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14

ADJUSTMENT LENDING POLICIES FOR SUSTAINABLE GROWTH

Country Economics Department

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COUNTRY ECONOMICS DEPARTMENT

The World Bank
Washington, D.C.

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Preface

i. This second report on adjustment lending has two parts. Part I reviews the Bank's experience with adjustment lending (chapters 2 to 5), examining in more depth, and with the benefit of another year of experience, the issues raised in the first report on adjustment lending and in the September 1988 Board discussion of that report. The overall conclusions on the effectiveness of adjustment lending and the conditions needed for its success are consistent with those of the first report. In addition, this report highlights the decline in investment associated with many adjustment efforts.

ii. Part II focuses on the need to restore growth in the adjusting countries and on the requirements for removing the impediments to factor mobility, increasing investment in the later stages of the adjustment, and (given the paucity of external funding) increasing national saving (chapters 6 to 8). These chapters draw on recent research and accumulated experience to identify policies that lead to higher growth through increases in saving, investment, and the efficiency of investment (see especially paras. 1.16-1.19). The findings in Part II are important for understanding the focus and recommendations in Part I for the design of growth-oriented adjustment programs.

iii. At the Board discussions of the first report, it was generally accepted that adjustment lending had become and would continue to be an important activity of the Bank. The Board requested that regular periodic evaluations of the design and implementation of adjustment operations give attention to increasing the effectiveness of adjustment lending and take specifically into account the impact of external factors on program effectiveness and implementation. This second report examines several issues identified in the first report and at the Board discussion as needing further attention:

- The impact of external factors on economic performance and the design of adjustment programs (chapters 2, 4, and 5).
- The sustainability and growth effects of adjustment programs (chapters 2, 6, 7, and 8).
- The impact of adjustment on poverty and living conditions (chapter 3).
- The effect of the debt overhang on prospects for adjustment in borrowing countries and on the Bank itself (chapter 5).
- The experience with the design and implementation of programs (chapter 4).
- The need for increased dialogue among the various aid-giving agencies to ensure the consistency of their lending and policy discussions with governments and appropriate funding of programs (chapter 5).
- The importance of political and institutional realities in the design of programs (chapter 4).
- The policies needed in adjustment programs to increase investment, saving, and growth in the adjusting countries (chapters 4, 6, 7 and 8).

iv. The IDA deputies requested that the Bank's regular reports on adjustment lending give explicit attention to IDA countries and the adjust-

ment lending to them. In chapters 2 and 3 the low-income countries are defined as the IDA-eligible borrowers. Chapter 4 shows separately the conditionality and implementation rates for IDA credit. The Annex tables (chapter 5) give a statistical overview of the amount of adjustment lending on IDA terms. Chapters 6 to 8 classify low-income countries according to the *World Development Report* classification, which is very close to the IDA list. This report thus contains extensive information on the patterns of economic performance and adjustment lending for the IDA countries.

Part I

Bank experience with adjustment lending

1

Summary and overview

Rationale for adjustment lending

1.1 In the typical country initiating a structural adjustment program, the government has realized that major policy reforms offer the best hope for restoring sustainable growth. Balance of payments financing facilitates the phased reduction of the financing gap over a period of time, while structural reforms are being implemented and their effects start to emerge. The typical adjustment lending country faces macroeconomic disequilibria such as an unsustainable current account deficit, a high fiscal deficit, and high inflation. It also faces microeconomic distortions such as impediments to factor mobility, barriers to domestic and foreign competition, and prices of tradables and public services unrelated to opportunity costs. And its institutions are weak, as typified by a severely impaired financial system and poor economic management. The macroeconomic disequilibria and the microeconomic distortions are usually the result of such weak institutions and inappropriate policies. These problems were exacerbated by large external shocks — to the real interest rate, commodity prices, and the demand for exports — and in some cases by a drastic reduction in foreign financing.

1.2 Adjustment programs must thus address stabilization, efficiency, and growth objectives. Structural reforms — including the correction of policies and the removal of institutional weaknesses and impediments — are essential to restore macroeconomic balances, increase the efficiency of resource use, and create the conditions for sustainable growth. Structural reforms to restore macroeconomic balance focus on bringing the level of demand and its composition (tradables relative to nontradables) in line with the level of output and the level of external financing that can be mobilized on a sustainable basis. Reducing high inflation and the external deficit usually requires a credible and sustainable reduction in the public sector deficit. Structural reforms to increase efficiency and restore growth focus on creating more appropriate incentives, removing constraints on factor mobility, and increasing saving and investment. The two components of structural reform are mutually reinforcing. In most cases, neither can succeed independently, but if either type of distortion is extreme, it should be addressed first. In particular, in countries experiencing large macroeconomic imbalances and financial instability, structural reforms to increase efficiency and restore growth are unlikely to succeed because the supply response to changing incentives would be severely curtailed. For these countries, adjustment programs should focus first on structural reforms that contribute directly to the restoration and maintenance of macroeconomic balances.

1.3 To enable governments to institute structural reforms at a lower cost to output, employment, and consumption, the Bank has supported the reforms by making additional resources available through adjustment lending and in this

way has helped to sustain a higher level of expenditure than otherwise, while the economies start to respond to the reforms (box 1.1). And to the extent that the Bank brings its expertise to bear, its lending helps member countries design more effective programs and in this way to adjust more successfully. Adjustment lending is thus justified for the Bank for two reasons. It helps member countries attain higher growth and, in so doing, it strengthens the Bank's portfolio by providing the right policy environment for successful project investments, whether financed by the Bank or others.

Conclusions of the previous report

Main conclusions

1.4 SUCCESS IN IMPROVING PERFORMANCE. To provide a link with the first report on adjustment lending, we start by summarizing the main conclusions and recommendations of that report. Adjustment lending was moderately successful in improving aggregate economic performance. Despite receiving more serious shocks, the 30 countries that received adjustment loans before 1985 performed better on average than the 63 that did not. The performance was even better in the 12 countries with three or more adjustment loans before 1987 and in countries that were substantial exporters of manufactured goods. Adjustment lending appeared to have been relatively less successful in the highly indebted countries and in Sub-Saharan Africa. Detailed country studies corroborated the statistical findings. The report cautioned, however, that the conclusions were tentative, because it was difficult to isolate the effects of adjustment lending from the effects of initial conditions and external shocks.

1.5 IMPLEMENTATION OF CONDITIONS. The overall rate of implementation of conditions was good, and conditions were more likely to be implemented when the loan agreement spelled them out precisely. In a sample of about 50 adjustment loans to 15 countries, 60 percent of the conditions were met fully during the loan period, and another 24 percent were substantially fulfilled.

1.6 ADEQUACY OF EXTERNAL FINANCING. Although the sudden cutoff of external financing made some type of adjustment essential, orderly and sustained adjustment required adequate external financing. In some countries unanticipated underfunding of the program reduced or delayed the benefits. In other instances, however, external adjustment assistance simply delayed the implementation of adjustment measures.

1.7 COMMITMENT TO THE REFORM PROGRAM. The governments that best sustained their commitment to reforms were those that "owned" the program from the start. Although international agencies often assisted in preparing the programs, the governments had to be convinced that the operations were the most appropriate way to address the problems facing their countries.

1.8 THREE PREREQUISITES FOR ADJUSTMENT LENDING. When the Board discussed the first report, there was general agreement that adjustment lending had become — and would continue to be — an important part of the Bank's support for the economic development of borrowing members. The issue, therefore, was not whether to continue adjustment lending, but how to make it more effective. The first report recommended that quick-disbursing adjustment loans should be made only under three basic conditions:

- The Bank and the government should reach an understanding on the diagnosis of the main impediments to restoring growth and on the overall structural adjustment program, including the short-term stabilization and longer-term development objectives, the needed macroeconomic and microeconomic policies, and the necessary institutional changes.
- The government must own the program, understand it, and fully accept it. In whatever way is appropriate, the government should propose and justify the overall strategy of the adjustment program to the general public.
- The adjustment program must be realistic. It must be restrictive enough to be consistent with the financing available, but not so restrictive as to be likely to prove socially and politically unacceptable and therefore unsustainable.

Additional recommendations

1.9 In addition to these three prerequisites, the first report made several other recommendations:

- Because SALs and SECALs both provide balance of payments financing in support of policy and institutional reforms, both require an adequate macroeconomic framework for their suc-

cess. Furthermore, because balance of payments support is an extraordinary form of assistance for the Bank, it should be conditional on a set of policies that over time would eliminate the need for such extraordinary assistance.

- Adjustment operations should give greater emphasis to the social costs of adjustment. That requires a better understanding of the impact of adjustment policies on the poor and the design of policy measures to protect them.
- Adjustment lending should continue the trend toward establishing key conditions that would contribute significantly to removing the obstacles to sustainable growth. These conditions should relate to policy and institutional changes under the direct control of the government.
- Whether IBRD or IDA financing is involved, adjustment with growth requires a mix of balance of payments support and more traditional sector and project financing. In many countries, adjustment lending continues to have a large payoff in supporting policy and institutional reforms that remove impediments to growth. Nevertheless, the predominant share of the Bank's lending portfolio should continue to be for project financing. This is required by the Articles of Agreement and is consistent with the Bank's primary role as a development institution. The ceiling of a 25-percent allocation for IBRD adjustment operations should continue.[1]
- Adjustment lending should be closely monitored through periodic reports on adjustment lending and speedier completion of Project Completion Reports and Post-Project Audit Reports.

This report's findings: Policies for the recovery of growth

1.10 AGGREGATE EFFECTS OF STRUCTURAL REFORMS. Countries adopting adjustment programs have on average grown faster than other countries (chapter 2). After taking account of the effects of initial conditions, external shocks, and the amount of external financing, the countries that entered full-fledged adjustment programs (EIAL, or Early Intensive Adjustment Lending countries) had a larger increase in the average rate of GDP growth than other countries.[2] For some of these countries

Box 1.1 Updated patterns of adjustment lending

Adjustment lending, after growing rapidly in the first half of the 1980s, leveled off in 1986-88, when it averaged $4.5 billion a year or 24 percent of Bank Group lending (see chapter 5 annex tables for details). During CY89 the Board approved 33 adjustment operations for a total of $6 billion, up from 27 operations for $4.7 billion in CY88. Adjustment lending as a share of total approvals rose, by value, from 25 percent in CY88 to 27 percent in CY89. SECALs continued to grow in importance — with 19 SECALs approved in CY89, for a total of $4.1 billion, up from 18 for a total of $3.9 billion in CY88. The main features of the Bank Group's adjustment lending are as follows:

- IDA ADJUSTMENT LENDING. IDA adjustment loans now account for about a quarter of all IDA commitments and disbursements — mostly to Africa, where AL accounts for more than a third of the commitments and the net and gross disbursements.
- IBRD ADJUSTMENT LENDING. Because of fast disbursements and nonconcessional terms, adjustment lending has been a much higher share of IBRD net disbursements — more than 50 percent in the last two years — than of commitments or gross disbursements.
- CHARACTERISTICS OF ADJUSTMENT LOANS. SECALs account for all the growth in adjustment lending from CY82 to CY88, rising from a three-year total of $202 million in 1980-82 to $10.9 billion in 1986-88, with more than half the increase going to the highly indebted countries. SAL lending rose sharply in CY89.
- COUNTRY PATTERNS. Sixty-four countries have received adjustment loans as of the end of CY89, seven of them for the first time in CY89. Eleven countries have had five or more SALs or SECALs — Turkey and Mexico nine each, 20 countries three or four adjustment loans, and 33 one or two. Adjustment-lending countries are about equally divided between low-income and middle-income countries, with Sub-Saharan Africa accounting for most of the former and the highly indebted countries for most of the latter.
- REGIONAL PATTERNS. The regional shares of total adjustment-lending commitments in CY89 were similar to those in recent years: LAC 44 percent, followed by SSA 20 percent, Asia 19 percent, and EMENA 17 percent.
- SHARE IN GLOBAL LENDING. Initially minuscule in the global financial picture, Bank Group adjustment lending has risen to about 5 percent of all lending to developing countries in 1988, 8 percent to the highly indebted countries, and 9 percent to Sub-Saharan Africa.
- DISBURSEMENTS AND REPAYMENTS. Staff estimates indicate that net disbursements of adjustment lending for IBRD borrowers will stay positive for all regions and major aggregates in the next decade. For highly indebted countries, the net disbursements of adjustment lending will decline dramatically. For Sub-Saharan Africa, they will continue to grow slowly.

— such as Nigeria, the Philippines, Malawi, Côte d'Ivoire, and Mexico — growth was slower than country characteristics would have predicted. In other countries — such as Korea, Mauritius, Morocco, Ghana, and Thailand — programs supported by the Bank appear to have stimulated growth by more than the initial conditions, external shocks, and external financing would have suggested. Exports and domestic saving expressed as shares of GDP have increased substantially in the EIAL countries, both before and after controlling for factors.

1.11 Controlling for these same factors, investment fell on average as a share of GDP in the EIAL countries.[3] This means, however, that the relative efficiency of investment in EIAL countries rose, because they achieved higher growth with less investment. Both public and private investment declined. Often a decline in public investment was desirable, since its level was unsustainable and some of it had been misdirected. But for countries that have made major progress in reducing macroeconomic imbalances and reducing distortions and institutional weaknesses, and where the lack of appropriate infrastructure is a major impediment to the recovery of private investment, resuming public investment in infrastructure is important for restoring growth and for stimulating private investment. The reduction of private investment in the initial years of an adjustment program was predictable, because incentives were being changed and the credibility of the program was building. The counterpart of the temporary decline in the investment ratio is that adjusting countries were able to have higher private consumption than otherwise.

1.12 NEED FOR A SUPPORTIVE MACROECONOMIC ENVIRONMENT. A stable macroeconomic framework contributes to the success of structural adjustment in every major area of the economy (chapter 4). Adjustment programs are more likely to fail when a stable macroeconomic framework is not in place, even when the adjustment package focuses mainly on microeconomic and sectoral policies. So, in a country that starts with high inflation and a large current account deficit, the structural adjustment program should focus initially on measures to reduce inflation and the current account deficit. The macroeconomic situation will be supportive of the adjustment program when the inflation rate is low and predictable, real interest rates are appropriate, the real exchange rate is competitive and predictable, public sector saving rates are compatible with the resource mobilization requirements of the program, and the balance of payments situation is perceived as viable.

1.13 EFFECT OF ADJUSTMENT ON POVERTY AND LIVING CONDITIONS. When an economy has to adjust to adverse external shocks or to the effects of previous policy mismanagement, some short-run social costs are usually inevitable. Even a well-designed adjustment program harms some groups, while the majority benefits, since adjustment usually involves changing relative prices and reducing some government expenditures. When some of the poor are among the losers from adjustment, they suffer greatly since they were already at a subsistence level. Although the situation of the poor offers nothing for the Bank to be complacent about, there is no evidence that adjustment lending causes an increase in the overall misery of the poor. On the contrary, orderly adjustment, supported by Bank lending, seems to be less costly for most of the poor and for the general populace than disorderly adjustment without Bank support.

1.14 Changes in the available socioeconomic indicators of living conditions do not appear to be systematically related to adjustment lending (chapter 3). The rate of growth of private consumption in EIAL countries in 1985-88 increased in total and on a per capita basis, in comparison with other country categories and when controlling for other factors. Current consumption appears to have been protected — relative to other countries — by reductions in investment expenditures. Other short-run indicators, such as nutrition and immunization, have also improved for the EIAL countries. Long-run indicators of living conditions, such as infant and child mortality, have continued to improve in most countries, with or without adjustment lending. However, the poor quality and the aggregate nature of the data do not point to unqualified conclusions on these issues.

1.15 While socioeconomic indicators show continued improvement, the share of central government expenditure on the social sector has fallen slightly on average in countries with adjustment lending. Per capita social expenditures by the central government have also declined in some adjusting countries. It is not certain whether the declines in health and education expenditures caused a deterioration in the total services available to low-income groups or whether more was

paid by local governments and by higher-income clients. The declines in education expenditure have been accompanied by falling primary school enrollment ratios for the EIAL countries. To prevent declines in socioeconomic indicators, most adjusting countries need to increase social sector expenditures targeted toward the poor.

1.16 Since adjustment is taking longer in most countries than originally expected, recent adjustment operations supported by the Bank include more detailed analyses of the social impacts of adjustment programs and more measures to alleviate the short-run costs of adjustment to the newly unemployed and the poor. Such measures include reallocations of social expenditures toward services used by the poor, severance payments and retraining for newly unemployed workers, and public works and employment schemes for unskilled workers. In some cases, several targeted interventions have been assembled into multisector compensatory programs. The fiscal cost of these programs is relatively low and the main constraint has been government commitment to assist the poor and institutional capacity to reach the poor.

1.17 RAISING EFFICIENCY. Increases in the efficiency of investment can reduce the need for more saving. Distortionary policies, such as trade restrictions and financial repression, hold down the efficiency of investment and thus the rate of growth for a given investment level (chapter 8). Removing these distortionary policies does the reverse: increasing the efficiency of investment and the growth rate of GDP for a given level of investment. Furthermore, the analysis indicates that reform efforts must reach a critical mass to be effective: small decreases in extremely high distortions do not have much effect on growth. To have significant payoffs, reform programs usually must focus on large reductions in the large distortions.

1.18 INCREASING INVESTMENT. To sustain adjustment and restore growth, countries must not only reduce distortions, they must also create the conditions for the eventual increase in investment (chapter 6). Some countries, especially in Africa, need more domestic saving and external financing to reach investment levels consistent with the restoration of growth. But in many countries, the prevalence of capital flight indicates that stagnant investment results from inadequate demand for investment rather than from the unavailability of saving. In highly indebted countries, the debt overhang often creates uncertainties about the sustainability of the balance of payments situation and about macroeconomic stability, and thus may thwart the recovery of private investment. Debt and debt-service reductions in the context of adjustment programs can help reduce these uncertainties.

1.19 The eventual recovery of investment requires an appropriate and credible economic environment. Investment does not respond well when investors, foreign and domestic, doubt that the government will sustain its reforms and when legal and bureaucratic impediments are left untouched. Private investors often wait before making irreversible investment decisions, keeping their assets elsewhere. Providing appropriate public investments that complement private investment and getting a few private investors to commit themselves usually help to overcome the doubts of the majority. But there is no simple way to bring this about. The obvious remedy of investment subsidies is likely to be expensive and at odds with the objectives of leaving decisions to market forces and restoring fiscal balance. An appropriate strategy for increasing investment contains four elements:

- Establishing and maintaining macroeconomic stability, including a predictable and competitive real exchange rate, a low budget deficit, and low rates of monetary growth and inflation.
- Removing legal and bureaucratic impediments to investment by domestic and foreign firms, and providing clear rules for taxation, property rights, and the regulation of production and trade.
- Expanding public investment that is complementary to private investment.
- Ensuring sufficient external financing to support a sound program in both the medium and the long terms. In highly indebted middle-income countries committed to sustaining a reform effort, the Brady initiative and other debt-reduction schemes should help improve the viability and credibility of adjustment programs.

1.20 RAISING SAVING RATES. To sustain desirable rates of investment and growth, the saving rates in most adjusting countries have to increase, especially in typical African countries which started the 1980s with very low saving rates (chapter 7). The most effective way to increase saving in the initial years of an adjustment program is to increase public saving (chapter 7). Private saving,

responsive mainly to an increase in the GDP growth rate, starts to increase after growth gets under way. Once real interest rates are positive, further increases of real interest rates on deposits and special tax treatments for savings are unlikely to cause any large increase in saving rates.

1.21 REFINEMENTS. The findings of the second report confirm and extend some of the conclusions of the first report. The sequence of reform measures is crucial (chapter 4). In countries that start with high inflation and a large current account deficit, structural reforms aimed at restoring macroeconomic balances should be emphasized first. Sectoral reforms should be sequenced in a way that takes account of the linkages among sectors. For instance, trade liberalization is likely to improve efficiency more if accompanied by measures that improve the functioning of domestic markets for goods and credit, provide needed infrastructure, and reduce controls on domestic investment and impediments to labor mobility. In some low-income countries, barriers to the integration of the domestic economy — poor roads, inappropriate domestic transport infrastructure, lack of domestic financial markets, and so on — are the major impediments to successful adjustment and the restoring of economic growth and should be tackled first.

1.22 The data set on conditionality and implementation, with a much expanded sample of loans approved in FY79-88, showed most of the same patterns found last year and revealed some new ones (chapter 4). Countries begin implementing their structural adjustment program before the adjustment loans become effective and frequently continue implementation after disbursement ends. Nevertheless, a uniformly applicable way to measure the progress in implementation is to see what share of conditions in the loan agreements have been implemented by the time of final tranche release. Of all conditions in the loan agreements in the sample, 84 percent had been implemented at least substantially — better than found in the first report — and 66 percent had been implemented fully or more than fully by the time of final tranche release.[4] The implementation rates increased during the 1980s, both for countries that had adjustment lending since the early 1980s and for countries that started more recently. For the loans in the sample that had final tranche release in FY89, i.e., since the first report, 99 percent of the conditions were implemented at least substantially, and 80 percent of the conditions were implemented fully or more, as originally written in our sample. In the rare cases when a condition does not seem necessary as originally written, the Bank waives the condition, with approval from the Board. Not counting the one loan in the sample for which this occurred in FY89 would raise the proportion of fully implemented conditions from 80 to 88 percent. Thus, the final tranches were released only when all conditions in the loans were at least substantially fulfilled.

1.23 Governments have been more frequently able to develop and maintain political support for structural adjustment when the program was designed with this aim in mind and when the government was active in explaining the source of the problems addressed by the program, how the government plans to tackle them, why this is the best option, and how people can benefit from the new policy environment. Mobilizing beneficiaries to become political supporters usually follows. While technical considerations sometimes cause unavoidable delays in program implementation, more prompt implementation almost always increases the chances of political support. Awareness of the economic problems that motivated the initial decision for reform will be strongest at the beginning, giving the authorities maximum latitude for reform. The support for sustaining the new status quo then develops as structural reform pays off in growth and higher living standards.

1.24 Adjustment programs need to give greater attention to reforming and developing institutions in several areas: the agricultural sector in Sub-Saharan Africa, the financial sector and fiscal management in many countries, and public enterprises in almost all countries (chapter 4). Although adjustment programs often call for a reduction of resources going into the public sector, it is equally important to strengthen public institutions through improved policies, organization, and management. Institutional development is essential for both the implementation and the ultimate success of many of the reforms the Bank supports.

Main recommendations of this report

1.25 This report has five main recommendations: removing distortions, increasing the priority of public sector reforms, increasing investment, timing disbursements with reforms, and ensuring macroeconomic stability. It thus extends the recommendations of the first report.

Removing distortions

1.26 The sequencing of a country's overall adjustment program should start with reforms that substantially reduce the largest distortions impeding the efficient allocation of resources and limiting output growth. When a country has acute macroeconomic imbalances, that is the largest distortion. There are increasing returns to reforms for an economy that begins adjustment with a high degree of distortion; the productivity-enhancing effect of any reform element is substantially reduced if major distortions remain in other areas and limit the payoff (chapter 8). As was recognized when the Bank began adjustment lending, a critical mass of reforms ordinarily requires more than one adjustment loan. But once the government and the Bank agree on the overall strategy of reform, the loans should be sequenced in a way that addresses the largest distortions first. If the largest impediments to restore macro balances, to improvements in efficiency and the expansion of saving, investment, and growth are not dealt with early on, the efficiency of adjustment lending is severely curtailed.

Increasing the priority of public sector reforms

1.27 Public sector reform programs aimed at permanently reducing public sector deficits and increasing efficiency should have high priority in most adjusting countries (chapter 4). In countries suffering major macroeconomic imbalances, a credible reduction of the public sector deficit is needed to restore macroeconomic balances. Therefore, structural reforms aimed at achieving a sustainable reduction in the public sector deficit are a high priority for these types of countries. Fiscal reforms are also important in countries with inefficient regulation and taxation and in countries that need to generate revenue in support of social expenditures and infrastructure investment. Some public sector reforms require institutional development and training and therefore need to be phased in gradually. Converting public enterprises to mixed or private ownership involves complex and time-consuming organizational and regulatory changes that need to be addressed carefully in the preparation and implementation of the loan. The pace of disbursement should reflect the longer time needed for these reforms.

Increasing investment

1.28 In countries that have already removed major policy distortions, adjustment programs must give special attention to inducing a recovery of investment. This requires maintaining a stable set of policies (especially macroeconomic and trade policies), removing the major impediments to factor mobility, and securing a steady flow of foreign financing over a multi-year horizon (chapter 6). In addition, public investment programs should be restored and sustained in areas that complement and encourage private investment. Support for public investment should emphasize expansion of infrastructure and human capital. SECALs should encourage the investment response in these countries not only by increasing the availability of financing but also by supporting policy reforms to remove the major obstacles to private investment — for instance, ill-defined property rights, excessive regulation and licensing, and barriers to labor mobility. For these countries, the Bank's lending program should also increase the emphasis on investment lending as a way to realize the fruits of the structural reforms.

Timing and continuity of support for reforms

1.29 Traditional quick-disbursing loans are appropriate in countries with balance of payments problems and major distortions that can be quickly removed, such as price subsidies, excessive government spending, and import quotas. However, when structural reforms that inevitably have a long implementation period are required (tax reform, financial sector reform, social sector reform, and public enterprise restructuring and privatization), the pace of disbursement should be matched to the speed at which the reforms are introduced. Assurance of a continued flow of financial support for such reforms can also increase the credibility and ultimate success of the policies being implemented. If balance of payments support is not required, it should be possible to support policy reforms through sectoral investment loans with enhanced policy content.

Ensuring macroeconomic stability

1.30 Since the ultimate success of adjustment of all kinds requires a sustainable macroeconomic situation, the program design should ensure

macroeconomic stability. When a macroeconomic situation is initially unsustainable, the early phase of the program should focus on measures to restore macroeconomic stability. Unless there is macroeconomic stability, capital inflows will be wasted or flow back out as capital flight.

Other supporting recommendations

1.31 Adjustment lending operations should be designed with the effects on poverty firmly in mind. The lack of reliable data, and the difficulties of separating the costs of adjustment from the costs of external shocks or poor policies, imply a continuing need for careful monitoring and analysis of the effects of adjustment on poverty. Adjustment programs should include poverty alleviation as an objective and provide measures to reduce the potential short-run burden on the poor of external shocks or adjustment policies. Social sector project loans or SECALs should complement adjustment policy reforms by supporting measures to achieve fundamental social objectives, such as improving the nutrition, health, and education of the poor. This lending should be an integral part of the overall adjustment program.

1.32 In countries that have made major progress in restoring macro balances and that have strong anti-export bias, adjustment lending operations should support policy reforms aimed at reducing the average level and variance of protection and the implementation of complementary reforms in domestic policy.

1.33 When a poorly developed financial sector is a major obstacle to an appropriate supply response, financial reforms need to be at the core of an adjustment program. Given the difficulties of implementing such reforms, aspects that require institutional and human capital development should be supported with slower-disbursing instruments, such as sectoral investment loans.

1.34 Technical assistance, as a component of a SAL or SECAL or as a free-standing operation tied to a SAL, is often important for preparing and implementing a complex adjustment program and for building institutional capacity in the public sector. Thus, technical assistance should receive increasing emphasis, in order to help countries formulate their adjustment programs in the areas of taxation, trade, and financial policy and public sector restructuring and privatization.

1.35 In countries with geographically fragmented domestic economies, the Bank should give increasing importance to policy reforms that develop institutions, reform regulations, and improve infrastructure to remove obstacles and distortions to domestic trade and factor mobility.

1.36 The design of adjustment programs should take into account the political support necessary to sustain the program — support that will enhance the credibility and ultimately the likelihood of long-run success. Compensatory measures, such as severance pay and job retraining, should encourage exit from groups that oppose the reforms and entry into groups that benefit from (and will support) the program. For the typical country in a crisis, reforms should come as early as is technically feasible, because political toleration for reform is almost always strongest at the beginning and because prompt action usually enhances credibility.

1.37 Consultative Group meetings can do much to ensure adequate and appropriate financing. As is often done already in Africa, greater attention needs to be paid to ensuring the adequacy of finance over a two-year or three-year period, instead of the conventional one-year (budget-driven) focus. As is being done for many African countries and Brady Plan participants, adjustment programs of both middle- and low-income countries should be supported more often with multi-year and contingency-financing arrangements.

1.38 As was argued in the Long-Term Perspective Study on Africa, policy-based lending for Sub-Saharan Africa should give increased emphasis to developing institutions and human capital.[5] It should also have a time frame corresponding to the relatively long period usually required to increase significantly the production of nontraditional exports.

1.39 Adjustment lending has proven itself a valuable instrument for supporting countries that are committed to reform their economic policies and reform their institutions. Although adjustment lending has encountered some difficulties, they are not so severe as to invalidate the strategy (box 1.2). The recommendations of this report aim to improve further the design of adjustment programs in the countries and the procedures of the Bank for supporting them.

Box 1.2 Nine criticisms of adjustment lending

To appreciate the main issues related to adjustment lending, it is useful to review some of the main criticisms of adjustment lending made in recent years. These are serious issues, which the rest of the report addresses, and this box only touches on the main points.

1. *"The Bank forces countries to undertake reforms that they would never choose freely."*

Countries have to decide by themselves whether to adjust, when to adjust, how to adjust, and whether to seek Bank support. For countries that seek its support, the Bank can help identify the components of a structural adjustment program that could best contribute to growth while protecting the poor. The financial support helps the countries to time the implementation of reforms in accord with the expected response, and in this way to carry out a credible and sustainable adjustment program. When a country does not perceive that the current state of affairs is unsustainable, the most productive role for the Bank is to assist the country in its diagnosis of the situation and to help identify the costs and benefits of adjusting now, in an orderly way, rather than adjusting later in the midst of a larger crisis.

2. *"Bank-supported structural adjustment programs have negative effects on the poor, which make the programs politically less viable."*

The root of the problem is in unsustainable policies sometimes as a consequence of the changed external economic environment (often compounded by inadequate national economic management), not in the measures taken to cope with these difficulties. One must consider what would have happened to the poor if the reduction of expenditures had been done without a Bank-supported program. The alternative is not between adjustment and nonadjustment but between different forms of adjustment. Evidence in this report indicates that adjustment programs have not negatively affected the standard aggregate indicators of welfare (see chapter 3). Furthermore, as adjustment often has taken longer than originally envisaged, Bank-supported adjustment programs increasingly include components to protect the poorest groups in the population through the use of well-targeted programs.

3. *"Bank-supported adjustment programs have a recessive bias."*

For a country facing a balance of payments situation that is unsustainable even in the short run, the Bank (often in conjunction with the IMF) supports a structural adjustment program that includes both stabilization and structural adjustment components. Well-designed structural adjustment programs therefore have, in the medium term, a less recessionary effect than programs that rely more heavily on expenditure-reducing policies. A country that cannot finance its current account deficit needs to raise output relative to expenditure, since the current account deficit is equal to their difference. To minimize the potential output contraction in countries where nontraded goods are a large share of GDP, the relative price of tradables must increase through a real devaluation. When institutions are weak and domestic markets function poorly, supply-enhancing policies need to include a major structural component aiming at facilitating resource reallocation and the response to changes in incentives. In the short run, the additional external financing provided by the Bank helps maintain both output and expenditures at higher levels than would otherwise have been possible.

4. *"Reducing the anti-export bias of policies, as the Bank usually recommends, results in a large drop in the terms of trade."*

Reducing the anti-export bias in an individual country is unlikely to have a large enough effect on world supply to alter the country's terms of trade, especially for nontraditional commodities. Often the export expansion from improved incentives affects chiefly nontraditional goods, where the share of a developing country in world trade would be small (Latin America's share in world exports of manufactures was only 1.7 percent in 1986). Even for traditional commodity exports, very few countries face a situation where terms of trade would decline seriously if developing countries increased exports together.

5. *"Adjustment operations supported by the Bank have a pronounced bias against government."*

Government actions are certainly crucial to successful adjustment and growth, but in developing countries the public sector is often overextended. Public enterprises in particular may be economically inefficient and run large deficits that add to the difficulties of macroeconomic management. An adjustment program should set priorities for the public sector, concentrating its resources in areas where it has an essential contribution to make (as in primary education, basic health, the regulatory framework, macroeconomic policy management, and basic social and economic infrastructure). The public sector should get out of activities where competing private firms could do a better job (as in manufacturing and marketing). More attention should go to the efficient management of enterprises remaining in the public sector. Government economic controls should be pared back if they serve mainly to promote favored private interests at the expense of the general welfare. The appropriate role of the state no doubt varies among countries, but the common goal is for the government to concentrate on doing things that only it can do and that it can do well. The public sector thus needs to strengthen its role in some areas and to reduce its role in others.

6. *"SALs are becoming too ambitious and complex."*

Conditionality is actually becoming more focused and specific. In addition, the Bank is lending more through SECALs, which focus on one sector, with only the necessary complements of reforms in other sectors and on a suppor-

(continued)

Box 1.2 (cont.)

tive macroeconomic framework. In some cases, however, where macroeconomic and fiscal problems are at the core, a SAL supporting both stabilization and structural reforms to restore macroeconomic balances is more appropriate. SALs are also the instrument of choice when a thorough evaluation reveals that sustainable growth requires corrections of economywide distortions.

7. "SALs have been based on unrealistic assumptions about the probable responses to changes in prices. Bank staff have been overly optimistic, in particular about the responses of savers, investors, and exporters."

This was in some cases a problem with early loans. Moreover, both the countries and the Bank have learned that, to obtain a response to a change in prices, the economic program must be perceived by economic agents as credible given the country's characteristics, including its institutional capacity. Once a program is formulated, the government needs to be fully committed to it. Indeed, the major resource reallocation that is usually needed will not materialize if improved incentives are perceived as only temporary. For example, the export response to a real exchange rate change is much smaller when people question whether the change will last, a conclusion confirmed by empirical evidence.

8. "Bank-supported adjustment loans merely bail out the commercial banks, and do not benefit the borrowing countries."

Many adjustment loans are made to countries whose debts are not primarily to commercial banks. In other cases, it is important that the commercial banks and other creditors share with the international agencies the burden of dealing with the debt crisis. Although progress was initially slow here, the Brady Plan should help achieve appropriate burden sharing. Chapter 5 addresses this issue.

9. "Reforms that benefit a country should not need the financial support of the Bank."

In times of very limited access to international financial markets, resources mobilized through a Bank-supported adjustment program allow the adjusting country to adjust expenditure at a more efficient pace than otherwise possible. As a result of the additional external financing, the country can focus more on output growth from efficiency-enhancing measures and less on expenditure-reducing policies. This strengthens the political and social feasibility of an orderly (rather than a disorderly) adjustment process.

2

Effectiveness of adjustment programs

Summary

2.1 Bank involvement in a country's adjustment program has, on average, been associated with better growth performance. Developing countries that adjusted early and intensively, with the assistance of Bank adjustment lending, on average grew faster than they would have without a Bank-supported program. The countries also expanded exports, restrained consumption by the public sector, and increased their domestic saving rates more than did other developing countries. Only rarely, however, did they experience an increase in investment, either public or private. The eventual recovery of sustainable growth will require substantial increases in efficient investment. Future adjustment programs thus need to do more to create conditions for increases in efficient investment.

2.2 These conclusions come from an evaluation of the performance of three country groups: the early intensive-adjustment-lending (EIAL) countries, other adjustment-lending (OAL) countries, and non-adjustment-lending (NAL) countries. Countries were assigned to the groups according to the number of adjustment loans that they have received and when they received the first one. The EIAL group — the main focus of analysis — includes countries with different degrees of success in using adjustment lending. The averages reported, therefore, reflect the cases of unsuccessful as well as successful adjustment lending. The discussion in the section on effectiveness does differentiate performance among EIAL countries, after controlling for its main determinants. For the three groups, performance during 1985-88, after the initiation of adjustment lending, was compared with performance during 1970-80 and 1981-84.

2.3 Comparing performance during 1985-88 with that during 1981-84, making adjustments for the effects of initial conditions, the severity of external shocks, and other nonprogram factors, adjustment programs for the EIAL countries are estimated to have boosted GDP growth by close to 2 percentage points. Most EIAL countries improved their growth by shifting more rapidly into the production of tradable goods, with the expansion of net exports (exports minus imports of goods and nonfactor services) offsetting the effects of contractionary fiscal policies that were required to reduce unsustainable current account deficits. The less successful EIAL countries did not shift fast enough from nontradable to tradable activities, usually because of market distortions and institutional weaknesses or because their macroeconomic stabilization programs broke down.

2.4 The experience of the EIAL countries shows that if a country can implement a real devaluation and increase net exports to offset the reduction in domestic spending — and promptly implement measures to increase efficiency — it can avoid a recession and get increase in output. Moreover, as private investors realize that the adjustment program's new incentives are credible (and consistent with long-run economic objectives), they increase investment. Output and

saving then rise further as investment boosts the growth of capacity. Getting into this virtuous cycle takes time, however — typically four to eight years.

