty objectives, not the poverty impact, of operations.<sup>31</sup> In parallel, there has also been a growing focus on social objectives—with the share of conditions in adjustment loans directly supporting social sector reforms increasing from 3 percent in FY80-88 to 18 percent in FY98-00.<sup>32</sup>
- ***Challenge for the 2000s.*** There clearly is still much room for improvement, especially in spelling out the strategy by which the policies and institutional reforms supported by the operations will contribute to poverty reduction and systematically

<sup>28</sup> For example, in African economies relatively higher prices for agricultural goods did not directly translate into higher incomes for poor farmers and wages for landless laborers, as long as there was no competition among traders and middlemen. See Esbern Friis-Hansen, *Agricultural Policy in Africa after Adjustment*, Centre for Development Research, Copenhagen, September 2000; Giovanna Cornia, *Liberalization, Globalization and Income Distribution*, Working Paper No.157, World Institute for Development Economics, Helsinki; and Kevin Watkins. *The Oxfam Poverty Report*, op. cit.

<sup>29</sup> See *The Social Dimensions of Adjustment Integrated Survey: A Survey to Measure Poverty and Understand the Effects of Policy Change on Households*, Working Paper Series, No. 14 (Washington, D.C.: World Bank, 1992).

<sup>30</sup> See *Poverty: World Development Report 1990* (New York: Oxford University Press for the World Bank, 1990).

<sup>31</sup> See *Poverty Reduction and the World Bank: Progress in 1999* (R2000-41), March 30, 2000, which followed an approach that classifies an adjustment loan as poverty-focused if it supports government efforts at poverty reduction in at least one of the following areas: (a) reallocating public expenditures in favor of the poor, (b) eliminating distortions and regulations that disadvantage the poor and limit their income-generating opportunities, or (c) supporting safety nets that protect the most vulnerable members of the population.

<sup>32</sup> The results are based on the share of binding conditions focused on the social sectors, including health, education, and social protection.

looking at the social and distributional consequences of key reforms. A recent review carried out by the Social Development Department for this retrospective finds that many operations included references to vulnerable groups, and that a majority of a sample of recent loans explicitly included separate poverty reduction components; however, a much smaller share zeroed in on the specifics either of the different vulnerable groups or of the measures to reduce/mitigate poverty.<sup>33</sup> QAG's CY99 quality-at-entry review rated investment operations substantially stronger than adjustment operations on poverty and social aspects, and stakeholder analysis and participation during loan preparation.

11. **Historical Trends.** Empirical analysis of the historical evidence on the impact of adjustment lending confirms these trends. Looking back over the past two decades and comparing countries with and without adjustment lending, the distributional and social impact of adjustment lending (beyond the effect on average incomes) appears to have been highly variable, but on balance limited and neither significantly positive nor significantly negative. Recent research indicates that adjustment episodes during FY80-98 that were supported by Bank and IMF adjustment lending helped smooth the incomes of the poor, curtailing the growth of poverty during economic contraction, but at the same time adjusting countries' inadequate policy environments and weak institutions limited the opportunities for the poor to share fully in the benefits of economic expansion.<sup>34</sup> There is also some systematic cross-country evidence that developing countries receiving adjustment loans in FY90-97 maintained and even increased social expenditures, on average as frequently as or more frequently than countries without adjustment loans. An analysis of trends in key education and health indicators—adult illiteracy, primary school enrolment, infant mortality, life expectancy, and immunization rates—in 430 cases of adjustment from FY80 to FY97 suggests improvements comparable to those in nonadjusting developing countries. While indicative of the role that adjustment lending can play, these results have important limitations.<sup>35</sup> The challenge now is to enhance the effectiveness of adjustment lending and other instruments in promoting poverty reduction.

12. **Structural Focus.** Adjustment lending has increasingly focused on long-run structural and institutional reforms, both across and within sectors. In the area of economic management, adjustment lending support has shifted from a short-term focus on stabilization and getting relative prices right to longer-term structural reforms to restore the basis for sustained growth. During the 1980s, adjustment lending mainly addressed fundamental distortions resulting from decades of import-substituting industrialization policies. During the 1990s, it increasingly supported reforms in public sector management, in the financial and private sectors, and in the

<sup>33</sup> The results are based on a review of 54 SALs/SECALs in 42 countries since 1997.

<sup>34</sup> See William Easterly, "IMF and World Bank Structural Adjustment Programs and Poverty," World Bank, Washington, D.C., April 2001, processed. These findings reinforce the message of the *World Development Report 2000/2001: Attacking Poverty* (New York: Oxford University Press for the World Bank, 2000), addressing the needs of poor people requires expanding economic opportunities by stimulating growth, making markets work better for the poor, and increasing poor people's inclusion by building up their assets through health care and education.

<sup>35</sup> For example, social expenditure may not always reach its intended beneficiaries, and there is no automatic link between basic social services and poverty reduction; aggregate social spending and social indicators do not capture the effects on specific vulnerable groups or the broader dimensions of poverty; and given the multifaceted nature of poverty, it is difficult, if not impossible, to attribute outcomes to specific operations. See Deon Filmer, Jeffrey Hammer, and Lant Pritchett, *Health Policy in Poor Countries: Weak Links in the Chain*, World Bank Policy Research Working Paper 1874, World Bank, Development Research Group, Poverty and Human Resources, January 1988; Vinod Thomas, et al., *The Quality of Growth* (Washington D.C.: World Bank, 2000).

social sectors. This change is reflected in a decline in the share of adjustment loan conditions in the areas of industry, energy, and agriculture policy from 22 percent in FY80-88 to 5 percent in FY98-00. Meanwhile, the share of public sector management conditions rose from 15 percent to 24 percent, and the share covering the financial and private sector from 28 percent to 41 percent.

13. ***Public Sector and Financial Management Focus.*** As many countries have removed economic distortions, adjustment lending is now increasingly supporting reform agendas associated with medium-term institution building. Almost a quarter of the conditions in FY98-00 loans surveyed by Operations Policy and Country Services (OPCS) included institution-building objectives, such as regulatory reform, the sale of public enterprises, and civil service restructuring.<sup>36</sup> Public sector reform measures, which traditionally emphasized public sector organizations and their management functions, now concentrate more on improving governance and accountability through institutional reform; thus the share of public sector reform conditions focused on civil service reform increased from 3 percent in FY80-88 to 29 percent in FY98-00. Concurrently, the critical developmental role played by borrowers' public expenditure, procurement, and financial management systems has been increasingly acknowledged and reflected in recent adjustment operations. The majority of adjustment operations are now underpinned by public expenditure reviews, and an increasing number by fiduciary assessments. But more economic and sector work (ESW) is needed in both areas if adjustment lending is to realize its full potential.

14. ***Financial and Private Sector Focus.*** Bank support for financial sector reform has also focused increasingly on institution-building measures. Including financial sector restructuring and the related corporate dimensions as well as the supervisory and regulatory framework, the share of financial sector conditions focused on financial institutions rose from 43 percent in FY80-88 to 63 percent in FY98-00, while those focused on liberalization of financial intermediation declined from 38 percent to 10 percent. Concurrently, the emphasis of measures to promote private sector development has shifted from the mere adoption of policies and the passage of laws to institutional development, capacity building, implementation of laws and policies, and improvements in procedures and systems—which is reflected in an increase of conditions supporting reforms in the regulatory framework and competition policies from 7 percent in FY80-88 to 32 percent in FY98-00.

15. ***Environmental Focus.*** Adjustment lending has involved environmental dimensions, both as part of conditionality and in terms of impact. The proportion of adjustment operations with environmental conditions has varied widely over time, averaging about 23 percent in the 1990s. However, the quality of coverage of environmental dimensions in adjustment operations has been rising, with QAG's CY99 quality-at-entry review showing the share of operations rated satisfactory increasing from 50 percent in 1998 to 77 percent in 1999. Notwithstanding the positive trends, only a small share of adjustment loans include environmental indicators as integral components of their monitoring and evaluation systems so as to enable impacts on the ground to be fully monitored. In accordance with OP/BP 4.01, *Environmental Assessment* (which requires environmental screening for sectoral adjustment loans, followed by an environmental assessment as appropriate), environmental screening was undertaken for all sector adjustment operations for which a Public Information Document was first issued after March 1, 1999.

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<sup>36</sup> Using a structured questionnaire, OPCS examined the loan documents of 107 adjustment operations approved in FY98-00.

### C. Conditionality

16. Given the special focus on instrument design, the retrospective used the operational lessons from earlier reviews of adjustment lending by OED<sup>37</sup> and DEC<sup>38</sup> to examine recent experience with adjustment lending in four areas, as spelled out below: country commitment and track record, number and complexity of conditions, tranching and phasing, and monitoring and evaluation.

17. ***Commitment and Track Record.*** Country ownership and reform readiness are key to effective adjustment and sustained development. They require both the commitment and the capacity to implement the reforms supported by Bank adjustment lending. Research on aid effectiveness indicates that when the country's commitment or implementation capacity is weak, conditionality is unlikely to be effective: In other words, conditionality by itself cannot lead to the adoption of better policies when there is no consensus for reform. Thus, before going ahead, the Bank must carefully assess the environment in which it plans to provide adjustment lending, mindful of the fact that appraising country ownership and readiness is a complex undertaking, and often the challenge is to identify reliable indicators and benchmarks that can serve as proxies for a judgment on the appropriateness of Bank adjustment support. The retrospective found that in the past few years, most—but not all—adjustment lending has gone to countries with above-average policy performance, for sectors where there was a track record of progress, and for issues for which where there was adequate supporting ESW. But work is needed to improve Bank performance in these areas, especially in analyzing the risks of going ahead where these conditions are not met.

18. ***Number and Complexity of Conditions.*** The number of conditions in adjustment loans has fallen significantly, from 61 conditions on average in the late 1980s to 33 conditions in FY00. At the same time, reflecting in part the growing long-run structural and institutional focus of countries' reform agendas, conditionality in Bank supported adjustment programs has grown more complex. According to OED, adjustment operations have grown more complex (86 percent of adjustment operations exiting in FY99-00, compared with 73 percent of adjustment operations exiting in FY90-94) and demanding (93 percent of adjustment operations exiting in FY99-00, compared with 82 percent exiting in FY90-94).<sup>39</sup> The OPCS survey of FY98-00 adjustment operations found that 24 percent were highly complex, and in 10 percent of the cases the likelihood of fulfilling conditions was judged, with hindsight, as unrealistic. Available evidence further suggests that adjustment loan outcome ratings rise as the number of conditions and complexity fall. Indeed, adjustment operations rated as more complex by OED also tended to have more waivers and lower ratings for outcomes and sustainability. Together these results can be substantially explained by the fact that the number of conditions tends to be higher and complexity tends to be a greater challenge in countries with weak performance and capacity, where adjustment lending is less successful. They highlight the ineffectiveness of attempts to address performance deficiencies and capacity limitations through a larger number of more

<sup>37</sup> In addition to the studies cited in footnote 3, see Carl Jayarajah and William Branson, *Structural and Sectoral Adjustment, World Bank Experience, 1980-92*, Operations Evaluation Study (Washington, D.C.: World Bank, 1995).

<sup>38</sup> See David Dollar and Lant Pritchett, *Assessing Aid: What Works, What Doesn't, and Why*, World Bank Policy Report (New York: Oxford University Press for the World Bank, 1998). See also Shantayanan Devarajan, David Dollar, and Torgny Holmgren, *Aid And Reform in Africa*, (Washington, D.C.: World Bank, 2001, available at [www.worldbank.org/research/aid/africa/intro.htm](http://www.worldbank.org/research/aid/africa/intro.htm)).

<sup>39</sup> OED found a similar trend for investment loans, but the ratings for substantial complexity (75 percent in FY99-00) and demandingness (82 percent in FY99-00) were lower than for adjustment loans.



complex and detailed conditions,<sup>40</sup> and confirm the central importance of continuing to concentrate adjustment support in countries with good policy and institutional environments.

19. ***Phasing and Tranching.*** A key challenge is to phase adjustment lending to support countries' increasing focus on complex medium-term structural and institutional reforms. Multiyear and multitranche operations are appropriate in some circumstances—in fact, reformers often welcome the opportunity to demonstrate their commitment and lock in multiyear reform programs through conditionality covering future actions.<sup>41</sup> However, many multiyear and multitranche operations run into implementation difficulties. For example, during FY90-99, 39 percent of two-tranche operations and 63 percent of three-tranche operations had waivers or cancellations. These patterns are especially pronounced for multiyear operations, given the practical problems of setting out during negotiations a detailed policy matrix covering actions to be taken several years later. An alternative approach is the use of a series of annual one- or two-tranche operations, with the medium-term (programmatic) framework specified at the outset, including completed up-front reform actions, monitorable progress indicators, and triggers for subsequent operations. Each of these operations would be discussed by the Board. In fact, OED's quality-at-exit assessment for FY98-00 rated single-tranche operations higher than multitranche operations in terms of satisfactory outcomes (100 percent vs. 80 percent) and sustainability (75 percent vs. 64 percent). OED's evaluations of the Africa Region's Higher Impact Adjustment Lending initiative also found that floating tranches provided considerable flexibility in timing and greater country ownership, especially when combined with the use of fewer but more focused conditions.<sup>42</sup>

20. ***Monitoring and Evaluation.*** Attention to borrower implementation and Bank supervision is as important to the effectiveness of adjustment programs as sound design and preparation. In the past, Bank supervision of adjustment loans has typically focused more on compliance with conditionality than on monitoring progress, outcomes, and impacts on poverty. Experience suggests that effective adjustment programs need to be designed to reflect on-the-ground institutional capacity in client countries and to include careful monitoring as an integral part of implementation, including (as appropriate) participation of local governments and civil society in the monitoring effort. Experience suggests that adjustment programs should monitor reform benchmarks that are clear on expected performance over the medium term while maintaining some scope for adaptation of the specific details of reform implementation to evolving country circumstances—as does programmatic adjustment lending involving a series of annual operations embedded in a medium-term program. To avoid shifting the burden of uncertainty to the borrower, performance indicators need to track policy actions that are within the control of the government. Based on a review of monitoring and evaluation arrangements in FY98-00 adjustment operations, OPCS found that more than half the adjustment operations surveyed included monitoring indicators that track progress in achieving loan objectives fully or at least to a substantial extent, with a small percentage having insufficiently specific benchmarks

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<sup>40</sup> For example, using the Country Policy and Institutional Assessment (CPIA), FY98-00 adjustment operations in countries with low policy performance ratings (CPIA ratings of 2.0-2.5) had 39 binding conditions on average, compared to 21 conditions on average in adjustment operations in countries with high policy performance ratings (CPIA rating of 4.5 or higher).

<sup>41</sup> See DEC case studies in Shantayanan Devarajan, David Dollar, and Torgny Holmgren, *Aid and Reform in Africa*, op. cit.

<sup>42</sup> See *Higher Impact Adjustment Lending (HIAL)—Initial Evaluation*, Operations Evaluation Report No. 19797, June 29, 1999; and *Higher Impact Adjustment Lending (HIAL) in Sub-Saharan Africa: An Update*, Chief Economist's Office, Africa Region, World Bank, November 25, 1998.



for assessing implementation progress. But, as judged by the write-ups in President's Reports, few operations fully spelled out the specific implementation arrangements needed for the program. Clearly, this is a priority for attention in future operations.

#### **D. Issues for Discussion**

21. The evolution of adjustment lending suggests that there may be scope in the Bank's support for country programs for greater reliance on a new generation of adjustment lending—with a stronger development orientation—incorporating the lessons learned from the past two decades of experience. However, the specific modalities need further discussion and debate. Against this background, the Board discussion of the adjustment lending retrospective on May 9, 2001, focused on the following issues:

- ***Country Selectivity.*** Research, evaluation findings, and operational experience all highlight the importance of a favorable policy and institutional environment for successful adjustment lending. Indeed, a large part of the improvement in adjustment lending outcomes during the 1990s reflects the increased country selectivity of the Bank's adjustment lending decisions. Adjustment lending to countries with poor track records cannot be ruled out, but it must be used with extreme caution, grounded in a careful assessment of risks and rewards that demonstrates the likelihood of a turnaround. ESW-based advice and capacity building are better suited to nurturing support for reforms in their early stages.
- ***Tranching and Conditionality.*** There are many options for tranching and phasing adjustment lending, but not all are appropriate for all country and sectoral situations. For strong performers with good track records, programmatic approaches using a series of annual *single-tranche* operations under a medium-term framework may be most appropriate. Programmatic approaches may also be useful for other countries with sound reform program but more limited capacity and less strong track records—albeit using a series of annual *multitranche* rather than single-tranche operations and, wherever possible, conditionality relating to prior actions rather than promises. Traditional multiyear, multitranche designs may be appropriate, especially for supporting in-depth sectoral reforms. One-off single-tranche operations should remain the exception, in line with current policy and practice.
- ***Fiduciary Assessment.*** An important part of the increased developmental orientation of adjustment lending has been the explicit focus on good governance, with support for public sector management reforms accounting for a large share of the increase in adjustment lending in recent years. These developments put a premium on ESW to assess countries' public expenditure, procurement, and financial management systems, and set out an action plan for addressing priority policy reforms and capacity building and for inclusion as appropriate in loan conditionality.
- ***Share of Lending.*** According to OD 8.60, adjustment lending should not normally exceed 25 percent of lending on a rolling three-year basis, averaged over IBRD and IDA, while not exceeding 30 percent for IDA. This was adopted as a pragmatic guideline in the late 1980s and early 1990s on the basis of conditions prevailing at the

time. Since then, the share of adjustment lending has grown, rising sharply in the aftermath of the East Asian crisis and decreasing afterwards. But it still remains above 25 percent, as investment lending to IBRD borrowers has declined, while adjustment lending has not. Given the analysis of the Task Force on the World Bank Group and the Middle-Income Countries on the outlook for investment lending, maintaining the 25 percent guideline would likely require a cutback in adjustment lending—and in total lending—to middle-income countries.

- ***Bank-Fund Collaboration.*** The Bank and Fund have a long-standing framework for working together. This collaborative framework has recently been enhanced in low-income countries, including through the Heavily Indebted Poor Country Initiative and Poverty Reduction Strategy Papers (PRSPs), with the IMF focusing on its core macroeconomic and related structural areas of responsibility and the Bank on social, structural, and sectoral issues. The Task Force on the World Bank Group and the Middle-Income Countries has recommended that operational collaboration be strengthened in middle-income countries, following principles broadly similar to those in low-income countries. Operationalizing this recommendation will have important implications for the content, tranching, and timing of adjustment operations, with a premium on coordination of mission schedules, analytic work, and the policy dialogue—all in support of country program and policy cycles.
- ***Social and Environmental Impact.*** During the 1990s, adjustment lending gave increased attention to poverty-focused objectives and the mitigation of possible adverse impacts of reform measures. Nonetheless, for the future it will be important to make these approaches more systematic and transparent, with the President's Reports for adjustment operations spelling out how the policies and institutional reforms they support will contribute to the achievement of country and CAS objectives. The World Bank and the IMF are developing a systematic approach to social impact analysis of macroeconomic and structural reforms, including the development of further diagnostic tools. This approach and corresponding tools can be used in the development of PRSPs and to underpin the poverty reduction support credits and IMF arrangements under the Poverty Reduction and Growth Facility that support them. More generally, it will be important to address the broader dimensions set out in the *World Development Report 2000/2001*, paying attention to the need to promote a level and quality of economic growth and sustainable development that result in poverty reduction and progress toward meeting the international development goals, including those for environmental sustainability.<sup>43</sup>

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<sup>43</sup> See *World Development Report 2000/2001: Attacking Poverty*, op. cit.; and *2000, A Better World for All: Progress towards the International Development Goals*, jointly issued by the IMF, Organization for Economic Co-operation and Development, the United Nations, and the World Bank Group (Washington, D.C.: International Monetary Fund, 2000), available at [www.paris21.org](http://www.paris21.org).

# ADJUSTMENT LENDING RETROSPECTIVE

## I. INTRODUCTION

1. This retrospective takes stock of trends in, and approaches to, adjustment lending, drawing lessons from earlier reviews and from fresh research and analysis. It is intended to provide background for a discussion of adjustment lending instruments and contribute to the update of Operational Directive (OD) 8.60, *Adjustment Lending Policy*, and its conversion into the Operational Policy/Bank Procedure (OP/BP) format. Following this brief introductory section, Chapter II summarizes the main trends in quantity and quality of adjustment lending. Chapter III analyzes the evolution of the content of adjustment lending. Chapter IV takes up key country and design dimensions of conditionality. Chapter V presents conclusions. And finally, Annexes A to D discuss experience with subnational adjustment loans, special structural adjustment loans, programmatic structural adjustment loans, and single-tranche loans; Annex E summarizes the findings of previous Bank studies of adjustment lending.

## II. QUANTITY AND QUALITY

2. Over the past two decades, adjustment lending has been evolving to meet the challenges of development and poverty reduction. While the nature and approach of the instruments have changed, the ultimate objective of adjustment lending has remained the same: to prevent or reverse unsustainable economic conditions that hurt the poor and to establish or restore the conditions for sustainable development that can help reduce poverty. First introduced in 1980 to help countries with severe balance of payments problems, adjustment lending quickly became a mainstay of the Bank's development instruments, but had a very mixed performance record. The Bank applied the lessons of experience in later operations; and during the 1990s, adjustment lending ratings for outcomes,<sup>1</sup> sustainability, and institutional development impact improved substantially. In response to client demands, new approaches to adjustment lending were introduced: structural adjustment loans/credits (SALs/SACs) were supplemented by sector adjustment loans/credits (SECALs/SECACs) in the early 1980s; and in the 1990s, subnational adjustment loans (SNALs) and programmatic adjustment loans/credits (PSALs/PSACs) were introduced in response to the evolving reform agenda. Later in the decade, the needs of countries affected by the East Asia crisis prompted the Bank to introduce special structural adjustment loans (SSALs) as an instrument for countries facing exceptional financing needs because of economic shocks.<sup>2</sup> During this period of economic distress for many borrowers, Bank adjustment

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<sup>1</sup> OED defines satisfactory outcomes at exit as projects that have efficiently met or exceeded their major relevant objectives. See *1999 Annual Review of Development Effectiveness: Toward a Comprehensive Development Strategy*, No. 23, World Bank, Operations Evaluation Department, December 9, 1999, available at [www.worldbank.org](http://www.worldbank.org) (search ARDE). It is important to note that outcome ratings refer to the extent to which an operation achieved its major objectives in a cost-efficient way. When the rating is done soon after loan closing, it may not necessarily capture long-term effects, and satisfactory ratings do not necessarily indicate that borrowers' overall economic and social performance is successful.

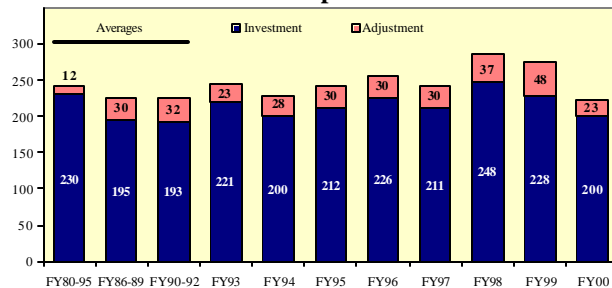
<sup>2</sup> Besides these adjustment loans, the Bank also provides *rehabilitation loans*, which support government policy reform programs and foreign exchange requirements for urgent rehabilitation of key infrastructure and productive facilities targeted to the private sector, and *debt reduction loans*, which help highly indebted countries reduce commercial debt and debt service to a manageable level as part of a viable medium-term financing plan in support of sustainable growth objectives. This paper does not discuss rehabilitation and debt reduction loans.

lending for the first time surpassed investment lending in volume. This chapter looks in greater detail at these aspects of the evolution of adjustment lending.<sup>3</sup>

## A. Quantity of Adjustment Lending: Distribution, Costs, and Approaches

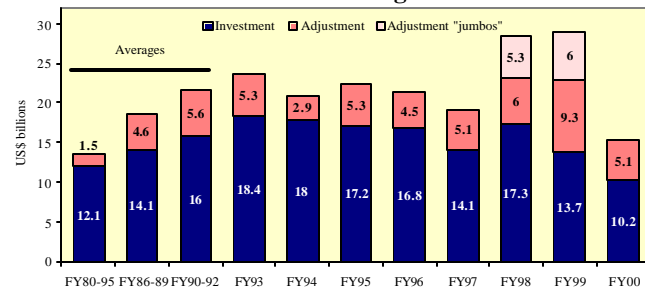
3. The Bank has provided program loans for nonproject financing since its earliest years.<sup>4</sup> Adjustment lending was introduced in 1980, in the aftermath of the second oil shock, to provide temporary balance of payments financing to member countries while stabilization and adjustment measures took effect.<sup>5</sup> In the 1980s, the Board approved 191 adjustment operations in 64 countries for a total of US\$27.1 billion. During the 1990s, the total volume of adjustment lending increased to US\$71.7 billion for 346 operations in 98 countries. From 1980 to 2000, the Bank's 537 adjustment operations supported programs in 109 countries—an annual average of 26 adjustment operations at about US\$184 million per loan. In FY99, when Bank lending spiked in response to the crisis in East Asia and other emerging markets, the Bank made an unprecedented 48 adjustment loans (see Figure 1). Among these loans were several large structural adjustment loans (so-called jumbo SALs), which were largely responsible for the great increase in adjustment lending volumes; in FY99, in fact, for the first time ever, adjustment lending surpassed investment lending in volume (see Figure 2).

**Figure 1. Number of World Bank Adjustment and Investment Operations since 1980**



Source: Staff calculations based on SAP data.

**Figure 2. Volumes of World Bank Adjustment and Investment Lending since 1980**



Source: Staff calculations based on SAP data.

### 1. Share of Bank Lending

4. OD 8.60, *Adjustment Lending Policy*, included a guideline on the share of adjustment lending commitments, stating that “adjustment lending should not normally exceed 25 percent of Bank or IDA lending, aggregated over the Bank as a whole and averaged over a three-year period, and should not under any circumstances exceed 30 percent for IDA.” This guideline, introduced as a pragmatic step based on the share of adjustment lending at that time, reflected two considerations:

<sup>3</sup> The Bank offers two basic types of lending instruments: investment loans (which typically have a long-term focus of 5 to 10 years and finance goods, works, and services), and adjustment loans (which typically have a shorter time horizon of 1 to 3 years and provide quick-disbursing external financing to support policy and institutional reforms). For an overview, see *World Bank Lending Instruments: Resources for Development Impact*, Operations Policy and Strategy, World Bank, July 2000.

<sup>4</sup> Program lending was approved by the Executive Directors in 1946, and the Bank's first three loans were program loans. See *A Review of Program Lending Policy and Practice* (R76-207), August 10, 1976; and *A Note on Program Lending* (SecM80-150), February 19, 1980.

<sup>5</sup> See *Lending for Structural Adjustment* (R80-22), February 5, 1980.

- **Legal.** The Bank’s Articles of Agreement provide that Bank loans should finance specific projects, “except in special circumstances.”<sup>6</sup> Adjustment loans, which do not indicate the specific uses to which their proceeds are to be put, have been justified on the basis of the “special circumstances” provision. While the guidelines in the OD have served as a mechanism for circumscribing the amount of adjustment lending, the Articles do not require that adjustment lending be kept within a predetermined portion of the Bank’s lending operations. An event or condition spanning one or more financial years may constitute a special circumstance if the particular situation is such as to justify a departure from the general rule. The determination of what is a special circumstance may be left for the Executive Directors to make on a case-by-case basis, with the only other condition being that the loan fall within the general purposes of the Bank.
- **Financial.** From a financial perspective, adjustment lending by its nature does not present more or less risk to the Bank than investment lending, since the Bank’s exposure to sovereign credit is the same. Adjustment lending can, however, introduce faster increases in exposure because of changing disbursement patterns. Since adjustment lending has a more accelerated disbursement profile than investment lending, it has the potential to increase the stock of the Bank’s net exposure faster than a comparable level of commitments for project loans.<sup>7</sup> The Bank’s ability to absorb such increased risk would depend on its initial risk position, the risk distribution among borrowers receiving adjustment loans, and the tranching. If adjustment lending becomes more predictable and is not limited to countries experiencing major difficulties—as would be the case with programmatic adjustment lending—it would offer advantages for financial management by reducing volatility in net disbursements and, therefore, risk patterns. From this perspective, the 25 percent guideline is a reminder of the intrinsic trade-offs that might need to be made in the Bank’s finances if the proportion of adjustment loans were to rise materially, such as by accepting extra capital risk, injecting fresh capital, or reducing other loan commitments. At the same time, the 25 percent guideline could be seen as somewhat redundant to the extent that the Bank has adequate systems and processes to signal impending increased demands on capital.

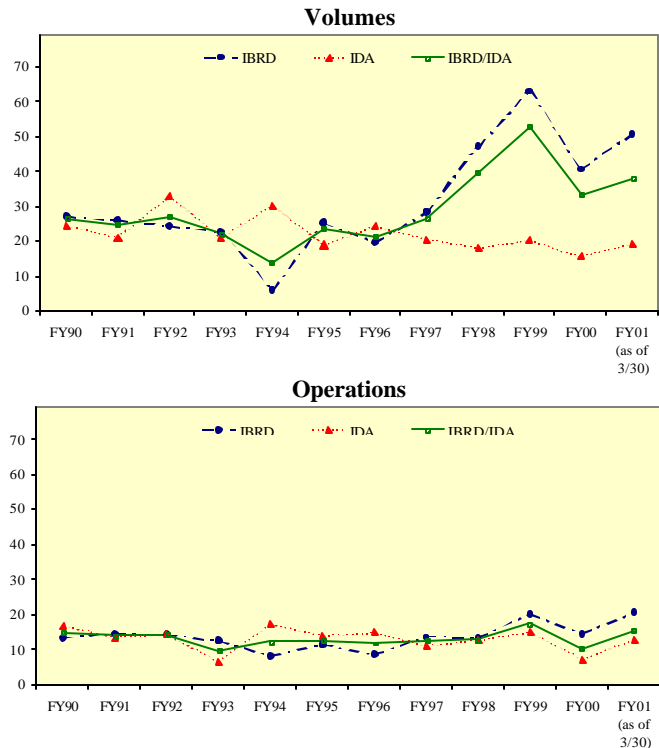
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<sup>6</sup> See *IBRD Articles*, Article III, Section 4 (vii); and *IDA Articles*, Article V, Section 1(b). See also Ibrahim Shihata, *Authorized Purposes of Loans Made or Guaranteed by the Bank*, Memorandum of the Vice President and General Counsel (SecM88-517), April 8, 1988, for a discussion of the “special circumstances” under which the Bank’s Articles of Agreement authorize adjustment lending. Special circumstances have been broadly interpreted to mean such circumstances as may, in the judgment of the Executive Directors, justify a departure from the general rule, whether these circumstances are country-specific, relate to a certain period of time, or result from a general economic situation affecting some or all borrowing countries. The Articles do not define such circumstances, and they provide the Bank with latitude to determine when such circumstances are present.

<sup>7</sup> With the Bank ensuring that it has enough IBRD capital/IDA resources to back adjustment lending, this translates into a relatively faster increase in the demands on the Bank’s risk-bearing capacity, and thus a more rapid required accumulation of reserves. To the extent that such funds are not available, a sudden significant rise in adjustment lending could produce pressures in a transition period, with a deterioration of the Bank’s risk and capital adequacy measures (such as its projected equity-to-loans ratio and its cash-flow-shock capital adequacy test).

5. **Experience.** Over the years, the share of adjustment lending has broadly followed this guideline. Before FY98, the three-year average share of adjustment in total lending exceeded 25 percent only during FY89-92, peaking at 27 percent in FY90, primarily as a consequence of the Bank's contributions to Latin American debt reduction initiatives. In FY99, at the time of the East Asia crisis, adjustment lending surpassed investment lending and constituted more than half of the Bank's total lending. More recently, the share of adjustment lending has fallen back to the precrisis level of US\$5.1 billion for 23 operations, about one-third of total Bank commitments and 10 percent of all operations (see Table 1). Most of the temporary increase in volumes was due to larger loans to IBRD countries, while the share of IDA countries remained fairly stable (Figure 3). The sudden increase in the share during the East Asia crisis raised the question of the relevance of the 25 percent guideline. It is expected that this issue will be taken up in the planned revision of OD 8.60.

**Figure 3. Adjustment Lending Share of IBRD, IDA, IBRD/IDA, FY90-01**



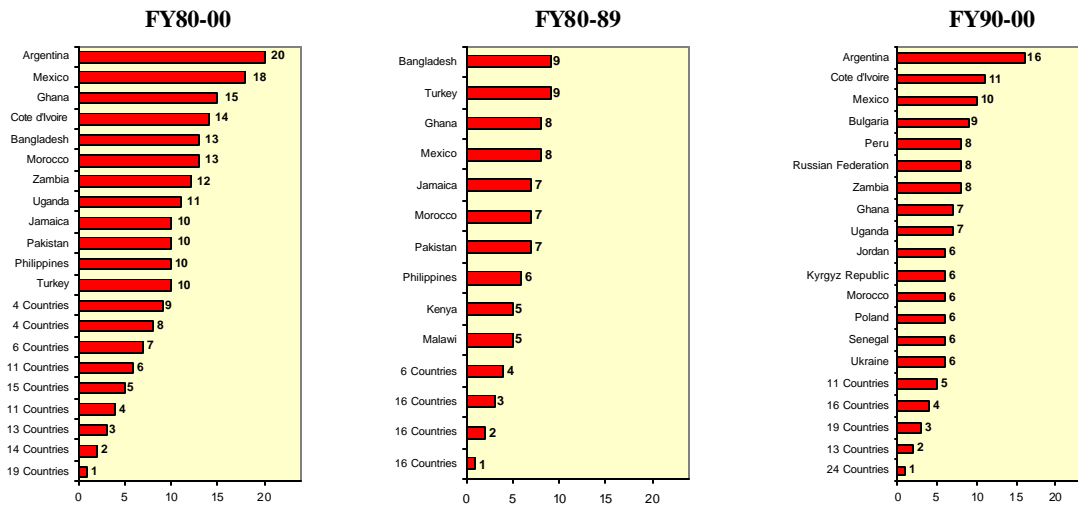
**Table 1. World Bank Adjustment Lending**

Category	FY80	FY85	FY90	FY95	FY99	FY00
Total IBRD & IDA commitments (US\$000)	11,482	14,384	20,702	22,522	28,994	15,277
Adjustment lending (US\$000)	425	1,608	5,479	5,324	15,326	5,107
Adjustment lending (percent share of total)	3.7	11.2	26.5	23.6	52.9	33.4
Number of loans	6	14	33	30	48	23

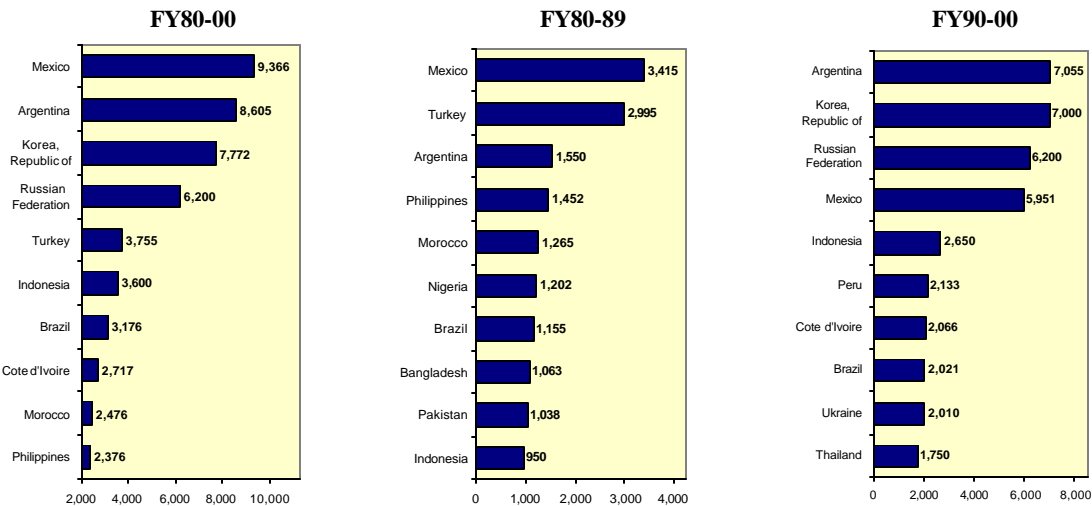
Source: Staff calculations based on SAP data.

## 2. Distribution by Borrowers

6. Over the last two decades a large number of countries have received repeated adjustment loans. Three countries (Argentina, Ghana, and Mexico) have received 15 or more adjustment loans since 1980 (see Figure 4), and the number of repeat borrowers has increased over time. In the 1980s, 25 percent of recipient countries undertook four or more adjustment operations, a share that increased to 42 percent during the 1990s. Many of the largest adjustment lending borrowers over the past two decades have been repeat borrowers (see Figure 5). Indeed, four of the 10 top borrowers in the 1980s continued to borrow heavily in the 1990s. Adjustment lending has become more concentrated through the years: in FY92-00, 39 percent of all adjustment lending went to four countries—Argentina, Mexico, Republic of Korea, and Russia—while the remaining 61 percent was divided among all other adjustment borrowers. During the East Asia crisis years, the share of these four countries rose to 55 percent.

**Figure 4. Number of Adjustment Loans by Country**

Source: Staff calculations based on SAP data.

**Figure 5. Top Borrowers of Adjustment Loans (US\$ millions)**

Source: Staff calculations based on SAP data.

### 3. Adjustment Lending to Low- and Middle-Income Countries

7. In the 1980s, IDA countries received a lower share of adjustment operations than IBRD countries, whereas during the 1990s they received almost as many (see Table 2). This pattern was very similar to the distribution of investment loans between IBRD and IDA. However, IBRD countries accounted for more than 75 percent of overall adjustment lending volumes—with a small increase in the share for IDA countries from 16.9 percent in the 1980s to 20.4 percent in the 1990s. In FY00, IBRD countries received 14 adjustment operations for US\$4.4 billion, accounting for 41 percent of IBRD lending; IDA countries received 9 adjustment operations for US\$970 million, or 15 percent of all IDA lending.



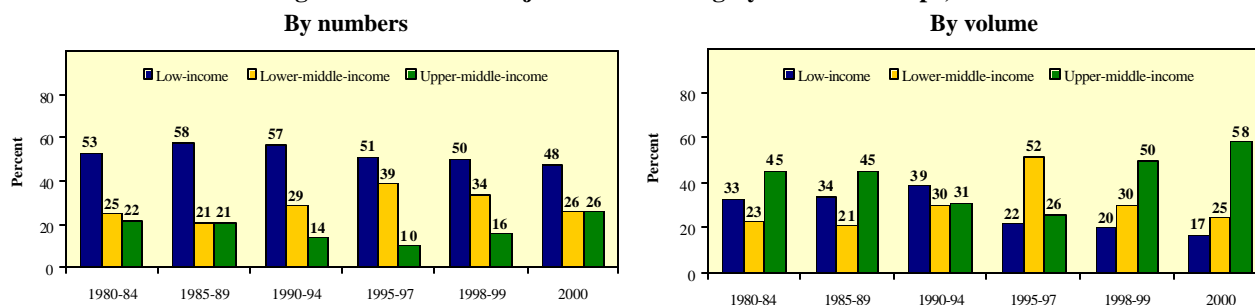
Table 2. IBRD/IDA Adjustment and Investment Lending

Lending instrument type	Number				Volume (US\$ 000)			
	FY80-89	FY90-00	Total	%	FY80-89	FY90-00	Total	%
<b>Adjustment</b>								
IBRD	101	169	270	50.3	21,801	54,983	76,784	77.7
IDA	84	166	250	46.6	4,584	14,627	19,211	19.4
Blend	6	11	17	3.2	703	2,090	2,793	2.8
<b>Total</b>	<b>191</b>	<b>346</b>	<b>537</b>	<b>100.0</b>	<b>27,088</b>	<b>71,700</b>	<b>98,788</b>	<b>100.0</b>
<b>Investment</b>								
IBRD	1,149	1,120	2,269	50.6	92,907	115,265	208,172	68.9
IDA	949	1,115	2,064	46.0	26,574	46,905	73,479	24.3
Blend	68	86	154	3.4	8,918	11,410	20,328	6.7
<b>Total</b>	<b>2,166</b>	<b>2,321</b>	<b>4,487</b>	<b>100.0</b>	<b>128,399</b>	<b>173,580</b>	<b>301,979</b>	<b>100.0</b>
<b>All instruments</b>								
IBRD	1,250	1,289	2,539	50.5	114,708	170,248	284,956	71.1
IDA	1,033	1,281	2,314	46.1	31,158	61,532	92,690	23.1
Blend	74	97	171	3.4	9,621	13,500	23,121	5.8
<b>Grand total</b>	<b>2,357</b>	<b>2,667</b>	<b>5,024</b>	<b>100.0</b>	<b>155,487</b>	<b>245,280</b>	<b>400,767</b>	<b>100.0</b>

Source: Staff calculations based on SAP data.

8. **Lending by Income Categories.** The number and volume of adjustment loans differ across the three broad groups of countries classified by per capita income—upper-middle-income, lower-middle-income, and low-income.<sup>8</sup> As Figure 6 illustrates, low-income countries have received more adjustment loans, but upper-middle-income countries have received greater adjustment volumes. At first, upper-middle-income countries immersed in the debt crisis commanded up to 45 percent of adjustment volumes. Once the debt crisis ended, the richer group obtained access to capital markets and refrained from adjustment borrowing; thus the share of Bank adjustment lending for low-income countries reached 39 percent in FY90-94, and the share for lower-middle-income countries reached 52 percent in FY95-97. At the time of the East Asia crisis, the upper-middle-income group came back for adjustment lending, accounting for 50 percent of adjustment volumes during FY98-99 but only 16 percent of the countries receiving adjustment lending. Conversely, low-income countries received 20 percent of adjustment lending volumes and 50 percent of adjustment operations.

Figure 6. Share of Adjustment Lending by Income Groups, FY80-99



Source: Staff calculations based on SAP data.

<sup>8</sup> To determine lending terms, the Bank assigns countries by per capita GNP to income categories I through V (see OP 3.10, Annex D1, *Countries Ranked by Per Capita Income*). *Low-income countries* are those in Category I; *lower-middle-income countries* are those in Categories II and III; and *upper-middle-income countries* are those in Categories IV and V.



#### 4. Cost and Speed of Preparing Adjustment Operations

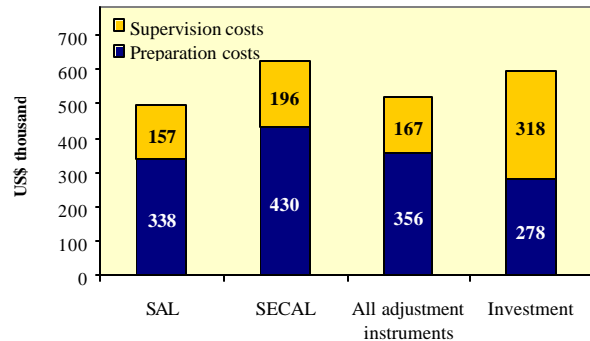
9. The key measure of successful adjustment lending is its contribution to sustainable growth that reduces poverty. However, in preparing budgets for country programs, it is essential to have the facts on preparation costs to ensure that they are fully funded. In FY90-00, average completion costs (including preparation and supervision) for adjustment operations were US\$523,000, compared to US\$596,000 for investment loans (see Figure 7). On average, the cost of supervision for adjustment operations was 53 percent of that for investment loans—US\$167,000 compared to US\$318,000. SECALs are somewhat more costly than SALs, with average completion costs of US\$626,000 compared to US\$496,000 for SALs. In sum, looking at costs to the Bank from start to finish, adjustment lending costs 12 percent less per operation than investment lending—28 percent more to prepare, but 47 percent less to supervise.

10. **Preparation Time.** Adjustment loans are often prepared in response to economic shocks. Not only is their preparation time much shorter than that of an average investment loan, but also the period from project concept document to Board approval has dropped sharply since FY95, to less than 8 months for a SAL and about 13 months for a SECAL (see Figure 8).

#### 5. Types of Adjustment Loans

11. To serve borrowers' particular needs, the Bank has developed various types of adjustment loans. Adjustment lending began with what became the standard SAL/SAC, aimed at economywide macroeconomic stabilization and comprehensive policy reform to help reduce poverty. In 1982, the SECAL/SECAC was introduced to support sector-specific reforms. The Bank has approved roughly equal numbers of SALs (255) and SECALs (233), together accounting for over 90 percent of all Bank adjustment operations (see Table 3). In recent years, several new approaches to adjustment lending have been added (see descriptions in Box 1). This section briefly summarizes the Bank's experience with several of these adaptations.

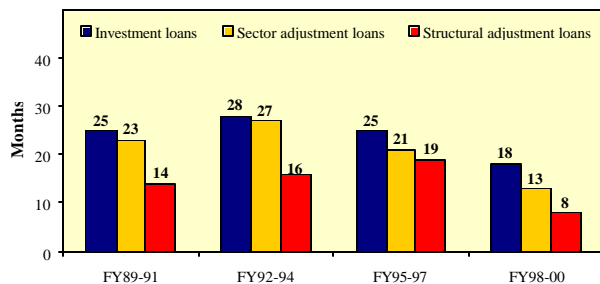
**Figure 7. IBRD/IDA Average Completion Costs by Lending Instrument, FY90-00**



Note: Figures reflect direct costs only.

Source: Staff calculations based on SAP data.

**Figure 8. Preparation Time by Lending Instrument**



Source: Staff calculations based on SAP data.

**Table 3. Types of Adjustment Loans, FY80-00**

	<i>Fiscal Years</i>	<i>SAL</i>	<i>SECAL</i>	<i>PSAL</i>	<i>SSAL</i>	<i>SNAL</i>	<i>DRL<sup>a</sup></i>	<i>RIL<sup>a</sup></i>	<i>Total</i>
Volume (US\$m)	1980-89	9,650	17,438						27,088
	1990-97	15,307	19,135				2,713	2,818	39,973
	1998-00	19,481	5,919	630	5,051	551	85	10	31,727
	1980-00	44,438	42,492	630	5,051	551	2,798	2,828	98,788
Share of volume (%)	1980-89	36	64	0	0	0	0	0	100
	1990-97	38	48	0	0	0	7	7	100
	1998-00	61	19	2	16	2	0	0	100
	1980-00	45	43	1	5	1	3	3	100
No. of operations	1980-89	88	103						191
	1990-97	109	100				10	19	238
	1998-00	61	30	3	6	5	2	1	108
	1980-00	258	233	3	6	5	12	20	537
Share of operations (%)	1980-89	46	54	0	0	0	0	0	100
	1990-97	46	42	0	0	0	4	8	100
	1998-00	56	28	3	6	5	2	1	100
	1980-00	48	43	1	1	1	2	4	100

<sup>a</sup> Debt reduction loans (DRLs) and rehabilitation loans (RILs) are included here to give a complete picture of Bank adjustment lending, but are not discussed in further detail in this report.

Source: Staff calculations based on SAP data.

### Box 1. Types of Adjustment Loans

Adjustment loans provide quick-disbursing assistance to countries with external financing needs, to support policy and institutional reforms needed to encourage the sustained and equitable growth that are essential for poverty reduction. There are several different types of adjustment loans:

**Structural adjustment loans (SALs)** support reforms that promote growth, efficient use of resources, and sustainable balance of payments over the medium and long term.

**Sector adjustment loans (SECALs)** support policy changes and institutional reforms in a specific sector.

**Programmatic structural adjustment loans (PSALs)** consist of a multiyear framework of phased support for a medium-term government program of policy reforms and institution building. The PSAL involves a series of adjustment loans over three to five years, each building on the preceding one(s), that provide funding for the government's medium-term reform program. The medium-term framework typically focuses on capacity and institution building in the public sector—strengthening governance, budgetary processes, and efficiency of service delivery—and on sustained, sequential structural and social reforms.

**Special structural adjustment loans (SSALs)** provide support for structural and social reforms to creditworthy borrowers approaching a possible crisis, or already in crisis, and with exceptional financing needs. By taking advantage of windows of opportunity for such reforms, these loans help countries prevent a crisis or, if one occurs, mitigate its adverse economic and social effects. Thus, the main justification for a SSAL is the structural origin of a crisis and its major social consequences. The Bank and the borrower reach agreement on structural, social, and macroeconomic policy reforms. SSALs are part of an international support package.

**Subnational adjustment loans (SNALs)** support policy changes and institutional reforms at the subnational level (provinces and states), with a focus on the subnational incentive and regulatory framework, institutional capability, and subnational expenditure programs and mitigation of social costs.

#### a. Sector Adjustment Loans

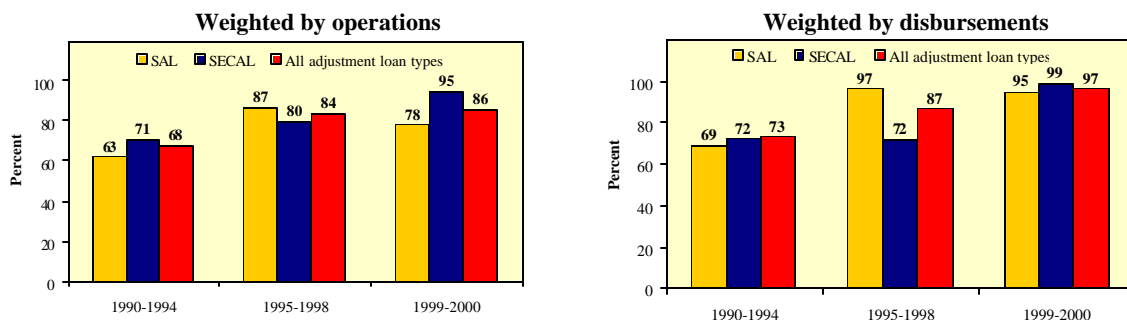
12. SECALs tend to have several general characteristics that distinguish them from SALs. As Figure 8 showed, SECALs have longer lead times, on average five months more than SALs.

SECALs are typically more focused on a single sector, often involving a single government agency that is responsible for implementing the reforms. As a result, SECALs may have comparatively deeper borrower ownership. A survey by the Bank's Operations Policy and Country Services (OPCS) suggests that SECAL conditionality in recent years has tended to be relatively more focused than that of SALs.<sup>9</sup> (Earlier research indicated that better-focused adjustment operations are generally more effective—a theme that is discussed in more detail in Chapter III.) Since SECALs are more likely to have direct effects at the sectoral level, they are also subject to specific operational policy requirements for environmental assessments.<sup>10</sup> In practice, however, the definition of an adjustment operation as either SAL or SECAL is often more a matter of degree, depending on how sectorally focused the operation is.

13. **Experience with SECALs.** The 233 SECALs the Bank approved until FY00 have a total value of US\$43.5 billion, and they represent 44 percent of both the total number of adjustment operations (537) and total adjustment lending volumes (US\$98.9 billion). During the 1980s, SECALs accounted for 54 percent of adjustment operations and 64 percent of adjustment commitments; they peaked in FY85 with 79 percent of adjustment operations and 90 percent of adjustment commitments. During the 1990s, the shares of SECALs in adjustment lending dropped to 35 percent of volume and 37 percent of operations. The decline can be attributed to the increased use of broad-based, cross-sectoral adjustment loans in transition economies and emerging markets affected by the East Asia crisis in the late 1990s. However, although the share of SECALs declined, the average SECAL commitment increased during the 1990s.

14. **Quality.** Average ratings of SALs and SECALs vary on a year-by-year basis; SALs may outperform SECALs in a given year and then fall behind SECALs in the next. During the 1990s, SECALs generally improved in quality—with outcomes weighted by operations improving from 80 percent satisfactory in FY95-98 to 95 percent in FY99-00—and they now perform more strongly than SALs on all exit measures (see Figure 9). When weighted by disbursements, the improvement is even more pronounced, as the share of SECALs with satisfactory outcomes rose from 72 percent in FY95-98 to 99 percent in FY99-00. The fact that SECAL ratings are higher than those of SALs may be partially explained by the fact that unsatisfactory outcomes of SALs in the Africa Region (which had few SECALs) drove down the overall share of satisfactory SAL outcome ratings in FY99.

**Figure 9. Quality at Exit: Satisfactory Outcomes by SAL/SECAL**



Note: Figures for FY00 are preliminary.

Source: Staff calculations based on OED data.

<sup>9</sup> The survey analyzed more than 100 FY98-00 adjustment loans.

