POLICY BASED LENDING AND THE WORLD BANK

by

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Introduction: The Bank and Policy Reform

The Bank since its inception has been interested in the economic policies and performance of its member countries. Even as it evolved into primarily a project lending institution making loans for specific investment projects with demonstrable high economic returns, there was an increase in its wider concern with country and sector policies. Country economic and sector work absorbed growing amount of resources and the depth and quality of the studies continued to improve. In subsequent years the Bank also undertook and supported a large volume of research on issues of development policy.

However, the link between concern for country policies and operations was not direct or very strong. Lending was not viewed as a vehicle for initiating and supporting policy reforms. That role was played by a policy dialogue carried on with the member country to which the country and sector work contributed. Clearly because of creditworthiness and country assistance strategy considerations, country policies at the extreme (i.e., if they were very poor or very good) did affect the level of lending and, perhaps, its composition. Also, to a certain extent, project and sector lending was associated with conditions such as agreed tariff changes or development of an institutional framework the impact of which went beyond the specific project. Further, there were occasions when the Bank did take a strong stance on policies and put its lending on the line in support of its position. Examples of this are the case of India during 1964-1966 and of some Latin American countries in the latter half of the sixties.1 However, such examples of an explicit and strong link between policies and lending were exceptions. The Bank generally tended to be content with developing a policy dialogue in order to recommend—rather than push—policy change.

Generally speaking, lending for projects has serious limitations as an instrument for policy change for three reasons. Firstly, the major discussions of the project loan are conducted primarily with the line ministry concerned with the sector in which the project lies, while policy changes generally require the involvement of the macro-oriented ministries like Planning, Economy and Finance. Often the discussions occur largely

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1/ These are documented in Messrs. Mason and Asher's History of the Bank.

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with the project authority which has even narrower perspective than the sector ministry. Hence, the occasion for a project loan is not the most appropriate to discuss policy changes. Traditional sector loans have a similar character though to a lesser extent than project loans. Secondly, individual project loans have their own preparation and implementation cycle, while policy changes are usually most effective when undertaken as a package. Specific policy changes linked to projects closest to these changes would tend to be intermittent and (if projects are delayed) uncoordinated. Thirdly, once a project is under implementation, it is not possible to effectively link disbursements to specific policy actions without seriously disrupting implementation. There have been many occasions when the dynamic of project construction led the Bank to agree to the erosion of financial and other covenants agreed when the loan was approved. The Bank's focus after the mid-1960s was, therefore, more on the improvement of project design and of project evaluation and post evaluation rather than on improving the policy aspects of project lending.

Program lending has been a lending instrument used by the Bank from its first days when program loans were made for reconstruction purposes. However, it was used in special circumstances, and primarily to support a "program" which the Bank had reviewed and approved. These terms were used in quite a broad sense and often the loans tended to become "routine" - witness the eleven annual import credits to India between 1964 and 1976.

Structural adjustment lending, therefore, marks a new stage in the Bank's relations with member countries in that the link between lending and policy change is explicit and direct. The SAL was a response by the Bank to a special situation. The worsening international economic situation in late 1970s (deteriorating terms of trade; recession in the OECD countries; very high international commercial lending rates) intensified the need for structural adjustment. It became evident that often good projects in poor policy environment do not yield the requisite benefits. The need to improve the efficiency of resource allocation became increasingly urgent. The SAL loans were in support of programs of structural adjustment which may be very comprehensive. But they include specific measures and institutional steps that are to be undertaken within particular time periods both before the loan is approved and as conditions for the release of later tranches of a SAL (or occasionally for the approval of another SAL). The initial SALs (e.g., Philippines, Turkey, Kenya) originated as program or sector loans already being processed, but were recast in the new mold. There was a process of learning within the Bank which is still going on regarding SALs. However, from the experience so far, two conclusions are fairly clear. Firstly, the SALs are a limited lending instrument applicable only to selected country situations besides being not acceptable to a few. So far SALs have been made to sixteen countries of which twelve are still active. For a period of five years, this is not a large number of active countries since structural adjustment problems of some kind are clearly prevalent in almost all the borrowing member countries. Secondly, they have shown that the Bank can effectively influence/support/accelerate policy and institutional changes in both low and middle-income countries.
(from Thailand to Togo). This has generated an increased interest in other instruments of lending linked explicitly with policy and institutional reforms which like SALs also are, "specific, time-bound and monitorable" and which are more widely applicable than the SAL. Policy linked sector lending is one of a variety of policy linked lending instruments that are being developed. (Public Investment Rationalization and Public Sector Rehabilitation loans are others.)