Introduction

2.5 The Bank's first report on adjustment lending concluded that the 30 countries receiving adjustment loans before 1985 performed better on average, by the end of 1987, than developing countries not receiving such loans. This conclusion was based on two comparisons: between the performance of countries before and after receiving adjustment loans, and between the average performance of countries receiving adjustment loans before 1985 and that of countries not receiving such loans. The 30 countries receiving loans had modest improvements in performance despite facing a more unfavorable external environment than the other group of countries. The 12 countries that received three or more adjustment loans before 1987 had more pronounced improvements.[1]

2.6 This second report focuses mainly on the contribution of adjustment lending to sustainable growth. For this purpose, it examines the performance of intermediate indicators of structural transformation — saving ratios, investment ratios, and export ratios — along with the rate of output growth. The analysis groups countries into three categories: early intensive-adjustment-lending (EIAL), other adjustment-lending (OAL), and non-adjustment-lending (NAL) countries (table 2.1).[2] In response to the Board's discussion of the first report, this chapter assesses the effects of adjustment lending using improved statistical techniques that take into account the nonprogram determinants of economic performance and the special characteristics of countries that decide to participate in an adjustment program. The technique thus attempts to isolate the effect of Bank-supported programs.

2.7 The performance of an adjusting country results from (a) the policies that would have been in place in the absence of adjustment lending from the Bank, (b) world economic conditions, (c) the effects of a Bank-supported program, and (d) other shocks to the economy (droughts, earthquakes, etc.). To isolate the net contribution of the Bank-supported program, we create a counterfactual scenario by estimating the effects on performance of:

Table 2.1 Country classification

I. EIAL (Early Intensive-Adjustment-Lending Countries)(25)

Bolivia *	Mauritius
Brazil	Mexico
Chile	Morocco
Colombia	Nigeria*
Costa Rica	Pakistan *
Côte d'Ivoire	Philippines
Ghana *	Senegal *
Jamaica	Tanzania *
Kenya *	Thailand
Korea, Rep. of	Togo *
Madagascar *	Turkey
Malawi *	Zambia *
Mauritania *	

II. OAL (Other Adjustment-Lending Countries)(25)

Argentina	Indonesia
Bangladesh *	Mali *
Burkina Faso *	Niger *
Burundi *	Panama
Central African Rep. *	Sierra Leone *
China *	Somalia *
Congo, People's Rep. of	Sudan *
Ecuador	Tunisia
Guinea *	Uruguay
Guinea-Bissau *	Yugoslavia
Guyana *	Zaire *
Honduras	Zimbabwe
Hungary	

III. NAL (Non-Adjustment-Lending Countries) (28)

Algeria (NA)	Malaysia (NN)
Benin * (NA)	Myanmar * (NA)
Botswana (NN)	Nicaragua (NA)
Cameroon (NA)	Oman (NN)
Dominican Republic (NA)	Papua New Guinea (NA)
Egypt, Arab Rep. of (NA)	Paraguay (NA)
El Salvador (NN)	Peru (NA)
Ethiopia * (NA)	Portugal (NN)
Greece (NN)	Rwanda * (NA)
Guatemala (NN)	Sri Lanka * (NA)
Haiti * (NA)	Syrian Arab Republic (NN)
India * (NN)	Trinidad and Tobago (NA)
Jordan (NA)	Venezuela (NA)
Liberia * (NA)	Yemen Arab Republic *(NN)

EIAL: countries that have received two SALs or three Adjustment Operations or more, with the first adjustment operation in 1985 or before.
OAL: other countries receiving adjustment lending.
NAL: countries that did not receive adjustment lending in the period 1980 to 1988.
Low-income countries (*) are IDA countries, and middle-income countries are non-IDA countries.
NA: countries that did not adjust although it was necessary for them to do so.
NN: other NAL countries.

• The economic policies in the preprogram period (indicated by real exchange rate, fiscal deficit to GDP ratio, and annual rate of inflation).

• The initial values of the performance indicators (GDP growth and the ratios of investment, saving, and exports to GDP).

• The external shocks in the current period (terms of trade, real interest rates, and actual external financing).

The performance of each indicator in 1985-88, the period after adjustment was initiated, is compared with performance in 1970-80 and in 1981-1984. Because some countries started to receive adjustment lending in the early 1980s, the base period 1970-80 corresponds more closely to a period before adjustment lending.

Determinants of performance

2.8 Initial conditions and external shocks are important determinants of performance and the demand for adjustment lending. Countries receiving adjustment loans are supposed to follow policies designed to reduce the current account deficit to a level compatible with sustainable financing — while implementing supply-side policies that improve economic efficiency. For countries without normal access to international capital markets, the evolution of the resource balance deficit (net imports of goods and nonfactor services) must follow closely the availability of financing. Thus, for countries that had their access to international capital markets seriously curtailed, the reduction of the resource balance deficit by itself is not a reliable indicator of program performance. Such a reduction can be achieved with very different saving and investment ratios and thus have very different implications for long-term growth.

2.9 As chapter 4 shows, aggregate fiscal, monetary, and exchange rate policies are the key macroeconomic tools for adjustment. The most common microeconomic reforms involve trade policy, agricultural policy, public sector management, the regulatory system, the financial system, and tax and expenditure policy. The reforms enhancing microeconomic efficiency are usually expected to increase output growth in the medium to long term. Initial conditions, external shocks, and macroeconomic policies mostly affect short to medium-term performance, examined in this chapter. After analyzing the initial conditions and external shocks, we examine the stance of macroeconomic policy. Then, we assess the effectiveness of adjustment programs by comparing the performance of EIAL and other countries, making statistical adjustments for nonprogram characteristics — initial conditions, external shocks, and policies before the program was put in place.

Table 2.2 Initial conditions (period average, 1970-80)

	1 External debt as % of GDP	*2 External debt as % of exports*	*3 Real effective exch. rate*	*4 Fiscal deficit as % of GDP*	*5 Resource balance as % of GDP*	*6 Annual avg. rate of inflation*	*7 Real GDP growth*	*8 Domestic saving as % of GDP*	*9 Investment as % of GDP*	*10 Exports as % of GDP*
EIAL countries	41.5 (3)	204.7 (2)	98.3 (3)	-6.4 (2)	5.1 (1)	23.2 (3)	4.6 (2)	17.4 (1)	22.5 (2)	24.2 (2)
LIC	46.5	180.6	97.9	-9.0	5.9	13.5	4.0	16.9	22.8	29.1
MIC	35.1	235.2	98.6	-3.2	4.2	34.7	5.5	17.9	22.1	17.9
OAL countries	39.6 (2)	206.2 (3)	97.9 (2)	-7.0 (3)	7.3 (3)	21.3 (2)	3.9 (3)	14.0 (3)	21.3 (3)	22.2 (3)
LIC	39.7	255.6	98.7	-9.1	10.2	13.7	3.2	8.1	18.3	18.0
MIC	39.5	143.3	96.8	-4.3	3.6	28.9	4.8	21.4	25.0	27.5
NAL countries	29.7 (1)	144.6 (1)	97.8 (1)	-4.4 (1)	6.7 (2)	12.2 (1)	5.5 (1)	16.7 (2)	23.4 (1)	26.3 (1)
LIC	23.8	195.7	97.5	-4.6	7.8	10.5	4.1	9.7	17.5	19.0
MIC	32.5	120.4	97.9	-4.3	6.1	13.2	6.2	20.1	26.2	29.7
NA	33.9	140.2	97.2	-4.6	6.5	12.3	4.7	15.7	22.2	25.7
NN	22.2	152.4	98.7	-3.0	7.0	12.0	7.0	18.6	25.6	27.3

Source: World Bank data.

Note: The ratios of the first two columns are computed with data in current U.S. dollars. For those columns the period used is 1975-80. Debt ratio data include total disbursed guaranteed and nonguaranteed debt. Column 4 considers only the average of the period 1976-80 and is based on IMF data; for this column Algeria, Bolivia, Indonesia, and Jamaica have data available only since 1979, Guinea-Bissau and Morocco since 1978 and Brazil, Burkina Faso, China, Congo, Greece, Niger, and Portugal since 1977. In column 2, exports of GNFS are obtained from balance of payments statistics from the World Bank data files. Individual country averages for the three periods are unweighted averages except for columns 6 and 7. In the latter two cases, least-squares growth rates are used. In the cases of missing information, the average was computed for the countries with data on Y.

All group results are unweighted averages of individual country averages. The numbers in parentheses are the ranking of a group of countries for that indicator (where "best" is 1).

Initial conditions

2.10 Among the three groups of countries (EIAL, OAL, NAL), in the 1970-80 base period, EIAL countries had the highest saving rate, the second highest investment rate, the lowest resource balance deficit, and the second lowest fiscal deficit, all as shares of GDP (table 2.2). In other words, they were outstanding performers. But they also had the highest average inflation rate and the highest ratio of external debt to GDP.[3] For GDP growth and the ratios of debt to exports and of exports to GDP in current prices, the EIAL countries were between the OAL and NAL countries.

2.11 The OAL countries had the slowest GDP growth, the highest debt to export ratio, the highest ratios of fiscal and resource balance deficits to GDP, and the lowest ratios of saving, investment, and exports to GDP in current prices. They did not rank first on any of the 10 indicators for 1970-80 in table 2.2. In contrast, the NAL countries had the most favorable ranking for eight of the ten indicators, and for the saving rate and the resource balance deficit to GDP they ranked second. From the review of the initial conditions in each group of countries, it appears that the NAL countries on average did not need to adjust — and that the EIAL countries also did quite well in the 1970s, except in their debt indicators.[4] Within the country groups, there are important differences between the averages of the low-income and middle-income countries. The low-income countries (all IDA borrowers) had the lowest saving rates and GDP growth rates and the largest fiscal deficit as a share of GDP, but they also had the lowest average inflation.[5] Within the NAL countries, the NA and the NN groups had quite similar initial conditions except that the rate of growth of GDP, the domestic saving rate, and the investment rate were much higher for the NN group. In contrast, the external debt to GDP ratio was much lower for the NN group.

External shocks

2.12 The early 1980s brought a world recession, the highest real interest rates since the Great Depression, declining and often volatile terms of trade, and for many middle-income countries a sudden cutoff from international financial markets.[6] The combined terms of trade and interest

Table 2.3 External shocks

	1981-84 compared with 1970-80			*1985-88 compared with 1970-80*			*1985-88 compared with 1981-84*		
	Terms of trade	*Real interest rate*	*Total shock*	*Terms of trade*	*Real interest rate*	*Total shock*	*Terms of trade*	*Real interest rate*	*Total shock*
EIAL countries	-10.5	-1.9	-12.4	-6.0	-3.2	-9.2	1.1	-0.2	0.9
LIC	-10.6	-2.0	-12.5	-7.0	-3.6	-10.6	0.6	-0.4	0.2
MIC	-10.4	-1.8	-12.2	-4.6	-2.9	-7.5	1.8	0.1	1.9
OAL countries	-2.9	-2.0	-4.9	-3.4	-3.6	-7.0	-0.4	-0.6	-1.0
LIC	-8.2	-1.6	-9.9	-6.2	-4.2	-10.3	1.2	-1.3	0.0
MIC	3.8	-2.4	1.4	0.2	-3.0	-2.8	-2.5	0.3	-2.2
NAL countries	-10.4	-1.2	-11.6	-13.9	-2.0	-15.9	-3.3	-0.3	-3.6
LIC	-18.7	-0.9	-19.5	-14.5	-1.8	-16.3	-1.3	-0.6	-1.9
MIC	-6.5	-1.3	-7.8	-13.6	-2.1	-15.7	-4.3	-0.1	-4.4
NA countries	-7.8	-1.3	-9.2	-13.9	-2.1	-16.1	-3.8	-0.2	-4.0
NN countries	-15.1	-0.8	-15.9	-13.8	-1.9	-15.7	-2.5	-0.5	-2.9

Source: World Bank data.

Note: The total effect of external shocks as % of GDP is computed as the sum of the real interest rate effect and the terms of trade effect. The interest rate effect is calculated as $-(r-r_{base})^{*}(debt/GDP)_{beg}$, where r is the real interest rate computed as $(i-dp/p)/(1+dp/p)$; r_{base} is the average real interest rate of base period (1975-80); (1981-84); it is the ratio of interest payments to total debt; interest payments are calculated by adding public interest payments to private interest payments; private interest payments are proxied by multiplying private debt by L (L equals three-month annualized LIBOR plus one percent); the private debt is estimated by subtracting public and publicly guaranteed debt from total debt; dp/p is "world" inflation (proxied by the percentage change of the U.S. GNP deflator), and $(debt/GDP)_{beg}$ is the ratio of debt to GDP of the year preceding the beginning of the end period. Debt data correspond to total disbursed guaranteed and nonguaranteed debt. Debt and interest rates information is available starting in 1975 only. Therefore, the average for the period 1970-80 is estimated using information for the period 1975-80.

The effect of terms of trade is computed as $((PX/PX_{base})-1)^{*}(X/GDP)_{beg}-((PM/PM_{base})-1)^{*}(M/GDP)_{beg}$, where PX and PM are the average export and import price indices deflated by US GNP deflator, respectively; PX_{base} and PM_{base} are the average price indices of the base period; X and M are exports of GNFS and imports of GNFS; and $(X/GDP)_{beg}$ and $(M/GDP)_{beg}$ are the ratios of X and M to GDP respectively at the year preceding the beginning of the end period. All the variables are denominated in current U.S. dollars.

rate shocks, comparing 1981-84 with 1970-80, caused an average annual loss of around 12 percent of the 1980 level of GDP for the EIAL and NAL countries and about 5 percent of GDP for the OAL countries. Comparing 1985-88 with 1970-80, the EIAL countries had a total external shock that was negative but not as large as that of the NAL countries (see table 2.8 for country differences). By contrast, when comparing 1985-88 with 1981-84, the external situation of the EIAL countries improved after 1985, but did not return to the levels of 1970-80. The OAL and NAL countries faced a continuing deterioration of their external conditions (table 2.3).[7]

2.13 For all three categories, average nonofficial net financial flows peaked at just over 3 percent of GDP and eventually fell to about zero, but the timing differed (table 2.4). Financing for EIAL countries peaked in 1981-82, and then fell sharply. External financing for OAL countries peaked in 1975-80 and fell to zero by 1983-84; for NAL countries it did not peak until 1981-82 and did not fall substantially until 1985-88. For both the EIAL and OAL countries, the drastic and sudden reduction in external financing came on top of negative terms of trade and interest rate shocks.

2.14 If the developing countries had perceived the external shocks of the early 1980s as temporary and if financing had been available, they might have pursued the option of using foreign reserves and foreign borrowing to avoid adjustment — a response that would have been appropriate if the shocks had indeed been temporary. But with the exception of IMF and World Bank lending, which was conditional on the adoption of an adjustment program, foreign credit dried up after August 1982. Moreover, once it became clear the adverse external environment would continue for some time, the countries had to adjust. Few countries had the option of working gradually back to internal and external balance by implementing appropriate adjustment policies, assisted by foreign commercial borrowing.

Table 2.4 Nonofficial external financing before and during adjustment — net flow as % of GDP

	1975-80	*1981-82*	*1983-84*	*1985-88*
EIAL countries	1.8	3.3	0.4	0.0
LIC	0.6	3.2	-0.2	-0.5
MIC	3.3	3.3	1.3	0.7
OAL countries	3.0	1.1	0.6	0.5
LIC	2.8	-0.3	1.0	0.3
MIC	3.3	2.9	0.2	0.8
NAL countries	1.1	3.1	2.2	-0.2
LIC	0.3	2.1	0.5	0.8
MIC	1.5	3.5	3.1	-0.7
NA	1.5	3.0	1.9	-0.8
NN	0.4	3.1	2.8	0.7

Source: World Bank data.
Note: The net capital flows correspond to net long and short-term capital flows obtained from balance of payments minus net flows (disbursements minus amortizations) provided by official (bilateral and multilateral) creditors. All variables are denominated in current U.S. dollars.
Panama is not included in the data to avoid the distortions that the enormous capital flight suffered by that country causes on the aggregate.

Policy stance

2.15 To see how the policy stance changed in EIAL countries, this section examines four indicators — the real effective exchange rate, the inflation rate, and the fiscal deficit and resource balance deficit as shares of GDP (table 2.5). Although a government cannot directly control the real effective exchange rate or the inflation rate, their evolution results from fiscal, monetary, and exchange rate policies. For countries that had to reduce their current account deficits, a substantial real devaluation was an important component of successful adjustment programs. And for many countries after 1982, the available financing, rather than policies, determined the evolution of the resource balance deficit.

2.16 Comparing 1981-82 with 1970-80, the EIAL countries experienced an increase in the fiscal deficit as a share of GDP, an appreciation of their currencies, an increase in their average inflation rates, and an increase in their average resource balance deficits. After 1981-82 both the low-income and medium-income EIAL countries improved their fiscal situation and achieved a continuous real depreciation. Nevertheless, average inflation rose continuously, the result of the greater monetization of their (smaller) fiscal deficits. The middle-income EIAL countries with large external public debts did adjust their budgets in response to the sharp drop in their capacity to borrow abroad. But at the same time interest payments on existing external debt were increasing, and government revenues were suffering from the worsened terms of trade.[8] The resource balance deficit as a share of GDP in both groups of EIAL countries was reduced by more than half between 1981-82 and 1983-84.

2.17 To deal with the fiscal crisis starting in 1981-82, the typical EIAL country cut its public expenditures (usually by drastically reducing

Table 2.5 Selected indicators of policy stance

	Real effective exchange rate [a]				*Ratio of fiscal deficit to GDP* [b]			
	1970-80	*1981-82*	*1983-84*	*1985-88*	*1970-80*	*1981-82*	*1983-84*	*1985-88*
EIAL countries	98.3 (3)	110.7 (3)	103.6 (2)	79.0 (1)	-6.4 (2)	-7.6 (3)	-6.2 (1)	-4.6 (1)
LIC	97.9	116.5	111.5	83.5	-9.0	-9.8	-7.4	-5.0
MIC	98.6	103.4	93.5	73.3	-3.2	-4.9	-4.7	-4.0
OAL countries	97.9 (2)	104.2 (1)	103.4 (1)	81.1 (2)	-7.0 (3)	-7.3 (2)	-7.6 (3)	-8.4 (3)
LIC	98.7	104.3	111.7	81.2	-9.1	-8.8	-9.8	-11.8
MIC	96.8	104.2	92.8	81.0	-4.3	-5.4	-4.8	-4.1
NAL countries	97.8 (1)	108.7 (2)	116.7 (3)	115.0 (3)	-4.4 (1)	-6.7 (1)	-7.0 (2)	-6.4 (2)
LIC	97.5	105.6	114.5	106.4	-4.6	-7.7	-8.5	-7.9
MIC	97.9	110.3	117.7	119.1	-4.3	-6.2	-6.3	-5.7
NA	97.2	107.6	115.0	118.1	-4.6	-6.0	-7.3	-7.2
NN	98.7	110.8	119.8	109.1	-3.0	-7.9	-6.5	-4.9

	Annual average rate of inflation [c]				*Ratio of resource balance deficit to GDP*			
	1970-80	*1981-82*	*1983-84*	*1985-88*	*1970-80*	*1981-82*	*1983-84*	*1985-88*
EIAL countries	23.2 (3)	27.5 (3)	59.8 (3)	150.4 (3)	5.1 (1)	7.1 (1)	3.2 (1)	1.4 (1)
LIC	13.5	24.9	78.2	228.4	5.9	9.2	4.1	3.4
MIC	34.7	30.6	38.0	51.2	4.2	4.5	2.0	-1.2
OAL countries	21.3 (2)	22.3 (2)	44.6 (2)	37.6 (1)	7.3 (3)	10.9 (2)	7.7 (2)	6.8 (3)
LIC	13.7	18.9	26.3	23.1	10.2	16.8	15.2	12.5
MIC	28.9	25.7	63.0	52.1	3.6	3.9	-1.1	-0.5
NAL countries	12.2 (1)	13.5 (1)	15.2 (1)	135.7 (2)	6.7 (2)	12.6 (3)	7.7 (2)	5.6 (2)
LIC	10.5	7.8	7.6	5.9	7.8	16.1	10.0	7.8
MIC	13.2	16.0	18.5	186.1	6.1	10.9	6.6	4.5
NA	12.3	13.8	17.1	191.8	6.5	12.7	8.0	6.3
NN	12.0	12.8	11.4	16.4	7.0	12.3	7.1	4.3

Source: World Bank data.
a. Real effective exchange rates are drawn from the IMF database where the first column considers only the average of the 1978-1980 period. A decrease in the index (1980=100) indicates a real depreciation.
b. IMF Data.
c. Inflation rates are measured using the CPI.
Algeria, Bolivia, Indonesia and Jamaica have data available only since 1979.
Guinea-Bissau and Morocco have data available only since 1978.
Brazil, Burkina Faso, China, Congo, Niger and Portugal have data available only since 1977.
1976 and 1988 data for Greece are missing.
Figures in parentheses indicate the ranking for the variable; (1) indicates the best performance.

public investment), increased its revenue, and relied more on domestic financing of the budget deficit (through domestic interest-bearing debt or credit from the central bank). The recession complicated the fiscal situation further. Fiscal adjustment was usually a prerequisite for improving internal macroeconomic stability and usually at the core of the structural adjustment program. For the EIAL countries, the resource balance deficit as a share of GDP was reduced continuously after 1981-82.

2.18 The OAL countries also showed mild deteriorations in all four policy indicators between 1970-80 and 1981-82, but changes were not uniform for low- and middle-income OAL countries. The middle-income OAL countries experienced a real appreciation, an increase in the fiscal deficit, and a small slowdown in inflation. They nevertheless made progress between 1983-84 and 1985-88 in achieving real devaluation, in reducing inflation, and in reducing resource balance deficits as shares of GDP. By contrast, the low-income OAL countries had a large deterioration in fiscal deficits between 1981-82 and 1985-88 and little or no reduction in resource balance deficits.

2.19 Economic policy before 1980 was better in the NAL countries than in other countries. After 1981-82, however, their policy indicators and real GDP growth worsened (table 2.5), with the exception of the resource balance deficit.

Differences in performance

2.20 A program's effectiveness cannot be judged solely on the basis of before-and-after comparisons of performance indicators, but such

comparisons provide a useful background for the more sophisticated evaluations presented later. Before-and-after comparisons of growth are also likely to be important for the political viability of adjustment programs. For these comparisons, we analyze four indicators of macroeconomic adjustment — real GDP growth and the shares of domestic saving, investment, and exports in GDP — in 1970-80, 1981-84, and 1985-88.[9]

2.21 For all country groups, GDP growth slowed substantially between 1970-80 and 1981-84, but then it recovered in 1985-88 for both groups of adjustment lending countries while continuing to slow down in the NAL countries (table 2.6). Among the NAL countries the drop in the growth rate of GDP was more pronounced for the countries that needed adjustment but did not adjust. The reduction in GDP growth between the first and second periods was greatest for the EIAL group. For both the low- and middle-income EIAL countries, the rate of GDP growth dropped substantially from 1970-80 to 1980-84 but then recovered in 1985-88 — an important, if imperfect, indicator of the success of adjustment lending.

2.22 The EIAL countries' investment to GDP ratio (in current prices) fell progressively in the 1980s (table 2.6). Because the real devaluations raised the relative price of investment goods, the declines in the investment to GDP ratio in constant prices were usually even larger than those in current prices.[10] For the OAL and NAL countries, the investment ratio rose in 1981-84 and fell in 1985-88, with the fall particularly large for the middle-income OAL and NAL countries.

2.23 Domestic saving as a share of GDP decreased for all three groups of countries in 1981-84 and then recovered somewhat in 1985-88. For the EIAL countries, the average share of saving in GDP dropped by 2.6 percentage points between the first and second periods and then recovered 2.4 percentage points in the third period. As chapter 7 discusses, these changes resulted largely from the fluctuations of GDP growth. For the NAL countries the drop in saving in 1981-84 was similar to that of the EIAL countries, but the recovery in 1985-88 was only 0.4 percentage points of GDP. Low-income countries in all three groups increased their average saving rates in 1985-88.

2.24 The EIAL countries' export to GDP ratio (in current prices) increased by almost 4 percentage points, on average, between 1970-80 and 1985-88. As a result of the real devaluations in the EIAL countries, the increase in the export to GDP ratio was smaller in real terms. The (current price) export ratio of the NAL countries declined somewhat over the period, with the decline for the low-income NAL countries amounting to 3.5 percentage points of GDP between 1970-80 and 1985-88. Again, there were important differences among NAL countries in accord with their need for adjustment — with the NN countries having a continuous improvement in their export to GDP ratio, and the NA countries a continuous decline.

Effectiveness of adjustment lending

2.25 The observed improvement in GDP growth, the saving rate, and the export rate of the EIAL countries in 1985-88 — after the Bank-sup-

Table 2.6 Country performances

	Real GDP growth [a]			*Investment to GDP*			*Domestic saving to GDP*			*Exports to GDP*		
	1970-80	*1981-84*	*1985-88*	*1970-80*	*1981-84*	*1985-88*	*1970-80*	*1981-84*	*1985-88*	*1970-80*	*1981-84*	*1985-88*
EIAL	4.6 (2)	1.3 (3)	4.2 (1)	22.5 (2)	19.9 (3)	18.6 (3)	17.4 (1)	14.8 (1)	17.2 (1)	24.2 (2)	25.1 (2)	28.1 (1)
LIC	4.0	0.1	3.9	22.8	18.4	16.6	16.9	11.8	13.2	29.1	27.3	29.6
MIC	5.5	2.8	4.7	22.1	21.9	21.2	17.9	18.6	22.4	17.9	22.4	26.1
OAL	3.9 (3)	2.3 (2)	3.0 (2)	21.3 (3)	22.0 (2)	20.1 (1)	14.0 (3)	12.7 (3)	13.3 (3)	22.2 (3)	24.4 (3)	23.6 (3)
LIC	3.2	2.1	4.1	18.3	19.3	19.3	8.1	3.3	6.8	18.0	19.4	19.1
MIC	4.8	2.5	1.7	25.0	25.2	21.1	21.4	23.8	21.6	27.5	30.2	29.3
NAL	5.5 (1)	3.1 (1)	2.7 (3)	23.4 (1)	24.1 (1)	20.0 (2)	16.7 (2)	14.0 (2)	14.4 (2)	26.3 (1)	26.1 (1)	24.6 (2)
LIC	4.1	3.1	2.7	17.5	19.1	15.5	9.7	6.0	7.7	19.0	18.1	15.5
MIC	6.2	3.1	2.7	26.2	26.4	22.1	20.1	17.7	17.6	29.7	29.9	28.9
NA	4.7	2.2	1.7	22.2	23.5	19.6	15.7	13.1	13.3	25.7	25.2	22.5
NN	7.0	4.7	4.5	25.6	25.1	20.7	18.6	15.4	16.4	27.3	27.8	28.5

Source: World Bank data.
a. The rate of growth is calculated from constant price local-currency data.
The ratios are calculated from current price local-currency data.
Figures in parentheses indicate the ranking for the variable; (1) indicates the best performance.

ported adjustment programs started — might have resulted from exogenous influences that had nothing to do with the Bank-supported adjustment programs. These influences include higher export prices, lower import prices, lower interest rates on external debt, and higher external financing. We saw, however, that the policy stance of EIAL countries, as reflected in the real exchange rate and fiscal deficit, improved substantially between 1981-84 and 1985-88. To assess the contribution of adjustment programs to macroeconomic performance, one needs to compare the actual performance of a country in the period after adjustment was initiated (1985-88) with an estimated counterfactual scenario of what would have happened in that period in the absence of a program but with the same exogenous influences (table 2.7).[11] The annex to this chapter explains the details of the technique.

2.26 After explicitly controlling for the external shocks, initial conditions, levels of external financing, and policies followed in the preprogram period, the change in the annual average rate of GDP growth of the EIAL countries was not different from that of all the other countries when measuring changes between 1970-80 and 1985-88. Between 1981-84 and 1985-88, however, adjustment programs are estimated to have boosted the rate of GDP growth by close to 2 percentage points. The IMF was also supporting most of these programs. The successful adjustment programs usually improved the growth rate as a result of higher export growth, which more than offset the effects of contractionary policies. The less successful programs did not shift resources rapidly enough from nontradable to tradable activities to increase growth, probably as a result of market distortions and institutional weaknesses. In some countries with severe macroeconomic instability, the programs supported by the initial adjustment loans broke down, which depressed growth in 1985-88.

2.27 Using the four indicators of performance listed in Table 2.8, when comparing 1985-88 with 1970-80, the top performers, in order, were Korea, Mauritius, Morocco, Ghana, and Thailand (table 2.8). The changes in their growth rates were much above what is predicted by their initial conditions, size of the external shocks, net capital inflows, policy stance in the preprogram period, and participation in adjustment programs. The performance over the average ranges from 5.9 percentage points for Korea to 1.9 percentage points for Thailand. (Box 2.1 describes policies in five of the top performers.) At the other extreme, the largest underperformers among the EIAL

Table 2.7 The effectiveness of adjustment lending

Period/ dependent variable	*Change in rate[a] of growth of GDP (%)*	*Change in investment/GDP (%)*	*Change in domestic saving/ GDP (%)*	*Change in export/GDP (%)*
Current prices				
1985-88 with 1970-80	1.3	-4.1**	4.0*	6.4**
1985-88 with 1981-84	2.0*	0.5	4.2**	5.0*
Constant prices				
1985-88 with 1970-80	1.0	-5.6**	2.0	1.2
1985-88 with 1981-84	1.9*	-0.1	5.8**	2.3

a. The rate of growth of GDP is measured at constant prices in both cases but the estimation procedure requires the use of lagged values of all the performance indicators and that is the reason for slightly different estimation of the effect of programs on rate of growth of GDP in the top and bottom of the table.

* Statistically significant at the 10 percent level.

** Statistically significant at the 5 percent level.

Table 2.8 Country differences: shocks and performances

	Largest positive external shocks	Largest negative external shocks
1985-88 compared with 1970-80		
	Indonesia	Yemen
	Somalia	Egypt
	Niger	Papua New Guinea
	Panama	Nicaragua
	Congo	Guyana
1985-88 compared with 1981-84		
	Somalia	Egypt
	Panama	Trinidad
	Jordan	Oman
	Zambia	Congo
	Mauritius	Burkina Faso
	Leading performers	**Lagging underperformers**
Change in annual average rate of GDP growth, 1985-88 compared with 1970-80		
	Korea	Nigeria
	Mauritius	Philippines
	Morocco	Malawi
	Ghana	Côte d'Ivoire
	Thailand	Mexico
Saving rate in current prices, 1985-88 compared with 1970-80		
	Korea	Nigeria
	Chile	Zambia
	Costa Rica	Malawi
	Jamaica	Philippines
	Mauritius	Senegal
Investment rate in current prices, 1985-88 compared with 1970-80		
	Costa Rica	Côte d'Ivoire
	Korea	Malawi
	Jamaica	Nigeria
	Chile	Zambia
	Kenya	Philippines
Investment rate in constant prices, 1985-88 compared with 1970-80		
	Korea	Malawi
	Mauritania	Zambia
	Mauritius	Nigeria
	Togo	Côte d'Ivoire
	Madagascar	Philippines
Export-to-GDP ratio in current prices, 1985-88 compared with 1970-80		
	Jamaica	Kenya
	Mauritius	Senegal
	Chile	Malawi
	Korea	Zambia
	Mauritania	Brazil
Export-to-GDP ratio in constant prices, 1985-88 compared with 1970-80		
	Jamaica	Kenya
	Mauritania	Zambia
	Korea	Nigeria
	Togo	Madagascar
	Mauritius	Malawi

Note: The designation as leading and lagging performers is based on the performance ranking of each country after adjusting for the effects of initial conditions and external environment.

Box 2.1 Top performers

The four indicators of macroeconomic performance show, after controlling for nonprogram characteristics, that the top performers in 1985-88 were Korea, Mauritius, Chile, Thailand, and Ghana.

Korea

The macroeconomic imbalances that developed in Korea in the late 1970s (a sharp slowdown in output and export growth, a large real appreciation, and an unsustainable current account deficit) are typical of the conditions facing most countries initiating structural adjustment efforts. Korea did not, however, face the drastic rationing in the external capital markets that other highly indebted countries did, though commercial lending to Korea was reduced by more than half between 1981 and 1983.

The structural adjustment program that Korea initiated in the spring of 1979 started with stabilization and real devaluation. In the early 1980s, it was extended to include many supply-friendly policies geared toward increasing output by improving the efficiency of factor use — increasing domestic competition, reducing financial distortions, improving the production and distribution of agriculture goods, and further rationalizing of trade incentives by lowering protection and making it more uniform. As a result of these policies — and a large export capacity and favorable external shocks — the current account deficit (8.6 percent of GDP in 1980), was transformed into a surplus in 1986, which reached 8.7 percent of GDP in 1987-88. Annual inflation, in the 25-40 percent range in 1980, dropped to 2-5 percent in 1987-88 and annual GDP growth reached 11.5 percent.

Mauritius

In the late 1970s and early 1980s, Mauritius faced an unsustainable macroeconomic situation — the fiscal deficit in 1980 was 10 percent of GDP, the current account deficit was 12 percent of GDP, and the annual rate of inflation was 24 percent. Mauritius then initiated a successful structural adjustment program, consisting of a stabilization component with a large fiscal adjustment — as well as a flexible exchange rate policy and a structural component that attacked distortions in the incentive program. (Quantitative import restrictions were lifted, a tariff reform was initiated, and direct foreign investment was encouraged). Major structural reforms were also aimed at reducing the anti-export bias of trade policies. Preferential price arrangements of sugar exports to the EEC and good management of sugar earnings helped the adjustment.

As a result of these policies, the current account had surpluses in 1986 and 1987 and only a small deficit in 1988. The fiscal deficit was only 2.6 percent of GDP in 1988, and annual inflation was in single digits.

Chile

Chile implemented far-reaching microeconomic reforms in 1976-80, reducing the anti-export bias of trade policies, increasing domestic competition, and improving the efficiency of the public sector. By 1982, however, Chile was in a major recession resulting from the accumulated decline in competitiveness, large losses in the terms of trade, and the impossibility of financing a current account deficit that had reached close to 15 percent of GDP in 1981.

With Bank and Fund support, Chile carried out a major adjustment program in early 1984, focusing on correcting the macroeconomic fundamentals and managing a large financial crisis. From 1984 to 1988, Chile engineered a real devaluation of close to 50 percent. The public sector deficit, including an estimate for the quasi-fiscal deficit of the central bank, was reduced from 9 percent of GDP in 1984 to a surplus of 3 percent of GDP in 1988. The current account deficit, which reached 14.5 percent of GDP in 1981, became a surplus of 0.7 percent of GDP in 1988. Inflation, 27 percent in 1983 and 20 percent in 1984, was held to 15 percent in 1988. The unemployment rate, 19.2 percent in 1984, was reduced to 11.2 percent in 1988. GDP growth averaged 6.3 percent a year in 1986-88.

Thailand

The Thai economy faced major imbalances in the late 1970s. The second oil shock resulted in a large terms-of-trade loss, accompanied by expansionary fiscal policy. Some real appreciation developed with the deterioration in the current account and an acceleration of inflation. The Thai government responded to these challenges with a structural adjustment program aimed at restoring the macroeconomic fundamentals and reducing the anti-export bias of the trade regime — a model that had been so successful for some of its neighbors. The program included fiscal retrenchment on both the expenditure and the tax side, a large real devaluation, and a liberalization of the trade regime.

Following a drastic reduction in the public sector and current account deficits, private investment grew 26 percent in 1987 and 34.1 percent in 1988 and GDP growth reached 8.1 percent in 1987 and 10.9 percent in 1988. As a result of this adjustment effort the ratio of total debt to GDP was reduced from 46.9 percent in 1985 to only 35.4 percent in 1988. The large increase in private investment has resulted in a large increase also in the total investment ratio, which reached 27.5 percent of GDP in 1988. The national saving rate has increased but not as much as the increase in the investment rate. So the current account deficit has increased but without an increase in the external debt to GDP ratio — because direct foreign investment increased.