<sup>10</sup> See OD 8.60, *Adjustment Lending*, December 1992; and the Operational Memorandum *Clarification of Current Bank Policy on Adjustment Lending*, June 5, 2000.

### ***b. Subnational Adjustment Loans***

15. Over the past two decades, subnational governments have grown in importance—for example, in India, Latin America, the countries of the former Soviet Union, and China. Often, services that are important to poor people—for example, highways, irrigation systems, urban transport systems, social services, and agricultural extension—are the responsibility of the state or municipality, and the national government has little authority to bring about sector reforms or to finance the costs of reform. Direct lending to the responsible government offers a suitable way to support improvements in the delivery of these services. For this reason, the Bank introduced SNALs.<sup>11</sup> (Annex A discusses experience with SNALs in greater detail.)

16. ***Experience with Subnational Adjustment Lending.*** Since FY98, the Bank has issued eight SNALs, to Argentina, India, and Mexico. Four other similar subnational loans to Brazil preceded the formal adoption of the SNAL approach. All of these subnational loans were based on substantial economic and sector work (ESW) and experience with the economic and social conditions of the specific state. They contained fiscal targets, and either there was an IMF arrangement in place or the IMF had affirmed the adequacy of the macroeconomic framework of the operations. SNALs generally emphasize governance reforms and poverty reduction through better budget management and improved allocations, better service delivery, and pro-poor institutional reforms. Implementation was sometimes slowed by constitutional provisions affecting national-subnational relations, policy differences between different levels of government, or changes in administration.

17. ***Conclusions.*** Experience so far suggests that SNALs may carry somewhat greater risks than adjustment loans to national governments, mainly due to the complexities of national-subnational relations. However, they can be an effective development tool for poverty reduction and governance reforms and can have a strong demonstration effect. Several lessons from experience should guide future SNALs. It is advisable to base the selections of states on clear criteria, including their relative performance, extent of poverty, and size. Moreover, it is important for the choice of a SNAL state to be linked to prior actions, not to promised future actions. Preparing and implementing SNALs during the reforming administration's period in power is an important factor for success, as is a supportive federal fiscal structure. Finally, SNALs are more effective when they concentrate on major, difficult-to-reverse structural reforms.

### ***c. Special Structural Adjustment Loans***

18. SSALs were introduced at the time of the East Asia crisis to finance reconstruction—including financial reconstruction—and long-term stabilization. To date the Bank has approved two SSAL packages. Argentina's SSAL transformed a dialogue into a two-year action plan, and Brazil's SSAL supported constitutional and legislative action. In addition, both programs included major efforts to sustain outlays for key social programs and expand funding for other programs for poor or unemployed people. Pricing was set to reflect the size and special circumstances of these loans and the consequent risks to the Bank.

19. ***Experience with Special Structural Adjustment Loans.*** SSAL recipients took advantage of the adjustment programs to implement difficult reforms, and economic recovery was soon under

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<sup>11</sup> See *Adjustment Lending to Subnational Units* (SecM98-96 Rev.), May 14, 1998.

way. The SSAL approach has demonstrated its usefulness, particularly for middle-income countries with prior access to private markets. The differential pricing achieved its intended effect of limiting demand while compensating the Bank for the increased risk of these operations. If the need for such lending arises in the future, experience suggests that the program might be most effective if it allowed for additional flexibility, an improved pricing differential, and better coordination among multilateral agencies. (Annex B discusses experience with SSALs in greater detail.)

#### *d. Programmatic Structural Adjustment Loans*

20. Introduced in 1998, PSALs/PSACs focus on the medium-term structural and social reforms that have come to predominate in the reform agendas of client countries.<sup>12</sup> They can allow integrated and sustained Bank and donor support of a country-owned reform program in support of poverty reduction over a timeframe of three to five years. Compared with standard SALs, they are characterized by greater flexibility for step-by-step institutional reforms, capacity building that typically involves significant policy content, and a scope that goes beyond individual projects.

21. **Features.** Programmatic adjustment lending consists of a series of single-tranche or two-tranche adjustment operations phased over several years, under a unifying medium-term framework. Unlike traditional adjustment loans, in which conditionality is based on future actions, each programmatic adjustment loan in the series is based on reform actions actually completed. PSALs/PSACs include progress indicators that closely monitor progress and trigger the next phase. The PSAL/PSAC structure allows flexibility, adaptation to changing circumstances, and learning by doing.

22. **Experience.** Programmatic adjustment operations approved to date include the Latvia PSAL (FY00), the Tanzania PSAC (FY00), the Thailand Public Sector Reform Loan (FY00), the Brazil Programmatic SECAL (FY01), the Brazil Financial Sector Adjustment Loan (FY01), and the Peru Programmatic Social Reform Loan (FY01). Additional PSALs/PSACs are under preparation in Brazil, Guinea, Jordan, Latvia, and Ukraine. A programmatic approach has also been followed in some subnational adjustment loans/credits, including in reforming Indian states such as Uttar Pradesh, Karnataka, and Andhra Pradesh. As the number of PSALs/PSACs is still small and most remain in the early stages of implementation, it is too early for a conclusive evaluation of their efficacy and impact. However, an initial assessment indicates that client countries have appreciated the ability to adapt subsequent program phases and lending volumes to evolving reform progress and financing requirements. The experience so far also suggests that these loans/credits helped build broad-based reform ownership and consensus on the reform program. With their medium-term program and clear benchmarks, PSALs/PSACs have provided a comprehensive reform road map and have facilitated donor coordination. (Annex C discusses experience with PSALs in greater detail.)

23. **Future Applications.** The poverty reduction support credit (PRSC) is being introduced as an application of the PSAC that would support IDA countries' poverty reduction strategies and the associated social and structural reforms. The PRSC principally draws from, and elaborates on, the government's Poverty Reduction Strategy Paper (PRSP) or Interim Poverty Reduction Strategy Paper (I-PRSP) and the analysis in the Joint Staff Assessment of the adequacy of that strategy. It

<sup>12</sup> See *Programmatic and Emergency Adjustment Lending: World Bank Guidelines* (R-98-249), October 22, 1998; and the *Operational Memorandum Guidelines for Programmatic Adjustment Loans/Credits*, February 11, 2000.

relies on core country-based ESW—notably a poverty assessment, public expenditure review, and fiduciary assessment—or similar analyses provided by the country or other donors and development partners. PRSCs will typically be annual operations under a medium-term framework, based on the up-front completion of a set of priority reform measures and public actions that demonstrate satisfactory progress with the country’s social and structural reform agenda in support of its poverty reduction strategy. The first PRSCs, for Uganda and Vietnam, were approved by the Board of Executive Directors on May 31 and June 5, 2001 respectively.

## **B. Quality of Adjustment Lending**

24. Evaluations by the Bank’s Operations Evaluation Department (OED) and Quality Assurance Group (QAG) suggest that the overall quality of adjustment lending improved markedly during the 1990s. However, weaknesses remain, particularly in sustainability and institutional development impact; and relative shortcomings in environmental, poverty, and social aspects deserve further attention. Also, satisfactory quality ratings do not necessarily reflect long-term outcomes. Further work is needed to corroborate or modify the preliminary findings and provide a more systematic analysis of the quality at entry and portfolio quality of Bank lending by instrument.

### ***1. Portfolio Quality***

25. A QAG review of the Bank’s FY00 portfolio showed that adjustment operations exiting the portfolio had better development objectives ratings and fewer projects at risk than did comparable investment operations.<sup>13</sup> Ten percent of exiting adjustment operations did not fully meet their development objectives, compared with 17 percent of investment operations; and 13 percent of exiting adjustment operations were at risk, compared to 23 percent of investment operations. However, for operations still in the portfolio, adjustment and investment operations had similar at-risk ratings, whether measured by projects (16 percent and 15 percent, respectively) or commitments (17 percent and 16 percent, respectively).

### ***2. Quality at Entry***

26. As part of its third quality-at-entry assessment (QEA3)<sup>14</sup> covering Bank operations that entered the portfolio during CY99, QAG reviewed a random sample of 11 adjustment operations that accounted for 49 percent of the dollar commitments of the overall sample. It rated all but one of the operations as satisfactory or better, although it rated none as highly satisfactory. In dollar terms, 93 percent of the commitments for adjustment operations were rated satisfactory or better—an improvement over the 79 percent of the previous year’s sample (QEA2).<sup>15</sup> Between FY98 and FY99, the ratings for several quality dimensions of adjustment lending improved: technical and economic aspects, poverty and social aspects, risk assessment and sustainability, and readiness for implementation (see Figure 10). There is a common idea that adjustment

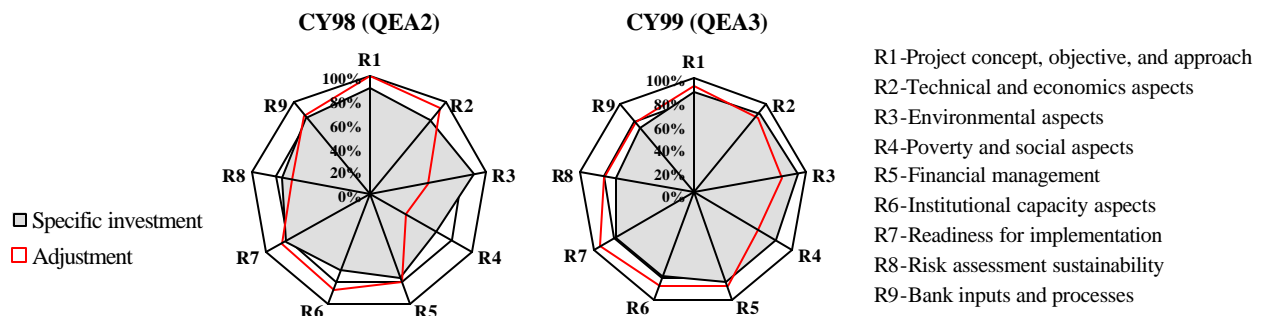
<sup>13</sup> See *Annual Report on Portfolio Performance—Fiscal Year 2000* (Washington, D.C.: World Bank, 2001).

<sup>14</sup> QAG’s quality-at-entry assessment evaluates the internal quality of Bank operations at the time of Board approval and the likelihood that these operations will meet their development objectives. The results reported in QEA3 include assessments of a total of 80 projects approved by the Board in CY99; see *Quality at Entry in CY99—A QAG Assessment* (CODE2000-63), June 16, 2000.

<sup>15</sup> See *Quality at Entry in CY98—A QAG Assessment*, World Bank, June 16, 1999.

lending is of lower quality than investment lending, but the QAG data do not support this hypothesis: the analysis showed no statistically significant difference in the overall ratings of investment and adjustment operations and no consistent relative strengths or weaknesses over time. In FY99, adjustment loans were more frequently rated satisfactory or better for project concept and approach, readiness for implementation, risk assessment and sustainability, and Bank inputs and processes, while specific investment loans received satisfactory or better ratings more frequently on environmental, poverty, and social aspects. These are areas for priority attention, going forward.

**Figure 10. Quality-at-Entry Ratings**  
(Percent satisfactory or better)



Source: Staff calculations based on *Quality at Entry in CY99—A QAG Assessment*, op. cit.

27. **Fiduciary, Environmental, and Social Aspects.** The QAG assessment drew attention to the fiduciary environmental, and social/poverty aspects of adjustment loans. With respect to the fiduciary aspects, all of the adjustment operations in QEA3 met the Bank's minimal requirements for financial management, including making provision for an optional audit of the special deposit account into which Bank loan proceeds are transferred.<sup>16</sup> Several operations went beyond this measure to include a due diligence process for mitigating fiduciary risks, for example, setting up a control group involving nongovernmental organizations (Indonesia Social Safety Net SAL, 1999) and monitoring key public expenditures in health, public works, and local government transfers (Albania SAC, 1999). Nonetheless, QAG highlighted the need for more guidance on financial management aspects for adjustment operations. On the environment, the QAG review showed an increase, with the share of operations rated satisfactory or better increasing from 50 percent in 1998 to 77 percent in 1999. However, the reviews showed considerable difficulty in reaching an understanding on the appropriate treatment of environmental issues for adjustment lending, and suggested that current policy—as articulated in OD 8.60 and OP 4.01, *Environmental Assessment*—may not yet be widely understood.<sup>17</sup> Subsequently, current policy was clarified in the Operational Memorandum *Clarification of Current Bank Policy on Adjustment Lending* (June 5, 2000).<sup>18</sup> Finally, the overall rating on poverty and social development aspects for the QEA3 sample operations was 64 percent. Seven operations were found to demonstrate significant and well-designed activities aimed at poverty reduction, while six were rated marginally satisfactory for participation and stakeholder analysis. Disaggregation of affected social groups and analysis of

<sup>16</sup> See description of fiduciary arrangements for adjustment lending in Chapter III, Box 6.

<sup>17</sup> See OD 8.60, *Adjustment Lending Policy*, and OP 4.01, *Environmental Assessment*.

<sup>18</sup> SECALs/SECACs are subject to the requirements of OP 4.01, under which they are screened and classified as Category A, B, or C operations. Further environmental assessments are then undertaken in accordance with OP 4.01 for SECALs/SECACs in Category A or B, but are not needed for those in Category C. Adjustment loans other than SECALs are not subject to the requirements of OP 4.01.

potential adverse social impacts were addressed by four adjustment loans. These issues are taken up in Chapter III below.

### 3. Risk Assessment

28. Development is inherently uncertain and risky. An important aspect of quality is an adequate assessment to determine whether the risks of an operation are commensurate with the returns. The range of contexts for lending operations means that one operation may involve high risks and another almost none. QAG reviews have found that the treatment of risks and their mitigation varied considerably, and have repeatedly highlighted shortcomings in risk management of investment lending.<sup>22</sup> A Risk Management Task Force has examined the Bank's risk management framework, identifying areas for improving the effectiveness of efforts at the project level.<sup>23</sup> Adjustment operations must balance the inherent tension between making an adequate risk assessment and meeting the objective of responding to specific client priorities. Reviews by OPCS and the Bank's Credit Risk Group (FINCR) highlight strengths and shortcomings of this trade-off in recent adjustment operations. The results show that the financial risk to IBRD and the operational risks of the loan—risks that are linked but not coincident—are typically treated together in loan documents; overall, 50 percent of loans surveyed in FY98-00 specifically considered the impact of formal loan conditions on the social situation, the environment, or the political economy.<sup>24</sup> However, loan documents often did not spell out the effects on the operation if the risks were to materialize, and rarely made a clear distinction between risks *to* the operation and risks *of* the operation.<sup>25</sup>

29. **Financial Risks.** A review of recent loans shows that, in general, the President's Reports for adjustment loans paid relatively little attention to financial risk to the Bank or the risk from higher exposure to a borrower with impaired creditworthiness. Few of them focused on indicators that reveal creditworthiness; of the FY98-00 adjustment loans that OPCS surveyed,<sup>26</sup> 22 percent discussed aspects of creditworthiness.<sup>27</sup> Furthermore, the risk sections in many reports did not refer to publicly available sovereign risk indicators such as rating agency scores, market

<sup>19</sup> See OD 8.60, *Adjustment Lending Policy*, and OP 4.01, *Environmental Assessment*.

<sup>20</sup> SECALs/SECACs are subject to the requirements of OP 4.01, under which they are screened and classified as Category A, B, or C operations. Further environmental assessments are then undertaken in accordance with OP 4.01 for SECALs/SECACs in Category A or B, but are not needed for those in Category C. Adjustment loans other than SECALs are not subject to the requirements of OP 4.01.

<sup>21</sup> See description of fiduciary arrangements for adjustment lending in Chapter III, Box 6.

<sup>22</sup> See *Quality at Entry in CY99—A QAG Assessment*, op. cit.

<sup>23</sup> See *Risk Management Task Force Report* (AC2000-59, CODE2000-78), July 14, 2000.

<sup>24</sup> Results are based on the OPCS analysis of more than 100 FY98-00 loans and the FINCR review of a sample of 10 President's Reports that were examined in depth.

<sup>25</sup> Terminology in loan documentation can be confusing. For example, some reports use the term *political risk* to mean the lack of commitment on the part of the borrower, or use it to refer more narrowly to events such as change of government, strikes, or street demonstrations; and use the term *policy risk* to mean the risk of policy slippage. The Risk Management Task Force suggests a clearer terminology, distinguishing among *development effectiveness risk*; *financial risk* (referring to country credit risk, counterpart credit risk, and market risk—e.g., currency or interest rate risk); *business operating risk* (where the aspect of fiduciary safeguards is of relevance for fast-disbursing loans); and *reputational risk* (risk of losing shareholder support as a consequence following from the other risks).

<sup>26</sup> The review used a structured questionnaire, including quantitative and qualitative indicators, to assess more than 100 operations in FY98-00, plus 35 operations from earlier years for comparison. The broad categories were (a) basic loan and country data, (b) loan design, (c) monitoring indicators and progress benchmarks, (d) risk assessment and ownership, and (e) focus and coverage. The resulting ratings were aggregated.

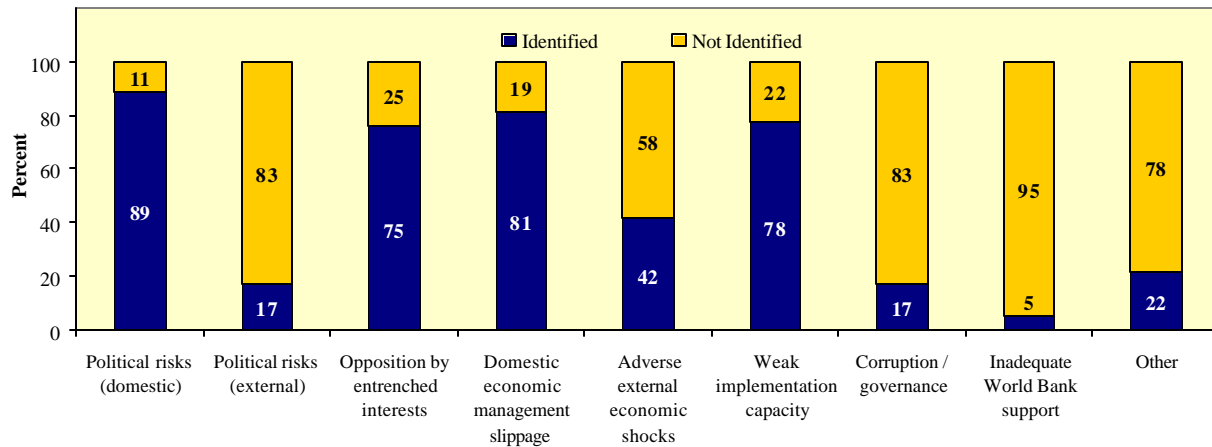
<sup>27</sup> Exceptions are Russia, where preferred creditor debt levels are mentioned, and Pakistan, where the low level of reserves and absence of creditors other than the international financial institutions is noted.



spreads, or external debt ratios. The President's Reports for loans to large borrowers usually referred to the Bank's risk-bearing capacity, stating that the proposed operation would keep exposure within the limit for a single borrower, without explicitly considering that default at much lower levels of outstanding debt could severely reduce net income.

30. **Operational Risks.** President's Reports usually divide operational risks into external and domestic. The components of domestic risk are political economy risk, implementation risk, institutional risk, and policy risk—but the definitions and coverage differ widely among operations. The operational risks typically identified in adjustment loans include domestic political economy risks, slippage in domestic economic management, opposition by entrenched interests, and weak implementation capacity (see Figure 11). In the OPCS analysis of FY98-00 loans, this assessment was judged as mostly realistic, with possible weaknesses in the treatment of domestic political economy risks and opposition. Risks that were more rarely identified include weak governance and inadequate World Bank support. Some 85 percent of loans also rate the risk of not proceeding with the operation as high or moderate.

Figure 11. Types of Risks Identified in Adjustment Operations, FY98-00



Source: OPCS survey.

31. **Risk Mitigation.** The identification and management of risks in Bank adjustment lending differ substantially across operations and are not always focused on lending. In principle, several measures can limit the risk of adjustment operations, including limiting exposure by invoking the trigger clauses in the underlying Country Assistance Strategy (CAS)<sup>28</sup> or the guidelines on the concentration ratio. Loan tranching is sometimes used in an attempt to limit both exposure risk and operational risk by aligning the provision of financing more closely to actual progress in reforms; different approaches are preferred across the Regions.<sup>29</sup> Residual risk—financial risk to the Bank—is dealt with by loan loss provisioning measures, but only after all other mitigating measures have been deployed. For operational risks, the Bank retains the option to stop further adjustment lending if the country fails to fulfill its development objectives. Despite this array of risk mitigation measures, a survey of recent adjustment operations reveals that risk mitigation was treated explicitly in less than half of the reports consulted, and then only superficially; there was

<sup>28</sup> The higher spread for SSALs is also a mitigating measure for containing risk (although this is not its only purpose; see Annex B).

<sup>29</sup> The Europe and Central Asia Region seems to prefer multiple tranching to contain risks (as in Russia). The South Asia Region, by contrast, has a preference for single-tranche loans with all the conditionality met at effectiveness (as in Pakistan).

rarely a broad discussion of risk mitigation strategy; and the risk discussion in the loan documents often lacked feedback on indicators relating to risk, although these data were often presented in annexes to the President's Report. These findings suggest the usefulness of exploring options for a more consistent risk management framework—an issue that is taken up in Chapter IV.

#### 4. *Quality at Exit*

32. Evaluations by OED suggest that the quality of adjustment lending has improved over time. These ratings are based on OED's systematic assessment of the success of operations in meeting their objectives. The ratings typically measure success by using intermediate output, indicators, such as policy reforms adopted and legislation approved.<sup>30</sup> To provide a full picture of likely development impact, OED complements its *outcome* rating (the most probable estimate of results) with ratings of long-term *sustainability* (an assessment of resiliency to risk) and *institutional development* (the contribution of the project to capacity building).<sup>31</sup> However, when the evaluations are done shortly after loan closing, OED ratings may not fully capture long-term outcomes of adjustment programs.<sup>32</sup> Work is thus under way in OED to augment and refine approaches to assessing adjustment lending. Nonetheless, there is widespread recognition that changes in ratings over time are indicative of systematic trends.

33. ***Trends in Adjustment Ratings.*** According to OED's evaluations, adjustment lending has improved in terms of satisfactory outcome and likely sustainability. There is also evidence of steady improvement in substantial institutional development, although at much lower levels. The improvements in ratings have occurred simultaneously with an increase in OED's measurements of the demandingness, complexity, and riskiness of adjustment loans. An analysis of the ratings suggests that the overall trend of improved quality of adjustment loans is due to enhanced performance by both borrowers and the Bank. There have been strong improvements in borrower performance, especially among upper-middle-income countries and by some repeat borrowers. On the Bank's side, lessons from previous adjustment experiences have been incorporated, and there has been a greater selectivity through a shift of adjustment lending to better-performing countries. These trends are discussed below.

34. ***Adjustment Ratings Weighted by Number of Operations.*** The 1990s have seen a systematic improvement in adjustment lending ratings:

- The overall quality of adjustment lending has improved markedly since the 1980s, when OED rated an average of 60 percent of outcomes satisfactory, and ratings for likely sustainability and institutional development impact were lower (see Figure 12).<sup>33</sup>

<sup>30</sup> OED follows a similar methodology for rating investment and adjustment operations. At the level of the individual operation, completion reports are prepared for all projects, and their performance ratings are independently validated by OED, which reports directly to the Bank's Board of Executive Directors. Field performance audits are carried out for 25 percent of all operations one to seven years after project completion. See *OED Reach: Development Effectiveness at the World Bank*, Number 24, Operations Evaluation Department, Spring 2000.

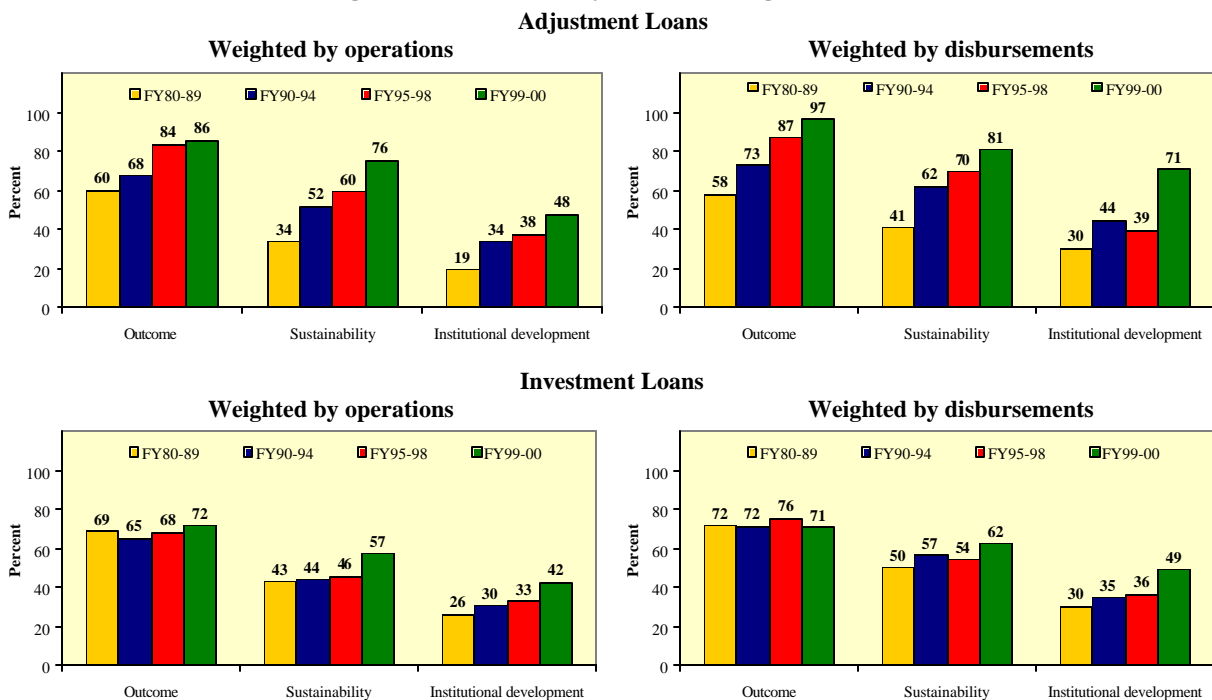
<sup>31</sup> OED rates outcomes on a six-point scale: highly satisfactory, satisfactory, marginally satisfactory, marginally unsatisfactory, unsatisfactory, and highly unsatisfactory. Sustainability is rated on a three-point scale: likely, uncertain, and unlikely. Institutional development impact is rated on a three-point scale: substantial, modest, and negligible.

<sup>32</sup> See *2000 Annual Review of Development Effectiveness: From Strategy to Results*, Report No. 21550, World Bank, Operations Evaluation Department, January 9, 2001, available at [www.worldbank.org](http://www.worldbank.org) (search ARDE).

<sup>33</sup> OED defines satisfactory outcomes at exit as projects that have efficiently met or exceeded their major relevant objectives. See *1999 Annual Review of Development Effectiveness: Toward a Comprehensive Development Strategy*, op. cit.

- Recently updated data for FY00 show that 86 percent of the adjustment operations exiting in FY99-00 that OED evaluated had satisfactory outcomes, compared to 68 percent in FY90-94.<sup>34</sup>
- The share of adjustment loans judged likely to be sustained is lower, but also rose, from 52 percent in FY90-94 to 76 percent in FY99-00; and the share with substantial institutional development impact rose from 34 percent to 48 percent over the same period.
- Performance has particularly improved in the Latin America and Caribbean Region (satisfactory outcomes up from 80 percent in FY90-94 to 100 percent in FY99-00) and in the Europe and Central Asia Region (up from 60 percent to 100 percent).
- Performance also improved in sectors covered by the Private Sector and Infrastructure Network (up from 69 percent to 100 percent).

Figure 12. OED Quality-at-Exit Ratings, FY90-00



Source: Staff calculations based on OED data.

35. **Results Weighted by Disbursements.** Considering results in dollar terms reveals a similar trend of improved ratings during the 1990s. Between FY90-94 and FY99-00, the share of commitments for satisfactory operations increased from 73 percent to 97 percent; for operations rated likely to be sustainable, from 62 percent to 81 percent; and for lending with substantial institutional development impact, from 44 percent to 71 percent.

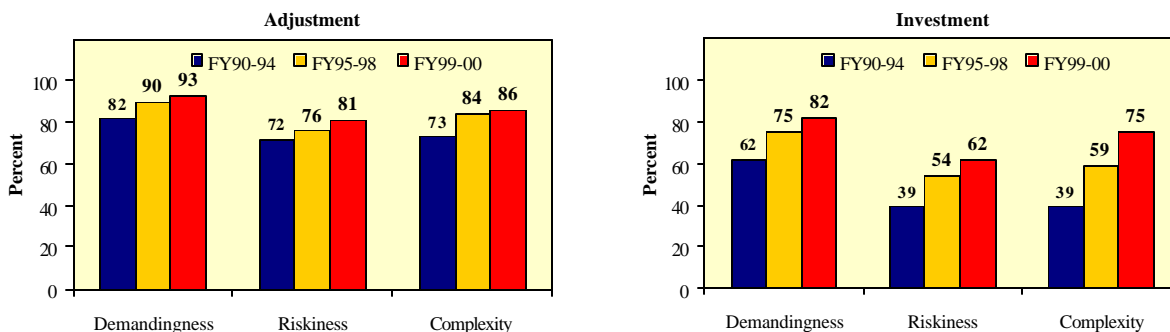
<sup>34</sup> The FY00 figures are preliminary and are based on a sample; the final figures may be subject to modification.

36. **Investment and Adjustment Ratings.** A direct comparison of the absolute ratings of investment and adjustment loans would not fully reflect the inherent differences between the two lending instruments. However, a comparison of the *trends* over time in the respective OED ratings reveals that the quality at exit of adjustment operations, like their quality at entry, has been systematically improving over time relative to the quality trends for investment lending.<sup>35</sup> As Figure 12 illustrates, throughout the 1990s adjustment lending ratings show substantial improvements of the three key performance measures (outcome, sustainability, and institutional development impact), reaching as high as 89 percent with satisfactory outcomes in FY96 and 100 percent in FY00. Ratings for investment loans also improved during the 1990s, although the improvement was much less pronounced than that of adjustment loans. When weighted by disbursements, adjustment ratings are generally even higher, meaning that larger operations have above-average ratings. Satisfactory outcomes by disbursements rose to 96 percent in FY99; when this figure is combined with the 100 percent satisfactory FY00 exit sample, the FY99-00 outcome ratings for adjustment loans stand at 97 percent satisfactory. By contrast, investment loans show stable outcome ratings when weighted by disbursements.

37. **Complexity.** Even as outcomes were improving, the complexity of adjustment operations was rising. In FY90-94, 73 percent of exiting projects were classified as substantially complex, but by FY99-00, the figure had risen to 86 percent (see Figure 13). At the same time, the share of adjustment lending that could be considered substantially demanding and risky was rising.<sup>36</sup> This trend generally cuts across Regions. OED found similar trends for investment loans, but ratings for substantial complexity, demandingness, and riskiness were lower than for adjustment loans.

38. **Borrower Performance.** The rise in adjustment loan outcomes appears to be linked to improved borrower performance, which has been particularly notable among upper-middle-income countries. Compared to borrower performance ratings in the 1980s, the 1990s saw a steady

**Figure 13. Quality at Exit: Substantial Demandingness, Riskiness, Complexity by Lending Instrument**  
(Weighted by operations)



Source: Staff calculations based on OED data.

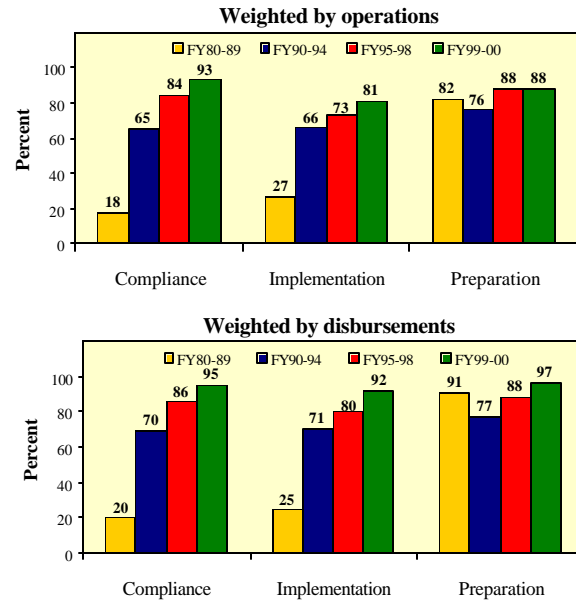
<sup>35</sup> OED notes that there are limits to the conclusions that can be drawn from a comparison of adjustment and investment loan outcomes. Apart from the obvious differences in their purposes and roles in promoting development, adjustment loans are implemented over a shorter time period than investment loans (two years on average, compared with seven years for investment loans). As a result, adjustment operations are also evaluated more quickly than investment operations—perhaps before all the ramifications of the reform actions have made themselves felt in the economy.

<sup>36</sup> OED defines *demandingness* as the extent to which the project could be expected to strain the economic, institutional, and human resources of the government or implementing agency. *Complexity* refers to such factors as the range of policy and institutional improvements contemplated, the number of institutions involved, the number of project components and their geographic dispersion, and the number of cofinanciers. *Riskiness* refers to the likelihood that the project, as designed, would be expected to fail to meet relevant project objectives efficiently.

improvement in ratings for preparation, compliance with loan covenants, and implementation (see Figure 14). For example, in FY80-89, 18 percent of exiting adjustment loans had satisfactory compliance—a proportion that had risen to 93 percent by FY99-00; and satisfactory implementation rose from 27 percent to 81 percent over the same time. The improvements are even more marked when weighted by disbursements. These overall positive trends show Regional discrepancies, with strong improvements in Latin America and the Caribbean (LCR) and Europe and Central Asia (ECA), and with Africa (AFR) and South Asia (SAR) lagging behind.

39. **Performance of Repeat Borrowers.** In aggregate, countries that have received multiple adjustment loans since the 1980s showed a broadly positive pattern: one-third had consistently satisfactory outcome ratings, and 24 percent improved over time (see Table 4). Notwithstanding the general improvement, actual performance has varied widely across countries: for some repeat borrowers (for example, Uganda and Zambia), OED outcome ratings for adjustment operations have improved steadily; for others, outcome ratings of successive adjustment operations were unchanged or deteriorated (see Figure 15). However, outcome ratings of adjustment loans do not always fully capture overall country performance—in Bangladesh, for example, some loans failed to achieve intended outcomes, but the overall economy has performed quite well in the past two decades. OED ratings in Morocco have been declining, but they reflect closed operations and do not yet capture recent sectoral adjustment operations on contractual savings and telecommunications that may be more effective in improving the structural policy environment. Often when the Bank took a risk by continuing support to countries with unsatisfactory outcomes for the first loans, later operations were successful: of the 30 borrowing countries in the 1980-90s with unsatisfactory outcomes for the first loan, 80 percent went on to borrow a combined total of 82 subsequent adjustment loans. Of these successor loans, 70 percent had satisfactory outcomes.

**Figure 14. OED Ratings: Satisfactory Borrower Performance on Adjustment Loans**



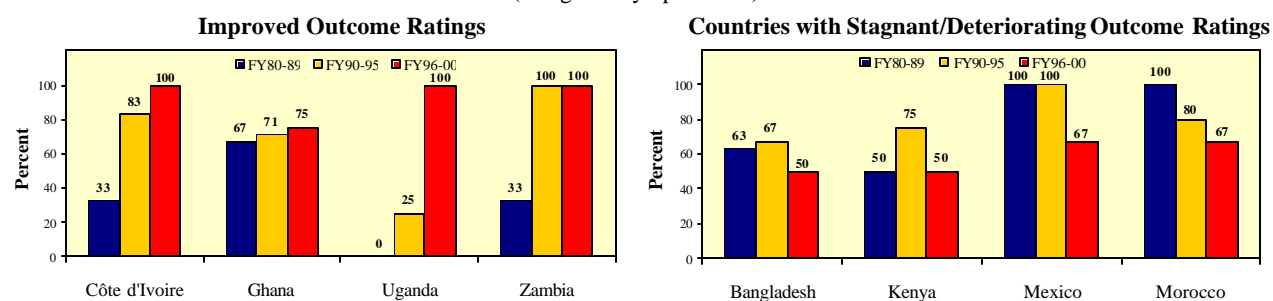
Source: Staff calculations based on OED data.

**Table 4. Outcome Records for Repeat Borrowers with Three or More Adjustment Loans, FY80-00**

Outcome	Borrowers	
	Number	Percent
Consistently had satisfactory outcomes (90% or more satisfactory ratings)	22	33
Started with unsatisfactory or mixed record but ended with series of at least 3 satisfactory outcomes	16	24
Consistently had unsatisfactory outcomes	1	1
Started off with a good or mixed record but ended with a series of at least 3 unsatisfactory outcomes	3	4
Had a truly mixed record throughout	25	37
<b>Total</b>	<b>67</b>	<b>100</b>

Source: Staff calculations based on OED data.

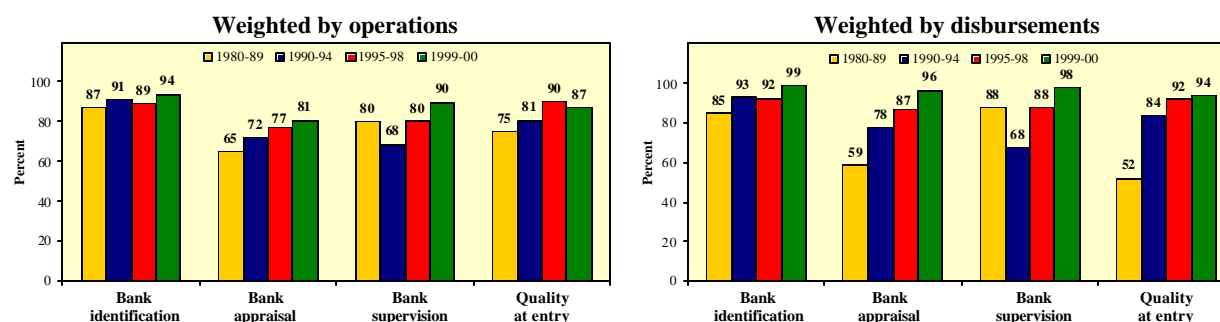
**Figure 15. Satisfactory Outcomes of Adjustment Loans for Selected Countries**  
(Weighted by operations)



Source: Staff calculations based on OED data.

40. **Bank Performance.** Recent Bank performance ratings reflect the fact that today's adjustment operations benefit from the lessons of previous adjustment experiences—which will be discussed in greater detail in Chapter IV—including increased attention to borrower ownership, fewer conditions, and a greater number of single-tranche operations. OED found that Bank performance has improved since the 1980s. In particular, 90 percent of FY99-00 adjustment loans received a satisfactory quality-at-entry rating, compared with 75 percent in FY80-89; and supervision ratings rose from 80 percent satisfactory to 87 percent during the same period (see Figure 16).<sup>37</sup>

**Figure 16. OED Ratings: Satisfactory Bank Performance on Adjustment Loans**



Source: Staff calculations based on OED data.

41. **Country Selectivity and Outcomes.** Greater selectivity in adjustment lending for above-average performers during the 1990s contributed to the improved outcome ratings. OED estimates that over a quarter of the improvement in adjustment lending performance is explained by the lower share of evaluated adjustment operations in the Africa Region, which has ranked last among Regions in adjustment lending performance.<sup>38</sup> However, the shift of adjustment lending toward better-performing countries is only a partial explanation, since outcomes have also been improving across different groups of performers. Comparing various World Bank measurements of policy performance<sup>39</sup> shows that outcomes were generally higher for better performers in both the 1980s

<sup>37</sup> See *1999 Annual Review of Development Effectiveness: Toward a Comprehensive Development Strategy*, op. cit.

<sup>38</sup> See *2000 Annual Review of Development Effectiveness: From Strategy to Results*, op. cit. The Africa Region's share of evaluated adjustment operations declined from 44 percent in FY90-94 to only 20 percent for FY99-00, with an increasing share represented by ECA.

<sup>39</sup> Ratings are based on the Bank's country performance ratings (1-5 scale from 1980-95), which were undertaken primarily by the Regions, and on ratings from the Country Policy and Institutional Assessment or CPIA (1-6 scale from 1996-00), a collaborative yearly exercise involving the Regions, Networks, and Central departments.



and 1990s, but there were noticeable improvements in outcomes for the bottom and middle performance tiers over time (see Figure 17). Of course, satisfactory outcome ratings based on compliance with loan conditions are not a guarantee of long-term sustainable results on the ground. But the general trend toward better outcomes in countries with different performance records may be explained, at least in part, by the fact that the evaluated operations incorporated lessons from earlier adjustment operations.

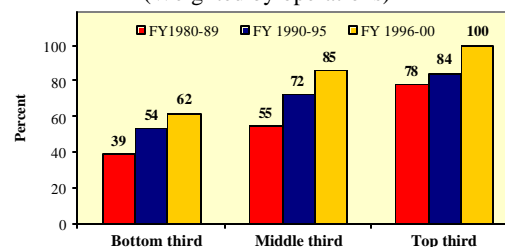
### 5. Comparisons of Adjustment Lending Quality

42. Adjustment operations in IBRD countries, whether weighted by number or volume, consistently receive better OED ratings for outcome, sustainability, and institutional development impact than those in IDA countries (see Figure 18). Ratings for IBRD adjustment operations have improved through the 1990s (with the exception of FY97), with an average of 82 percent (weighted by operations) rated as having satisfactory outcomes. IDA's outcome ratings during the 1990s reached an average of 73 percent satisfactory, but the yearly fluctuations have been more volatile, peaking at 90 percent rated satisfactory in FY96 and dropping to a seven-year low of 64 percent in FY99. Performance in AFR explains a large part of this drop.

43. **Adjustment Lending Outcomes by Region.** Because of small numbers and year-to-year fluctuations, Regional trends have to be interpreted with caution.<sup>40</sup> Nonetheless, available data indicate that adjustment lending outcomes differed strongly by Region throughout the last decade (see Figure 19). LCR and ECA—which accounted for 42 percent of all adjustment loans evaluated from FY90 to FY00—showed substantial improvement in outcomes between FY90-94 and FY99-00. By contrast, AFR experienced relatively low levels of satisfactory outcomes, with an average of 65 percent (weighted by operations) during the 1990s. Outcome ratings for AFR improved significantly in FY95-98, but fell again after a weaker performance in FY99-00, when 50 percent of its SECALs and 57 percent of its SALs were judged to have unsatisfactory outcomes. Preliminary figures show that all three adjustment loans evaluated in FY00 attained satisfactory outcomes.

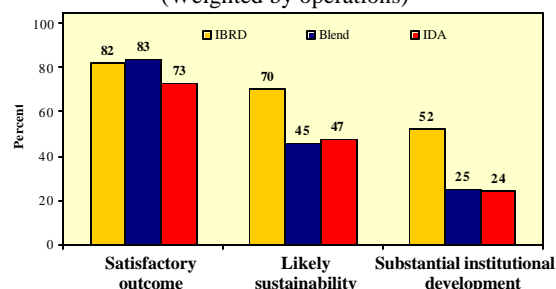
44. **Sustainability and Institutional Development by Region.** AFR had a relatively low average rating of 41 percent for likely sustainability during the 1990s, albeit with some improvement over the period. Similarly, SAR adjustment operations in the 1990s had a 44 percent rating for likely sustainability; but a small sample of projects showed a 100 percent

**Figure 17. Satisfactory Outcome Ratings by Country Performance Ratings, Exit FY80-00**  
(Weighted by operations)



Source: Staff calculation based on OED data and CPIA and World Bank country performance ratings.

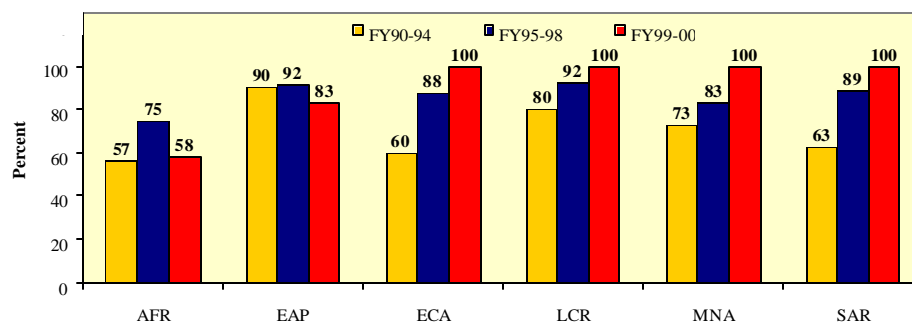
**Figure 18. OED Ratings of IBRD/IDA Adjustment Loans Exiting in FY90-00**  
(Weighted by operations)



Source: Staff calculations based on OED data.

<sup>40</sup> Although some information on all Regions is presented here, according to OED, only AFR, ECA, and LCR included sufficient projects—set arbitrarily at more than 10 closings a year—for a balanced evaluation.

**Figure 19. Quality at Exit: Satisfactory Outcomes of Adjustment Loans by Region**  
(Weighted by operations)



Source: Staff calculations based on OED data.

likely sustainability rating in FY99. Sustainability ratings for adjustment operations in the other Regions—East Asia and the Pacific (EAP), ECA, LCR, and Middle East and North Africa (MNA)—averaged in the upper 60 percent to lower 70 percent range for the decade. Institutional development impact ratings for adjustment operations remained modest across all Regions, with a Bankwide average of 37 percent rated substantial during the 1990s. The institutional development impact ratings of LCR adjustment operations improved until FY95, with 80 percent rated as substantial, but they have since declined.

45. **Improving the Quality of Adjustment Lending.** The quality of adjustment lending has improved notwithstanding rising levels of risk, complexity, and demandingness of operations—all of which test borrower and Bank capacities alike. The poor and variable past performance in AFR raises questions as to whether the levels of complexity and demandingness of projects are appropriate to borrower implementation capacity. The low (albeit improving) institutional development impact in all Regions remains another concern. Adjustment lending outcome ratings do not fully capture the longer-term outcomes or the broader development impact of adjustment operations. In particular, the *1998 Annual Review of Development Effectiveness*<sup>41</sup> indicates that reforms were maintained for at least nine years in 12 percent of countries with adjustment loans. At exit, 66 percent of adjustment operation outcomes were judged to be resilient to risk and thus likely to be sustained, and 45 percent were judged satisfactory in institutional development. Although the ratings show that adjustment lending has improved more than investment lending through the 1990s, there remains significant room for improvement in quality.

46. **Areas for Further Work.** Continuing analysis of the effectiveness of adjustment operations will focus on the following:

- Augmented and refined approaches to assessing adjustment lending in Implementation Completion Reports, OED Evaluation Summaries, and OED Project Audit Reports. Elements of such approaches would include enhanced focus on longer-term results and on adjustment programs, as well as individual operations.
- The relationship between quality at entry and loan outcomes, and the determinants of adjustment loan performance.

<sup>41</sup> See “Development Effectiveness, 1998: Opportunities in a Volatile Environment,” *Précis*, No. 175, World Bank, Operations Evaluation Department, 1999.



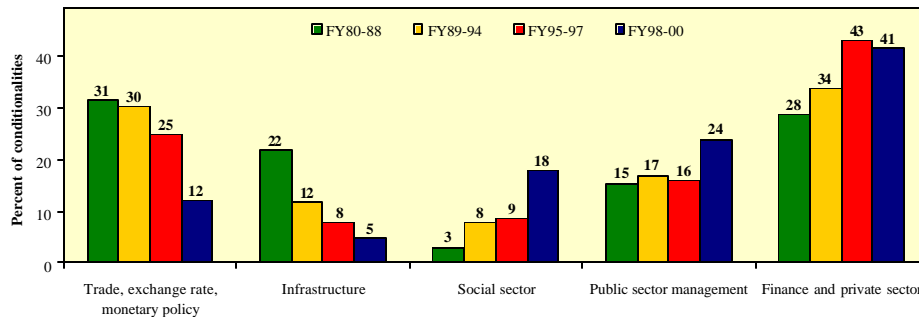
### III. CONTENT AND COVERAGE

47. Over the past two decades, the content of adjustment lending has changed with the nature of the reforms these loans support. In its early years, adjustment lending focused on economic stabilization and the correction of distortions, devoting little attention to the social impact of adjustment and other reforms. More recently, it has evolved to support institutional reforms in the financial and private sectors and in public sector management, and has emphasized poverty reduction and social sector reforms. This chapter traces the evolution of the content and coverage of adjustment lending across key sectors to which it has been applied.

#### A. Thematic Trends in Adjustment Lending

48. Begun in 1980 to help developing countries adjust their balance of payments after the 1979 oil shock, adjustment lending shifted its focus in the early years from fiscal adjustment in response to external shocks to removing obstacles to growth, with the idea of enabling countries to grow out of debt. In the early 1990s, it began focusing on adjusting relative prices that were distorted from decades of import-substituting industrialization policies. Today it more often supports institutional reforms in public sector management and in the financial and social sectors (see Figure 20). Many countries that have already removed economic distortions are now predominantly engaged in more complex reforms—capacity building and development of institutional infrastructure. As a result, the share of policy conditions applied to infrastructure, energy, and agriculture declined from 22 percent in FY80-88 to 5 percent in FY98-00. By contrast, the share of conditions supporting public sector reform increased from 15 percent in FY80-88 to 24 percent in FY98-00, and reforms in the financial and private sector increased from 28 percent to 41 percent of the conditions over the same time. Across all sectors, the reform issues supported by adjustment lending are increasingly long-term, institutional, and microeconomic.

Figure 20. Evolution of Conditionality by Sector, FY80-00



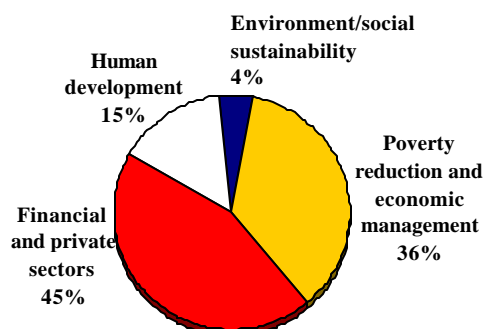
Note: Measures include binding conditions but exclude nonbinding, desired actions.

Source: ALCID.

49. **Conditionality Themes.** OPCS assessed more than 100 adjustment loans and credits for FY98-00 and found that the conditionality in these operations focused on four thematic areas: poverty reduction, financial and private sectors, human development, and environmental and social sustainability (see Figure 21). These thematic areas cut across Bank Networks. Traditionally, most of the operations have fallen under the responsibility of the Poverty Reduction and Economic Management (PREM) Network, followed by the Private Sector and

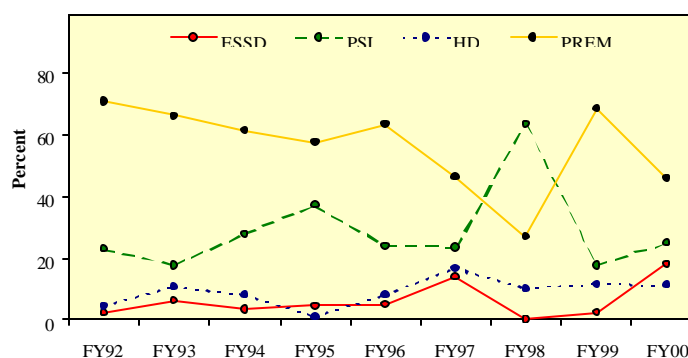
Infrastructure (PSI) Network—except in FY98, when there was heavy emphasis on financial sector restructuring during the East Asia crisis (see Figure 22). Recent years have seen adjustment lending operations take on an increasing role in the Human Development (HD) and Environmentally and Socially Sustainable Development (ESSD) Networks. Table 5 shows the sectoral distribution of commitments.<sup>42</sup>

**Figure 21. Thematic Areas of Tranche Conditions, FY98-00**



Source: OPCS survey.

**Figure 22. Share of Adjustment Loan Volumes by Network, FY92-00**



Source: Staff calculations based on SAP data.