**Issues for Policy Based Lending**

**The Need for an Analytical Framework**

A fundamental issue concerning policy based lending is the analytical framework within which the policy and institutional package is designed and evaluated. At present no explicit framework even broadly similar to that incorporated in the methodology of project evaluation used in the project lending exists. There is an implicit framework provided by neoclassical economic theory which underlies the series of reforms supported— that prices that reflect scarcity values would improve the efficiency of resource allocation; that trade liberalization by improving the balance of incentives between exporting and importing will improve efficiency and the balance of payments; and so on. However an explicit, at least partially quantifiable, analytical framework does not exist which would enable the results of alternative policy packages to be evaluated even in broad terms and permit the investigation of trade-offs between the short term and the long term and between the attainment of competing objectives (e.g., employment and productivity growth). Consequently, it becomes difficult to question and evaluate the balance and the even approximate optimality of the policy packages associated with a particular SAL or other policy linked loan. It is clear that we are not seeking a vast economic model of the economy which would answer the questions raised above. Even if such a model could be developed — and one may be skeptical that it could — the data basis for validating such a model exists in almost no developing country. More fundamentally, while a program of structural adjustment is being considered, the values of the parameters and the structural coefficients of the model will be changing. Without a complete and integrated model, however, much progress has been made by pursuing within the framework of a SAL an interrelated package of policy reforms resting on partial equilibrium analysis.

**The "Success" of the Policy Package**

In the absence of a comprehensive analytical framework, how does one determine whether a specific policy based loan was well designed and if it has been successful? There is a large element of judgment at all stages of the process. The implementation of agreed measures at the agreed time may be one index for judging success of an operation. However, even this is not always easy to determine. For example, consider an agreement to reduce protection by carrying out certain specific changes in QRs and
tariffs. Suppose these measures are carried out in a SAL in a modified fashion (not in the form agreed) and with a delay of six months. Was the agreed measure implemented? It is essentially a matter of judgment. Much more important is the difficulty in determining whether the measures actually carried out achieved what they were intended to achieve. How was/or ought the objective of the measures to be defined? Measured? And finally even if we did have the answer there is the problem of determining what part of the actual development was due to the policy measures and what part to other factors (weather, international developments, measures not in the Bank program). Supposing that all this were done, there is the final question of constructing the “without the policy change” scenario as the base with which the actual outcome has to be compared. It is evident that the whole process involves a major element of judgment at all stages. Hence, the only conclusion I come to is that if in the long run the country is not having a reasonable trend growth performance in a reasonable international economic environment (let us hope that it will emerge) then the policy package(s) supported by us in that country should be judged to be a failure. (This as distinct from the success or failure of specific policy based operations which is the counterpart of the project by project evaluation of the OED-type.)

CESW and Policy Change

The Bank has devoted a large volume of resources – from one-fifth to one-fourth of the operation budget – to country economic and sector work. However, this work has been geared to meeting the needs of the Bank and other donors and to providing a basis for economic and sector policy dialogue. It has not been directed towards the design of specific policy and institutional reform packages. It is a major step from having a good analysis and diagnosis of the problems in the economy or sector (which itself is a tall order) and making general recommendations about needed policy changes, to designing specific measures which are both effective and feasible. It involves much detailed and indepth work and an understanding of the institutional and socio-economic framework. It consumes time and resources and may also take the Bank into areas where it does not necessarily have a comparative advantage. Time and again the experience has been that major studies necessary for designing policy change are not available. At the same time, one cannot help feeling that sometimes studies reflect a decision to postpone to undertake certain necessary changes and it may make more sense to start with first approximations – changes in the right direction – and leave fine-tuning until the results are available of more detailed studies.

The Balance between Policy and Institutional Change

Policy based lending is intimately linked to institutional reform. The adjustment programs supported by the Bank invariably have a large institution building component. In fact the objective, given the medium-term perspective of the Bank, is to institutionalize the policy adjustment process so that the distortions and problems being tackled do not emerge again. For example, in the case of agriculture, the Bank
supports measures to change specific prices which are out of line with (say) "world" prices. But it also strives to establish an institutional framework in which these prices are periodically reviewed and changed in the light of changing circumstances. Questions arise regarding the relatively long time perspective over which institutions can be developed and strengthened, the pressing nature of the problems in the countries that need to be addressed and the possibility of having an immediate impact by policy measures. Essentially, it is a question of balance. Even in the area of policy reform there are measures like increases in specific prices which can be implemented in the short term and the reorientation of investment priorities which may take longer. There is no general view possible on the appropriate balance between policy and institutional change except that it is likely to differ from country to country, at different times for a given country, and from sector to sector.