Ghana

Ghana had a major crisis in the early 1980s. In 1981-83 its real GDP declined 4.7 percent a year (it had been declining for a decade). The fiscal deficit was close to 5 percent of GDP, the current account deficit was 7.6 percent of GDP, and average annual inflation was 76 percent. In early 1983, with Bank and Fund support, the government introduced a structural adjustment program with a stabilization component (including a competitive exchange rate), and microeconomic and institutional reforms to encourage export-oriented and efficient import-competing activities. The reforms also aimed at initiating the rehabilitation of the physical and social infrastructures and removing impediments to the expansion of private investment. After five years, Ghana achieved remarkable results. For 1986-88, the average annual rate of GDP growth reached 5.1 percent, the fiscal deficit to GDP was reduced, and inflation was reduced to 39 percent a year. However, part of the recovery in growth may have been from better use of existing capacity, so to maintain high growth, a recovery of investment will be necessary.

countries were Nigeria, the Philippines, Malawi, Côte d'Ivoire, and Mexico, which had changes in their rates of growth much below predicted values. Among these countries, Nigeria and Mexico initiated major adjustment efforts only later in the 1985-88 period, so their growth figures capture more of the transitory short-term costs than medium-term benefits. The Philippines went through political upheavals, and Malawi was adjusting to unsustainable expenditures at the same time as it was suffering from the severance of rail routes through Mozambique, due to regional conflicts. Côte d'Ivoire's large fiscal deficits and institutional rigidities in key relative prices were major constraints to successful adjustment.

2.28 After controlling for the effects of other factors, the domestic saving rate in current prices increased more in EIAL countries than in other countries (see table 2.7). (The domestic saving rate is more appropriate than the national saving rate for measuring the impact of adjustment on resource mobilization, because domestic saving does not deduct net factor payments abroad and does not include net foreign transfers.[12]) As a share of GDP, it rose about 4 percentage points more for the EIAL countries than for the other countries, whether using 1970-80 or 1981-84 as the base period.

2.29 When other factors are controlled for, the adjustment programs appear to have led to a drop in the investment share in GDP (in current prices) of 4.1 percentage points between 1970-80 and 1985-88. The decreases between 1981-84 and 1985-88 were small and not statistically significant. The impact of the programs on investment should be interpreted carefully. Since adjustment is not estimated to have reduced growth, it must have increased the average efficiency of capital.[13] Where an integral component of adjustment programs was to curtail low-efficiency public (and private) investment programs, a decrease in the investment rate was part of the adjustment. The result is worrisome nonetheless, since in most countries the achievement of sustainable higher growth is likely to require an increase in investment above the average levels of the 1980s. The hoped-for recovery of investment to sustain future growth did not occur in most EIAL countries, though their experience varies (table 2.8).

2.30 Because most EIAL countries carried out a real depreciation in 1985-88, the relative price of investment goods rose. So, the effect of the programs was an even larger average reduction — 5.6 percentage points of GDP — in the constant-price ratio of investment to GDP between 1970-80 and 1985-88.

2.31 The different statistical techniques all show that countries with adjustment programs had lower investment-to-GDP ratios than other countries. As chapter 6 shows, this decline came not only from lower public investment, but from lower private investment, probably caused in part by greater economic uncertainty at the start of an adjustment program. A reduction in the rate of private investment may be unavoidable in the initial phase of an adjustment program (see chapter 6). With the pressure to reduce public sector deficits, many governments substantially reduced their investment programs (and current expenditures for the maintenance of infrastructure), because of their incapacity to reduce other expenditures. Such reductions of public investment in infrastructure and human capital seriously jeopardize the resumption of private investment and the ultimate success of the adjustment programs. Expansion of efficient public investment, however, enhances the supply response to the reformed incentive structure by increasing the credibility of adjustment programs and thus contributing to the expansion of private investment (see chapter 6).

2.32 After controlling for other factors, the Bank-supported programs also had a positive effect on the export to GDP ratio in current prices, boosting it about 6.4 percentage points of GDP between 1970-80 and 1985-88 and 5.0 percentage points between 1981-84 and 1985-88 — with large differences across countries. The strong positive effect of programs on the export to GDP ratio in current prices could be due in part to the accounting effect of real devaluations by the EIAL countries in the third period. After controlling for other factors, the adjustment programs on average had a positive, though not statistically significant, effect on the export to GDP ratio in constant prices (table 2.6).

2.33 The small and statistically insignificant effect of adjustment programs on the export to GDP ratio in constant prices raises concerns about the speed of the supply response of exports to the changed incentives brought about by a real devaluation. The small and slow average response may be accounted for by the absence of investment needed to increase supply and by uncertainties about the stability of the improved incentives for exports. For countries with a long history of macroeconomic instability, discrimination against exports and unstable real exchange rates,

the export response would be low.[14]

2.34 For EIAL countries, the programs had a small negative effect on the ratio of imports to GDP (in current prices) of 1.7 percentage points from 1970-80 to 1985-88 — and a small positive effect of 1.3 percentage points from 1981-84 to 1985-88.[15] Because output has in some countries been constrained by lack of imports, the apparent improvement in the efficiency of investment between 1981-84 and 1985-88 may partly reflect fuller use of existing productive capacity because of better access to imported inputs.

2.35 The countries that consistently performed above the level predicted by the model were Chile, Ghana, Korea, Mauritius, and Thailand (table 2.8). They made major progress in restoring macroeconomic balances, resulting in lower inflation and a lower current account deficit. They initiated or continued structural reforms aimed at improving the efficiency of resource use while encouraging export growth. And they used fiscal, monetary, and exchange rate policies to reduce current account deficits, control inflation, and achieve a substantial real devaluation. The poor performers are still struggling to establish sustainable macrobalances while at the same time initiating serious adjustment efforts. For these countries, the eventual success of the structural adjustment hinges on restoring macrobalances while lifting restrictions that limit the supply response to the structural reforms.

Conclusions

2.36 Simple comparisons show that the growth performance of EIAL countries improved relative to other countries, but this effect was statistically significant only when comparing 1985-88 with 1981-84. The adjustment lending programs usually increased the ratios of domestic saving and exports to GDP, but reduced the average ratio of investment to GDP, even after explicitly controlling for external shocks, external financing, initial conditions, and determinants of the demand for adjustment programs — with important differences across countries.

2.37 The drop in the investment rate in the initial years of the adjustment has to be interpreted carefully. Most EIAL countries had to implement a stabilization program as an integral component of the structural adjustment program. The initial uncertainty when an adjustment program is started most likely discourages domestic private investment anyway. A stable macroeconomic framework, coupled with public investment in infrastructure that supports private investment, could contribute much to increasing investment and thus restoring sustainable growth as adjustment continues.

2.38 The investment reduction in the early stages of an adjustment program also means that private consumption rates are higher than otherwise for a given level of resource transfer (although they did not necessarily increase). As the reform program becomes more credible and the demand for private investment starts to increase, foreign financing and higher government saving will be needed to finance the investment recovery (chapter 7). Public investment in infrastructure compatible with the overall direction of the adjustment program generally helps to hasten the recovery of private investment (chapter 6).

2.39 There is a sound explanation for these findings. If a country can implement a real devaluation and net exports rise to replace the reduction in domestic expenditure — and if efficiency-enhancing measures are implemented early on — output should change little in the first year or two, and it should start to grow thereafter. Private consumption would remain relatively constant, perhaps even increasing as a share of GDP. Later on, as private investors start to believe that the new incentives are credible and consistent with the long-term objectives of economic policy, private investment should start to increase. Output and saving should then rise further as investment boosts the growth of capacity. The economy then enters into a virtuous cycle. As evidence from Korea, Chile, and Thailand suggests, however, it typically takes four to eight years to get there.

2.40 Despite their disappointing investment performance, the EIAL countries increased their rates of growth from 1981-84 to 1985-88, reflecting increases in efficiency and capacity use. For the adjustment effort to result in sustainable growth in the medium term, however, investment must resume. Part II of this report discusses the factors that determine the response of investment in the medium term.

Annex: Statistical analysis of country performance

A2.1 Economists have used three approaches to assess the effects of a program on performance: the before-and-after approach, the control-group approach, and the modified control-group approach.[16] This annex explains each method, its advantages and disadvantages, and how they were used in chapter 2.

Before-and-after approach

A2.2 The before-and-after approach to program evaluation, used implicitly in the first part of this chapter, compares performance after a specific program was initiated with performance before the program. For the countries that had adjustment lending, one compares the average GDP growth, investment ratio, and so on in the period following the initiation of adjustment lending with the average of these indicators during a base period before adjustment lending began. The "before" and "after" periods can be tailored to the timing of adjustment in each country, as was done in the first report. The average change in a performance indicator in the program countries is attributed exclusively to program effects. The standard t-test, as well as some nonparametric tests, reveal the statistical significance of the results.

A2.3 The before-and-after approach yields useful descriptive statistics, but it implicitly assumes that all other things are equal, which ignores some of the available information. During the 1980s the nonprogram determinants of performance, especially terms of trade and international interest rates, varied widely over time and from country to country. Furthermore, a negative shock to the level of a macroeconomic performance indicator in the preprogram period increases the probability of a positive change in the same indicator during the program period. If one defines the effectiveness of a program as the difference between the actual macroeconomic performance observed and the performance that would have been expected in the absence of such a program, the before-and-after estimate would be a poor estimator of this counterfactual.[17] The situation prevailing before the program is not likely to be a good predictor of what would have happened in the absence of a program, given that nonprogram determinants can and do change from period to period.

Control-group approach

A2.4 The control-group approach can overcome, in part, the inability of the before-and-after approach to distinguish between program and nonprogram determinants of macroeconomic outcomes. Chapter 2 also uses the control-group approach, when comparing performance in EIAL and the other two groups of countries (OAL and NAL). The behavior of a control group of nonprogram countries reflects what would have happened in the program group in the absence of programs. The control-group approach assumes that all countries are subject to the same nonprogram influences — that is, they face the same external environment — and that the effect on performance of these other determinants is the same for both groups of countries. This approach also ignores the effects of preprogram and other country-specific characteristics on performance.

The most common version of the control-group approach compares the average change in the performance variable (GDP growth, investment ratio, and so on) for both program and nonprogram countries and attributes the difference to the effect of programs. This approach requires a uniform definition of the period before and after adjustment, since the same period must apply to the nonprogram countries.

A2.5 The results of the control-group approach are still biased if the external environment of program countries differs systematically from nonprogram countries — for instance, if nonprogram countries experienced more favorable terms of trade changes. In addition, if the decision of countries to undertake Bank-supported adjustment programs is positively (or negatively) correlated with the nonprogram determinants of macroeconomic performance, the control-group estimate of program effects will be overstated (or understated). For instance, if program countries experienced temporary negative shocks in the preprogram period, a comparison of changes in aggregate performance between program and nonprogram countries will overstate the true independent effect of the programs. Empirical results in chapter 2 indicate that the negative shock in the preprogram period simultaneously increases the probability of program participation and increases the probability of improved economic performance during the program period. So, attributing all of the improvement to a program overstates the real effect of the program, an overstatement known as sample-selection bias.

Modified control-group approach

A2.6 The modified control-group approach is one way to minimize the sample-selection bias and to take account of the changing external environment of each country.[18] The approach recognizes the nonrandom selection of program countries, identifies the specific differences between program and nonprogram countries in the preprogram period, and then controls for these differences in the comparison of subsequent economic performance.

A2.7 The rationale of the version of the modified control-group approach used here starts from an equation for the macroeconomic outcome variables in country i in the evaluation period (1985-88):

$$y_i = x_i' \omega + W'\alpha + ß_4 d_i + e_i \qquad (1)$$

The outcome of a given performance variable (y, for GDP growth and the shares of saving, investment, and exports) is assumed to depend on x_i — a group of variables representing the macroeconomic policy that would be expected in the absence of a program in country i; W — (a group of variables representing the external economic environment that actually existed for the country); and d_i — which takes the value of one if a country has a program, and the value of zero otherwise. The error term is e_i.

A2.8 Of course, in countries with programs, the policies that would have prevailed in the absence of a program cannot be observed, so they have to be modelled somehow. We did this with a policy reaction function, which assumes that the changes in policy (Δx_i) can be predicted by the value in the performance variables in the preceding period ($y_{i,-1}$). Implicitly this assumes that policymakers in one period react to deviations of performance from constant target variables in the previous period. The relationship

$$\Delta x_i = \gamma_{oi} - \gamma y_{i,-1} + u_i \qquad (2)$$

is used to express Δx_i as a function of the observable lagged values of performance variables. A potentially important limitation of the modified control-group estimator is that such a reaction function may be highly unstable.

A2.9 Obviously, even this method is imperfect in estimating counterfactual policy scenarios, but it does pick up some policy changes like the tightening of Korean and Bolivian fiscal policy in response to the need to increase saving rates that would have happened even without a Bank-supported program. Otherwise, these would have been fully attributed to Bank adjustment programs.

A2.10 By subtracting $(y_i)_{-1}$ from both sides of equation (1), and substituting x_i by equation (2), our model to estimate the effects of a specific program is:

$$\Delta y_i = \beta_0 + \beta_1 (y_i)_{-1} + \beta_2 (x_i)_{-1} + \beta_3 W_i + \beta_4 d_i + e_i \qquad (3)$$

One must also recognize, however, that the dummy variable, (d_i), included in the right side of the equation, measuring the effect of the program in country i, is endogenous. The choice of a country to undertake a program is not random, but depends on expected improvements in performance, which means that direct estimation of the coefficient on the program variable, β_4, is bi-

ased and inconsistent. This kind of bias can also be called self-selection bias, because the data are generated by self-selection of countries.

A2.11 Several techniques can eliminate the selection bias. The method used here essentially treats d_i as an endogenous variable and uses instrumental variables to correct for the bias.[19] A first stage consists of estimating a status equation for whether a country is likely to undertake a program. We estimate the following status equation using the maximum likelihood probit method:

$$P(d_i=1) = \phi[\delta_0 + (y_i)_{-1}\delta + (x_i)_{-1}\omega + W'\varnothing + R'\varnothing] = \phi[V_i\theta] \quad (4)$$

where $\phi[\ ]$ denotes the standard normal cumulative distribution, depending on the lagged values of performance indicators, $(y_i)_{-1}$ and policy indicators, $(x_i)_{-1}$; a group of world nonprogram variables, W; and some individual country characteristics, R, such as whether the country has a low per capita income, whether it is highly indebted, whether it has a concurrent agreement with the IMF, and so on. In a second stage, we use the value of the probability of the country to undertake a program with the World Bank, calculated from equation (4), as an instrument for d_i in the estimation of equation (3). The probability of the country's undertaking a specific program is calculated by the probit model as:

$$\hat{d}_i = \phi[V_i\hat{\theta}] \quad (5)$$

A2.12 Thus, using an instrumental variables technique in the estimation of equation (3), with $\hat{d}_i$ as an instrument of d_i, allows us to obtain a consistent estimate of the β_4 coefficient. This coefficient reflects the average effect of Bank programs on the performance variables y_i.

A2.13 In our estimation of equation (3), we consider four different sets of performance indicators. The first set includes GDP growth and the ratios of domestic saving to GDP, domestic investment to GDP, and exports of goods and nonfactor services to GDP. The last three variables are measured in current prices. The second set also has GDP growth but the other three ratios are in constant prices. For this second case, we are especially interested in the constant-price ratios of investment and exports. The third and fourth sets use national saving, with the third in current prices and the fourth in constant prices.

A2.14 In the estimation of the status equation (4), the country decision to seek Bank support for a series of adjustment loans (with the first one in 1985 or before) is taken by a country in the period 1981-84. We then assume that important variables in that decision are the value of the external shock during 1981-84 compared with 1970-80 (the sum of terms of trade and interest rate shocks), the level of investment to GDP ratio in 1981-84, the level of the real effective exchange rate in 1981-84, the level of fiscal deficit to GDP in 1981-84, plus dummy variables for the presence of a concurrent IMF program, for regions in the world, and for the 17 highly indebted countries. The estimation procedure also uses lagged performance indicators, as well as the lagged policy-stance variables. For example, when comparing performance in 1985-88 with performance in 1970-80 in the estimation of equation (4), we also use 1970-80 GDP growth, saving rate, investment rate and export ratio as additional regressors, plus the real effective exchange rate of 1970-80, fiscal deficit to GDP of 1970-80, and the size of the external shock in 1981-84 compared with 1970-80. In the equation for program participation, the following variables are significant at a 10 percent level: investment ratio of 1981-84, the size of the external shock in 1981-84 compared with 1970-80, the existence of a concurrent IMF agreement, and whether a country is classified as highly-indebted.

A2.15 Using $\hat{d}_i$ as an instrument for d_i, we estimate equation (3) by the instrumental variables procedure, for each of the four performance indicators, including in the right-hand side lagged values of the policy variables (real effective exchange rate, fiscal deficit to GDP), the size of the external shock in the same period, the amount of net external financing to GDP,[20] the dummy variable of program participation, and the values of the performance indicators in base period (1970-80 or 1981-84). Dummy variables are also introduced to deal with outliers: Bolivia, China, Congo, and Tanzania. The estimated value of the β_4 coefficient and its level of significance is reported in table 2.7 of this chapter.

A2.16 Although the method used here takes account of many nonprogram influences, some important ones remain in the error term or are inappropriately picked up by the coefficient of $\hat{d}_i$. The effect of lagged values microeconomic policy variables could not be readily incorporated in the method here, for lack of uniform data, and the effect of IMF programs is partly picked up by the estimated World Bank program variable $\hat{d}$. The method here does, however, represent a considerable advance over previous analysis.

3

Structural adjustment and living conditions in developing countries

Summary

3.1 Adjustment from an unsustainable economic situation, following adverse external shocks or policy mismanagement, often has social costs in the short run. The question is whether Bank-supported lending, which promotes orderly adjustment, is less costly than other adjustment. Even a well-designed adjustment program will have losers as well as gainers, since adjustment usually requires substantial relative price changes and reduced fiscal deficits through selective government expenditure cuts. The poor, who already have low welfare levels, may find it difficult to absorb losses. This issue is especially critical if renewed growth, following the initiation of an adjustment program, takes longer than expected. The need for specific measures to protect the poor during the transition period is widely recognized, and an increasing share of Bank programs now include such measures.

3.2 Data on distributional changes over time are limited, but data on average living standards could shed some light on any major changes in the status of the poor. The available evidence shows that changes in living conditions in the short run do not appear to be systematically related to adjustment lending. Short-run indicators of living conditions have not deteriorated in the early intensive adjustment lending (EIAL) countries, and long-run indicators have continued to improve because of past investments. Adjustment lending programs increased the growth of per capita consumption in EIAL countries relative to non-EIAL countries in 1985-88. For all country groups, nutrition improves after 1983, immunization data show increased coverage, and mortality data show continued progress. But there are declines in social expenditures in some EIAL countries, which may have negative effects in the future. Health and education expenditure shares on average decline for the EIAL countries, as do their average primary school enrollment rates.

3.3 The findings support three recommendations. First, the lack of reliable data—and the difficulties in separating the costs of adjustment from the costs of external shocks or poor policies—imply a continuing need for more careful monitoring and analysis of the impacts of adjustment on poverty. For example, data should be collected on the internal terms of trade for poor farmers and the real unskilled wage, two key variables that reflect the status of the poor. Second, adjustment programs need to include poverty alleviation as an objective, and should provide measures to reduce the potential short-run burden on the poor of external shocks or adjustment policies. Examples include better targeting of reduced fiscal expenditures toward the poor and short-run measures to help newly unemployed workers find employment. Third, fundamental objectives, such as improving the nutrition, health, and education of the poor can be approached through project loans or social sector SECALs, and this lending should be an integral part of the adjustment process.

Introduction

3.4 For countries with an unsustainable current account deficit, the macroeconomic components of adjustment programs encourage a reduction in aggregate demand, generally through monetary and fiscal restraint. They also support switches in production from the nontradable to the tradable sectors, generally through a real devaluation. The reductions in aggregate demand are likely to have negative short-run effects on output growth and employment. By contrast, the structural reforms (economy-wide and sector-specific) improve the efficiency of the economy, have a longer-term positive impact on output growth, and are likely to reduce poverty in the medium to longer run. The reduction of aggregate demand and the structural reforms are bound to have distributional consequences, but the potential adverse short-run effects must be weighed against the longer-run benefits of a successful adjustment program. The questions are whether the poor bear an excessive or disproportionate amount of any short-run adjustment burden and whether this burden can be diminished while preserving the required macroeconomic adjustment.[1]

3.5 Monetary and credit restraint policies in countries with high inflation are designed to reduce inflation and should help the poor, who are less able to protect the real value of their assets and incomes from inflation. Reducing the fiscal deficit requires a combination of revenue increases and expenditure cuts. On the revenue side, income tax increases generally do not affect the poor, and excise taxes may exempt the goods they consume. On the expenditure side, decreases will affect the poor depending on the incidence of the expenditures. For example, reductions in health spending may have negative impacts. But if the composition of health expenditures switches toward preventive medicine and away from curative medicine going mainly to the middle class, the impact on the poor can be softened.

3.6 Moving to structural reforms, changes in relative prices that remove the biases against labor should help reduce poverty in the long run. Exchange rate devaluation will help the poor if they produce tradable goods and will hurt them if they consume tradable goods, such as imported necessities. The removal of ceilings on agricultural prices will benefit the rural poor who are net producers of food, but hurt the urban poor who are net consumers of food.

3.7 Some concerns have been raised about the impact of adjustment programs on the poor and on living standards in general. UNICEF, in its study *Adjustment with a Human Face* (1987), pointed to the possible social implications of adjustment policies that seemed to focus solely on macroeconomic indicators.[2] Others have suggested that UNICEF may have overstated the case. A critical review of UNICEF's work concluded that in most of the countries studied, infant and child mortality had declined and nutritional indicators and school enrollment had risen, sometimes despite the decreases in government expenditures on health and education.[3] A recent study commissioned by the Bank's Operations Evaluation Department (OED) assessed the analytical base underlying UNICEF's conclusions and stated that: "... adjustment programs may have deleterious effects on health and nutrition, but the empirical evidence presented to date is not very convincing due to confusion among levels, trends, and deviations from the trends and questionable data interpretations."[4]

3.8 The conclusions are contradictory for three reasons. First, it is inherently difficult to establish causality, to isolate the effects of adjustment programs from other factors, and particularly to determine whether alternative policies would have done better or worse. Second, socioeconomic data on the living conditions of the poor are scarce and often of dubious quality. Although many of the poor work in the informal sector, data on informal sector output and other variables are usually not included in official statistics. Third, adjustment programs are relatively new, and their long-run positive impact could take longer than the experience with adjustment so far. While a complete analysis of adjustment programs would cover the entire adjustment period, interim evaluations, such as those here, are necessary.[5]

Changes in social indicators

3.9 The poorest groups in developing countries may have their extremely low living standard temporarily reduced further when external conditions and the cumulative effects of past policy errors result in a crisis or force the country to undergo an adjustment. This section first examines data on poverty changes in several countries in the 1980s. Next, it analyzes how the trends in per capita private consumption differ between adjustment lending and nonadjustment lending countries. Then, it examines the trends in socio-

economic indicators of poverty — such as nutrition and infant and child mortality — and assesses whether these trends in social indicators differed significantly between adjustment lending and nonadjustment lending countries in the 1980s.[6]

Changes in poverty in the 1980s

3.10 Ideally, regular household surveys would measure poverty changes during the adjustment period. The effect of adjustment programs on poverty changes could then be estimated by using appropriate techniques to control for initial conditions, external shocks, and domestic policies that would have occurred if adjustment policies had not been followed — the counterfactual. But these household surveys are available only for a few countries for a few years.

3.11 The conclusion from the fragmentary evidence on poverty in the 1980s is that changes in the incidence of poverty are not clearly related to Bank-supported adjustment (table 3.1).[7] The sample is very small, however, and many important countries have no relevant data.

- For Brazil, Costa Rica, Pakistan, and Hungary there were poverty reductions, and for Thailand and Yugoslavia there were poverty increases, after adjustment lending was initiated. But this before-and-after approach does not control for other nonprogram factors affecting poverty or permit a counterfactual analysis.
- For China, Poland, and Venezuela there were poverty increases, and for Malaysia there was a poverty decline, without Bank-supported adjustment.
- In Chile, the incidence of poverty was higher in 1985 than in 1980, but there have recently been improvements. Data on poverty are not available after 1985, but data on real wages and unemployment imply that poverty has declined in the latter stages of adjustment. From 1985 to 1989, real wages increased by 10 percent, and unemployment fell significantly from 21 to 10 percent.
- Indonesia is noteworthy. It initiated an adjustment program in 1983 (without Bank lending) in response to negative terms of trade shocks. A 1987 survey revealed that poverty had been reduced after 1984. The government has had a strong commitment to poverty alleviation, and this has been an important factor in its poverty success. The government protected per capita consumption by reducing investment in the short run and avoiding expenditure cuts on programs in which the poor participated heavily ; in addition, the real devaluation helped the rural poor.
- In Côte d'Ivoire, 86 percent of the poor are either food-crop or export-crop farmers, so the poor have benefited from rural-urban terms of trade movements in favor of the rural areas, the

Table 3.1 Poverty incidence in selected countries

Country	*Change in poverty*	*Measure*	*Poverty time period*	*Effective loan dates*
EIAL				
Brazil	-	income	1983 & 1986	1983, 1983, 1986
Chile	+	income	1980 & 1985	1985, 1986, 1987
Costa Rica	-	income	1983 & 1986	1984, 1985, 1989
Pakistan	-	expenditure	1979 & 1984/85	1980,82,85,86,88,89
Thailand	+	income	1981 & 1986	1982, 1983
OAL				
China	+	income	1985 & 1988	1988
Hungary	-	income	1985 & 1987	1986, 1988
Indonesia	-	expenditure	1984 & 1987	1987, 1988, 1989
Yugoslavia	+	income	1983 & 1987	1983
NAL				
Malaysia	-	income	1984 & 1987	
Poland	+	income	1980 & 1987	
Venezuela	+	income	1982 & 1987	1989, 1989

Source: Background papers for World Development Report 1990, forthcoming.
Notes: The poverty measure is the headcount index using national definitions of poverty lines.
A minus (plus) sign indicates measured poverty declined (increased) between the first and second surveys.
Data for Chile are for the Greater Santiago Area.
Data for China are for the rural population.
Venezuela is a NAL country because the country classification is based on loans up to the end of 1988.

Box 3.1 Adjustment and the poor in Côte d'Ivoire

Côte d'Ivoire's economy contracted sharply in the early 1980s following severe terms of trade shocks: per capita GDP fell by 19.1 percent from 1979 to 1984 and per capita private consumption fell by 16.7 percent. A severe drought in 1983 compounded the problems.

At the end of 1981, the Ivoirian government launched a structural adjustment program with support from the IMF's Extended Fund Facility. The Bank made the first two structural adjustment loans in 1981 and 1983. Among the policies they specified were a freeze on government salaries, greatly reduced public investment, increases in various taxes (vehicles, insurance, property, and business licenses), and increased producer and consumer prices for various foodstuffs.

What were the implications of the program for the poor? The incidence of poverty in Côte d'Ivoire is highest for food-crop farmers (50 percent) and export-crop farmers (36 percent). Given the decline in the international prices of its major export crops, and the severe drought in 1983, which no policy could stop, there is little doubt that the poor were worse off in the mid-1980s than in 1980.

Were the poor hurt more than average? Most of the poor, especially the poorest 10 percent, are in rural regions. Movement of the rural-urban terms of trade in favor of rural areas suggests that adjustment may on balance have helped the poor. Decomposing aggregate poverty into poverty by regions, examining how growth between regions varied, and applying regional elasticities of poverty with respect to growth, calculations suggest that although poverty in Côte d'Ivoire increased by 5 percent a year from 1980 to 1984, it would have increased 14 percent a year without the adjustment of prices in favor of agriculture.

The lesson is that some adjustment policies can help correct macroeconomic imbalances *and* reduce the impact of external shocks on the poor.

result of the structural adjustment program of the early eighties (box 3.1).

Although there does not appear to be a systematic relationship between changes in poverty and Bank-supported adjustment, it is still necessary to include measures to protect the poor from short-run costs during the transition period, and such special measures are increasingly included in adjustment programs. These are discussed later, following the data analysis.

Growth rates of real per capita private consumption

3.12 In the EIAL countries, real private consumption per capita appears to have been protected, relative to other countries, during the 1985-88 period. This relative increase in consumption reflects a relative decrease in investment. For the EIAL countries, per capita real consumption growth was 2.5 percentage points higher in 1985-88 than in 1981-84, having recovered to 1970-80 rates (table 3.2). At 1.4 percent, their average per capita consumption growth rate was higher than the average rates for the OAL, NAL+, and NAL- groups in 1985-88.[8] The low-income EIAL countries increased their growth rate by 3.6 percentage points, and the middle-income EIAL countries by 1.6 percentage points. The OAL countries had a slight decline in their average growth rate of consumption from 1981-84 to 1985-88, with decreases in per capita consumption growth for the middle-income OAL countries but increases for the low-income OAL countries. The NAL+ countries had continued positive growth in consumption per capita throughout the entire 1980s and the NAL- countries had significant declines.

3.13 In 1985-88, 18 of the EIAL countries had positive per capita consumption growth, and only six countries had negative growth (table 3.2). This contrasts with the distribution of the early 1980s, when nine of the EIAL countries had positive growth and 15 had negative growth. The EIAL countries had the largest improvement in the number of countries with positive consumption growth. The OAL and NAL groups had little or no change in the distribution of countries with positive and negative consumption growth in the two periods in the 1980s.

3.14 When the EIAL countries are compared to all the other countries, they show higher consumption growth in the 1985-88 period compared to other periods. This result also holds after controlling for preprogram conditions and the evolution of such external economic conditions as changes in a country's terms of trade, international interest rates, and net foreign financing.[9] The external shocks to the EIAL countries were unusually adverse compared to other countries, yet they managed to recover per capita consumption growth rates to levels similar to previous rates. Comparing 1985-88 with 1970-80, adjustment programs raise the average annual growth rate of real consumption per capita by 3 percentage points for the EIAL countries relative to the OAL and NAL countries.[10]

3.15 There are important differences in per-

Table 3.2 Annual growth rates of real per capita private consumption (percent)

Country classification	*Number of countries*	*1970-80 Growth (+:-)*		*1981-84 Growth (+:-)*		*1985-88 Growth (+:-)*	
EIAL countries	24	1.5	(17:7)	-1.1	(9:15)	1.4	(18:6)
LIC	11	0.1	(6:5)	-2.6	(2:9)	1.0	(7:4)
MIC	13	2.7	(11:2)	0.2	(7:6)	1.8	(11:2)
OAL countries	23	1.6	(19:4)	0.2	(11:12)	-0.1	(12:11)
LIC	12	0.7	(9:3)	-0.1	(6:6)	0.5	(8:4)
MIC	11	2.6	(10:1)	0.5	(5:6)	-0.9	(4:7)
NAL+ countries	12	3.5	(12:3)	1.4	(8:7)	1.1	(8:7)
LIC	4	2.8	(3:1)	3.3	(4:0)	1.5	(3:1)
MIC	8	3.8	(9:2)	0.4	(4:7)	0.9	(5:6)
NAL- countries	15	2.8	(9:3)	-1.7	(3:9)	-2.9	(3:9)
LIC	5	0.4	(2:3)	-1.4	(1:4)	-1.0	(2:3)
MIC	10	4.0	(7:0)	-1.9	(2:5)	-3.9	(1:6)
All developed countries	74	2.1	(57:17)	-0.4	(31:43)	0.0	(41:33)

Source: World Bank data.
Notes: Data for Chad, Gabon, Gambia, Lesotho, Mozambique, Nepal, Poland, South Africa, Uganda and Yemen PDR that are needed to implement the methodology of chapter 2 are missing. Real per capita consumption data for Guinea, Oman, Sierra Leone and Tanzania are missing. This leaves 74 countries.
EIAL countries are Early Intensive Adjustment Lending countries and OAL countries are Other Adjustment Lending countries. The Non-Adjustment Lending (NAL) countries are divided into those whose per capita real GDP increased from 1981 to 1988 (NAL+) and those where it decreased (NAL-). The Low Income Countries (LIC) are those that received IDA loans in FY89, and Middle Income Countries (MIC) are those that did not.
The ratio is the number of countries with positive growth rates to the number of countries with negative rates.

formance among the EIAL countries. When comparing 1985-88 with 1970-80, consumption per capita grew more rapidly in Zambia, Madagascar, Korea, Tanzania, and Chile than predicted by their preprogram conditions, the size of their external shocks, and their participation in adjustment programs. The largest underperformers in the EIAL group are Côte d'Ivoire, Madagascar, Mauritania, Nigeria, and Mexico— with changes in real per capita consumption growth rates below their predicted values.

3.16 The evidence on consumption growth suggests that EIAL countries protected consumption in the 1985-88 period, especially when compared to other countries. This presumably had a positive impact on average living standards in the short run. As chapter 2 shows, however, this relative increase in consumption was accompanied by a relative decline in investment, which may have negative effects on living standards in the future.

Nutrition

3.17 Average nutrition may be a better indicator of the basic living standard of the poor than average consumption, which includes luxuries as well as necessities. Negative changes in average nutrition are likely to affect the poor more seriously since their food budget shares are high and their nutritional levels low. Nutrition is defined here as the population's average intake of calories; the nutrition index is calculated as the percentage excess of calorie intake over required intake, estimated on the basis of normal body weight, typical physical activity, and climate of the country.[11]

3.18 For the EIAL group, the index of nutrition worsened between 1981 and 1983 and then improved between 1983 and 1986, so that the index of nutrition in 1986 is better than in 1980 (table 3.3). The decline in the early 1980s occurred mainly in the low-income EIAL countries; the middle-income EIAL countries had a fairly consistent improvement in nutrition from 1980 to 1986 (except for 1983). The OAL countries followed a similar pattern, with decreases in nutrition from 1981 to 1984 and improvement thereafter. The NAL+ countries significantly improved their nutritional status during the 1980s. The NAL- countries also improved their nutritional status (except for 1983), but this is due to the middle-income countries; the low-income NAL- countries had declining nutrition from 1981 to 1985.[12]

3.19 A review of nutrition changes in Africa shows no clear relationship between such changes and whether the country is in the EIAL or NAL group. In eight of 12 EIAL countries in Africa, the nutrition index worsened between 1980 and 1983-84. In ten of 12 it improved between 1983-84 and

Table 3.3 Nutrition (percent)

Country classification	*Number of countries*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*
EIAL countries	24	5.62	5.84	5.52	4.33	5.38	6.38	6.61
LIC	11	-4.51	-4.43	-5.36	-7.35	-6.07	-4.82	-5.20
MIC	13	14.18	14.52	14.73	14.22	15.07	15.85	16.60
OAL countries	30	-1.98	-0.78	-1.17	-1.63	-2.80	-0.41	0.80
LIC	18	-9.75	-8.12	-8.91	-9.70	-11.64	-8.05	-6.62
MIC	12	9.68	10.23	10.44	10.49	10.47	11.06	11.93
NAL+ countries	14	7.73	8.32	8.84	10.07	11.17	12.00	12.30
LIC	5	-0.97	-0.26	0.68	3.69	3.98	5.10	5.39
MIC	9	12.56	13.09	13.37	13.61	15.16	15.84	16.14
NAL- countries	18	0.06	0.53	0.99	0.56	1.15	1.36	1.73
LIC	7	-12.57	-12.43	-12.54	-14.71	-14.26	-14.62	-14.33
MIC	11	8.09	8.77	9.59	10.28	10.95	11.53	11.96
All developed countries	86	2.15	2.82	2.78	2.40	2.58	3.88	4.49

Source: FAO data.
Notes: Nutrition is calculated as N = ((U-R) / R) * 100 where U is the average per capita calorie intake of a country and R is its average requirement.
Data for Oman and Zambia are missing.

1986. Even after this improvement, seven EIAL African countries still had lower nutrition in 1986 than in 1980. The 10 NAL countries in Africa (excluding South Africa) look very much the same, with six showing deteriorations between 1980 and 1983-84 and five showing improvements after 1983-84. In five of 10 African NAL countries, the situation was worse in 1986 than in 1980. The few countries in Africa that managed to steadily increase nutrition during 1980-86 are in both the EIAL and the NAL groups.

3.20 Caloric intake is the minimum dimension of nutrition; but protein consumption is essential for a healthy work force. Changes in per capita consumption of protein indicate an average improvement in 86 developing countries from 1980 to 1986, but there are large differences across the countries. The EIAL countries and OAL countries have the same average pattern: an improvement in 1980-81, a slight decline in 1982-84 during the crisis years, and an improvement in 1985-86. Among the nonadjustment lending countries, the NAL+ group had a continuous improvement after 1982, and the NAL- group showed a slight increase. Per capita protein consumption generally improved, and there does not appear to be a relationship between protein intake and adjustment lending. These results on nutrition suggest that average food consumption has improved and that there is no systematic effect of adjustment lending in reducing food consumption.