**Table 5. IBRD and IDA Adjustment Lending Commitments by Sector, FY95-00**

Sector	Share of total adjustment lending (percent)					
	FY95	FY96	FY97	FY98	FY99	FY00
Agriculture	4.6	5.1	13.8	0.0	0.5	0.0
Economic policy	54.7	34.2	32.5	13.0	64.4	23.3
Education	0.9	0.0	0.0	0.7	0.0	0.0
Electric power and energy	2.8	0.0	0.0	0.9	0.2	0.0
Environment	0.0	0.0	0.0	0.0	0.0	1.0
Finance	34.6	23.7	17.6	50.9	11.8	24.0
Health, nutrition, and population	0.0	7.8	0.0	6.2	0.0	0.0
Mining	0.0	11.1	5.9	7.1	2.0	0.0
Public sector development	2.3	12.3	3.1	0.9	2.9	0.4
Private sector management	0.1	5.9	8.4	7.8	4.7	41.1
Social protection	0.0	0.0	18.7	10.9	11.5	9.9
Transportation	0.0	0.0	0.0	1.6	0.2	0.4
Water supply and sanitation	0.0	0.0	0.0	0.0	2.0	0.0
Total (percent)	100.0	100.0	100.0	100.0	100.0	100.0
Total (US\$ million)	5,325.0	4,509.0	5,087.0	11,290.0	15,330.0	5,107.0

Source: Staff calculations based on SAP data.

**50. Investment-Adjustment Complementarities.** Adjustment and investment lending are complementary: when adjustment lending succeeds, it tends to improve the policy environment

<sup>42</sup> The distribution of adjustment commitments by traditional Bank sectors does not always coincide with that of the policy focus of conditionality. Commitments are classified under only one major sector for each operation, while policy conditions in the operation usually cover several different areas. For example, public sector management accounted for only 6 percent of the dollar commitment share in FY99, while a significantly higher share—about 35 percent of policy conditions—covered related areas (including public enterprise restructuring and public institutions and regulations).

for investment lending (see Box 2).<sup>43</sup> OPCS findings suggest that not only do the two instruments complement each other, but they share an expanding middle ground.<sup>44</sup> Adjustment lending supports policy reform, but increasingly addresses institution building issues as well; and investment lending has a growing focus on sectoral reforms.

## **B. Specific Content Areas**

51. Across the different sectors, adjustment support for policy reform has focused increasingly on complex institutional issues that require a longer time horizon. This section summarizes the Bank's experience in adjustment lending in key sectors—poverty reduction and the social dimension, economic management, public sector reform, financial sector reform, private sector development, and the environment.

### ***1. Poverty and Social Focus of Adjustment Lending***

52. The ultimate objective of adjustment lending is to enhance the well-being and increase the incomes of poor people. It aims to prevent or reverse unsustainable economic conditions that hurt the poor, and to establish or restore the conditions for sustainable development that are necessary for promoting poverty reduction. Adjustment programs supported by the Bank seek to achieve social and structural reforms to enhance allocative efficiency, equitable growth, better access of the poor to public services, and sustainable reductions in poverty. In addition, adjustment lending plays a critical role in helping prevent economic crises, which can be devastating for the poor—for instance, by helping to improve the soundness of financial systems. It can also help minimize the impact of economic crises on poor people—for instance, by helping to build social safety nets and by providing financing that can help make the consequences to the poor of the adjustment process in response to an economic shock less drastic than they otherwise would have been. Based on the CAS and building on the principles of the Comprehensive Development Framework (CDF), the Bank's adjustment lending provides financing, analytic underpinning, and a reform framework in support of borrowing countries' poverty reduction strategies and their progress toward the international development goals.<sup>45</sup> This section sketches the evolution of the Bank's attention to the social dimensions of adjustment<sup>46</sup> and the coverage of social and poverty issues in recent loans. It also briefly surveys some of the available evidence on the social impact of adjustment lending.<sup>47</sup>

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<sup>43</sup> Successful structural adjustment is expected to improve both public sector performance and private sector investments by reducing distortions, improving the response to changes in relative prices, and promoting increased integration of developing economies in international markets. The performance of World Bank investment projects is more effective in an undistorted policy climate that furthers productivity and economic growth. See Carl Jayarajah and William Branson, *Structural and Sectoral Adjustment, World Bank Experience, 1980-92*, Operations Evaluation Study (Washington, D.C.: World Bank, 1995), Box 12.4, p. 268.

<sup>44</sup> See *Lending Retrospective: Volume and Instruments Issues Paper* (SecM99-512/1), November 16, 1999.

<sup>45</sup> See 2000, *A Better World for All: Progress towards the International Development Goals*, jointly issued by the IMF, Organization for Economic Co-operation and Development, the United Nations, and the World Bank Group (Washington, D.C.: International Monetary Fund, 2000), available at [www.paris21.org](http://www.paris21.org).

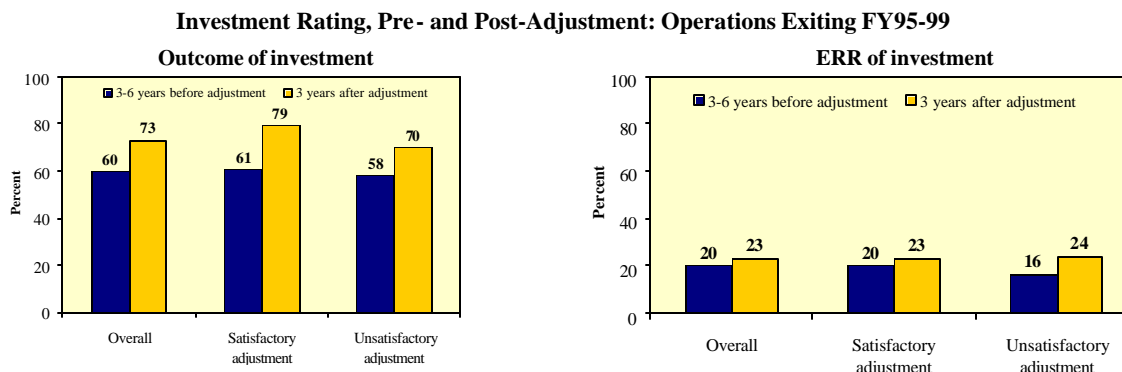
<sup>46</sup> The term "social dimensions of adjustment" typically refers to the impact on poverty, broadly understood, including measures of income, health and education status, vulnerability, insecurity, and the social fabric.

<sup>47</sup> A full treatment of the ongoing research and sometimes contentious debate on the subject is beyond the scope of this report.

### Box 2. Is Adjustment Lending Beneficial for Investment Projects?

Successful adjustment operations help improve the performance of investment projects. By contributing to a better policy environment in borrowing countries, adjustment lending tends to make Bank investment loans more effective. Empirical evidence suggests that adjustment loans with satisfactory outcome ratings can make a significant difference in the performance of investment projects, as measured by their outcome ratings or economic rates of return (ERR). This conclusion is based on OED outcome ratings and the ERR of investment operations undertaken in the same countries as Bank-financed adjustment operations exiting during FY95-99.

In countries with adjustment lending, investment loans had outcome ratings that were on average 13 percent higher following an adjustment operation, and 18 percent higher when the adjustment loan had a satisfactory outcome rating. When the outcome ratings of adjustment lending are satisfactory, the ERRs for accompanying investment projects are on average 3 percentage points higher than those of investment loans prior to an adjustment program.



Note: Outcome ratings based on 82 cases; ERR based on 37 cases.

Source: Calculations based on OED data.

#### a. Evolution of Poverty and Social Dimensions in Adjustment Lending

53. Through the years, the actual effects of adjustment lending on poor people have been much debated. Early adjustment operations had the primary objective of stabilizing economies and addressing key economic distortions. Widespread thinking at that time held that the ensuing improved economy would help alleviate poverty. The underlying reasoning was that setting relative prices right would increase the demand for the abundant factor of unskilled labor and thus on balance help poor farmers and workers. A complementary understanding held that support for reforms should be seen as part of an overall country assistance program, with social measures primarily supported by investment operations in such areas as social funds and maternal and child health and nutrition. But starting in the 1980s, critics of adjustment lending charged that adjustment programs led to deteriorating social conditions and expenditure cutbacks that hurt poor people.<sup>48</sup>

54. *Social Dimensions in the 1980s.* When the Bank first started adjustment lending, it was expected that adverse transitional effects would be short-lived. For instance, industrial workers in overprotected industrial branches affected by adjustment in Latin American economies were thought to be able to rely on existing social safety nets, which traditionally included severance payments, health insurance schemes, and strong unions. But these defenses were overwhelmed by increasingly tougher fiscal adjustments up to the late 1980s, before it was generally accepted that a return to growth would require lasting reductions in debt and debt service. In many cases

<sup>48</sup> The argument that social concerns received too little attention in the design of adjustment operations was forcefully made in Giovanni Andrea Cornia, Richard Jolly, and Francis Stewart, eds., *Adjustment with a Human Face*, UNICEF (New York: Oxford University Press, 1987-88).

where deep-rooted problems were not amenable to quick fixes, first-round reforms such as trade liberalization were not accompanied by lasting reductions in poverty or improvements in social conditions. For instance, the development community learned over time that in African economies, relatively higher prices for agricultural goods did not directly translate into higher incomes for poor farmers and wages for landless laborers, if there was no competition among traders and middlemen. There was a limited understanding of how rural markets operated, how the specific conditions in developing countries' labor markets determined the response to adjustment programs, and how interhousehold and intrahousehold distribution of incomes and assets changed during economic adjustment.<sup>49</sup> In early adjustment programs there was insufficient analysis of where expenditures would be cut as part of fiscal austerity programs, leading to greater cuts in expenditures for health and education than for military expenditures. Despite some successes, notably in East Asia, it became increasingly clear that adjustment programs would need to incorporate more direct measures to accelerate poverty reduction. Thus, beginning in the late 1980s, adjustment operations included measures specifically designed to protect poor people—for example, by maintaining levels of public spending on key social areas such as education, health, and social assistance.

55. *Social Dimensions in the 1990s.* To enhance positive and mitigate potential adverse effects of adjustment lending on poor and lower-income groups, adjustment operations were broadened in the 1990s to include the establishment of social safety nets. But despite such increased efforts to protect social expenditures, critics have pointed to cases in which cost recovery policies introduced as part of adjustment programs have even hurt poor people's access to social services.<sup>50</sup> In more recent years there has been an increasing awareness of the need to improve the analysis of the poverty situation and to design adjustment operations that address poverty as a priority. This includes a better analysis of the distributive impact of reforms and of the relationship between income and social indicators. Adjustment lending is now viewed as just one among several possible instruments used under the CAS to reduce poverty. Although there has been growing attention to the relationship between adjustment lending and social sector spending and targeted interventions, an OED evaluation of a selected sample of CASs found that few made explicit the meaning of broad-based growth or established country-specific links between growth-oriented policies and poverty reduction.<sup>51</sup> More recently, however, the poverty focus of CASs has shown an improving trend.<sup>52</sup>

<sup>49</sup> See Esbern Friis-Hansen, *Agricultural Policy in Africa after Adjustment*, Centre for Development Research, Copenhagen, September 2000; Giovanna Cornia, *Liberalization, Globalization and Income Distribution*, Working Paper No.157, World Institute for Development Economics, Helsinki; and Kevin Watkins. *The Oxfam Poverty Report* (Oxford U.K.: Oxfam Publishing, 1995).

<sup>50</sup> See Sanjay Reddy and Jan Vandemoortele, "User Financing of Basic Social Services," staff working paper, UNICEF, New York, 1996.

<sup>51</sup> See Alison Evans, *Poverty Reduction in the 1990s: An Evaluation of Strategy and Performance* (Washington D.C.: World Bank 2000). The report surveyed a sample of CASs, mostly from the early and middle 1990s. It found that most of the CASs in the sample gave modest attention to employment and labor force trends in the context of strategies to remove tariff barriers and stimulate investment in tradable sectors. Structural and institutional barriers to the entry of the poor into formal markets were not widely addressed in the sample. Only 20 percent of the CASs in the sample included an explicit treatment of microeconomic constraints and equity issues that affect poor people's access to physical assets and key markets, and few of the surveyed CASs directly addressed the relationship between persistent gender inequalities and the strategy for broad-based growth. The report suggested that these issues all relate to obstacles that prevent poor people from directly and immediately benefiting from growth, and should therefore be part of the diagnosis of the links between growth and poverty reduction.

<sup>52</sup> See *Country Assistance Strategies: Retrospective and Implications* (R99-228/2), May 22, 2000.

56. ***Including Broader Poverty Dimensions.*** Recent thinking highlights poor people's vulnerability to economic change, especially during periods of economic distress. *The World Development Report (WDR) 2000/2001* proposes a broader strategy for attacking poverty. It identifies three dimensions: (a) *promoting opportunity*, which emphasizes the importance of overall growth, but also the quality of growth; (b) *facilitating empowerment*, ensuring that institutions are responsive to the needs of poor people; and (c) *enhancing security*, reducing the vulnerability of the poor to all forms of shocks.<sup>53</sup> The new operational perspectives on poverty reduction are likely to shape the way in which the social and poverty focus of adjustment programs will be designed in the future, including addressing such dimensions of poverty as conflict, debt burden, commodity price fluctuations, and gender.

57. ***Linking to International Development Goals.*** The seven development goals adopted by the international community provide an ambitious yardstick against which to measure the contribution of Bank adjustment operations to the campaign against world poverty.<sup>54</sup> The first of these seven goals is to reduce by half the proportion of people living in absolute poverty (defined as living under US\$1 a day) by 2015. Taken together, the goals reflect the multidimensional nature of poverty and include targets for increasing school enrollment, reducing child and maternal mortality, expanding access to reproductive health services, eliminating gender disparities, and improving environmental management for sustainable development. They describe a world with substantially less poverty, better health and education, and social and environmental sustainability for present and future generations. Aligning the Bank Group's operations—including adjustment lending—with these goals will require the development of realistic timeframes, intermediate goals, and measures differentiated by regions and countries.<sup>55</sup>

### ***b. Coverage of Poverty and Social Dimensions in Recent Operations***

58. Adjustment lending is part of the Bank's overall support for a country's development and poverty reduction efforts. The specific mix of lending instruments, and hence the focus of a particular adjustment operation in support of this strategy, is determined for each country in the context of its CAS. Nonetheless, there are several indicators—the emphasis of operational policy, the sectoral focus, and the share of adjustment operations specifically focusing on poverty reduction—that broadly reflect the evolution during the 1990s of the Bank's sensitivity to the social dimensions of adjustment. Coverage of social and poverty aspects in particular loans by itself says little about ultimate outcomes, but it is indicative of a strategic shift in the approach to poverty reduction.

59. ***Operational Policy on Social Dimensions.*** Poverty reduction is the ultimate objective of the Bank's overall assistance strategy for a country, which supports government efforts with a range of lending and nonlending instruments. Within the CAS program, structural and sector adjustment operations support the macroeconomic and sectoral policies for efficient resource allocation and accelerated sustainable growth that are essential to a comprehensive poverty reduction strategy. Adjustment lending has a significant role to play in poverty reduction by

<sup>53</sup> See *World Development Report 2000/2001: Attacking Poverty* (New York: Oxford University Press for the World Bank, 2000).

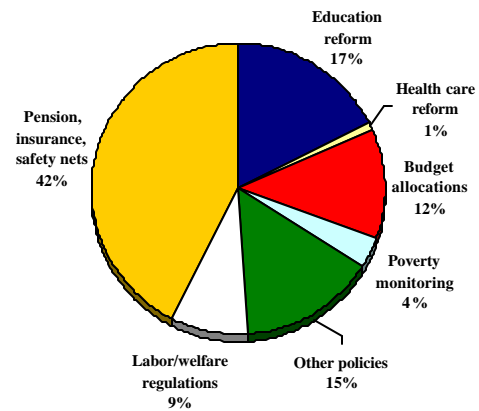
<sup>54</sup> See the Millennium Declaration signed by over 150 heads of states or governments, New York, September 2000; and 2000, *A Better World for All: Progress towards the International Development Goals*, op. cit.

<sup>55</sup> The Bank Group's strategy in aligning its efforts with the international development goals is set out in World Bank Group, *Strategic Framework*, January 24, 2001.

supporting measures to stimulate growth, investment, and job creation; and some adjustment operations may include specific poverty reduction measures. Bank policy emphasizes the social dimensions of adjustment<sup>56</sup> and advises that loan documentation should indicate the potential social effects of the adjustment program envisaged.<sup>57</sup>

60. **Social Sectors.** During the 1990s, adjustment lending increasingly focused on social sectors—health, education, and social safety nets—as measured by the share of lending and conditions. Social sector lending rose from 10 percent in FY93 to reach 25-30 percent of adjustment lending in FY98-99. As Figure 18 illustrates, the share of adjustment loan conditions directly supporting social sector reforms increased from 3 percent in FY80-88 to more than 18 percent in FY98-00. In FY98-00, pensions, insurance, and safety nets were the most important areas of social sector conditions (see Figure 23). To help governments become more responsive to the needs of poor people, social sector policy conditions also included improvements in budget allocations and poverty monitoring systems. For instance, in the Africa Region, 43 percent of Higher Impact Adjustment Lending (HIAL) operations include measures to reallocate expenditures to the social sectors.<sup>58</sup> Increased social sector spending by a government does not, of course, necessarily imply better social outcomes, which depend on the efficiency of public expenditure. There are also other sectors—such as rural development and infrastructure—that can play a significant role in poverty reduction.

**Figure 23. Social Sector Conditions, FY98-00**



Source: ALCID.

61. **Poverty Focus of Adjustment Operations.** In regular reports to the Board on poverty reduction, PREM has assessed how many Bank-supported operations included a specific poverty focus. PREM considers an adjustment loan to be “poverty-focused” if it supports government efforts at poverty reduction in at least one of three areas: (a) reallocating public expenditures in favor of the poor, (b) eliminating distortions and regulations that disadvantage poor people and limit their income-generating opportunities, or (c) supporting safety nets that protect the most vulnerable members of the population. This is a rather broad measure, which focuses on the implicit objectives of the program, rather than its actual implementation. This measure of the

<sup>56</sup> See OD 8.60, *Adjustment Lending Policy*; OD 4.15, *Poverty Reduction*; and the Operational Memorandum *Clarification of Current Bank Policy on Adjustment Lending*, June 5, 2000.

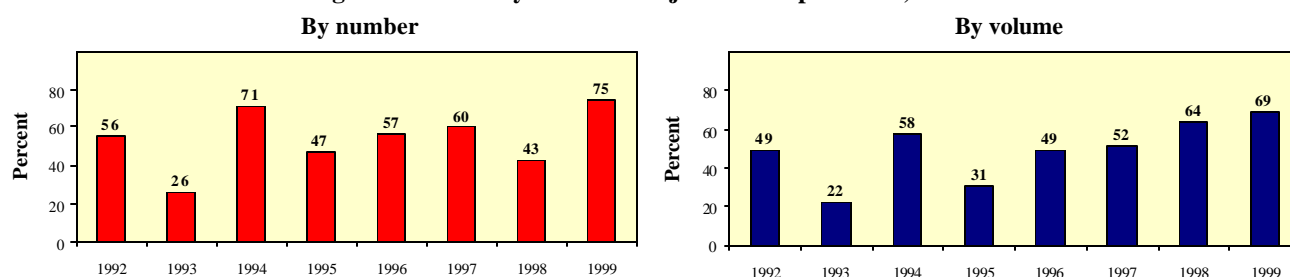
<sup>57</sup> Current Bank guidelines advise staff to ascertain that adjustment operations are supportive of, and consistent with, the country’s efforts to reduce poverty and mitigate the social costs of adjustment. The CAS is central to this, setting out a country program—adjustment lending, project lending, and nonlending services—that supports the government’s efforts to reduce poverty and mitigate the social costs of adjustment. Country circumstances, as analyzed in the CAS, determine when individual adjustment operations should focus more specifically on poverty reduction by addressing distortions and regulations that affect the poor especially and by supporting a reorientation of public expenditures toward infrastructure and social services for the poor. While not every adjustment operation can—or needs to—contain such specific poverty reduction measures, each adjustment operation is intended to contribute to poverty reduction as part of the overall country program. For each adjustment operation, staff are strongly encouraged to include at least a summary of the social impact of the Bank-supported policy reforms in the President’s Report.

<sup>58</sup> See *Higher Impact Adjustment Lending (HIAL): Initial Evaluation*, World Bank, the Operations Evaluation, Report No. 19797, June 29, 1999.



poverty focus of adjustment operations also does not capture broader concepts of poverty introduced in the *WDR 2000/2001* (for instance, opportunity, empowerment, and security), and it does not include the poverty-focused measures of the overall CAS program. However, as the method has been used systematically for a number of years, it can show something about the evolution of the Bank's focus, indicating the relative emphasis given to policy measures that address poverty reduction directly. At the aggregate level, the proportion of adjustment operations rated as poverty-focused has risen from 47 percent of the total in FY95 to 75 percent in FY99 (see Figure 24).<sup>59</sup> Over the same period, the volume of poverty-focused lending more than doubled, from 31 percent to 69 percent.<sup>60</sup> Poverty-focused adjustment operations frequently support more than one of the three objectives: of FY99 operations, 69 percent supported safety nets for the poor, 50 percent reallocated public expenditures toward the poor, and 42 percent addressed economic distortions.<sup>61</sup> The relative emphasis has varied over time, with some decreasing focus on expenditure reallocations and an increasing emphasis on social safety nets (see Table 6).

**Figure 24. Poverty Focus of Adjustment Operations, FY92-99**



Source: *Poverty Reduction and the World Bank: Progress in Fiscal 1999* (R2000-41), March 30, 2000.

**Table 6. Lending for Poverty-Focused Adjustment Operations, FY95-99**

FY	Adjustment operations (total #)	Poverty-focused adjustment operations (total #)	%	Adjustment lending (total US\$m)	Poverty-focused lending (total US\$m)	%	Objectives of loans					
							Reform public expenditures		Address distortions		Create/expand safety net	
							No.	%	No.	%		No. %
96	30	17	57	4,509	2,227	49	14	82	6	35	8	47
97	30	18	60	5,087	2,649	52	12	67	9	50	10	56
98	37	16	43	11,290	7,235	64	10	62	3	19	15	93
99	48	36	75	15,330	10,689	69	18	50	15	41	25	69

Note: Some poverty-focused adjustment loans have more than one objective.

Source: *Poverty Reduction and the World Bank: Progress in Fiscal 1999* (R2000-41), March 30, 2000.

62. **Attention to Poverty in Recent Adjustment Operations.** Judging by the greater emphasis on conditions that relate to the social sectors and the steady increase in the number of adjustment operations rated as poverty-focused, coverage of poverty issues has been growing. Although several operations illustrate examples of good practice (see Box 3), some detailed surveys—which used a variety of criteria to evaluate the attention given to poverty in recent adjustment operations—show that there is significant room for improvement.

<sup>59</sup> The series is available only from 1992. See *Poverty Reduction and the World Bank: Progress in Fiscal 1999* (R2000-41), March 30, 2000.

<sup>60</sup> This is not a wholly adequate measure, however, since adjustment lending is just one part of an overall program directed at poverty reduction. Other components may have as least as great a beneficial effect on the poor.

<sup>61</sup> See Annex F of *Poverty Reduction and the World Bank: Progress in Fiscal 1999*, op. cit.



### Box 3. Good Practice Poverty-Focused Adjustment Programs

**Uganda.** The Bank began disbursing the first of five adjustment loans to Uganda in 1981. Between 1992 and 1998, poverty in the country (as measured by the headcount index) declined, from 56 to 44 percent of the population. While many factors were probably responsible for this impressive decline in poverty, it seems that adjustment operations played an important supporting role in at least four areas.

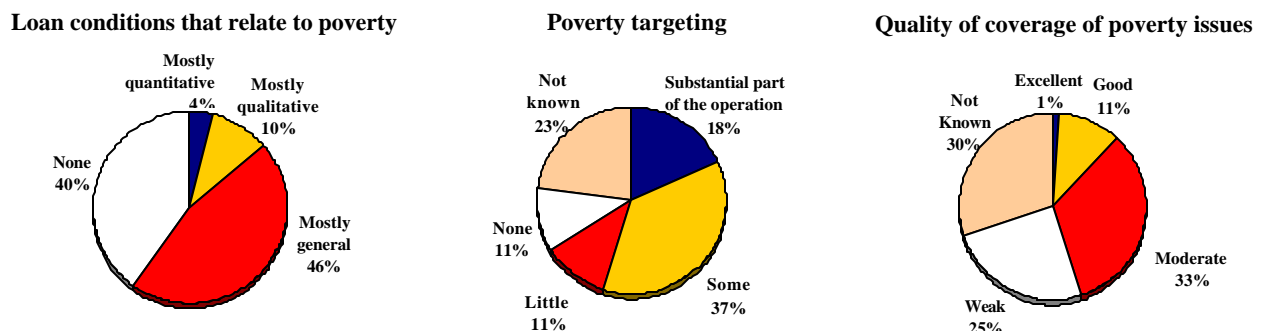
- Adjustment operations in Uganda helped lay the foundations for broad-based economic growth. Before 1990, annual real GDP growth in Uganda averaged 3.1 percent; and after 1990 it averaged 7.2 percent. Much of this success was due to the impact of successive adjustment programs, which helped to slow the rate of inflation, achieve exchange rate stability, and reform the overstuffed public sector. The loans on trade reform, in particular the lowering of tariffs and elimination of trade barriers, had an important impact on the magnitude and quality of growth.
- Adjustment supported efforts to help revitalize coffee and cotton production in rural areas, where most poor people live. By liberalizing the trade regime for coffee exports and raising the prices paid for cotton, adjustment operations helped put more income in the hands of poor rural producers. The timing of the adjustment program was fortuitous since world commodity prices for coffee were high during this period. For example, real incomes in cash crops (principally coffee and cotton) grew by an average annual rate of 24 percent between 1987 and 1996. The adjustment program had a positive effect on cash crop farmers, but there are some areas for concern: (a) the terms of trade for these cash crops have deteriorated since 1997, and the net impact of this change on poverty is not yet known; and (b) although cash crop farmers targeted by the reforms have benefited from adjustment, the incidence of poverty among food crop farmers has not changed substantially. More work needs to be done on the impact of increased income within households, especially on the gender dimensions.
- An important factor in Uganda's adjustment experience was the effort to return properties to Asians who had been expelled from the country. This contributed to making the investment environment more secure—an exceptional step that has stimulated substantial investment from the returning Asian entrepreneurs.
- Adjustment operations in Uganda helped reform public expenditures by shifting resources into programs (such as primary education and primary health care) that benefit poor people. For example, public spending on primary education increased about twofold between FY95-96 and FY98-99. A key factor here was government commitment, with the president endorsing full primary enrollment as a priority policy. As a result, primary enrollment doubled from 2.7 to 5.3 million children. A tranche release condition in a 1998 adjustment loan included the creation of a system for monitoring the accountability of public funds to primary schools and school districts.

**Korea.** In response to the East Asia economic crisis, the Bank made three large adjustment loans to Korea. These loans had important measures designed to cushion the impact of the crisis on poor and vulnerable people. Two particular measures represent good practice: (a) the extension of unemployment insurance, and (b) the expansion of the public works program to provide income support to the unemployed poor.

- Although Korea had a nascent program of unemployment insurance as part of the mandatory Employment Insurance Scheme prior to the crisis of FY97-98, only firms with more than 30 workers were covered. This left the bulk of the workforce uncovered. Coverage to include firms with 10 or more workers was already scheduled for January 1998, but the adjustment operations extended the coverage further to include firms with fewer than 5 workers, and temporary and part-time workers. This entailed an expansion of eligibility coverage from an initial 5.7 million workers at the beginning of 1998 to a total of 8.7 million workers by the end of that year. The required contribution period before eligibility was also shortened, and the duration of benefit payments was extended under the adjustment operations.
- At the peak of the crisis, poverty rates were two to three times the precrisis levels; they have since declined, by about 40 percent as of third quarter 1999. Since most of Korea's new jobless did not benefit from the 1998 accelerated expansion of unemployment insurance coverage, additional measures were introduced to provide income maintenance for the unemployed through a temporary public works program. By the first quarter of 1999, the public works program became the most important instrument of income maintenance for Korea's jobless, with around 2.5 times more people benefiting from public works than from the unemployment insurance.

- Poverty-Focused Conditionality and Monitoring.** The OPCS survey of over 100 adjustment operations in FY98-00 found that many recent loans directly support poverty reduction measures, but the survey identified further room for strengthening quality and monitoring. More than half of the loan conditions of surveyed operations related directly to poverty, although most did so in a general rather than a specific manner (see Figure 25). Similarly, more than half of the operations surveyed involved direct poverty targeting to a substantial or at least moderate degree. The survey judged the quality of coverage to be good or excellent in 12 percent of cases, but weak in one-quarter of cases. Poverty and social indicators were explicitly monitored as part of the program in 22 percent of FY98-00 adjustment operations.
- Poverty Focus by Type of Coverage.** Around 60 percent of recent adjustment operations surveyed by ESSD's Social Development Department for this retrospective explicitly included specific, distinct poverty reduction elements or components, but 40 percent did not. The survey also found that many operations included short references to vulnerable groups, but few directly and clearly disaggregated vulnerable groups (see Table 7). Moreover, less than 20 percent of the sample linked the adjustment program to efforts to directly reduce or mitigate poverty. However, in some of the operations, poverty reduction was specifically addressed by parallel social sector operations or more directly in the CAS, or may not have been an appropriate focus (as in highly technical operations).
- Poverty Focus by Sectoral Content.** According to the same survey by the Social Development Department, loans with social protection provisions to mitigate the negative impact of reform on society's most vulnerable people typically mandate a certain level of real government spending in health and education.<sup>62</sup> Social sector, public sector management, and multisector loans showed the most consistent attention to poverty, with over half addressing the poor in some way. The review also identified areas—for example, privatization—where adjustment operations have not paid sufficient attention to the potentially adverse social impact of reforms.

**Figure 25. Poverty Coverage in Adjustment Loans, FY98-00**  
(Percent of loans)



Source: OPCS survey.

<sup>62</sup> See "Review Note for Adjustment Lending Retrospective" (Social Development, ESSD, August 2000, processed), based on survey of 54 SALs/SECALs in 42 countries since 1997.

**Table 7. Attention to Poverty in Recent Adjustment Operations**

<i>Aspect</i>	<i>Operation</i>	
	<i>Number</i>	<i>Percent</i>
Has no mention or only cursory mention of poverty	22	41
Mandates government spending in health, education, or social welfare program	23	43
Provides both poverty analysis and specific mechanisms to effectively reduce poverty	9	17

*Source:* "Review Note for Adjustment Lending Retrospective" (processed, Social Development Department, ESSD, 2000).

### *c. Poverty and Social Impact of Adjustment Programs*

63. Few questions have generated as much debate as the issue of social outcomes of adjustment lending. Yet broad conclusive statements on the social effects of structural adjustment programs are typically hampered by methodological challenges. Devising an appropriate counterfactual and attributing poverty outcomes to specific operations is empirically difficult, if not impossible—especially as Bank adjustment lending often constitutes only a small portion of the resources available to governments. To interpret the results correctly, it is necessary to separate the effects of adjustment programs from the dire economic conditions that prompted adjustment in the first instance. It is also useful to distinguish World Bank adjustment lending from adjustment experiences that were supported by the IMF, multilateral development banks, and other institutions. Methodological problems are also compounded by the complexity of distinguishing the effects of particular adjustment measures on different poverty groups. For example, a devaluation may benefit poor rural farmers producing cash crops, but its inflationary effect may hurt the urban working poor. While research is under way inside and outside of the World Bank on all these matters, this section provides a (necessarily incomplete) overview of available evidence. It separates different aspects of the social impact—the link of poverty reduction to growth, adjustment, and adjustment lending, and the effect on social expenditures, gender, and social indicators—that together suggest broad trends.

64. ***Growth and Poverty.*** Changes in measurable (income) poverty are most strongly influenced by the pace of economic growth. There is strong evidence suggesting an overall positive, though variable, linkage between growth and poverty reduction.<sup>63</sup> The findings suggest that, on average, poor people typically share in the benefits of rising affluence, and they typically suffer from economic contraction. However, even when growth results in rising incomes and aggregate poverty reduction on average, it may not be accompanied by general improvements in poor people's absolute and relative incomes. In fact, the range of particular country experiences indicates a sizable variance around the "typical" outcomes for poor people. While growth-promoting policies may have close to zero average impact on inequality, specific countries may experience sizable distributional impacts, both positive and negative.<sup>64</sup> Recent estimates find that between 1987 and 1998 the incidence of poverty fell in Asia, the Middle East, and North Africa, changed little in Latin America and Sub-Saharan Africa, and rose in Eastern Europe and Central Asia.<sup>65</sup> There were two main reasons for the disappointing rate of poverty reduction in some

<sup>63</sup> See David Dollar and Aart Kraay, "Growth is Good for the Poor," *International Monetary Fund Seminar Services (International)*, No. 2000-35: 1-44, March 2000. For a debate on findings of this paper, see Jan Vandemoortele and Enrique Delamonica, *Growth is Good for the Poor: A Comment*, UNICEF, New York, June 2000; and Kevin Watkins, *Growth with Equity is Good for the Poor*, Oxfam, June 2000.

<sup>64</sup> See Martin Ravallion, *Growth, Inequality and Poverty: Looking Beyond Averages*, World Bank, Development Research Group, November 1, 2000.

<sup>65</sup> See Shaohua Chen and Martin Ravallion, *How Did the World's Poorest Fare in the 1990s*, World Bank Policy Research Working Paper 2409, August 2000.

countries: too little of the aggregate economic growth in developing countries took place in the poorest countries; and persistent inequalities (in income and other measures) within and among countries prevented poor people from fully participating in the growth that did occur. At the same time, a wide variety of factors affected performance in many countries—from a decline in terms of trade for commodity exporters to the adverse effects of diseases such as malaria and AIDS.

65. ***Adjustment Lending and Poverty Reduction.*** Adjustment supports poverty reduction principally by contributing to the creation of economic conditions that are conducive to economic growth. Successful adjustment can remove distortions and lay the foundations for higher growth. Ongoing research suggests that higher growth will benefit the poor if it is not offset by worsening income distribution. Adjustment lending can also help reduce the likelihood of an economic crisis that hurts the poor. Several researchers have questioned whether there is a systematic connection between structural adjustment programs and economic growth.<sup>66</sup> Cross-country evidence suggests that successful adjustment policies involving market reforms—often supported by adjustment lending—have tended to increase growth rates on average with little or no effect on income distribution. It further suggests that policies such as openness to international trade, low inflation, moderate government size, and strong rule of law, generally benefit the incomes of poor people as much as those of anyone else; and that some policies, notably stabilization of high inflation, may benefit the poor disproportionately.<sup>67</sup> Critics point to country cases in which adjustment lending has been associated with unsatisfactory economic outcomes, and question whether adjustment programs have meaningfully reduced poverty.<sup>68</sup> In many of these cases, inadequate implementation rather than inadequate design led to the failure of the programs.<sup>69</sup> On the other hand, some researchers have identified in adjustment programs an inadequate understanding of the complexities of the rural economy and the distributional effects on the rural poor.<sup>70</sup> Other evidence and findings are summarized below:

- ***Reductions in Inflation.*** According to an OED study, poverty-focused adjustment loans successfully helped manage reductions in inflation, and thus were an important factor in lowering income poverty.<sup>71</sup>
- ***Income and Opportunities.*** Recent research findings suggest that countries suffering economic contractions that receive adjustment loans experience smaller increases in poverty than their contracting counterparts without adjustment loans. The findings show that during FY80-98 IMF and World Bank adjustment programs together provided a smoothing of income for the poor. Multilateral efforts to help countries adjust to shocks thus reduced the burden on poor people. Adjustment episodes supported by IMF and World Bank adjustment programs helped curtail the growth of poverty during economic contraction, but were also associated with a less than

<sup>66</sup> See Francis Stewart, *Adjustment and Poverty: Options and Choices* (London: Routledge, 1995); and David Sahn (ed.), *Economic Reform and the Poor in Africa* (Oxford: Clarendon Press, 1996).

<sup>67</sup> See David Dollar and Aart Kraay, "Growth is Good for the Poor," *op. cit.*

<sup>68</sup> See Tony Killick, *Making Adjustment Work for the Poor*, Overseas Development Institute Poverty Briefing, May 1999.

<sup>69</sup> See *Adjustment in Africa: Reforms, Results, and the Road Ahead*, World Bank Policy Research Paper (New York: Oxford University Press, 1994).

<sup>70</sup> See Esbern Friis-Hansen, *Agricultural Policy in Africa after Adjustment*, Center for Development Research Policy Paper, Copenhagen, September 2000; and Pauline Peters, *Failed Magic or Social Context? Market Liberalization and the Rural Poor in Malawi*, Harvard Institute for International Development, Cambridge MA, November 1996.

<sup>71</sup> See Carl Jayarajah, William Branson, and Binayek Sen, *Social Dimensions of Adjustment: World Bank Experience 1980-93*, Operations Evaluation Study (Washington, D.C.: World Bank, 1996).

proportionate fall in poverty during economic expansion.<sup>72</sup> Possible explanations for the limited benefits of these economic expansions for the poor include these countries' inadequate policy environments and weak institutions, which prevent the poor from taking advantage of new opportunities created by structural adjustment reforms. These findings reinforce the message of the *WDR 2000/2001* addressing the needs of poor people requires expanding economic opportunities by stimulating growth, making markets work better for the poor, and increasing poor people's inclusion by building up their assets through health care and education.<sup>73</sup>

- ***Distributional Effects of Adjustment.*** The distributional effects of adjustment programs can be positive or negative on the income of various groups. Adjustment programs have sometimes been associated with growing inequalities. However, there is insufficient evidence to provide general conclusions about the overall effects of adjustment on income distribution.<sup>74</sup> Indeed, research simulating the effect of not adjusting as a counterfactual suggests that adjustment experiences were not only better for economic growth, but also were more equitable, than not adjusting.<sup>75</sup>
- ***Improved Social Conditions.*** The OED study referred to above found that countries that have successfully implemented adjustment programs and created growth are more likely to have improved social conditions and reduced poverty. OED evaluated a sample of 23 countries with poverty statistics available before and after adjustment and found that two-thirds successfully implemented adjustment, achieved per capita income growth, and reduced the incidence of poverty. The OED review suggests that, *on average*, adjustment improves conditions for poor people through indirect growth and direct spending effects.

66. ***Adjustment and Social Expenditures.*** Criticism of adjustment lending has focused on the argument that efforts to restore balance in government finances as part of macroeconomic stabilization can lead to direct cuts in public services, with negative effects on poor people. One measure of adjustment lending's impact on the poor is its effect on social expenditures. However, the link is a complex one,<sup>76</sup> as social expenditure may not always reach its intended beneficiaries and the linkage between basic social services and poverty reduction is not automatic. Also, available cross-country data on social expenditures do not capture access to services; the breakdown of primary, secondary, and tertiary expenditures; or the effects on user fees.<sup>77</sup> Nevertheless, available data indicate that developing countries receiving adjustment loans

<sup>72</sup> See William Easterly, "IMF and World Bank Structural Adjustment Programs and Poverty," World Bank, Washington, D.C., April 2001, processed.

<sup>73</sup> In addition to its effects on growth, the policy mix used to achieve adjustment may also have direct short- and long-term effects on poverty through its impact on prices, labor demand, distribution of assets, provision of public services, and the social fabric. These effects may be positive or negative, depending on the policies used and the characteristics of the poor in a given country.

<sup>74</sup> See Tony Killick, *Making Adjustment Work for the Poor*, op. cit.

<sup>75</sup> See Francois Bourguignon and Christian Morrisson, *Adjustment and Equity in Developing Countries: A New Approach*, Organization for Economic Co-operation and Development, Development Centre, Paris, 1992.

<sup>76</sup> See Deon Filmer, Jeffrey Hammer, and Lant Pritchett, *Health Policy in Poor Countries: Weak Links in the Chain*, World Bank Policy Research Working Paper 1874, World Bank, Development Research Group, Poverty and Human Resources, January 1988; and Vinod Thomas, et al., *The Quality of Growth* (Washington D.C.: World Bank, 2000).

<sup>77</sup> There is a vast body of literature related to cost recovery for health and education, focusing on increasing access to primary services. See, inter alia, Sanjay Reddy and Jan Vandemoortele, "User Financing of Basic Social Services," op. cit.

maintained and even increased social expenditures—on average, equally to or more frequently than countries without adjustment loans.

- An OED study found that in the majority of a sample of completed adjustment loans, social spending levels were protected.<sup>78</sup> In a few cases, spending levels increased significantly.<sup>79</sup> In fewer cases, the protection of social sector spending was accompanied by a successful reorientation in spending to priority areas (primary health, basic education).<sup>80</sup> In some operations, social expenditures declined during the period of implementation, mainly through a combination of weak borrower ownership and poor program coordination.
- An earlier OED study found that even when total social expenditures declined, adjusting countries were typically able to help the poor by safeguarding essential services.<sup>81</sup> The social impact of adjustment was more positive for countries that managed to preserve budgetary allocations for priority social expenditures while carrying out macroeconomic policy and supply-side reforms.
- Some evidence for Latin America suggests that in times of fiscal contraction, public spending on key social areas (education and health) fell more than public spending on nonsocial areas.<sup>82</sup> This research suggests that targeted spending for the poor may be procyclical—that is, it expands or contracts along with the state of the economy, which leads to a lack of protection for the poor during economic difficulties.
- OPCS systematically examined social expenditures in countries that received Bank adjustment lending in the period FY90-97 compared with countries without Bank adjustment lending. Its findings include the following:
  - Social expenditures *as a share of total expenditures* rose in 41 percent of countries receiving Bank adjustment lending for which social expenditure data are available,<sup>83</sup> and in 29 percent of countries with no adjustment program used as a counterfactual.<sup>84</sup>

<sup>78</sup> See Alison Evans, *Poverty Reduction in the 1990s: An Evaluation of Strategy and Performance*, op. cit.

<sup>79</sup> Examples include Ghana Private Sector Adjustment (1995), Malawi Entrepreneurship Development (1992), and Uganda First Structural Adjustment (1992).

<sup>80</sup> Some success was achieved in the Morocco SAL II (1992) and in the Bangladesh Public Resources Management (1992).

<sup>81</sup> See Carl Jayarajah and William Branson, *Social Dimensions of Adjustment, World Bank Experience 1980-93*, op. cit.

<sup>82</sup> See Norman L. Hicks and Quentin T. Wodon, *Protecting the Poor During Crises Through Public Spending? Framework and Application to Argentina and Mexico*, draft, World Bank, Latin America and the Caribbean Region, November 1999. The Argentina SSAL established an explicit condition for the protection of spending for key social programs during the 1999 adjustment period. In addition, a major part of the SSAL was targeted to the reform of social sectors and the labor market.

<sup>83</sup> Analysis of social (health, education, social security, and welfare) expenditure data for the period 1990-98 from the IMF's *Government Finance Statistics Yearbook* for 28 countries with 46 Bank adjustment loans during that period (data are unavailable for other countries). See "Social Expenditures and Adjustment Lending" (OPCS, June 2000, processed).

<sup>84</sup> Based on expenditure and GDP data for 15 nonadjusting countries.

- Social expenditures *as a share of GDP* increased or remained broadly unchanged in 90 percent of the adjusting countries examined.<sup>85</sup> By contrast, 14 percent of countries with no adjustment lending saw social expenditures increase as a share of GDP, and 50 percent saw no change.
- Social expenditures *per capita* rose substantially more often than they fell one to three years after an adjustment loan. Specifically, the per capita share of *nominal* social expenditures (health, education, social security, and welfare) had increased in 93 percent of the cases; and the per capita share of *real* social expenditures had increased in 37 percent of the cases and remained the same in 55 percent.<sup>86</sup>

67. ***Adjustment Policies and Labor Markets.*** Labor markets play a critical role in adjustment programs. Adjustment programs typically affect labor markets through three key channels: exchange rate policies, policies to reduce expenditures, and structural reforms.

- ***Exchange Rate Policies.*** Exchange rate policies have a dual role. First, in the short term, devaluations can help dampen domestic demand as part of the stabilization effort. Second, exchange rate realignments attempt to change the composition of national output in favor of tradable products. By altering domestic relative prices, they provide incentives for the production of exports and import-competing products; inducing reallocations of labor from the nontradable to the tradable sector, and eventually reducing wage differentials.
- ***Expenditure-Reducing Policies.*** Short-run stabilization in response to external or internal shocks typically involves a reduction in final domestic demand through restrictive monetary policies and budget deficit reductions (unless there is a need to increase absorption). The underlying assumption of early stabilization programs was that the labor market could absorb the fall in demand—with the real product wage falling in response to declines in production levels and labor demand, thus reducing production costs and maintaining levels of production at a lower product price.
- ***Structural Policies.*** Structural policies aim to increase the dynamic efficiency of product and factor markets by eliminating structural obstacles and removing price controls and subsidies. Typical measures include trade, price, and financial market liberalization. Traditional trade theory predicted that, as the abundant factor in many developing countries, labor would benefit from trade liberalization.<sup>87</sup>

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<sup>85</sup> Based on 27 countries with 41 adjustment loans. In countries where GDP and spending shares were falling, preserving shares of social expenditures tended to be associated with falling social expenditures per person among poor populations—partly because the number of poor persons rises during a period of decline. See Norman L. Hicks and Quentin T. Wodon, *Protecting the Poor During Crises Through Public Spending? Framework and Application to Argentina and Mexico*, draft paper, World Bank, Latin America and the Caribbean Region, op. cit.; and Martin Ravallion, *Are the Poor Protected from Budget Cuts? Theory and Evidence for Argentina* (Washington, D.C.: World Bank, Development Research Group, Poverty and Human Resources, 2000). Further work will be required to determine the adequacy of spending levels and the composition of decreases and increases in spending.

<sup>86</sup> The cases where real social expenditures fell substantially included countries as different as Belarus, Cameroon, and Hungary.

<sup>87</sup> The conclusion that the abundant factor of production gains as a result of opening trade is the corollary of the Stolper-Samuelson theorem, which contends that those who supply the scarce factor of production gain higher returns through protection that restricts imports, even though society as a whole loses.

68. **Functioning of Labor Markets under Adjustment.** Experience has shown that the effectiveness of adjustment programs in developing countries is affected by the specific characteristics of their labor markets, including the importance of the agricultural sector and self-employment in economic activity, as well as labor market segmentation.<sup>88</sup> The effects of policy packages on labor markets were found to be complex, and dependent on the initial economic and social setting.

- **Short-Run Effects.** Concerns were raised in the mid-1980s, most notably by UNICEF,<sup>89</sup> that reductions in real wages would lead to deteriorating welfare for those whose main asset is their own labor, unless this wage reduction were accompanied by an expansion in the demand for labor. In practice, the outcomes on employment and incomes cannot be generalized, but depend on initial conditions. Evidence suggests that in the absence of growth, stabilization is likely to have an adverse effect on employment where production is unequally distributed in economies specializing in mineral exports or agricultural products, where urban poverty is high in relation to rural poverty, or where there is a large oligopolistic modern sector. But employment is likely to improve where tradables are labor-intensive relative to nontradables, rural poverty is high in relation to urban poverty, and rural incomes are fairly evenly distributed.<sup>90</sup>
- **Long-Run Effects.** The extent of employment creation depends on the degree of labor-saving technical and institutional changes during adjustment. For an overall increase in employment, the positive effect of productivity increases on employment creation (primarily in the private sector) would have to outweigh the negative effects of the loss of employment due to institutional changes (primarily in the public sector). A comprehensive World Bank study of labor effects under adjustment found that most of the country cases show trend increases in unemployment, as well as underemployment related to periods of adjustment, with a shift from formal to informal employment as a form of quantity adjustment.<sup>91</sup> By contrast, the study showed differences in the real wage behavior among different groups of countries, with East Asian economies experiencing a steady increase, and less successful adjustment countries showing a less severe wage decline than severe adjustment countries. Case studies for Africa confirm a decline in public sector employment, which is insufficiently matched by an increase in private, formal sector employment, and accompanied by an increasing informalization of the

<sup>88</sup> See Pierre-Richard Agenor, "The Labor Market and Economic Adjustment," *IMF Staff Papers*, Vol. 43, No. 2, June 1996.

<sup>89</sup> See Giovanni Andrea Cornia, Richard Jolly, and Francis Stewart, eds., *Adjustment with a Human Face*, op. cit.

<sup>90</sup> See Francis Stewart, *Adjustment and Poverty: Options and Choices* (London: Routledge, 1995). Interpretations of labor markets are also complicated by findings that real wages are not only a cost factor, but also an important determinant of aggregate demand [see Lance Taylor and World Institute for Development Economics Research, *Varieties of Stabilization Experience* (Oxford: Clarendon Press, 1988)]; that the import propensity of consumption rises with incomes [see Rolph van der Hoeven and Lance Taylor, "Structural Adjustment, Labor Markets and Employment: Some Considerations for Sensible People," *Journal of Development Studies: Issues and Experience*, Vol. 36, No. 4, April 2000]; and that adjustments in product markets are needed before labor markets can function well [see John Toye, *Structural Adjustment and Employment Policy* (Geneva: International Labor Office, 1995)]. Beside well-functioning labor markets, changes in sectoral output and labor reallocations may be driven by factors such as changes in infrastructure, investment, and credit [see Rolph Van der Hoeven, "External Shocks and Stabilization Policies, Spreading the Load," *International Labor Review*, Vol. 126, No.2. 1987].

<sup>91</sup> See Susan Horton, Ravi Kanbur, and Dipak Mazumdar, *Labor Markets in an Era of Adjustment* (Washington, D.C.: World Bank, 1994).



economy.<sup>92</sup> Public expenditure cuts as part of adjustment programs have often tended to rely on pay cuts, as opposed to personnel reductions—reflected in the relative stability of public employment and a drop in real public salaries, most notably in Africa, although this seems to have been subsequently reversed.<sup>93</sup>

69. **Gender Impact.** Concerns have been raised, both within and outside the World Bank, that gender disparities in access to and control of productive resources, and in economic mobility, impede women's ability to participate in and benefit from the economic opportunities associated with adjustment.<sup>94</sup> It has been suggested that adjustment programs can have adverse effects on women, who tend to be more vulnerable to private and public sector downsizings and reduced access to basic services when user fees rise.<sup>95</sup> An ongoing OED study has found that in most countries there is analytic work indicating that the impact of adjustment programs could be different on men and women.<sup>96</sup> While the evidence on actual impacts is mixed, it suggests the need to consider gender in designing social protections strategies if policymakers are to adequately protect both women and men from the short-term costs of adjustments (see Box 4). Cross-country evidence does not show strong impacts of adjustment lending and related policies on gender equity on average. However, such analyses may conceal important differences in impacts between countries where operations explicitly addressed gender concerns in their design and those where they did not.

70. **Coverage of Gender Aspects.** Most Bank adjustment operations have not taken gender issues into account in their design. Between FY88 and FY00, according to PREM's Women in Development (WID) ratings,<sup>97</sup> 15.2 percent of all adjustment operations both analyzed women's and gender issues and included specific gender-related actions (WID 2); and an additional 13.8 percent discussed or analyzed women's or gender issues, but did not include specific gender relation actions (WID 1). The proportion of adjustment operations that discussed, analyzed, or included women's or gender issues (WID 1 and 2) has varied from year to year, most recently reaching 44 percent in FY99 and 26 percent in FY00.

71. **Adjustment and Social Indicators.** Claims that adjustment lending has been accompanied by deteriorating social indicators are not supported by available evidence. In fact, ongoing OPCS

<sup>92</sup> See Rolph Van der Hoeven and Willem van der Geest, "Africa's Adjusted Labor Markets: Can Institutions Perform?" in Willem van der Geest and Rolph van der Hoeven, *Adjustment, Employment and Missing Institutions in Africa: The Experience in Eastern and Southern Africa* (Geneva: International Labor Office, 1999).

<sup>93</sup> See Pierre-Richard Agenor, "The Labor Market and Economic Adjustment," *op. cit.*

<sup>94</sup> See, for example, Paul Collier, *Women in Development: Defining the Issues*, Planning Research Working Paper 129, Population and Human Resources Department Policy, World Bank, 1988. For summaries of concerns raised by academics and practitioners outside the World Bank, see also Commonwealth Secretariat, *Women and Structural Adjustment*, Commonwealth Economic Papers 22, Economic Affairs Division, 1991; and Nilufer Cagatay, Diane Elson, and Caren Grown, "Gender, Adjustment and Macroeconomics: Introduction," *World Development* 18(5): 695-705, 1995.