The Commitment of the Government to Reform

The question is often asked that if the policy and institutional changes being encouraged by the Bank are in the interest of the country, why does the government need a loan linked to policy changes to undertake them? There are many possible answers to this - and all of them may be applicable in certain situations. Governments may not be convinced that the reforms would bring about the results being indicated, perhaps, because their judgment about the magnitude of the response mechanisms is different from ours. Governments may have a very different time horizon (rate of time discount) in evaluating the costs and benefits of the changes, with the short term costs receiving relatively greater weight. Governments may also have a quite different set of concerns in their objective function - including political concerns and group interests - from those which the Bank promotes. The policy linked loan from the Bank, therefore, can be viewed in terms of support to offset short term costs, "sweetener" to compensate for other concerns in the governments' objective function, "earnest money" to demonstrate the Bank's conviction that the policy measures are sound and will lead to net beneficial results and so on. However, the important operational by product of the question raised relates to the commitment of the government to sticking with the reform program which has a fundamental effect on the likely success of the program itself. The economic adjustments the Bank is primarily concerned with are long term in nature and consequently a program "imposed" by circumstances on a reluctant government which is not convinced about its appropriateness is unlikely to be successful. Consequently, ultimately the role of the Bank is to support, through its lending, a government's own program and persuading and convincing the administration, and during the process of adjustment over a period of time, is a key element for a successful policy loan. This process is ongoing and does not stop when the loan is appraised and negotiated. Lending is not the only instrument through which this process is carried out.
Size of the Operation

There is no simple analytical technique or guideline for determining the size of a policy loan in relationship to the policy package being undertaken. Clearly the size of the economy or the sector in which reform is being supported is relevant. In some situations (e.g., liberalization of the protective system), the notion of the short term effects on the balance of payments provides a peg on which to "hang" the issue. More generally the need to offset the short term transition costs of policy changes may be used for this purpose. Another element to consider is the judgment on the level of Bank support for the reform program that is necessary to make the support "credible". This is a subject on which perhaps more thinking needs to be done, though I suspect that a large element of judgment will always be required in deciding on the appropriate size of a policy linked operation, within the constraints (e.g., country lending allocations and the approved country assistance strategy) that the Bank usually operates under.

Some Special Questions Concerning Policy Linked Sector Loans

As mentioned earlier, experience has shown that comprehensive economy wide reform programs supported by the Bank are appropriate only in relatively limited number of countries. The reasons are to be found on both the demand (country) side and the supply (Bank) side. Also, countries are eligible only for a limited number of SALs and the institutionally set limit has been reached for Turkey. After the series of SALs is completed policy linked sector loans take over and these, therefore, are increasingly in evidence. There may also be a more positive reason for the growth of such loans. Specific and more narrowly focussed policy reform, supported by a sector loan, may be judged to be a more effective approach to successful adjustment in certain situations. A package of such sectoral loans, a la Pakistan, may be an appropriate structural adjustment approach. Some hypothesis may be ventured about situations in which sector policy loans can make sense and are worth exploring. First, as a precursor, or a successor to more comprehensive adjustment programs supported by a SAL. Second, in some large complex countries (e.g. Brazil, India, Mexico) where a comprehensive program may well nigh be beyond the capacity of either the Bank or the country. Thirdly, in situations where broadly concurrent sectoral policy changes can be carried out. Fourthly, situations where there is a particularly dynamic team and appropriate circumstances to secure reform in a sector or subsector, but little hope of government acceptance of a comprehensive program. Fifthly, situations where there is a major policy issue in a sector--e.g. agricultural interest rate subsidies--which is having serious effect on project lending and cannot be addressed by it. There are obviously other situations in which the appropriateness of sector loans need to be pursued. However, in addition to the issues which have been discussed, there are some others associated with a sectoral or subsectoral approach to policy reform. Is it appropriate to tackle the structural adjustment problem of a country piece by piece or are there advantages in a mutually supportive package approach
to policy and institutional change? This is a question which cannot be answered in a general fashion. Much depends on specific situations and the policy areas considered. Where the objective is related to reorienting the policy stance of a government – say from an interventionist approach to one relying more on market forces – it may be difficult to successfully carry out a program for encouraging market orientation in a sector within an overall government policy framework wedded to intervention and control. Similarly, if the object is to improve the investment decision-making process in one sector and hope that the improvement will stick and not revert to system norm. The judgment on this question has to come from experience.