Infant and child mortality

3.21 Infant and child mortality rates reflect the percentage of children who do not have access to or cannot afford minimum standard care — and indicate changes in the living standards of the poor. Although the rates are averages for a country, they do reflect distributional changes: small changes in the average values are likely to imply large changes for the poor. In the aggregate — and for each of the four categories (EIAL, OAL, NAL+, and NAL-) — the infant mortality rate declined monotonically during 1972-87.[13] For the EIAL country group, the rate of decline from 1982 to 1987 was slower than the decline from 1977 to 1982. This result, however, is due to one country: Chile had a 13-percent drop in its infant mortality rate in 1982-87, after a 50-percent drop in 1977-82. Excluding Chile, the average decline for the EIAL countries is higher in the 1980s than in the late 1970s. The newest data in this area — the Demographic and Health Surveys (DHS) for 11 countries — show the decline in infant mortality to have been large and continuing in the 1980s.[14]

3.22 Some demographers prefer the child mortality rate as a measure of countries' living conditions because it is likely to be more robust to cultural differences.[15] Of the 10 EIAL countries with good time series on child mortality, four showed faster improvement in the 1980s than in the late 1970s.[16] Five showed a continued reduction in child mortality in the 1980s, but at a less

rapid pace than in the 1970s. Of these five, two had mortality rates under 60 per 1000 births in 1980-85, a level at which large declines in child mortality may become more difficult to attain. Only one EIAL country (Ghana) had an increase in child mortality in the 1980s, but it is unclear whether the change occurred before or after the country started its adjustment program. Of the 10 NAL countries in the sample, four increased their pace of improvement in the 1980s, while six improved more rapidly in the 1970s than in the 1980s.

3.23 Generalizations are difficult to make from this small sample. The continuing progress (in 26 of 28 countries) during the 1980s is notable; the increase in its speed in 11 of the 28 countries is important. The apparent lack of a relationship between adjustment lending and child mortality is another significant finding: both EIAL and NAL countries had increases and decreases in the pace of improvement in the 1980s. What emerges from these data is that the general positive correlation between economic development (growth in GNP per capita) and social progress (reductions in child mortality) does not hold for periods of recession. Child mortality appears to be affected only in the long run, because of time lags in the underlying chain of causal events. The increasing availability of affordable, low-technology, life-saving interventions allows for continued progress even in times of recession.

Changes in social spending

3.24 To attain sustainable fiscal accounts, structural adjustment programs usually require changes in the provision of public services and government transfer payments. Some observers claim that the social sectors, such as health and education, suffer most from the spending cuts under structural adjustment.

3.25 Interpretations of changes in the shares of the central government budget as indicators of the level of social services delivered in total and to the poor require caution for two reasons. First, improved policies associated with structural adjustment programs may recommend the use of better targeting and cost-recovery measures that allow budget-cutting along with sustained or increased provision of social services, especially for the poor.[17] This is possible because typically the middle- and upper-income classes benefit the most from the use of social services and transfers. In many cases, services such as hospital care and university education account for 80 percent or more of government social outlays but benefit just 20 to 30 percent of the people, most of them urban. Thus budget cuts and improved access by the poor are simultaneously possible. Second, there may be reallocations of social expenditures between central and regional governments, and the data pick up only changes in the central government expenditures.

3.26 With these caveats in mind, we turn to the data on central government social spending. Central government total expenditures (excluding interest payments) increased slightly as a proportion of GDP from 1970-80 to 1981-84 and then decreased by 1.3 percentage points in 1985-87 on average for the 10 EIAL countries having data (table 3.4).[18] The share of spending on education and health in central government expenditure in the EIAL countries increased from 22.3 percent in 1970-80 to 24.4 percent in 1981-84 and then decreased to 22.4 percent in 1985-87.[19] The average share of expenditures on other welfare programs increased from 16.8 percent to 17.1 percent in the EIAL countries during the 1980s. The OAL countries also have a decreasing ratio of total public expenditure to GDP in the 1980s, but their social sector shares increased on average. The NAL countries increased their expenditure shares on health and education in the 1980s, but decreased their shares on other welfare.

3.27 Since total government expenditure varies over time, ratios of welfare expenditure to total expenditure do not indicate whether real welfare expenditures are decreasing or increasing. Data on the annual growth of real per capita education expenditures (in domestic currency) show that the average growth for the EIAL group continued to be positive in the 1980s, but growth was much slower than in the 1970s (table 3.5). The average growth in health expenditures was negative in 1981-84 but recovered in 1985-87. But there is substantial variation among EIAL countries. For education, six of 10 countries had negative growth in the 1981-84, and four had negative growth in 1985-87. For health, five of 10 EIAL countries had negative growth in 1981-84, and three had negative growth in 1985-87. There also is great variation in the magnitudes of change for individual countries.

3.28 Moving from inputs to outputs of social programs, average gross primary school enrollment rates declined from 94 percent in 1980 to 90 percent in 1985 in the EIAL countries, in contrast to a rising average for all the other groups (table

Table 3.4 Government expenditure and welfare expenditure shares (average % share)

	(G-Int)/GDP			Education/(G-Int)			Health/(G-Int)			Other/(G-Int)		
	1970-80	1981-84	1985-87	1970-80	1981-84	1985-87	1970-80	1981-84	1985-87	1970-80	1981-84	1985-87
EIAL countries												
Chile	31.4	31.1	28.1	15.0	14.5	13.7	7.8	6.5	6.4	34.4	46.4	46.7
Costa Rica	19.6	19.6	21.9	29.5	22.9	19.2	13.4	29.9	23.2	25.2	19.7	26.7
Korea, Rep. of	15.2	16.0	14.9	16.8	20.6	19.7	1.3	1.5	1.9	7.6	8.8	8.7
Mauritius	22.0	22.5	18.7	15.7	19.1	16.9	9.0	9.4	9.6	26.5	27.4	24.8
Mexico	12.6	18.1	13.0	19.8	18.1	19.3	4.5	2.0	2.6	25.6	19.6	20.0
Morocco	28.9	31.0	24.8	16.9	19.8	20.1	4.2	3.3	3.4	8.2	8.2	8.7
Pakistan	15.4	16.2	18.1	2.3	3.3	3.4	1.6	1.4	1.1	6.6	11.9	13.3
Thailand	14.7	17.6	16.9	22.3	22.5	23.0	4.4	5.5	7.0	7.7	5.8	6.2
Togo	37.9	29.1	34.5	10.7	21.0	13.5	5.1	6.4	4.0	15.2	14.6	11.8
Turkey	23.0	22.7	19.9	19.6	14.2	13.1	3.1	1.9	2.4	4.9	5.4	4.3
Average	22.1	22.4	21.1	16.9	17.6	16.2	5.4	6.8	6.2	16.2	16.8	17.1
OAL countries												
Hungary		53.0	54.8		1.7	1.9		3.1	3.7		26.2	27.9
Indonesia	18.2	20.6	20.0	8.7	9.9	10.8	2.2	2.6	2.3	2.4	2.4	2.8
Panama	28.3	28.6	26.1	18.7	16.3	19.6	15.5	18.2	19.5	14.8	18.0	22.1
Uruguay	22.5	24.6	20.6	10.7	7.3	7.4	4.4	3.7	4.8	48.3	54.7	54.8
Zimbabwe	29.1	31.1	33.0	14.5	23.3	23.7	6.4	7.2	7.1	8.1	9.2	7.7
Average		31.6	30.9		11.7	12.7		6.9	7.5		22.1	23.0
NAL countries												
India	10.9	11.9	14.3	2.5	2.2	2.6	2.2	2.6	2.4	3.9	5.1	6.0
Oman	51.9	44.9	47.6	3.5	7.2	10.1	3.4	3.5	4.9	3.0	3.5	3.8
Sri Lanka	26.5	26.0	27.0	11.9	9.4	9.7	6.6	5.0	5.2	26.0	16.3	13.0
Venezuela	18.2	20.9	18.5	17.3	19.4	22.1	10.2	8.9	10.7	10.5	14.5	12.9
Yemen, Arab Rep. of	22.6	37.9	28.9	8.2	16.3	19.9	3.2	4.3	4.2	2.3	2.0	2.2
Average	26.0	28.3	27.3	8.7	10.9	12.9	5.1	4.9	5.5	9.1	8.3	7.6

Source: IMF Government Finance Statistics.
Notes: (G-Int) is consolidated central government total expenditure less total interest payments.
Other expenditures are for social security and welfare, housing and community affairs, and recreational, cultural, and religious affairs.
Countries were selected if they had complete data for 1981-1986.
All averages are over nonmissing data.

3.6). Data are not available for the interim years, and these enrollment declines reflect the effects of both the crisis and the early phases of the adjustment program. The trend in the student-teacher ratio for the EIAL countries has been decreasing, a possible indication that the decreases in demand for education are larger than those in supply.[20] Families faced with falling incomes may have withdrawn their children from primary school to save on educational expenditures and to have their children contribute to household income. This may be especially true for low-income households whose time horizons are relatively short and who place less value on benefits that come several years in the future — an issue that needs to be investigated more fully.

3.29 Output in the health sector is not well measured, but one indicator is the percentage of children under one year old who have been immunized. On average, immunization coverage for measles and polio increased between 1981-84 and 1985-88 in the 18 EIAL countries for which there are data.[21] With wide variations around the mean, coverage declined for measles in four of the EIAL countries, and in six countries for polio. Declines in coverage were similar in NAL countries but less common among the OAL countries. The general picture shows immunization increasing almost everywhere, probably accounting for much of the continued decline in infant and child mortality. More information is needed to get a full picture of what happened to the quantity and quality of health services delivered to people in adjusting countries.

3.30 Health and education expenditure shares declined on average for the EIAL countries in

1985-87, and growth rates of real per capita health and education expenditures turned negative for five of 10 EIAL countries in 1981-84, with some recovery in 1985-87. The declines in health and education expenditures are cause for concern, especially in countries that, by any account, need to improve their social infrastructure significantly. In general, greater emphasis needs to be given to the social sectors during adjustment to avoid further reductions. Such expenditures are not only desirable in their own right, but the provision of health and education services can also be viewed as an investment in human capital, a contribution to long-term sustainable growth.

Social measures in adjustment programs

3.31 Changes in living conditions do not appear to be systematically related to adjustment lending, but there still can be short-run costs from adjustment programs. Adjustment operations should include assessments of the impact of the policy reforms on poverty, and poverty alleviation should be one of the objectives of the program. Throughout the adjustment period, certain key variables that reflect the status of the poor should be monitored — such as the internal terms of trade for poor farmers and the real unskilled wage.[22] To monitor them would require regularly collecting data on, say, the producer prices for small farmers, wages of daily agricultural laborers, and cost-of-living indices for the urban poor and the rural poor. Public sector expenditures important for the poor, such as primary education and nutrition programs, should also be monitored.

3.32 One issue is the time horizon to be used when designing social measures to alleviate poverty in adjustment programs. Since adjustment programs have short lending periods and rapid

Table 3.5 Annual percentage change in real government expenditure per capita

	G-Int			*Education*			*Health*			*Other*		
	1970-80	*1981-84*	*1985-87*	*1970-80*	*1981-84*	*1985-87*	*1970-80*	*1981-84*	*1985-87*	*1970-80*	*1981-84*	*1985-87*
EIAL countries												
Chile	4.8	-1.3	-2.1	3.1	-3.4	-3.4	2.2	-4.8	-2.9	5.9	4.0	-4.3
Costa Rica	11.5	-2.4	15.4	8.6	-9.7	7.3	117.6	-7.0	1.7	1.8	14.7	52.5
Korea, Rep. of	11.3	5.5	7.7	10.8	8.7	6.9	13.2	10.6	29.9	13.4	10.7	13.9
Mauritius	10.2	-1.4	4.3	15.2	-2.5	0.0	5.6	3.6	4.1	16.8	-1.2	7.1
Mexico	9.8	2.8	-8.9	11.4	-1.8	-13.8	1.4	-4.8	-9.0	7.1	-4.3	-6.1
Morocco	7.6	-5.8	1.8	8.1	-2.1	-1.9	1.8	-6.7	0.5	5.2	-3.9	3.2
Pakistan	3.6	6.4	12.4	24.8	14.9	6.1	10.5	2.3	0.1	10.2	30.3	3.5
Thailand	6.6	2.6	2.0	6.4	5.3	-0.3	8.2	12.0	6.1	2.7	1.1	6.4
Togo	-8.1	1.5	16.3	9.8	-1.1	3.0	-0.2	2.9	-8.0	13.9	12.3	-3.1
Turkey	7.0	-0.8	-8.4	10.0	2.6	3.8	5.7	-25.7	12.0	17.8	67.7	-6.2
Average	6.4	0.7	4.1	10.8	1.1	0.8	16.6	-1.8	3.4	9.5	13.1	6.7
OAL countries												
Hungary		-1.2	5.3		-7.6	21.7		3.8	8.2		2.0	2.5
Indonesia	14.2	-2.1	4.6	16.6	6.9	-2.2	25.5	-0.3	-9.8	37.7	-3.9	5.6
Panama	4.7	3.0	-1.4	-0.4	5.2	1.5	3.5	9.1	-3.2	10.7	5.1	6.7
Uruguay	-0.9	-4.9	0.8	-1.0	-12.2	10.6	24.2	-10.3	14.7	-0.3	-2.9	2.4
Zimbabwe	8.7	1.0	-5.2	11.0	10.2	-4.4	2.2	5.6	-4.3	13.3	-2.0	-3.7
Average		-0.8	0.8		0.5	5.5		1.6	1.1		-0.3	2.7
NAL countries												
India	7.8	3.9	10.5	5.1	5.4	20.8	14.1	15.7	0.8	13.7	8.9	20.4
Sri Lanka	14.1	-5.8	5.1	3.4	-2.6	6.5	8.0	-3.9	14.0	9.9	-7.8	0.3
Venezuela	9.9	-0.6	1.5	11.7	-1.8	1.9	5.4	-1.1	8.2	17.1	5.9	1.1
Average	10.6	-0.8	5.7	6.7	0.3	9.7	9.2	3.6	7.7	13.6	2.3	7.3

Source: IMF Government Finance Statistics for government expenditures, World Bank for CPI deflator and population.
Notes: (G-Int) is consolidated central government total expenditure less total interest payments.
Other expenditures are for social security and welfare, housing and community affairs, and recreational, cultural, and religious affairs.
Countries were selected if they had complete data for 1981-1986.
All averages are over nonmissing data.

Table 3.6 Gross primary enrollment ratio (percent)

Country classification	*Number of countries*	*1975*	*1980*	*1985*
EIAL countries	25	83.2	94.2	90.1
LIC	12	68.1	84.5	78.5
MIC	13	97.1	103.1	100.8
OAL countries	26	69.9	73.5	80.1
LIC	15	49.7	51.9	55.3
MIC	11	97.4	102.8	114.0
NAL+ countries	15	81.7	87.8	97.9
LIC	5	75.5	85.1	99.6
MIC	10	84.8	89.2	97.0
NAL- countries	18	79.1	84.5	85.6
LIC	7	56.1	64.0	64.0
MIC	11	93.7	97.5	99.3
All developing countries	84	77.9	84.5	87.4

Source: UNESCO.
Note: Data for Congo, Gambia, Guinea-Bissau, and Guyana are missing.

disbursements, social programs included in this type of lending should have similar time spans. This implies that social policies included in SALs and nonsocial sector SECALs should focus on short-term programs to compensate immediate losers, alleviate transitional costs to the poor, and protect priority poverty programs from expenditure cuts. Longer term measures to reduce poverty — such as those for sanitation, health, and education — should be implemented during the adjustment process through project lending or specific social sector SECALs. For these projects, SALs can be useful in helping identify areas where self-standing projects are needed to alleviate poverty.

3.33 The Bank has been increasing its attention to social dislocations that may arise during the adjustment.[23] The Social Dimensions of Adjustment project in the Africa Region is strengthening institutions to identify the poor and collect data on social indicators. The Living Standards Measurement Surveys are contributing useful data at the household level. These data will help in the design of short-term adjustment programs and in longer-term strategies for fighting poverty.

3.34 Since 1987 the President's Reports for adjustment loans have been required to address the social impacts of adjustment.[24] The share of loans with at least one social policy reform increased from 16 percent in FY79-FY85 to 26 percent in FY86-FY88 to 34 percent in FY89.[25] The number of social policy conditions in loan agreements required during the loan period is low but has also increased: conditions on social policy reforms, as a share of all conditions in SAL and SECAL loan agreements, increased from 1 percent in FY79-FY85 to 5 percent in FY86-FY88, and to 7 percent in FY89.[26] The shares have been increasing, but an examination of the content and adequacy of the conditions is also required to assess the importance of social reforms in programs.

3.35 As part of the effort to assist countries with the rationalization of their public expenditure programs, the Bank includes special measures in SALs to protect the poor and vulnerable groups from the adverse impact of expenditure cuts. Many Bank-supported SALs require the reallocation of government expenditures to priority sectors that most benefit the poor, improvements in the efficiency and equity aspect of social expenditures, and better targeting of subsidy programs. For Chile's milk distribution program — where about 20 percent of expenditures were benefiting the richest 40 percent — better targeting was part of the condition for the release of second tranche funds under SAL III. A study of Jamaica (box 3.2) found that a targeted food-stamp program and a school-feeding program were more effective in reaching the poor than a generalized food-stamp program. As part of the education sector loans in Ghana and Morocco, the Bank is helping to reorient education expenditures to primary education. And as part of an agricultural sector loan in Mexico, pilot programs of food assistance targeted to low-income families in rural areas were introduced. The Bank also promotes cost recovery for social services through user charges that exempt the poor (as in Senegal, Malawi, Niger, Sierra Leone, Ghana, and Indonesia).

Box 3.2 Jamaica: adjustment and the poor in the 1980s

Jamaica's performance from the late 1940s to the early 1970s was impressive whether measured by economic or social indicators. Yet a prolonged economic decline began in 1972 and many educated Jamaicans left the island for better prospects.

Per capita GDP in 1980 was down 18 percent from its level in 1972. A new government put more emphasis on the private sector and on export-oriented growth. Unfortunately, the international prices of bauxite and alumina dropped precipitously in the early 1980s, forcing the government to cut its spending severely.

The World Bank made three structural adjustment loans to Jamaica between 1982 and 1984, totaling $191.4 million. The loans were conditional on scaling down government intervention in the economy, reducing trade restrictions, and other common structural adjustment policies. Some of the measures proved to be unpopular, leading to strikes and even riots.

In response to worries that the structural adjustment policies might reduce the living standards of the poor, the government initiated several programs in 1984 to reduce the social costs of adjustment. In 1987 these were brought under the jurisdiction of a new government entity, the Social Well-Being Program. After the 1989 elections the new government adopted a revised version of this program under the Human Resources Development Program.

The major policy initiatives to compensate people during the structural adjustment process were:

- The Food Aid Program, which provides food stamps to mothers and small children, as well as to elderly and low-income individuals.
- General food subsidies, started in 1986, for wheat flour, rice, cornmeal, and powdered milk.
- Provision of school lunches (nutri-bun and milk) to selected primary-school-age children.
- Job training for the unemployed, especially youths and women.
- A variety of steps to strengthen the delivery of primary health care services to the population.

What was the impact of the adjustment program on the living conditions of the poor? And what effect did the social actions have in removing any possible negative effects? Some argue that the poor suffered a substantial deterioration in their quality of life as a result of structural adjustment. But others contend that controlling for past trends leads to a much less negative assessment of adjustment impacts. Two sources of data are available for looking at changes over time: national aggregate data on social indicators, and a set of three nutrition surveys for 1978, 1985, and 1989.

The average per capita consumption levels of the population fluctuated substantially from 1980 to 1987, but there is no apparent link with the initiation of Bank-supported adjustment programs, which started in 1982 (box table 1). The average daily calorie intake, by contrast fluctuated little. Primary school enrollment data show a steady increase from 1980 to 1985.[1] And infant mortality declined from 1982 to 1987. In sum: the evidence is not conclusive — but the data show no direct link between the structural adjustment program and Jamaica's aggregate social indicators in the 1980s.

From 1978 to 1985 the percentage of low weight-for-age children rose only slightly, indicating no major increase in malnutrition because of the introduction of the structural adjustment program (box table 2). By 1989 malnutrition had been substantially reduced, from 14.6 percent to 9.2 percent, suggesting that some of the support measures were effective. Indeed, the food stamp and school feeding aspects of the program clearly reached the poor (box table 3). But the general food subsidy program provides more assistance to the better-off groups than to the poor and are a less attractive subsidy program.

[1] The (gross) primary school enrollment ratio can exceed 100 if some primary school students are older or younger than the normal primary school age.

3.36 In some countries undergoing adjustment, special interventions are required to assist laid-off public workers unable to find alternative employment in the private sector during the early stages of the adjustment period. For instance, as part of Bank-supported adjustment programs, Central African Republic, Congo, Gabon, Gambia, Ghana, and Guinea have provided severance payments to laid-off public workers and, in some cases, to those departing voluntarily. Madagascar and Ghana are providing special retraining programs to retrenched workers. Mauritania's SAL I is helping laid-off workers from the iron ore enterprises to resettle as private farmers in the South, and the government is providing special credit to help other laid-off public employees to establish small businesses. In addition, some governments have encouraged employment through public works (Bolivia, Chile, Ghana, and Guinea) or food-for-work programs (Ghana, Mauritania, and Sao Tome and Principe).

3.37 In some countries, self-standing projects have been designed to help address the difficulties associated with the transitional period of adjustment. Examples include Ghana's Program of Action to Mitigate the Social Costs of Adjustment (PAMSCAD), Guinea's Social Economic Development Support Project (SDSP), Guinea-Bissau's Social and Infrastructure Relief Project (SIRP), and Bolivia's Emergency Social Fund (ESF), highlighted in box 3.3. Components under Ghana's PAMSCAD include labor-intensive priority public works programs, food-for-work projects for the rural unemployed, and supple-

Box table 1 Social indicators for Jamaica, 1980-87

Year	Private consumption per capita (constant 1980 J$)	Average daily calorie intake	Primary school enrollment	Infant mortality rate
1980	1,443	2,582	101	-
1981	1,397	2,554	-	-
1982	1,441	2,520	-	21
1983	1,538	2,583	-	-
1984	1,561	2,594	-	-
1985	1,510	2,559	106	-
1986	1,450	2,590	-	-
1987	1,580	-	-	18

Source: World Bank for consumption, calorie intake, and infant mortality rate. UNESCO for primary school enrollment.

Box table 2 Malnutrition in Jamaica, 1978, 1985, and 1989 (percentage of children aged four years and under)

Year	Moderate malnutrition	Severe malnutrition	Total malnourished
1978	13.4	0.9	14.3
1985	13.6	1.0	14.6
1989	8.5	0.7	9.2

Source: Ministry of Health; Statistical Institute of Jamaica.

Box table 3 Program benefits by income quintile (percent)

Program	Quintile 1 Poorest	2	3	4	5 Richest
General food subsidies	14	20	20	21	26
Food stamps	31	26	20	16	8
School feeding	32	24	21	14	10

Source: "Survey of Living Conditions", Statistical Institute of Jamaica, 1988.

mental feeding and nutrition education for mothers and children. Under Guinea's SDSP, the Bank helped set up a Special Intervention Fund to help finance small-scale income generating projects and social assistance projects.

3.38 In many countries the lack of institutional capacity to organize targeted programs for the poor provides a role for nongovernmental organizations (NGOs). NGOs are able to reach poor communities and remote areas, they can promote local participation and the use of local resources, and they have low costs of operation. Bolivia's ESF successfully used NGOs for execution of subprojects. The project in Guinea-Bissau includes an NGO Fund to finance specific subprojects to be prepared and implemented by NGOs.

3.39 The Bank maintains a collaborative working relationship with other donors in addressing the social costs of adjustment. At the regional level, the multidonor-financed Social Dimensions

Box 3.3 Bolivia's emergency social fund

Years of economic mismanagement caught up with Bolivia in 1985. Inflation exceeded 11,000 percent, the public sector deficit was over 30 percent of GDP, and GDP per capita had fallen by more than 20 percent since 1980. In September 1985 Bolivia embarked on a wide-ranging orthodox stabilization program.

As part of this program, the public wage bill was frozen and plans were prepared for restructuring of state enterprises. Soon after the government started implementing this program, Bolivia's economy suffered setbacks from the collapse of the international tin market. As a result, 80 percent of the employees of state mining companies were laid off.

From the outset of the adjustment program, the government placed emphasis on alleviating the social costs of adjustment. Laid-off mine workers were provided with compensation payments. In 1986 the government established the Emergency Social Fund and embarked on a major program with three goals: (1) to cushion the adverse effects of the crisis and the resulting stabilization program on the poor, (2) to facilitate the transition through the structural adjustment process, and (3) to alleviate any further deterioration in social conditions. The ESF obtained most of its resources from bilateral concessional aid, and the World Bank has supported it with two credits amounting to $37 million.

The ESF provided funds to economic infrastructure projects, such as road maintenance and irrigation drainage; social infrastructure projects in health, education, and sanitation; social assistance interventions, such as school feeding and vaccination programs; and the provision of credit to microenterprises through NGOs. The primary emphasis of the ESF program was to provide temporary employment opportunities.

The program differed from typical government work programs in several aspects. First, it was intended to encourage local initiative in that it funded projects sponsored by local governmental and nongovernmental agencies. Second, its projects were executed by private subcontractors working under the supervision of the local agency and the central ESF management team. Third, the ESF was established explicitly as a temporary financial institution to operate outside the government bureaucratic structure for three years (1986-89).

The ESF proved successful both as a demand policy instrument and as an institution that could effectively mobilize external funds and disburse them quickly. By the end of 1989, the ESF had raised more than $150 million in foreign currency, or about a third of the 1988 current account deficit. Operating outside the government structure, the ESF was particularly effective in making resources available to smaller local groups and nongovernmental organizations (NGOs). By the end of 1989 the ESF had committed about $20 million to NGOs..

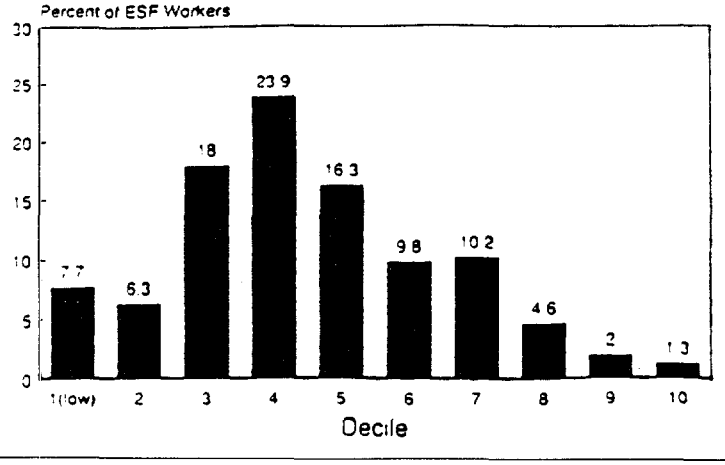
The ESF program reached workers in the lower income deciles. ESF workers were mostly prime-age unskilled males who were the main income earners of their households. The ESF did not target the ex-miners and laid-off public workers. A little over 30 percent of all those working in ESF projects were ex-construction workers, and 10 percent were ex-miners.

ESF workers acquired substantial temporary gains in earnings mostly through additional hours of work, rather than higher wages. A counterfactual simulation shows that the average ESF worker could be predicted to earn hourly wages that were 9 percent higher than what he would have earned without the ESF, but total earnings of workers on ESF funded projects could be expected to be 48 percent more with than without the ESF. Even with these gains in earnings, however, most of the workers would remain in the lower income deciles.

Programs such as the ESF provide temporary employment during the adjustment period until growth resumes and permanent jobs become available. If the selected subprojects are intensive in unskilled labor, they will reach the poorer segments of the population.

The ESF distributed donor funds quickly to low-income workers — giving it favorable publicity and making the adjustment program more sustainable. The positive experience with the ESF has motivated efforts to establish similar funds in Guatemala, Guyana, Haiti, and Jordan. This type of employment program is worth trying elsewhere, but country circumstances may require different program organization.

Distribution of ESF workers by earnings deciles



of Adjustment project in Africa (SDA) is sponsored by the UNDP, the African Development Bank, and the World Bank. At the country level, the Bank and UNICEF work closely in Ghana's PAMSCAD project, with UNICEF active in the nutritional surveillance and the food-for-work activities under this program. Under Senegal's SAL, the ILO is providing assistance with credit, training, and project identification in the creation of small-scale enterprises for laid-off employees from public sector enterprises. USAID also provided funds to these employees in the form of separation payments to be used as seed money. Under SAL I in Guinea-Bissau, the UNDP and other donors are assisting the government with a program to retrain and resettle laid-off civil servants into agricultural activities in the villages. In Nepal, the UNDP supported SAL I by providing financing for technical assistance activities to improve the administration of development expenditures.

Conclusions

3.40 Cross-sectional data on changes in poverty are limited, but the available data do not suggest that adjustment lending has on average increased poverty. Furthermore, aggregate data support similar conclusions.

- On average, the rate of growth of private consumption in the EIAL countries recovered in the late 1980s to the rate achieved in the 1970s—and the rate in the late 1980s was higher in total and on a per capita basis, in comparison with other country categories.
- The available socioeconomic indicators of the status of the poor did not deteriorate in the 1980s on average for developing countries or for the EIAL category. Indicators of nutrition improved and average protein intake continued to rise from 1983-84 to 1986 in all categories of countries, with and without adjustment lending. Infant and child mortality, indicators of the longer-run health status of the poor, continued to improve on average for country categories with and without adjustment lending.
- Central government expenditure shares for health and education declined on average in the EIAL countries having data. Some of the decline in health and education expenditures may have occurred because better targeting of public expenditures left middle- and upper-income groups to pay for more of the provision of these services or because other levels of government took responsibility for some of these expenditures. In education, the declining primary school enrollment ratios for the EIAL countries are inconsistent with restoring sustainable long-term growth, which requires strengthening the human capital base, an important input to the growth process. In health, the immunization coverage generally increased for all country groups, and this increase probably accounts for much of the continuing decline in infant and child mortality rates.

3.41 This review of the Bank's experience with social measures to protect the poor during adjustment shows that adverse impacts on the poor can be reduced, consistent with the macroeconomic component of adjustment programs. Public expenditure reductions can be coordinated with policies to shift the composition of expenditure, improve targeting of social sector expenditures, and promote the collection of user charges for social services from middle- and upper-income groups. Adjustment programs can include measures to improve the mobility of newly unemployed labor into profitable sectors through retraining, credit allocations and severance payments. Public works programs that are intensive in unskilled labor are a promising way to improve the incomes of the poor. And in many countries, the lack of institutional capacity to organize targeted programs for the poor provides a role for nongovernmental organizations.

3.42 The Bank has made progress in addressing the transitional costs of adjustment in the design of adjustment programs, but further advances are possible. In adjustment operations, the impact of the policy reforms on poverty should be considered, and poverty alleviation should be included as one objective of the program. The social measures in adjustment programs should focus on reducing immediate costs directly related to the adjustment program — for example, easing the transition between jobs of newly unemployed workers and protecting the poor from expenditure cuts. Longer-term developmental policies to reduce poverty through project lending or social sector SECALs should complement adjustment policy reforms, and this lending should be implemented *during* the adjustment process.

4

Designing and implementing adjustment programs

Summary

4.1 This chapter reviews the issues and lessons in major policy areas for adjustment lending — macroeconomics, public enterprises, government finance and administration, and the trade, industrial, agricultural, and financial sectors. It discusses the importance of macroeconomic stability for the success of reforms in other areas. It reviews the record of borrowers in implementing their adjustment programs. It analyzes how President's Reports and loan agreements describe the program and conditionality and how the specification affects implementation. And it also considers how the design and presentation of a program can build the political support that is essential to sustain adjustment.

Overview of program design and implementation

4.2 While each adjusting country faces a unique set of problems and requires a unique mix of remedies, the Bank's cross-country experience suggests some generalizations about the design of successful structural adjustment programs. The country's reform program is generally broader than the components the Bank supports with adjustment lending, and usually includes some elements supported by the IMF. The reforms fall into three broad policy categories:

- Expenditure-reducing policies — principally fiscal and monetary measures — to bring domestic demand in line with available resources.
- Expenditure and production switching policies, to encourage both exports and efficient import substitution by raising the domestic price of tradables relative to the price of nontradables.
- Supply-side, growth-oriented policies to remove the structural causes of macroeconomic imbalances, to improve the efficient use of resources in the public and private sectors, to strengthen institutional capacities, and to increase saving and investment.[1]

Many policies have effects in two or even three areas, but the primary impact is usually in one. Supply-side, growth-oriented policies account on average for over 80 percent of conditions in the Loan Agreements and a similar share of all actions called for in the President's Report (table 4.1).[2] As discussed below, expenditure-reducing and switching policy reforms are also vital. In particular, fiscal reforms that permanently reduce public sector deficits can enhance the benefits of supply-side reforms.

4.3 Adjustment loans have become more focused, a change reflected in the rising share of SECALs, especially for larger countries with complex problems (box 4.1). Because of the importance of complementary reforms in different policy areas, recent adjustment loans address as wide a variety of policy areas as they did when SALs were dominant (table 4.2). For the EIAL countries, with their longer history of adjustment lending, trade and agricultural sector conditions have declined in importance, and financial-sector reform has become more important. Deficit reduction and other fiscal reforms have declined

as a share of the growing number of total conditions in loan agreements but have increased slightly in absolute number per loan, appearing in about half of the loan agreements.

4.4 The typical adjustment loan disburses in two tranches, with some of the conditions required for effectiveness (first tranche), some required for the second tranche, and others (special covenants) required by a specific date or during the life of the loan. When not all the conditions can be satisfactorily implemented as originally written, management either cancels the loan or recommends appropriate changes in the conditionality in light of the new circumstances, and it brings the matter to the Board. Canceled loans include Jamaica Second Export Development Fund and Panama SAL II. Recent examples of loans with revised conditionality accepted by the Board include Argentina Agricultural Sector AL, Colombia Energy Sector AL, Congo SAL, Jamaica Trade and Financial Sector AL, Mexico Financial Sector AL, Morocco Public Enterprise Reform Loan, and Sao Tome and Principe SAL. As experience has made clearer the importance of credible reforms for the economic recovery of adjusting countries, the Bank has increased its insistence on program implementation.

4.5 This report extends the analysis, done in the first report, of the pattern of implementation of loan conditions using a larger sample of loans. Based primarily on the tranche release document, with supplemental information from loan supervision reports and discussions with operational staff, the implementation of each condition was classified as none, partial, substantial, full, or more than full.[3] Of course, a statistical analysis cannot capture all the nuances of judgment necessary to evaluate program implementation, and the results need careful interpretation. Nevertheless, the statistics show trends in implementation and reveal some factors that influence implementation.

4.6 From all the conditions in the legal agreements for adjustment programs in the sample covering all the 1980s, the overwhelming majority — 84 percent — were implemented, as originally written, at least substantially by the time of final tranche release, and 66 percent were implemented fully or more than fully (table 4.3). For

Table 4.1 Content of conditionality

	Distribution of loan-agreement conditions by policy area and country type (percent)											*Distribution of all actions in Presidents' Reports* [c] *(percent)*
							EIAL countries [b]			*Other AL countries*		
	All countries	*HICs*	*SSA*	*SAL*	*SECAL*	*Hybrid-loans* [a]	*79-85*	*86-88*	*89*	*79-85*	*86-89*	
I. Supply-side, growth-oriented policies	85	89	82	77	91	90	88	88	88	87	80	84
Trade policies	16	22	14	15	17	4	26	17	11	10	13	16
Sectoral policies [c]	28	23	26	18	35	62	36	21	44	53	23	28
Industry	4	4	4	3	4	5	6	4	7	4	2	5
Energy	6	3	2	3	7	31	5	4	24	2	4	5
Agricultural	17	16	19	12	20	19	25	13	12	47	14	17
Financial sector	10	12	7	10	9	1	3	14	18	9	7	10
Rationalization of gov't finance & administration	7	7	6	11	4	0	8	6	5	3	8	9
Public enterprise reforms	16	18	19	15	17	7	14	21	6	6	18	14
Social policy reforms	4	5	5	2	5	14	0	8	0	2	5	3
Others	4	2	5	4	3	1	1	2	2	3	7	5
II. Absorption reduction policies	12	9	13	18	8	8	11	10	9	9	15	11
Fiscal policy	9	7	12	16	6	7	9	9	7	8	11	8
Monetary policy [money supply targets]	2	2	2	2	2	0	1	1	3	2	4	3
III. Switching policies	3	2	4	5	2	2	1	2	3	4	5	5
Exchange rate	2	2	2	2	1	0	1	2	2	2	2	3
Wage policy	2	0	3	3	1	2	0	1	1	3	3	2
Total [d]	100	100	100	100	100	100	100	100	100	100	100	100

Source: Based on an analysis of 183 SALs and SECALs to 61 developing countries. A total of 7,723 actions were considered in all.
a. Based on a subset of 10 hybrid SECALs.
b. See Table 2.1. Years refer to fiscal year of Board approval.
c. All actions in all countries, including conditions in loan agreements.
d. Total includes more than itemized sub-categories.