<sup>95</sup> See, for instance, Diane Elson, "Gender Awareness in Modelling Structural Adjustment," *World Development*, Vol. 23, No. 11, 1995; Ingrid Palmer, "Public Finance from a Gender Perspective," *World Development*, Vol. 23, No 11, 1995; Pamela Sparr, *Mortgaging Women's Lives: Feminist Critiques of Structural Adjustment* (London: Zed Books, 1994); and Kevin Watkins, *The Oxfam Poverty Report*, *op. cit.*

<sup>96</sup> See "The Gender Dimensions of Bank Assistance for Women: An Evaluation of Results," OED, March 26, 2001 (forthcoming).

<sup>97</sup> In 1987, the Bank established a system of WID ratings to monitor the attention paid to women and gender in all loans presented to the Board. All lending operations are reviewed and the projects are rated according to the following criteria: WID=0 (zero), if project design documents make little or no reference to women's or gender issues; WID=1, if they discuss or analyze women's or gender issues, but do not include specific actions; and WID=2, if gender concerns are analyzed and specific actions to help women are initiated.

#### Box 4. Gender Impact of Adjustment Programs

Available cross-country evidence on gender suggests that structural adjustment almost always affects women and men *differently*. This difference is due to gender inequalities in rights and resources as well as to persistent gender divisions of labor in societies. The evidence also highlights the fact that while women often experience new economic opportunities following successful adjustment, they also face a number of gender-specific risks, especially in the short term.

*Engendering Development*, a new World Bank Policy Research Report on gender and development, found, for example, that negative income shocks (whether due to economic shocks or adjustment) and price shocks (for example, those associated with government budget cuts and cost recovery programs) tend to have a larger negative impact on demand for education and health care for females than for males.<sup>a</sup> Similarly, when firms downsize, whether because of public sector retrenchment or private sector restructuring, female workers tend to be let go earlier and in greater numbers than male workers.

At the same time, the report finds that when structural adjustment leads to renewed economic development, this can contribute to gender equality. For example, increases in household income and firm-level demand for labor are commonly associated with the closing of gender gaps in human capital investments and in employment. On balance, the gender impacts of adjustment do not appear to have been as negative as some critics have claimed: adjustment lending and associated economic policies do not have significant long-term effects on gender equality—either positive or negative— independent of their effect on income growth.<sup>b</sup>

A number of adjustment operations illustrate good practice gender components or gender-related conditionality:

- The Rwanda Economic Recovery Credit (2000) supports legislation to eliminate discrimination against women with respect to inheritance and ownership rights; the adoption of a comprehensive action plan to eliminate other forms of discrimination against women and improve their access to economic services and opportunities; as well as legal and institutional changes in the agricultural sector and labor market to foster economic growth and reduce rural poverty.
- The Mali Economic Management Credit (1996) provides support to the government's efforts to address gender-based constraints on access to land and credit. This support included identifying constraints to women's access to credit; replenishing a fund that provided small credit to women; and conducting a media campaign to sensitize the public on women's rights. The credit also supported a scheme to provide financing for women's cooperatives; supported facilitating access to land for women; and provided support to the National Commission for the Promotion of Women.

<sup>a</sup> See *Engendering Development: Through Gender Equality in Rights, Resources, and Voice*, Policy Research Report (New York: Oxford University Press for the World Bank, 2001).

<sup>b</sup> See, for example, David Dollar and Roberta Gatti, *Gender Inequality, Income and Growth: Are Good Times Good for Women?*, Policy Research Report on Gender and Development, Working Paper Series No. 1, World Bank, Development Research Group, May 1999; and Nancy Forsythe, Roberto Korzeniewicz, and Valeria Durrant, "Gender Inequalities and Economic Growth," *Economic Development and Cultural Change* 48 (3), April 2000.

analysis of 430 cases of adjustment lending during FY80-97 shows that, on average, social indicators improved in countries during episodes of adjustment lending, with improvements in education and health status that were similar to those in nonadjusting developing countries. Over the last two decades, broad trends in technological advances and public policy have made education, health care, safe water, and sanitation more accessible in many developing countries. The rates of improvement in education and health indicators have varied significantly across adjusting countries and regions. Indeed, the evidence suggests that country-specific factors, including the impact of economic and domestic instability, coupled with drought, civil strife, or war, have overall been more significant than Bank adjustment lending in influencing social indicators. Table 8 summarizes the findings during the 1980s and 1990s, showing considerable variation in the social indicators across adjusting and nonadjusting countries.

- **Education Indicators.** Results show that one to five years following adjustment lending experiences, the majority of adjusting countries have improved both adult literacy and higher primary school enrollment compared to one to five years before

adjustment. Both education indicators improved broadly at the same rate in nonadjusting countries in the same periods.

- **Health Indicators.** Similarly, one to five years following adjustment lending experiences, the majority of adjusting countries show improvements in three health indicators—infant mortality, life expectancy, and immunization—compared to one to five years before adjustment. Progress in health indicators was broadly similar in nonadjusting developing countries for the same periods. For instance, all countries—with or without adjustment lending—substantially advanced the share of children immunized against diphtheria during the 1980s; and annual increases of more than 100 percent were not uncommon, especially in Africa and nonadjusting countries. By contrast, the gains in infant mortality and life expectancy across countries were not as large during the 1980s, with some adjusting African countries experiencing substantially lower improvements in infant mortality. However, by the mid-1990s, improvement rates in infant mortality had equalized among adjusting and nonadjusting countries. On average for the 1980-97 period, yearly improvements in life expectancy ranged from 2-3 percent in Bank adjusting countries, compared with 1-4 percent in nonadjusting countries.

**Table 8. Annual Average Percentage Change in Social Indicators, Adjusting and Nonadjusting Developing Countries, FY80-97**  
(1-5 years after adjustment relative to 0-5 years before adjustment)

Period	Education indicators <sup>a</sup>				Health indicators <sup>a</sup>					
	Illiteracy rate for adults (% people aged 15+)		Primary school enrollment (%, net)		Infant mortality rate (per 1,000 live births)		Life expectancy at birth (years)		Immunization (% children under 12 months) <sup>b</sup>	
	With ADJ	Without ADJ	With ADJ	Without ADJ	With ADJ	Without ADJ	With ADJ	Without ADJ	With ADJ	Without ADJ
1980s	14	15	2	4	11	15	3	3	133	119
1990-97	16	14	3	2	13	13	2	2	10	9
<b>Average share of cases where social indicators improved or remained the same, following a World Bank adjustment loan</b>										
1980s	100	—	79	—	94	—	99	—	96	—
1990-97	100	—	82	—	94	—	90	—	92	—

a Positive rate of change represents improvement of the indicator.

b Receiving diphtheria immunizations.

Source: World Development Indicators database and Bank Business Warehouse.

72. **Determinants of Social Indicators.** Country-specific experiences and good practice examples (see Box 3) suggest that improvements in social indicators were associated with a number of key factors:

- **Readiness for Reform.** In countries with adequate commitment and implementation capacity, adjustment in response to an economic shock can be quicker and the adverse impact on the poor may therefore be lower. Countries with strong ownership of the reform program are also better able to extend social safety nets and begin addressing structural changes. Korea is a good example.
- **Macroeconomic Stability.** When countries were faced with dominant macroeconomic problems—such as hyperinflation in Argentina, an overvalued exchange rate in Côte d'Ivoire, the terms of trade situation in Zambia—macroeconomic pressures tended to

place additional stress on the allocation of public expenditures for the social sector. However, as the macroeconomic difficulties were addressed (as in Argentina in 1992 and Côte d'Ivoire in 1994), steady improvement in social indicators ensued.

- ***Moderate Reforms.*** Adjustment was associated with steady improvements in social indicators even in several countries that were not able to undertake rapid, sweeping reforms, but were willing to adopt a moderate approach. Step-by-step reforms often were effective in improving the allocation and efficiency of public resources and providing better incentives for the private sector. The results were improved expenditures for health, education, and water supply, which increase life expectancy and reduce infant mortality.

73. ***Challenges.*** In the future, increased attention to the distributional impact of adjustment lending and the broader dimensions of poverty highlighted in the *WDR 2000/2001* will be critical. Effective monitoring of the poverty outcomes of adjustment lending would include specific indicators linked to the international development goals. This will require strong diagnostic and analytic work as an important underpinning of effective adjustment lending. The PRSCs described in Chapter II could be a vehicle to incorporate these principles, basing IDA countries' programs of social and structural reforms on their own poverty reduction strategies, as articulated in their PRSPs. More generally, adjustment lending faces several specific challenges to addressing its social dimensions:

- ***Opportunities and Income Distribution.*** To make adjustment work for the poor, the findings of the *WDR 2000/2001* suggest that objectives be broadened beyond lifting average economic growth rates. To maximize the distribution of benefits to poor people, it is important for adjustment programs to take account of the social and distributional consequences of key reforms and include measures to provide greater opportunities for poor people—including those marginalized from the formal sector—to build up their assets and increase their productive capacity. Such measures could include greater access to education and health care, more equitable regional development policies, support for labor institutions, and greater use of the redistributive role of the tax and transfer system.
- ***Safety Nets during Adjustment.*** A second challenge will be to maintain efforts to protect social spending on poor people and provide pro-poor services for primary health and education, clean water and sanitation, and rural infrastructure. One important element in this is adjustment lending support for the creation of effective countercyclical programs and well-targeted safety nets to protect the poor during periods of economic distress.
- ***Accountability for Pro-Poor Adjustment.*** The development community has also learned a great deal about the conditions conducive to successful pro-poor adjustment—committed government, accountable public institutions, and broad local participation. There is a growing awareness of the importance of recognizing local conditions in the development and design of adjustment loans. As the *WDR 2000/2001*

suggested, one way to improve the impact of safety nets is to make service delivery and public institutions (both local and national) accountable to poor men and women.<sup>98</sup>

- ***Monitoring Social Impact.*** During the 1990s, adjustment lending gave increased attention to poverty-focused objectives and the mitigation of possible adverse impacts of reform measures. Nonetheless, for the future it will be important to make these approaches more systematic and transparent, either ex ante in the design phase or ex post in the monitoring phase. Ongoing research would benefit from more comprehensive baseline and follow-up data to evaluate the impact of adjustment operations on poor people. In particular, data on the incidence, depth, and characteristics of poverty in a country—before and after adjustment—are key to a reliable assessment of progress in poverty reduction, the possible role of adjustment lending in it, and the distributional effect of key reforms. The World Bank and the IMF are developing a systematic approach to social impact analysis of macroeconomic and structural reforms, including the development of further diagnostic tools. This approach and corresponding tools can be used in the development of PRSPs and to underpin the PRSC and IMF arrangements under the Poverty Reduction Growth Facility that support them.
- ***Adjustment Lending as Part of Overall Poverty Reduction Strategy.*** Overall, it is clear that even the best designed adjustment operation can make only a partial contribution to the effort to reduce poverty. For the future, it will be important to ensure that the economic reform agenda in adjusting countries reinforces, and is reinforced by, an effective strategy for poverty reduction, including reforms in the social protection policies and institutions supported by adjustment programs.

## 2. *Economic Management*

74. The thrust of economic policy reforms has changed over time. During the 1980s, such reforms principally focused on realigning relative prices by removing obstacles to growth. Today, they are more likely to center on longer-term structural reforms involving institution building, to restore the basis for sustained growth. Adjustment lending requires that adequate macroeconomic policies be in place. The experience of Bank-IMF coordination in this regard is discussed in detail in Chapter IV.

75. ***Beginnings.*** In 1980, when structural adjustment lending began, most candidates for a structural adjustment loan had large external deficits, large fiscal deficits, and often, high inflation rates. Stabilization required changes—usually reductions through fiscal adjustment—in domestic demand to match the level of available resources. But adjustment began to expand beyond stabilization to address the fundamental distortions created by decades of import-substituting industrialization policies, such as trade protection, industrial subsidies, financial repression, public enterprises, and agricultural marketing boards. Adjustment programs focused on getting relative prices right—typically through reducing effective protection in trade, liberalizing agricultural markets, and reducing subsidies for energy pricing. Originally focused

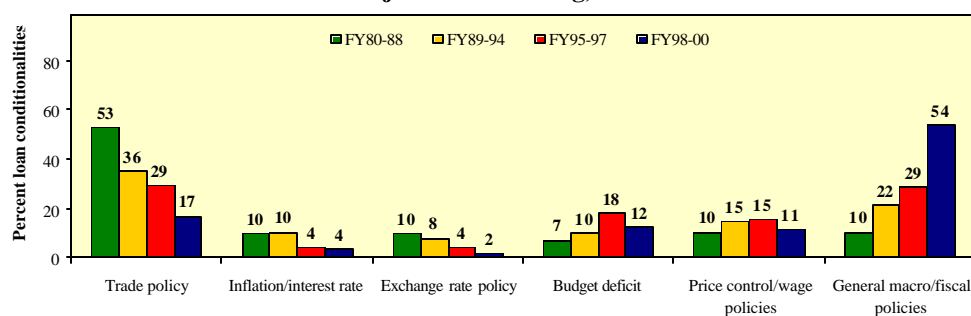
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<sup>98</sup> For example, recent adjustment operations in Brazil have supported the decentralization of social assistance programs to states and municipalities, in order to increase transparency and accountability throughout the system. This includes Brazil's Community Health Program, which involves the local population in providing training and services to health clinics in poor rural areas. See *World Development Report 2000/2001: Attacking Poverty*, op. cit.

on helping countries to grow out of their external debt burden, these market-opening reforms evolved over time into what came to be labeled as the “Washington Consensus.” The one-off reforms of early adjustment operations were relatively successful in addressing balance of payments problems. But once the fundamental distortions to sustainable growth had been addressed, it became apparent that the focus on getting relative prices right needed to be broadened to long-term structural reforms to confront the much more complex agenda of reducing poverty.

76. ***Evolution of Approach to Economic Management.*** Over the last decade, economic management reforms supported by Bank-financed adjustment operations have come to address a wider range of issues that are more institutional in nature. This transformation has been reflected in the economic management conditionality attached to loans, which has come to focus more on fiscal reforms, including tax administration and budget deficit management (see Figure 26). Emphasis on reforming internal regulations, public enterprises, and the financial and social sectors has increased. Other changes have been the more thoughtful integration of fiscal reforms into country-specific budget processes and a greater consideration of revenue generation and expenditures in the context of deficit reductions. At the same time, institutional reforms in public finance and in the financial and social sectors—areas traditionally supported by slower-disbursing instruments—have increasingly become an important focus of adjustment programs. By contrast, there has been less emphasis on reforms in trade policy.

**Figure 26. Economic Management Conditionality in Adjustment Lending, FY80-00**



Source: ALCID.

77. ***Recent Experiences.*** In terms of program design, recent adjustment operations with a focus on economic management have typically been supported by broad economic and sector work, often accompanied by technical assistance to improve fiscal and debt management with modern methods of management, accounting, and information technology. Recent loans have considered a broad range of economic aspects, including labor market reforms and an increasing focus on fiscal policy. On the revenue side, besides conventional analysis on increasing revenue collection from traditional sources, there are innovative programs to improve customs collection, address corruption, and improve the yield from natural resources. On the expenditure side, recent loans have often reviewed subsidies to public enterprises and agricultural inputs and products, and have evaluated the efficacy of expenditures on social infrastructure, especially health, education, and social security.

78. ***Labor Markets Reform.*** Economic management reforms have included reforms of labor market institutions, which can play an important role in shaping the response to adjustment programs. Labor market distortions may imply inefficient allocation of resources; conversely, East Asia's high growth of employment without excessive wage pressures has been attributed to the fact that it has only limited labor market distortions.<sup>99</sup> The East Asia experience has led to recommendations that it is good practice for developing countries to abolish minimum wage laws, contest the practice of making wage settlements binding for whole sectors, and revoke dismissal laws.<sup>100</sup> But there is evidence that economic reform processes need institutions that can provide a positive climate for growth while dealing with trade-offs, human capital development, income distribution, and the social consequences of adjustment.<sup>101</sup> In many cases, labor market regulations have not hindered economic reforms, and labor markets show flexibility despite regulations.<sup>102</sup> Although inflexible labor regulations are still an impediment to productivity increases in many countries, a balanced view would embrace the positive aspects of institutions that are macroeconomically compatible,<sup>103</sup> including their contribution to social stability and equity, wage moderation, and reduced pressure for government expenditure.<sup>104</sup>

79. ***Expenditure Policy Reforms.*** Past Bank adjustment operations in developing countries have supported efforts to examine public spending priorities for consistency with countries' development needs—often informed by public expenditure reviews. Reviews of capital expenditures received the greatest attention in loan conditions, followed by reforms of public employment and wages, and elimination of subsidies to state enterprises and on agricultural commodities. In recent years, the Bank has focused more on social sector spending. A review of Bank-assisted programs to enhance the efficiency and equity of public sector service provision finds that (a) Bank conditions had small positive effects on expenditure patterns; and (b) loan conditions on social sector spending had a stimulative impact on social spending.<sup>105</sup> Adjustment lending conditions also sought to ensure that adequate resources were set aside to maintain existing facilities, especially road networks; but the record in shifting public spending toward operations and maintenance was mixed. In part, the mixed performance in implementing loan conditions on public expenditures can be traced to the budgetary inflexibility faced by many developing countries, where large expenditure categories such as fiscal transfers to lower levels of government, defense, and debt charges cannot be adjusted in the short run.

### 3. *Public Sector Reform and Fiduciary Issues*

80. The deepened appreciation that effective reforms for sustainable development and poverty reduction have institutional dimensions has been reflected in the growing importance of public sector reform—including civil service reform and improvements in budget management—during the 1990s. There has also been an increasing emphasis on improving transparency, accountability, and effectiveness in borrowers' management of public finances, which has a

<sup>99</sup> See Gary Fields and Henry Wan, Jr., "Wage Setting Institutions and Economic Growth," *World Development*, Vol. 17, September 1989.

<sup>100</sup> See Rolph van der Hoeven and Lance Taylor, "Structural Adjustment, Labor Markets and Employment," op. cit.

<sup>101</sup> See Rolph van der Hoeven and William van der Geest, "Africa's Adjustment Labor Markets," op. cit.

<sup>102</sup> See Zafiris Tzannatos, *Labor Policies and Regulatory Regimes*, PSP Occasional Paper No.11, World Bank, Washington, D.C.

<sup>103</sup> See John Toye, *Structural Adjustment and Employment Policy*, op. cit.

<sup>104</sup> See Rolph van der Hoeven and Lance Taylor, "Structural Adjustment, Labor Markets and Employment," op. cit.

<sup>105</sup> See Jeff Huther, Sandra Roberts, and Anwar Shah, *Public Expenditure Reform under Adjustment Lending: Lessons from World Bank Experience*, World Bank Discussion Paper No. 382 (Washington, D.C.: World Bank, 1997).

bearing on the management of adjustment funds. This section first traces the evolution of the Bank's approach to public sector reform supported by adjustment programs, and then describes the current fiduciary arrangements for adjustment lending.

### *a. Public Sector Reform*

81. For many years the Bank has supported public sector reform through adjustment lending and related technical assistance (TA) operations. To help governments sustain reforms, lending has not only provided incentives for immediate policy changes, but has also supported reforms in the management of public resources—such as budget preparation and execution, tax and customs, and management of personnel and the wage bill. The Bank has had mixed success in civil service reform, improvements to economic and financial management, and procurement.<sup>106</sup> The record shows that public sector management loans have overall performed poorly and that technical assistance in this area has had a success rate of 43 percent, compared with a 65 percent success rate for the whole TA portfolio. In the past, adjustment lending has focused on short-term cost-containment measures<sup>107</sup> designed to permit governments to meet new fiscal targets while improving the allocative and technical efficiency of personnel expenditures—but these measures have had little medium-term impact.<sup>108</sup> In some cases, the focus on short-term measures that are part of a fiscal consolidation program has been accompanied by insufficient consideration of the necessary institutional prerequisites for successful reform. Pay and employment reforms, for instance, have depended on technical systems that many countries lacked.

82. **Public Sector Retrenchment.** An important part of Bank support for public sector reform has been assistance for public sector downsizing, to help countries reduce budget deficits and address inefficiencies created by state-led development strategies. However, programs to reduce the role of the state can be difficult to agree on domestically and to implement, especially when they involve large-scale dismissals. Thus, voluntary approaches that offer severance pay to encourage redundant workers to quit have become more frequent.<sup>109</sup> Typical assessments of the returns from downsizing compare savings in terms of public sector wages with the cost in terms of severance pay packages, retraining, and redeployment programs, complemented to the extent possible by consideration of the economic returns and externalities of mass retrenchments. While the gains from downsizing are potentially large, the chances of mishandling the process are likewise considerable: the risks include subsequent rehiring of separated workers, arbitrary severance packages, and ineffective retraining and redeployment programs.<sup>110</sup> A World Bank research project on public sector retrenchment found that the downsizing operations supported by the World Bank yielded high financial returns, indicating that the present value of the

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<sup>106</sup> The results of the many evaluations and assessments are summarized in *Reforms of Public Institutions and Strengthening Governance: A World Bank Strategy*, Volume I, Overall Strategy (CODE99-97), December 30, 1999.

<sup>107</sup> These address issues such as a civil service that is too large in terms of total government revenues and as a percentage of GDP; excessive numbers of low-level staff; erosion of public sector salaries; and wage compression, which makes middle- and high-level salaries demotivating and uncompetitive.

<sup>108</sup> See *Civil Service Reform, A Review of World Bank Assistance*, Operations Evaluation Sector Study No. 19599, World Bank, August 1999; and Barbara Nunberg and John Nellis, *Civil Service Reform and the World Bank* (Washington, D.C.: World Bank, 1995).

<sup>109</sup> For an overview of public sector downsizing, see Martin Rama, "Public Sector Downsizing: An Introduction," *The World Bank Economic Review (International)*, 13:1-22, January 1999.

<sup>110</sup> See Barbara Nunberg, "Experience with Civil Service Pay and Employment Reform: An Overview," in David Lindauer and Barbara Nunberg, eds., *Rehabilitating Government: Pay and Employment Reform in Africa* (Washington, D.C.: World Bank, 1994).



reductions in the public sector wage bills outweighed the up-front cost in terms of severance pay and enhanced safety nets.<sup>111</sup> But it also found rehiring in 40 percent of the operations and a considerable amount of resources spent inefficiently on active labor market programs such as training and job placement.

83. ***Lessons Learned.*** In the past, donors were reluctant to acknowledge that good governance determines public sector reform success. They overemphasized the potential of technical inputs to bring about transparent and accountable public sector management. However, decisions on key strategic elements such as the rationale and objectives of these reforms require a balancing of domestic interests. Reform means changing the rules and behavior that govern and embody the management of such key functions as procurement, customs and taxation, and financial and personnel management; thus it may threaten many of those who control the resources and mechanisms of the state apparatus. Success in public sector reform requires that Bank efforts be based on an understanding of the country's political economy. Also important are a clear government vision of the role it expects of the public administration; broad consensus on a comprehensive program of carefully sequenced measures; top government commitment to, and involvement in, the reform process; and appropriate sequencing of reform actions during implementation. In some cases, existing management systems may make it difficult to sustain reforms until certain prerequisites, such as an accurate database and management system for persons and posts, are in place. In such cases, it will typically be important to first create the systems and procedures for improved pay and employment management.

84. ***New Approach to Public Sector Reform.*** The Bank's new approach to public sector reform recognizes that ineffective public institutions and weak governance are the real roadblocks to development effectiveness, and that flawed organizations and management functions are of secondary importance.<sup>112</sup> Consequently, the Bank is supporting the much broader reform agendas of its members: improving public service delivery; realigning of responsibilities among governmental bodies to enhance checks and balances and improve accountability; strengthening courts and oversight agencies, such as auditors general; redefining internal rules and procedures in budget management; enhancing the role of civil society; and building anticorruption institutions.

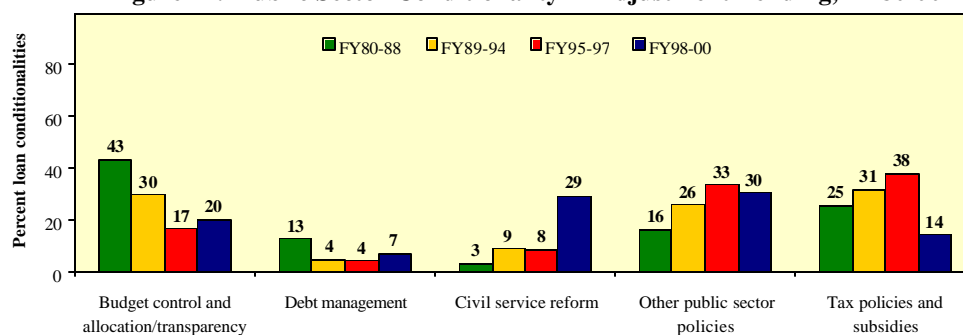
85. ***Content of Public Sector Reform Conditions.*** The Bank's new approach still targets the core functions of government—macroeconomic management, expenditure management, revenue generation, deregulation and private sector development, and civil service and administrative reform—as is evident in recent operations. In FY98-00, for instance, 20 percent of conditions in the area of public institutions and regulations related to the budgeting process and 29 percent to civil service reforms (see Figure 27). But the focus of these reforms is increasingly on governance and transparency. Three projects approved in 1999 included anticorruption initiatives, which cut across all functions, and five included other measures that were generally absent in the past: realignment of core functions of the state (Latvia), redefinition or strengthening of decentralized levels of government (Argentina and Indonesia), and greater

<sup>111</sup> See the website of the research project: Shrinking Smartly: The Public Sector Downsizing Clearinghouse, [www.worldbank.org/research/projects/downsize](http://www.worldbank.org/research/projects/downsize).

<sup>112</sup> This is reflected in the *World Development Report 1997: The State in a Changing World* (Washington D.C.: Oxford University Press for the World Bank, 1997). See *Reforming Public Institutions and Strengthening Governance: A World Bank Strategy*, Volume I, Overall Strategy (CODE99-97), December 30, 1999; and the *Civil Service Reform: A Review of World Bank Assistance*, Operations Evaluation Sector Study No. 19599, World Bank, August 4, 1999.

accountability and transparency (Latvia and Thailand).<sup>113</sup> These projects reflected the new importance the Bank places on governance, not merely on improved technical functions.

**Figure 27. Public Sector Conditionality in Adjustment Lending, FY80-00**



Source: ALCID.

86. **Trends in Recent Loans.** The conditions in some regions and countries offer suitable environments in which to deploy the core tools of the new approach—voice, competition, institutional analysis, reform of state institutions, and combating corruption—and operations in these countries exhibit characteristics that are considered good practice. Most lending now includes a long-term institutional approach and reform through various types of lending or analytic and advisory services, even when loans are not formally programmatic adjustment loans.<sup>114</sup> The focus on ultimate objectives rather than on technical problem areas, combined with measures to involve other economic and social stakeholders and to introduce competition and contestability, is an important element of current adjustment lending more generally.

87. **Future Considerations.** Improved loan design can only partially address the difficulties of achieving change in weak public sector environments. Implementing institutional reforms has proven notoriously difficult, despite decades of Bank and donor community experience. This suggests the need for continuous efforts to revisit and adapt good practice in reform management in general. Technical assistance, training, and knowledge transfer in economic, financial, and human resources management remain critical to promoting institutional reforms. But the difficulty and complexity of institutional reforms requires a medium-term approach—there are few quick fixes. Public sector reform is not just a technical issue. It also needs to address the underlying incentives for, or political economy of, the reform effort, taking into account the country's specific circumstances. It requires both the commitment of a country's top leadership and informed stakeholder demand. Sector work and analysis of the political economy are required to evaluate country capacity and ensure adequate levels of understanding and involvement in formulating and promoting reforms.

<sup>113</sup> Argentina SSAL (1999), Indonesia Policy Reform Support Loan I and II (1999), Latvia PSAL (2000), and Thailand Public Sector Reform Loan (2000).

<sup>114</sup> While the Brazil Public Sector PSAL, Latvia PSAL, and Thailand Public Sector Reform Loan are formally designated as programmatic adjustment loans, other recent adjustment operations supporting public sector reform in this set share programmatic characteristics. Older loans (Malawi and Honduras) have the narrower focus, that prevailed before 1997; the Argentina, Morocco, and Yemen loans reflect elements of the new approach; the loans approved in 1999 to Indonesia, Latvia, and Thailand extend coverage and directly address governance issues, such as corruption, and support voice mechanisms.

***b. Fiduciary Issues for Adjustment Lending***

88. Fiduciary issues in adjustment lending are addressed through specific arrangements for the disbursement, reporting, and auditing of loan proceeds, as well as through a developmental focus on good governance, with support for public financial management reforms.

89. ***Arrangements for Disbursement, Reporting, and Auditing of Loan Proceeds.*** The disbursement, reporting, and auditing procedures governing adjustment lending are set out in OD 8.60 and accompanying Operational Memoranda (see Box 5). The 1996 Operational Memorandum introducing simplified disbursement arrangements, noted that “given the fungibility of resources, in the context of adjustment lending it is more important for the Bank to focus on the borrower’s overall use of foreign exchange. Therefore, simplifying disbursement procedures under adjustment operations goes hand in hand with an emphasis on the overall use of resources through more efficient foreign exchange markets (normally handled in IMF programs) and appropriate public expenditure allocations. Public expenditure reviews are thus at the center of the Bank’s adjustment work.”<sup>115</sup> As part of the broader effort to strengthen financial management in borrower countries, Bank staff have increased monitoring of fiduciary arrangements. For example, enhanced reporting arrangements have been included in recent adjustment operations in Cambodia, India’s state of Uttar Pradesh, and Uganda. Staff are also consulting with the Fund to ascertain whether it has any major concerns over the control environment of central banks in which proceeds of adjustment loans are deposited.

**Box 5. Disbursement, Reporting, and Auditing Arrangements for Adjustment Lending**

The Bank simplified disbursements for adjustment lending in 1996 by delinking disbursements from specific imports.<sup>a</sup>

- Under the simplified disbursement procedures, documentary evidence of imports is no longer required to support disbursements. Proceeds of adjustment loans are now disbursed upon satisfactory implementation of the adjustment program, including compliance with the stipulated tranche release conditions and achievement of a satisfactory macroeconomic framework. Disbursements of the loan proceeds are made into a deposit account opened by the borrower in its central bank; loan proceeds may be used to finance general foreign exchange needs, subject to a negative list of ineligible items.<sup>b</sup>
- If an amount of the loan is used to finance ineligible expenditures, the Bank requires the borrower to (a) either return that amount to the deposit account for use for eligible purposes, or (b) refund the amount directly to the Bank, in which case the Bank will cancel an equivalent undisbursed amount of the loan.
- Although the Bank does not routinely require an audit of the deposit account, it reserves the right to do so.

<sup>a</sup> See the Operational Memorandum *Simplifying Disbursements under Structural and Sectoral Adjustment Loans*, February 8, 1996.

<sup>b</sup> Ineligible items on the negative list include the items imported from nonmember countries local expenditures, non-productive expenditures (such as military and luxury items) and goods and services from a country under an embargo decision of the United Nations Security Council.

90. ***Expenditure Reviews and Fiduciary Assessments.*** Over the past years, with the recognition of the critical role that borrower arrangements for managing public finances play in development outcomes, and with adjustment lending volumes rising during the global financial market downturn, the Bank’s range of diagnostic instruments to review country performance has evolved accordingly. The scope and depth of public expenditure work in the Bank have grown significantly and have been complemented by the upgrading of the fiduciary diagnostic products—the Country Financial Accountability Assessment (CFAA) and the Country Procurement Assessment Report (CPAR). Together, the traditional public expenditure review (PERs), CFAAs,

<sup>115</sup> See the Operational Memorandum *Simplifying Disbursements under Structural and Sectoral Adjustment Loans*, op. cit.

and CPARs provide an integrated and multidisciplinary perspective on public expenditure and financial management.

- ***Public Expenditure Reviews.*** PERs analyze the expenditures and revenues of the broad public sector. Although not required by current operational policy as a prerequisite of adjustment lending, this analysis is crucial to help evaluate the quality of government spending and spending policies in promoting economic growth and reducing poverty. PERs also generally cover the quality of the public expenditure management system. Thus a PER is a critical tool in preparing adjustment operations, although the same information may also be available from other sources. In the 1980s and early 1990s, the content of PERs varied widely, addressing a range of issues from conventional concerns about fiscal sustainability and debt dynamics to the much broader theme of institutional capacity for public resource management. Reflecting the Bank's increased focus on governance and institution building during the 1990s, PERs of recent years stress the need to understand the rules of the game that govern budget formulation and execution and the way institutions influence the choice and achievement of government objectives.<sup>116</sup>
- ***Country Financial Accountability Assessments.*** The CFAA is a diagnostic tool designed to enhance the Bank's knowledge of financial accountability arrangements in the public and private sectors in client countries.<sup>117</sup> It supports the exercise of the Bank's fiduciary responsibilities by identifying the strengths and weaknesses of accountability arrangements in the public sector and the risks that these may pose to the use of Bank funds. It also supports the achievement of the Bank's development objectives by facilitating a common understanding—by the borrower, the Bank, and, where possible, development partners—of the country's financial management arrangements in both the public and private sectors, thus supporting the design and implementation of capacity-building programs. A full-scope CFAA addresses public sector budgeting, accounting, and financial reporting; internal control systems and records management; auditing; legislative oversight; and public access to information. In practice, the content varies from country to country, reflecting country circumstances, the availability of other ESW within the Bank and from development partners, and the expected size and nature of the Bank's program. Thirty-nine percent of FY99 adjustment operations, and 50 percent of those approved in FY00, were underpinned by a CFAA/CPFA that was less than five years old.
- ***Country Procurement Assessment Report.*** The CPAR has also evolved since its introduction in the mid-1980s. It was originally designed as an internal tool for Bank staff to identify unacceptable national procurement practices that could not be used with Bank-financed projects. The revised CPAR introduced in 1998 serves as a tool

<sup>116</sup> See "World Bank Work on Public Expenditure Management and Accountability: Evolution and Current Status," Draft, Public Sector Group, PREM, March 2001.

<sup>117</sup> Country diagnostic reviews of financial accountability were introduced in the early 1990s. Initially, they were carried out in a relatively small number of countries. Starting in FY97, the Bank began to increase coverage using the CPFA, which provides an overview of the accountability environment. CPFAs have now been carried out in a total of 44 countries. At the same time, it was apparent that a more detailed review would be needed, and this led to the upgrade and increased use of the more detailed CFAA.

to assess the health of a country's procurement system and to initiate a dialogue with the government on actions to improve the system. It encompasses an assessment of the legal framework, trade practices, the financial framework, procurement organization and procedures, decisionmaking authority, and anticorruption initiatives and programs undertaken with the full cooperation and often active participation of representatives from the client country government. In addition, it includes analysis of the operation of the system through interviews with private sector and public sector users. CPAR still serves Bank needs by helping to identify operational risks in a country and set appropriate Bank supervision standards, and by contributing to the design of risk mitigation plans for countries that will receive sector and programmatic loans. Many of the earlier assessments have led client countries to initiate reform programs. CPARs have also led to a heightened interest in capacity building, which has been identified as an issue in every country reviewed to date. Seventeen percent of FY99 adjustment operations, and 30 percent of those approved in FY00, were underpinned by a CPAR that was less than five years old.

91. ***Strengthening Public Financial Management.*** The performance of institutions, particularly those charged with the management of public financial resources, is critical to ensuring that adjustment loan proceeds are used to support the adjustment program and that borrower resources are effectively managed. The increased diagnostic work has provided a solid underpinning for lending operations to help strengthen the performance of borrower institutions. The Bank's greater focus on governance and institution building is reflected in higher proportions of adjustment and total lending devoted to strengthening public sector management (see Box 6). Reforms supported by adjustment lending measures can help to combat corruption by, for instance, removing opportunities for rent seeking, increasing public sector transparency, and strengthening public institutions' accountability. There is also emphasis on country risk analysis to evaluate the level of corruption and its effect on country economic performance or the borrower's ability to carry out the program.<sup>118</sup> Notwithstanding the complexity and diversity of public financial management systems, their effectiveness depends on the adequacy of several key elements, including (a) a comprehensive budget, with an appropriate focus on poverty reduction expenditures; (b) systems to guide and monitor budget implementation and monitoring; and (c) systems of fiscal reporting and auditing.

92. ***Ongoing Work.*** Several options to more effectively address fiduciary issues in adjustment lending are currently under consideration:

- Increasing country coverage by the core fiscal and fiduciary products—PERs, CFAAs, and CPARs—moving from an average of about 40 reports in FY00-01 to 60-75 reports in FY02. These ESW products identify problems for policy action, institutional change, and capacity building, notably in the context of programmatic lending, that can enhance the effectiveness of development spending and the confidence of donors that funds are spent as intended.
- Working with global partners—in particular the Fund and the global standard-setting agencies in accounting and auditing—to enhance the set of generally accepted

118 See *Helping Countries Combat Corruption: The Role of the World Bank* (Washington, D.C.: Poverty Reduction and Economic Management, World Bank, 1997). This policy was reaffirmed in *Bank's Anti-Corruption Action Plan for FY99*, Memorandum of the Managing Directors to Staff, January 6, 1999.

### **Box 6. Public Expenditure Management in Adjustment Lending**

The Bank's focus on governance has significantly affected the content of the Bank's lending programs. As the first-generation reforms related to the removal of policy distortions were completed, the Bank's lending programs have focused increasingly on institution building. While only 0.6 percent of Bank lending supported core public sector reforms in FY80, the share had risen to 15.9 percent of total lending (\$2.4 billion) by FY00. The bulk of this amount (\$2.1 billion) was for adjustment lending in support of public sector management reform. Within this rising portfolio of public sector reform loans, the focus on public expenditure management has substantially increased. Over the FY97-00 period, the number of public expenditure and financial management components in Bank lending more than doubled, from 21 components in FY97 to 48 components in FY00.<sup>a</sup> A number of recent innovative adjustment operations have made public expenditure management a central element of their focus on improved governance.

- The \$400 million Thailand Public Sector Reform Loan, approved in September 1999, supported government efforts to undertake an ambitious public sector reform program that sought to achieve a more performance-oriented budget system, a flexible and effective civil service, greater public sector accountability, and fiscal transparency. Bank support also included intensive policy dialogue, technical assistance, and knowledge sharing.
- A \$40.4 million programmatic SAL to Latvia, approved in February 2000, was focused on strengthening the capacity and credibility of public sector institutions by supporting the development of links between the government strategy and a medium-term budget, a transparent and unified public accounts system to strengthen accountability for resource use, and a move toward performance-oriented budgeting in line ministries.
- A \$250 million PRSC for Uganda presented to the Board on May 31, 2001, has been prepared on the basis of a long and fruitful collaboration on diagnostic analysis and technical assistance on public expenditure issues.

<sup>a</sup> See "World Bank Work on Public Expenditure Management and Accountability: Evolution and Current Status," Draft, Public Sector Group, PREM, World Bank, March 2001.

standards for financial management in the public sector, and increasing the use of these standards as a reference point in country assessments and capacity-building operations

- Including measures to strengthen the management of public finances in Bank support programs, including adjustment lending.
- Exploring how oversight institutions in borrowing countries—in particular public auditing bodies—can provide enhanced assurance to both the public and donors on the use of public funds.

#### **4. Financial Sector Reform**

93. Financial sector reform has become one of the most important areas supported by adjustment loans. During the 1980s, for example, onlending through individual institutions through financial intermediary loans (FILs) still accounted for 70 percent of Bank financial sector lending. By 1988, the number of FILs had begun to fall sharply. Structural adjustment lending with financial sector conditionality and TA loans became the main financial sector lending instruments.<sup>119</sup> A 1989 report (the so-called Levy report) argued the case for a more comprehensive approach to the financial sector that would emphasize strengthening policies and institutions and relying on market forces. It also warned that macroeconomic stability, real sector efficiency, and a sound regulatory and supervisory framework were essential for financial

<sup>119</sup> See *Financial Sector Reform: A Review of World Bank Assistance*, Operations Evaluation Study, No.17454, March 6, 1998.

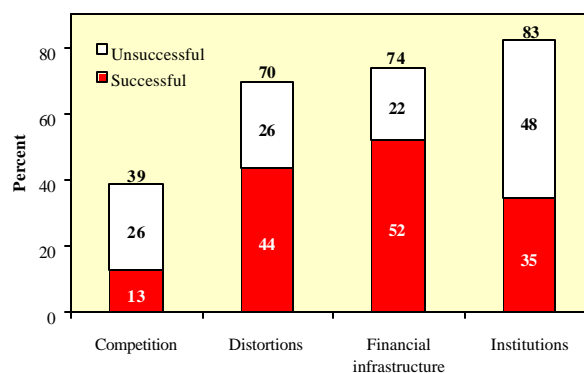
liberalization.<sup>120</sup> This approach was eventually codified in the 1992 OD 8.30, *Financial Sector Operations*. In 1998 the OD was replaced by OP 8.30, *Financial Intermediary Lending*, which recommended a comprehensive approach to the financial sector, and cautioned against lending to economies characterized by unstable and distorted macroeconomic environments and administered interest rates.

94. **FSALs.** Financial sector adjustment loans (FSALs) were authorized in 1985 to support reforms of financial sector policy (notably to encourage market-based interest rates) and institutional reforms. FSALs are often prepared in response to financial sector distress following a devaluation. In the last 15 years, financial sector lending has increased steadily:

- In FY85-96, there were 30 FSALs averaging US\$265 million each and totaling US\$8 billion. About 40 percent of the lending was in six large loans to Argentina, India, and Mexico.<sup>121</sup> In addition, the Bank often included financial sector conditionality in SALs, FILs, and specific investment loans during this period.
- In FY97-99, 15 countries received 14 FSALs totaling US\$3.2 billion, plus six SALs with significant financial sector conditionality, for US\$8.8 billion. Some 85 percent of this lending was in nine loans, of which seven were extended as part of IMF-Bank packages to East Asian crisis countries.<sup>122</sup>

95. **Quality of Financial Sector Adjustment Loans.** OED's 1998 evaluation of FY85-96 financial sector loans rated outcomes successful in 52 percent of the sample.<sup>123</sup> To evaluate the loans, OED divided conditionality into four areas: (a) removing distortions (for instance, liberalizing interest rates, directed credit, and the capital account); (b) fostering competition (privatizing financial institutions, leveling the playing field, and easing entry restrictions, including those on foreign banks); (c) improving financial infrastructure (addressing legal issues and promoting transparency); and (d) strengthening institutions (for instance, those responsible for supervision and restructuring). As Figure 28 illustrates, the OED outcomes suggest that it may be harder to restructure institutions and increase competition than it is to remove distortions and to pass and enforce stiff regulatory and legal measures: regulatory forbearance—when the authorities enact new regulations but allow for a gradual phasing in of their enforcement—was frequently applied even in successful cases. For example, in the 1988

**Figure 28. Conditionality and Success in Financial Sector Reform Lending, FY85-96**



Source: OED, *Financial Sector Reform: A Review of World Bank Assistance*, Operations Evaluation Study No.17454, World Bank, 1998.

<sup>120</sup> See *Report of the Task Force on Financial Sector Operations* (R89-163), August 1, 1989.

<sup>121</sup> See *Financial Sector Reform: A Review of World Bank Assistance*, op. cit. Three loans were made for US\$500 million (two to Argentina, one to Mexico), one US\$700 million package went to India, and one of US\$1 billion went to Mexico.

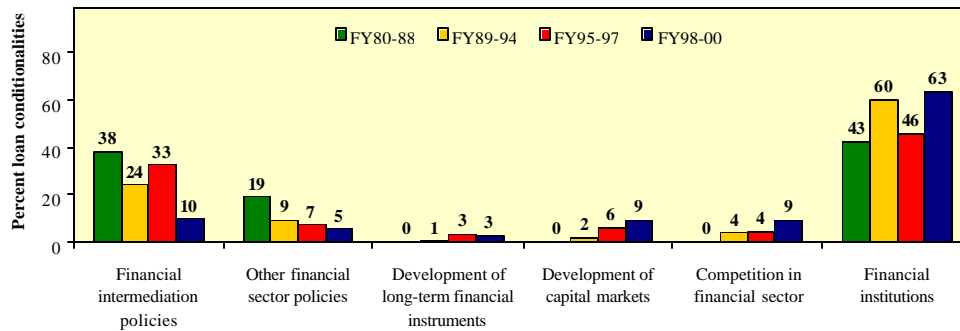
<sup>122</sup> This included three FSALs to Thailand for US\$1.3 billion, two SALs to Indonesia for US\$1.5 billion, and two SALs to Korea for US\$5 billion, plus two operations to Argentina for US\$2.4 billion.

<sup>123</sup> See *Financial Sector Reform: A Review of World Bank Assistance* op. cit., The ratings of the Project Completion Reports and Performance Audit Reports, although they differed in particular country cases, were broadly similar—58 percent satisfactory. These ratings were much lower than the supervision ratings, which averaged 78 percent successful.

Indonesia loan and the 1989 Mexico loan, OED rated as satisfactory actions on institutional strengthening, but in both cases regulatory forbearance contributed to the periods of financial distress in the 1990s. The OED report generally supported the Bank's approach to operational policy (then OD 8.30). Like the 1985 Board paper, the 1989 Levy report, and OD 8.30, the OED report echoed the importance of macroeconomic stability for success; it also recommended greater attention to client ownership, closer cooperation with the IMF and IFC, better loan design and monitoring, and prior economic and sector work.

96. **Content of Financial Sector Conditions.** Reflecting the importance of strengthening the soundness and quality of financial institutions in borrowing countries, adjustment lending policy measures increasingly focus on long-term capacity building, particularly on (a) strengthening and restructuring institutions, and (b) improving financial infrastructure. The share of financial sector conditions focused on financial institutions increased from 43 percent in FY80-88 to 63 percent in FY98-00, while liberalization of financial intermediation declined from 38 percent to 10 percent over the same period (see Figure 29). Reflecting the substantial worldwide trend toward financial liberalization since the mid-1980s, 70 percent of adjustment lending conditionality in FY85-96 still focused on removing distortions; by contrast, conditionality to remove distortions was present in fewer than half of recent country cases.

**Figure 29. Financial Sector Conditionality in Adjustment Lending, FY80-00**



Source: ALCID.

97. **Recent Experience.** The Bank's experience suggests that restructuring in the financial sector is a lengthy and inherently difficult process, largely because of the distributional impact it has in allocating the cost of financial sector distress among the government, shareholders, creditors, and depositors. Achieving lasting improvements to financial infrastructure is notoriously difficult because improved laws and supervisory capacity are frequently undermined by regulatory forbearance. Furthermore, the sudden and unexpected onset of economic shocks sometimes precludes carrying out economic and sector work—one of the essential building blocks for successful financial sector adjustment operations.<sup>124</sup> More fundamentally, considerable liberalization has taken place in most countries and the reforms needed now are more complex—improving regulation and supervision, especially regulatory enforcement, and restructuring financial institutions and corporations.

<sup>124</sup> See Morris Goldstein, *The Asian Financial Crisis: Causes, Cures and Systemic Implications* (Washington, D.C.: Institute for International Economics, 1998); and Jason Furman and Joseph E. Stiglitz, "Economic Crisis: Evidence and Insights from East Asia," *Brookings Papers on Economic Activity* (U.S.), No. 2:1-135, 1998.



98. **Monitoring Progress.** Bank involvement cannot substitute for borrower commitment, but borrower commitment can be enhanced by closer links with the Bank during the reform process. Although OED has recommended closer monitoring, supervision of FSALs has been uneven—hampered occasionally by low supervision budgets, infrequent supervision missions, and frequent changes of task manager. Closer monitoring will require a strong Bank staff with country-specific knowledge who develop and maintain closer relationships and dialogue with financial authorities.

99. **Cooperation with the IMF.** Recent FSALs and SALs with financial sector conditions have tended to be closely linked with IMF packages; in FY97-99, in 12 of the 15 countries with an FSAL or a SAL with significant financial sector conditionality, the adjustment lending came within four months of an IMF loan. During the East Asia crisis in particular, the IMF often took the lead in discussing conditions for a Standby Agreement, both during and after the crisis. The close link to external financing packages in such situations raises several questions: What is the role of an FSAL in transferring funds and in supporting medium-term systemic financial sector reforms? Does FSAL conditionality form an up-front part of donor discussions of support? What are the loan's prospects of success, given that macroeconomic stability is not assured and restructuring financial infrastructure is a lengthy and difficult process? The IMF-World Bank Financial Sector Assessment Program (FSAP)<sup>125</sup> may help increase up-front attention to financial sector issues by providing collaborative analyses of key problems that could form the basis of joint conditionality.

100. **Future Considerations.** The Bank's experience with policy-based lending in the financial sector suggests that future support for financial sector reform needs to resolve the tension between short-term response to economic shocks and long-term capacity building. Macroeconomic stability is a prerequisite for successful financial sector reform,<sup>126</sup> but financial sector issues are increasingly long-term, requiring sustained country ownership beyond the end of loan disbursements. The experience with financial sector adjustment lending suggests that the Bank should position itself to shape the programs and sustain longer-term institutional reform after emergency funds are disbursed. To ensure sound financial systems, the Bank's response should include more extensive analytic work, more intensive dialogue, and more technical assistance, before and after periods of economic and financial distress. The FSAP initiative with the IMF will be a critical part of the Bank's response to these challenges.

## 5. Private Sector Development

101. The content of adjustment lending operations reflects the growing role of the private sector in development. Of the 193 adjustment loans approved during FY96-99, 112 (58 percent) had at least one conditionality related to private sector development (PSD) and 55 (28 percent) had 10 or more. By FY99, PSD conditions were attached to fully 70 percent of adjustment loans.

102. **Evolution of the Bank's Approach to PSD.** In the 1980s, one of the Bank's broad aims was to establish incentives for private sector development through macroeconomic stability and

<sup>125</sup> The Financial Sector Assessment Program, being piloted jointly with the IMF, is intended to identify strengths, vulnerabilities, and risks of the financial system; ascertain the sector's development and technical assistance needs; assess observance and implementation of relevant international standards, codes, and good practices; determine whether key sources of risk and vulnerabilities are being addressed; and help design appropriate policy responses.

<sup>126</sup> See *Financial Sector Reform: A Review of World Bank Assistance*, op. cit.; and OP 8.30, *Financial Intermediary Lending*.

appropriate relative prices. Adjustment loans supported trade liberalization, removal of price and exchange controls, and financial sector liberalization. Despite these reforms, many countries failed to attract significant private investment; this suggested that macroeconomic stabilization and relative price reforms were necessary but not sufficient conditions for efficient private-sector-led growth. The reform agenda then expanded, emphasizing microeconomic and institutional reforms to build or improve markets, remove government constraints, and better integrate policy reforms. A wide array of procedural, regulatory, and legal reforms came to the fore—including removing entry and exit barriers, reducing market rigidities, simplifying tax systems, streamlining property rights, and modifying trade restrictions. In the middle to late 1990s, as developing countries faced the challenges of globalization and capital flow volatility, the Bank fostered measures to enhance competitiveness and global integration.<sup>127</sup> Following the East Asia crisis, the emphasis shifted to incentives for good corporate governance, corporate restructuring, and debt work-outs.

103. **Privatization.** Privatization of nonfinancial and noninfrastructure enterprises has been a major area of adjustment lending,<sup>128</sup> although its role has declined somewhat in recent years. In FY99, it accounted for a little less than one-fifth (18 percent) of all PSD conditionalities, down from around 30 percent in FY96. Public enterprise reform (other than privatization), once an important component of adjustment operations, has steadily declined in importance. This reflects the poor experience with such reforms in most countries and the realization that reforms short of privatization are ineffective or easily reversed. In recent years, private participation in infrastructure (PPI) conditionality has significantly expanded. Of the 306 projects with PPI components approved during FY88-00, 43 percent were approved in the last three years. Investment lending remains the dominant instrument; however, adjustment lending has also become important as a vehicle for promoting PPI. Of the 52 adjustment loans with PPI components approved during FY88-00, 28 were approved in FY99-00. Most of these adjustment loans (37 out of 52) are multisectoral.<sup>129</sup> Adjustment lending has supported three broad areas of PPI: (a) privatization of infrastructure enterprises, (b) sectoral reforms to allow new private entry, and (c) development of regulatory frameworks and institutions.