Relation between Project and Policy Based Lending

At first sight, project and policy based lending would appear to be substitutes. Funds going into policy linked loans in a given country are not available for project lending. However, this would be a misleading conclusion. With the worsened international economic environment, many countries are faced with an urgent need for adjustment which cannot be postponed. In many countries there was as a consequence a drastic reduction in investment – particularly new investments. Policy reform by helping to restore the country to its medium-term growth seeks the revival of investment. Consequently in a number of countries, lending linked to policy changes helps create the conditions in which project lending can continue and expand. For example, in Jamaica which has received three SALs so far, there has emerged a very close complementarity between the structural adjustment program and the Bank’s project lending. The President’s Report of SAL III for Jamaica states “As the SAL process has continued, the relationship between SAL lending and project lending has become closer. This is a two-way process; in some areas the SAL is creating a framework which makes project lending more possible, for example through improvements in the viability of certain enterprises; in other cases, the SAL process is identifying certain project lending needs, such as the recently approved Public Administration Reform Project; and yet in other areas, the implementation of projects reveals policy areas that need to be addressed, and it is through the SAL that the action programs are designed” (para. 61). In more and more countries, the real challenge is to develop this symbiotic relationship between policy linked lending and project lending in order to maximize the Bank’s contribution to the development of the country.

Processing Issues

There are a large number of issues regarding policy based lending relating to internal Bank organization and procedures. A number of these are raised in the discussion of specific experiences, and they are clearly issues to be resolved in the interest of economy, efficiency and effectiveness. First, there is the question of how the existing organization of the Regional Offices in Projects and Programs departments affects the processing of such loans. SALs have generally been prepared with the lead role being taken by Programs but an important input being provided by Projects. Policy linked sector loans are generally the primary
responsibility of Projects. In some Regions coordination of inputs at all stages has been secured by setting up a "core group" of Programs and Projects divisional and front office staff. Experience needs to be reviewed and lessons disseminated. Secondly, concerns about the appropriateness of the expertise and experience of existing staff for policy based lending have been expressed. The skill requirements for developing and negotiating a policy loan are usually considered to be distinct from those the Bank has built up through project lending. There is an element of truth in this. However, experience indicates that policy based lending requires very large role for technical experts. For example, the review and rationalization of investment programs which is a key element in SALs requires a major involvement of technical staff. The role of technical staff in policy based sector loans is likely to be even larger. Thirdly, with policy based lending the Bank needs to coordinate its activities much more closely with the Fund. Structural adjustment and stabilization in many situations have to be undertaken simultaneously and the complementarity between the Fund and the Bank supported program has to be ensured and conflicts resolved. This has not always been easy and absorbs time and resources. Fourthly, the existing procedures for processing loans may not always be appropriate for policy linked loans. Some distinctions are already in place. For example, the Loan Committee meets to discuss initiating memoranda for such loans to provide guidance to the Region on the policy package which is considered to be associated with the loan. The initiating memorandum is also a useful device from bringing about a coherent institutional view of the policy adjustments to be sought in the specific operation. The IMF which has been in the policy linked "lending" business for a long time has evolved a system by which the missions have a large degree of freedom to negotiate conditionality in the field, within the limits set out in a "negotiating brief" approved by the Managing Director. However, this is possible partly because the concerns of the Fund are largely macroeconomic and short term and their performance criteria related to controls on 'credit' expansion, the government budget and external borrowing are capable of quantification and relatively straightforward monitoring. At the same time, and not necessarily contrary to what has been just said, the IMF Board apparently has a significant role in determining the broad framework of the IMF-supported program. Finally, there is a perception among Bank staff and perhaps also among some governments that the institution's overall lending objectives tend to put pressure on staff to deliver planned levels of lending, particularly towards the end of the fiscal year. This clearly undercuts the process of persuading reluctant governments to undertake policy reform.

Conclusion

The above outline of the experience of the Bank with SALs and other policy based loans clearly shows that there are more questions than answers at this stage. The Bank is in a process of learning by doing and is dealing with problems in a pragmatic fashion while accumulating experience which would help it to design more effective policy linked loans with a more economical use of its staff resources. In terms of parallels, policy lending is where project lending was in the 1950s, when the evaluation methodology used was rudimentary and the best guarantee of success was the common sense and pragmatism of a technically high quality and committed staff.