Box 4.1 Adjustment lending programs in FY89

Adjustment lending programs in the last year and a half have followed previous trends. SECALs continued to grow in relative importance except in small countries in SSA and LAC, where SALs remained important. SECALs focused on industry and trade (six ITSALs), financial sector (five FSALs), and agriculture (four AgSALs).

- Most but not all SALs required the reform of macroeconomic policies; only a minority of SECALs had conditions addressing the macroeconomic situation.
- Most countries that received adjustment lending in FY89 had macroeconomic difficulties ranging from mild stagflation in Uruguay to hyperinflation, acute external imbalance, and an accelerated decline of output in Argentina. Of the Argentine loans scheduled for release in FY89, the AgSAL's second tranche was released in summer 1989 despite non-fulfillment of the main condition. But the Banking Sector loan, which was revised in the fall, failed to become effective. The Trade Policy loan, which also became effective in the fall, has had the second tranche indefinitely delayed.
- In some countries with adjustment loans in effect during FY89, macroeconomic imbalances became more severe (Cameroon and Pakistan). In others the situation was improving (Ghana, Uruguay, and Philippines). Some countries, such as Bolivia and Mexico, made major progress on stabilization but have not yet restored adequate growth.
- A review of 23 adjustment loans to 18 countries in FY89 produced the following findings: A few countries, for instance, Bolivia, Uruguay, and Philippines, had a well thought-through and consistent macroeconomic program at the time of Board presentation. Other countries, such as Argentina, Cameroon, and Pakistan, lacked a credible program.
- Three-fourths of the SALs in FY8 and two-thirds of the SECALs also had an International Monetary Fund agreement in place at the time of Board presentation.
- Three-fourths of the Letters of Development Policy had a reference to the macroeconomic program, but only a third of these letters recorded a specific understanding on monetary and fiscal policies to ensure stability during the period of the loan.
- The average number of conditions in the loan agreements has increased. This contradicts the letter but not the spirit of the recommendation in the first report, because the larger number of conditions usually reflects more detailed, step-by-step specification of what would have been a vague condition in earlier years.
- Hybrid loans became more common in FY89. The Africa region used five hybrid loans in FY89 and will probably use over three times that many in FY90. Agriculture and human resource development are the fastest growing policy areas for hybrid loans.

Table 4.2 Content of lending operations

	Share of loans with loan-agreement conditions in various policy areas (percent)											
							EIAL countries			*Other AL countries*		*Share of loans with actions in various policy areas[a] (percent)*
	All countries (183)	*SSA (84)*	*HICs (64)*	*SAL (73)*	*SECAL (110)*	*Hybrid (10)*	*79-85 (55)*	*86-88 (49)*	*89 (15)*	*79-85 (9)*	*86-89 (55)*	
I. Supply-side, growth oriented policies												
Trade policies	58	58	67	64	55	30	60	69	33	56	55	79
Sectoral policies												
Industry	22	30	16	25	20	10	24	20	27	22	20	44
Energy	15	12	14	21	11	30	15	14	7	22	16	27
Agricultural	45	62	33	56	37	30	44	35	27	89	53	62
Financial sector	31	26	31	40	25	20	16	35	27	44	40	51
Rationalization of gov't finance & administration	51	57	50	71	38	10	51	53	40	44	55	72
Public enterprise reforms	44	58	34	49	40	40	31	49	33	33	56	65
Social policy reforms	11	13	9	11	11	10	4	20	0	22	11	24
Other	28	42	17	33	25	10	7	27	20	33	51	49
II. Absorption reduction policies												
Fiscal policy	51	69	41	78	34	30	47	51	53	33	58	67
Monetary policy [Money Supply Targets]	16	14	13	14	16	10	7	16	13	11	24	42
III. Switching policies												
Exchange rate	16	18	20	22	13	0	9	18	20	11	22	45
Wage policy	13	23	5	25	6	20	4	8	7	11	29	22

Source: Based on an analysis of 183 SALs and SECALs to 61 developing countries.
Notes: Numbers in parentheses ( ) are total number of loans.
a. All countries. All conditions called for in all loan agreements or other actions called for in all Presidents' Reports.

the five or six most critical actions in the program (coded on the basis of the President's Reports), the implementation rates are as good on average as for all conditions in the legal agreement. Legal agreements, following recommendations in the President's Reports, include on average only a third of the expected actions in the corresponding President's Reports, but most of the other actions were also implemented substantially or fully. Some impediments to implementation, such as changes in world interest rates and the terms of trade, are beyond the control of the countries. Loans over the 1980s to countries with stable or improving external circumstances during the loan period had higher average implementation rates than loans to countries with major negative shocks.[4]

4.7 Implementation rates increased during the 1980s. Loans since 1985 have higher average implementation rates than those made earlier (table 4.7). The increased average implementation rate of conditions on loans to the EIAL countries contributed to the overall increase.[5] There was an even bigger change in loans to non-EIAL countries. Before 1986 loans to these countries had below-average implementation rates, but after 1986 the non-EIAL loans (mostly to a different set of countries than the pre-1986 non-EIAL loans) had higher average implementation rates than the loans to EIAL countries. For the loans with the final tranche release in FY89, 99 percent of the conditions had been at least substantially implemented, and 80 percent had been fully implemented. Excluding the Morocco PERL, the only loan in the sample for which some conditions were waived with Board approval in FY89, the share of conditions fully implemented rises from 80 to 88 percent. Thus, current procedures assure satisfactory implementation of the program before the final tranche is released.

4.8 Macroeconomic stability was associated with improved implementation; presumably they reinforced each other. Countries with low average annual inflation (less than 10 percent average annual inflation rate in the four quarters after effectiveness) implemented 93 percent of conditions at least substantially, whereas countries with moderate inflation (10 to 50 percent) implemented 79 percent, and high inflation countries implemented only 74 percent (see table 4.4). Rising inflation rates were also associated with lower implementation rates. As expected, policies to reduce the budget deficit were poorly implemented in inflationary economies. Inflation also reduced the chances of reforming price and exchange rate policies: in high-inflation countries less than half of the exchange rate conditions were fully implemented. Because the stability and appropriate level of the real exchange rate and the predictability of relative prices are central to the success of trade reform, reforms that focus on reducing the structural causes of macroeconomic imbalances should be a first priority for countries with severe macroeconomic imbalances. And the maintenance of a stable macroeconomic situation should be a supportive condition for sectoral reforms in other countries.[6]

4.9 Two groups of countries account for most of the recent adjustment lending — Sub-Saharan Africa and the highly indebted countries. In Sub-Saharan Africa the negative effects of policy distortions are compounded by institutional weaknesses. Unfavorable changes in terms of trade have increased the need for adjustment there. Overall, the Sub-Saharan countries have implemented about 80 percent of the conditions in their loan agreements substantially — not as high as other regions — but they have had above-average success with fiscal and industrial sector reform. As in other regions, structural reform to reduce macroeconomic imbalances have been necessary to realize the full benefits of sectoral reforms (box 4.2).

4.10 The highly indebted countries have reduced primary budget deficits (budget deficits exclusive of interest payments on domestic and foreign debt), borrowed more domestically, and often resorted to printing money to replace the loss of foreign financing. Of the fiscal reforms called for by loan agreements with the highly indebted countries, particularly the budget-deficit reduction measures, about 93 percent have been at least substantially implemented by the time of final tranche release. High debt service has kept conventionally measured budget deficits high in some cases and contributed to inflation, despite substantial fiscal adjustment.

Policy reforms in adjustment programs

4.11 All SALs and most SECALs call for policy reforms in more than one area, but each area has its own set of issues that warrant separate attention.

Table 4.3 Implementation of conditions (percent at final tranche release)

	In all loan agreements[a]		*SALs*	*SECALs*	*HICs*	*SSA*	*Critical actions*[b]	
	Fully implemented	*At least substantially implemented*	*At least substantially implemented*	*At least substantially implemented*	*At least substantially implemented*	*At least substantially implemented*	*Fully implemented*	*At least substantially implemented*
I. Supply-side, growth-oriented policies								
Trade policies	62	85	79	88	87	84	56	82
Sectoral policies								
Industry	72	92	90	92	100	96	53	65
Energy	69	80	70	84	79	67	72	80
Agricultural	62	81	86	80	88	75	49	74
Financial sector	73	89	94	83	97	80	79	92
Rationalization of gov't finance and admin.	63	81	79	83	85	85	54	68
Public enterprise ref.	66	80	77	78	90	71	67	77
Social policy reforms	59	91	67	92	93	75	55	82
II. Absorption reduction policies								
Fiscal policy	74	82	81	85	93	84	72	89
Monetary policy [money supply targets]	67	83	0*	91	100*	50*	61	89
III. Switching policies								
Exchange rate	75	85	78	91	80	91	71	81
Wage policy	45	91	89	100	33	100	50*	50*
Total								
Loan agreement conditions[c]	66	84	83	84	89	80	67	83
All conditions or actions[d]	57	77	73	80	82	75	60	79

Source: Based on an analysis of 97 SALs and SECALs in 32 developing countries. The sources of information on implementation were mainly supervision reports, tranche release documents, and where available, Project Completion Reports and Program Performance Audit Reports.
a. The data on implementation indicate the extent to which a condition or action was fulfilled at final tranche release. A total of 1,015 legal conditions were graded on implementation.
b. Critical actions are so identified because Bank staff designing the operation put particular emphasis on them and because they were expected to make a significant contribution to adjustment in a short time. A total of 494 actions were coded as critical, of which 303 appeared as conditions in the loan agreements.
c. The implementation rate of conditions that appear in the loan agreement.
d. Average Implementation of actions which appear in the President's Report or conditions in the loan agreement. A total of 2,231 actions were graded on implementation.
* Less than five observations in these cells.

Macroeconomic policy

4.12 The relation between structural adjustment and macroeconomic stability depends on the situation of the country. When the country has acute macroeconomic imbalances and needs structural adjustment in order to achieve macroeconomic stability and a sustainable balance of payments, adjustment loans focus on supporting the structural measures necessary to restore long-run macroeconomic balance, such as reform of taxes, public expenditures, and public-sector enterprise. If the macroeconomic situation is not acute, although it might not be sustainable in the long term, adjustment lending has been effective in supporting sectoral reform measures with mostly indirect macroeconomic effects — as the economy benefits from reduction of microeconomic distortions. Here, the success of structural reform depends on the maintenance of a supportive macroeconomic environment — competitive and stable real exchange rates, low and predictable inflation, domestic interest rates that are competitive with international interest rates, and a sustainable current account deficit. In the past, a number of countries initiated well-designed sectoral reform programs, in areas such as trade and the financial sector, and then abandoned or reversed them because of an unstable macroeconomic situation.

4.13 Trade reforms aim to shift investment and labor from nontradable and highly protected import-competing activities toward the production of exports and efficient import substitutes.

Table 4.4 The macroeconomic environment and implementation

Average rate of inflation[a]	*Loan type*	*Number*	*Implementation of conditionality*[b]		*Number with concurrent IMF programs at effectiveness*[c]	*Number with concurrent IMF programs at least 8 of first 12 mnths*
			Fully implemented (percent)	*At least substantially implemented*		
Low						
-10 to 10	SECAL	27	75	92	20	20
	SAL	22	72	95	21	15
Moderate						
10 to 20	SECAL	12	61	93	7	7
	SAL	15	57	73	12	12
High						
20 to 50	SECAL	24	58	76	17	16
	SAL	10	59	81	10	8
50 to 400	SECAL	18	53	78	12	9
	SAL	7	52	66	5	6

Source: Based on an analysis of 135 SALs and SECALs to 52 developing countries. Inflation data based on quarterly data drawn from IFS.
a. The rate of inflation is based on the average annual percentage change of the CPI index for the four- quarter period beginning the quarter of loan effectiveness.
b. The rate of implementation is based on the average share of conditions implemented per loan. In this regard only conditions listed in the loan agreement were considered. A total of 53 SECALs and 35 SALs were graded on implementation.
c. Includes Stand-by arrangements, Extended Fund Facilities, Structural Adjustment Facilities, and Enhanced Structural Adjustment Facilities.

But overvalued exchange rates undermine such efforts. The Southern Cone countries of Argentina, Chile, and Uruguay faced this problem in the late 1970s, as do some of the African franc zone countries today. Overvalued or unpredictable real exchange rates are also common in countries with high and unpredictable inflation, such as Brazil and Yugoslavia. A major study of trade liberalization found that countries that carried out and sustained trade reform usually had lower fiscal deficits than the countries where liberalization failed. In some cases successful trade liberalization was carried out while stabilization was still under way — as in Chile in 1974-79 and Turkey in 1980-84. But in the more typical cases, either severe macroeconomic instability contributed to the failure of liberalization (in Argentina, Brazil, and Sri Lanka in the 1960s, and Peru, Philippines, Portugal, Turkey, and Uruguay in the 1970s) or stability contributed to successful liberalization (in Greece, Korea, and Spain).[7]

4.14 Financial sector and interest rate reforms can compound an economy's problems if the government continues to run a high deficit, as in Argentina in the late 1970s, Israel in the early 1980s, and Turkey in the late 1980s. If large public deficits persist, or if the public perceives that a large devaluation is imminent, market-determined real interest rates are also likely to be high. High real interest rates choke off new investment and bankrupt firms that would otherwise be viable with normal interest rates. Chile made tremendous progress in privatizing banking in the 1970s, but the cycle of currency overvaluation, depression, and devaluation in 1982-83 caused system-wide financial failures that led the government to re-nationalize most of the banking system.

4.15 The evidence thus shows that some otherwise desirable reforms lose their credibility if undertaken without appropriate macroeconomic adjustment, possibly having an overall negative effect. If people doubt that a program will last, the economy will not respond as favorably as if the program had full credibility. In addition, when countries borrow to finance adjustment programs that fail, the increased external debt compounds the negative effects of policy failure. Keeping inflation low helps to reduce the fiscal deficit by increasing the efficiency of the tax system and preventing an overvalued real exchange rate.[7]

4.16 Expenditure-reducing or switching policies are present as conditions in at least four out of five SAL legal agreements. Measures that improve the administration and finances of the government and public sector enterprises also help to address the structural causes of macroeconomic imbalances. Over three fourths of SALs require fiscal reforms to reduce absorption and over one-fifth require exchange rate reform, the key policy to encourage switching. Usually this involves keeping a competitive real exchange rate. Exchange rate reform has been especially important in adjustment lending programs that were

Box 4.2 Macroeconomic foundations for structural adjustment in Sub-Saharan Africa: examples from Ghana and Tanzania

A large number of adjustment loans have gone to Sub-Saharan Africa, and the share of adjustment lending there is expected to remain high longer than in other categories of countries. The current need for balance of payments support is typically necessary to complete a full program of policy reform. These special needs do not diminish, but rather increase, the importance of constructing a sound macroeconomic foundation. Fiscal policy and exchange rate policy are key components in macroeconomic reform in Africa, as elsewhere, although the initial problems are usually manifested differently. Of particular interest for structural adjustment has been the problem of parallel exchange markets.

In a typical economy of Sub-Saharan Africa before adjustment, a major source of government revenue is often a legal monopoly in purchasing bulk export commodities (in return for overvalued domestic currency) and selling them at full price in export markets. The difference accrues as purchasing power in the hands of the government to use for external debt service and imports for itself or favored private groups. Evasion from this effective export tax results in a parallel market—often very extensive—where producers sell for foreign exchange at the black-market rate and import smuggled goods or accumulate flight capital. For example, the share of the parallel-market economy was one third in Ghana in 1982 and above 60 percent in Sudan for most of the 1980s. The premium in the black market for foreign exchange often exceeds 200 percent.

The black market premium in these economies depends in the long run mainly on the size of the fiscal deficit (net of the revenue for export marketing boards), because the size of the premium determines the rate of the implicit tax on agricultural exports, such as cocoa in Ghana or cotton in Tanzania. Devaluations will not greatly reduce the premium in the long run, therefore, unless accompanied or preceded by serious fiscal adjustment.

Parallel markets for foreign exchange are a symptom of policy distortions—controlled exchange rates and excessive budget deficit. In a transition, the parallel markets offer an important safety valve for some parts of the economy to operate with less distorted prices. But the expansion of parallel markets often worsens macroeconomic performance and leads to a crisis that forces the government to recognize the need for structural adjustment. Their spread reduces the government's revenue from conventional (and implicit) taxation. Parallel markets react quickly to changes in expectations and thus expose any credibility problems of government policy. The interaction between the elements of the parallel economy—the black market for foreign exchange, smuggling, under- and over-invoicing of exports and imports—complicates commercial policy and creates large-scale opportunities for corruption.

The adjustment experiences of Ghana and Tanzania, two relatively successful cases in Sub-Saharan Africa, illustrate how macroeconomic reform is needed to address the problem of a pervasive parallel market. Before starting structural adjustment, Ghana's black market exchange rate was more than twenty times the official rate, annual inflation exceeded 100 percent, and real GDP had been declining on a per capital basis since the 1960s and in total since the mid 1970s. Since initiating an economic recovery program in April 1983, real per capita output has risen substantially and inflation declined, as described in box 2.1. Reductions of the fiscal deficit facilitated large real devaluations and substantial trade liberalization.

The fiscal reform started strongly in Ghana, bringing the deficit quickly down from 6.9 percent of GDP, and has kept the deficit at around 2 percent of GDP since 1983. Because real GDP fell during the first year of the program, revenue declined and the government had to make difficult expenditure cuts. Ghana substantially reduced losses on state-owned enterprises and increased revenue from conventional taxes. Administrative reforms improved collection of income taxes (with somewhat reduced rates) and of import tariffs, which also rose because of the real devaluation. Even though the terms of trade have worsened by about 25 percent, the reform is succeeding in Ghana.

Tanzania also had widespread economic controls and parallel markets. To finance an ambitious public expenditure program in the 1970s and early 1980s, the authorities implicitly taxed agricultural exports heavily via export marketing boards and an overvalued exchange rate. Depressed exports led to serious shortages of foreign exchange, and controlled prices discouraged the imports and production of consumer goods, and provided large rents to those with privileged access. Speculative demand for foreign exchange and consumer durables exacerbated the shortages and led to even more elaborate controls.

Tanzania's first attempts at reform in 1980-82 failed because the government did not reduce sufficiently the fiscal deficit or the currency overvaluation. The second Economic Recovery Program, begun in mid 1986, is addressing these problems gradually—and thus far with with success. Administrative tax reforms and a rising volume of (taxed) imports have raised revenues. But more importantly, the government has reduced outlays by freezing most public-sector employment, slashing subsidies to state-owned enterprises, and reducing social expenditures through better targeting. Tanzania has thus been able to devalue the official rate by over 95 percent in real terms, closing the gap with the parallel rate, and stimulating exports other than coffee, for which

continued

Box 4.2 (cont.)

the world price dropped in 1987-89. Non-coffee exports rose 79 percent from 1986 to 1989, and growth of GDP has resumed—to more than 4 percent a year.

Improving the economies of Sub-Saharan Africa requires reducing the fundamental macroeconomic imbalances that give rise to the sizable parallel markets and thwarts their integration into the regular economy. Fiscal reforms and technical assistance to strengthen fiscal institutions need to accompany exchange rate devaluation and trade reforms. The macroeconomic reforms usually enhance the incentives for agriculture, which must continue to play a major role in the economic development of most countries in Sub-Saharan Africa. That Ghana and Tanzania succeeded with reform, despite their unfavorable external economic environment, indicates the potential of economic reform in Sub-Saharan Africa.

1. Pinto, Brian (1985), "Fiscal Deficits, Inflationary Expectations and Parallel Exchange Markets in Ghana: Monetarism in the Tropics?" CPD Discussion Paper No. 1985-86.
2. Box 8.1 also discusses the case of Ghana in longer-term perspective. For an extended discussion, see Stephen D. Younger, "Ghana: Economic Reform Program," in Successful Development in Africa: Case Studies of Projects, Programs, and Policies, EDI Development Policy Case Series, No. 1 The World Bank, Washington, DC, 1989.

initiated after the mid-1980s. In countries where the real exchange rate greatly exceeds the level required by macroeconomic fundamentals, and rigidities impede adjustment, exchange rate policy should not be seen simply as a tool for balance of payments management; it is one of the fundamental instruments in structural adjustment. Although one would not expect macroeconomic policies to be the centerpiece of SECALs, the full success of sectoral reforms generally does require satisfactory macroeconomic management. In 1980-89, however, fewer than half the SECALs included conditions focused on absorption reduction. (In a few countries, such as Mexico and Pakistan in FY89, one adjustment loan had macroeconomic conditions that could serve for the other loans to the same country in the same year, but most SECALs were made one at a time.)

4.20 The Bank's practice is to bring an adjustment loan to the Board only if there is a sound program for establishing or maintaining macroeconomic stability, depending on the stage of the country's adjustment process.[9] Reasonable progress in implementing or sustaining the macroeconomic aspects of the program is a condition for tranche releases, in addition to the other policy conditionality. The Bank often evaluates the macroeconomic situation on the basis of specific indicators, such as the public sector deficit, inflation rate, interest rate on bank deposits, real exchange rate, and the growth of exports. These indicators provide early warnings, clearly recognized by the Bank and the borrower, of whether the macroeconomic framework is getting out of control. Some of them are not under the direct control of the government but their evolution is fundamental for the eventual success of an adjustment program. The practice of using these indicators is becoming more prevalent.

4.21 Experience has resulted in greater attention to macroeconomic fundamentals. In some cases since the first report, the second tranche release has been held up mainly because of failure to implement the macroeconomic program — Zaire SAL and Turkey FSAL II. (The rest of the Zaire loan was disbursed when macroeconomic conditions showed some improvement; the second tranche of the Turkey loan has not disbursed at the time of writing.) Disbursement of two adjustment loans to Argentina —Banking Sector and Trade Policy — have been held up since early 1989 because of a total breakdown of the program, including the macroeconomic aspects. (The Banking Sector Loan was never made effective and will probably be cancelled.) In other cases tranches were released, but an evaluation centered on the key indicators would have revealed macroeconomic difficulties that did, in fact, ultimately lead to a breakdown of the program.[10] Sectoral reforms were then reversed or had reduced benefits.

4.22 The Bank consults regularly with the IMF and usually has refrained from adjustment lending if a country with macroeconomic instability does not have a concurrent stabilization program supported by the IMF. This practice has been universal since March 1989. But the Bank needs to make its own macroeconomic assessments because it often must make decisions on tranche release when an IMF agreement is not in place and because of the creditworthiness issues raised in chapter 5. Over four-fifths of the SALs and about three-fifths of the SECALs were made to countries with an IMF agreement at the time of Board presentation[11] — a standby agreement, an extended Fund-facility, a SAF or an ESAF. (See table 4.5. Annex table 5.5 lists Bank Adjustment Loans and concurrent IMF agreements.) Even if an agreement with the Fund were in place at the time of Board presentation, or if the situation then did not indicate the need for an IMF program, the macroeconomic situation may have

deteriorated by the time later tranches were released. In one sixth of the cases where a country had an IMF agreement at the Board presentation of an adjustment loan, the IMF agreement was cancelled within a year of Bank program effectiveness, usually because of some policy deterioration. (Half of the cancelled IMF agreements are subsequently renewed, usually with revisions.) The absence of cross-conditionality means that, after approval of a loan by the Board, failure to meet the Fund targets is not grounds to hold up effectiveness and tranche releases of a Bank loan. Therefore, the loan agreements also need to contain a clear definition of expected progress in the macroeconomic program.

Government finances and administration

4.23 Fiscal reform is often vital both for restoring a sustainable macroeconomic situation and for increasing investment and efficiency. Fiscal reforms include measures to reduce the fiscal deficit, to enhance the efficiency of raising revenue, and to increase the effectiveness of government expenditure. Reductions in fiscal deficits are typically at the core of successful stabilization programs, which are often prerequisites for successful structural adjustment. In the initial years of a program, increased public-sector saving is the key to increase saving and to achieve a sustainable reduction in the current account deficit (chapter 7). The allocation of public expenditures and the means of raising revenue also affect private investment and overall growth (chapter 6 and 8). Public investment in complementary infrastructure as well as expenditures for maintenance are vital for stimulating private investment. More than three fourths of the loan agreements for SALs and more than a third of those for SECALs require measures that aim at improving fiscal efficiency.

4.24 To obtain more benefit per unit of public spending, some programs have measures to target social spending, upgrade the quality of civil servants, and contract with the private sector to provide public services.[12] Public-sector expenditure reviews need to include the current expenditures as well as investments. In countries with an overextended bureaucracy, reducing the number of civil servants has been a common condition, especially in SALs to Africa. In Ghana, Kenya, Mexico, and Uruguay, some recent programs have increased the salaries of top civil servants; the increased costs are offset by the expected benefit of improved performance. In Ghana the government curbed civil service spending by creating a roster of civil servants to ensure that no phantom workers were on the payroll.

4.25 Many adjustment lending programs have attempted to improve tax policy. In some cases this has involved new taxes — like the value-added tax in Turkey — to replace more distortionary trade taxes or monetary financing. In Asia the Bank has supported many administrative reforms of the tax system, particularly the streamlining of customs administration procedures, revision of tax codes, and the improvement of excise-tax collection. Tax reform is one of the most universally important aspects of structural adjustment to increase public sector saving and reduce distortions (chapters 7 and 8).[13]

4.26 Adjustment programs receiving Bank support should continue to include fiscal reforms when reducing deficits is necessary, when major distortions result from the tax structure, and when expenditures need to be better targeted. To change the bundle of goods purchased by the government, loans should have explicit conditionality to sustain expenditure for priority items while limiting the aggregate outlays. In many countries, adjustment should include reforming the decision-making institutions for fiscal policy.

Trade policy

4.27 Trade policy reform, which often also involves tax reform, has been most important in countries with very distorted trade regimes and pressing needs to increase exports, especially manufactured exports. Countries vary greatly in their response to trade policy reforms. Poorer and less diversified economies, which often face institutional weaknesses and major impediments to factor mobility, have usually reacted slowly to changes in the real exchange rate and a rationalization of tariff structures. Some countries reversed earlier trade liberalization when adverse shocks or inappropriate macroeconomic policies led to a balance of payments crisis. Trade policy reforms have become relatively less important in the late 1980s for the EIAL countries, but post-1985 adjusters have started out emphasizing trade reform, as did their predecessors. The Trade Policy Paper (SecM89-1454), recently submitted to the Board, evaluates trade policy reforms.

4.28 About 85 percent of trade policy conditions were at least substantially implemented (see

Table 4.5 Fund agreements, inflation, and implementation of Bank adjustment-loan conditions

	Loan type			
	SAL		*SECAL*	
Concurrent IMF agreements at board presentation[a]	Yes	No	Yes	No
Number of loans	56	15	70	43
Fiscal year of board date				
1979-84	27	2	17	5
1985-88	21	9	36	33
1989	8	4	17	5
Share of Bank loans with Fund agreements in place at loan effectiveness[b,c]	95%	60%	94%	33%
Fiscal year of board date				
1979-84	93%	100%	100%	80%
1985-88	95%	67%	89%	30%
1989	100%	25%	100%	0%
Share of Bank loans with Fund agreements in place for at least 8 of first 12 mths since effectiveness[b,c]	79%	60%	79%	45%
Fiscal year of board date				
1979-84	74%	100%	81%	80%
1985-88	81%	67%	71%	39%
1989	88%	25%	100%	50%
Number of Bank adjustment loans with Fund agreement cancelled	12	1	10	4
Number of Bank adjustment loans with Fund agreement cancelled and then renewed	5	1	4	0
Average rate of inflation[d]	19%	27%	39%	38%
Implementation of conditionality[e]				
Fully implemented	60%	70%	64%	62%
At least substantially implemented	79%	100%	84%	84%

Source: Based on an analysis of 184 SALs and SECALs to 61 developing countries. Fund Program data drawn from IMF Annual Reports and IMF Surveys. Inflation based on quarterly data from IFS.

a. Based on a sample of 184 SALs and SECALs approved by the Board through FY89. The numbers in each column refer to the set of loans indicated at the top of the column.

b. Based on a sample of 176 loans, excluding those that had not become effective as of January, 1990. Six FY89 SECALs were not yet effective as of Jan, 1990, while two SECALs (one in FY84 and one in FY88) were never made effective.

c. Fund programs include Stand-by arrangements, Extended Fund Facilities, Structural Adjustment Facilities, and Enhanced Structural Adjustment Facilities.

d. Based on the average annual percentage change of the CPI index for the 12-month period beginning the month of Loan Effectiveness. Based on a 135 Loan sample for which data were available.

e. Based on the average share of conditions in the loan agreement that were implemented. 36 SALs and 53 SECALs were graded on implementation in total (but only two SALs without IMF programs at Board Presentation were graded on implementation).

table 4.3). Efforts to strengthen the institutional base for exports have often taken more time than originally estimated and, in some cases, have conflicted with other objectives of the adjustment program. For example, duty-drawback systems for exporters have been difficult to establish in countries with fiscal stringency and low institutional capacity, although the resulting trade growth usually increases tax revenues in the long run. Vested interests, sometimes in the government, have often stymied efforts to reduce protection for highly protected import-competing industries. For example, trade reform in Argentina has seldom dared attack the high-cost steel produced by a plant that the armed forces own. In Colombia a proposal to reduce protection for an automobile assembly firm was defeated after vigorous opposition by the government agency holding shares in the firm and by the head of a trade regulatory agency with ties to the firm. The bureaucracy that administers trade restrictions may also derive rents and power from them — and therefore resist reform.[14]

4.29 Trade reform needs to be rapid enough to develop momentum without being so sudden as to provoke a political backlash, or generate budget deficits or current account deficits that lead to a reversal, as happened in many Latin American

countries. Reducing protection according to a preannounced, credible schedule can enhance the supply response and help counter the pressures for ad hoc reinstatement of protection that arise when firms are exposed to import competition. The experience of many countries shows that credibility and sustainability are enhanced if trade liberalization begins with a bold move, signaling that the government is serious. Often the best signal of the government's resolve has been a dramatic institutional change, such as Turkey's elimination of QRs, Venezuela's elimination of the agency in charge of foreign exchange allocation, Korea's move from positive to negative lists for import restrictions, and Chile's elimination of QRs and drastic reduction in the highest tariff rates. Such moves may have only a small direct impact initially, but they make further liberalization more automatic. By contrast, programs that begin with weak steps have seldom been sustained.[15] Moreover, realizing the maximum efficiency gains from trade liberalization usually requires complementary reforms in exchange rate, regulatory, public sector, labor market, and financial sector policies.

4.30 The Trade Policy Paper showed that, while trade reforms generally succeeded in reducing nontariff barriers significantly, tariffs remained high in many countries that received trade adjustment loans. It is therefore recommended that conditionality in trade loans generally require more rapid and significant reductions in tariffs.

Agricultural policy

4.31 The large share of the agricultural sector in both GDP and employment, particularly in low-income countries, makes it an important area for efficiency-enhancing reforms. Attention to agriculture seems to have waned since 1986 in the EIAL countries and in other adjusting countries (tables 4.1 and 4.2). Despite the frequent need for further agricultural reform, most agricultural adjustment loans have not been followed up with second loans in the area, perhaps because of the pressures from the interest groups involved — or because of the duration and intensity of effort required by the Bank and the borrower governments to prepare an AgSECAL — only Brazil, Mexico, Morocco, Somalia, Sudan, and Tunisia have prepared a second AgSAL, despite the frequent need for further agricultural reform.

4.32 While trade, exchange rate, and pricing policies have always been crucial elements in efficiency-enhancing reforms in agriculture, recent adjustment loans in a few countries — such as Mexico, Morocco, and Tunisia — have integrated agricultural reforms with related reforms of food policy, internal and external regulations, and management of public investment. Environmental concerns are also receiving more recognition (box 4.3). Cost recovery can make irrigation projects self-financing, reduce wastage of water, and avoid subsidizing the rich. In middle-income countries, the agricultural sector has close links to agro-industry, and adjustment programs have correspondingly increased in complexity.

4.33 In some countries where public agencies monopolized agricultural commodity trade and input distribution, Bank-supported programs have taken major steps toward decontroling agricultural markets. Jamaica divested some major commodity marketing boards of all nonmarketing functions and promoted private sector marketing of export crops. Côte d'Ivoire reorganized the sugar marketing board and liquidated many of its direct refining operations. Nigeria abolished most marketing boards. It is politically difficult to make such reforms, but they tend to last. Where programs have not dismantled public agencies quickly, they have used other mechanisms. For example, Mexico eliminated a major parastatal monopoly on food imports, and linked domestic agricultural prices to international prices with a formula to reduce distortions sequentially — avoiding arbitrariness and increasing the likelihood of sustained reform.

4.34 Public investment in agricultural infrastructure — mainly roads, irrigation, and flood control — can be vital in the transition from structural adjustment to revived long-term growth.[16] But in almost all developing countries, the rate of such investment dropped markedly in the 1980s, and the capital stock deteriorated. The need to invest in and maintain agricultural infrastructure is reflected in the growing number of AgSAL hybrids in Africa. In Sub-Saharan and in other small low-income countries, institutions for project evaluation must be developed. To realize economies of scale, small countries in a region may need to set up a regional institution for project evaluation, as they did in Central America.

4.35 The Bank should continue to expand its use of adjustment lending to support agricultural policy reform. Reforms of relevant trade and

Box 4.3 Structural adjustment and the environment

Although most adjustment programs have not focused on environmental issues, most of them include measures that, on balance, appear more likely to help than to hurt the environment. Overcoming an immediate macroeconomic crisis increases the government's ability to plan ahead. Strengthening public sector finances and improving the efficiency and foresight of public sector institutions increases the likelihood of developing and implementing coherent environmental strategies. Without orderly adjustment, growing fiscal deficits, unsustainable external imbalances, mounting external debt, hyperinflation, and sharp declines in investment work their way through economic decline and increased poverty to shorten the planning horizon and worsen environmental degradation.

Typical adjustment measures reduce the distortion of prices relative to world prices, and thus have mixed effects on the environment. Raising the price of gasoline, fertilizers, pesticides, water, and other inputs to world levels typically benefits the environment. This may happen by cutting government subsidies, or through a real devaluation. But, raising the price of tradable goods, for instance through a devaluation, may encourage resource-intensive production.

Financial reforms probably have mixed effects on environmental pressures. Raising the real interest rate encourages more intensive use of resources, but financial deepening lowers the effective real interest rate for many firms. Increased government saving encourages less intensive use of natural resources and promotes conservation. Restoring long-term growth tends to increase concern for the environment, which increases with per capita income.

Adjustment lending in FY89 revealed the potential of such lending for achieving environmental objectives. Of the 34 adjustment operations approved, seven contained conditions directly related to environmental management: four SALs (to the Gambia, Ghana, Guinea-Bissau, and Laos), two agricultural sector loans (to Pakistan and Burundi), and an energy sector loan (to Pakistan). These operations include establishing an environmental management system, eliminating subsidies on agricultural inputs that have an adverse effect on the environment, and introducing incentives for conserving vulnerable natural resources.

The Ghana FY89 SAL supports a comprehensive environmental action plan for land management, soil degradation and erosion, water resource development, conservation of forestry and wildlife, coastal zone management, control of mining and industrial pollution, and improved planning for human settlements. The Gambia SAL addresses environmental issues, including salinity intrusions along the Gambia River, excessive exploitation of trees for fuelwood, overgrazing of pastures, and inadequate groundwater management. The adjustment loans to Guinea-Bissau and to the Laos People's Democratic Republic emphasize conservation of forest resources through measures like royalty payments on logging. In Guinea-Bissau the loan supports a plan for the use and replenishment of forest resources.

The agriculture SECALs to Pakistan and Burundi aim at strengthening soil management and conservation, rehabilitation and maintenance of drainage and irrigation systems, and integrated pest management to reduce the use of agrochemicals that have contaminated groundwater. The energy SECAL to Pakistan supports a monitorable environmental action plan including standards to protect against air and water pollution, and establishment of guidelines to assess the environmental impact of energy-producing activities.

Adjustment lending programs are thus increasingly recognizing the importance of maintaining a sustainable natural resource balance as well as a sustainable external resource balance.

pricing policies are important, but in countries that have made major progress in reducing policy distortion, supporting investment in agricultural infrastructure and institutional development warrants more attention.