104. **Content of PSD Conditions.** Adjustment lending and associated TA loans have supported a wide range of PSD activities during the last two decades, with the emphasis shifting from the mere adoption of policies and the passage of laws to their implementation and to institutional development, capacity building, and improvements in procedures and systems. One measure of this transformation is the increase in conditions supporting reforms in regulatory

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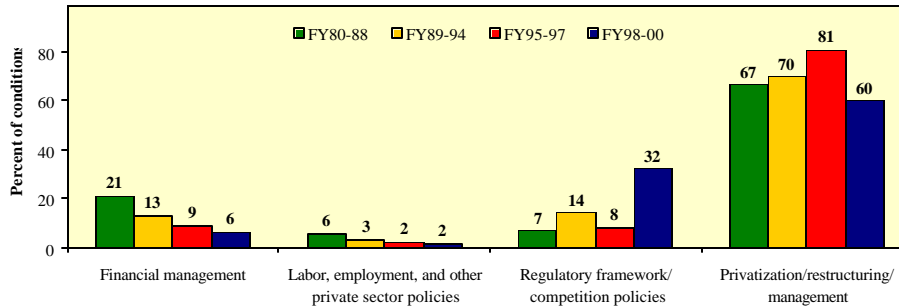
<sup>127</sup> Measures focused on enhancing firm-level capacities, adopting competition policy and regulatory reform to country capacities, benchmarking and reducing transaction costs, strengthening inter-firm linkages and government-business consultations, and supporting global integration through exports and foreign direct investment.

<sup>128</sup> Privatization became an important feature in the Bank's adjustment lending from the mid-1980s. This reflected both the concurrent ideological shift in favor of private ownership as well as the Bank's long, and painful, experience with failed attempts at reforming public enterprises. The first World Bank structural adjustment loan with a privatization component (Jamaica SAL I) was approved in 1982. However, prior to FY85, most conditions in adjustment loans related to public enterprise reforms, rather than privatization. The OED report on privatization published in 1994 (*World Bank Assistance to Privatization in Developing Countries*, OED Report No. 13273, August 1994), stated that only 8 percent of all public enterprise reform conditions in pre-FY85 adjustment loans related to privatization. This proportion increased to 14 percent during FY85-89 and 32 percent during FY90-94.

<sup>129</sup> Forty TA loans with PPI components have been approved since FY88. Many of these have been associated with, and have complemented, adjustment loans.

framework and competition policies, which rose from 7 percent of total PSD conditionality in FY80-88 to 32 percent in FY98-00 (see Figure 30).

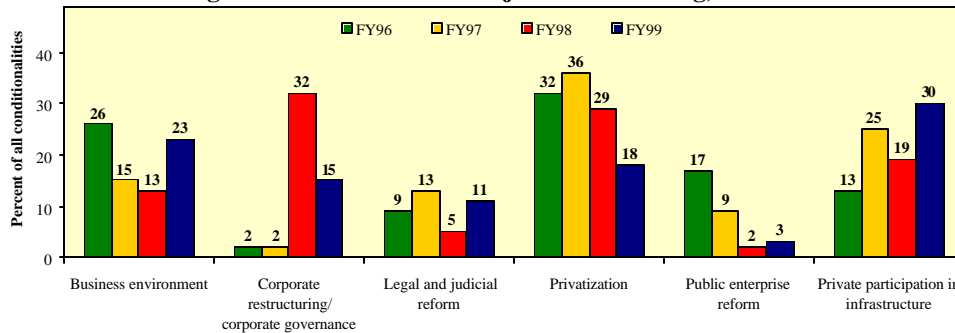
**Figure 30. Policy Area of PSD Conditionality, FY80-00**



Source: ALCID.

105. **Focus of Recent PSD Operations.** A PSD review of recent adjustment operations for this retrospective showed that strengthening the business environment (defined to include legal and judicial reforms and corporate governance and restructuring) has been the leading theme in PSD conditionality in recent years. It constituted about 40 percent of all PSD conditions during FY96-99; by comparison, a little more than one-third of PSD conditions related to privatization and public enterprise reforms, and one-quarter promoted private participation in infrastructure (see Figure 31).

**Figure 31. PSD Focus in Adjustment Lending, FY96-99**



Source: PSD analysis based on ALCID data.

106. **Privatization and the Social Costs of Reform.** Fear that privatization will have adverse effects on the welfare of the workers may undermine the support of key stakeholders for reform efforts. The effect of privatization on labor depends on the relative share of public enterprise employment, the number of layoffs expected just before or after privatization, and the potential of the economy to generate employment for those who are laid off.<sup>130</sup> The available evidence shows a wide range of experiences:

- Large employment reductions have often accompanied the privatization of state enterprises that had been heavily subsidized and protected from competition.<sup>131</sup> Especially in Central and Eastern Europe, where public enterprises were the backbone

<sup>130</sup> See Rolph van der Hoeven and Gyöorgy Szirácski, *Lessons From Privatization: Labour Issues in Developing and Transitional Countries* (Geneva: International Labour Organization, 1997).

<sup>131</sup> See Sunita Kikeri, *Privatization and Labor*, World Bank Technical Paper No. 396 (Washington D.C.: World Bank, 1998).

of the economy and were responsible for a large share of output, privatization has resulted in large-scale job losses that often were not rapidly absorbed by other privatized firms or new firms.<sup>132</sup> In these and other cases with far-reaching privatization programs, workers face a risk of being marginalized, either through worsening and more vulnerable employment conditions or redundancies.<sup>133</sup>

- By contrast, privatization has had minimal effect on employment in countries that carried out labor reforms well before privatization (for example, Chile) or for workers in competitive enterprises (Ghana, Mexico, Morocco, and Tunisia).<sup>134</sup> Since in many developing countries public enterprises account for a relatively small share of total employment, the effect of privatization on total employment is often moderate.
- Privatization has created new jobs at the enterprise level and at the sectoral level, when private operators used assets more productively and made new capital investments that might not have been made in the absence of privatization.<sup>135</sup> Job creation was particularly prevalent in sectors with large investment backlogs—for example, telecom markets in East Asia and Latin America and airlines in Zambia saw increased competition and employment after privatization.
- An empirical study of the welfare consequences of selling public enterprises found a positive net world welfare change of large magnitude in most of the surveyed cases of privatization.<sup>136</sup> It found that workers did not suffer from divestiture, probably because they had sufficient power to negotiate predivestiture agreements that made them no worse off.<sup>137</sup> Other studies point out that the private sector offers the possibility of increased salaries for those who remain employed, since wages are more likely to be tied to performance.<sup>138</sup>

107. ***Enhancing the Poverty Focus of PSD Reforms.*** Attention to the poverty impact of PSD reforms takes two forms: minimizing the costs of reforms to the poor and ensuring that poor people benefit from reforms. An increasing number of Bank operations on privatization and PPI have explicit components dealing with the social impact of privatization, particularly the impact on labor. Measures include provision of severance payments, counseling, and retraining and redeployment of retrenched staff. Recent examples of adjustment loans with such components include the Turkey Economic Reform (2000) and the Uttar Pradesh Fiscal Reform and Public

<sup>132</sup> See Richard Jackman, "Economic Policy and Employment in Transition Economies of Central and Eastern Europe. What Have We Learned?" *International Labour Review, Lessons From Privatization*, 133, No. 3: 327-45, 1994.

<sup>133</sup> See Rolph van der Hoeven and György Sziráczi, *Lessons from Privatization*, op. cit.

<sup>134</sup> See Sunita Kikeri, *Privatization and Labor*, op. cit.

<sup>135</sup> See Sunita Kikeri, *Privatization and Labor*, op. cit.

<sup>136</sup> See Ahmed Galal, Leroy Jones, Pankaj Tandon, and Ingo Vogelsang, *Welfare Consequences of Selling Public Enterprises* (New York: Oxford University Press for the World Bank, 1994). It found that the annual component of the perpetuity equivalent of the gains averaged 30 percent of predivestiture sales; in more than half of the cases, the gain in welfare exceeded 10 percent; in the single negative case the loss was only 7 percent.

<sup>137</sup> In the surveyed cases, workers gained either from share appreciation or from higher wages. Cases of individual layoffs were accompanied by substantial severance pay and in a context of reasonably full employment.

<sup>138</sup> See Sunita Kikeri, John Nellis, and Mary Shirley, *Privatization: The Lessons of Experience* (Washington, D.C.: World Bank, 1992).

108. Sector Restructuring Credit (2000).<sup>139</sup> Most PPI operations now explicitly address the issue of protecting or expanding poor people's access to infrastructure services following the entry of private providers. Measures include market reforms, improvements in the regulatory framework, inclusion of pro-poor provisions in contracts with private providers, and establishment of special funds (e.g., rural electrification or telecom funds) targeted to the needs of remote and poor regions. While features of this kind have been an important part of the Bank's infrastructure operations for many years, the links between infrastructure privatization and poverty alleviation now receive more explicit focus in the design stage of the operation.

109. *Lessons of PSD Reforms.* Lessons from PSD reform<sup>140</sup> suggest the importance of borrower ownership, implementation capacity, greater realism and flexibility in program design, better risk assessment and greater use of performance indicators, cost-effective supervision, and flexible tranching. A review of recent adjustment operations with PSD components suggests that these lessons are increasingly being taken into account. During the preparation of adjustment loans there are efforts to bring a wider range of stakeholders on board and to strengthen country capacity. Program design appears to be more realistic; for example, it reflects a more explicit recognition that many PSD reforms require an implementation period longer than that provided by a single quick-disbursing adjustment loan.

- **Ownership.** PSD reforms are not merely technical; they are also intensely controversial processes because they imply the reduction or elimination of privileges long enjoyed by powerful groups in societies. Benefits from reforms are often dispersed and take time to materialize, whereas the costs can be immediate and concentrated. As a result, borrower ownership of PSD reforms has often been weak, resulting in poor project performance. Helping build the necessary ownership requires deeper consultations with a wide range of stakeholders, more explicit attention to the social costs of reforms, public education and communication programs, and knowledge sharing. An example of incorporating stakeholder participation is provided by the recent series of economic and financial sector adjustment loans to Thailand. Individuals with legal expertise in domestic bankruptcy and foreclosure issues were involved early in the preparation of these loans, and helped ensure that the resulting legislation reflected the priorities of debtors and creditors.<sup>141</sup>
- **Institutional Capacity.** Reforms such as privatization, opening up a sector to private participation, or passage of laws are important on their own. However, to be fully effective, these measures usually require the development of complementary institutions and the adoption of related rules, regulations, and procedures. For example, the adoption of competition laws or reforms in tax policies has limited impact if competition agencies and tax administrations are weak. The 1998 Korea SAL I (see

<sup>139</sup> The Turkey Economic Reform Loan supported a framework that provided specific support for workers affected by privatization. It also included sector work that provided the basis of a privatization social support project to fund severance pay, assistance for retraining and job search, and studies about the impact of the overall reform on employment and social variables.

<sup>140</sup> These lessons build on consultations with Bank staff, a PSD review for this retrospective of the Implementation Completion Reports of some recently closed adjustment loans, and the findings of an earlier PSD review for QAG. See *Review of Public Enterprise and Privatization Operations*, World Bank, Development Economics, Private Sector Development Department, August 1996.

<sup>141</sup> Other recent initiatives aimed at building ownership include work on communications strategy for privatization in Pakistan and Thailand, and dialogue with Ugandan parliamentarians on PSD issues.

Box 7) recognized that effective implementation of the competition policy agenda would require substantial institutional strengthening of the Korean Fair Trade Commission, involving enhanced policy analysis and evaluation capacity, provision of timely information to the market, and greater operational capacity and transparency.

- ***Complexity, Realism, and Flexibility.*** A PSD review for QAG suggests the general finding that loans are less likely to be satisfactory when they tend to be overly optimistic about the country's commitment to reform and its institutional and administrative capacity.<sup>142</sup> In some cases, this may be the result of an inadequate analysis of the country's readiness and willingness to reform. Project design benefits from greater realism and flexibility. The PSD review highlighted the need for operations to be designed with the understanding that PSD reforms take time. Quantitative targets for privatization that were common in earlier adjustment loans often turned out to be unrealistic. A positive example is the Romanian Private Sector Adjustment Loan, approved in June 1999, which—in contrast to earlier privatization adjustment loans that had limited achievement—did not require the immediate sale of large, difficult-to-bring-to-market enterprises, but only the identification of a specified number of enterprises to be privatized and the hiring of investment banks to help carry out the privatization. These conditions were met, and a follow-up adjustment loan was prepared to assist in the actual sale of these enterprises.
- ***Judging and Reducing Risk.*** Better risk assessment and greater use of performance indicators are critical. More detailed and rigorous analysis of risks, including more explicit consideration of past Bank experience with PSD reforms, is needed during project appraisal. In particular, borrower commitment and capacity to carry out PSD reforms should be assessed more systematically, and the findings should be clearly reflected in project appraisal reports. It is also important to clearly specify, after discussions with borrowers, the indicators to be used to monitor and evaluate implementation performance and the development impact of reforms.
- ***Dealing with Labor Market Adjustment.*** Labor adjustments are one of the most sensitive aspects of privatization, and the perceived threat of unemployment and loss of benefits can threaten or delay reforms. But empirical studies show that divestiture can be managed so as to leave workers no worse off.<sup>143</sup> Three major employment policy responses are possible, all of which have advantages and disadvantages: measures to protect employment by spreading labor adjustment over a longer period (which slows down reforms and may involve a financial burden), compensatory measures through severance payment regulations or bonuses for voluntary resignations (which may provide incentives for the most productive workers to quit), and measures to facilitate the reintegration of laid-off workers into other forms of employment, such as job search assistance, retraining, and job creation schemes (which have not always been effective).<sup>144</sup> Experience suggests that attractive

<sup>142</sup> The review found that of a sample of 29 loans in which enterprise reform and/or privatization featured prominently, 13 had satisfactory ratings, 8 had unsatisfactory ratings, and 8 had no ratings. See *Review of Public Enterprise and Privatization Operations*, World Bank, Development Economics, Private Sector Development Department, August 1996.

<sup>143</sup> See Ahmed Galal et al., *Welfare Consequences of Selling Public Enterprises*, op. cit.

<sup>144</sup> See Rolph van der Hoeven and György Sziráczki, *Lessons from Privatization*, op. cit.

severance packages and employee-ownership schemes have helped limit opposition and have created social safety nets.<sup>145</sup> At the same time, these safety nets can be a heavy burden on governments; experience suggests that they should be part of a larger process of structural change rather than an ad hoc alternative to job creation.<sup>146</sup> Consultation and negotiations on measures to lessen adverse effects for employees are also important elements of a productive dialogue to alleviate unjustified fears.

- **Supervision.** Effective supervision makes a difference: the PSD review found that, even in difficult conditions, effective supervision produced good results.<sup>147</sup> To enhance the objectivity of supervision, it would be advisable to include supervisory staff drawn from those who were not involved in the preparation of the operation, and to involve outsiders in assessments of the operation's performance. PSD components of adjustment operations typically require intensive supervision. The Implementation Completion Reports of a number of recently completed adjustment operations have highlighted the valuable supervisory role played by country offices.

#### **Box 7. Good Practice Example of Adjustment Lending for Private Sector Development**

In Korea, the Economic Reconstruction Loan, approved in December 1997, and the two structural adjustment loans (SALs I and II), approved in March 1998 and October 1999, respectively, illustrate a step-by-step approach to PSD reforms supported by adjustment lending. The Korea Economic Reconstruction Loan and SAL I supported the first stage of the PSD reform program, and focused on financial sector restructuring and development, corporate restructuring and reform of corporate governance and competition policies, and labor market reform and strengthening of social safety nets. SAL I supported several measures to develop the equity and bond markets; and SAL II incorporated follow-on measures, including legal changes facilitating the establishment of mutual and venture capital funds and issuance of asset-based securities. With regard to corporate governance, SAL I required the inclusion of outside directors on the boards of all listed companies and banks. SAL II went a step further and required, as a first tranche release condition, that this outside representation on the boards be increased to a minimum of 25 percent. The threshold for the exercise of minority shareholder rights was lowered progressively under the two SALs. SAL I supported improvements in insolvency laws, and these were further fostered by SAL II, which included reforms to facilitate prepackaged work-outs. To strengthen the independence and effectiveness of internal and external audits, a study was initiated under SAL I on the introduction of audit committees of boards of directors in listed companies. As a next step, and as a second tranche condition, SAL II envisaged the adoption of a time-bound implementation plan for the establishment of such committees, consistent with international best practice. In the interim, it called for improvements in the existing audit selection committees to make them more independent and transparent.

## **6. Environment and Environmental Assessment**

110. Initially, typical adjustment operations were concerned with balance of payment and structural issues, and only addressed a partial range of national and global environmental problems.<sup>148</sup> However, since the mid-1980s, environmental components have been explicitly

<sup>145</sup> See Sunita Kikeri, Nellis, and Mary Shirley, *Privatization*, op. cit.

<sup>146</sup> See Rolph van der Hoeven and György Sziráczki, *Lessons from Privatization*, op. cit.

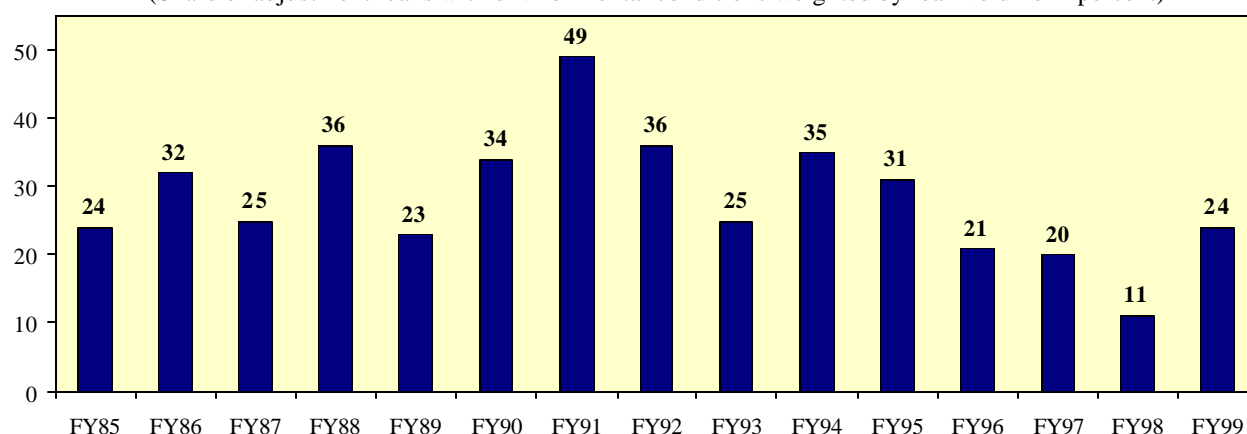
<sup>147</sup> See *Review of Public Enterprises and Privatization Operations*, op. cit.

<sup>148</sup> See Iona Sebastian and Adelaida Alicbusan, *Sustainable Development: Issues in Adjustment Lending Policies*, World Bank Environment Department, Divisional Paper No. 1989-6 (Washington, D.C.: World Bank, 1989). Several adjustment operations of the late 1980s included protection measures to complement economywide policies, such as pollution standards and pesticide-use clauses. By 1987, 22 countries in the sample mentioned environmental issues in the loan documentation. Among the issues mentioned were erosion control and deforestation (Central African Republic, Côte d'Ivoire, Kenya, Madagascar, Morocco, Nepal, and Tunisia); pesticide use (Philippines and Sudan); desertification (Mauritania); cultivation of marginal lands (Kenya, Mauritania, and Somalia); air pollution (Korea and Mexico); energy conservation as it related to fuelwood conservation and deforestation (Kenya, Malawi, Thailand, and Togo); and waterlogging in irrigated agriculture (Pakistan).

included in adjustment lending operations, especially in agriculture, energy, forestry, and industry.<sup>149</sup>

111. **Environmental Coverage.** The proportion of adjustment loans/credits that deal with environmental issues has varied widely over time, averaging about 23 percent in the 1990s (see Figure 32). Table 9 shows the extent of environmental conditionality in adjustment lending, as well as its distribution by SALs and SECALs, from FY85-99. The general pattern in the number of conditions is one of higher proportions of conditionality for SALs.

**Figure 32. Environmental Conditionality in Adjustment Lending**  
(Share of adjustment loans with environmental conditions weighted by loan volume in percent)



Source: ALCID.

**Table 9. Share of SALs and SECALs with Environmental Conditionality**

FY	Percentage of adjustment operations with environmental conditionality	SALs						SECALs	
		Total number	SALS with environmental conditionality		Total number	SECALs with environmental conditionality			
			Number	Percent		Number	Percent		
1985	28.6	3	1	33	11	3	27		
1986	25.9	9	4	44	18	3	17		
1987	33.3	13	8	62	20	3	15		
1988	35.5	11	6	55	20	5	25		
1989	18.2	18	6	33	26	2	8		
1990	23.3	17	5	29	26	5	19		
1991	31.1	23	9	39	22	5	23		
1992	31.3	26	10	38	22	5	23		
1993	17.6	16	2	13	18	4	22		
1994	30.2	22	11	50	21	2	10		
1995	16.2	22	3	14	15	3	20		
1996	19.0	18	5	28	24	3	13		
1997	17.1	25	7	28	16	0	0		
1998	14.0	29	5	17	14	1	7		
1999	22.4	35	11	31	23	2	9		

Source: ALCID.

<sup>149</sup> An earlier review covering the period FY88-92 includes Jeremy Warford, A. Schwab, W. Cruz, and S. Hansen, *The Evolution of Environmental Concerns in Adjustment Lending: A Review*, Environment Working Paper No 65, World Bank, 1994.



112. **Content of Environmental Conditions.** Similarly, the environmental issues addressed in adjustment lending have changed over the years.<sup>150</sup> Environmental conditionality has typically covered the following sectors.

- **Energy sector**, including pricing mechanisms (full cost recovery pricing, lowering of subsidies, and increase of prices/tariffs), institutional strengthening (energy programs), and direct environmental interventions (energy conservation measures).
- **Water sector**, including pricing mechanisms (increase of water tariffs), legal enforcement (water resource use law), institutional strengthening (increasing efficiency in the management unit), improving incentives for efficient water use (water fee collection program), and explicit environmental activities (compliance with efficiency targets).
- **Forestry sector**, including support functions (reforestation funding), legal programs (forest law enforcement), and environmental projects (policy for viable ecoforestry, master plan for forest conservation).
- **Industry/mining sector**, including legislation (for instance, on industrial waste), taxation (mineral taxation), and environmental actions (environmental audits).
- **Agricultural sector**, including taxation on agricultural products, charges on water for agriculture, land/soil conservation, increase in the price of fertilizers, environmental criteria for agricultural project selection, and environmental memoranda on agriculture.
- **Environmental sector**, including in some cases explicit environment policy prescriptions, such as the creation and strengthening of environmental institutions; adoption of policies for environmental protection; natural resource management plans; investments in pollution abatement; environmental impact assessments; or environmental taxation, standards, and regulation.

Table 10 shows the distribution of environmental conditionality among these sectors over time. A predominant theme is energy, reflecting the Bank's concern that developing countries spend more than US\$250 billion annually on subsidizing energy.<sup>151</sup> There has been a shift away from agriculture as the profile of borrowers has changed.

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<sup>150</sup> The following is based on an analysis of a database on adjustment loan conditions (ALCID) using broad search criteria to identify those conditionalities in adjustment loans that can possibly foster environmentally sustainable development through increased efficiency. For example, policies that increase efficiency in resource use (e.g., removing subsidies for energy use) are considered an environmental conditionality for the data below. The potential positive impact of such measures is not studied in the context of the particular country but is based on a brief description of the conditionality in the ALCID database. Loans that explicitly deal with improving the host's environmental policy are also included.

<sup>151</sup> See *Energy Efficiency and Conservation in the Developing World: The World Bank's Role*, World Bank Policy Paper No. 1014-8124 (Washington, D.C.: World Bank, 1993).

**Table 10. Percentage of Conditions with Environmental Focus**

<i>Period</i>	<i>Category</i>	<i>Energy</i>	<i>Water</i>	<i>Agriculture</i>	<i>Forestry</i>	<i>Industry/ mining</i>	<i>Environment</i>
1985-1989	number of loans	49	34	5	34	10	10
	loan amount	56	34	6	32	4	13
1990-1994	number of loans	51	20	14	14	20	51
	loan amount	62	22	16	9	13	53
1995-1999	number of loans	56	26	0	13	23	21
	loan amount	56	15	0	17	20	34
1999	number of loans	57	29	0	14	29	21
	loan amount	85	20	0	28	14	36

*Note:* The analysis uses broad search criteria to identify all loans with environment-linked conditionality. Shares add up to more than 100 percent because loans addressed several environmental problems.

*Source:* ALCID.

113. **Regional Distribution of Environmental Conditions.** Environmental conditionality typically addressed environmental problems that were most relevant to the Region concerned. The Regional shares of all FY85–99 adjustment loans with environmental conditions shown in Table 11 reflect each Region’s relative priority on energy, water, agriculture, forestry, industry/mining, or the environment sector. North Africa, which faces major water issues, has the highest percentage of loans targeting water conservation; East Asia, which is highly dependent on the forestry sector, emphasizes forestry protection in its adjustment reforms. Environment, particularly natural resource management, is the biggest concern for Sub-Saharan Africa. The large share of environmental reforms in the energy sector in Eastern Europe and Central Asia reflects the Region’s needs to restructure the subsidized energy sector.

**Table 11. Sectoral Distribution of Environmental Conditionality by Region**

	<i>AFR</i>	<i>MNA</i>	<i>LCR</i>	<i>ECA</i>	<i>SAR</i>	<i>EAP</i>
Energy	38	64	52	70	55	64
Water	28	43	36	6	27	27
Agriculture	9	0	12	3	0	9
Forestry	25	21	20	0	9	55
Industry/mining	25	21	20	0	9	55
Environment	30	0	16	15	9	9

*Source:* ALCID.

114. **Impact on the Ground.** While the coverage of environmental conditions in adjustment loans is an indication of their relevance, the real challenge is the actual monitoring, implementation, and enforcement of conditions. How do economywide policy reforms interact with the environment? There are several principal channels of interaction which Bank research has highlighted:<sup>152</sup>

- Removal of price distortions, promotion of market incentives, and relaxation of other constraints on balance contribute to both economic and environmental gains.

<sup>152</sup> See Mohan Munasinghe and Wilfrido Cruz, *Economywide Policies and the Environment, Lessons from Experience* (Washington, D.C.: World Bank, 1995); and Mohan Munasinghe, ed., *Environmental Impacts of Macroeconomic and Sectoral Policies* (Washington, D.C.: International Society for Ecological Economics: World Bank: United Nations Environment Programme, 1996).

- Unintended adverse effects occur, however, when economywide reforms are undertaken while other policy, market, or institutional imperfections are neglected. Relative price changes may have positive effects (for example, when an increase in fuel taxation results in reduced energy consumption and pollution) or adverse effects (for example, when a devaluation is associated with greater harvest of timber).<sup>153</sup>
- Measures aimed at restoring macroeconomic stability generally yield environmental benefits, since instability undermines sustainable resource use.
- The stabilization process may have unforeseen adverse short-term effects on the environment.
- Economywide policies may have additional longer-term effects on the environment through employment and income distribution changes.

115. ***Environmental Practice in Adjustment Loans.*** The experience with loan conditionality in recent adjustment operations suggests that coverage of environmental issues in adjustment lending has varied across countries and over time.<sup>154</sup> Adjustment loans in the most environmentally sensitive countries deal with environmental issues.<sup>155</sup> For instance, in recent years all of the adjustment loans of the heavily forested and forest-dependent countries (Cambodia, Indonesia, Madagascar, Solomon Islands) involve conditionality that concerns granting concessions and management of forest resources.

- A report by OED noted progress in addressing environmental concerns in energy and in rural and urban sector strategies, but found that adjustment operations often failed to incorporate complementary policies to mitigate environmental impacts.<sup>156</sup> One specific concern arising from recent SALs is that issues of environmental liability in privatization are often not fully considered, presenting particular risks when facilities such as mines or heavy industrial sites with contamination problems are privatized. A second concern from recent SALs is that some loans related to budgetary retrenchment and civil service reform have not paid specific attention to whether these measures might be harmful to environmental management.
- An Environment Department survey for this retrospective found that 65 percent of recent SALs included an explicit environmental section, generally consisting of a statement to the effect that no environmental effects could be expected; 44 percent mentioned environment as a factor linked to the loan objectives; 26 percent mentioned environment in the risk section; 39 percent had environmental conditionality; and 26 percent had measures aimed at environmental mitigation.<sup>157</sup>

<sup>153</sup> See David Wheeler and Kiran Pandey, "Structural Adjustment and Forest Resources: The Impact of World Bank Operations" (processed: Development Economics Research Group, World Bank, January 2001).

<sup>154</sup> See Sebastian and Alicibusan, *Sustainable Development: Issues in Adjustment Lending Policies*, op. cit.; and Jeremy Warford et al., *The Evolution of Environmental Concerns in Adjustment Lending: A Review*, Environment Working Paper No. 65 (Washington, D.C.: World Bank, 1994).

<sup>155</sup> Based on a review of the President's Reports for SALS during the period February 1999 to April 2000.

<sup>156</sup> See Muthukmara Mani, *Promoting Environmental Sustainability in Development: An Evaluation of the World Bank's Performance*, Phase I Interim Report, OEDST, World Bank, 2000.

<sup>157</sup> Desk review by the Environment Department based on 23 operations going to the Board from February 1999 to April 2000.

116. **Policy Considerations.** SECALs for which Project Information Documents were issued after March 1, 1999 are now subject to OP 4.01 and are assigned an environmental rating A, B, or C (Box 8).<sup>158</sup> Of the 10 SECALs/SECACs subject to OP 4.01 in FY99 and FY00, one was classified as Category B, and nine were classified as Category C; these classifications were recently confirmed in an internal Environment Department review. Under current policy, SALs are not subject to the requirements of OP 4.01. Indeed, an issue for future consideration is that many adjustment operations do not easily lend themselves to the traditional methodology of environmental assessments, because their economywide effects on the environment tend to be broad, indirect, and uncertain. Sometimes such effects are not obvious at the initial stage, and often they appear only over a longer period as investors respond to changing incentives. The appropriate treatment of environmental issues in adjustment lending will be examined in detail as part of the analytic work that will feed into the planned update and conversion of the operational policy for adjustment lending.

**Box 8. Operational Policy on Environmental Assessment**

According to OP 4.01, *Environmental Assessment*, the Bank conducts environmental screening of proposed operations—including SECALs/SECACs—to determine the extent and type of environmental assessment needed.<sup>a</sup> The Bank classifies the proposed project depending on the type, location, sensitivity, scale, nature, and magnitude of its potential environmental impacts.<sup>b</sup> Projects classified in Category A or B require further environmental assessment actions.<sup>c</sup> Adjustment loans other than SECALs/SECACs are not subject to OP 4.01. However, according to OD 8.60, *Adjustment Lending Policy*, Bank staff are expected to review the country's national environmental policies and practices to see that they are taken into account in the design of structural adjustment programs, and to identify the linkages with the proposed reforms. If there are negative linkages, it is good practice to devise specific measures to counteract them, or to explain how they are to be mitigated within the CAS.

<sup>a</sup> For a summary, see the Operational Memorandum *Clarification of Current Bank Policy on Adjustment Lending*, op. cit.

<sup>b</sup> The Bank classifies proposed projects into one of four categories. A proposed project is classified as Category A if it is likely to have significant adverse environmental impacts that are sensitive, diverse, or unprecedented. Category B applies to a proposed project if its potential adverse environmental impacts on human populations or environmentally important areas—including wetlands, grasslands, and other natural habitats—are less adverse than those of Category A projects. A proposed project is classified as Category C if it is likely to have minimal or no adverse environmental impacts. Beyond environmental screening, no further environmental assessment is required for a Category C project. Category FI applies to projects that involve investment of Bank funds through a financial intermediary, in subprojects that may result in adverse environmental impacts. See OP 4.01, paragraph 8.

<sup>c</sup> The environmental assessment focus for a SECAL/SECAC is the potential environmental impact of planned policy, institutional, and regulatory actions under the loan. Actions that would require such assessment include, for example, privatization of environmentally sensitive enterprises, changes in land tenure in areas with important natural habitats, and relative price shifts in commodities such as pesticides, timber, and petroleum. See OP 4.01, paragraph 10.

#### IV. CONDITIONALITY

117. Conditionality, the core of policy-based lending, has evolved in tandem with the content. It has begun to incorporate the lessons of experience and of research, which underscore country ownership and a good policy environment as the foundations of effective adjustment lending. Meanwhile, several issues—of institutional capacity, the nature of conditions, tranching, and measuring results on the ground—have emerged more into the foreground. This chapter reviews

<sup>158</sup> Bank projects are classified A, B, or C to determine the appropriate level of environmental analysis and assessment to which they will be subjected. Category A projects are likely to have significant adverse environmental impacts that are sensitive, irreversible, or diverse and require full environmental assessment. Category B projects are likely to have impacts that are less significant, sensitive, or diverse. Only a simple environmental analysis is required. Category C projects are those which are judged to have negligible, insignificant, or minimal impacts on the environment and are not subjected to any environmental analysis or assessment.

the experience with conditionality, taking into account both country dimensions (deciding where and when to lend, on the basis of country ownership and reform readiness) and design dimensions (deciding how to shape the elements of the loan). It then examines the coordination of conditionality with the IMF.

## A. Country Dimensions of Conditionality: Ownership and Readiness for Reform

### 1. Overview

118. Conditionality is central to policy-based lending. The Bank's memorandum introducing adjustment lending stated that it was "only justified if there is a specific program of structural adjustment to be supported which has as its objective increased efficiency of resource use and improved responsiveness of the economy to changes in economic conditions. Lending for 'structural adjustment' must be conceived as an association with a borrower in a program of structural change over three to five years which will require financial support and technical cooperation throughout this period."<sup>159</sup> On the basis of this understanding with the government on an overall program, a set of policy measures is developed,<sup>160</sup> which the Bank has traditionally attached as conditionality to tranche releases of specific loans. Conditionality thus links financial support to the implementation of a program of reforms considered critical for the country's economic and social adjustment. It serves as a commitment between two parties—providing assurances to the Bank that the objectives of an operation will be met through the implementation of agreed reforms and public actions by a borrowing country, and to the country that compliance with conditionality will make the agreed financing available.

119. *Assessments of Conditionality.* Adjustment lending's problems in the 1980s were well documented in internal and external evaluations,<sup>161</sup> which in turn influenced the design of subsequent operations. The experience with conditionality in Bank-supported adjustment lending has been subject to a number of reviews.<sup>162</sup> Several country studies have identified a positive role for conditionality: reformers welcomed conditionality and used the associated external commitment as a tool to push through reforms, especially when conditionality focused on a few important measures to which the government was already committed.<sup>163</sup> In other cases, however, reform commitments were not carried out, or were delayed or even reversed.

120. *Loan Objectives.* The OPCS survey found that 72 percent of recent adjustment operations were consistent with the stated CAS objectives, and 18 percent were not part of the

<sup>159</sup> See *Structural Adjustment Lending* (R80-122, IDA/R80-83), May 9, 1980.

<sup>160</sup> See OD 8.60, *Adjustment Lending*, para. 40.

<sup>161</sup> See *Structural Adjustment Lending: A First Review of Experience*, Operations Evaluation Report No. 6409, World Bank, September 24, 1986; *Report on Adjustment Lending: Policies for the Recovery of Growth* (R90-57 IDA/R90-49), March 26, 1990; *The Third Report on Adjustment Lending: Private and Public Resources for Growth* (R92-47, IDA/R92-29), March 24, 1992; Paul Mosley, Jane Harrigan, and John Toye, *Aid and Power: The World Bank and Policy-based Lending, Volume I—Analysis and Policy Proposals* (New York: Routledge, 1991); and Vinod Thomas, Ajay Chhibber, Mansoor Dailami, and Jaime de Melo, eds., *Restructuring Economies in Distress: Policy Reform and the World Bank* (Washington, D.C.: Oxford University Press for the World Bank, 1991).

<sup>162</sup> See summary, Annex E IMF-supported conditionality is being reviewed; see *Conditionality in Fund-Supported Programs* 34 *Overview*, International Monetary Fund, Policy Development and Review Department, (SM/01/60) February 20, 2001.

<sup>163</sup> See Development Economics case studies in Shantayanan Devarajan, David Dollar, and Torgny Holmgren, *Aid and Reform in Africa* (Washington, D.C.: World Bank, 2001), available at [www.worldbank.org/research/aid/africa/intro.htm](http://www.worldbank.org/research/aid/africa/intro.htm). For instance, the Ghana and Uganda studies argue that the government technocrats identified important measures to which they wanted to be bound. In that context, conditionality was a helpful tool for generating, implementing, and cementing reforms.

original CAS scenario but were consistent with its objectives. In some operations (10 percent) there was no CAS because the borrower had not been an active borrower. There were no cases in which the loan appeared inconsistent with the CAS. The OPCS survey also found that the loan objectives were unambiguously clear and relevant in 12 percent of the operations, and were vague or not well defined in 5 percent of the operations; the remaining 83 percent of loans fell somewhere in the middle.

121. ***Justification of Adjustment Lending.*** Adjustment lending provides quick-disbursing policy-based financing, based on the existence of actual or anticipated external financing gaps in either the balance of payments or fiscal accounts.<sup>164</sup> In practice, adjustment lending has been used for several distinct, not mutually exclusive, functions: (a) to provide a cushion against economic shocks, (b) as an effective external financing vehicle to generate medium-term local counterpart funds in support of the government's budgeted development program, and (c) to promote policy reform. All three functions have often been used concurrently, but there has been an evolution of the mix, with a gradual shift away from short-term temporary balance of payments support toward a greater emphasis on medium-term external financing of government expenditure programs and the support of social and structural reforms. Examining how FY98-00 adjustment loans were justified and disbursed, the OPCS survey indeed found multiple rationales:

- ***Rationale.*** The explicit rationale for some 59 percent of the adjustment loans (mostly in IBRD countries) was the financing of balance of payments deficits; 61 percent of the operations (mostly in IDA countries) referred to fiscal needs; and often loans were justified by both.<sup>165</sup>
- ***Cyclical and Medium-Term Lending.*** A historical perspective suggests that it is useful to distinguish between two broad types of adjustment lending: (a) short-term countercyclical adjustment lending specifically in response to external financing needs, and (b) adjustment lending of a more developmental character in support of medium-term structural reforms. Figure 33 provides a rough approximation of the shares of cyclical and medium-term adjustment lending over the past two decades.<sup>166</sup> It shows cyclical adjustment lending rising and falling in response to volatility in world and individual countries' economic and financial systems. On average, explicitly and specifically in response to acute balance of payments financing needs, short-term cyclical adjustment lending accounted for 14 percent of the 550 FY80-00 adjustment operations, or 26 percent of adjustment lending volumes during the period. The remainder, while meeting an external financing need, focused on medium-term structural and social reforms. On an annual basis, cyclical adjustment lending was highly volatile—with peaks reflecting global recession, terms of trade

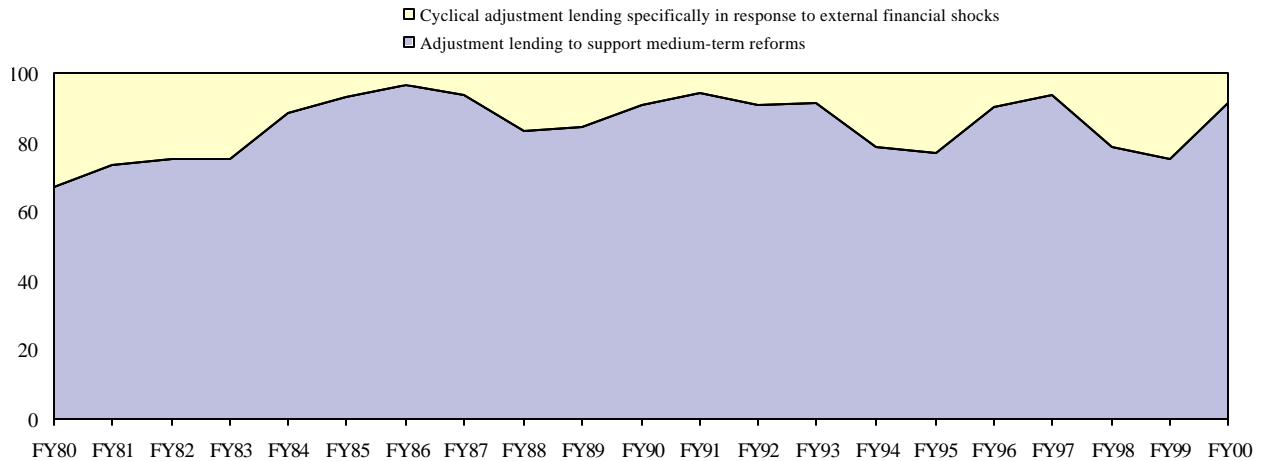
<sup>164</sup> Typically, policy reforms entail higher budget deficits, which can lead to a current account deficit. Noninflationary methods for financing the increase in the public deficit include additional domestic borrowing, drawing down international reserves, or additional foreign borrowing. Usually, at least some additional foreign borrowing is involved, which implies less crowding out of private investment, and larger current account deficits than would have resulted with purely domestic financing. Depending on the case, the amount of financing needed to cover the incremental fiscal deficit varies with the effect of adjustment-related price and income changes on private savings and investment. See *Issues in Adjustment Lending* (SecM96-18), January 16, 1996, which also addresses the fiscal rationale for adjustment.

<sup>165</sup> Most loans have multiple justifications; thus the shares add up to more than 100 percent.

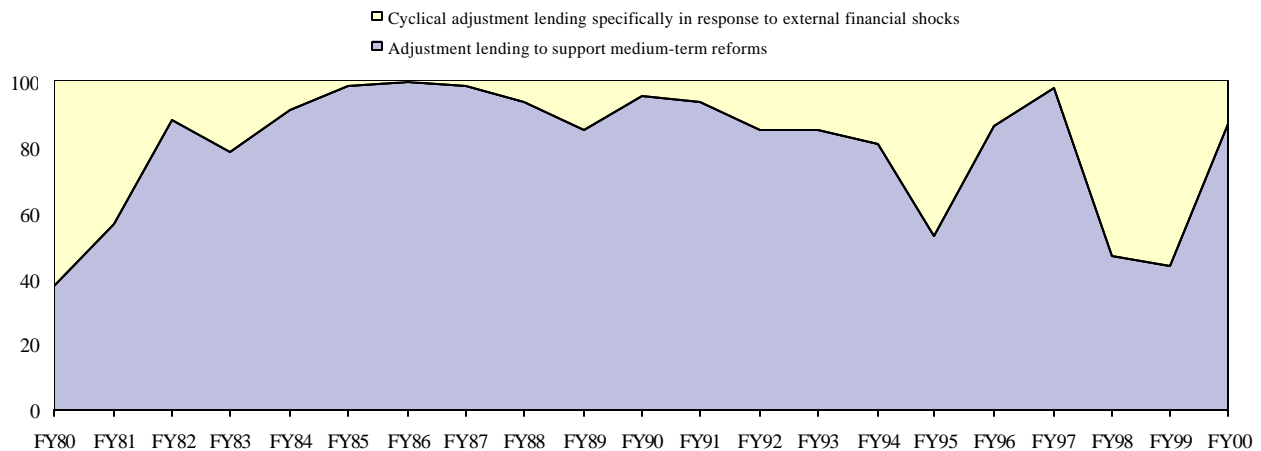
<sup>166</sup> The classification of adjustment loans is based on a review of 537 adjustment loans approved during the FY80-00 period. Criteria for cyclical adjustment lending were based on acute balance of payments needs arising from a country's external debt situation, terms of trade shocks, large devaluations, financial/banking crises, or a conflict/war situation.

shocks, and debt crises during the 1980s; as well as the Mexico crisis, the East Asia crisis, market stress in Russia, and contagion in the transition countries and Latin America during the 1990s.<sup>167</sup> By FY00, cyclical adjustment lending returned to lower levels.

**Figure 33. Shares of Medium-Term and Cyclical Adjustment Lending, FY80-00  
(Percent of Total Number of Operations)**



**(Percent of Total Commitment Volumes)**



122. **Disbursements.** The proceeds of adjustment loans are based on satisfactory implementation of the adjustment program, including compliance with stipulated tranche release conditions and maintenance of a satisfactory macroeconomic framework. Disbursements are not linked to specific imports.<sup>168</sup> However, adjustment operations often focus on the uses to which the local counterpart funds generated by the Bank's financing are put. The OPCS survey found that 40

<sup>167</sup> For a list of crisis episodes, see Gerard Caprio and Daniela Klingebiel, "Episodes of Systemic and Borderline Financial Crisis," Financial Sector Strategy and Policy, World Bank, October 1999, processed; and Vinod Thomas, Ajay Chhibber, Mansoor Dailami, and Jaime de Melo, eds., *Restructuring Economies in Distress: Policy Reform and the World Bank* (Washington, D.C.: Oxford University Press for the World Bank, 1991).

<sup>168</sup> See the Operational Memorandum *Simplifying Disbursement under Structural and Sectoral Adjustment Loans*, February 8, 1996.

percent of FY98-00 adjustment operations notionally linked the use of counterpart funds generated from the loan to a specific set of reforms, such as civil service retrenchment.

123. **Loan Size.** OD 8.60 states that “the adjustment program must be adequately funded,” because underfunding jeopardizes the program. The OD also acknowledges that “there is no simple rule for determining the size of an individual adjustment loan.” It suggests that the costs of the reforms to be supported may be a helpful indicator of the appropriate size of the loan, but adds that “such costs are hard to measure with precision.” In fact, the OPCS survey found that just above 60 percent of FY98-00 adjustment operations estimated the cost of reforms. Generally speaking, the appropriate size of an adjustment operation is a matter of judgment based on a number of factors, including the actual or expected external financing gap, the scope for burden sharing with other donors and lenders, and the size of the overall lending program. Decisions on loan size are also influenced by the country’s creditworthiness (for IBRD countries) or claim on concessional resources (for IDA countries).

## 2. Policy Environment

124. How should the Bank decide where and when to provide adjustment lending? Adjustment lending is not effective in all circumstances. Country ownership and readiness to reform are critical factors in determining where and when to lend to ensure effective adjustment and sustained development—but they are difficult to assess in practice. Conditionality can usefully reinforce country ownership, but cannot substitute for it when it is weak. In fact, there may be inherent tensions between country ownership and the use of conditionality to ensure that the objectives of the program are achieved. Adjustment lending by itself cannot persuade reluctant governments to adopt good policies. Conditionality can support and encourage policy changes, but more is needed if those changes are to be implemented and carried through. Commitment to reform is essential. Although the long-term benefits of successful adjustment can be high, recent research suggests that these benefits can be realized only where the initial policy environment is favorable. When there is commitment to reform, adjustment lending can accelerate, broaden, and deepen it, enhance its impact, and contribute to growth and development. However, in the absence of commitment to reform, adjustment lending may not only fail to support improvements in policies and institutions, but may indeed contribute to delays in reform. These findings are confirmed by Development Economics (DEC) research, which shows that policy change is driven primarily by the domestic political economy, not by foreign assistance or adjustment lending.<sup>169</sup>

125. **Country Policy Environment and Adjustment Loan Outcomes.** The DEC findings point to a clear and significant positive relationship between country policy and institutional characteristics and adjustment loan success rates.<sup>170</sup> There is also no tendency for surges in finance to lead to policy reform—in fact, policy is quite persistent and large policy changes are

<sup>169</sup> Both econometric studies summarized in David Dollar and Lant Pritchett, *Assessing Aid: What Works, What Doesn’t, and Why*, World Bank Policy Research Report (New York: Oxford University Press for the World Bank, 1998) and case studies in *Aid and Reform in Africa*, op. cit., show the importance of the domestic political economy.

<sup>170</sup> See David Dollar and Jakob Svensson, *What Explains the Success or Failure of Structural Adjustment Programs?* (Washington, D.C.: World Bank, Development Research Group, Macroeconomics and Growth, 1998), which shows that, after controlling for these characteristics, the success rate for low- and middle-income countries is the same.



the exception, not the rule.<sup>171</sup> When is adjustment financing most effective? Research on aid effectiveness suggests that in many countries there are three distinct phases to the reform process: (a) an initial period of shifting from bad to better economic policies, (b) an intermediate phase of accelerating reform efforts, and (c) a period of consolidating reforms at a more measured pace.<sup>172</sup> During the initial period, when policymakers are still uncertain about the appropriate course of policy reforms for their country, low-level assistance in the form of capacity building and advice can help a learning process that involves studying other countries, plus trial and error. When countries actually begin to reform, additional finance may leverage the benefits of policy improvements. Aid strengthens confidence in the reform program, attracts more private investment, and enables the government to provide public services that complement private investment. Furthermore, when citizens see the benefits of adjustment reforms, the reforms are more likely to be sustained. During the final phase of increased reform efforts, reformers welcome the opportunity to lock in their commitment through the conditionality attached to additional financing.<sup>173</sup> However, while it may be possible to recognize distinct phases of the reform process in a country *ex post*, this may not be possible *ex ante*; and indeed, the phases may not apply in every country. Lending decisions thus invariably require a careful judgment of the opportunities and attendant risks; and the appropriate design of conditionality can vary depending on specific country circumstances.

126. ***Trends in Aid Allocation and Performance.*** In the earlier years of adjustment lending, donors did not favor countries with good policy over those with weak policy.<sup>174</sup> Over the past decade, however, adjustment lending has been targeted more toward borrowers with satisfactory policy performance; for example, judging from Country Policy and Institutional Assessment (CPIA) ratings, the strength of the link between IDA disbursements and country policy tripled between FY90 and FY97-98. As a result, the development effectiveness of adjustment lending has improved.<sup>175</sup> In fact, the overall performance of official development assistance allocations improved dramatically between FY90 and FY97-98, possibly because the Bank had signaled to other donors the link between good policy and development effectiveness.

127. ***Performance and Adjustment Lending.*** If the Bank properly manages adjustment lending, *ex post* evaluation should reveal that more lending has been allocated to good performers. Country performance and commitment are essential to success, which highlights the importance of carefully assessing the environment into which adjustment funds are lent. In fact, recent adjustment operations show increased selectivity in Bank lending decisions. In FY95-00, the Bank made 72 percent of its adjustment loans to countries that it judged to have above-average performance on a broad range of policies—and the remainder included several countries where improvements in the policy environment suggested the potential for a turnaround (see Figure 34).

<sup>171</sup> See Alberto Alesina and David Dollar, “Who Gives Foreign Aid to Whom and Why?” *National Bureau of Economic Research Working Paper Series* (U.S.) No. 6612:1-[45], June 1998.

<sup>172</sup> See case studies in *Aid and Reform in Africa*, *op. cit.*

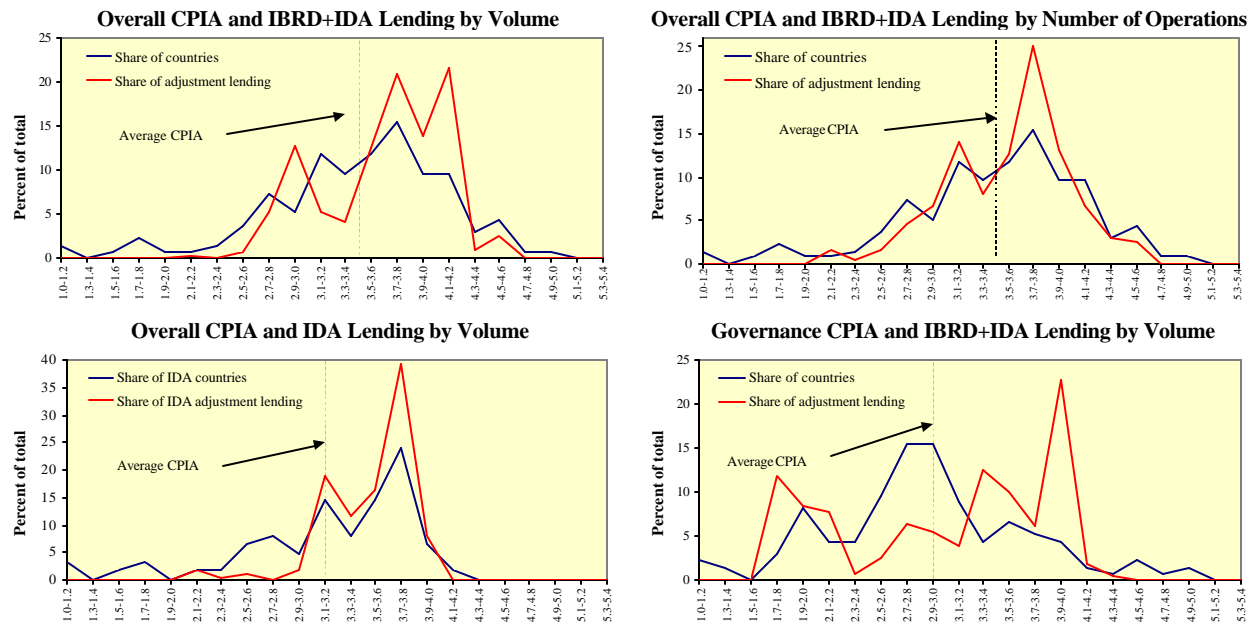
<sup>173</sup> In both Ghana and Uganda, donors in the past continued to use conditionality well after the end of the rapid reform period. In Ghana, conditionality became more stringent over time, despite the fact that the overall quality of policies had improved.

<sup>174</sup> See Craig Burnside and David Dollar, *Aid, Policies, and Growth*, World Bank Policy Research Working Paper No. 1777 (Washington, D.C.: World Bank, 1997), which suggests that adjustment lending had a positive role in supporting reforms in Ghana and Uganda, but was less effective in Kenya (where structural reforms stalled despite some progress in macroeconomic reforms), Tanzania, and Zambia.

<sup>175</sup> Asking the question whether major changes in policy were typically followed by surges in donor financing, Alesina and Dollar found that although donors have quickly responded with financing to political reform, they have not done so consistently to major economic policy changes; see Alberto Alesina and David Dollar, “Who Gives Foreign Aid to Whom and Why?” *op. cit.*

However, investment lending—which is not explicitly linked to performance—also went predominantly to above-average performers.<sup>176</sup> Furthermore, recent data confirm that countries with relatively weak performance, including countries with weak governance, have also received substantial lending. Preliminary results of ongoing OPCS research suggest that in more than half of the countries with adjustment operations since 1995, there were no significant changes in performance following an adjustment loan.<sup>177</sup> These results support the findings from research on aid effectiveness that adjustment lending can provide effective support in strong policy environments, but by itself is typically not effective in promoting improvements in performance of weak performing countries. OED finds that all lending instruments perform better in countries with better policy and institutional environments—but ratings for SALs were higher than other lending instruments (including SECALs and investment loans) in both high and low CPIA countries.<sup>178</sup> This suggest that adjustment lending may often be the most appropriate instrument to support structural reforms even in a weak policy environment—provided there is commitment. A key challenge for the Bank and other development partners is striking a balance between supporting strong performing countries and maintaining portfolio quality on the one hand, and taking risks in countries with a weak track record, but improving performance and a potential for turnaround on the other hand. While country performance and a strong policy environment are critical to development impact, the Bank’s mission to help lift people out of poverty would not allow it to turn its back on the poor in countries where capacity is weak and the consensus for reform is still emerging. Even in the absence of a favorable environment, Bank support in the form of analytic services and capacity building can catalyze a critical mass for reform.

**Figure 34. Policy and Allocation of Adjustment Lending, FY95-00**



Source: Staff calculations based on SAP data and CPIA ratings.

<sup>176</sup> The results are influenced by some large borrowers in all policy categories (such as Indonesia, Korea, Mexico, and Russia). CPIA index is a composite measure of policy performance across a wide spectrum of policy areas and portfolio performance. It is debatable whether it can be used as a tool to determine the choice of instruments made available to borrowers.

<sup>177</sup> The experience in East Asia suggests that Bank ratings of country policy performance (like those of the rating agencies) actually fall when economic fundamentals are reassessed after a crisis has occurred and when adjustment lending is needed.

<sup>178</sup> See *2000 Annual Review of Development Effectiveness: From Strategy to Results*, op. cit.

### 3. Assessing Ownership

128. Government ownership is one of the most critical conditions for ensuring the success of reforms supported under adjustment loans.<sup>179</sup> Ownership is a concept that denotes a high probability that the policy and institutional changes associated with a lending operation will be adopted and implemented even if there is internal opposition. Several conceptual frameworks, each with merits and limitations, have been put forward to assess the level and quality of ownership (see Box 9).

#### Box 9. Conceptual Framework for Assessing Ownership

**Leadership analysis** focuses on senior government policymakers by assessing four variables: the locus of initiative in formulating and implementing the reform program; the level of intellectual conviction among key policymakers; expression of commitment by top leadership; and efforts to build consensus among various constituencies. Leadership is of course key to successful reform, but senior policymakers may underestimate the difficulties in securing support from other interest groups and sustaining institutional effort.

**Stakeholder analysis** focuses on understanding the power relationships, influence, and interests of stakeholders affected by policy reform, including those within the government. This analysis also attempts to capture the extent to which stakeholders can express their voice and participate in decisionmaking, are capable of reaching consensus, and are willing to accept short-term costs for long-term gains and uncertainties in the distribution of benefits.

**Reform readiness analysis** requires detailed knowledge of the political economy; it captures the commitment and performance of key policymakers and important interest groups. Based on the findings that successful reforms must be within the interests of policymakers, feasible, and sustainable over time, this analysis looks at the policy rationale for leadership positions and the institutional arrangements for decisionmaking.

*Source:* D. Morrow, "PREM Note on Assessing Borrower Ownership," *PREM Note* No.25, 1998. This reform readiness approach is embodied in the form of a questionnaire; see Luke Haggarty and Yasuhiko Matuda, *Assessing Clients' Commitment to Sectoral Reforms: A Reform Readiness Analysis*, World Bank, DEC, 1999.

129. **Assessing Ownership in Practice.** In practice, level of commitment is not easily assessed. One criterion for determining ownership is the locus of initiative on the reform program.<sup>180</sup> In the past, there was often an emphasis on Bank additionality, in the sense that Bank financing was thought to support reforms that would otherwise not have been carried out. Indeed, the OPCS survey suggests that 65 percent of adjustment operations policy conditions were developed with some support from the Bank, and in 21 percent of cases with considerable Bank influence. However, the concept of Bank additionality becomes less meaningful when emphasis is put on country ownership—understood as support for country or government initiative. While ownership is difficult to assess in practice, some practical indicators of commitment are available:

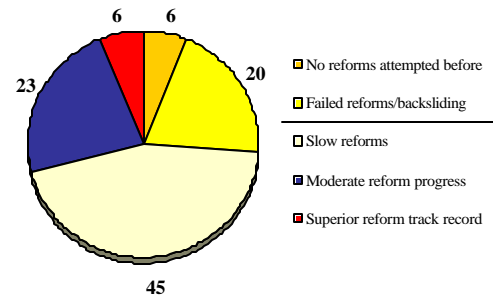
- **Letter of Development Policy.** In reviewing adjustment operations, both ex ante and ex post, it is useful to examine how much government and civil society participation went into preparing the reform program. A Letter of Development Policy can serve a dual purpose in this respect: it outlines the government's reform intentions, and the borrower government can signal ownership and reform commitment through its initiative in preparing the Letter of Development Policy.

<sup>179</sup> See, for instance, John H. Johnson and Sulaiman Wasty, *Borrower Ownership of Adjustment Programs and the Political Economy of Reform*, World Bank Discussion Paper No. 199 (Washington, D.C.: World Bank, 1993); Richard Heaver and Arturo Israel, *Country Commitment to Development Projects*, World Bank Discussion Paper No. 4 (Washington, D.C.: World Bank, 1986); and *Quality at Entry in CY99—A QAG Assessment* (CODE2000-63), June 16, 2000.

<sup>180</sup> See John H. Johnson and Sulaiman Wasty, *Borrower Ownership of Adjustment Programs and the Political Economy of Reform*, op. cit.

- Participation.** Experience also suggests that consultations with civil society, local officials, and donors contribute to a greater public consensus and support for sustained policy reform.<sup>181</sup> A key feature of the PRSP for IDA countries is the objective of genuine country ownership and broad-based participation in preparing programs. Indeed, involvement by civil society—broadly defined—in preparing, implementing, and monitoring adjustment programs can be crucial in building broad country ownership of macroeconomic and structural reform programs (see Box 10). It can also help reduce adverse effects on poor and vulnerable people by involving them in decisions on key reforms. However, the recognition of the important role of country-owned reforms is still relatively recent and still in the process of being fully realized in country programs. To date, adjustment programs have rarely been based on systematic civil society participation, but stakeholder consultations are becoming a more important feature of many operations.
- Track Record.** The most useful proximate indicator of commitment is the government's track record of reforms. Most recent adjustment loans implicitly recognize this: the OPCS survey found that about three-quarters of FY98-00 adjustment loans were based on some progress in the sector where reforms were proposed (see Figure 35). Of course, incomplete reforms in the sector provided the original justification for the envisaged loan. It is also understood that the past record is not necessarily a reliable predictor of future government commitment—particularly as the nature of the reform agenda changes, the consensus and coalitions for reforms evolve, and the possibility of a turnaround in country performance emerges.

**Figure 35. Track Record on Reforms in Sector, FY98-00**  
(Percent)



Source: OPCS survey.

- New Government.** If there is a limited track record, a change of regime—especially to a newly elected government—can signal a greater likelihood of reform. In fact, a new, elected government has a 95 percent probability of a successful adjustment program, compared to 67 percent for an entrenched government in power for 12 years.<sup>182</sup> Existing regimes that are not committed to reform develop vested interests and benefit from distorted exchange and trade regimes, inefficient state enterprises, and generalized corruption; hence there is less desire to change.

<sup>181</sup> See OED “Review of Participatory Processes” (forthcoming), 2001; and *The World Bank Participation Sourcebook*, Environmentally and Socially Sustainable Development Network (Washington, D.C.: World Bank, 1996).

<sup>182</sup> See David Dollar and Jakob Svensson, *What Explains the Success or Failure of Structural Adjustment Programs?* op. cit. This study is based on 220 adjustment loans, mostly carried out in the 1980s and the early 1990s, of which about one-third had failed.

### Box 10. Participation and Partnerships

A sufficient level of national consensus before implementing policies is important to build ownership of reform. Many levels of consensus are required: within various line ministries of government, with the business community, labor unions, farmers' associations, church groups, and nongovernmental organizations, and so on. It is important that the various stakeholders have a clear understanding of the goals of the reform. Civil society involvement in preparing, implementing, and monitoring adjustment programs can be crucial in building broad country ownership of macroeconomic and structural reform programs. It can also help reduce adverse effects on poor and vulnerable people by involving them in decisions on key reforms. To date, most adjustment programs have involved some stakeholder consultations but were rarely based on systematic civil society participation. An ESSD survey of 54 SALs/SECALs prepared since FY97 found that most task teams consulted and involved stakeholders in the government and the private sector—with 43 (or 79 percent) of the adjustment loans involving some degree of consultation or participation in the process of loan preparation—but few teams reported consultation with, or participation of, civil society organizations and organizations of the poor. For FY98-00 adjustment operations, the OPCS survey found that 16 percent of the loan documents explicitly mention civil society involvement through consultations.

**Participation Modalities.** Good practice civil society involvement is representative, and it collects a wide range of perspectives to build broad country ownership throughout the life of a reform program, including planning, monitoring, and evaluation.<sup>a</sup>

- Half or more of the population of adjusting countries is composed of women, yet in many, women are underrepresented in government. Consultations with women's groups therefore become an essential part of consultations with civil society. The CAS consultations for Senegal and the draft CAS for Korea provide good examples of involving women's groups to specifically address gender issues in the Bank's assistance strategy.
- In practice, it is often difficult to involve a very broad spectrum of civil society in the preparation of an adjustment operation, particularly when a rapid response to an economic shock is essential. Besides the demand for speed, the technical complexity of economic policy makes meaningful participation difficult for many civil society groups. Moreover, it is essential that participation be undertaken within the context of the country's own constitutional and legislative framework.
- Where there is participatory policy dialogue on a country's overall development strategy, this can provide a sound basis for civil society inputs when quick action is necessary. For IDA borrowers, strong civil society involvement in the development of the PRSP is therefore especially important. For non-IDA borrowers, participation in the CDF and CAS would help feed into adjustment operations by surfacing issues of economic and structural reform for wide public debate and consensus building.

**Examples.** Most examples of involving civil society in adjustment operations have emerged on an informal basis. Some discussions revolved around a particular component, as in the Second Ghana Economic Reform Support Credit (1999), where the Government led extensive discussions on cocoa reform with marketing companies, farmers, and producers. In other loans, such as the Thailand Public Sector Reform Loan (1999), there were consultation meetings that involved civil society and academics. In still other cases, there have been structured discussions with civil society about sectoral reform, as in the Indonesia Water Sector Adjustment Loan (1999) and the Uganda Education Sector Adjustment Credit (1998). Although none of these have gone so far as to map out how civil society would be involved in preparing, implementing, and monitoring adjustment operations, the participatory processes related to the PRSP and CDF will result in a broader discussion of policy choices in future adjustment operations. The Uganda PRSC approved by the Board on May 31, 2001 is based on extensive discussions about the Government's Poverty Eradication Action Plan.

**SAPRI.** One important exercise that can provide lessons on dialogue for future operations is the Structural Adjustment Participatory Review Initiative (SAPRI). Established in 1996, SAPRI brings together the Bank, governments, and civil society from six countries to consider the performance of past adjustment programs. It is currently examining operations in Bangladesh, Ecuador, Ghana, Hungary, Mali, and Uganda, and provides an opportunity for civil society groups, governments, and the Bank to discuss economic reforms. While it is too early to draw firm conclusions on how successful SAPRI will be in helping to create conditions for better economic and social policies in the participating countries, the discussions that have taken place in the context of SAPRI have contributed to a broader understanding of adjustment policies and their impact.

<sup>a</sup> See *The World Bank Participation Sourcebook*, Environmentally and Socially Sustainable Development Network, (Washington, D.C.: World Bank, 1996).

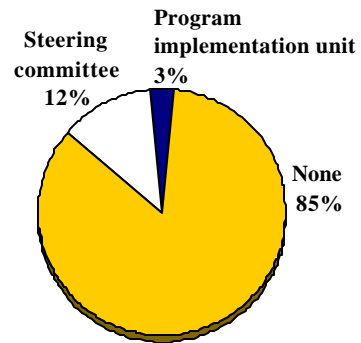
## 4. Implementation Capacity

130. Besides assessing the country's commitment to reform, adjustment lending must also take into consideration the government's readiness and ability to carry out the reforms. Operational policy suggests that "conditionality should refer to reforms that are within the competence of the

borrower to bring about, and not to economic performance as outcome of policy change.”<sup>183</sup> But the OPCS survey of FY98-00 adjustment loans found that most loans paid limited attention to the government’s implementation capacity. The survey also confirmed a trend highlighted in OED ratings toward more complex conditionality, which derives in part from the fact that more countries are seeking Bank support for complex institutional reforms.

- Implementation Arrangements.** Some 85 percent of FY98-00 adjustment loans gave limited consideration to the specific arrangements by which the program would actually be implemented—although the lack of a mechanism to coordinate and manage implementation is precisely where many operations run into difficulties. Twelve percent of the loans involved a coordination committee (that is, responsibility for program oversight assigned to a regular meeting of representatives from different implementing agencies), and 3 percent foresaw a program/project implementation unit that would be in charge of day-to-day management of the adjustment program (see Figure 36). Although 29 percent of FY98-00 operations had multiple implementing agencies, loans rarely highlighted interagency coordination as an issue. Operations that had a single lead agency were generally judged more effective.<sup>184</sup>

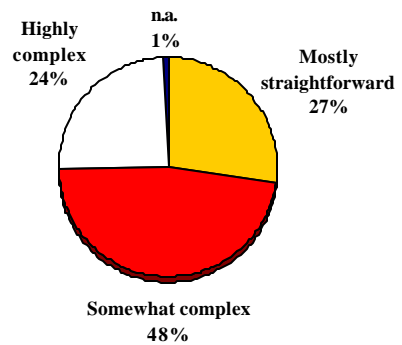
**Figure 36. Share of Adjustment Loans by World Bank Implementation Arrangement, FY98-00**



Source: OPCS survey.

- Complexity.** For many operations, the scope and difficulty of the reform measures may be too demanding. About 27 percent of the adjustment operations surveyed were straightforward; 48 percent were somewhat complex, and 24 percent were highly complex (see Figure 37). The complexity of conditionality was not noticeably less in IDA countries despite their presumed lower capacity. This confirms the OED findings, discussed in Chapter II, that the complexity and demandingness of adjustment loans have been increasing. However, it appears that adjustment operations with more complex conditions tend to have lower ratings for outcomes and sustainability (see Figure 38).

**Figure 37. Share of Adjustment Loans by Degree of Complexity of Policy Conditionality, FY98-00**

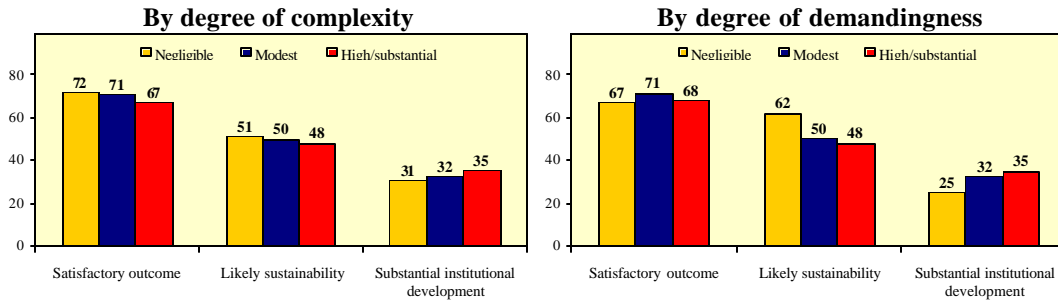


Source: OPCS survey.

<sup>183</sup> See OD 8.60, *Adjustment Lending Policy*.

<sup>184</sup> Program/project implementation units have a mixed record. If they are separated from the line ministries that have the mandate—but lack the capacity—to do the job, they can drain government capacity. See *Review of Aid Coordination and the Role of the World Bank* (SecM99-709), November 1, 1999.

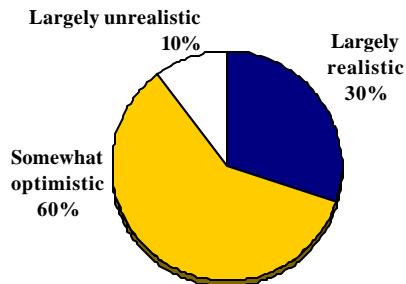
**Figure 38. OED Adjustment Lending Quality Ratings, Exit FY90-00**  
(Weighted by operations)



Source: Staff calculations based on OED data.

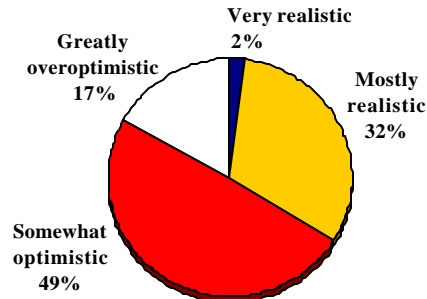
- Realism.** The OPCS analysis of FY98-00 operations found that about one-third had conditions that were largely realistic and likely to be fully implemented (see Figure 39). Many adjustment operations were less realistic, with 10 percent overly optimistic about the time required to achieve objectives. Financial sector reforms, in particular, seem to have taken much longer than originally envisaged.<sup>185</sup> Similarly, many adjustment loans appear to have overestimated government capacity (see Figure 40).

**Figure 39. Degree of Realism of Policy Conditionality: Adjustment Loans, FY98-00**



Source: OPCS survey.

**Figure 40. Description of Government Capacity: Assessment in Adjustment Loans, FY98-00**



Source: OPCS survey.

131. **Bank Support for Program Implementation.** Even in a favorable policy environment, adjustment lending cannot rely on conditionality alone to catalyze and implement a country's reform program. To be fully effective, the policy dialogue must be supported by other Bank instruments that identify institutional weaknesses and help build country capacity step by step.

- Analytic Work.** Adequate country and sector knowledge contribute to the success of adjustment operations.<sup>186</sup> The OPCS survey judged that 77 percent of the FY98-00 adjustment loans were based on adequate or very thorough sector knowledge, revealing weaknesses in the analytic foundations of operations. The extent to which adjustment operations are underpinned by ESW that is considered current—that is, less than five years old—varies widely (see Table 12). There were also shortcomings in the coverage of social, poverty, and environmental aspects, as discussed in Chapter

<sup>185</sup> See Chapter III. B.4 of this paper on financial sector reforms.

<sup>186</sup> For a recent confirmation of this finding, see Lessons from Large Adjustment Loans, *PREM Note*, Number 27, August 1999.

II. Although the Bank's recent efforts to include poverty and social assessments in regular countrywide social and structural reviews go some way toward correcting this situation,<sup>187</sup> more remains to be done to assist countries by providing the analytic work to underpin lending programs and to help sustain longer-term institutional reform even after the last tranche has been disbursed.<sup>188</sup> This would include (a) core integrative country assessments for all active borrowers, (b) other diagnostic ESW as needed for future dialogue and lending, and (c) customized ESW produced at the request of clients.<sup>189</sup> Such upgrades in the ESW program are expected to have major cost implications.

**Table 12. Share of Countries with ESW Underpinning Adjustment Lending**

FY	No. of countries receiving adjustment loans	Type of ESW available (Percent)				
		PER	CFAA/CPFA	CPAR	PA	CEM/SSR
1999	36	58	39	17	78	75
2000	20	65	50	30	65	70

Note: PER = Public Expenditure Review, CFAA=Country Financial Accountability Assessment, CPFA=Country Profile of Financial Accountability, CPAR=Country Procurement Assessment Report, PA=Poverty Assessment, CEM=Country Economic Memorandum, and SSR=Social and Structural Review. Figures refer to ESW less than five years old.

Source: Staff calculations based on Sector Board/Regional data.

- **Helping Catalyze Reforms in Countries with Poor Performance.** As the impact of adjustment programs tends to build gradually, often with some lag after substantial progress with reforms has been made (especially when the reforms are institutional in nature), it is important for the Bank to help build momentum for reform in partnership with civil society and key champions. Effective ESW entails new approaches to preparing the terrain for reform, delivering services, and disseminating knowledge as a core business.<sup>190</sup>
- **Supervision.** Adjustment loans have tended to be less supervision-intensive than investment loans, in part because their typical lifespan is shorter. However, supervision is one of the factors—together with design—that can help make adjustment operations more effective. There is some evidence that stronger supervision could have made a difference in the implementation of adjustment programs rated as unsatisfactory by OED.<sup>191</sup> Such stronger supervision could involve independent third parties and civil society representatives, and could complement efforts to track reform progress through the increased use of intermediate and output indicators. Supervision ends at project completion—but to enhance sustainability, it is desirable that the Bank's dialogue extend beyond the life of the program to provide ongoing monitoring of outcomes.
- **Capacity Building.** Technical and managerial capacity has to be sufficiently strong to successfully implement and sustain reforms. The OPCS survey found that most

<sup>187</sup> See, *Malaysia: Social and Structural Policy Review Update*, World Bank, PREM, East Asia Region, August 2000.

<sup>188</sup> See *Fixing ESW: Where Are We?* (CODE2000-76), July 11, 2000.

<sup>189</sup> For suggestions on analytic underpinnings for middle-income countries, see *Report of the Task Force on the World Bank Group and the Middle-Income Countries* (SecM2001-0204), March 27, 2001.

<sup>190</sup> See *Fixing ESW: Where Are We?* op. cit.

<sup>191</sup> See *Portfolio Improvement Program: Review of Adjustment Operations*, DEC, World Bank, December 5, 1996.



adjustment loans were accompanied by some form of capacity building. However, several reviews over the years have questioned the effectiveness of technical assistance.<sup>192</sup> In practice, effective implementation assistance requires not so much a simplistic transfer of capacity or formulas, but more a sensitivity to the specific requirements of local conditions and a reorganizing of existing institutions, building on existing competencies, routines, and procedures to sustainably meet program objectives. Given the increasing emphasis of adjustment programs on complex institutional reforms, the core implementation challenge is the capacity to communicate and foster stakeholder support.

## B. Design Dimensions of Conditionality

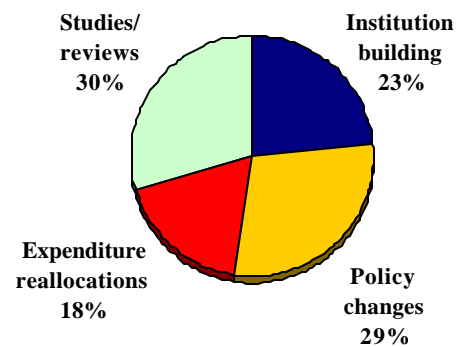
132. Country conditions for successful reforms include sufficient broad-based ownership and institutional capacity to carry out reforms. In addition to these factors, the design of conditionality in policy-based lending has an important role in helping achieve better results on the ground.

### 1. Number and Nature of Conditions

133. Operational policy advises that “conditionality in the areas focused upon by the loan should be related to the key policy and institutional reforms being supported.”<sup>193</sup> In practice, the number and nature of conditions have varied considerably. The OPCS survey assessed the quality of conditionality on the basis of several key characteristics—including type, number, relevance, timing, and sequencing.

134. **Type of Conditionality.** Not all of the conditions in recent loans dealt with changes in policy—only 29 percent of them supported reforms such as abolishing commercial restrictions, establishing fiscal transparency, or changing the application of existing rules (e.g., prudential regulations) or the tax and tariff regime. In fact, almost one-quarter had explicit institution-building objectives involving changes in legislation, the reform of existing institutions, the sale of public enterprises, or civil service restructuring. The rest of the conditions involved either expenditure reallocations or studies, reviews, action plans, or an unspecified “implementation of action plans” (see Figure 41).

**Figure 41. Share of Lending Conditions by Type of Measure, FY98-00**



Source: OPCS Survey.

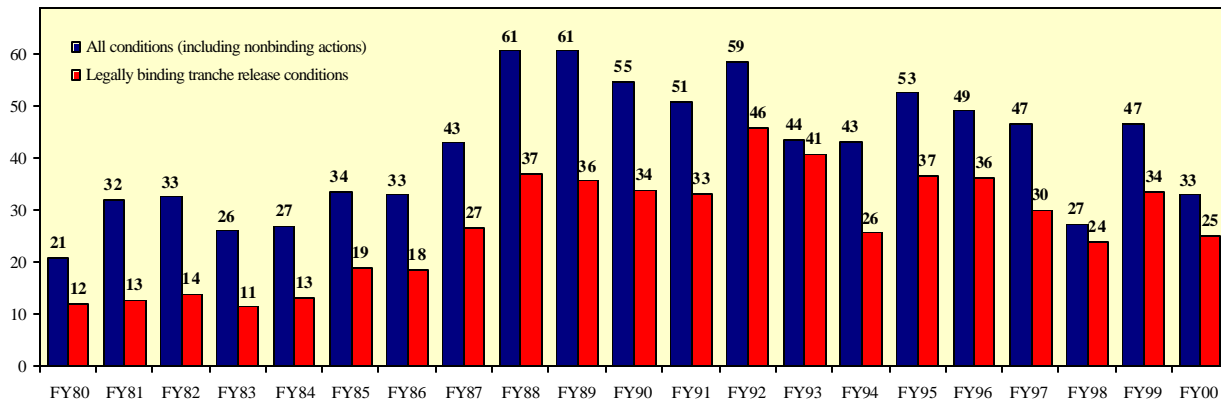
135. **Number of Conditions: Desired Actions.** There is no single “right” number of conditions that should be included in a loan. Operational policy suggests that a priori limits on the number of conditions are undesirable because they tend to restrict the number of reforms that can be supported. In practice, determining what should be regarded as conditions in adjustment loans is often not straightforward. Not only do the policy matrices often contain a multitude of conditions, but also they tend to mix key reform measures, desired actions, and detailed

<sup>192</sup> See *Review of Aid Coordination and the Role of the World Bank*, op. cit.

<sup>193</sup> See OD 8.60, *Adjustment Lending Policy*, para. 47.

processing steps. Many adjustment loans appear overloaded with conditions: the loan documentation of the average adjustment operation in FY00 had 33 conditions, including both binding tranche release conditions and nonbinding desired actions (see Figure 42). That number had already come down from its peak of 61 broad conditions—in the late 1980s. IBRD and IDA operations typically have a similar number of conditions—despite the typically more limited implementation capacity in low-income countries.

**Figure 42. Average Number of Adjustment Loan Conditions, FY80-00**



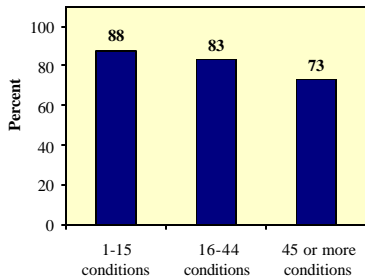
Source: ALCID.

136. **Number of Conditions: Binding Actions.** A clearer picture of loan conditions is provided by the average number of binding measures—prior actions preceding Board presentation, effectiveness conditions, and conditions for tranche release set out in the legal agreements. The original expectation was that the borrower would spell out its overall program in the Letter of Development Policy, including the comprehensive set of policies and actions designed to achieve the program objectives. From this large group, only those actions—agreed at negotiations—that were essential to the success of the program were to be included in the legal agreements as specific conditions of tranche release.<sup>194</sup> Nonetheless, as Figure 42 shows, many loans departed from this principle and included a large number of legal conditions.

137. **Number of Conditions and Performance.** Although the average number of conditions fell in recent years, it is still high. Figure 43 relates the share of adjustment operations rated satisfactory by OED to the number of conditions per tranche, showing that higher numbers of conditions are generally associated with poorer outcomes. There is also evidence that the number of conditions tends to be higher in countries with poor performance, as measured by the CPIA rating (see Figure 44). This is consistent with anecdotal evidence that a “shotgun approach”—many conditions in diverse areas—may sometimes be used in countries with a weak reform record, in the hope that at least some reforms will materialize, or in countries where a sudden economic shock has created an opportunity to tackle overdue reforms.

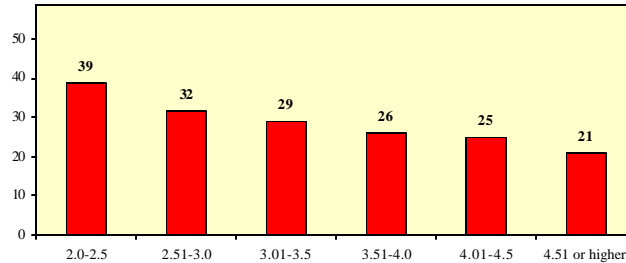
<sup>194</sup> Legal agreements also include as additional “general” conditions of tranche release Bank satisfaction with (a) the overall progress achieved by the borrower in carrying out the program, and (b) the borrower’s macroeconomic policy framework, as measured on the basis of indicators agreed between the borrower and the Bank. The Bank also retains the right to suspend the loan if “a situation has arisen which shall make it improbable that the Program, or a significant part thereof, will be carried out.”

**Figure 43. Satisfactory Outcome Ratings of Adjustment Loans by Number of Conditions, Exit FY90-00**  
(Weighted by operations)



Source: Staff calculations based on OED data and ALCID.

**Figure 44. Average Number of Conditions per Adjustment Loan by Country CPIA Rating, FY98-00**



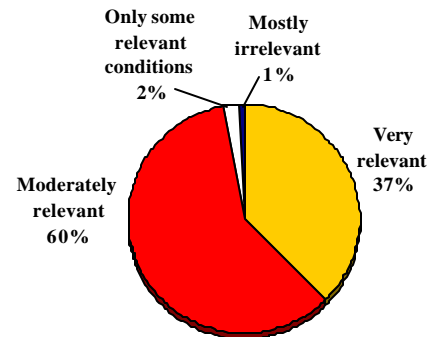
Source: Staff calculations based on ALCID and CPIA results.

138. **Relevance of Focus.** According to operational policy, Bank adjustment loans should contain only those conditions that are necessary for attaining the loan objectives.<sup>195</sup> The OPCS survey suggests that nearly all policy conditions are at least moderately relevant (see Figure 45).

139. **Precision.** The appropriate specificity of conditions may vary across countries by performance and degree of ownership. Conditionality requiring excessively detailed actions (rather than target outcomes) often reflects a lack of confidence about countries with a weak track record and a greater risk of failure.<sup>196</sup> However, such micromanagement of conditionality tends to be unsuccessful where country ownership, willingness to reform, and implementation capacity are missing or where country circumstances are rapidly changing or there are a variety of ways to achieve a given objective. Relatively more detailed conditions may be appropriate when they can help proponents of reforms specify and lock in planned reform actions benefiting the poor or other vulnerable groups over opposition from vested interest groups. But in countries where the future course of reform is less certain—for example, where long-term institutional reforms are being put in place—it may not be desirable (or indeed possible) to define conditionality in terms of highly detailed actions. The OPCS survey revealed that 19 percent of FY98-00 adjustment loans included general, nonspecific conditions (see Figure 46).

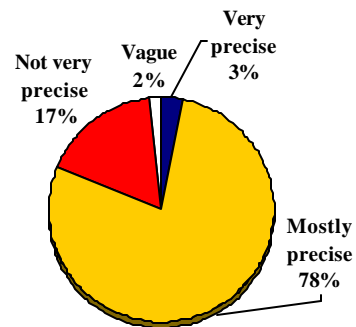
140. **Timing.** Many multitranche loans have tended to be backloaded with future actions, with few up-front actions completed before loan effectiveness. The OPCS survey found that, of the FY98-00 multitranche adjustment loans, 80 percent were somewhat or even strongly

**Figure 45. Relevance of Focus of Policy Conditionality Loans, FY98-00**



Source: OPCS survey.

**Figure 46. Degree of Precision of Policy Conditionality Loans, FY98-00**



Source: OPCS survey.

<sup>195</sup> See OD 8.60, *Adjustment Lending Policy*, para 51.

<sup>196</sup> See *Aid and Reform in Africa*, op. cit.

backloaded (see Figure 47). Although 56 percent of all conditions were to be fulfilled before Board presentation (compared to 32 percent at second tranche), these up-front actions often focused on formulating plans and strategies or establishing working groups, but left the actual implementation to the second tranche.

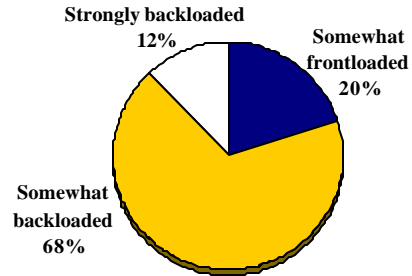
141. **Sequencing and Coherence of Measures.** Operational policy highlights the importance of sequencing and suggests key lessons: (a) priority should be given to those structural reforms that are important for both stabilization and improvement in the efficiency of resource allocation, (b) reforms are best initiated with substantial reductions in the largest or costliest distortions, and (c) it is important to identify complementarities among different elements of the reform package.<sup>197</sup> Using these criteria, the OPCS survey found that more than half of adjustment conditions showed a coherent or adequate sequencing. A sizable share of the conditions were judged to have minor sequencing problems, and a small minority revealed inconsistent sequencing (see Figure 48).

142. **Quality of Conditionality by SAL/SECAL.** The OPCS survey found wide variation in the quality of conditionality between the SALs and SECALs it reviewed. SALs, which range across a number of ministries, tended to be more complex. On balance, the conditionality of SECALs was judged to be more relevant, clear, and realistic than that of SALs (see Figure 49). A possible explanation is that the preparation of SECALs tends to have greater involvement by the line authorities who are responsible for carrying out these conditions (and who also understand that some of the funding provided by SECALs is more likely to be directed toward the corresponding ministry).

## 2. Phasing and Tranching

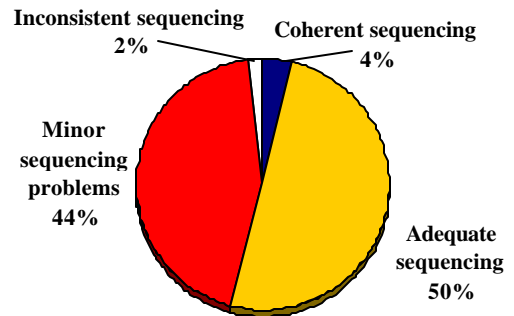
143. The timing and phasing of the activities under an adjustment operation are critical to the success of the program. When adjustment loans are used to provide fast-disbursing financial support in response to economic distress, they tend to be deployed to address problems that are amenable to short-term measures—wage bill or labor force reductions, and the like. However, when an adjustment loan supports complex structural reforms in areas such as public sector management, privatization, and the financial sector, there is a

**Figure 47. Timing of Policy Conditionality, FY98-00**  
(Multitranche operations)



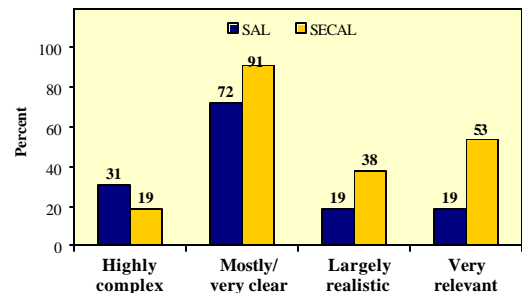
Source: OPCS survey.

**Figure 48. Loan Sequencing of Policy Conditionality, FY98-00**



Source: OPCS survey.

**Figure 49. Quality of Policy Conditionality: SAL/SECAL, FY98-00**



Source: OPCS survey.

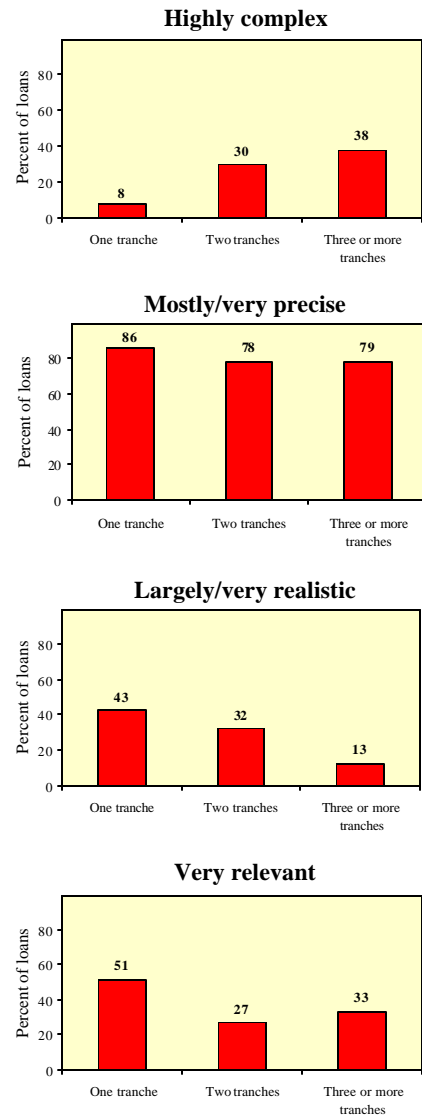
<sup>197</sup> See OD 8.60, *Adjustment Lending Policy*, para 8.

tension between the rapid provision of financing and the often slower pace of intensive structural reforms. To reflect these timing considerations, adjustment loans are disbursed in tranches; that is, a portion of funding is withheld until certain conditions are met.

144. **Tranching.** There is no fixed rule regarding the number of tranches an adjustment operation should have. While the Bank has traditionally relied on multitranche operations, since FY88 traditional two-tranche operations have accounted for less than half (47 percent) of adjustment loans.<sup>198</sup> Nontraditional tranching, in particular single-tranching, has become more frequent over the last few years. As different tranching options tend to be appropriate in different country circumstances—depending on the country’s policy environment, capacity, and reform record—a careful assessment of advantages and disadvantages of various alternatives is important part of loan design program.

145. **Multitranche Operations.** The Bank uses multiple tranches to support commitments as they are met over time within the framework of a single operation. Experience shows that reformers often welcome the opportunity to demonstrate their commitment and lock in a reform program through conditionality covering future actions.<sup>199</sup> Multitranche operations can be appropriate in such circumstances. In principle, multiple tranches also have the advantages of clarifying future commitments when a country’s track record is weak. In practice, however, the OPCS survey suggests that operations with a greater number of tranches are associated with conditionality that is less precise, more complex, less realistic, and less relevant (see Figure 50).<sup>200</sup> Also, the ex ante rigidity of multiple tranches can make later adaptation to changing circumstances difficult. As a result, multitranche operations frequently run into implementation delays, if they do not have flexible conditions. Especially in cases where the reform agenda involves substantial institutional change, a standard multitranche adjustment loan may therefore be problematic.<sup>201</sup>

**Figure 50. Quality of Loan Conditionality by Number of Tranches, FY98-00**



Source: OPCS survey.

<sup>198</sup> The rest of the adjustment loans have been fairly evenly split between single-tranche and multitranche loans, with a few loans disbursed in four or more tranches.

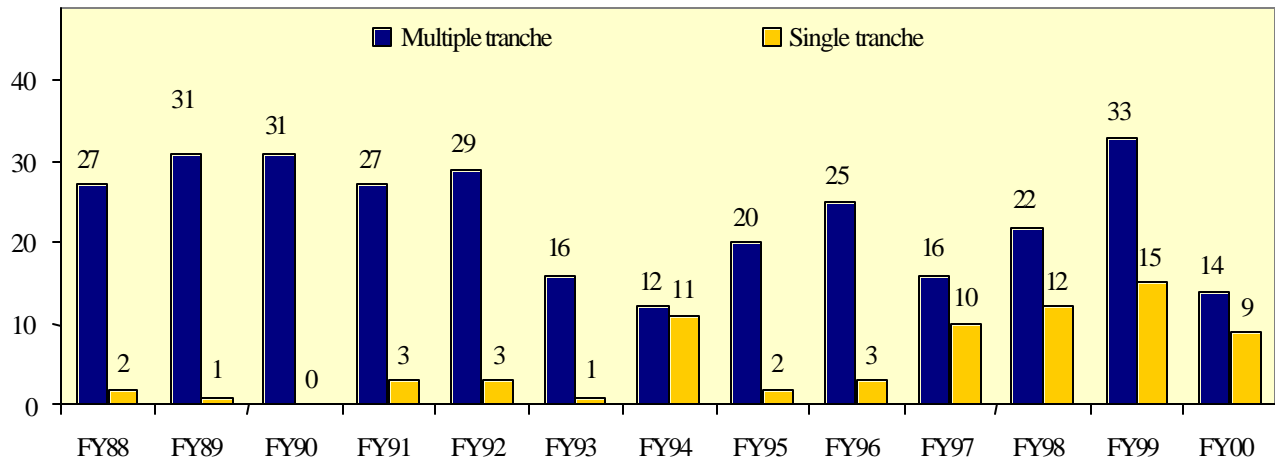
<sup>199</sup> See DEC case studies in Shantayanan Devarajan, David Dollar, and Torgny Holmgren, *Aid and Reform in Africa*, op. cit.

<sup>200</sup> This result, of course, is not so much a consequence of the number of tranches, but a reflection of uncertainty over a country’s policy environment and reform progress, which may have prompted the use of tranches in an attempt to manage risks.

<sup>201</sup> See *Quality at Entry in CY99—A QAG Assessment*, op. cit.

146. **Single-Tranche Operations.** Single-tranche operations—especially series of single-tranche operations—offer a different approach to conditionality. They support completed actions, specified and agreed in advance, instead of future ones. The use of single-tranche operations has grown more common over the last decade. Between FY98 and FY00, 36 single-tranche adjustment operations were approved for a total of \$12.8 billion; and by FY00, single-tranche loans accounted for 39 percent of the number of adjustment operations (see Figure 51), and a 38 percent share by volume. The overall experience with single-tranche operations has been encouraging—in part because they were used more frequently in countries with a better policy environment.<sup>202</sup> OED quality-at-exit ratings for FY90-00 show that single-tranche operations were rated higher than multitranche operations in terms of satisfactory outcomes and sustainability (see Figure 52). They were rated slightly lower in terms of institutional development impact, which likely reflects the fact that they disburse over a shorter time span. Indeed, concern about the sustainability of single-tranche operations is the main reason for the operational policy provision that a single-tranche operations may be appropriate in high uncertainty environments—provided there is adequate up-front conditionality and a satisfactory medium-term program within which the operations can be evaluated.<sup>203</sup> Single-tranche operations embedded in a medium-term framework specified at the outset can also combine country ownership with systematic reform implementation, by building on completed actions, specified and agreed in advance, instead of future ones.

Figure 51. Adjustment Lending Operations by Number of Tranches, FY88-00



Note: Figures exclude DRLs and RILs

Source: Staff calculations based on SAP data.

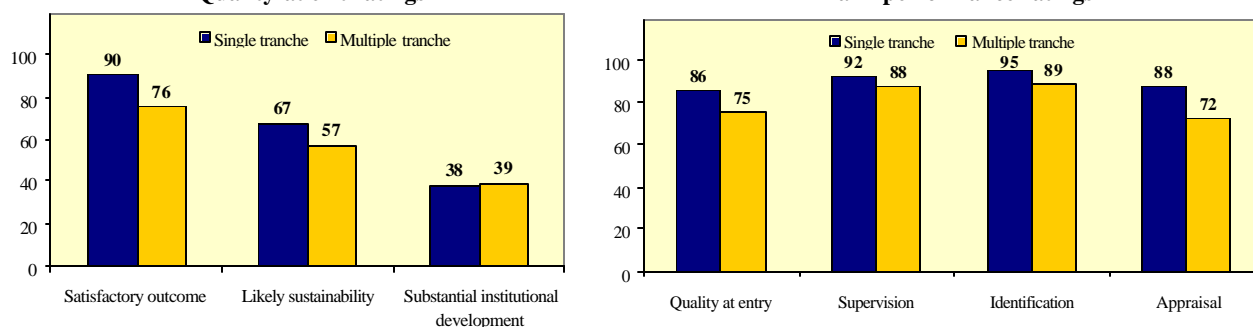
147. **Series of Single-Tranche Loans.** At first considered suitable as short-term support, especially for countries with urgent financing needs, single-tranche operations are now frequently used in series as part of a multiyear strategy. This approach can reduce the risk of an episodic treatment of the country's reform needs, and provides one possible way to structure and strengthen the medium-term framework of support for the government's program. In such a series of single-tranche operations, the medium-term framework includes not only the completed up-front reform actions and monitorable progress indicators of future reform progress. It also

<sup>202</sup> See Annex D for a discussion of the experience with single-tranche operations.

<sup>203</sup> See *Issues in Adjustment Lending* (R-96-55), April 2, 1996. For a summary, see the Operational Memorandum *Clarification of Current Bank Policy on Adjustment Lending*, June 5, 2000.



**Figure 52. OED Evaluated Ratings of Single-Tranche vs. Multitranche Adjustment Loans, FY90-00**  
Quality-at-exit ratings



Source: Staff calculations based on OED and SAP data.

specifies the expected nature and timing of the key future reform actions that serve as triggers for the subsequent operations. If progress stays on track as expected, the triggers specified at the outset become prior actions for the subsequent operations and are reflected in their documentation. Compared with a multitranche operation, where conditions for all future tranches are rigidly specified at the beginning in one legal agreement for the entire operation, a series of single-tranche operations covering the same period offers greater flexibility, while still tying the provision of financing closely to performance. They also offer increased scope to the Bank's Board of Executive Directors for regular monitoring and review of the Bank's support throughout the reform program, and they offer borrowers the advantage of lower commitment fees. Such series of single-tranche operations have been used to support medium-term reform programs in the financial sector, public sector, private sector, and in other areas and have proven broadly effective.

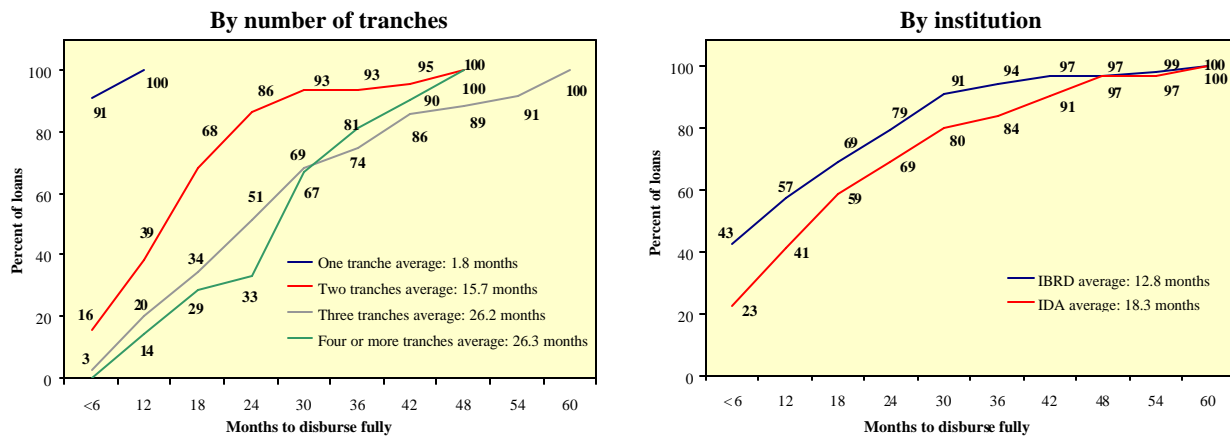
148. **Floating Tranches.** The Bank has increasingly used "floating" tranches—that is, tranches that are disbursed as specific conditions are fulfilled. This approach can be appropriate for clearly defined discrete reform actions with uncertain timing, such as privatization of public enterprises. Preliminary evidence suggests that floating tranches for different parts of an overall reform package can increase the credibility of loan conditionality. They offer the advantage of complementarities and synergies among reform measures, without specific reforms holding up progress in the overall program. A recent example of this approach is the Tanzania PSAC I (2000); although this operation remains too new to have yet validated the approach. The OED interim evaluations of the Higher Impact Adjustment Lending Program, which has used this approach, found that, on average, countries that benefited from the disbursement flexibility of floating tranches had better policy outcomes than were achieved by the comparator groups of countries, in fiscal adjustment, exchange and interest rate policy, and structural reforms.<sup>204</sup> Floating tranches can thus provide considerable flexibility in adjustment lending, especially when combined with the use of fewer, but more meaningful, conditions. The effective use of floating tranches entails careful consideration of the implications for the relative phasing of Bank and Fund support when Bank adjustment operations proceed in parallel with time-bound IMF arrangements.

<sup>204</sup> See *Higher Impact Adjustment Lending (HIAL) Initial Evaluation*, Operations Evaluation Report No. 19797, World Bank, June 29, 1999.

### 3. Disbursement

149. Adjustment loans have been conceived to provide fast-disbursing financial support, and their disbursement pattern still tends to have a short-term focus although the instrument has become more developmental in character. A typical two-tranche operation was originally intended to disburse within 12 to 18 months, and a three-tranche operation within 24 months. On average, the various FY93-00 loans met or came close to these goals: single-tranche operations took close to 2 months to disburse after Board approval; two-tranche loans, 16 months; and three-tranche loans, 26 months. However, there was wide variation in the time individual operations took to disburse fully. Some single-tranche operations took 14 months to disburse fully; some two-tranche loans took about 50 months; and some three-tranche loans took up to 60 months. (One explanation for the duration of three-tranche operations might be that they tend to be used in countries with weak implementation capacity.) One year after Board approval, 57 percent of all IBRD and 41 percent of IDA operations were fully disbursed. On average, IBRD loans took 13 months to disburse, and IDA loans took 18 months. Figure 53 displays the distribution over time of total portfolio disbursement across tranches and institutions.

Figure 53. Disbursement Profile of Adjustment Loans: Closed Operations, FY93-00

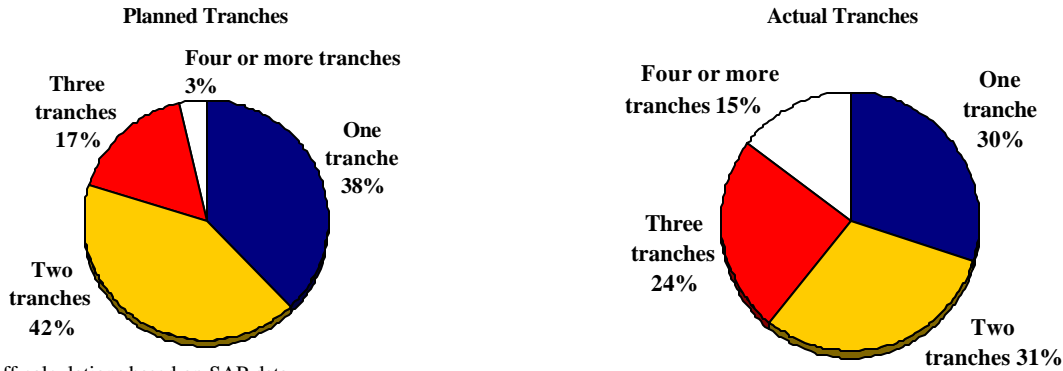


150. **Delays and Amendments.** During FY90-99, second-tranche release was delayed more than six months in about half of all adjustment operations, although the record in this area improved during the decade: the proportion of operations with delayed second tranches dropped from a high of 81 percent in FY93 to 29 percent in FY99. Adjustment loans are also frequently subject to restructuring after loan implementation begins (see Figure 54). Often restructuring is accomplished by increasing the number of tranches in response to implementation difficulties; this practice leads to a much higher than planned number of operations with three or more tranches.