Industry

4.36 Countries have often undertaken structural adjustment because the inefficiencies of previous strategies to promote industrialization — import substitution and state enterprises — contributed to low growth and an inability to accommodate external shocks. Switching to a more export-oriented, market-directed strategy for industrialization has been an important part of structural adjustment programs in many countries, including Bangladesh, Ghana, Turkey, Mexico, Tunisia, Mauritius, and the Philippines. The emphasis of conditionality in the industrial sector has shifted away from restructuring and direct investment incentives toward pricing policy, entry barriers, the regulatory environment, and technology policy. The scope of industrial sector loans has also broadened to include the financial and general business environment, reflecting an effort to increase the pace at which firms restructure and resume investment. In Africa, industry loans initially focused mostly on rehabilitating exports and eliminating major price distortions through changes in exchange rates and trade regimes. Countries could have implemented these reforms quickly, and often did. But where institutions were very weak the economy's response was of-

ten disappointingly slow.

4.37 In recent years adjustment programs have given more attention to increasing competition in domestic and export markets — to raise productivity and make firms more cost-competitive. Mexico, for example, has increased the range of competition and clarified its laws on foreign investment, but deregulation of prices has progressed slowly. In most countries with small domestic markets, as in Africa, import competition and freer access to imported inputs allow market forces to encourage efficiency and growth in industries with a comparative advantage.

4.38 Some adjustment programs have addressed problems with industrial labor relations policy, especially some SALs to African nations. Hungary's Industry SECAL (1987) supported programs to retrain and redeploy laid-off workers and to improve unemployment compensation mechanisms. In other cases, particularly Latin American countries, but also Tunisia and Bangladesh, the Bank has acquiesced in the desire of governments to avoid the politically sensitive issue of labor retrenchment.

4.39 Where entry regulations, investment and pricing controls cause major distortions, removing or reducing them should continue to be a high priority in adjustment lending. In other cases, the priority should go to reforming industrial and labor regulations.

Financial system

4.40 Successful structural adjustment requires a healthy financial system to help mobilize resources for investment in newly viable sectors. But usually countries in need of adjustment have credit-allocation systems unrelated to sector profitability or crippled financial institutions with many nonperforming assets. Financial sector adjustment is complex and has a potentially high payoff to World Bank (and IMF) expertise. Financial sector reform typically needs to ensure an orderly transition for banking systems burdened with nonperforming loans (sometimes to public enterprises), and to rationalize and ultimately decontrol lending and deposit rates. When financial institutions need recapitalization, it is important to establish prudential regulation and supervision systems first.

4.41 Financial reform has become an increasingly important component of adjustment lending operations (see table 4.2). The Bank made only three FSALs before FY88, but has made ten in the last two years. Financial sector conditions in SALs and nonfinancial SECALs usually touch on only the most obvious and easily corrected distortions — relaxing interest rate ceilings and reducing reserve requirements. Reducing the quasi-fiscal deficit of the financial public sector and the politically directed allocation of credit are often vital for fiscal stabilization and the initiation of structural reform. FSALs take a more comprehensive approach, including restructuring, strengthening portfolios, regulation and supervision, and sometimes developing new capital market instruments.

4.42 Closing or restructuring major banks requires a pragmatic approach that recognizes the explicit and implicit guarantees of deposits and the way individual banks reflect the soundness of the whole financial system. When insolvent institutions are allowed to stay open, with government-guaranteed deposits, they have an incentive to roll over bad loans and make risky new loans. In the process, they push up interest rates, affecting other financial institutions and the whole economy. The eventual budgetary cost of restoring the banking system then grows — very rapidly. The need for rapid action must be balanced, however, against the risk of causing a financial panic by moving before mechanisms are in place to back up fundamentally sound banks. By downsizing the ailing institutions in a series of steps, the government may be able to limit the transition cost and avoid the upheaval of bank failures.

4.43 Institutional reforms in the financial sector are essential in most adjusting countries. In Mexico, although the government retains the banks it nationalized in 1982, the 1989 FSAL eliminates restrictions on entry to domestic banking and encourages competition in the financial sector. The 1989 FSAL in Kenya merges 10 weak finance companies into a single institution that may eventually be financially viable. Jamaica's 1987 SAL and Kenya's and Pakistan's 1989 FSALs aim at developing capital markets; 1989 FSALs in Mexico and the Philippines address the problem of restructuring development finance institutions (DFIs). The Philippine FSAL provided seed funding for the Development Bank of the Philippines to reduce retail lending and shift to wholesale long-term lending. DFIs that grew up with the business of directing subsidized credit to protected sectors often are not financially viable in a postadjustment economy. As the Bank often encouraged the establishment of the DFIs,

it has a special responsibility for their fate, whether diversification or orderly dissolution.[17]

4.44 Successful financial reform requires an appropriate macroeconomic policy framework, but FSALs have generally had weaker macroeconomic conditionality than SALs. When a country has major macroeconomic problems, it is better to address them first with a SAL, or SECAL with conditionality focusing on the structural causes of the imbalances — public expenditure, taxation and public enterprises in tandem with an IMF agreement. When the FSAL comes in the follow up phase, it needs sufficient macroeconomic conditionality to insure the maintenance of an appropriate macroeconomic framework. Some countries have negotiated FSALs without an adequate macroeconomic program in place — for instance, Turkey and Argentina — although the Argentina loan was never made effective, and the second tranche of Turkey's FSAL II has been delayed.

4.45 Financial reform is undermined when the government taxes financial intermediation through very high reserve requirements and other means of financial repression. In Turkey, despite five SALs (several with financial sector conditionality) and two FSALs (the only country to get a second), fiscal and quasi-fiscal impositions on the financial system still force banks to charge borrowers a high spread over the deposit rate. Financial reform is even more difficult if large budget deficits and high real interest rates have bankrupted the borrowing firms and produced insolvency throughout the financial system. When controls on interest rates are lifted, they move toward market-clearing levels that are often substantially higher, particularly when depositors expect high inflation or large exchange rate devaluations. Higher real interest rates by themselves present budgetary problems for governments with high domestic debts, such as Zambia, Mexico, and Turkey in the mid-1980s, and Argentina and Brazil recently. The recent Philippine FSAL explicitly recognized this problem by deferring a requirement to reduce taxes on financial intermediaries until other tax revenue had reached an adequate level.

4.46 The Bank should continue to support financial reform. Such reforms have a much higher payoff when macroeconomic imbalances have been brought under control, although correcting very high negative real interest rates on loans and deposits is almost always useful. Therefore, FSALs are usually appropriate at a later stage in adjustment, after the macroeconomic situation has been stabilized and trade and pricing reforms are under way. In countries with macroeconomic stability, financial sector reforms often have highest priority for inducing efficient investment. When reforming institutions and developing markets are at the core of FSALs, as is often the case, slow-disbursing loans that match the pace of reform are most appropriate.

Public enterprises

4.47 Public enterprise reform has been a component in more than a third of recent adjustment loans (tables 4.1 and 4.2). When the circumstances warrant continued public ownership, reform measures must improve both efficiency and profitability. Reforming management and allowing competition from private firms and foreign firms usually help to raise efficiency. For instance, the 1989 Public Enterprise Reform Loan to Mexico supports measures that will compel state-owned firms to operate in a more competitive environment. Turkey's state-owned steel and textile firms have faced increasing competition from the private sector during the 1980s. In some cases, however, state enterprises reduce their losses by using their monopoly position to raise prices (e.g., electricity in Argentina).

4.48 The efficiency of state-owned enterprises often can and should be increased, and many firms that are not competitive internationally at an overvalued exchange rate may become competitive after a real devaluation. Because outputs of state enterprises are usually inputs to other firms, prices of traded goods like steel and textiles should be set at the world level (plus appropriate tariffs), and nontraded goods like electricity should be priced according to the marginal cost of efficient production. Where state-owned enterprises would lose money if their output were sold at world prices or efficient marginal cost, there is a tradeoff between getting the prices right and reducing the government budget deficit. It may be necessary during a transitional period to allow state-owned enterprises to sell at prices above desired levels, although competing imports of tradable inputs should be allowed.

4.49 In economies with overextended public sectors, privatization is an important strategy, as in the recent loans to Chile, Costa Rica, Mexico, Morocco, Pakistan, Ghana, Kenya, Malawi, and Tunisia. Privatization (at a fair price to the government) requires a credible and sustainable pol-

icy environment. This is true whether the prospective buyers are domestic or foreign firms. It has proven wise to give a government that is committed to reform some flexibility in the timing and identification of which enterprises to privatize so that it can take full advantage of market conditions. When countries have strict deadlines and lists of firms to privatize, potential buyers may collude to offer low prices.

4.50 Privatization, especially of large enterprises, is often a complex undertaking and requires technical assistance. Some countries, like Chile, have made significant progress because of their success in other policy areas. Other countries, such as Ghana, have had difficulty with financially ailing entities: shutdowns have meant increased unemployment and political opposition. Industries that have not been rehabilitated are not attractive to potential buyers, and underdeveloped domestic capital markets are frequently unable to lend funds for such enterprises. As a result, governments continue to run the enterprises at a loss.

4.51 Structural adjustment of public enterprises must start with an evaluation of the activities and firms that should remain in the public sector and those that can be done as well or better by the private sector and should be transferred there. For those remaining in the public sector, reforms need to restructure the incentives of managers to encourage efficiency.

Timing and conditionality

4.52 Structural adjustment has usually taken longer than originally anticipated. It has become an integral part of the development strategy for many countries, especially where sustainable growth requires the further development of appropriate institutions and human capital. The stabilization phase of the adjustment may take a few years, and the introduction of a fiscal reform is a key component of the stabilization program. The subsequent phases should not be initiated until the stabilization is substantially under way. Thus a country generally needs a series of operations. The early operations usually focus on structural reforms to reduce the fiscal deficit and achieve a competitive real exchange rate. The next round of reforms aims at reducing the other distortions to efficient resource allocation — typically distortions of domestic prices, interest rates, and the trade regime. The later stages of adjustment focus on building institutions, restoring investment, and restructuring the financial system.

The timing and continuity of support for reform

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

4.54 The appropriate composition of an adjustment lending program — a series of quick disbursing adjustment loans, one big slow-disbursing loan, or several slower-disbursing adjustment loans running concurrently — depends on the circumstances, including the speed at which major distortions can be removed, constraints on commitment levels, and the timing of the need for balance of payments support. These considerations will be reflected in the mix of adjustment loans (SALs, SECALs, and hybrid loans — quick and slow disbursing) and policy-based sector investment loans that form part of the overall lending program. There is no need here for a new lending instrument, since adjustment loans (SALs or SECALs) with extended disbursement through multiple tranches, hybrid loans, and sectoral investment loans with enhanced policy content loans offer ways to establish continuity of support for adjustment.

Table 4.6 Types of conditions

	Total number of conditions and other actions per loan[a]	Average share of total conditions and other actions (percent)				
		Loan agreement conditions[b]	Precise actions[c]	Precise and legal[d] conditions	Prior actions[e]	Other actions in President's Report[f]
All	42	34	27	10	18	48
HICs	39	36	27	11	20	43
SSA	44	36	28	10	14	50
SALs	50	24	27	7	19	56
SECALs	37	42	27	13	17	41
IDA credits	41	31	27	10	20	49
IBRD loans	43	37	27	10	16	48
Hybrid-loans	46	49	26	16	9	42
Early-intensive adjustment- lending countries						
FY79-85	30	31	24	9	16	54
FY86-88	39	43	29	12	17	40
FY89	56	29	23	7	22	49
Other adjustment-lending countries						
FY79-85	27	50	28	12	14	36
FY86-89	56	29	29	10	19	52

Source: Based on an analysis of 183 SALs and SECALs to 61 developing countries.
A total of 7,723 actions were considered in all of which 2592 were legal conditions.
a. The conditions in the Loan Agreement or other actions (including prior actions) called for in the President's Report.
b. All conditions listed only in the Loan Agreement (including dated and undated covenants).
c. Precisely specified actions or condtions are those which are specific and usually quantifiable.
d. Precisely specified and legal conditions are those which appear in the Loan Agreement and are specific in nature.
e. Prior actions are those which a country has undertaken prior to a loan's negotiation, either on its own initiative or with support from an Adjustment loan.
f. Actions listed only in the President's Report (excluding prior actions), to be implemented during the lifetime of the loan.

4.55 When a country has completed the initial phases of adjustment, reducing policy distortions and the pressure on the balance of payments, an increasing share of adjustment lending should be structured to encourage the transition to investment lending. The increase to eight hybrid loans in FY89 reflects movement in this direction. As structural adjustment blends into development strategy, the Bank should support longer-term policy reforms in many cases with sector investment loans with policy conditions. Such loans could contribute much in a country that has a stable macroeconomic situation but needs more investment and further policy reform and institutional development.

The nature of conditionality

4.56 Guided by experience, the Bank has changed the conditionality of adjustment lending — mainly by using more fully specified conditions to achieve each overall objective.[18] This strategy makes sense because more specific conditions have higher implementation rates. The average number of conditions in loan agreements has risen from about 10 before 1985 to 17 in recent years (see table 4.6). The number of actions in the policy matrices of the President's Reports has similarly risen, to an average of 56 in FY89 for the EIAL countries. Of these, in FY79-FY89, 18 percent pertained to actions initiated prior to appraisal, 34 percent were required by the loan agreement, and 48 percent were listed only in the President's Report as actions to be taken within the timeframe of the program.

4.57 More than a quarter of all policy actions are precisely specified — usually with targets quantified — but only 10 percent of the conditions are both precise and included in the loan agreements as actions for disbursement — an average of four per loan. IDA credits have about the same share as IBRD loans (a tenth). With hybrid loans, half of the actions in the President's Report on average are conditions in the loan agreements, and a third of those are precise (16 percent of the total). In addition to specifying more precisely the actions agreed to by the borrower, typical conditions in more recent loans have specified more explicitly whether the action was a condition for a tranche release.

Table 4.7 Implementation of conditions (average percent at final tranche release)

	All conditions or actions[a]		*Loan agreements*[b]		*Precise*[c]	
	Fully implemented	*At least substantially implemented*	*Fully implemented*	*At least substantially implemented*	*Fully implemented*	*At least substantially implemented*
All	57	77	66	84	62	78
HICs	61	82	72	89	71	87
SSA	55	75	60	80	56	71
SALs	53	73	65	83	56	74
SECALs	60	80	66	84	67	82
IDA credits	57	77	70	86	65	80
IBRD loans	57	77	59	80	56	75
EIAL countries						
FY79-85	53	71	63	80	60	75
FY86-88	60	82	66	86	62	79
Other AL countries						
FY79-85	33	67	35	74	43	83
FY86-88	70	94	86	93	83	93

	Precise and legal[d]		*Actions only in Presidents' Reports*[e]	
	Fully implemented	*At least substantially implemented*	*Fully implemented*	*At least substantially implemented*
All	71	86	49	72
HICs	78	93	50	74
SSA	66	82	50	70
SALs	73	87	47	69
SECALs	70	86	53	76
IDA credits	75	88	47	71
IBRD loans	62	83	55	73
EIAL countries				
FY79-85	71	85	47	66
FY86-88	69	85	54	78
Other AL countries				
FY79-85	46	92	30	59
FY86-88	93	97	51	95

Source: Based on an analysis of 97 loans to 32 developing countries.
a. All conditions called for in the loan agreement or other actions called for in the President's Report, except prior actions. Prior actions are not included because they are said to be fulfilled "prior" to negotiation.
b. All conditions in the loan agreement.
c. Precise conditions or actions are specific and usually quantifiable.
d. Precise and legal conditions are those which appear in the Loan Agreement and are specific in nature.
e. Actions which appear only in the President's Report (excluding prior actions).

4.58 Serious controversy has surrounded the issue of lending to support prior actions, where many but not all of the structural reforms were initiated before the loan appraisal and sustaining the reforms is the chief goal of the program. The long-run adjustment performance has been excellent where the Bank supported adjustment measures undertaken before the loan approval was complete. In Indonesia, for example, the government independently encouraged private sector development and foreign direct investment as part of its adjustment strategy. Growth of nonoil output has been restored to more than 5 percent annually, inflation is under 10 percent, and the deficit in the current account of the balance of payments has been reduced to less than 3 percent of GDP. When adjustment lending for prior actions was not allowed, governments on occasion delayed reforms so that the Bank would give them credit for the actions. Adjustment lending for prior actions has thus proven effective when the timing of the loan meets the financing needs of adjustment and when:

- The government has a strong track record for reform.
- A borrowing government is prepared to take the necessary actions but finds it politically difficult to appear to be acting on the basis of Bank

dictates rather than its own initiative.

- The prior actions are part of the ongoing reform process.

4.59 Rates of implementation depend significantly on whether a policy action is specific or qualitative and whether it is a condition in the loan agreement (table 4.7). As noted earlier (para. 4.9-4.11), these implementation rates need to be interpreted with care. Conditions that are precise or in the loan agreement have higher-than-average rates of implementation, and conditions that are precise *and* in the loan agreement have even higher average rates of implementation (71 percent fully and 88 percent at least, substantially for the whole 1980s). The high rates of implementation for precise and legally binding conditions imply a recommendation to make legal agreements as specific and detailed as possible on critical policy actions.[19] Greater detail may require a larger number of conditions. General conditions that summarize the spirit of the adjustment effort are also important, however.

4.60 The incentive of tranche releases obviously motivates policy adjustment, but the perceived benefits of adjustment and the desire to have ongoing adjustment lending also motivate reform. Measures put in the loan agreement as conditions are selected with the recognition that they do not constitute the whole program — and with the intention to focus on the actions most central to the program's success and most indicative of the government's commitment to reform. As mentioned earlier, the five or six actions the Bank considered most critical for achieving the objectives of the program had implementation rates that averaged as high as those for all conditions in the loan agreements.[20] In addition, countries carry out the majority of the actions in the President's Reports that are not in the loan agreements. After the final tranche release, countries usually sustained or increased the rate of fulfillment (table 4.8). Of the conditions that were not met at all during the loan, over a fourth are substantially or completely implemented later. Reversals have occurred on less than a tenth of the conditions met during the loan — showing that most governments believe that their adjustment programs were beneficial.

Political economy of adjustment

4.61 The first report and many other analyses have stressed the importance of government commitment for the success of adjustment pro-

Table 4.8 Implementation of conditions prior to and after final tranche release

	Percentage of conditions			
	As of final tranche release		*As of 1988-89*[a]	
	Fully implemented	*At least substantially implemented*	*Fully implemented*	*At least substantially implemented*
I. Supply-side, growth-oriented policies				
Trade policies	60	85	66	85
Sectoral policies				
Industry	62	86	52	76
Energy	73	82	77	86
Agricultural	62	84	69	87
Financial sector	71	90	75	93
Rationalization of gov't finance and administration	62	79	72	89
Public enterprise reforms	63	88	70	92
II. Absorption reduction policies				
Fiscal policy	74	85	74	89
III. Switching policies				
Exchange rate	68	89	58	90
Total				
Loan-agreement conditions[b]	65	86	69	88
All conditions or actions	54	77	61	82

Source: Based on an analysis of 57 SALs and SECALs to 23 developing countries. The same loans were graded on implementation at final tranche release and in 1988 or 1989.

a. At least 18 months after final tranche release.

b. Based on conditions which appear only in the loan agreements. A total of 813 legal conditions could considered.

grams. This commitment can be enhanced, sustained, or even undermined by the adjustment process itself. Although the Bank must rigorously avoid interfering in politics, the cost of failure is too great for the borrowing countries, as well as for the Bank, to ignore the potential contribution of a better understanding of the political economy of adjustment.

4.62 The credibility of the adjustment program depends on the quality of the program and also on the way that the government identifies itself with the program and shows consistency between announced intentions and policy actions. Governments in Bolivia, Mexico, Korea, Ghana, and Thailand made extensive efforts to publicize their commitments to reform, explaining the nature and timing of the reforms and why initially painful measures were necessary for obtaining widespread benefits over the long run. It has proved counter-productive to oversell the program and create unrealistic expectations or to blame austerity measures on the Bank and the Fund. It is particularly difficult to sustain reform measures if the government has openly disavowed the reform. This occurred in Zambia, where the reform process was reversed in the face of political protest, even though the loan had been disbursed.[21]

4.63 When a country has a severe economic and balance of payments crisis, and there is an imminent political crisis or upcoming election, the government is sometimes unwilling to adopt a sufficiently comprehensive adjustment. In such cases — including Nicaragua and Peru today and Poland and Ghana earlier in the 1980s — the Bank wisely refused to make exceptions in the design of programs or to provide adjustment loans simply in order to avert crisis. As painful as they may be, crises can increase the likelihood of reform by increasing the perception within and outside the government that policies must change, by weakening anti-reform interest groups, and by increasing the willingness to rely on technocrats.[22] This was true in Bolivia, Mexico, Nigeria, and Ghana and may occur in Argentina and Peru.[23]

4.64 The timing of reform measures can affect the political and economic viability of a program. Where new economic teams or governments have come to power and the policies of the previous team or government have been discredited, there is more leeway to undertake reform measures — in Mexico under de la Madrid and Salinas, and during the stabilization of Bolivia's hyperinflation under a new democratic government in 1985-86. The strongest political asset of new teams and governments is often people's dissatisfaction with previous policies and their willingness to try something fresh — the honeymoon effect, as exemplified in Poland and Argentina (in the first months of the Menem administration). The effects are temporary, however, and the key political task is to produce economic results before the honeymoon is over. In such political conditions, therefore, reforms should be introduced as quickly as is economically and technically feasible. As the temporary dislocations associated with adjustment and with the previous crisis decrease, improvements will be attributed to the initial reforms. When the government moves quickly, it also reduces the opportunity for opposition to coalesce and helps increase the credibility of the reform.

4.65 Although it has generally proved unwise for governments to yield to interest-group pressure for gradualism, some measures require time to develop institutions and human capital, as noted earlier. The lack of administrative capacity also limits the number of fronts on which reform can go forward. The Bank has thus urged governments to group reforms into packages that not only have an economic and administrative coherence but also will produce identifiable benefits, creating public support for the broader reform effort. In Mexico, sectoral reforms supported by agricultural and industrial SECALs assisted the government in this way.

4.66 Sometimes the benefits of early success with part of the program can undermine the commitment of the government and the populace to press forward with a thorough structural adjustment. For example, the initial benefits of stabilization in Argentina in 1985-86 induced some complacency, which contributed to the failure to tackle underlying budget deficits that undermined the program. Despite Turkey's rapid growth of exports through the 1980s, it now also faces problems with budget deficits and inflation. Grouping the reforms and publicizing the overall agenda from the beginning can help with this dilemma, because the areas needing future reform remain better identified in the minds of the populace and policymakers.

4.67 Most successful political strategies for sustaining adjustment have built coalitions around the beneficiaries of adjustment, for example, exporters in Korea, Thailand, Zimbabwe, and Chile. In developing a program, it is thus

important to identify the groups that benefit from adjustment. It has sometimes been politically useful to establish economic organizations of reform beneficiaries, such as the exporters' associations in Korea and Chile, which also function as focal points for political support.

4.68 Although compensation to adversely affected groups usually requires taxing those who benefit from reform, it can contribute to other valid objectives, such as targeting subsidies for poverty reduction. More serious opposition to reform, which needs to be defused, usually comes from upper- and middle-income groups that were previously collecting high rents and that see themselves as permanent losers from the reform. Compensation measures like severance pay (which requires workers to exit from the adversely affected groups) and retraining subsidies (to prepare people to enter expanding sectors) have enhanced both economic efficiency and political viability. Recent programs in Bolivia, Hungary, and Ghana have included such measures.

4.69 To enhance the political viability of structural adjustment, the Bank should maintain its high standards for program design, even in the face of economic and political crises. Programs can only be credible if the government identifies with them fully and seeks to explain the benefits of reform to the populace. Particularly where new governments and economic teams have come to office, reforms should be introduced as quickly as is technically feasible — while public disillusionment with past policies is high, and the support for new measures is strong. Adjustment programs should thus be designed and presented with an awareness of the importance for political sustainability of building a coalition of groups benefiting and expanding from the reform process. Protection of the poor not only contributes to sustainability of the reform effect but also is an important objective in itself.

Conclusions

4.70 Most of the conditions in the loan agreements have been substantially or fully implemented, as originally written, by the time of the final tranche release. The rates of implementation have improved over time and have been especially high since the first report was written. Conditionality in the loan agreements has become more precisely specified, apparently contributing to the increasing rates of implementation. Many loans have experienced delays in tranche release due to unforeseen delays in implementing the programs. If it becomes clear that the loan conditions as originally stated cannot be satisfactorily met, Bank management recommends either cancellation of the loan or appropriate modification of the conditionality in light of the new information, and it brings the matter to the Board.

4.71 In all policy areas that call for resource reallocation and investment, successful reform requires predictable incentives and therefore macroeconomic stability. While such stability has always been a consideration, it has been difficult to achieve and has undermined adjustment in some important cases. In FY89, conditions concerning macroeconomic policy became more prevalent in loan agreements, usually as references to the program in the Letter of Development Policy. For countries with acute macroeconomic problems, adjustment lending should support structural reforms essential to address the fundamental causes of the problems. Other countries need to maintain a macroeconomic framework that is conducive to the success of the sectoral reforms supported by adjustment lending. To make sure that the borrowers and the Bank have a common understanding of what a supportive macroeconomic framework means, the conditionality in loan documents often refers explicitly to target values of key indicators of macroeconomic stability.

4.72 As the Bank's experience with adjustment lending has evolved, the emphasis on reforming internal regulations, public enterprises, and financial sectors has increased. Fiscal, trade, agricultural, and industrial policy reforms have remained important aspects of adjustment programs. Trade policy reform programs should give increased attention to supporting domestic reforms, as well as to removing quantitative restrictions early on and reducing high levels and variance of effective protection. Agricultural sector reforms need sustained attention and support, especially where they require institutional development. Increasing competition has become a higher priority for industrial policy reform and should be encouraged, despite the frequent opposition from interest groups. Financial sector reforms —including measures that can be implemented quickly, like liberalizing interest rates, and longer-term measures like reorganizing banking systems — are important for restoring

efficient investment and sustainable growth but should be supported only at appropriate stages of the adjustment process. It is usually appropriate to undertake the quicker measures at the beginning of the adjustment process; but financial restructuring is unlikely to succeed until the macroeconomic situation is stabilized. In countries where the public sector is overextended, adjustment programs should restructure that sector. In many countries, adjustment programs can benefit from privatization as a means for the public sector to exit from activities that the private sector could do as well or better. At the same time, the public sector should be strengthened in areas where it has a comparative advantage — such as providing infrastructure and educational services.

4.73 Although our knowledge of the ideal sequencing of reforms is still imperfect, the Bank's experience supports several generalizations. High inflation or other manifestations of severe macroeconomic imbalances, if present, need to be reduced at the beginning of the program. Adjustment lending to support any other reforms is most likely to be effective after the structural reforms are underway to reduce the extreme macroeconomic imbalances. Removing price distortions and impediments to factor mobility should proceed at roughly the same pace as trade is liberalized so that reform can increase output rather than prompt speculation and unemployment. Institution-building and regulatory reform, along with human capital development, generally take much longer.

4.74 Adjustment lending traditionally has been fast-disbursing, but the slow pace of implementation and the slow response to some types of reform indicate that they might be better supported with a slower rate of disbursement. Slower disbursing instruments are usually more appropriate for institutional reforms in the public finance and financial sectors, as well as in the social sector, as discussed in Chapter 3. Hybrid loans are growing in importance, partly in recognition of the benefits assuring that appropriate investment complements policy reform. They are also useful when the recovery of investment is central to obtaining a supply response — and when the expansion of investment will cause a temporary current account problem if consumption cannot be reduced.

4.75 If governments are to sustain their commitment to reform, which the first report emphasized as a precondition for successful adjustment, they need to maintain political support for the program. The design and presentation of a program can enhance its political support. A major effort to convince the public of the program's virtues has usually had important benefits and should accompany adjustment lending. To take advantage of public dissatisfaction with the prereform crisis and to demonstrate commitment, a country in a crisis situation have had more success when starting reforms with a new team and as quickly as technically feasible. Compensation measures for groups unfairly injured by the adjustment process can help reduce economic inequality and soften political opposition, but they should be designed to move labor and capital into sectors that are expanding with adjustment.

4.76 Structural adjustment succeeds best when the country strives to achieve, in an appropriate sequence, all the major reorientations needed. Countries demonstrating such commitment to reform should get more adjustment lending, if they need it, through such procedures as lending in support of prior actions. Countries that persist in trying to avoid adjustment — as revealed by unsatisfactory macroeconomic performance, continued high distortion of relative prices, or frequent back-tracking — should receive no adjustment lending.

5

Bank exposure, risk management, burden sharing, and operational issues

Summary

5.1 Adjustment lending, because it is quick-disbursing, has accelerated the net lending from the Bank and increased its exposure, especially to countries with protracted balance of payments problems. The policy reforms supported by successful adjustment lending help restore a country's growth and improve its creditworthiness. If the country's adjustment program is not sustained, adjustment lending burdens the country with additional debt, making adjustment more difficult for any future reform-minded government, and weakens the Bank's portfolio. It is therefore essential to assess realistically the prospects for successful adjustment in individual countries, to take political sustainability into account in program design, and to sequence the program of reforms in a way that will increase the likelihood of success. Important strides have been made in this regard over the last two years, but further progress is required.

5.2 Securing appropriate financing for adjustment programs has been a major problem in recent years. As commercial lending has decreased substantially, the Bank has explored other ways to mobilize financing such as cofinancing. Cofinancing now plays an important role in complementing Bank lending in general and adjustment lending in particular — with the ratio of cofinancing per dollar of Bank commitment steadily increasing. Although cofinancing efforts have succeeded in attracting an above average ratio of cofinancing for adjustment loans to highly indebted middle-income countries, most of this cofinancing is from official sources and has not sufficed to check the rapid increase in the Bank's share of loans to these countries. Unexpected shortfalls of financing or, occasionally, excess optimism in projecting other sources of financing, have in several cases resulted in the Bank's providing a disproportionate share of the financing and in some cases may have seriously undermined the prospects for success of the program.

5.3 Bank-supported adjustment programs have benefited from the coordination among donors that takes place through consultative groups and the Special Program of Assistance for Sub-Saharan Africa.

5.4 Supervision of the macroeconomic framework often has not been given as much importance as it deserves, especially for SECALs. Furthermore, the assessment of the macroeconomic situation has not always been taken into account in decisions to release tranches. Macroeconomic supervision should be strengthened. While Bank-Fund collaboration, as reaffirmed in the March 1989 agreement between the managements of the two institutions, continues to be essential, the Bank needs to conduct its own assessment of macroeconomic developments to make decisions about loans and tranche releases and to protect its portfolio.

Introduction

5.5 At the Board's review of the first report on adjustment lending, the Executive Directors ex-

pressed concern over some operational aspects of adjustment lending. This chapter addresses three categories of these concerns:

- The role of adjustment lending in the Bank's overall lending strategy and risk management for each country.
- The need for coordination of assistance, burden-sharing and adequate funding.
- The arrangements for macroeconomic monitoring, staff deployment, and supervision.

Adjustment lending and Bank Group exposure

5.6 The management of adjustment lending must strike a balance between promoting adjustment programs that remove serious obstacles to growth (and thereby raising creditworthiness) and controlling exposure to high-risk situations. By supporting the policies required to restore sustainable growth, adjustment lending can play an important role in restoring a borrower's creditworthiness, in increasing the confidence of other creditors, and in catalyzing workout packages.

5.7 At the same time, adjustment lending entails new risks for the Bank from two sources. First, adjustment lending disburses quickly to countries on a path that is sustainable only with the agreed on major policy and institutional reforms. Second, adjustment lending in some circumstances increases the potential severity of disputes between the Bank and the borrower, as elaborated below. Both the potential risks and the potential gains from adjustment lending are reflected in the Bank's attention to exposure and risk concerns in the formulation of country assistance strategies.

5.8 Because adjustment loans disburse quickly, adjustment lending has obviously accelerated net flows and exposure.[1] In countries where adjustment lending has constituted a high proportion of Bank assistance — such as Jamaica, Mexico, Morocco, and the Philippines — the impact of fast-disbursing lending on exposure has been particularly marked. Figure 5.1 illustrates, for major groups of borrowers and for some individual countries, how the share of adjustment lending in IBRD net flows to borrowing countries has risen over the last few years.

5.9 Adjustment lending has mostly been to countries with protracted balance of payments problems. During CY80-89, 48 percent of the Bank Group's adjustment lending commitments went to the highly indebted countries and 24 percent to Sub-Saharan Africa.[2] This is natural and appropriate, since these countries need both balance of payments support and policy reforms to reduce eventually the need for external financing. Not surprisingly, they have used adjustment lending the most. Indeed, the Bank's ability to accelerate disbursements through adjustment lending has enabled the institution to play a central role in providing financing and supporting policy reforms in countries most in need of foreign exchange (table 5.1). The Bank Group provided 27 percent of net debt-creating flows to the highly indebted countries during 1983-85, while accounting for only 4 percent of these countries' debt at the beginning of the period. Approximately 32 percent of the Bank's net flows to the highly indebted countries during this period took the form of adjustment loans (see the annex tables for this chapter). This share rose to 115 percent in CY88 and 109 percent in CY89 (figure 5.1 and table A5.3 in the Annex to chapter 5). For Sub-Saharan Africa, adjustment lending enabled the Bank Group to accelerate its disbursements and provide 21 percent of the net financial flows during 1983-88, even though the Bank accounted for only 10 percent of Sub-Saharan Africa's debt at the outset.

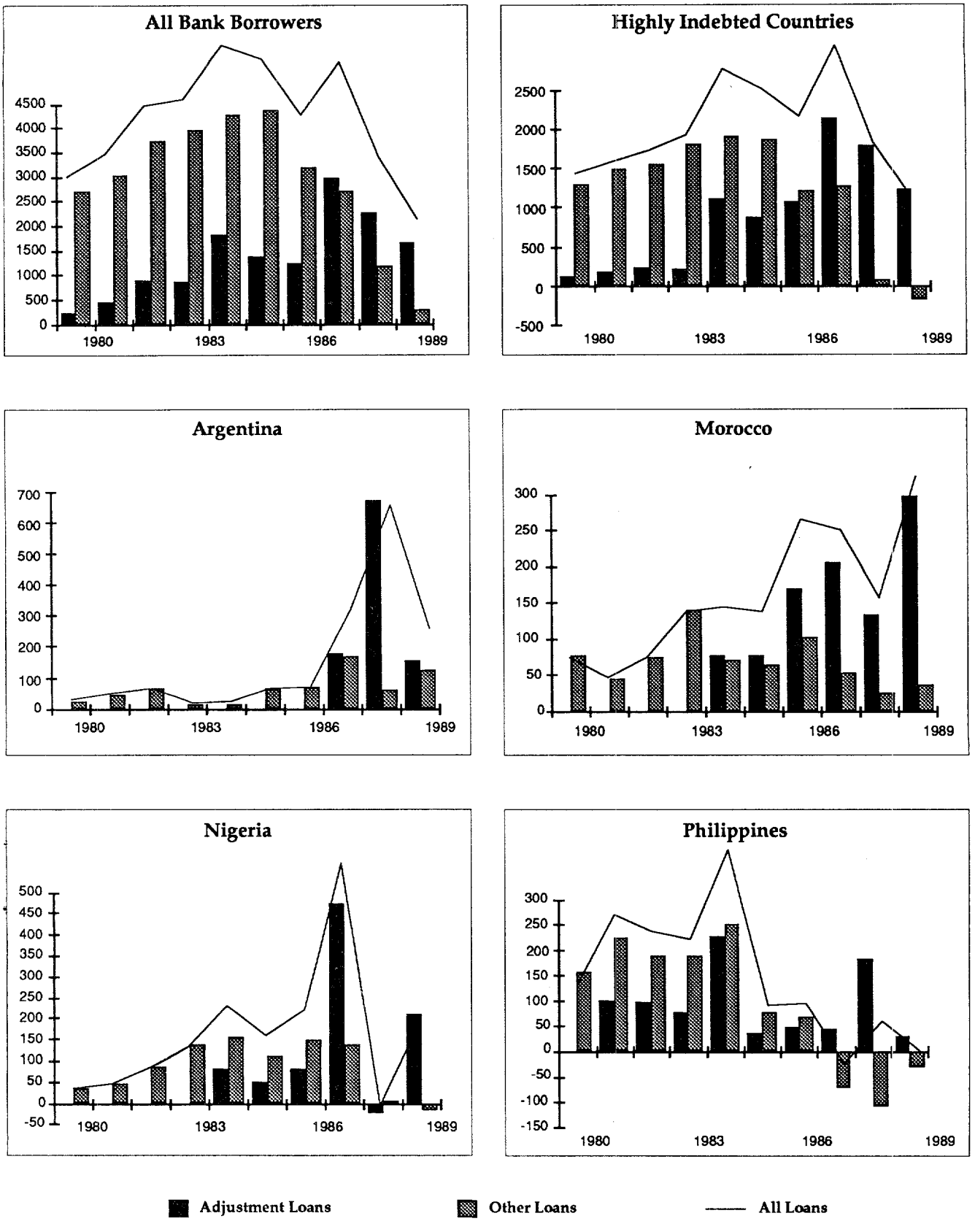
5.10 The potential returns from successful adjustment lending are very large, as noted throughout the report. These returns accrue to the borrowing country — through higher sustainable growth — and also to the Bank — through the borrowers' improved creditworthiness. But failure to sustain adjustment programs, as in Argentina, Brazil, Guyana, Honduras, Panama, Yugoslavia, and Zambia, weakens the country's creditworthiness. Sustained adjustment programs, for example in Chile, Ghana, Korea, Madagascar, Mauritius, Mexico, Thailand, and Tunisia, have had the more typical effect, however, of improving creditworthiness.

Incorporating risk and exposure in country strategy

5.11 Adjustment lending has risks, which stem from several closely related but distinguishable effects.

- The Bank's role in a country tends to become more politicized with adjustment lending than with project lending.
- The design and implementation of a comprehensive adjustment program raise difficult issues of the timing, sequencing, and political support for reforms and require greater institutional ca-

Figure 5.1 Role of adjustment lending in IBRD net flows (US$ millions, FY1980-89)



Source: FRS Data Base

Table 5.1 External debt and Bank Group exposure, 1980-88[a]

	$ Billion					Percentage distribution				
	Level			Change		Share			Change	
	1980	1983	1988p	1980-88	1983-88	1980	1983	1988	1980-88	1983-88
All countries										
Total external debt	579.7	815.6	1160.4	580.7	344.8	100.0	100.0	100.0	100.0	100.0
Long-term debt	437.2	644.9	993.2	556.0	348.3	75.4	79.1	85.6	95.7	101.0
Public and publicly guaranteed	362.2	533.3	915.2	553.0	381.9	62.5	65.4	78.9	95.2	110.8
Official creditors	165.5	225.7	456.0	290.5	230.3	28.5	27.7	39.2	50.0	66.8
IBRD and IDA	34.0	55.5	121.1	87.1	65.6	5.9	6.8	10.4	15.0	19.0
IBRD	22.1	37.0	84.5	62.4	47.5	3.8	4.5	7.3	10.7	13.8
IDA	11.9	18.6	36.6	24.7	18.0	2.1	2.3	3.2	4.3	5.2
Private creditors	196.8	307.6	459.2	262.4	151.6	33.9	37.7	39.6	45.2	44.0
Private, non-guaranteed	75.0	111.6	78.0	3.0	-33.6	12.9	13.7	6.7	0.5	-9.8
Use of IMF credit	9.4	30.9	33.0	23.6	2.1	1.6	3.8	2.8	4.1	0.6
Short-term debt	133.1	139.8	134.2	1.1	-5.6	23.0	17.1	11.5	0.2	-1.6
Highly indebted countries[b]										
Total external debt (EDT)	288.9	421.9	511.9	223.0	90.0	100.0	100.0	100.0	100.0	100.0
Long-term debt	205.4	334.4	445.7	240.3	113.3	71.1	79.3	87.1	107.8	123.7
Public and publicly guaranteed	148.2	250.1	402.6	254.4	152.5	51.3	59.3	78.6	114.1	169.4
Official creditors	38.2	55.6	129.7	91.5	74.1	13.2	13.2	25.3	41.0	82.3
IBRD and IDA	10.8	17.0	40.9	30.1	23.9	3.7	4.0	8.0	13.5	26.6
IBRD	10.5	16.7	40.4	29.9	23.7	3.6	4.0	7.9	13.4	26.3
IDA	0.3	0.3	0.5	0.2	0.2	0.1	0.1	0.1	0.1	0.2
Private creditors	110.0	194.5	272.8	162.8	78.3	38.1	46.1	53.3	73.0	87.0
Private, non-guaranteed	57.2	84.3	43.1	-14.1	-39.2	19.8	20.0	8.5	-6.3	-45.7
Use of IMF credit	3.0	12.3	19.2	16.2	6.9	1.0	2.9	3.8	7.3	7.7
Short-term debt	80.5	75.2	47.1	-33.4	-28.1	27.9	17.8	9.2	-15.0	-31.2
Africa, South of Sahara[b]										
Total external debt (EDT)	56.0	79.2	133.7	77.7	54.5	100.0	100.0	100.0	100.0	100.0
Long-term debt	44.3	63.0	115.5	71.2	52.5	79.1	79.5	86.4	91.6	96.3
Public and publicly guaranteed	41.4	58.6	109.6	68.2	51.0	73.9	74.0	82.0	87.8	93.6
Official creditors	24.8	35.5	75.4	50.6	39.9	44.3	44.8	56.4	65.1	73.2
IBRD and IDA	5.1	8.2	19.8	14.7	11.6	9.1	10.4	14.8	18.9	21.3
IBRD	2.5	3.9	8.4	5.9	4.5	4.5	4.9	6.3	7.6	8.3
IDA	2.6	4.4	11.3	8.7	6.9	4.6	5.6	8.5	11.2	12.7
Private creditors	16.6	23.2	34.2	17.6	11.0	29.6	29.3	25.6	22.7	20.2
Private, non-guaranteed	2.9	4.4	5.9	3.0	1.5	5.2	5.5	4.4	3.8	2.7
Use of IMF credit	2.0	5.1	5.9	3.9	0.8	3.6	6.4	4.4	5.0	1.5
Short-term debt	9.7	11.1	12.4	2.7	1.3	17.3	14.0	9.3	3.5	2.4

Source: World Debt Tables, 1988-89; Preliminary Bank Estimates for 1988.
a. Numbers may not add up due to rounding.
b. Nigeria and Côte d'Ivoire are included in both country groupings.
p=preliminary

pacity to put programs in place, including a greater capacity to react to unexpected events. These difficulties, if not properly dealt with, could result in policy reversals.

- In the event that adjustment lending is interrupted by policy setbacks, net disbursements can fall sharply and become negative precisely when relationships are likely to be at a low point.
- To the extent that adjustment lending substitutes for project lending, which disburses more slowly, the size of the undisbursed pipeline is lower, thus reducing a potential incentive to service Bank loans even when the policy dialogue may have broken down.

5.12 The Bank is following several strategies to manage these risks:

- Dialogue with the country authorities and economic and sector work to develop a sound program, identifying the priority and sequencing of reforms, choosing the appropriate lending instruments to support them, and taking account of political economy in evaluating sustainability (chapter 4)
- Realistic assessment of the *most likely* outcome for the country for the coming years
- Assessment of the downside risks facing the country, whether from a deterioration in the external environment or from possible domestic policy setbacks
- Careful attention to the adequacy of the prospective financial flows over a multiyear period and to the burden-sharing implied under the proposed lending strategy
- Introduction of policy-conditioned sectoral investment loans and hybrid loans (with various shares of quick-disbursing resources) to support

aspects of adjustment that take longer to implement, as discussed in chapter 4.

5.13 In countries with unsustainable debt burdens to commercial lenders, debt reduction schemes can substantially increase the effectiveness of adjustment lending (chapter 4). Bank adjustment lending to support debt reduction entails some special risks, to which management is paying particular attention. In analyzing individual proposals, staff assess carefully the robustness of the proposed financial workout in the event of plausible downside events. In the light of such an assessment, the Bank should support debt reduction schemes that in themselves provide sufficient cash flow relief and flexibility to make the financing plan viable.

Coordination of assistance, burden-sharing, and adequate financing

5.14 The Bank supports adjustment programs on the assumption, made explicit in the projections in the President's Reports, that the country will also receive financing from other sources. A shortfall between the external financing needed by a country and the funds actually received sometimes damaged the credibility and delayed the benefits of even well-designed adjustment programs, as in Mexico and Bolivia. Although one cannot identify with statistical procedures precisely which countries had substandard growth because of underfunded programs, there is no doubt that it was a factor in some cases.

5.15 Some adjustment programs encountered difficulties because they did not provide a way to deal with unexpected external shocks. The volatility of the external environment needs increased attention in program design. Traditional strategies include accumulating higher foreign exchange reserves and diversifying exports. It is also important to consider financing plans that can handle unforeseen events, such as commodity-linked financing and the contingency facilities in the Mexican financing package of 1987 and the Paraguay loan of 1984.[3] Such procedures should be extended further to increase the credibility of programs.

5.16 To try to assure adequate total external financing for the adjustment programs that the Bank supports, and to share the risk burden of lending to countries without voluntary access to commercial lending, the Bank plays a major role in mobilizing and coordinating aid and official lending flows to individual countries. For a variety of countries — ranging from some of the smallest to such large countries as India and Pakistan and to such middle-income borrowers as Côte d'Ivoire and Costa Rica — the traditional vehicle has been the consultative group or aid consortium, with representatives from official creditors and donors. Consultative groups have succeeded in mobilizing important amounts of resources for many countries. Traditionally the consultative groups focused on financing of public investment projects and usually had a one-year time horizon, in keeping with the government budget process of the members. Now they focus more on overall financing needs, taking into account indebtedness, and the need for policy adjustment. For African countries the groups have begun to take a longer time view, a trend that should continue, given the needs for institutional development and human capital formation in the region.[4] Except in the context of debt-reduction agreements, there is no analogous institution for longer-term coordination of financial support from commercial sources.

5.17 The Special Program of Assistance (SPA) for Sub-Saharan Africa has succeeded in mobilizing and coordinating aid exclusively for the low-income, debt-distressed countries in that region. With the precondition of IDA-adjustment lending, the SPA emphasizes policy reforms and associated balance of payments support. The SPA also provides an international forum for the countries it covers, to discuss generic problems with adjustment lending, overall financing, and streamlining procedures. Specific country problems continue to be discussed at the consultative group meetings, where delegates have more detailed mandates concerning their governments' assistance strategies for each country. As of May 1989, commitments of about $5.4 billion in cofinancing and coordinated financing for 1988-90 had been mobilized through the SPA. In Asia, where there are few such special programs, low income countries have received only limited increases in net official flows — smaller than the growth of their needs.

5.18 For a sample of 26 major adjusting countries, table 5.2 presents data on cofinancing from official and nonofficial sources during the periods in which Bank adjustment lending took place.[5] For Bank commitments for investment and adjustment operations totaling $21 billion in those countries, about $21 billion was mobilized in cofinancing. Two thirds of the cofinancing was related to investment projects, with about $0.90

in cofinancing mobilized per dollar of Bank contributions. One third was related to adjustment operations (SALs and SECALs), with about $1.40 in cofinancing mobilized per dollar of Bank contributions. The Bank Group has been slightly more successful than average in mobilizing cofinancing for IDA countries (including blend countries) — mobilizing, on average, $1.20 per dollar of Bank Group financing, overwhelmingly from official sources.

5.19 IBRD adjustment lending has had higher ratios of cofinancing — $1.50 per dollar of adjustment lending. Of the cofinancing in the riskier middle-income countries, more than 40 percent has been associated with Bank adjustment lending. Three quarters of the cofinancing for these countries came from other official sources. The Bank has had only limited success in mobilizing commercial financing to dilute its exposure risk in middle-income countries posing the highest risk. Among the countries with unsustainable debt burdens to commercial lenders, adjustment lending — to be effective — would need an accompanying debt reduction plan.

Supervision

5.20 In considering the supervision of adjustment loans, a key issue is the extent to which an independent assessment of the macroeconomic picture should be an integral aspect of the supervision process. In preparing and appraising the adjustment program, macroeconomic considerations are nearly always important. When formal loan conditions refer to macroeconomic considerations only in general terms, they have tended to play a much smaller role during supervision, especially for SECALs. This sometimes has occurred even when the efficacy of the loan depended on the macroeconomic situation. In many cases supervision is divided among a number of specialists (and among the divisions in charge of different components) and is sometimes performed sequentially rather than simultaneously. Different missions sometimes leave aide-memoires concerning different aspects of the program, and that can make it difficult to convey an overall message on the progress of adjustment.

5.21 Relatively thorough macroeconomic monitoring is in many instances performed outside loan supervision, but the results may not be integrated with those from routine supervision. For the Turkey FSAL I, for example, thorough independent macroeconomic monitoring was carried out, although the results were not adequately fed into loan supervision and decision-making. Macroeconomic assessments reached fairly negative conclusions, but they did not prevent a decision to release the second tranche in early 1987. At that same time, preparation of Turkey's FSAL II was facing macroeconomic difficulties and suffering major delays. The recently revised guidelines for project supervision recommend comprehensive and systematic macroeconomic monitoring. Chapter 4 discusses specific procedures being used to improve macroeconomic monitoring.

5.22 Numerous examples of thorough supervision are documented in the files, including fully adequate macroeconomic assessments at regular intervals, such as the Chile SAL II during 1987-88 and the Tunisia AGSAL during 1986-88. At the other extreme, macroeconomic monitoring was sometimes completely dissociated from specific loan supervision.

5.23 Although the IMF's macroeconomic assessments have been and should continue to be valuable inputs to supervising adjustment loans, as well as preparing them, the Bank should continue its independent macroeconomic monitoring for the reasons given in paragraph 4.22 of chapter 4.

Conclusions

5.24 Adjustment lending has improved the growth and development prospects of most recipients, as indicated in chapters 2 and 4, by improving their policies. Until the payoff of substantially higher growth is realized in adjustment lending countries, however, adjustment lending will have increased the riskiness of the IBRD's portfolio by increasing the concentration of exposure to countries whose poor creditworthiness barred their access to commercial financing.

5.25 The Bank has had mixed success in attracting cofinancing for adjustment lending. Other official creditors have more than matched Bank financing to IDA countries with grants and other loans that were disbursed on a similar schedule. Cofinancing for IBRD borrowers with poor credit ratings has come mainly from official sources, and the small amount of financing from commercial sources has contributed to the sharp increase of the Bank's share of total financing. The Bank has to continue its efforts to arrange more adequate burden-sharing, both to generate financing for the programs and to reduce the risk to its

Table 5.2 Cofinancing in twenty-six countries with intensive adjustment lending

Countries	Period[a]	Amount of cofinancing (US$ million)					
		Grand total	Official sources	Nonofficial sources[b]	Associated with adj. lending[c]	Official sources	Nonofficial sources
Argentina	FY87-89	1,536.0	650.5	885.5	500.0	0.0	500.0
Bolivia	FY80-89	202.7	202.7	0.0	50.0	50.0	0.0
Brazil	FY84-87	108.6	0.9	107.7	0.0	0.0	0.0
Chile	FY86-89	493.1	356.3	136.8	0.0	0.0	0.0
Colombia	FY85-88	1,421.7	414.7	1,007.0	1,030.0	300.0	730.0
Costa Rica	FY89	100.0	100.0	0.0	100.0	100.0	0.0
Côte d'Ivoire	FY82-88	272.0	227.0	45.0	0.0	0.0	0.0
Ghana	FY82-89	1,100.6	1,062.5	38.1	480.4	480.4	0.0
Indonesia	FY86-89	278.9	116.9	162.0	0.0	0.0	0.0
Jamaica	FY79-89	467.6	417.4	50.2	453.0	390.5	62.5
Kenya	FY80-89	553.4	536.7	16.7	85.9	85.9	0.0
Korea	FY82-88	7.4	7.4	0.0	0.0	0.0	0.0
Malawi	FY82-89	458.4	458.4	0.0	275.5	275.5	0.0
Mexico	FY84-87	2,009.2	45.3	1,963.9	240.0	240.0	0.0
Morocco	FY84-89	601.0	411.1	189.9	140.0	140.0	0.0
Nigeria	FY86-89	242.5	66.0	176.4	0.0	0.0	0.0
Pakistan	FY81-89	3,211.6	2,020.8	1,190.8	532.9	449.9	83.0
Philippines	FY81-89	1,771.0	647.0	1,124.0	1,109.0	430.0	679.0
Senegal	FY81-89	352.0	352.0	0.0	106.1	106.1	0.0
Tanzania	FY81-89	527.2	527.2	0.0	193.3	193.3	0.0
Thailand	FY82-89	2,105.6	564.5	1,541.1	0.0	0.0	0.0
Tunisia	FY87-89	27.1	27.1	0.0	8.8	8.8	0.0
Turkey	FY80-89	2,605.7	265.5	2,340.2	1,595.7	0.0	1,595.7
Uruguay	FY86-89	118.9	0.0	118.9	0.0	0.0	0.0
Yugoslavia	FY84-89	521.9	237.3	284.6	0.0	0.0	0.0
Zambia	FY84-87	343.2	343.2	0.0	209.3	209.3	0.0
Total		21,437.3	10,058.4	11,378.8	7,109.9	3,459.7	3,650.2

Countries	Period[a]	Number of cofinancing operations/sources						US$ million	
		Grand total	Official sources	Non-official sources[b]	Associated with adj. lending[c]	Official sources	Non-official sources[b]	Bank contribution[d]	of which IDA
Argentina	FY87-89	5	3	3	1	0	1	1,162.5	0.0
Bolivia	FY80-89	10	10	0	1	1	0	223.3	223.3
Brazil	FY84-87	5	1	4	0	0	0	873.4	0.0
Chile	FY86-89	3	2	3	0	0	0	1,379.4	0.0
Colombia	FY85-88	7	3	6	1	1	1	1,008.8	0.0
Costa Rica	FY89	1	1	0	1	1	0	100.0	0.0
Côte d'Ivoire	FY82-88	10	9	2	0	0	0	539.5	0.0
Ghana	FY82-89	23	24	3	8	8	0	791.8	791.8
Indonesia	FY86-89	21	15	9	0	0	0	2,172.8	0.0
Jamaica	FY79-89	7	5	3	1	1	1	132.0	0.0
Kenya	FY80-89	21	21	1	4	4	0	788.3	484.5
Korea	FY82-88	3	3	0	0	0	0	138.0	0.0
Malawi	FY82-89	16	16	0	5	5	0	344.4	318.6
Mexico	FY84-87	4	2	4	1	1	0	935.0	0.0
Morocco	FY84-89	10	9	1	2	2	0	848.5	0.0
Nigeria	FY86-89	5	4	2	0	0	0	435.5	0.0
Pakistan	FY81-89	31	29	9	2	2	1	2,363.7	1,134.0
Philippines	FY81-89	9	7	6	3	2	3	1,324.5	0.0
Senegal	FY81-89	16	16	0	2	2	0	328.0	328.0
Tanzania	FY81-89	13	13	0	4	4	0	542.2	542.2
Thailand	FY82-89	16	12	11	0	0	0	1,179.4	0.0
Tunisia	FY87-89	3	3	0	1	1	0	236.0	0.0
Turkey	FY80-89	16	7	11	5	0	5	2,255.3	0.0
Uruguay	FY86-89	2	0	2	0	0	0	138.5	0.0
Yugoslavia	FY84-89	5	4	3	0	0	0	582.0	0.0
Zambia	FY84-87	11	11	0	4	4	0	256.5	181.5
Total		273.0	230.0	83.0	46.0	39.0	12.0	21,079.3	4,003.9

Source: World Bank data.
a. Period during which adjustment lending and any cofinancing took place.
b. Export credit, private financial institutions, IFC.
c. Includes program loans/rehabilitation loans.
d. Excludes IFC; IFC included in non-official co-financing sources.

portfolio. Assuring the adequacy of funds for successful programs would in some cases include the use of debt and debt-service reduction schemes. For low-income countries, the Bank is expanding its efforts to increase bilateral aid flows.

5.26 Consultative groups and the Special Program of Assistance for Sub-Saharan Africa have helped coordinate adjustment lending by official lenders and donors. The consultative groups need to give increased attention to the policy framework in the borrowing country and to work with a longer time horizon. Extending the time frame is important for most Sub-Saharan African countries, where the need for developing institutions and human capital slows the structural adjustment process, and for the highly indebted countries, where debt-related uncertainty has stifled private investment.

5.27 Supervision of the macroeconomic framework has in some cases been inadequate, especially for SECALs. Macroeconomic monitoring needs to be strengthened and taken into account more consistently in decisions on tranche releases. For the reasons given in chapter 4, IMF supervision of the macroeconomic framework does not always provide information with the timing and emphasis that the Bank needs. The Bank should conduct its own assessments of macroeconomic developments for decisionmaking about loans and tranche releases and for better risk management.

Annex tables

Annex table 5.1 Adjustment lending operations, CY 80-89 ($ millions)

	1980-82 [b]	*1983-85* [b]	*1986*	*1987*	*1988*	*1989*
Commitments:						
Total adjustment lending	809	2183	4305	4424	4707	6094
IBRD	673	1951	3455	3475	3615	4959
IDA [a]	136	232	850	949	1092	1117
SAL	741	910	848	934	790	2028
SECAL	67	1274	3457	3490	3917	4066
Disbursements: [c]						
Gross disbursements	782	1547	3165	3650	4087	3882
IBRD	659	1431	2631	2785	3200	2940
IDA	123	116	534	865	887	941
Net disbursements	755	1475	2974	3173	2977	3114
IBRD	640	1374	2465	2349	2122	2208
IDA	115	102	509	824	855	906

Note: Adjustment lending includes the fast-disbursing portion of hybrid loans.
a. IDA AL includes Special Facility for Africa. Total SAL & SECAL amount of SFA was 1985:97 ($M), 86:443.1 ($M), 87:405.3 ($M), 88:63.9 ($M)
b. Average annual rates for 1980-82 and 1983-85
c. Adjustment Lending Gross & Net Disbursements

Annex table 5.2 Adjustment loans and lending commitments

	1980-82 [b]	*1983-85* [b]	*1986*	*1987*	*1988*	*1989*	*Total 1980-89* [c]
Africa [a] ($ millions)	190	468	1,497	754	1,472	1,235	6,933
(% Total AL)	24	21	35	17	31	20	24
(No. of Loans)	3	8	16	11	13	14	85
Asia ($ millions)	200	383	0	840	600	1,130	4,320
(% Total AL)	25	18	0	19	13	19	15
(No. of Loans)	1	2	0	4	2	6	20
EMENA ($ millions)	357	657	803	990	1,150	1,064	7,047
(% Total AL)	44	30	19	22	24	17	25
(No. of Loans)	2	3	5	4	5	6	34
LAC ($ millions)	62	675	2,005	1,840	1,485	2,665	10,206
(% Total AL)	8	31	47	42	32	44	36
(No. of Loans)	1	4	7	10	7	7	48
HICs ($ millions)	171	1,095	2,607	1,840	2,135	3,166	13,545
(% Total AL)	21	50	61	42	45	52	48
(No. of Loans)	2	6	8	10	8	6	55
Total ($ millions)	809	2,183	4,305	4,424	4,707	6,094	28,506
(No. of Loans)	7	17	28	29	27	33	187

Source: Economic Advisory Staff.
Note: All figures are based on Calendar Year.
a. Africa includes Special Facility for Africa (for dollar amounts but not number of operations.)
b. Per year, average of three years.
c. Total sum of CY 1980-89.

Annex table 5.3

	Adjustment lending commitments as a share of total IBRD and IDA commitments (percent)						
	1980-82 [b]	*1983-85* [b]	*1986*	*1987*	*1988*	*1989*	*Total 1980-89* [b]
Africa [a]	11	22	44	29	36	37	25
Asia	4	7	0	11	9	13	7
EMENA	17	23	20	27	38	23	23
LAC	2	18	39	37	30	45	21
HICs	4	22	39	28	36	40	22
Total	7	15	24	23	25	27	16
IBRD AL/IBRD commitments	8	17	24	25	25	29	18
IDA AL/IDA commitments	4	8	23	20	25	23	12

	Adjustment lending disbursements as a share of total IBRD & IDA disbursements (percent)						
	1980-82 [b]	*1983-85* [b]	*1986*	*1987*	*1988*	*1989*	*Total 1980-89* [b]
Africa [a]							
Net	16	24	45	52	40	57	31
Gross	14	21	38	45	35	47	27
Asia							
Net	7	8	1	16	6	15	8
Gross	6	7	2	11	12	12	8
EMENA							
Net	28	30	33	47	65	107	42
Gross	21	23	22	28	30	31	24
LAC							
Net	8	23	60	58	97	105	41
Gross	5	15	37	28	40	36	20
HICs							
Net	12	32	60	71	115	109	49
Gross		22	37	35	39	39	24
Total							
Net	13	18	33	38	39	45	25
Gross	10	15	23	25	26	27	18
IBRD AL/IBRD disbursements							
Net	16	24	43	48	55	60	33
Gross	12	18	26	25	27	27	19
IDA AL/IDA disbursements							
Net	6	4	15	24	23	27	12
Gross	6	5	16	24	23	27	12

Source: Economic Advisory Staff, Controllers - Management Information Division (CTRMI), and ANDREX database.
a. Africa includes Special Facility for Africa (for dollar amounts but not number of operations.)
b. Average of annual shares for 1980-82, 1983-85, and 1980-89.
Notes: 1. Breakdown of IBRD & IDA is share of adjustment lending commitments (& disbursements) to Total commitments (& disbursements) of all IBRD & IDA recipients included in RAL2 country list.
2. Net disbursement ratio is Net adjustment lending disbursement/Net disbursements, and Gross disbursement ratio is Gross adjustment lending disbursements/Gross disbursements. Net disbursements are Gross disbursements less principal repayments.
3. All figures are based on Calendar Year.

Annex table 5.4 Adjustment lending flows compared with total international flows (percentage)

Group	*Ratios*	*1980-82* [b]	*1983-85* [b]	*1986*	*1987*	*1988*	*1989*
Total [a]	AL/Total loans disbursed	0.9	2.2	5.0	5.8	5.4	4.2
	AL/Total off disbursements	2.9	5.5	9.9	11.2	9.3	6.2
	AL net disb./off net disb.	3.9	8.5	18.4	21.7	14.2	12.2
Low-income [a]	AL/Total loans disbursed	1.1	2.0	6.6	10.4	7.3	6.8
	AL/Total off disbursements	2.1	3.2	9.2	12.9	8.4	7.7
	AL net disb./off net disb.	2.4	4.3	13.6	17.7	10.7	10.2
Middle-income	AL/Total loans disbursed	0.9	2.2	4.6	4.6	4.8	3.3
	AL/Total off disbursements	3.1	6.4	10.2	10.4	9.7	5.5
	AL net disb./off net disb.	4.5	10.4	21.2	26.1	18.0	14.3
HICs	AL/Total loans disbursed	0.5	3.3	10.3	8.8	8.1	5.5
	AL/Total off disbursements	2.4	8.9	17.0	15.9	13.5	7.8
	AL net disb./off net disb.	3.7	16.0	32.8	31.0	26.1	14.4
SSA	AL/Total loans disbursed	1.5	4.6	11.6	15.5	9.4	9.4
	AL/Total off disbursements	3.4	7.5	16.7	19.8	11.1	11.1
	AL net disb./off net disb.	3.7	10.2	23.2	25.5	12.7	14.8
Asia [a]	AL/Total loans disbursed	1.4	1.6	0.6	4.8	3.7	3.4
	AL/Total off disbursements	3.5	4.1	1.4	7.9	5.1	4.4
	AL net disb./off net disb.	4.3	5.0	1.2	15.5	-0.5	5.6
EMENA	AL/Total loans disbursed	1.4	2.2	2.1	3.2	3.3	2.4
	AL/Total off disbursements	3.5	6.1	5.7	8.7	7.5	4.7
	AL net disb./off net disb.	5.0	10.4	12.1	26.5	16.8	9.1
LAC	AL/Total loans disbursed	0.3	1.9	9.4	5.8	7.5	4.4
	AL/Total off disbursements	1.4	5.0	14.9	10.9	13.8	6.5
	AL net disb./off net disb.	2.1	8.6	26.5	20.3	30.3	13.0

Source: Source of Adjustment Lending disbursements is Controls-Management Info. Division (CTRMI). Source of all other data is ANDREX database.
a. Exclude India and China.
b. Average of annual shares for 1980-82 and 1983-85.
Note: All figures are based on calendar year.

Annex table 5.5 Bank and Fund concurrent operations (through FY89)

	Country	Board date of Bank program FY	Loan type	Loan #	Amount ($millions)	Date of effectiveness	Date of closure
IMF	Argentina		Stand-by Arrangement			84-12	86-05
WB	Argentina	86	Agricultural Sector Loan	2675	350.0	86-07	89-06
IMF	Argentina		Stand-by Arrangement			87-07	88-09
WB	Argentina	87	Trade Policy Loan	2815	500.0	87-08	90-06
WB	Argentina	88	Banking Sector Loan	2923	400.0	–	–
WB	Argentina	89	2nd Trade Policy Loan	2996	300.0	88-11	90-06
IMF	Bangladesh		Structural Adj. Facility			87-02	90-02
WB	Bangladesh	87	Industrial Sector Loan	1816	190.0	89-04	90-03
WB	Bangladesh	89	Energy Sector Loan	1999	175.0	89-06	91-12
IMF	Benin		Structural Adj. Facility			89-06	92-06
WB	Benin	89	SAL I	2023	45.0	89-06	90-03
IMF	Bolivia		Stand-by Arrangement			80-02	81-01
WB	Bolivia	80	SAL I	1865	50.0	80-06	81-06
IMF	Bolivia		Stand-by Arrangement			86-06	87-06
WB	Bolivia	86	Import Reconstruction Loan	1703	55.0	86-10	90-06
IMF	Bolivia		Structural Adj. Facility			86-12	88-07
WB	Bolivia	87	2nd Import Reconstruction Loan	1828	47.1	88-03	90-06
IMF	Bolivia		Enhanced Structural Adj. Facility			88-07	91-07
WB	Bolivia	88	Financial Sector Loan	1925	70.0	89-04	90-06
IMF	Brazil		Extended Fund Facilitty			83-03	86-02
WB	Brazil	84	Export Development Loan	2347	352.0	83-10	86-12
WB	Brazil	84	Ag and Trade Develop. Loan	2348	303.0	83-10	87-03
WB	Brazil	86	Agricultural Mkt Reform Loan	2727	500.0	86-09	90-06
IMF	Brazil		Stand-by Arrangement			88-08	90-02
WB	Burkina Faso	85	Fertilizer Loan	1550	13.7	85-11	91-12
IMF	Burundi		Structural Adj. Facility			86-08	89-08
IMF	Burundi		Stand-by Arrangement			86-08	88-03
WB	Burundi	86	SAL I	1705	31.2	86-09	88-06
WB	Burundi	88	SAL II	1919	90.0	88-11	90-12
WB	Burundi	89	Ag Services Sector Loan	2024	33.1	89-07	96-12
IMF	Cameroon		Stand-by Arrangement			88-09	90-03
WB	Cameroon	89	SAL I	3089	150.0	89-11	91-09
IMF	CAR		Stand-by Arrangement			85-09	87-03
IMF	CAR		Stand-by Arrangement			87-06	88-05
IMF	CAR		Structural Adj. Facility			87-06	90-05
WB	CAR	87	SAL I	1732	30.0	86-10	87-12
WB	CAR	88	Agricultural Sector Loan	1836	15.0	87-10	89-12
WB	CAR	88	SAL II	1916	40.0	88-09	90-05
IMF	Chad		Structural Adj. Facility			87-10	90-10
WB	Chad	89	Financial Sector Loan	1945	37.5	88-10	90-06
WB	Chad	89	Transportation Sector Loan	2007	60.0	89-06	94-06
IMF	Chile		Extended Fund Facilitty			85-08	89-08
WB	Chile	86	SAL I	2625	250.0	85-11	86-10
WB	Chile	87	SAL II	2767	250.0	86-11	87-12
WB	Chile	88	SAL III	2892	250.0	87-12	89-06
WB	China	88	Rural Sector Loan	2967	300.0	88-09	90-07
WB	Colombia	85	Trade and Export Divers. Loan	2551	300.0	85-06	88-06
WB	Colombia	86	Trade and Ag Policy Loan	2677	250.0	86-06	89-12
WB	Colombia	88	Energy Sector Loan	2889	300.0	88-06	90-01
IMF	Congo		Stand-by Arrangement			86-08	88-04
WB	Congo	87	SAL I	2866	70.0	87-10	89-03
IMF	Costa Rica		Extended Fund Facilitty			81-06	84-06
WB	Costa Rica	83	Export Development Loan	2274	25.2	84-03	85-06
IMF	Costa Rica		Stand-by Arrangement			85-03	86-04
WB	Costa Rica	85	SAL I	2518	80.0	85-08	86-06
IMF	Costa Rica		Stand-by Arrangement			87-10	89-03
IMF	Costa Rica		Stand-by Arrangement			89-05	90-05
WB	Costa Rica	89	SAL II	3005	100.0	89-11	91-01

	Country	Board date of Bank program FY	Loan type	Loan #	Amount ($millions)	Date of effectiveness	Date of closure
IMF	Cote d'Ivoire		Extended Fund Facilitty			81-02	84-02
WB	Cote d'Ivoire	82	SAL I	2058	150.0	81-12	82-12
WB	Cote d'Ivoire	84	SAL II	2332	250.0	83-08	84-12
IMF	Cote d'Ivoire		Stand-by Arrangement			84-08	85-05
IMF	Cote d'Ivoire		Stand-by Arrangement			85-06	86-06
IMF	Cote d'Ivoire		Stand-by Arrangement			86-06	88-06
WB	Cote d'Ivoire	86	SAL III	2711	250.0	87-02	87-12
IMF	Cote d'Ivoire		Stand-by Arrangement			88-03	89-04
IMF	Ecuador		Stand-by Arrangement			85-03	86-03
WB	Ecuador	86	Agricultural Sector Loan	2626	100.0	86-02	89-06
IMF	Ecuador		Stand-by Arrangement			86-08	87-08
WB	Ecuador	88	Financial Sector Loan	2897	100.0	87-12	89-12
IMF	Ecuador		Stand-by Arrangement			88-01	89-02
IMF	Gabon		Stand-by Arrangement			86-12	88-12
WB	Gabon	88	SAL I	2933	50.0	88-05	89-12
IMF	Gambia		Stand-by Arrangement			86-09	87-10
WB	Gambia	87	SAL I	1730	16.5	86-10	88-06
IMF	Gambia		Enhanced Structural Adj. Facility			88-11	91-11
WB	Gambia	89	SAL II	2032	23.0	89-08	91-06
IMF	Ghana		Stand-by Arrangement			83-08	84-08
WB	Ghana	83	Trade and Import Sector Loan	1393	40.0	83-08	86-03
WB	Ghana	84	Export Rehab. Loan	1435	76.0	84-06	88-12
IMF	Ghana		Stand-by Arrangement			84-08	85-12
WB	Ghana	85	2nd Trade and Import Sector Loan	1573	87.0	85-08	88-12
WB	Ghana	86	Industrial Sector Loan	1672	53.5	86-06	90-12
IMF	Ghana		Stand-by Arrangement			86-10	87-10
WB	Ghana	87	Educational Sector Loan	1744	34.5	87-04	90-12
WB	Ghana	87	SAL I	1777	115.0	87-05	90-06
IMF	Ghana		Extended Fund Facilitty			87-11	90-11
IMF	Ghana		Structural Adj. Facility			87-11	88-11
WB	Ghana	88	Financial Sector Loan	1911	100.0	88-08	90-09
IMF	Ghana		Enhanced Structural Adj. Facility			88-11	91-11
WB	Ghana	89	SAL II	2005	120.0	89-06	91-03
IMF	Guinea		Stand-by Arrangement			86-02	87-03
WB	Guinea	86	SAL I	1659	42.0	86-05	88-12
IMF	Guinea		Structural Adj. Facility			87-07	90-07
IMF	Guinea		Stand-by Arrangement			87-07	88-08
WB	Guinea	88	SAL II	1926	65.0	89-03	90-12
WB	Guinea Bissau	85	Import Reconstruction Loan	1531	15.0	85-02	89-06
WB	Guinea Bissau	87	SAL I	1798	15.0	87-06	90-07
WB	Guinea Bissau	89	SAL II	2019	23.4	89-08	92-06
IMF	Guinea-Bissau		Structural Adj. Facility			87-10	90-10
IMF	Guyana		Extended Fund Facilitty			79-06	82-06
IMF	Guyana		Extended Fund Facilitty			80-07	83-07
WB	Guyana	81	SAL I	1948	22.0	81-03	83-06
WB	Honduras	89	SAL I	2990	50.0	88-11	89-12
WB	Hungary	86	Industrial Sector Loan	2700	100.0	86-08	92-06
IMF	Hungary		Stand-by Arrangement			88-05	89-05
WB	Hungary	88	2nd Industrial Sector Loan	2965	200.0	88-07	90-06
WB	Indonesia	87	Trade Policy Loan	2780	300.0	87-03	87-06
WB	Indonesia	88	2nd Trade Policy Loan	2937	300.0	88-08	89-03
WB	Indonesia	89	Private Sector Develop. Loan	3080	350.0	89-09	90-03
IMF	Jamaica		Extended Fund Facilitty			78-06	81-06
IMF	Jamaica		Extended Fund Facilitty			79-06	81-06
WB	Jamaica	79	Export Develop. Fund Loan	1715	31.5	79-08	82-12
IMF	Jamaica		Extended Fund Facilitty			81-04	84-04
WB	Jamaica	81	2nd Export Develop Fund Loan	1978	37.0	81-08	83-12
WB	Jamaica	82	SAL I	2105	76.2	82-03	83-03