151. **Waivers.** Evidence reveals frequent waivers of tranche release conditions, indicating that program implementation under traditional multitranche loans often falls short of original expectations (see Figure 55). In general, waivers were more frequent in loans that were more complex, demanding, and risky (see Figure 56). Of the 292 adjustment operations during FY90-99 for which all the tranches have been released, 68 percent were operations with regular tranche release, while the remaining 32 percent had waivers—including 9 percent for which a tranche was canceled altogether. All single-tranche operations were released as scheduled, since they



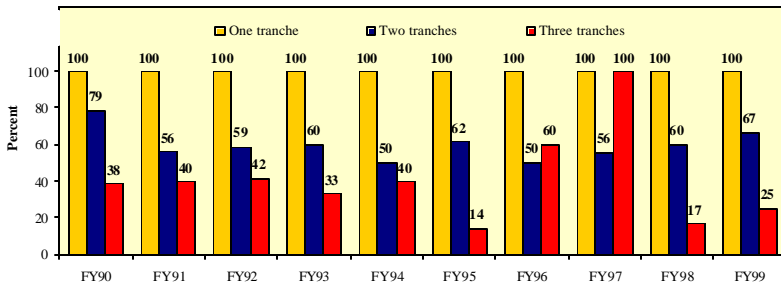
**Figure 54. Planned vs. Actual Tranching of Closed Operations, FY93-00**



Source: Staff calculations based on SAP data.

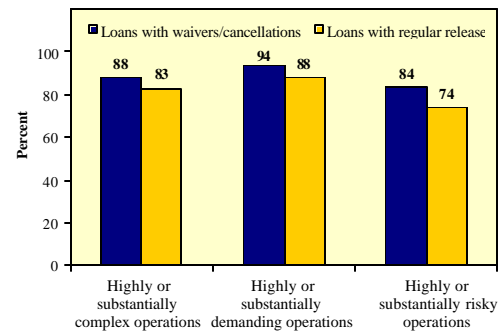
were presented to the Board only when the actions were completed. Among two-tranche operations, 39 percent had waivers or cancellations; among three-tranche operations, the figure was 63 percent. Single-tranche operations, including series of single-tranche operations, entail fewer waivers and cancellations than multitranchise loans. But apart from clearly signaling country ownership of completed reform actions, this advantage of fewer waivers in single-tranche than in multitranchise operations is mainly one of convenience and simpler processing. Indeed, single-tranche operations are effective in linking disbursement to performance *only* if they are embedded in a strong medium-term framework—ideally in an integrated series of single-tranche operations—and, like multitranchise operations, are based on transparent prior actions and clear triggers for subsequent operations specified in advance.

**Figure 55. Share of Operations with Regular Tranche Releases by Number of Tranches, FY90-99**



Source: Staff calculations based on SAP data.

**Figure 56. Complexity, Demandingness, and Riskiness Ratings of Adjustment Loans by Tranche Release Type, Exit FY94-00**



Source: Staff calculations based on OED and SAP data.

#### 4. Monitoring Results

152. Monitoring and evaluating the development impact of lending operations has been a key issue for the Bank, especially since the Wapenhans Report stressed its importance.<sup>205</sup> The Bank’s strategy is also to align country and sector strategies to the international development goals.<sup>206</sup> Recent efforts to strengthen monitoring and evaluation of the Bank’s loan portfolio have focused

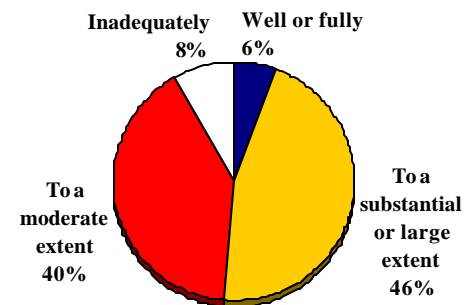
<sup>205</sup> See *Effective Implementation: Key to Development Impact—Report of the World Bank’s Portfolio Management Task Force* (Wapenhans Report) (Washington, D.C.: World Bank, 1992).

<sup>206</sup> See *World Bank Group Strategic Framework*, January 24, 2001; and 2000, *A Better World for All: Progress towards the International Development Goals*, op. cit.

primarily on investment lending.<sup>207</sup> Monitoring of results in adjustment operations has in practice focused on supervising progress toward meeting agreed conditionality on policy actions that are within the control of the government. Adjustment programs implicitly involve assumptions about the expected effects of a particular set of actions on economic performance and incentives, social conditions, poverty reduction, and the environment. In practice, however, it is difficult to define and apply performance indicators that compare actual to expected outcomes and allow corrections of the program. Linking policy measures supported by adjustment operations and the associated financing to particular economic and social outcomes faces several problems: adjustment programs inherently have complex economywide repercussions, poverty reduction and economic performance are influenced by many other factors, the availability of reliable data is often constrained, and changes in countrywide economic, social, and environmental trends may appear only with a considerable lag. Evaluation of adjustment operations is further complicated by the difficulties of specifying the counterfactual of what would have happened without the operation.

153. **Practice.** Judging from the information available in the documentation of the FY98-00 adjustment loans surveyed by OPCS, monitoring indicators track progress in achieving loan objectives fully or at least to a substantial extent in slightly more than half of the cases (see Figure 57). About 8 percent of adjustment loans have insufficiently specific benchmarks to evaluate implementation progress on the ground. Few adjustment operations include up-front agreement on specific monitoring indicators; in most cases, progress in program implementation is measured simply by compliance with loan conditionality. Most adjustment operations focus on outputs (for instance, the passage of a law, or expenditure shifts) for the reasons mentioned above. A clear definition of expected outcomes (for instance, quantitative targets for the reductions in infant mortality) is rare. Responsibility for monitoring progress mostly lies with the Bank team, which focuses on checking compliance with loan conditions, often in the context of supervision missions.

**Figure 57. Degree to which Indicators Monitor Objectives, FY98-00**



Source: OPCS survey.

154. **Defining Monitorable Indicators.** Developing a clear road map that allows meaningful assessment of reform progress under policy-based operations and goes beyond a mere compliance with policy conditions has proved to be an operational challenge. It requires the policy matrix to spell out a practical framework that links the strategy to results on the ground through monitorable progress indicators. (For series of single-tranche operations, these monitorable progress indicators complement the specification of key actions that serve as triggers for subsequent operations.) The challenge is to define performance indicators that are precise enough to guide implementation and enable unambiguous monitoring of results, but that are pragmatic and flexible enough to allow for the inherently unpredictable nature of institutional reforms over the medium term. For the necessary combination of precision and flexibility, it is

<sup>207</sup> See *Report of the Working Group on Improving Quality of Monitoring and Evaluation in Bank Financial Operations* (CODE2000-72), June 29, 2000.

useful to make judicious use of three broad types of performance indicators that are not part of the operation's conditionality per se.<sup>208</sup>

- ***Policy indicators*** to monitor policy and institutional actions required to implement the program<sup>209</sup>—for example, the maintenance of a stable macroeconomic environment,<sup>210</sup> structural reforms to support sustainable growth by improving the allocation and use of resources in the economy, and protection of social expenditures or building of social safety nets. Policy actions are relatively easy to monitor, although data needed to confirm compliance may be subject to delays, and indicators for institutional reform are more indirect.
- ***Intermediate indicators*** to track the impact of policy reforms on stabilization, structural change, and the provision of social services.<sup>211</sup> It is good practice for adjustment operations to provide projections of the effect of the adjustment process on key economic indicators, including domestic savings and investment, tax revenues, inflation, current account deficit, and budget deficit. Proxy or leading indicators (e.g., user survey results) are useful for structural changes, the provision of social services (e.g., number of children vaccinated, supply of textbooks), or areas where data are not readily available.
- ***Outcome indicators*** to monitor progress toward the ultimate objectives of the adjustment program in terms of growth, poverty reduction, better social conditions, and environmental protection.<sup>212</sup> Monitoring of outcome indicators is made difficult by the short-term effects of the adjustment process on growth estimates, and, frequently, the lack of reliable and timely national accounts data and poverty and social indicators.

For practical purposes, there is a continuous spectrum of performance indicators.<sup>213</sup> Policy indicators can be thought of as leading indicators for intermediate indicators, while intermediate indicators can be leading indicators of outcomes. Typically, indicators would not be used as conditions that have to be met, but rather to alert policymakers that the program is off track and corrective action is needed.

155. ***Lessons of Experience.*** Good practice examples also suggest some lessons that allow better monitoring of results. Performance indicators should be agreed up front, with a clear understanding of which indicators (primarily those related to policy actions) are within the control of the government. A risk of outcome-related benchmarks is that they shift the burden of uncertainty over the release of financing to the borrower. It is therefore critical to link these benchmarks clearly to measures over which policymakers have discretion. Government efforts to

<sup>208</sup> See Mark Baird, Michael Lav, and Deborah Wetzel, *Performance Indicators for Adjustment Programs: A First Edition Note*, World Bank, DEC, March 1995.

<sup>209</sup> Under this typology, *policy indicators* combine input and process indicators.

<sup>210</sup> Specific stabilization measures involving limits on fiscal deficits, external debt, net domestic assets of the banking system, targets for external and domestic arrears, and so on are typically the focus of IMF-supported programs.

<sup>211</sup> *Intermediate indicators* are also sometimes called output indicators.

<sup>212</sup> *Outcome indicators* are also sometime called impact indicators.

<sup>213</sup> More narrowly defined, the term “indicator” refers to variables that can change over time, while the term “benchmark” refers to fixed targets.

strengthen domestic capacity for monitoring economic, social, poverty, and environmental outcomes are also critical. An important factor that allows borrowers to take on responsibility for monitoring reform implementation is to assign performance indicators to specific government agencies—ideally the same agencies responsible for implementing the program or its components.

156. **Risk Management.** As discussed in Chapter II, adjustment lending would benefit from a strategy for mitigating and managing the inherent risks of an operation. Effective risk management deals with uncertainty through a system of identification, assessment, and action that continues throughout the life of an operation and focuses on developing and refining the best means of achieving its objectives. At a minimum, this involves feedback on indicators relating to the assessment of risks during the approval and implementation of a program. It also involves a clear identification of any residual risk that cannot be mitigated and needs to be managed. Further work on the development of a framework for assessment and management of risk would be useful, particularly where the Bank is engaged for a sustained period through programmatic adjustment lending.

### C. Coordinating Conditionality with the IMF

157. The Bank and the IMF have distinct, but complementary, areas of responsibility and expertise with which to support member countries' adjustment programs. The two institutions have long had in place a framework for collaboration to help ensure that their advice is consistent and that it fully exploits the expertise and financial resources of each.<sup>214</sup> The collaborative framework delineates areas of primary responsibility and a few areas of overlap.

#### 1. Framework for Consultation and Coordination with the IMF

158. Broadly, the IMF concentrates on macroeconomic policies and directly related structural policies, including exchange rate regimes, monetary institutions, and the aggregate aspects of fiscal policy. The Bank concentrates on structural policies (except those directly related to macroeconomic policies) and on social policies and institutional reforms. The interests of the Bank and the Fund overlap in the areas of trade, tax policy and administration, public expenditure management systems, and the financial sector. While the two institutions have agreed on the delineation of their areas of primary responsibility, they are also aware of strong interdependencies between macroeconomic and structural adjustment. The lending decisions of both institutions therefore consider the adequacy of the country's overall program. The Bank conditions all adjustment lending on the country's having an appropriate macroeconomic framework in place. IMF practice so far has been to address concerns about an appropriate structural environment through structural benchmarks in its lending arrangements.

159. **Coordination Arrangements.** According to the Joint Guidelines, Bank and IMF staff are to provide country authorities with a clear understanding of how the delineation will be applied to the country's adjustment program.<sup>215</sup> The arrangement provides for early and full consultation between Bank and IMF staff on key policies. Final responsibility for advising and negotiating with the authorities rests with the institution that has primary responsibility in a designated

<sup>214</sup> See *Report of the Managing Director and the President on Bank-Fund Collaboration* (SecM98-733), September 4, 1998. This document is referred to as the Joint Guidelines.

<sup>215</sup> See *Report of the Managing Director and the President on Bank-Fund Collaboration*, op. cit.

policy area.<sup>216</sup> Agreed coordination mechanisms serve to ensure that either institution relies as much as possible on the analysis and monitoring of the institution that has primary responsibility in the policy area in question and leads the dialogue with the authorities.<sup>217</sup> This arrangement exploits the synergies of Bank and IMF involvement in a country, but allows each institution to focus on its areas of expertise and safeguard its independent lending decisions. Recent developments in Bank-Fund collaboration in low-income countries, which are discussed in more detail below, are leading to a stricter concentration of each institution's conditionality on areas of its primary responsibility. To the extent that this becomes future common practice, it will take the place of the specific coordination arrangements for cases of support to measures in areas of the other institution's primary responsibility.

## **2. Bank-IMF Coordination on Macroeconomic Policies**

160. As noted, Bank adjustment loans and credits are always conditioned on the country's having satisfactory macroeconomic policies in place.<sup>218</sup> In this context, cooperation with the IMF has two aspects: early consultation to ensure that the IMF's macroeconomic policy advice to the country benefits from Bank input, and IMF input into the Bank's assessment of the adequacy of macroeconomic policies for adjustment loans and credits.

161. **Assessing Macroeconomic Policies for Adjustment Lending.** In making its lending decisions, the Bank takes responsibility for determining whether the country's macroeconomic framework is sufficient to allow Bank-supported structural and social reforms to succeed. In making the determination, the Bank relies as much as possible on the Fund's assessment. To that end, the Bank's policy on cooperating with the IMF in assessing the adequacy of a country's macroeconomic policies states that "adjustment lending is not normally undertaken unless an appropriate IMF arrangement is in place. If there is no IMF arrangement, Bank staff should ascertain, before making their own assessment, whether the IMF has any major outstanding concerns about the adequacy of the country's macroeconomic policies. In some cases this may entail the IMF's consulting with the country authorities. The Bank also takes into account the IMF's assessment of macroeconomic policies before it authorizes tranche releases."

162. **Bank-IMF Coordination of Programs.** Bank practice adheres closely to this policy. Most Bank adjustment programs have been undertaken when an IMF program was in place, and in the few cases of approval of a tranche release without an active IMF arrangement, there was close consultation between the two institutions. An analysis of the adjustment lending approvals and tranche releases in FY98-00 (see Table 13) shows the following:

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<sup>216</sup> The Joint Guidelines state: "Before finalizing its position on key elements of a country's policies and reform agenda, each institution will solicit the views of the other and share its evolving thinking at as early a stage as feasible. This should lead to better policy advice and program design benefiting from the perspectives of both institutions. When ... differences of view ... cannot be resolved at the staff level, the issue will be raised at the level of senior management for resolution. If agreement still cannot be reached, the views of the institution with primary responsibility will prevail in the final advice to, or negotiations with, a member country, and such differences will be reflected in reports on the country to the Executive Boards of the two institutions."

<sup>217</sup> The Joint Guidelines state that "each institution should rely as much as possible on analyses and monitoring of the other institution in the areas of primary responsibilities of the latter, while safeguarding the independence of institutional decisions."

<sup>218</sup> See OD 8.60, *Adjustment Lending Policy*.

- The great majority of the 108 adjustment operations from FY98 to FY00 were approved for countries that either had, or would soon enter into, an arrangement with the Fund. In the remaining cases, 15 operations in 12 countries, Bank staff ascertained that Fund staff had no major concerns or reached an understanding on how these concerns would be addressed. This understanding was usually based on recent Article IV consultations, and the IMF's support of the adequacy of the macroeconomic framework in these cases was provided in varying formats and degrees of specificity.<sup>219</sup>
- The status of Fund arrangements also is an important factor in the authorization of tranche releases. Among the recipient countries in FY98-00, the great majority received Fund disbursements in the same fiscal year, had stand-by or extended arrangements of a precautionary nature, or would soon enter into an arrangement.<sup>220</sup> In countries without a Fund arrangement, Bank staff ascertained—through joint missions, written statements, or Fund comments during Board discussion—that Fund staff had no major concerns.

In practice, Bank and IMF country teams routinely consult on macroeconomic program issues and bring them to the attention of Senior Management if there are differences in view. Judging from the cases discussed by Senior Management in FY98-00, it appears that Bank teams primarily raised the issue of the sustainability of IMF-supported programs.

**Table 13. IBRD/IDA Adjustment Operations and IMF Arrangements, FY98-00**

<i>Category</i>	<i>Approval year</i>		
	<i>FY98</i>	<i>FY99</i>	<i>FY00</i>
<b>Number of adjustment operations approved</b>	<b>37</b>	<b>48</b>	<b>23</b>
With IMF arrangement in place at approval	28	40	19
IMF arrangement within two quarters of approval	3	2	1
Without IMF arrangement	6	6	3
<b>Number of countries for which adjustment operations approved</b>	<b>29</b>	<b>36</b>	<b>20</b>
With IMF arrangement in place at approval	22	29	16
IMF arrangement within two quarters of approval	3	2	1
Without IMF arrangement	4	5	3
<b>Number of countries with Bank tranche releases</b>	<b>52</b>	<b>46</b>	<b>41</b>
With IMF disbursements in the same FY	36	38	30
Without IMF disbursements in the same FY	16	8	11
With IMF arrangement at or within 2 quarters of tranche release	6	3	8
Without IMF arrangement at or within 2 quarters of tranche release	9	5	3

*Note:* Bank adjustment operations include structural adjustment loans and credits, and sector adjustment loans and credits. IMF arrangements include stand-by, extended, and enhanced structural adjustment arrangements.

*Source:* Staff calculations based on SAP data and IMF *International Financial Statistics*.

163. **Macroeconomic Monitoring.** According to Bank policy, country authorities and the Bank reach agreement on what will constitute satisfactory macroeconomic policies in the context

<sup>219</sup> Four cases involved Fund staff leading a dialogue with the authorities on the design of appropriate macroeconomic measures that would be supported by the Bank's adjustment operation.

<sup>220</sup> There was one tranche release to a country where the existing arrangement was off track, but in this case the Fund was already negotiating a new arrangement and expressed support for the release.

of tranche release conditions.<sup>221</sup> In practice, in line with the division of labor in the Joint Guidelines noted above, the Bank typically relies on the existence of an IMF program to ensure that an adequate macroeconomic framework is in place. Indeed, all legal agreements for adjustment loans include a general provision that requires the continued maintenance of a satisfactory macroeconomic framework, as determined on the basis of macroeconomic indicators acceptable to the borrower and the Bank. Only a minority of cases (12 out of the 107 FY98-00 operations that OPCS surveyed) conditioned tranche releases on specific macroeconomic targets (fiscal indicators, inflation, and the balance of payments). In all of these cases, the macroeconomic targets were consistent with targets included in IMF arrangements or, in cases without Fund arrangement, reflected IMF recommendations. Specific macroeconomic indicators—consistent with Fund targets—have also been included in such documents as the minutes of negotiations agreed upon with the borrowers. In all cases, Bank staff consult with the IMF on the adequacy of the macroeconomic performance during the implementation of the operation.

### ***3. Bank-IMF Coordination on Structural and Social Policies***

164. The principles of Bank-IMF coordination are also valid for the structural and social components of countries' adjustment programs, where the Bank has primary responsibility for advice on policy design and for monitoring and evaluating policy performance. Generally, the Bank consults early with the IMF on key aspects of its structural and social policy advice, and the IMF asks for Bank input into its assessment of the adequacy of structural and social policies for IMF arrangements. IMF staff also seek Bank staff support for the design of structural benchmarks and the evaluation and monitoring of policy performance. In practice, the IMF has incorporated many structural benchmarks in its programs, often including both measures supported by Bank adjustment lending and other measures. A recent review of IMF conditionality confirms that the total number of structural conditions included in Fund-supported programs—derived by adding the numbers of performance criteria, prior actions, and structural benchmarks—has increased substantially over the past decade.<sup>222</sup>

165. ***Practice of Bank-IMF Coordination on Structural and Social Policies.*** A quantitative analysis of IMF structural benchmarks and World Bank adjustment lending conditions in countries that had both an IMF arrangement and adjustment credit or loan approvals in FY97-99 reveals significant overlap in the coverage of structural conditions. Some 69 countries had Fund arrangements for all or part of this period, of which 50 were also supported with one or more Bank adjustment operations. For the analysis, Fund structural benchmarks and Bank policy conditions were classified according to a modified version of the Bank's ALCID code, which distinguishes among 77 structural and social policies, including 13 in areas of overlapping responsibility and 64 in areas of the Bank's primary responsibility. The main results, reported in Table 14, include the following:

<sup>221</sup> OD 8.60, *Adjustment Lending Policy*, states, "The Letter of Development Policy (in the case of SALs) and the Letter of Sector Policy (in the case of SECALs), and the corresponding policy matrices, spell out the macroeconomic targets to be monitored so as to avoid misunderstandings."

<sup>222</sup> The magnitude of the increase depends on how different monitoring tools are taken into account in an overall definition of conditionality. The total number of performance criteria is much smaller, and has increased less, than that of prior actions and structural benchmarks. See *Conditionality in Fund-Supported Programs—Overview*, International Monetary Fund, Policy Development and Review Department (SM/01/60), February 20, 2001.

- The overall reach of IMF structural benchmarks across all policy areas (68 out of 77 possible areas) was nearly as wide as that of Bank policy conditions (74 out of 77), and included most of the areas of Bank primary responsibility (55 out of 64).
- The breadth of past IMF involvement in supporting countries' structural reform programs is indicated by the high average number of policy areas covered by structural benchmarks (11.2)—about two-thirds of the areas supported by Bank policy conditions. (In the Bank's areas of primary responsibility, there were about three IMF structural benchmarks for every five policy conditions in Bank adjustment operations.)
- Among the structural and social policy areas covered by IMF structural benchmarks, on average one-half (5.6 out of 11.2 per country) were not covered by Bank adjustment lending conditions.

**Table 14. IMF Structural Benchmarks and Bank Adjustment Loan Conditionality, FY97-99**  
(In countries with both Fund arrangements and Bank adjustment lending)

<i>Area</i>	<i>Areas of responsibility</i>		
	<i>Overlapping responsibility</i>	<i>Bank primary responsibility</i>	<i>All policy areas</i>
<b>Number of policy areas</b>			
Total possible	13	64	77
Covered by Bank adjustment lending conditionality	12	62	74
Covered by Fund structural benchmarks	13	55	68
<b>Average number of policy areas covered per country</b>			
In Bank adjustment lending	3.7	12.9	16.6
In Fund arrangements	3.4	7.8	11.2
In both Bank adjustment lending and Fund arrangements	1.5	4.1	5.6
In Bank adjustment lending only	2.2	8.8	11.0
In Fund arrangements only	1.9	3.7	5.6
Overall	5.6	16.6	22.2

*Note:* This analysis for 48 countries with both Fund arrangements and Bank adjustment lending during FY97-99 includes 30 IDA-eligible countries and 18 IBRD-only countries. Fund structural benchmarks and Bank policy conditions were classified according to a modified version of the Bank's ALCID code, which distinguishes between conditions that are the Bank's primary responsibility and those that are overlapping.

*Source:* Staff calculations based on ALCID, IMF MONA database, and IMF staff country reports.

166. **Past Use of IMF Structural Benchmarks.** The frequent use of IMF structural benchmarks not covered by Bank adjustment support significantly increased the total number of structural and social policy areas in a typical country program covered by Bank or Fund conditionality (from 16.6 to 22.2). In addition, where reforms have been supported by both institutions, the short-term horizon of IMF-supported macroeconomic programs has tended to constrain the time periods built in for the implementation of structural reforms supported by the same overall arrangements, and has sometimes complicated coordinated performance evaluation.

167. **Further Strengthening of Bank-Fund Collaboration.** The collaborative framework for the two institutions<sup>223</sup> has recently been enhanced for low-income countries under the Heavily Indebted Poor Country (HIPC) and PRSP initiatives. These arrangements provide for each institution to take the lead responsibility for distinct aspects of policy dialogue with borrowers, and set a common framework in which the Bank and the Fund jointly and independently assess

<sup>223</sup> See *Report of the Managing Director and the President on Bank-Fund Collaboration*, op. cit.



and monitor progress. As the report to the Development Committee and the International Monetary and Finance Committee states, “The PRSP approach envisions that Fund and Bank operations should focus on key measures to support the priorities in the PRSP, and that conditionality in Fund and Bank operations should be applied according to institutional responsibilities.”<sup>224</sup> Efforts are under way to improve the streamlining of conditionality between the Fund’s PRGF and Bank operations, especially, over time, through use of PRSCs.<sup>225</sup> Following the work of the Task Force on the World Bank Group and the Middle-Income Countries, Bank management have proposed, and the Development Committee has discussed the case for following similar principles (though with inevitable differences in practice) in Bank-Fund cooperation in respect to the policy dialogue with middle-income countries.<sup>226</sup> In fact, the International Monetary and Finance Committee of the Board of Governors of the IMF has suggested that the IMF focus more on its core macroeconomic and related structural areas of responsibility, looking to the Bank to lead the dialogue and program support on the social, structural, and sectoral agenda in its domain.<sup>227</sup> In a recent paper,<sup>228</sup> Fund staff have pointed out that progress in limiting the scope of Fund conditionality will depend on achieving a framework for complementary conditionality comparable to the one implicit in the emerging arrangements for low-income countries.<sup>229</sup> Meanwhile, the successful Bank-Fund joint work on the Financial Sector Assessment Program and on the Reports on Observance of Standards and Codes provides a strong foundation for a broad-based partnership on the shared aspects of the policy and institutional agenda in middle-income countries. These developments make it especially important that the Bank enhance its capacity to lead the dialogue on the social, structural, and sectoral agenda, and reinforce the urgency of rebuilding the ESW program.

## V. CONCLUSIONS

168. The nature of policy reform in client countries has broadened over the last two decades—from an exclusive focus on short-term macroeconomic issues and economic distortions in the 1980s to a wider development perspective in the 1990s, including a more complex institutional agenda that requires a longer time horizon and greater adaptability. The findings described in this retrospective show that adjustment lending support for reforms has been moving in the same direction—focusing much more on institutional issues, which now have an equal weight with policies in adjustment lending conditionality. While this shift can enhance the development

<sup>224</sup> See *Heavily Indebted Poor Countries (HIPC) Initiative and Poverty Reduction Strategy Papers (PRSP)—Progress in Implementation* (IDA SecM2000-487), August 14, 2000; and paragraphs 23-26 and paragraph 43 in *Poverty Reduction Strategy Papers—Operational Issues*, Joint IMF-World Bank Paper, December 10, 1999, available at [www.imf.org/external/np/pdr/prsp/poverty1.htm](http://www.imf.org/external/np/pdr/prsp/poverty1.htm).

<sup>225</sup> See the Operational Memorandum *Guidelines for Poverty Reduction Support Credits (PRSCs)*, Discussion Draft, January 4, 2001.

<sup>226</sup> See *Report of the Task Force on the World Bank Group and the Middle-Income Countries* (SecM2001-0204), March 27, 2001, and *Communiqué of the Development Committee of the Board of Governors of the World Bank and the IMF*, April 30, 2001.

<sup>227</sup> See *Communiqué of the International Monetary and Finance Committee of the Board of Governors of the IMF*, April 29, 2001.

<sup>228</sup> See *Structural Conditionality in Fund-Supported Programs*, Draft, IMF Policy Development and Review Department, January 25, 2001, background paper to *Conditionality in Fund-Supported Programs—Preliminary Considerations*, op. cit.

<sup>229</sup> In the remaining cases in which the Fund sees a need for supporting policy measures falling within areas of Bank primary responsibility, in accordance with the 1998 Report of the Managing Director and the President, the Bank will lead the policy dialogue and be responsible for advising the authorities on the design of measures and for monitoring and evaluating performance.

impact of Bank-supported adjustment operations, it carries risks—especially of complexity and intrusiveness, as conditionality on institutional issues can all too easily translate into micromanagement. Some progress has been made in moving toward greater support for programs that are owned by the countries, anchored in the CAS, and tied to results. But there remains room for improvement—especially in increasing sustainability and institutional development impact. A key challenge will be to refine the Bank’s approach to adjustment lending by strengthening the treatment of social, environmental, and fiduciary issues and the selective provision of Bank funds based on actual performance, while also emphasizing country ownership and step-by-step institution building. If the new generation of adjustment lending is to become an effective approach for supporting countries’ structural and social reform agendas, it will need to evolve in these directions.

## **ANNEXES**



## SUBNATIONAL ADJUSTMENT LENDING

1. Adjustment loans to subnational units (SNALs) were formally adopted in 1998 to support social and structural reforms at the subnational level.<sup>1</sup> This annex briefly reviews the experience with SNALs to date.

2. ***Policy Framework for Subnational Adjustment Lending.*** SNALs conform to the Bank's policies governing adjustment lending.<sup>2</sup> They require: (a) a satisfactory macroeconomic framework and its implementation;<sup>3</sup> (b) a satisfactory framework for and implementation of financial relationships between the national and subnational levels of governments; (c) a specific program of subnational reform (focusing on the subnational incentive and regulatory framework, institutional capability, and subnational expenditure programs and the mitigation of social costs) that can be monitored on a specific time schedule; and (d) a satisfactory program of subnational expenditures. For IBRD borrowers, a SNAL can be made directly to the concerned subnational unit—with the guarantee of the member country—to support a program of policy reforms acceptable to the Bank described in a Letter of Development Policy issued by the subnational unit and agreed to by the central government. When a subnational unit does not have the legal or financial capacity to borrow from the World Bank, the loan is made to the member country concerned, with arrangements for counterpart funds to be transferred to the subnational unit. IDA credits are made to member countries, which onlend credit proceeds to subnational units in accordance with applicable financial and other criteria.

3. ***Trend of Devolution.*** Over the past two decades, subnational governments have grown in importance. Previously centralized countries have devolved substantial powers. In many countries, social and other services have increasingly become the responsibility of subnational entities, and direct lending to the responsible provinces or states is a suitable vehicle for the Bank to support improvements in service delivery. For example, in Brazil, 98 percent of basic or primary education outlays are made by the states and municipalities; in India, it is well over 75 percent, and in Argentina, 97 percent. Highways, irrigation systems, urban transport systems, and even agricultural extension systems are often managed by a state or provincial government.

4. ***Bank Lending to Subnational Governments.*** The Bank has a long history of working directly with subnational governments. For some time, about half of the Bank's lending to Brazil has consisted of state loans. Although in most cases national governments have onlent Bank funds to the participating subnational government, many operations supported by the Bank have been directly prepared and executed by subnational governments. Over the past three years, in line with borrowing countries' requests, the Bank has undertaken a new approach, providing adjustment loans to states or provinces in support of subnational finances and reforms. This new approach, subnational adjustment loans, has been used in three countries—Argentina, India, and,

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<sup>1</sup> See *Adjustment Lending to Subnational Units* (SecM98-96[Rev.]), May 14, 1998.

<sup>2</sup> See summary in the Operational Memorandum *Clarification of Current Bank Policy on Adjustment Lending*, June 5, 2000.

<sup>3</sup> SNALs would require the same macroeconomic conditions as sector adjustment loans. Usually, the implementation of a macroeconomic framework that is considered satisfactory to the Bank has been assured by the presence of an active IMF program or structural adjustment loans. But in some instances there has been less need for detailed macroeconomic conditionality because of prior reforms, or a satisfactory track record of macroeconomic management.

most recently, Mexico. Four earlier subnational loans for Brazil<sup>4</sup> had similar features, but were designed before the introduction of the SNAL approach and were classified as investment loans.

5. **Rationale for Subnational Adjustment Lending.** The Bank's subnational adjustment lending has the same rationale as its national adjustment lending—although for subnational loans, the case for providing external financing always has both a fiscal and a balance of payments rationale. Fiscal distress at the subnational level can have important balance of payments effects. Subnational adjustment lending was first envisioned to help address fiscal imbalances at their source in such cases.<sup>5</sup>

**Table A1. Subnational Lending, FY97-01**

<i>Country and state</i>	<i>Project ID</i>	<i>FY</i>	<i>Tranche (US\$m)</i>	<i>Amount (US\$m)</i>	<i>Key conditions</i>	<i>Assessment and status</i>
<b>Subnational operations approved before introduction of SNALs</b>						
<b>Brazil</b>						
Rio Grande do Sul	P039196	97	50/25/30/20	125	Fiscal reform; privatization; private participation in infrastructure; regulatory reform	Satisfactory implementation, based on ICR (19398-BR) <sup>b</sup>
Rio de Janeiro	P039197	98	125/75/50	250		Satisfactory implementation, based on ICR (20518-BR)
Minas Gerais	P040033	98	100/70	170		Not put into effect
Mato Grosso	P006559	98	25/10/10	45		Under implementation
<b>SNALs</b>						
<b>Argentina</b>						
Salta	P051693	98	45/35	75	Fiscal performance; education reforms (reduce number of teachers, close duplicative training institutions, reform private school subsidies); health reforms (new insurance and payment schemes, autonomous hospitals); keep health and education outlays constant	Satisfactory implementation, based on ICR (20698-AR)
San Juan	P006006	98	10/25/15 <sup>a</sup>	50		Unsatisfactory implementation, based on draft ICR
Tucuman	P051695	98	55/45	100		Satisfactory implementation, based on ICR (20699-AR)
Rio Negro	P051694	98	25/25/25 <sup>a</sup>	75		Unsatisfactory implementation, based on draft ICR
Catamarca	P044447	01	26/20/25	71		Under implementation
Cordoba	P068344	01	103/100/100	303		Under implementation
<b>India</b>						
Uttar Pradesh	P065471	00	251	251	Fiscal reform; public sector restructuring	ICR pending
<b>Mexico</b>						
State of Mexico	P070479	01	200/100/205	505	Fiscal reform; privatization; pension reform; utilities sector reform	Under implementation

<sup>a</sup> Third tranche canceled.

<sup>b</sup> ICR=Implementation Completion Report.

Source: Data from various President's Reports.

<sup>4</sup> The four Brazil subnational operations were Rio Grande do Sul (March 1997), Rio de Janeiro (July 1997), Mato Grosso (April 1998), and Minas Gerais (April 1998). Ultimately, these loans were classified as investment loans, but they had the characteristics of an adjustment operation. Disbursements were made against an array of eligible government expenditures in time slices (instead of disbursements against imports in tranches). This supported a policy agenda that was spelled out in the form of a policy matrix, similar to adjustment loans.

<sup>5</sup> See *Issues in Adjustment Lending* (R96-55), April 4, 1996.

6. **First SNALs.** Since FY98, when the Board discussed subnational adjustment loans,<sup>6</sup> the Bank has made eight SNALs (see Table A1). Although some provincial reform loans with a fast-disbursement capacity were made to Argentina during 1991-95, as was an adjustment loan for the privatization of provincial banks, these were based on the traditional concept of agreement with the national authorities on generic eligibility criteria and then universal access by any province that qualified. (This approach has been used over the years by the Bank for its municipal loans.) However, the eight loans defined as SNALs, as well as the subnational lending operations in Brazil, were prepared, negotiated, and supervised by Bank staff directly with a specific subnational government. Their tranching funds were disbursed either through a nationally managed fund (which made the national government the borrower, at least financially) or directly to that subnational government.

### A. Subnational Adjustment Lending in Latin America

7. The Argentine SNALs and Brazilian operations had many similarities. Strong subnational policy and reform performance was a key criterion for the selection of states to receive subnational loans. Both series of loans were preceded by substantial economic and sector work (ESW) on the federal fiscal situation and the sectoral issues addressed by the loans. Preparation time was spent on the specifics of reform actions and their implementation. In both countries, Bank staff ascertained the adequacy of the macroeconomic framework with the IMF.

8. **Starting Point.** There were also important differences in the operations in these countries—notably, in the starting point. By 1995, with the Bank's strong support, the Argentine national authorities had completed a series of major trade, public enterprise, public administration, and financial reforms that had transformed the country's economic landscape and led to rapid growth of the economy and fiscal resources. Facing increasingly hard budget constraints, some provinces had begun to sell state-owned enterprises (SOEs) and provincial banks and to restructure the civil service. Nonetheless, few provinces had yet implemented deeper public sector reforms to provide and sustain efficient government services. In Brazil, except for the privatization of productive SOEs, virtually all the reforms to improve Brazil's delicate fiscal situation—especially social security and civil service reforms—required constitutional amendments. Moreover, Brazil's states have long had wide autonomy. Thus the Brazilian operations were designed to support a careful focusing of the role of the state, whereas the Argentine operations were designed to support subsequent improvements in state administration.

9. **Provincial Reform.** Argentina's government requested Bank assistance in late 1996 for already reforming provinces—ones that had privatized their provincial banks and a major utility, had completed some revenue reforms, and had ratified a new fiscal arrangement with the national administration. The four provinces receiving SNALs concentrated on improving their fiscal viability and their public education and health systems. In Brazil, after engaging in preparatory work with six states, the Bank focused its support on four states that publicly announced and intensively pursued their reform agendas. Although each state program varied, all four states emphasized downsizing of the public service and other efforts to improve fiscal viability, as well as major privatization programs (for example, the state bank and large utilities) combined with regulatory legislation.

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<sup>6</sup> See *Adjustment Lending to Subnational Units*, op. cit.

10. ***Disbursing the SNALs.*** Disbursement arrangements also varied between Argentina and Brazil. Argentina opted for disbursement into a national fund—with the nation as the borrower—and immediate redispbursement to a participating province as it completed agreed-on tranche conditions. The provinces would repay the fund on the same terms and conditions as the Bank loan; and the peso-U.S. dollar peg meant the exchange rate risk on U.S. dollar loans was minimal. As the Brazilian loans were prepared before Board discussion of the SNAL approach, disbursement provisions for investment loans applied (disbursements against eligible expenditures for agreed severance pay, goods purchased by competitive bidding, and so forth). Documentation of these expenditures was sent to the Bank in advance. This arrangement proved complex in practice, and after returning from a mission to Brazil, Executive Directors supported the more flexible SNAL procedure adopted soon thereafter.

11. ***Reform Implementation.*** In Argentina, in the context of hard budget constraints on the provinces, two of the four SNAL states either met or came close to meeting their fiscal targets. Although fiscal stringency measures were postponed in the other two states, both have since sought or are seeking to reinstate fiscal adjustment. In the Brazilian states receiving subnational lending, fiscal reform continued to proceed slowly. On the whole, sector reforms were implemented successfully. In Brazil, all recipient states undertook the major privatizations expected (except for water), including Minas Gerais, where the Bank's subnational loan never came into effect. In Argentina, all of the provinces conducted major reforms of their health system, and two have completed the expected education reforms; the other two SNAL provinces have partially completed education and administrative reforms.

12. ***Status of SNAL Program.*** Three of the four Brazilian operations have been closed. All four of the FY98 Argentine SNALs are now fully disbursed. Last year, two SNALs in Argentina were approved for Catamarca Province and Cordoba Province; and one was approved in Mexico for the State of Mexico.

13. ***Operational Conclusions.*** The experience with subnational lending in Latin America, before and after the formal adoption of the SNAL approach, yielded several operational conclusions:

- ***Importance of Federal Transfer and Debt Resolution Mechanisms.*** In Brazil, subnational debt restructuring agreements with the federal government, which were expected to accompany public sector downsizing, were delayed—leading to a change in emphasis in future operations from fiscal to sector reforms. In Argentina, high provincial debts to the national treasury led to appeals for debt write-off or rescheduling. The national authorities did not permit such debt relief, because of a concern that write-downs for reforming provinces could set a precedent and lead to irresistible pressure for write-downs from equally distressed provinces without equally strong performance records.
- ***Clarity of Legal Mandate.*** States and provinces found it difficult to undertake reforms within the mandate of municipalities. In Brazil, for example, the largest water companies are state-owned, but it is the municipalities that contract for water/sewerage service. (Some municipalities have their own companies and others already contract with private providers, but in many cases the municipalities sign multiyear contracts with the semi-monopolistic state water company.) Efforts by the



Bank to support the privatization of state companies, or to encourage municipalities to contract with private service firms, were not successful.

- ***Suitability for Support of Sector Reforms.*** Supported by subnational lending operations, Brazilian states led the way in state bank privatization, urban transport privatization, privatization of gas distribution, corporate restructuring of electricity companies, voluntary dismissal programs, and the development of pension models to guide reform actions when legally permissible. In Argentina, it is likely that more health reforms may have been achieved in the four SNAL provinces—along with education reforms in two of them—than through indirect efforts with the national administration. The combination of a close dialogue with state governors and cabinets, direct Bank advice, and the provision of financial support directly to the reforming administrations proved broadly effective.
- ***Approval and Effectiveness.*** Unanticipated factors having to do with relations between the central and subnational governments can lead to long delays between appraisal and Board presentation, and also between Board approval and effectiveness (on average 11 months in Brazil).<sup>7</sup> In Argentina, loans and guarantees are approved as part of the budget, so the SNALs became effective in four months.

## **B. Uttar Pradesh SNAL**

14. In April 2000, the Board approved the Uttar Pradesh Fiscal Reform and Public Sector Restructuring loan and credit to India. This is expected to be the first operation in a medium-term lending program to the state linked to a series of major reforms, and to be followed by other SNALs if the program remains on track. Uttar Pradesh has a weak record of social service delivery, and its past lack of transparency poses critical challenges. However, Uttar Pradesh is also India's most populous state (with 160 million citizens) and has extensive poverty (41 percent of the population). A more effective state government is therefore expected to have a major impact on poverty reduction. At the same time, an important rationale for the operation is to address fiscal problems at their source.

15. ***Loan Approach.*** The strong programmatic content of the operation and the associated performance measures are intended to tackle a comprehensive set of difficult reform issues. The loan also takes into account several lessons learned from experience, as follows:

- It is the first operation with a broad program, based on a methodical, 18-month preparation that included intensive dialogue with the government.
- Key actions were agreed on and taken up front before this single-tranche loan took effect.
- The program aims at a comprehensive public sector restructuring with the prospect of future operations if the program stays on track. This strategy also reduces risks to the Bank if the program goes off track.

<sup>7</sup> Excluding onlending, which lapsed after 18 months.

- Substantial technical assistance helps to address limited implementation capacity.
- There is a clear set of agreed-on output indicators.
- The program includes measures to improve fiduciary safeguards.

### C. Considerations Going Forward

16. Although subnational adjustment operations can have high returns that justify their risk, these gains are not obtained inexpensively. There is economic justification for state-level work—Uttar Pradesh’s population is almost equal to Brazil’s; Minas Gerais and Rio de Janeiro in Brazil have larger populations than Chile—but an effective SNAL requires extensive preparation and supervision effort.

17. **Future SNALs.** The SNAL for Uttar Pradesh is the keystone of a medium-term, state lending program linked to a series of major reforms in the state. As previously noted, in 2000 the Board approved two more SNALs in Argentina and one in Mexico. Given the complexity and relatively high costs of SNALs, it is likely that they will be used selectively in the near- to medium-term future.

18. **Lessons Learned.** Experience with subnational adjustment lending operations to date has led to some fairly clear lessons, the most important being that such loans are typically somewhat riskier than loans to central governments. Among the other lessons are the following:

- **An Effective Tool in Support of Reform.** Subnational fiscal and governance reforms supported by SNALs can provide an effective contribution to accelerate growth and reduce poverty—certainly in comparison to a situation where the central government reforms but the states continue to mismanage their affairs. Bank subnational operations supported major reforms in the Brazilian states, and they had a substantial catalytic effect on the rest of Brazil and the subsequent national and state reform agenda. In Argentina, SNALs proved effective in supporting social sector (particularly health) reforms. Moreover, SNALs have generated interest by other states and provinces in Argentina and by those in India to emulating these reforms.
- **Linkage to Prior Actions.** The experience in Brazil highlights the importance of ensuring that some fiscal reforms are in place before proceeding with a SNAL. Clear criteria for the selection of states could include the reform track record of the subnational government and the extent of poverty.
- **Linking SNAL Timing to the State Electoral Cycle.** Extending the time horizon of a SNAL, or a series of SNALs, beyond the term of single administration will likely be difficult, given both the complex relationships between levels of government and the typically different schedules of national and state/provincial (let alone municipal) elections.
- **Emphasis on Governance Reforms.** SNALs are well suited to support civil service reform, public enterprise reform, anticorruption initiatives, and reforms in financial

management and accountability. The high direct benefits of such reforms through improvements in service delivery are more likely to outweigh the potential political economy costs of reforms at the local level than at the central level.

- ***Medium-Term Fiscal Sustainability at the State Level.*** State-level, medium-term, fiscal frameworks that fully take into account up-front fiscal costs of the reforms (both structural and sectoral) are a major vehicle for achieving fiscal sustainability. They can also be an important factor in capacity building at the state level, as the experience with subnational reform lending in India shows.



## SPECIAL STRUCTURAL ADJUSTMENT LENDING

1. Special structural adjustment loans (SSALs) were introduced in 1998. This annex provides a brief overview of the framework for SSALs and their use so far.<sup>1</sup>

2. ***Policy Framework for SSALs.*** SSALs are intended to provide exceptional support for structural and social reforms to client countries approaching a possible crisis, or already in crisis, with exceptional financing needs. By taking advantage of windows of opportunity for structural and social reforms that might otherwise have remained closed, they help countries prevent a crisis or, if one occurs, mitigate its adverse economic and social impact. Although SSALs are exceptional and not a regular business activity of the Bank, they fall within the overall policy framework for adjustment lending, and the standard justification and rationale for structural adjustment loans (SALs) apply to them.<sup>2</sup> That is, they support specific policy changes and institutional reforms and provide fast-disbursing support in countries with external financing gaps that may have balance of payments or fiscal origins. Their purpose is not liquidity financing per se. Indeed, the main justification for exceptional Bank support through an SSAL is the structural origin of a crisis and its major social/poverty consequences. At the same time, the exceptional nature and increased risks of lending to countries approaching a possible crisis, or already in crisis, are reflected in special financial terms; and the use of SSALs must be justified in each individual case against the above general criteria, as well as further specific eligibility criteria and features, as follows:

- The borrowing country faces an actual or potential financial crisis with substantial structural and social dimensions.
- The structural, social, and macroeconomic policy reform package is satisfactory, with conditionality embedded in a strong policy program.
- The SSAL is part of an international support package, including the multilaterals, bilateral donors, and private lenders and investors.
- A Fund program is in place. SSALs require especially close coordination between the Bank and the IMF to help ensure sound balance and close links among the macroeconomic, structural, and social components of international financial institutions' support for the government's program. For SSALs, as a general rule, World Bank disbursements do not precede, but proceed in parallel with or follow IMF disbursements.
- The country's external financing plan is likely to be sustainable, and the SSAL and its associated debt service are within medium-term debt sustainability limits.
- The country is IBRD-eligible. The magnitude of financial support is subject to the availability of adequate IBRD financial and risk-bearing capacity.

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<sup>1</sup> See *Financial Crisis and Structural Reform: The Bank's Role and Instruments* (SecM98-743), September 27, 1998; *Programmatic and Emergency Adjustment Lending: World Bank Guidelines* (R98-269), October 22, 1998; and the *Operational Memorandum Guidelines for Special Structural Adjustment Loans*, April 19, 1999.

<sup>2</sup> See OD 8.60, *Adjustment Lending Policy*; and *Issues in Adjustment Lending* (SecM96-18), January 16, 1996.

- Tranche release depends on the satisfactory completion of a review of progress in meeting tranche conditions.

3. ***The Argentina SSAL.*** In August 1998, Argentina requested extraordinary World Bank and Inter-American Development Bank (IDB) support. Following the 1998 IBRD-IMF Annual Meetings (when a US\$2.8 billion IMF Extended Fund Facility was already in place in Argentina), a US\$2.5 billion SSAL was prepared in two months for Board consideration on November 11. It was accompanied by a US\$500 million repurchase facility for the Argentine Central Bank. IDB agreed to cofinance the SSAL with US\$2 billion, along with another US\$500 million for the repurchase facility. The combined support from the Bank, the IDB, and the IMF thus amounted to US\$8.3 billion, with a total of US\$3.0 billion from the Bank (see Table B1). Argentina had a strong reform track record, and the Bank had been engaged in deep and intense dialogue with the government for eight years. As a result, the authorities could proceed quickly with a wide-ranging and detailed program, supported by a single, three-tranched loan with tranche conditions extending over a two-year period. The subsequent policy based-guarantee to Argentina—with US\$250 million of the SSAL’s second tranche reallocated to the guarantee, leaving the Bank’s exposure unchanged—enabled the Argentine authorities to obtain private borrowings of US\$1.12 billion with an average maturity of more than three years.

4. ***The Brazil SSALs.*** At about the same time, Brazil requested support from the Bretton Woods institutions and IDB as part of a package that would also include bilateral lenders. Brazil first negotiated a three-year program with the MF. In November 1998, a US\$18.1 billion-equivalent IMF Stand-By Arrangement was agreed on (including Supplementary Reserve Facility financing equivalent to US\$12.7 billion).<sup>3</sup> The Bank and IDB each agreed to provide US\$4.5 billion over three years, with the Bank’s support taking the form of a series of single-tranched “special” sector adjustment loans (SECALs), presented to the Board under the umbrella of an overall Framework Paper. The package also included bilateral support of US\$14.5 billion equivalent from the central banks of industrial countries in North America, Europe, and Asia (see Table B1).<sup>4</sup> Overall, Brazil’s total package amounted to US\$41.6 billion.

5. ***Financial Burden-Sharing.*** As mentioned above, the SSAL guidelines state that, “the SSAL is part of an international support package, including multilaterals, bilateral donors, and private lenders and investors” and that “as a general rule, World Bank disbursements do not precede, but proceed in parallel with or follow IMF disbursements.” The practice and experience to date has been as follows:<sup>5</sup>

- ***Phasing and Proportion of Bank and Fund Support.*** In the Argentina package, the Bank’s SSAL and Repurchase Facility was roughly of the same size as the Fund’s precautionary Extended Fund Facility (EFF) arrangement in place since February 1998.<sup>6</sup> In the event, Argentina did not draw on the EFF and only drew on Fund resources under a new \$7.2 billion three-year Stand By Arrangement approved in

<sup>3</sup> See “IMF Approves SDR 13 Billion Stand-By Credit for Brazil; Activates NAB,” IMF Press Release (No. 98/59), December 2, 1998.

<sup>4</sup> See “Multilateral Financial Assistance to the Banco Central do Brasil,” Bank for International Settlement (BIS) press release, December 19, 1998.

<sup>5</sup> See *Special Structural Adjustment Loans: Composition of International Support Packages* (SecM2001-0308), May 8, 2001.

<sup>6</sup> The EFF was approved on February 4, 1998; see “IMF Approved Three-year Extended Fund Facility for Argentina,” IMF Press Release (No. 98/1), February 4, 1998.

**Table B1. Composition of International Support for Argentina and Brazil**

	<i>US\$ billion</i>	<i>Planned support</i>	<i>Realized support</i>
<b>ARGENTINA</b>			
World Bank	3.0	\$2.5 billion SSAL and \$0.5 billion Special Repurchase Facility Support Loan (SRFSL)	\$2.52525 billion SSAL and \$0.50505 billion SRFSL, both approved in November 1998 <sup>a</sup>
IMF	2.8	\$2.8 billion-equivalent three-year Extended Fund Facility (EFF), dated February 4, 1998 <sup>b</sup>	No purchases were made under the EFF, which was replaced by a \$7.2 billion three-year Stand-By Credit in March 2000 <sup>c</sup>
IDB	2.5	\$2.5 billion for Special Structural Adjustment Program (SSAP) and Strengthening of Banking System Safeguards	\$2.5 billion SSAP Loan, approved December 1998 <sup>d</sup>
<b>BRAZIL</b>			
World Bank	4.5	\$1.0 billion social protection program of two loans  \$1.5 billion social security reform program of two loans  \$1.0 billion administrative reform program of two loans  \$1.0 billion banking reform loan	Social Security Special SECAL (\$0.75757 billion), approved in January 1989 <sup>e</sup>  Social Protection Special SECAL (\$0.25252 billion), approved in January 1989 <sup>f</sup>  Fiscal and Administrative Reform Special SECAL (\$0.50506 billion), approved in March 2000 <sup>g</sup>  Second Social Security Special SECAL (\$0.50506 billion), approved in March 2000 <sup>h</sup>
IMF	18.1	\$18.1 billion three-year Stand-By Credit, December 1998 <sup>i</sup>	Drawings of \$4.63 billion (December 1998), \$4.88 billion (April 1999) and \$1.14 billion (December 1999) <sup>j</sup>
IDB	4.5	\$1.1 billion for Global Multisector Financing Program (GMFP)  \$2.2 billion for Social Sector Reform and Social Protection Program (SSRSPP)  \$1.2 billion for Global Credit Program (GCP)	\$1.1 billion for GMFP, approved in September 1998 <sup>k</sup>  \$2.2 billion SSRSPP and \$1.2 billion GCP, approved in March 1999 <sup>l</sup>
Bilaterals	14.5	\$13.28 billion credit facility coordinated by the Bank for International Settlements and backed by central banks of 19 industrialized countries; and a \$1.25 billion credit facility granted by Bank of Japan <sup>m</sup>	Drawings of \$4.54 billion in December 1998 and \$4.92 billion in April 1999 <sup>n</sup>

<sup>a</sup> See *President's Report to the Executive Directors on a Proposed Special Sector Adjustment Loan in the Amount of US\$2.52525 Billion and a Proposed Special Repurchase Facility Support Loan in the Amount of US\$505.06 Million to the Argentine Republic* (Report No. P-7268-AR), November 3, 1998.

<sup>b</sup> See "IMF Approves Three-Year Extended Fund Facility for Argentina," IMF Press Release (No. 98/1), February 4, 1998.

<sup>c</sup> See "IMF Approves Augmentation of Argentina's Stand-By Credit to US\$14 Billion and Completes Second Review," IMF Press Release (No. 01/3), January 12, 2001.

<sup>d</sup> See "IDB Approves \$2.75 Billion for Argentina," IDB Press Release (NR-323/98), December 16, 1998.

<sup>e</sup> See *President's Report to the Executive Directors on a Proposed Social Security Special Sector Adjustment Loan in the Amount of US\$757,570,000 to the Federative Republic of Brazil* (Report No. P-7277-BR), December 10, 1998.

<sup>f</sup> See *President's Report to the Executive Directors on a Proposed Social Protection Special Sector Adjustment Loan in the Amount of US\$252,520,000 to the Federative Republic of Brazil* (Report No. P-7281-BR), December 16, 1998.

<sup>g</sup> See *President's Report to the Executive Directors on a Proposed Fiscal and Administrative Reform Special Sector Adjustment Loan in the Amount of US\$505.06 Million to the Federative Republic of Brazil* (Report No. P-7275-BR), March 7, 2000.

<sup>h</sup> See *President's Report to the Executive Directors on a Proposed Second Social Security Special Sector Adjustment Loan in the Amount of US\$505.06 Million to the Federative Republic of Brazil* (Report No. P-7360-BR), March 7, 2000.

<sup>i</sup> See "IMF Approves SDR 13 Billion Stand-By Credit for Brazil; Activates NAB," IMF Press Release (No. 98/59), December 2, 1998.

<sup>j</sup> See *IMF Staff Report for the Seventh Review Under the Stand-By Arrangement for Brazil*, (EBS/01/36), March 15, 2001.

<sup>k</sup> See "IDB Approves Largest Loan in Its History in Two Financing Operations for Brazil Totaling \$1.350 Billion," IDB Press Release (NR-212/98), September 23, 1998.

<sup>l</sup> See "IDB Approves Record Loan Package of \$3.4 Billion for Brazil," IDB Press Release (NR-54/99), March 8, 1999.

<sup>m</sup> See "Multilateral Financial Assistance to the Banco Central do Brasil," BIS Press Release, December 10, 1998.

<sup>n</sup> See *IMF Staff Report for the Seventh Review Under the Stand-By Arrangement for Brazil* (EBS/01/36), op. cit.

March 2000.<sup>7</sup> The experience gained in the case of Argentina with regard to burden sharing and phasing of disbursements were subsequently reflected in preparation of the SSAL guidelines issued to staff,<sup>8</sup> and in the design of Bank and Fund support and Bank-Fund burden-sharing and coordination in the case of Brazil—where substantial purchases from the IMF in 1999 (about US\$10.7 billion) preceded World Bank disbursements.<sup>9</sup> The Bank had planned to provide about US\$4.5 billion over three years through a series of seven single-tranched SECALs.<sup>10</sup> In the event, four special SECALs with a total loan amount of US\$2.02 billion were presented to the Board.<sup>11</sup>

- **Coordination with the IDB.** In both support packages, the World Bank and the IDB worked closely together and provided a comparable level of support. In Argentina, the IDB cofinanced the Bank’s SSAL and Special Repurchase Facility Support Loan with the Special Structural Adjustment Program and Strengthening of Banking Safeguards Loan.<sup>12</sup> In Brazil, the Bank and the IDB jointly appraised the Bank’s Social Protection Special Sector Adjustment Loan and the IDB’s Social Sector Reform and Social Protection Program Loan.<sup>13</sup> The IDB also included in its contribution to the international support package the 1998 Global Multisector Financing Program Loan and the 1999 Global Credit Program for Small- and Medium-Sized Enterprises Loan.<sup>14</sup>
- **Participation of Bilaterals.** The participation of bilaterals differed in the Argentina and the Brazil international support packages. There was no bilateral contribution to the concerted international support effort for Argentina. In the case of Brazil, the Bank of Japan, a group of central banks of 19 industrial countries represented by the Bank for International Settlements (BIS), and the BIS together pledged about

<sup>7</sup> See “IMF Approves US\$7.2 Billion Three-Year Stand-By Credit for Argentina,” IMF Press Release (No. 00/17), March 10, 2000.

<sup>8</sup> See the Operational Memorandum *Guidelines for Special Structural Adjustment Loans*, April 19, 1999.

<sup>9</sup> See “IMF Approves SDR 13 Billion Stand-By Credit for Brazil; Activates NAB,” IMF Press Release (No. 98/59), December 2, 1998; and *IMF Staff Report for the Seventh Review Under the Stand-By Arrangement for Brazil* (EBS/01/36), March 15, 2001.

<sup>10</sup> See *Framework Paper: Special Program of Support for Brazil* (SecM98-943), November 25, 1998.

<sup>11</sup> The Brazil Social Protection Loan (Ln. 44300), the Brazil Social Security Reform Loan (Ln. 44310), the Brazil Administrative and Fiscal Reform Loan (Ln. 45430), and the Brazil Social Security Reform Loan II (Ln. 45420). See *President’s Report to the Executive Directors on a Proposed Social Security Special Sector Adjustment Loan in the Amount of US\$757,570,000 to the Federative Republic of Brazil* (Report No. P-7277-BR), December 10, 1998; *President’s Report to the Executive Directors on a Proposed Social Protection Special Sector Adjustment Loan in the Amount of US\$252,520,000 to the Federative Republic of Brazil* (Report No. P-7281-BR), December 16, 1998; *President’s Report to the Executive Directors on a Proposed Fiscal and Administrative Reform Special Sector Adjustment Loan in the Amount of US\$505.06 Million to the Federative Republic of Brazil* (Report No. P-7275-BR), March 7, 2000; and *President’s Report to the Executive Directors on a Proposed Second Social Security Special Sector Adjustment Loan in the Amount of US\$505.06 Million to the Federative Republic of Brazil* (Report No. P-7360-BR), March 7, 2000.

<sup>12</sup> See *President’s Report to the Executive Directors on a Proposed Special Sector Adjustment Loan in the Amount of US\$2.52525 Billion and a Proposed Special Repurchase Facility Support Loan in the Amount of US\$505.06 Million to the Argentine Republic* (Report No. P-7268-AR), November 3, 1998; and the *1998 Annual Report: Inter-American Development Bank* (Washington, D.C.: IDB Office of External Relations, 1998).

<sup>13</sup> See *President’s Report to the Executive Directors on a Proposed Social Protection Special Sector Adjustment Loan in the Amount of US\$252,520,000 to the Federative Republic of Brazil* (Report No. P-7281-BR), December 16, 1998; and the *1999 Annual Report: Inter-American Development Bank* (Washington, D.C.: IDB Office of External Relations, 1999).

<sup>14</sup> See “IDB Approves Largest Loan in Its History in Two Financing Operations for Brazil Totaling \$1.350 Billion,” IDB Press Release (NR-212/98), September 23, 1998. See also “IDB Approves Record Loan Package of \$3.4 Billion for Brazil,” IDB Press Release (NR-54/99), March 8, 1999.



US\$14.5 billion, or 35 percent of the total amount.<sup>15</sup> Of the total amount, about US\$9.5 billion was drawn in the 12-month period during which these resources were available.

- **Role of the Private Sector.** The private sector did not participate directly in either the Argentina or the Brazil international support effort. The Argentina SSAL package included incentives for financial markets to stay engaged. The repurchase facility support loan strengthened the central bank's ability to engage in repurchase transactions with a syndicate of private commercial banks. Also, the Bank provided a US\$250 million policy-based guarantee on special terms to Argentina in October 1999, while US\$250 million from the second tranche of the Argentina SSAL was cancelled. The guarantee facilitated private borrowings with a face value of US\$1.5 billion.<sup>16</sup>

6. **Pricing.** The financial terms of SSALs reflect the exceptional nature and high risks of lending for crisis support beyond anticipated levels. SSAL terms include a minimum charge of 400 basis points over LIBOR, a front-end fee of 100 points, and a reduced five-year maturity and a three-year grace period (see Table B2).

7. **Financial Effects.** As mentioned above, SSALs increase the Bank's overall risk; they are large and by nature cannot be anticipated, adding significant country-specific risk during global or regional financial distress, precisely when both covariance and credit risks to the Bank are rising.<sup>17</sup> The Bank has limited flexibility to rapidly manage its risk profile or raise additional risk capital. Rather, the Bank has been structured as a long-term development finance cooperative, with low loan charges and, hence, low-targeted returns. The extension of large, rapidly disbursing sums to a few members, with respect to which credit and covariance risk may be increasing rapidly, means that SSALs could consume a disproportionate share of the Bank's limited capital. Since the Bank's primary role is the provision of long-term development financing, the pricing and other financial terms of SSALs were set at levels that both compensated the Bank for its extra risk and encouraged commitments and drawdowns only when they were absolutely essential for the member countries concerned. Thus, the impact of SSALs on the Bank's finances is both positive (because the higher-than-normal margin results in extra income to the Bank, provided that no extra losses materialize from the increased risks taken),<sup>18</sup> and negative (because the extra risk that the Bank assumes over its normal business requires members to accept either an increased likelihood of call on callable capital or reductions in other programs). The higher pricing for SSALs builds up the extra risk-bearing capacity for the Bank only over the life of the loans, since the spreads are not charged as an up-front risk premium. Moreover, even after SSALs have been fully repaid (assuming no losses), the Bank will be able

<sup>15</sup> Countries backing the US\$13.28 billion BIS credit facility for Brazil included Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States. The BIS also contributed to the facility. Japan provided a credit facility of \$1.25 billion coordinated with the BIS. See Focus—Banco Central do Brasil, December 21, 2000, accessible at [www.bcb.gov.br](http://www.bcb.gov.br).

<sup>16</sup> See President's Report (P-7268-AR), op. cit.; *President's Report to the Executive Directors on a Proposed Policy-Based Guarantee Operation in the Amount of US\$250.0 Million to the Argentine Republic* (Report No. P-7331-AR), September 10, 1999; and *Republic of Argentina, World Bank Policy-Based Guarantee for US\$1.5 Billion Zero-Coupon Notes, Final Terms of the Guarantee* (R99-176/1), October 15, 1999.

<sup>17</sup> As discussed with the Board in *Financial Crisis and Structural Reform: The Bank's Role and Instruments* (SecM98-743), September 4, 1998.

<sup>18</sup> See *Allocation of FY99 Net Income, Transfer from Surplus, and Waivers of Loan Charges for FY00* (R99-143), July 20, 1999.

Table B2. Argentina and Brazil SSALs—Financial Terms

Country	Name	Amount (US\$m)	Board date	Terms		
				Percentage over LIBOR	Front-end fee (%)	Maturity (years)
Argentina	Special SAL	2,525	Nov. 11, 1998	4.00	1.0	5
	Repurchase Facility Support Loan	505	Nov. 11, 1998	4.00	1.0	5
Brazil	Social Security Special SECAL	758	Jan. 7, 1999	4.00	1.0	5
	Social Protection SECAL	252	Jan. 7, 1999	4.00	1.0	5
	Second Social Security Special SECAL	505	March 30, 2000	4.00	1.0	5
	Administrative and Fiscal Reform	505	March 30, 2000	4.00	1.0	5

*Note:* All loans were single currency (US\$); all loans except the Argentine SSAL were single-tranched. It was triple-tranched (with US\$1.0/1.0/0.5 billion tranches); the US\$250 million for the policy-based guarantee was deducted from the SSAL second tranche by repayment of that sum. The commitment fee was the same for all SSALs—0.75 percent.

*Source:* Data from various President's Reports.

to retain the extra risk-bearing capacity thus accumulated only if it retains all of the accumulated margins from such loans in earmarked reserves, instead of distributing them in transfers.

8. **Country Results So Far.** Thus far, implementation of the SSAL-supported programs in Argentina and Brazil has been broadly successful. Both programs included major efforts to sustain outlays for key social programs and expand funding for other programs for poor or unemployed people. In both countries, the effect of the economic distress was considerably dampened or the economic recovery was stronger and more rapid than expected.

- **Argentina.** During the serious economic downturn in 1994-95, deposits fell by 18 percent, threatening the viability of the financial system. Meanwhile, GDP fell by 2.8 percent, and in 1996 unemployment rose from 12.2 to 18.4 percent. By contrast, during 1999, deposits actually grew by 4.4 percent and there was no threat to the financial system. And although GDP fell as much as it had in 1996, unemployment rose by only two percentage points. In addition, the subsequent policy-based guarantee, created through a re-allocation of US\$250 million from the second tranche of the SSALs, provided valuable leveraged support during the government transition at end-1999.
- **Brazil.** In Brazil, a currency devaluation and move to a flexible exchange rate regime in early 1999 did not lead, as they might have, to the inflationary pressures and economic downturn: inflation was held to 9 percent during 1999, and the real GDP actually grew by almost 1 percent. Key civil service and social security pension reforms were passed, with special SECAL support. According to the United Nations Conference on Trade and Development, during 1999 almost one-third of all foreign direct investment to Latin America and the Caribbean went to Brazil (US\$30 billion), increasing the country's reserves.

9. **Overall Experience to Date.** In Argentina and Brazil, the SSAL vehicle allowed the Bank to respond flexibly to the two countries' exceptional and unanticipated financing needs. To date, there have been no further SSAL packages, underscoring the exceptional nature of SSAL support. This confirms the clear distinction between SSALs and regular adjustment operations, which are programmed and prepared within the country assistance strategy and support

countries' medium-term programs for development and poverty reduction. Both the Argentina SSAL and the Brazil special SECALs were prepared exceptionally quickly, as part of international support packages, with no apparent trade-off in quality. The Argentina SSAL received the Quality Assurance Group's top quality rating in FY99. Finally, the differential pricing of SSALs, which reflects their increased risk compared to regular adjustment operations, achieved its intended effect of limiting demand while providing the desired quick support for the financial stabilization of the countries concerned.



## PROGRAMMATIC ADJUSTMENT LENDING

1. Programmatic structural adjustment loans or credits (PSALs/PSACs) were introduced in 1998 to apply the programmatic approach to adjustment operations.<sup>1</sup> This approach involves the support of a sustained medium-term program; parallel advisory work, step-by-step capacity building, and institutional reform; and integrated Bank-donor support of a single government program. As designed, PSAL/PSACs feature a series of adjustment loans, typically single-tranched, phased in line with the borrower's budget cycle. A key characteristic is a medium-term framework to support a multiyear reform program, with a notional multiyear financing umbrella and monitorable progress benchmarks. Board conditions of the first PSAL/PSAC are agreed on up front, while conditions of subsequent PSALs/PSACs draw on progress benchmarks specified at the outset as part of the medium-term framework.<sup>2</sup> PSALs/PSACs typically focus on complex medium-term institutional reforms, which the Bank is increasingly called on to support. PSALs/PSACs are suited to support gradual institutional changes whose specific nature and timing are often uncertain and difficult to predict.

2. ***Experience with PSALs/PSACs.*** Programmatic adjustment operations approved to date include the Latvia PSAL (FY00), the Tanzania PSAC (FY00), the Thailand Public Sector Reform Loan (FY00), the Brazil Programmatic SECAL (FY01), the Brazil Financial Sector Adjustment Loan (FY01), and the Peru Programmatic Social Reform Loan (FY01). The Board of Executive Directors also approved the first Poverty Reduction Support Credits, to Vietnam and Uganda in FY01. (Proposed PSALs/PSACs are under preparation for Ukraine and Jordan, as is another PSAL each for Brazil and Latvia.) Subnational programmatic adjustment loans/credits are also being applied to reforming Indian states, such as Andhra Pradesh, Karnataka, and Uttar Pradesh. PSALs/PSACs have focused on public expenditure management, public sector reform, and private sector development. Reform measures supported by PSAL/PSACs include streamlining business regulations and financial supervision and fostering associated institutions that interact directly with the market, such as regulatory agencies. The reform agenda has typically involved the strengthening of public institutions. This kind of reform is time-intensive, and as it unfolds it invites the monitoring of progress and governance aspects, including by civil society. Such monitoring, in turn, builds a broader base of consensus for the reform program. An initial assessment of experience with PSALs/PSACs shows that client countries have particularly appreciated the flexibility of adapting later phases of the program and lending volumes to their evolving reform progress and financing requirements. This flexibility fosters greater borrower ownership of the reform program, which, along with a broad-based consensus, has helped reduce the risk of loss of government support for reform efforts in these countries. Bank endorsement of the countries' medium-term programs, with clear benchmarks, also offers a comprehensive reform road map and facilitates donor coordination.

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<sup>1</sup> See *Programmatic and Emergency Adjustment Lending: World Bank Guidelines* (R-98-249), October 22, 1998; and the *Operational Memorandum Guidelines for Programmatic Adjustment Loans/Credits*, February 11, 2000.

<sup>2</sup> For a series of PSALs/PSACs, the medium-term framework is reflected in a multiyear matrix of policy and institutional reforms with monitorable indicators and progress benchmarks for each loan in the series; these indicators and benchmarks in turn form the basis for reviews of reform progress and for conditions of subsequent PSALs/PSACs.

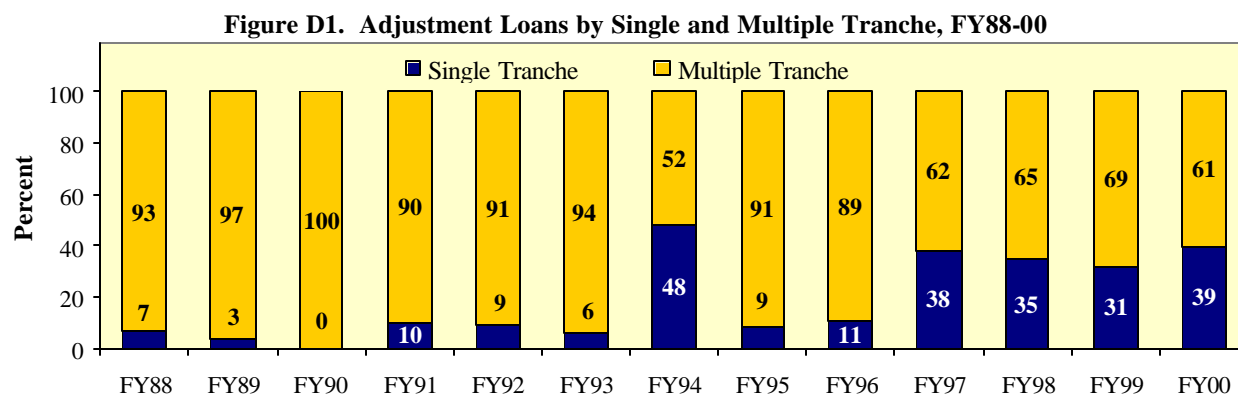
3. ***Future PSAL/PSACs.*** Looking to the future, some key questions and challenges emerge.
- ***Capacity Requirements for PSALs/PSACs.*** In practice, PSALs/PSACs place significant demands on institutional capacity and more demands on interagency coordination since they involve a wider approach with many agencies, development partners, and other stakeholders in the country and the Bank.
  - ***Share in Bank Lending Program.*** There is no presumption about the share of PSAL/PSACs in the Bank lending program. However, especially in recipient countries with overall small Bank lending programs, they may often account for a large share of those programs. Within the country assistance strategy program, PSAL/PSACs may also be an appropriate instrument to support both policy changes and institution building that would otherwise have been undertaken through an investment operation.
  - ***Borrower Demand for PSALs/PSACs over Time.*** Particularly in countries with relatively sophisticated institutional capacity and with limited or declining external financing requirements, borrower demand for subsequent PSAL/PSACs may decline. In such cases, a medium-term program of nonlending support may provide effective support.
  - ***Cost Implications.*** First indications from a limited sample of operations are that the initial cost of preparing PSAL/PSACs may be higher than for other adjustment operations. Most of these costs are incurred during the start-up phase of the program because of the learning curve associated with a new approach and the broader consultations needed to achieve consensus on the medium-term reform steps. These up-front costs will likely decrease over time as subsequent operations build on the up-front investment.

## SINGLE-TRANCHE OPERATIONS

1. According to Operational Directive (OD) 8.60, *Adjustment Lending*, “there is no fixed rule regarding the number of tranches an adjustment operation should have; while most operations are structured around two tranches, both single-tranche and three-tranche operations are also common.” Based on a review of experience, the Board of Executive Directors approved in FY96 the consideration of single-tranche adjustment operations in a variety of circumstances.<sup>1</sup> Specifically, the use of single tranches is justified in operations that support economic recovery and rehabilitation. Single tranches may also be justified when an operation supports one-off debt reduction in the context of an ongoing reform program. The use of a single-tranche operation can also be useful when a country has a strong medium-term program and a proven track record. When the government’s commitment, track record, and implementation capacity are less certain, and the reform program itself is less well defined, decisions on the use of single tranching involve trade-offs between the greater flexibility and country acceptability it allows, and the enhanced commitment and more focused supervision that multiple tranching may entail. Single-tranche operations may be appropriate in such cases, provided there is adequate up-front conditionality and a satisfactory medium-term program within which the operations can be evaluated. In general, to ensure coherence of the reform program, staff should relate a proposed single-tranche operation to any subsequent adjustment operations.

### A. Lending Trends

2. Single tranching has been used for a variety of purposes, including debt reduction exercises (principally during FY88-96) and rehabilitation operations. More recently, it has been increasingly used for adjustment lending in general, and it is these operations that are examined here. The recent rise of single-tranched adjustment operations is shown in Figure D1. (See Table D1 for a list of single-tranche operation approved during FY96-00.) In FY00, single-tranche loans accounted for 39 percent of adjustment operations and a 38 percent share by volume. During FY96-00, 49 single-tranche adjustment operations (excluding debt reduction and rehabilitation loans) were approved, for a total of US\$14.4 billion (see Table D2). The average size of single-tranche operations was much larger for IBRD countries (US\$412 million) than for



Note: Excludes debt reduction and rehabilitation loans.

Source: Staff calculations from SAP data.

<sup>1</sup> See *Issues in Adjustment Lending* (R-96-55), April 2, 1996. For a summary, see the Operational Memorandum *Clarification of Current Bank Policy on Adjustment Lending*, June 5, 2000.

IDA ones (US\$37 million). Individual loan/credit amounts have ranged from US\$15 million for economic management reform in Burkina Faso to US\$3 billion for economic reconstruction in the Republic of Korea in the wake of the East Asia crisis in the late 1990s.

**Table D1. Single-Tranche Operations, Approved FY96-00**

<i>Fiscal year</i>	<i>Country</i>	<i>Amount (US\$m)</i>	<i>Project</i>	<i>Fiscal year</i>	<i>Country</i>	<i>Amount (US\$m)</i>	<i>Project</i>
1996	Cambodia	40	Eco. Rehabilitation Credit	1999	Albania	30	Pub. Exp. Support
1996	Chad	30	SAC I	1999	Argentina	505	Spec. Repurchase
1996	Jordan	80	Eco Reform/Dev. Loan	1999	Brazil	758	Social Security Reform I
1997	Bosnia-Herzegovina	90	Transition Assistance Credit	1999	Brazil	253	Social Protection
1997	Chad	25	SAC II	1999	Bulgaria	76	ASAL I
1997	Jordan	120	ERDL II	1999	Burkina Faso	15	Economic Mgmt. Reform
1997	Madagascar	70	SAC I	1999	Chad	30	SAC III
1997	Mexico	400	Contractual Savings	1999	Indonesia	500	PRSL II
1997	Mongolia	10	Banking & Ent.-BESAC	1999	Jordan	120	ERDL III
1997	Niger	30	Public Sector Adj.	1999	Morocco	250	Policy Reform Support
1997	Peru	100	Pension Reform Adj. Loan	1999	Pakistan	350	Structural Adjustment Loan
1997	Romania	50	Social Protect. Adj.	1999	Panama	61	Public Policy Reform
1997	Russian Federation	600	SAL	1999	Thailand	400	EFAL I
1998	Albania	25	Rehabilitation	1999	Thailand	600	EFAL II
1998	Bulgaria	100	FESAL I	1999	Yemen, Republic of	50	PSMAC
1998	Ghana	50	Eco. Ref. Support Operation	2000	Brazil	505	Admin. & Fiscal Reform
1998	Hungary	150	PSAL Contractual Savings	2000	Brazil	505	2nd Social Security
1998	Korea, Republic of	3,000	Emergency Assistance Loan	2000	Bulgaria	100	FESAL 2
1998	Korea, Republic of	2,000	SAL	2000	Burkina Faso	25	SAC III
1998	Malaysia	300	Eco & Soc. Sec. Support Loan	2000	India	251	U.P. Fiscal Ref./Pub. Sec. Rstr.
1998	Mexico	400	Contractual Savings II	2000	Latvia	40	PSAL I
1998	Morocco	100	MA-Contractual Savings	2000	Mauritania	30	Fiscal Ref. Support Operation
1998	Pakistan	250	Banking Sector Reform	2000	Thailand	400	PSRL
1998	Thailand	350	Fin. Companies Reconstruction	2000	Uruguay	81	Financial Sector Reform
1998	Uruguay	100	Contractual Savings				

**Table D2. Number, Volume, and Average Size of Single-Tranche Operations, FY96-00**  
(excluding debt reduction and rehabilitation loans)

<i>Country group</i>	<i>No. of operations</i>	<i>Volume (US\$m)</i>	<i>Share of operations (%)</i>	<i>Share of volume (%)</i>	<i>Average volume (US\$m)</i>
IBRD	33	13,604	67	94	412
IDA	15	550	31	4	37
Blend	1	251	2	2	251
<b>Total</b>	<b>49</b>	<b>14,405</b>	<b>100</b>	<b>100</b>	<b>294</b>
AFR	9	305	18	2	34
EAP	10	7,600	20	53	760
ECA	10	1,261	20	9	126
LCR	11	3,668	22	25	333
MNA	6	720	12	5	120
SAR	3	851	6	6	284
<b>Total</b>	<b>49</b>	<b>14,405</b>	<b>100 (rounded)</b>	<b>100</b>	<b>294</b>

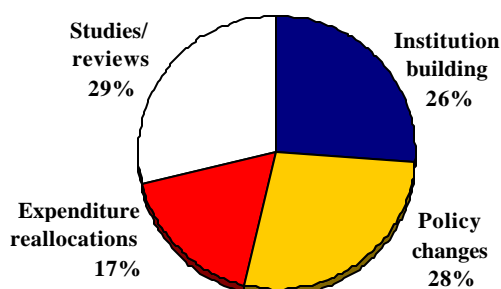
Source: Staff calculations from SAP data.



3. **Regional Distribution.** As Table D2 shows, single-tranche operations were used most frequently in the Latin America and Caribbean Region (LCR), followed by the East Asia and Pacific Region (EAP) and the Europe and Central Asia Region (ECA). However, the Regional distribution by value is heavily skewed, with EAP receiving more than half of the total, followed by LCR. Countries in the Africa Region (AFR) received 2 percent of the total lending through single-tranche operations, and had the lowest average single-tranche loan size.

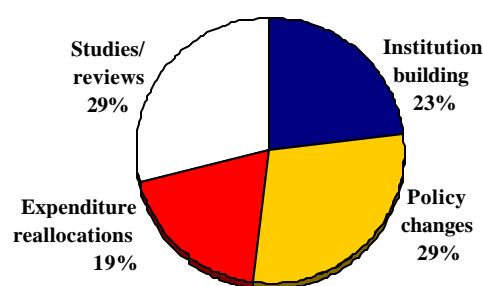
4. **Types of Reform Measures.** There is little difference between single- and multiple-tranche operations in the types and balance of policy conditions. Whereas intuition holds that “easier,” less capacity-intensive conditions (such as studies or reviews) should fall naturally in the first tranche of an operation, the Operations Policy and Country Services (OPCS) review of FY98-00 adjustment operations shows this has not been the case.<sup>2</sup> Figures D2 and D3 illustrate this point. The types and relative share of conditions in the first tranche of a multitranche loan are similar to those of a single-tranche operation.

**Figure D2. Types of First-Tranche Lending Conditions in Multiple-Tranche Loans, FY98-00**



Source: OPCS survey.

**Figure D3. Types of Lending Conditions in Single-Tranche Loans, FY98-00**



Source: OPCS survey.

## B. Quality of Single-Tranche Operations

5. Among adjustment operations, single-tranche loans appear to perform as well as or better than multitranche operations. A quality-at-entry analysis by the Quality Assurance Group (QAG) for adjustment operations approved in FY97 rated all four single-tranche operations satisfactory or better, whereas 2 of the 12 multitranche structural adjustment loans/sector adjustment loans (SALs/SECALs) were rated marginal or poor.<sup>3</sup> The OPCS survey found that 98 percent of single-tranche operations were rated good or moderate for design. However, 18 percent were rated inferior for monitoring and evaluation and 29 percent were rated inferior in the risk and sustainability category.

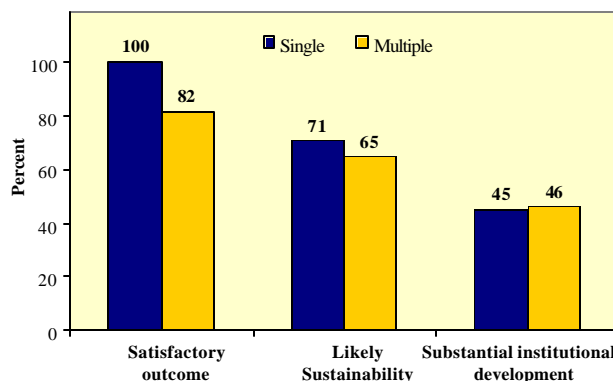
6. **Quality at Exit.** According to ratings by the Operations Evaluation Department (OED) based on implementation completion reports that are available for 34 single-tranche operations exiting in FY96-00, all were rated satisfactory for outcome. A little less than three-quarters of these operations were rated favorably for likely sustainability, and 45 percent were rated favorably for

<sup>2</sup> The OPCS review used a structured questionnaire, including quantitative and qualitative indicators, to assess more than 105 operations in FY98-00, plus 35 operations from earlier years for comparison. The broad categories were (a) basic loan and country data, (b) loan design, (c) monitoring indicators and progress benchmarks, (d) risk assessment and ownership, and (e) focus and coverage. The resulting ratings were aggregated.

<sup>3</sup> See *Quality at Entry in CY98—A QAG Assessment*, World Bank, Quality Assurance Group, June 16, 1999.

institutional development impact (see Figure D4). Compared to the multitranche operations evaluated for the same years, these single-tranche operations had higher ratings for outcome and sustainability, and slightly lower scores in terms of institutional development impact. While current OED ratings for single-tranche operations are higher compared to those analyzed in FY90, as with adjustment lending in general, a similar pattern prevailed then—higher outcome and sustainability scores for single-tranche than for multitranche operations, but lower development impact ratings. Part of the explanation is that single-tranche operations are based on the actual completion of reform measures and that they have often been used in countries with a more favorable policy environment (contributing to the higher ratings for outcome and sustainability) while they have much shorter life spans than multitranche operations (hence a more modest institutional development impact).

**Figure D4. OED Quality Ratings by Single- and Multiple-Tranche Loans, FY96-00**



Note: Excludes debt reduction and rehabilitation loans.  
Source: Staff calculations from OED and SAP data.

### C. Program Design and Implementation Experience

7. There were wide variations in program design, objectives, and context (reform program sequencing, economic shocks, and uncertain political economy environment or government commitment) in the single-tranche operations reviewed. Single-tranche operations have been used with some success in three ways: (a) as part of a medium-term program, (b) in response to economic shocks or post-conflict situation, and (c) to deal with program uncertainties.

8. **Supporting a Medium-Term Reform Program.** Single-tranche operations have been most effective in the context of a medium-term reform program developed in close collaboration with the donor community and with strong government commitment to reform. Experience highlights the importance of embedding single-tranche operations in a medium-term framework of reform:

- **Jordan.** Three characteristics contributed to the highly successful experience of the economic reform and development loans (ERDL I and II) to Jordan: (a) a well-sequenced, medium-term reform program; (b) close coordination among the Bank, IMF, and the donor community; and (c) committed government ownership. The centerpiece of Bank assistance to Jordan was a series of three adjustment operations to support broad economic reforms centered on privatization, trade liberalization, and other measures to improve enterprise and financial market efficiency. Following the successful policy performance under ERDL I, ERDL II was phased to cover the annual financing gap during approximately four years of reform; it also continued to support the already initiated comprehensive reform program.
- **Thailand.** The adjustment lending program in Thailand involved three broad-based single-tranche loans that aimed to provide building blocks for the medium-term reform program, which evolved from tracking the distressed financial sector to focusing on structural reforms. The first loan supported financial resolution measures

directed toward suspended finance companies, and supported the government's comprehensive financial sector reforms. The second loan, an economic and financial adjustment loan (EFAL I), helped efforts to deepen financial sector restructuring and supported measures to strengthen the corporate sector. The third loan, EFAL II, helped promote reforms in the financial and corporate sectors and social protection programs. The Bank coordinated specific aspects of assistance for structural reforms with other donors, and the government showed sustained strong commitment to articulate and implement reforms.

9. ***Single-Tranche Operations with Substantial Uncertainty.*** Some adjustment operations are prepared in countries where there is much uncertainty about the reform and commitment is variable. However, because follow-up is intrinsically uncertain, a single-tranche operation may prove risky even if there is intensive monitoring and supervision during implementation. In these cases, a single-tranche operation could be justified if, in addition to a medium-term program (even if necessarily uncertain), a strong track record of policy actions can effectively signal government commitment to help reduce risks:

- ***Russia.*** Given the substantial risks, the Russian SAL was designed as a single-tranche operation based on past performance. Nevertheless, consensus for reform subsequently weakened. It is uncertain whether, in this situation, greater up-front conditionality or a multiple-tranche loan structure might have reduced the risk to the Bank.
- ***Up-Front Conditionality.*** The implementation experiences in Madagascar SAC I (1997), Peru Pension Reform (1997), and Romania Social Protection (1997) demonstrate that even when the core loan conditions are met up front, there may not be adequate follow-up and post-disbursement implementation. These operations were adversely affected by delays in implementation, weak institutional capacity for follow-up, or unsatisfactory results.

10. ***Responding to Shocks.*** The Bank has used single-tranche loans in exceptional circumstances, such as post-conflict situations or short-term balance of payments shortfalls. Even when these operations succeed at short-term objectives, sustaining their benefits depends on government commitment and capacity to formulate and implement medium-term programs:

- ***Post-Conflict Support: Bosnia.*** Bosnia-Herzegovina's postwar situation in 1996 posed substantial risks for the fragile peace process and reintegration. The Bank's presence in the policy area through an immediate disbursement of a transition assistance credit (TAC) was intended to pave the way for federation building and reorganization of structures by fostering a market-based legal and regulatory framework for the banking sector. The TAC succeeded in meeting its development objectives: core federal legislation was adopted and institutional reforms were implemented. These reforms included establishing a federation tax administration and customs authority, unifying the federation banking system, and creating a legal and regulatory framework to privatize banks and enterprises. However, the TAC was followed by two Bank-supported public sector adjustment credits that have built on, and sustained, the core reforms of the TAC.

- ***Establishing a Foundation for Growth: Korea.*** Single-tranche financial support can also help catalyze reforms that subsequent operations can foster. The US\$3 billion economic reconstruction loan for Korea in FY98 not only dealt with the immediate foreign exchange shortfall, but also helped catalyze reforms in the financial and corporate sectors and in labor markets and social safety nets. These reforms were then supported by two further adjustment operations that helped foster the longer-term resilience and competitiveness of the economy and helped Korea return to strong and sustained growth.

## D. Summary

11. Traditionally, the Bank has favored multitranche operations, but single tranches have recently become more common. Originally considered suitable mainly as a short-term measure in response to economic shocks, single-tranche operations are now used frequently as part of a series of operations, in the context of a multiyear strategy. Concurrently, their ratings have improved across the board, and now exceed those of multitranche operations as regards outcomes and sustainability. Their main advantage is that they allow financing on the basis of actual performance, rather than promises. The downside risk is that they may entail an episodic approach to policy reforms, unless embedded in a medium-term framework. But because of the intrinsically uncertain follow-up, a single-tranche operation may prove risky even if there is intensive monitoring and supervision during implementation. In these cases, a single-tranche operation could be justified if it is not only part of a medium-term program, but if there is also a strong track record of policy actions that can effectively signal government commitment to help reduce risks.

12. ***Choice of Single-Tranche Operations.*** A decision to use single-tranche operations is based on country circumstances and the specific objectives of the operation. Single-tranche operations are more often used in countries with a good reform record and a relatively well-articulated path for development. Single-tranche operations are used frequently in financial sector, public sector, and private sector operations. Operations that require more time can often be more appropriate for a series of single-tranche operations under a medium-term framework.

13. ***Lessons of Experience.*** Experience suggests that single tranching can provide a flexible and effective approach to adjustment lending in different country circumstances. It can be useful for providing financing to countries rebuilding a program after domestic upheavals and changes, and for economies in transition, because it can respond to uncertainties of reform programs. Also, a series of single-tranche operations can reinforce ownership through fresh negotiations with the authorities, especially when there is rapid turnover of government officials and Bank counterparts. Single tranching can foster country ownership of reforms by rewarding past performance. Single tranching appears to work well when the government has a good track record of reform, and the operation is one of a series within a multiyear strategy. Good practice also suggests that single-tranche operations should be closely coordinated with other donors.

14. ***Single-Tranche Operations and Programmatic Adjustment Lending.*** Programmatic adjustment loans/credits (PSALs/PSACs) involve a series of single-tranche operations in a coherent medium-term framework, as the experience of operations in Latvia and Thailand shows.<sup>4</sup>

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<sup>4</sup> See the Operational Memorandum *Guidelines for Programmatic Adjustment Loans/Credits*, February 11, 2000.

Such programs focus on step-by-step capacity building and institutional reform, and single-tranche operations can adapt and phase the program in line with evolving country circumstances and external developments. With this type of single tranching, the Bank can not only calibrate funding to client resource needs, but it can also tie sustained Bank support to sustained progress with reforms. (For a discussion of programmatic adjustment lending, see Annex C.)

15. **Floating Tranches.** The Bank is increasingly using floating tranches, which are tied to fulfilling specific conditions (see Box D1). In principle, this allows partial disbursements as conditions are fulfilled even if implementation of other parts of the program is delayed. Floating tranches can be a useful approach for discrete reforms with uncertain timing—such as the privatization of a state-owned enterprise.

#### **Box D1. Floating Tranches**

Floating tranches have been used particularly in the Africa Region, under the aegis of the Higher Impact Adjustment Lending (HIAL) initiative. Introduced in 1995, and thus far restricted to Sub-Saharan Africa, HIAL has two main aims: (a) to offer governments more flexibility in the timing of agreed-on reforms, and (b) to eliminate what was a forced choice for the Bank when conditionalities were not fully met—to disburse regardless or to risk macroeconomic stability.

**Experience with Floating Tranches.** During FY96-98 there were 21 HIAL operations, nine of which, totaling US\$1.2 billion, used floating tranches. The number of floating tranches ranged from one to five, and the value of individual tranches from US\$4 million to US\$26 million. Usually, floating tranches were aimed at selected sector policy reforms, and in several cases floating tranches supplemented conventional tranches. Floating tranches under HIAL included financial and banking sector reforms plus parastatal, public sector, and civil service reform. A floating tranche variant was also used in a sector adjustment operation in the Côte d'Ivoire PSAC, where a tranche release was triggered whenever any two conditions were met, one from each list—core and non-core conditions. (For a list of all FY96-00 operations with floating tranches, see Table D3.)

**Flexibility Leads to Better Outcomes.** Preliminary evidence suggests that floating tranches help increase the Bank's leverage and the credibility of loan conditionality. OED's interim evaluations of HIAL since 1995 found that, on average, the disbursement flexibility of floating tranches delivered better policy outcomes than those of the comparator groups in fiscal adjustment, exchange and interest rate policy, and structural reforms. Floating tranches provide considerable flexibility in adjustment lending, especially when combined with (a) more and smaller tranches, and (b) the greater use of ex post conditionality.

See *Higher Impact Adjustment Lending (HIAL)—Initial Evaluation*, Operations Evaluation Study No. 19797, World Bank, June 29, 1999; and *Higher Impact Adjustment Lending (HIAL) in Sub-Saharan Africa: An Update*, Chief Economist's Office, World Bank Africa Region, November 25, 1998.

**Table D3. Operations with Floating Tranches, FY96-00**

<i>FY</i>	<i>Country</i>	<i>Project name</i>	<i>Volume (US\$m)</i>
1996	Cameroon	SAC II	224
1996	Côte d'Ivoire	Private Sector Adjustment Credit	271
1996	Malawi	Fiscal Restructuring	112
1996	Mali	Economic Management	60
1996	Mauritania	Public Resource Management Credit	60
1996	Romania	FESAL	280
1997	Tanzania	SAC I	132
1997	Uganda	SAC III	132
1998	Bolivia	Capitalization Program	25
1998	Côte d'Ivoire	Transport Sector Adjustment Credit	100
1998	Russia	Coal SECAL	800
1999	Cameroon	SAC III	180
1999	Ghana	ERSO II	178
1999	Nicaragua	Financial Sector	70
1999	Rwanda	Economic Recovery Credit	75
1999	Zambia	ESAC III	170
2000	Cambodia	SAC	30
2000	Central African Republic	FCC	20
2000	Ecuador	SAL	152
2000	Guinea-Bissau	Economic Rehabilitation Credit	25
2000	Mexico	Bank Restructuring Facility	505
2000	Mongolia	Financial SECAL	32
2000	Papua New Guinea	Governance Promotion Loan	90
2000	Sierra Leone	Economic Rehabilitation Credit	30
2000	Tanzania	PSAC	190
2000	Zambia	Fiscal Sustainability Credit	140

*Source:* World Bank SAP/R3 data.

## EARLIER REVIEWS OF ADJUSTMENT LENDING

1. More than two decades have passed since the 1980 inception of adjustment lending, and periodic reviews have highlighted lessons that have progressively enhanced this instrument. The first three Bank reports on adjustment lending, commonly referred to as RAL I (1986), RAL II (1990), and RAL III (1992);<sup>1</sup> and a 1995 report by the Operations Economic Department (OED)<sup>2</sup> analyzed the adjustment experience as of the date of their investigations and provided recommendations to strengthen the instrument's effectiveness. Although these earlier reports did not have the benefit of an extensive track record, it is striking that many of their observations remain pertinent to the success of adjustment lending today.

2. ***Report on Adjustment Lending I.*** RAL I noted that adjustment lending was intended to support policies to reduce external imbalances and stimulate sustained growth. Based on a sample of 30 countries that had then received 100 percent of adjustment loans, the report concluded that, on average, countries that received adjustment lending had moderately higher imports, exports, and GDP growth in the 1980s than countries that did not. Better performers—Korea, Thailand, Turkey, and Colombia—followed relatively sound policies over the long term and adjusted quickly to shocks. Programs were easier to support when the negative effects on growth, employment, and poverty reduction were short-lived. The RAL I identified government commitment and popular support as crucial for sustainability, and also noted the following:

- Failure to address social costs of adjustment accounted for some policy reversals; unlike many other countries, Korea's mortality and poverty indicators improved during the adjustment period; short-term compensatory programs should be part of adjustment programs.
- Supply response in low-income countries, especially in Sub-Saharan Africa, was slow, suggesting the need for an appreciation of the time required for structural changes, especially institutional reforms.
- Inadequately specified conditionalities were sometimes loosely interpreted (particularly for second-tranche releases), and there was a need for a more explicit and monitorable approach for Board approval of tranche releases once a program was in operation.
- A more selective approach to adjustment lending was needed for balance of payments support; an adequate macroeconomic program should be maintained; greater realism was needed in the expected speed of responses; and over-optimism should be avoided.

3. ***Report on Adjustment Lending II.*** RAL II mainly focused on sustainability, and its findings were consistent with those of RAL I. RAL II found that external shocks and initial conditions were important determinants not only of performance but also the demand for

<sup>1</sup> See *Structural Adjustment Lending: A First Review of Experience*, Operations Evaluation Report No. 6409, World Bank, September 24, 1986; *Report on Adjustment Lending: Policies for the Recovery of Growth* (R90-51, IDA/R90-49), March 26, 1990; and *The Third Report on Adjustment Lending: Private and Public Resources for Growth* (R92-47, IDA/R92-29), March 24, 1992.

<sup>2</sup> Carl Jayarajah and William Branson, *Structural and Sectoral Adjustment, World Bank Experience, 1980-92*, Operations Evaluation Study (Washington, D.C.: World Bank, 1995).

adjustment lending, and that adverse terms of trade and the debt burden constrained the freedom of policy action in many countries. Following Board instructions, RAL II paid attention to the impact of adjustment lending on poverty, especially in IDA countries. Whereas the analysis in RAL I was essentially limited to indicators, the RAL II analysis was more sophisticated. The performance of three country groups—early intensive adjustment lending (EIAL), other adjustment lending, and nonadjustment lending—was compared during two periods: 1981-84 and 1985-88. The growth rate and other performance indicators of the EIAL group, which included Korea, Mauritius, Morocco, and Thailand, were superior to those of the other adjustment lending group. This was judged a consequence of EIAL countries having allowed more time for changes in policy stance to take hold. However, in some performance areas the record of the EIAL group was not better than that of the nonadjustment lending group, which included Egypt, India, Malaysia, and Sri Lanka. The EIAL group suffered a noticeable drop in investment rate, a critical dimension for sustainability. Concern was also expressed for the decline in health and education expenditures for five of the 10 EIAL countries. Grouping countries by income revealed that low-income countries (all IDA borrowers) had the lowest savings rates, the lowest GDP growth rates, and the highest fiscal deficits as shares of GDP. RAL II suggested that policy-based lending for Sub-Saharan Africa should place increased emphasis on developing institutions and human capital, and should have a correspondingly longer timeframe.

4. ***Early Reports Confirm Framework.*** RAL II noted that, guided by experience, more fully specified conditions were being employed to achieve each overall objective, and that it was still necessary to include measures to protect the poor during the transition period, even though there was not any systematic relationship between adjustment and changes in poverty. The report confirmed the assessment of RAL I that an adequate macroeconomic framework was necessary for effective adjustment lending. When countries had made satisfactory progress with macro adjustment and removal of major distortions, the strategy could then focus on sustainable growth. Appropriately focused sector adjustment loans (SECALs) could support this strategy. However, without macroeconomic stability, SECALs could be ineffective, and in some instances promote inefficient investments.

5. ***Report on Adjustment Lending RAL III.*** RAL III findings were consistent with those of the previous RALs, and its methodology was also basically similar to that of its predecessors. The report highlighted the value of private investment and a restructuring of public spending. The adjustment process was swift in a few countries—Korea, Indonesia, and Thailand—but in most middle-income countries it took many years. In low-income (IDA only) countries it was even slower. This longer duration was attributed to the initial macroeconomic situation, the level of structural distortions, and the limited development of the private sector. RAL III also noted that although the poor might gain from adjustment over the medium term, at least some of them suffer during the adjustment period. The report emphasized the need to address core reforms, but also called for increased attention to second-generation policies to support the business environment. RAL III called for increasing attention to the allocation of public sector spending; cushioning income declines for vulnerable groups; and ensuring allocation of resources to development activities, especially when there are high or growing military expenditures.

6. ***Adjustment Patterns Follow Country Characteristics.*** RAL III noted that differing patterns of adjustment broadly corresponded to country characteristics. First, adjustment starts—



Korea, Thailand, and Indonesia—started off with less severe macro imbalances and less distorted economies, and made swift policy reforms. An emerging second set of stars—Chile, Mexico, and Morocco—started with more severe macro imbalances and greater distortions but had protracted responses to policy reform, often assisted by debt reduction. There was a noticeable absence of stars from the low-income Sub-Saharan Africa group. Although some countries—such as Ghana, Kenya, and Tanzania—had reasonable growth rates, the broad prospects for policy and growth looked fragile, perhaps due to a weaker human resource base, poor infrastructure, and poorly functioning institutions. Consequently, RAL III recommended that:

- The Bank should continue to provide policy-based lending for countries seriously undertaking policy reforms.
- More attention should be given to alleviating the suffering of the poor during adjustment.
- Public spending should be an integral part of the policy framework, and it should provide an enabling environment and infrastructure for growth, enhance human capital, and alleviate poverty.

7. ***The 1995 OED Report.*** OED analyzed the outcomes of 99 loans to 42 countries from 1980 to 1992. Its analysis was based primarily on OED audits and project completion reports. The report paid particular attention to persistent concerns about policy design and the effect of programs on adjusting countries. Many of the lessons it drew were consistent with those of RAL III:

- Macroeconomic stability was essential. Countries with favorable initial conditions, such as strong institutions and a robust private sector, were more likely to achieve reforms and to have better outcomes than their counterparts with less favorable environments. Some countries might be inappropriate candidates for adjustment, especially those emerging from conflict or recovering from natural disasters. Adjustment operations might also be inappropriate for countries with heavy debt burdens.
- Borrower ownership was crucial. Adjustment programs should include institutional development components to provide incentives for different agencies to back reform objectives.
- Institutional weaknesses seriously undermined adjustment operations, particularly SECALS; adequate knowledge of a sector is a critical precursor of adjustment operations.
- Successful programs in the industrial sector focused on particular rigidities and distortions and included policies to facilitate a supply response. Many agricultural SALs were not successful because of an inappropriate real exchange rate and an inadequate appreciation of internal sensitivities and the importance of up-front actions.

- Adjustment needed to be supported by investment lending for development of the economic infrastructure.
- Some earlier operations failed to monitor in sufficient detail the social impact of adjustment lending. Rather than concentrating solely on compensatory measures, the Bank should tackle more fundamental issues of poverty and development when designing adjustment programs.
- Appropriate types and balance of lending approaches depended on country conditions; and decisions on them should be taken, in consultation with borrowers, as part of overall country assistance strategies.

8. ***Lessons Learned.*** The earlier adjustment loans were successful in their original purpose of addressing balance of payments difficulties. When the instrument was used more widely, weaknesses and challenges emerged:

- The more successful experiences were in countries with strong ownership of reform programs (which was often manifested by up-front actions) and well-developed institutions.
- Stabilization and removal of major distortions should be addressed either before or during an adjustment operation.
- Effective policy design requires adequate analysis, complementary investment, realism about implementation capacity, and evaluation and monitoring components to ensure compliance, especially when internal decisionmaking is difficult.
- Addressing poverty concerns by compensatory actions is insufficient; instead, it is necessary to address fundamental issues, such as the efficiency and allocation of public expenditures to education, health, and the social infrastructure.
- As successful adjusters progress they need to address second-generation policies—governance, environment, legal system—to support the business environment.
- Most low-income (IDA only) countries are faced with adverse initial conditions; increased emphasis is needed to develop institutions and human capital, which inherently requires more time.
- Adjustment lending may not be appropriate for all countries. It is important that the country strategy address the economic, political economy, and social conditions, and choose the most appropriate blend of approaches to suit the country circumstances.