Annex table 5.5 (continued) Bank and Fund concurrent operations (through FY89)

	Country	Board date of Bank program FY	Loan type	Loan #	Amount ($millions)	Date of effectiveness	Date of closure
WB	Jamaica	83	SAL II	2315	60.2	83-06	84-05
IMF	Jamaica		Stand-by Arrangement			84-06	85-06
WB	Jamaica	85	SAL III	2478	55.0	84-11	85-06
WB	Jamaica	83	3rd Export Develop. Fund Loan	2320	30.1	85-04	86-12
IMF	Jamaica		Stand-by Arrangement			85-07	87-05
IMF	Jamaica		Stand-by Arrangement			87-03	88-05
WB	Jamaica	87	Trade and Finance Sectors Loan	2848	40.0	87-06	88-12
WB	Jamaica	87	Public Enterprise Sector Loan	2849	20.0	87-06	88-12
IMF	Jamaica		Stand-by Arrangement			88-09	90-05
IMF	Kenya		Stand-by Arrangement			79-08	81-08
WB	Kenya	80	SAL I	999	70.0	80-06	80-12
IMF	Kenya		Stand-by Arrangement			80-10	82-10
IMF	Kenya		Stand-by Arrangement			82-01	83-01
WB	Kenya	83	SAL II	2190	130.9	82-08	83-12
IMF	Kenya		Stand-by Arrangement			83-03	84-09
IMF	Kenya		Stand-by Arrangement			85-02	86-02
WB	Kenya	86	Agricultural Sector Loan	1717	60.0	87-03	88-06
IMF	Kenya		Structural Adj. Facility			88-02	91-01
IMF	Kenya		Stand-by Arrangement			88-02	89-07
WB	Kenya	88	Industry and Trade Sectors Loan	1927	112.0	88-08	90-04
IMF	Kenya		Enhanced Structural Adj. Facility			89-05	92-05
WB	Kenya	89	Financial Sector Loan	2049	120.0	89-07	91-09
IMF	Korea		Stand-by Arrangement			80-03	82-03
IMF	Korea		Stand-by Arrangement			81-02	82-03
WB	Korea	82	SAL I	2071	250.0	82-03	82-12
IMF	Korea		Stand-by Arrangement			83-07	85-03
WB	Korea	84	SAL II	2354	300.0	83-11	84-12
IMF	Korea		Stand-by Arrangement			85-07	87-03
WB	Korea	85	Industry and Finance Sectors Loan	2571	222.0	85-12	90-09
WB	Lao P.D.R.	89	SAL I	2037	40.0	89-08	91-07
IMF	Madagascar		Stand-by Arrangement			85-04	86-04
WB	Madagascar	85	Industrial Assistance Loan	1541	60.0	85-08	89-03
IMF	Madagascar		Stand-by Arrangement			86-09	88-02
WB	Madagascar	86	Agricultural Sector Loan	1691	93.0	86-11	89-12
IMF	Madagascar		Structural Adj. Facility			87-08	90-08
WB	Madagascar	87	Industry and Trade Policy Loan	1834	83.0	87-09	89-12
IMF	Madagascar		Stand-by Arrangement			88-09	89-07
WB	Madagascar	88	Public Sector Adjustment Loan	1941	125.0	88-12	90-12
IMF	Madagascar		Enhanced Structural Adj. Facility			89-05	92-05
IMF	Malawi		Stand-by Arrangement			79-10	81-12
WB	Malawi	81	SAL I	2026	45.0	81-08	82-12
IMF	Malawi		Stand-by Arrangement			82-08	83-08
WB	Malawi	83	Fertilizer Loan	1352	5.0	83-06	88-03
IMF	Malawi		Extended Fund Facilitty			83-09	86-09
WB	Malawi	84	SAL II	1427	55.0	84-01	85-06
WB	Malawi	86	SAL III	1644	70.0	85-12	88-09
IMF	Malawi		Stand-by Arrangement			88-03	89-05
IMF	Malawi		Enhanced Structural Adj. Facility			88-07	91-07
WB	Malawi	88	Industry and Trade Policy Loan	1920	70.0	88-09	90-12
IMF	Mali		Stand-by Arrangement			83-12	85-05
IMF	Mali		Stand-by Arrangement			88-08	89-10
IMF	Mali		Structural Adj. Facility			88-08	91-08
WB	Mali	88	Public Sector Loan	1937	40.0	88-09	90-12
WB	Mali	89	Human Resources Loan	2054	26.0	89-07	94-12
IMF	Mauritania		Stand-by Arrangement			85-04	86-04
WB	Mauritania	85	Public Sector Loan	1567	16.4	86-03	90-12
WB	Mauritania	86	Public Enterprise Loan	2643	20.0	86-03	88-12
IMF	Mauritania		Stand-by Arrangement			86-04	87-04

	Country	Board date of Bank program FY	Loan type	Loan #	Amount ($millions)	Date of effectiveness	Date of closure
IMF	Mauritania		Stand-by Arrangement			86-04	87-04
IMF	Mauritania		Structural Adj. Facility			86-09	89-09
IMF	Mauritania		Stand-by Arrangement			87-05	88-05
WB	Mauritania	87	SAL I	1812	42.4	87-08	88-12
IMF	Mauritania		Enhanced Structural Adj. Facility			89-05	92-05
IMF	Mauritius		Stand-by Arrangement			79-10	81-10
IMF	Mauritius		Stand-by Arrangement			80-09	81-09
WB	Mauritius	81	SAL I	2010	15.0	81-06	82-06
IMF	Mauritius		Stand-by Arrangement			81-12	82-12
IMF	Mauritius		Stand-by Arrangement			83-05	84-08
WB	Mauritius	84	SAL II	2361	40.0	84-03	85-06
IMF	Mauritius		Stand-by Arrangement			85-03	86-08
WB	Mauritius	87	Industrial Sector Loan	2791	25.0	87-10	89-06
IMF	Mexico		Extended Fund Facilitty	83-01	85-12	87-12	87-12
WB	Mexico	83	Export Development Loan	2331	352.0	83-12	89-06
IMF	Mexico		Stand-by Arrangement			86-11	88-04
WB	Mexico	87	Trade Policy Loan	2745	500.0	86-11	90-11
WB	Mexico	88	2nd Trade Policy Loan	2882	500.0	88-01	88-12
WB	Mexico	88	Agricultural Sector Loan	2918	300.0	88-03	90-11
IMF	Mexico		Extended Fund Facilitty			89-05	92-05
WB	Mexico	89	Financial Sector Loan	3085	500.0	89-06	91-06
WB	Mexico	89	Industrial Sector Loan	3087	500.0	89-06	90-06
WB	Mexico	89	Public Enterprises Reform Loan	3086	500.0	89-07	91-06
WB	Mexico	89	Industrial Restructuring Loan	3047	250.0	89-09	94-12
WB	Mexico	88	Fertilizer Sector Loan	2919	265.0	89-11	93-12
IMF	Morocco		Stand-by Arrangement			83-09	85-03
WB	Morocco	84	Trade and Industry Policy Loan	2377	150.4	84-05	85-06
IMF	Morocco		Stand-by Arrangement			85-09	87-02
WB	Morocco	85	Agricultural Sector Loan	2590	100.0	85-10	87-12
WB	Morocco	86	2nd Trade and Industry Loan	2604	200.0	85-10	87-05
WB	Morocco	86	Educational Sector Loan	2664	150.0	86-09	89-12
IMF	Morocco		Stand-by Arrangement			86-12	88-03
WB	Morocco	87	Public Enterprises Reform Loan	2820	240.0	87-12	90-06
WB	Morocco	88	Agricultural Sector Loan	2885	225.0	88-07	90-03
IMF	Morocco		Stand-by Arrangement			88-08	89-12
WB	Morocco	89	SAL I	3001	200.0	88-12	89.12
IMF	Mozambique		Structural Adj. Facility			87-06	90-06
WB	Mozambique	88	Economic Recovery Program	1841	88.6	87-10	90-12
WB	Mozambique	89	Economic Recovery Program	2021	90.0	89-08	91-04
IMF	Nepal		Stand-by Arrangement			85-12	87-04
WB	Nepal	87	SAL I	1769	50.0	87-05	88-12
IMF	Nepal		Structural Adj. Facility			87-10	90-10
WB	Nepal	89	Sal II	2046	60.0	89-08	91-12
IMF	Niger		Stand-by Arrangement			85-12	86-12
WB	Niger	86	SAL I	1660	60.0	86-05	87-12
IMF	Niger		Structural Adj. Facility	86-11	88-12	91-03	91-03
IMF	Niger		Stand-by Arrangement			86-12	87-12
WB	Niger	87	Public Enterprises Reform Loan	1833	80.0	88-01	90-09
IMF	Niger		Enhanced Structural Adj. Facility			88-12	91-12
WB	Nigeria	84	Fertilizer Sector Loan	2345	250.0	83-12	86-12
WB	Nigeria	87	Trade and Investment Sector Loan	2758	452.0	86-11	89-12
IMF	Nigeria		Stand-by Arrangement			87-01	88-01
WB	Nigeria	89	2nd Trade and Investment Loan	3011	500.0	88-12	90-03
IMF	Nigeria		Stand-by Arrangement			89-02	90-04
IMF	Pakistan		Extended Fund Facilitty			80-11	83-11
WB	Pakistan	81	Fertilizer Sector Loan	1066	50.0	80-12	82-09
IMF	Pakistan		Extended Fund Facilitty			81-12	83-11
WB	Pakistan	82	SAL I	2166	140.0	82-09	83-12

Annex table 5.5 (continued) Bank and Fund concurrent operations (through FY89)

	Country	Board date of Bank program FY	Loan type	Loan #	Amount ($millions)	Date of effectiveness	Date of closure
WB	Pakistan	85	Energy Sector Loan	2552	178.0	85-09	88-12
WB	Pakistan	86	Export Development Loan	2701	70.0	86-08	88-12
WB	Pakistan	89	Agricultural Sector Loan	2986	200.0	88-11	90-06
IMF	Pakistan		Stand-by Arrangement			88-12	90-03
IMF	Pakistan		Structural Adj. Facility			88-12	91-12
WB	Pakistan	89	2nd Energy Sector Loan	3107	250.0	89-06 [b]	91-12
WB	Pakistan	89	Financial Sector Loan	3029	150.0	89-07	90-12
IMF	Panama		Stand-by Arrangement			83-06	85-12
WB	Panama	84	SAL I	2357	60.2	83-12	84-12
IMF	Panama		Stand-by Arrangement			85-07	87-03
WB	Panama	87	SAL II	2768	100.0	86-12	87-12 [c]
IMF	Philippines		Stand-by Arrangement			80-02	81-12
WB	Philippines	81	SAL I	1903	200.0	80-11	85-06
IMF	Philippines		Stand-by Arrangement			83-02	84-02
WB	Philippines	83	SAL II	2266	302.3	83-04	84-12
WB	Philippines	85	Agricultural Sector Loan	2469	150.0	84-10	86-12
IMF	Philippines		Stand-by Arrangement			84-12	86-06
IMF	Philippines		Stand-by Arrangement			86-10	88-03
WB	Philippines	87	Economic Recovery Program	2787	300.0	87-06	89-12
WB	Philippines	88	Public Sector Loan	2956	200.0	88-11	91-08
IMF	Philippines		Extended Fund Facilitty			89-05	92-05
WB	Philippines	89	Financial Sector Loan	3049	300.0	89-07	91-12
WB	Sao Tome	87	SAL I	1825	7.0	88-01	90-03
IMF	Sao Tome		Structural Adj. Facility			89-06	92-06
IMF	Senegal		Extended Fund Facilitty			80-08	83-08
WB	Senegal	81	SAL I	1931	60.0	81-03	83-06
IMF	Senegal		Stand-by Arrangement			81-09	82-09
IMF	Senegal		Stand-by Arrangement			82-11	83-11
IMF	Senegal		Stand-by Arrangement			85-01	86-07
WB	Senegal	86	SAL II	1656	64.0	86-02	87-06
IMF	Senegal		Structural Adj. Facility			86-11	88-11
IMF	Senegal		Stand-by Arrangement			86-11	87-11
IMF	Senegal		Stand-by Arrangement			87-10	88-10
IMF	Senegal		Enhanced Structural Adj. Facility			88-11	91-11
WB	Senegal	87	SAL III	1802	85.0	89-05	90-02
IMF	Sierra Leone		Stand-by Arrangement			84-02	85-02
WB	Sierra Leone	84	Agricultural Sector Loan	1501	21.5	84-12	88-06
IMF	Sierra Leone		Structural Adj. Facility			86-11	89-11
IMF	Sierra Leone		Stand-by Arrangement			86-11	87-11
WB	Somalia	86	Agricultural Sector Loan	1711	62.6	86-08	89-12
IMF	Somalia		Structural Adj. Facility			87-06	90-06
IMF	Somalia		Stand-by Arrangement			87-06	89-02
WB	Somalia	89	2nd Agricultural Sector Loan	2030	70.0	89-08	92-01
IMF	Sudan		Extended Fund Facilitty			79-05	82-05
WB	Sudan	80	Agricultural Rehab. Loan	1022	65.0	81-02	89-06
IMF	Sudan		Stand-by Arrangement			82-02	83-02
IMF	Sudan		Stand-by Arrangement			83-02	84-03
WB	Sudan	83	2nd Agricultural Rehab. Loan	1389	50.0	83-12	86-11
IMF	Sudan		Stand-by Arrangement			84-06	85-06
IMF	Tanzania		Stand-by Arrangement			80-09	82-06
WB	Tanzania	81	Export Rehab. Loan	1133	50.0	81-05	83-03
IMF	Tanzania		Stand-by Arrangement			86-08	88-02
IMF	Tanzania		Structural Adj. Facility			87-10	90-10
WB	Tanzania	87	Multisector Rehab. Program	1741	96.2	88-02	89-12
WB	Tanzania	89	Industry Rehab. and Trade Loan	1969	135.0	89-10	90-04
IMF	Thailand		Stand-by Arrangement			81-06	83-03
WB	Thailand	82	SAL I	2097	150.0	82-05	83-03
IMF	Thailand		Stand-by Arrangement			82-11	83-12

	Country	Board date of Bank program FY	Loan type	Loan #	Amount ($millions)	Date of effectiveness	Date of closure
WB	Thailand	83	SAL II	2256	175.0	83-06	84-01
IMF	Thailand		Stand-by Arrangement			85-06	87-03
IMF	Togo		Stand-by Arrangement			83-03	84-04
WB	Togo	83	SAL I	1365	40.0	83-09	85-12
IMF	Togo		Stand-by Arrangement	84-05	85-05	83-12	84-03
IMF	Togo		Stand-by Arrangement			85-05	86-05
WB	Togo	85	SAL II	1599	37.8	85-09	87-12
IMF	Togo		Stand-by Arrangement			86-06	88-04
IMF	Togo		Structural Adj. Facility			88-03	91-03
IMF	Togo		Stand-by Arrangement			88-03	89-04
WB	Togo	88	SAL III	1892	45.0	88-06	90-05
IMF	Togo		Enhanced Structural Adj. Facility			89-05	90-05
IMF	Tunisia		Stand-by Arrangement			86-11	88-05
WB	Tunisia	87	Agricultural Sector Loan	2754	150.0	86-11	89-06
WB	Tunisia	87	Industry and Trade Policy Loan	2781	150.0	87-08	89-12
IMF	Tunisia		Extended Fund Facility			88-07	91-07
WB	Tunisia	88	SAL I	2962	150.0	89-03	90-04
WB	Tunisia	89	2nd Agricultural Sector Loan	3078	84.0	89-09	94-12
IMF	Turkey		Stand-by Arrangement			79-07	80-07
WB	Turkey	80	SAL I	1818	200.0	80-04	81-09
IMF	Turkey		Stand-by Arrangement			80-06	83-06
WB	Turkey	81	SAL I Supplement	1915	75.0	81-01	81-08
WB	Turkey	81	SAL II	1987	300.0	81-07	82-11
WB	Turkey	82	SAL III	2158	304.5	82-07	83-12
IMF	Turkey		Stand-by Arrangement			83-06	84-06
WB	Turkey	83	SAL IV	2321	300.8	83-09	85-03
IMF	Turkey		Stand-by Arrangement			84-04	85-04
WB	Turkey	84	SAL V	2441	376.0	84-07	86-03
WB	Turkey	85	Agricultural Sector Loan	2585	300.0	85-08	89-06
WB	Turkey	86	Financial Sector Loan	2714	300.0	86-06	90-06
WB	Turkey	87	Energy Sector Loan	2856	325.0	87-07	90-09
WB	Turkey	88	2nd Financial Sector Loan	2964	400.0	88-06	90-12
IMF	Uganda		Stand-by Arrangement			82-08	83-08
WB	Uganda	83	AgriculturalSector Loan	1328	70.0	83-07	90-06
IMF	Uganda		Stand-by Arrangement			83-09	84-09
IMF	Uganda		Structural Adj. Facility			87-06	89-04
WB	Uganda	88	Economic Recovery Program	1844	65.0	87-10	90-03
IMF	Uganda		Enhanced Structural Adj. Facility			89-04	92-04
IMF	Uruguay		Stand-by Arrangement			83-04	85-04
WB	Uruguay	84	Agricultural Sector Loan	2468	60.0	84-12	86-09
IMF	Uruguay		Stand-by Arrangement			85-09	87-03
WB	Uruguay	87	SAL I	2836	80.0	87-10	88-12
WB	Uruguay	89	SAL II	3081	140.0	89-08	90-12
IMF	Venezuela		Extended Fund Facility			89-06	92-06
WB	Venezuela	89	Trade Policy Loan	3092	353.0	89-11	91-06
WB	Venezuela	89	SAL I	3091	402.0	89-11	91-06
IMF	Yugoslavia		Stand-by Arrangement			81-01	83-12
WB	Yugoslavia	83	SAL I	2326	275.0	83-08	85-06
IMF	Yugoslavia		Stand-by Arrangement			84-04	85-05
IMF	Yugoslavia		Stand-by Arrangement			84-04	85-04
WB	Yugoslavia	84	Fertilizer Loan	2410	90.0	84-05	88-07 [c]
IMF	Yugoslavia		Stand-by Arrangement			85-05	86-05
IMF	Zaire		Stand-by Arrangement			86-05	88-03
WB	Zaire	86	Industrial Sector Loan	1708	80.0	87-01	88-06
IMF	Zaire		Structural Adj. Facility			87-05	90-05
IMF	Zaire		Stand-by Arrangement			87-05	88-05
WB	Zaire	87	SAL I	1831	149.3	87-09	89-12
IMF	Zaire		Stand-by Arrangement			89-06	90-06

Annex table 5.5 (continued) Bank and Fund concurrent operations (through FY89)

	Country	Board date of Bank program FY	Loan type	Loan #	Amount ($millions)	Date of effectiveness	Date of closure
IMF	Zambia		Extended Fund Facilitty			81-05	84-05
IMF	Zambia		Stand-by Arrangement			83-04	84-04
IMF	Zambia		Stand-by Arrangement			84-07	86-04
WB	Zambia	84	Export Rehab and Diversification	2391	75.0	84-07	88-09
WB	Zambia	85	Agricultural Sector Loan	1545	35.0	85-08	88-06
WB	Zambia	86	Industrial Sector Loan	1630	62.0	85-11	88-12
IMF	Zambia		Stand-by Arrangement			86-02	88-02
IMF	Zambia		Stand-by Arrangement			86-02	88-02
WB	Zambia	86	Economic Recovery Program	1720	50.0	86-12	90-06
IMF	Zimbabwe		Stand-by Arrangement			83-03	84-09
WB	Zimbabwe	83	Export Industry Policy Loan	2239	70.6	83-03	87-07

Source: Adjustment Lending Conditionality and Implementation Database; IMF Annual Reports.
a. Agreement date listed, as loan is not yet effective.
b. Approval date listed, as loan is not yet effective.
c. Loan subsequently cancelled.

Part II

Investment, saving, and growth

One of the key findings of Part I of the report is the sharp declines in investment rates in adjusting countries and the need to reverse these declines in the later phases of adjustment. Part II presents research findings on the determinants of investment, saving, and growth, which must be considered when designing adjustment programs.

Investment in all country groups peaked from 1974 to 1982, and then sharply declined with the rise of world interest rates and the onset of the debt crisis (see figures, opposite). The drop of investment was largest for the highly indebted countries, with a slight recovery in the mid to late 1980s. The average investment share in the other middle-income countries was highest in the 1970s and continued to decline throughout the 1980s, although it is still higher than that of the other groups.

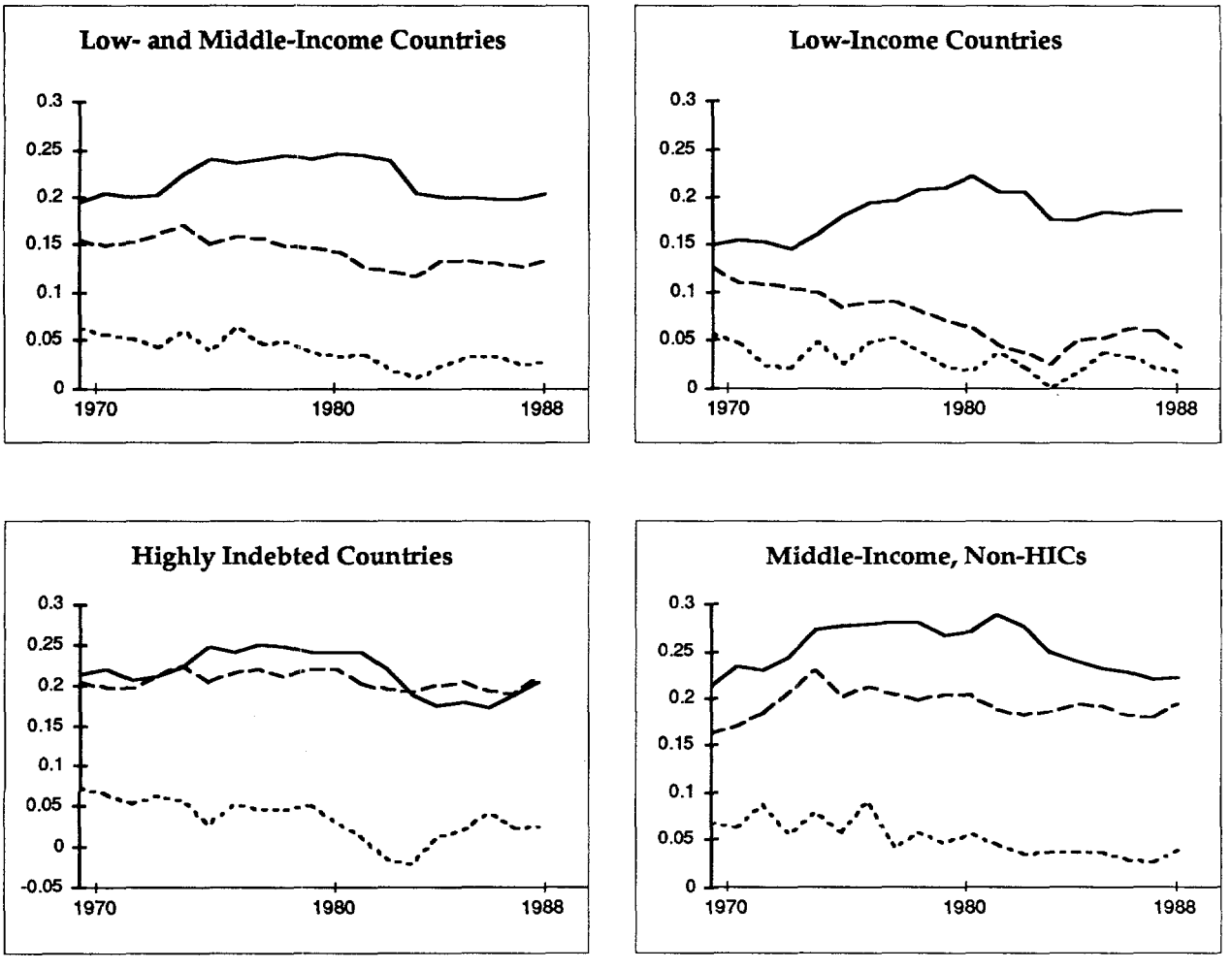
Domestic saving ratios have been falling since 1974. Low-income countries on average have had the largest declines, with some important differences among them. The large low-income countries — India, Nigeria, Indonesia, and especially China — had higher than average saving rates. Saving in most Sub-Saharan countries has declined precipitously. In the highly indebted and other middle-income countries, domestic saving rates have hovered around 20 percent since the early 1970s. Rising interest payments on the foreign debt as a share of GDP have reduced national saving rates — the domestic saving available for capital accumulation.

Growth rates in the 1980s have generally been lower than in the 1970s, with an especially sharp drop in 1982-84, reflecting the low or negative average growth rates of the low-income countries and the highly indebted countries. In both groups, the rebound of growth since 1983 has been larger than the rebound of investment. Among the other middle-income countries, the average growth rate has been steady in the 1980s, although at a lower level than in the 1970s.

The recovery of sustainable growth — the main yardstick for judging the success of structural adjustment programs — requires higher efficiency and more investment. Part of the reason for the falling investment to GDP ratio in the EIAL countries is that private investment often responds slowly to stabilization and a reduction of distortions (Mexico, Bolivia, Chile, and Ghana). The recovery of private investment mainly requires an increase in the demand for investment, but an appropriate level of saving to finance this investment is also necessary. Furthermore, greater efficiency allows a country to obtain more output growth from a given investment to GDP ratio.

Part II starts with a discussion of the determinants of the level of investment, especially by the private sector (chapter 6). It also examines the role of public investment and public policy in generating an investment response, noting that the bulk of the financing for any increased investment will have to come from domestic saving. Accordingly, chapter 7 discusses the determinants of the level of saving. To minimize the sacrifices in current consumption, policy reforms can increase the share of saving going into domestic investment by discouraging capital flight — and increase the rate of growth for a given level of investment. Chapter 8 discusses how policies affect the efficiency of investment and the economy's growth.

Figures II.1-II.4 Investment and domestic saving as shares of GDP and GDP growth (1970-88 unweighted averages)



—— Gross Domestic Investment/GDP ---- Gross Domestic Saving/GDP ..... Real GDP Growth

Note: Investment and saving ratios are calculated with data in local currency and current prices.

6

Policy and investment

Summary

6.1 Adjustment to eliminate unsustainable external imbalances, especially in highly indebted and in Sub-Saharan countries, has typically resulted in substantially lower investment — for three main reasons. First, the higher interest payments on external debt and lower foreign lending were not matched by a corresponding increase in domestic saving. Second, the fiscal situation worsened because of inadequate adjustment to reduced foreign lending, which forced a reduction in public investment. Third, the debt overhang's implicit tax on current and future output — and the resultant credit rationing in international capital markets — increased uncertainty and discouraged investment.

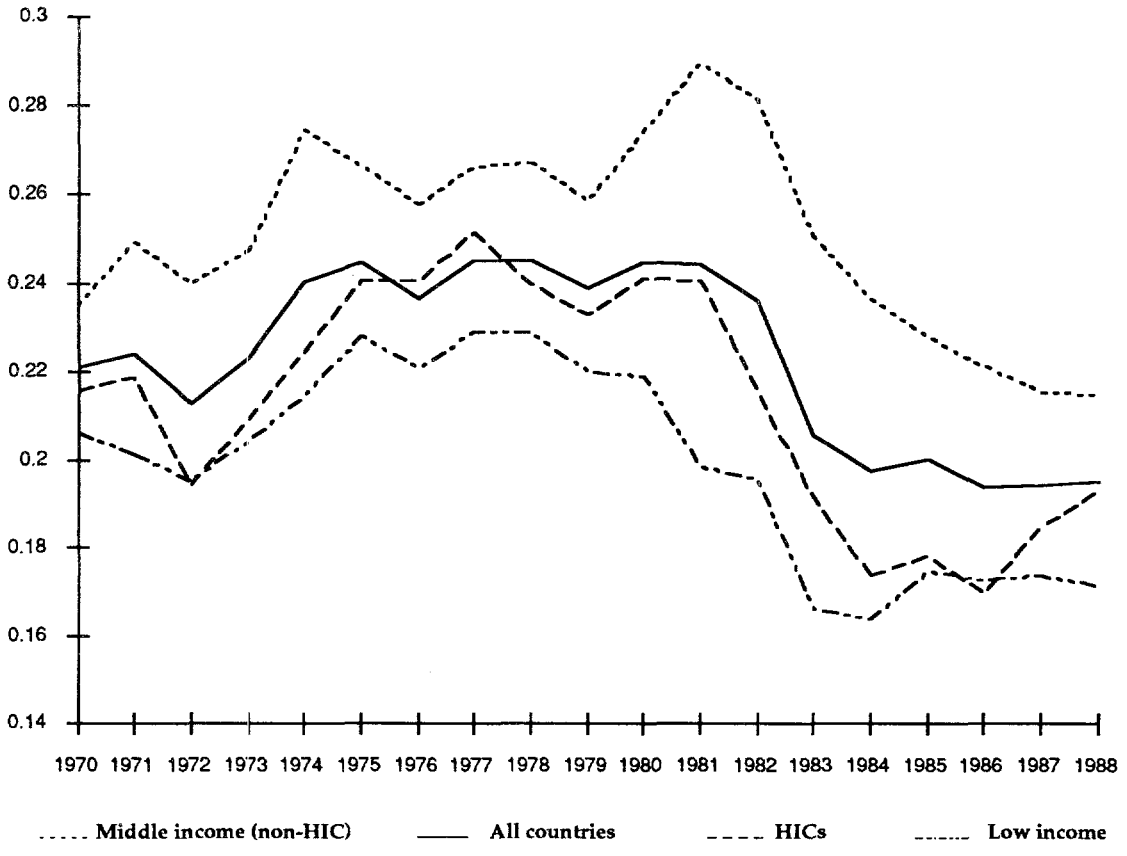
6.2 In the short run, macroeconomic adjustment policies — such as fiscal restraint, monetary tightening, and real depreciation of the exchange rate — dampen private investment through several transmission channels. These include cuts in complementary public investment, a rise in domestic real interest rates, and the increasing cost of imported capital goods as a result of the real devaluation. Once macroeconomic stabilization is achieved, adequate economic incentives are necessary, but not sufficient, for the resumption of investment and growth. The response of private investment to changes in incentives depends crucially on perceptions of uncertainty and economic stability — and on the regulatory environment and the strength of institutions.

6.3 The relationship between investment and short-run demand management (fiscal, monetary, and exchange rate policies) raises two issues. First, the impact of fiscal reform on private investment depends on whether current expenditure or public investment, complementary to private investment, is curtailed. Second, the short-run effect of large exchange rate devaluations on investment may be negative in economies heavily dependent on imported capital goods and in which the public and private sectors hold liabilities in foreign currencies. In the medium and long run, however, a competitive real exchange rate will have a positive effect on the profitability of exporting and import-competing firms — and that should encourage capital accumulation in these sectors and raise overall rates of investment.

Investment in developing countries, 1970-88

6.4 Between 1970 and 1988 the investment rates in developing countries exhibited two distinct patterns, with 1982 as the point of demarcation (figure 6.1).[1] For 78 developing countries the average share of investment in GDP (in constant prices) increased from about 22 percent in 1970 to 25 percent in 1981 — and for most of this period, investment rates were historically high. With the adjustment to the rise in international real interest rates in 1981 and the onset of the debt crisis in 1982, the rate of investment fell sharply. Investment fell earlier — and farther — for the highly indebted countries than for other developing countries (table 6.1). For all groups of developing countries the decline in investment was accom-

Figure 6.1 Share of investment in GDP for developing countries (unweighted averages)



panied by a slowdown in growth (tables 6.1, 6.2).

6.5 The fall in investment has been so severe that some countries may not even have been fully replacing depreciating capital. In Africa the minimum investment needed to replace depreciated capital is estimated at 13 percent of GDP, and seven Sub-Saharan countries had investment rates below that level in 1987. Similarly, the minimum investment rate to replace capital in Latin America is estimated at 14 percent, and three countries were below that level in 1987.

6.6 Investment declined because of the reduced availability of financing and the lower demand for investment. There were important changes in the resource balance deficit — defined as the difference between domestic investment and domestic saving — following the debt crisis in 1982 (table 6.1). The decline in this deficit (because of lower external financing) was not matched by a sufficient increase in domestic saving, so the deficit was almost entirely reflected in reduced investment.

6.7 Investment demand declined for several reasons. Public investment contracted because in some cases it was unsustainably high and of dubious productivity and also due to the deterioration in fiscal conditions (as a result of the cut in foreign lending and the lack of adjustment in other fiscal expenditures), the rise in international and domestic interest rates, and the sharp acceleration of inflation (which erodes real tax receipts). Slower or even negative growth discouraged private investment in several countries, as did the increase in macroeconomic instability associated with adverse external shocks, the uncertainty about the new configuration of relative prices and incentives, and the inability of governments to stabilize the economy. In addition, the debt overhang may have discouraged investment not only through the uncertainty it created but through its implicit "tax" on future output and the resultant credit rationing in international capital markets.

6.8 Analysis of 29 countries shows that the share of private investment in GDP (in current prices) was relatively stable until 1980 and then declined, followed by a modest recovery after 1985 (figures 6.2 and 6.3).[2] The decline was larger

Table 6.1 Investment, saving, and growth in developing countries, 1970-88

Indicator	*Group*	*1970-80*	*1981-82*	*1983-84*	*1985-88*
Gross domestic investment	All	22.4	24.0	20.2	19.6
(percentage of GDP	Highly indebted	22.8	23.0	18.0	18.4
at current prices)	Middle income	25.5	28.6	24.4	21.9
	Low income	19.7	20.3	17.0	17.4
Gross domestic saving	All	16.1	13.7	13.9	14.9
(percentage of GDP	Highly indebted	20.3	20.1	19.8	20.2
at current prices)	Middle income	18.3	17.5	17.7	17.8
	Low income	12.5	7.6	8.0	9.9
Resource balance deficit	All	6.4	10.3	6.2	4.6
(percentage of GDP	Highly indebted	2.5	2.9	-1.7	-1.8
at current prices)	Middle income	7.2	11.1	6.7	4.0
	Low income	7.2	12.7	8.9	7.5
Gross domestic investment	All	23.4	24.1	20.6	19.6
(percentage of GDP	Highly indebted	23.1	22.3	17.1	16.8
at constant prices)	Middle income	25.7	28.6	24.9	22.1
	Low income	21.5	20.7	17.8	18.0
Rate of growth of real GDP	All	4.7	2.7	1.8	3.3
(percentage per year)	Highly indebted	5.0	-0.3	-0.4	2.7
	Middle income	6.1	4.5	3.9	3.2
	Low income	3.5	2.5	0.5	3.5

in the highly indebted countries than in the other countries. Public investment as a share of GDP and of total investment rose until 1980 and then fell after 1982, two years later than private investment (table 6.3). Unlike private investment, public investment rates declined steadily until 1988.

Macroeconomic policies and private investment

6.9 Monetary, fiscal, and exchange rate policies all affect private investment through various transmission mechanisms (table 6.4). Understanding how these mechanisms influence investment decisions is important for understanding how private investment responds to changes in the incentive structure that are part of an adjustment program.

Monetary policy

6.10 The structure of financial markets determines how monetary and credit policies affect private investment. When the macroeconomic situation is unsustainable and the adjustment program relies mostly on monetary restraint rather than on fiscal adjustment, restrictive monetary and credit policies discourage private investment by raising the real cost of bank credit and the opportunity cost of retained earnings — the two most important sources of investment financing in most developing countries. For example, tight monetary policy in the Philippines in 1985-86 caused real interest rates on loans to rise to about 20 percent a year.[3] Higher real costs of credit and higher opportunity costs of retained earnings reduce the market value of existing capital relative to the price of new capital goods, discouraging investment. In repressed financial markets, credit policy affects the level of investment directly — through the stock of credit avail-

Table 6.2 Growth and investment

	Real GDP growth		*Investment ratio*	
Region	*1965-88*	*1980-88*	*1965-88*	*1980-88*
Sub-Saharan Africa	3.3	0.5	17.6	15.9
Asia	6.3	7.4	27.7	31.1
Europe/Middle East/ N. Africa	4.6	2.8	28.4	27.3
Latin America and Caribbean	4.5	1.6	19.7	17.9

Source: Short-term Outlook, Table 15.

Figure 6.2 Public and private investment for 29 countries (unweighted average, percent of GDP)

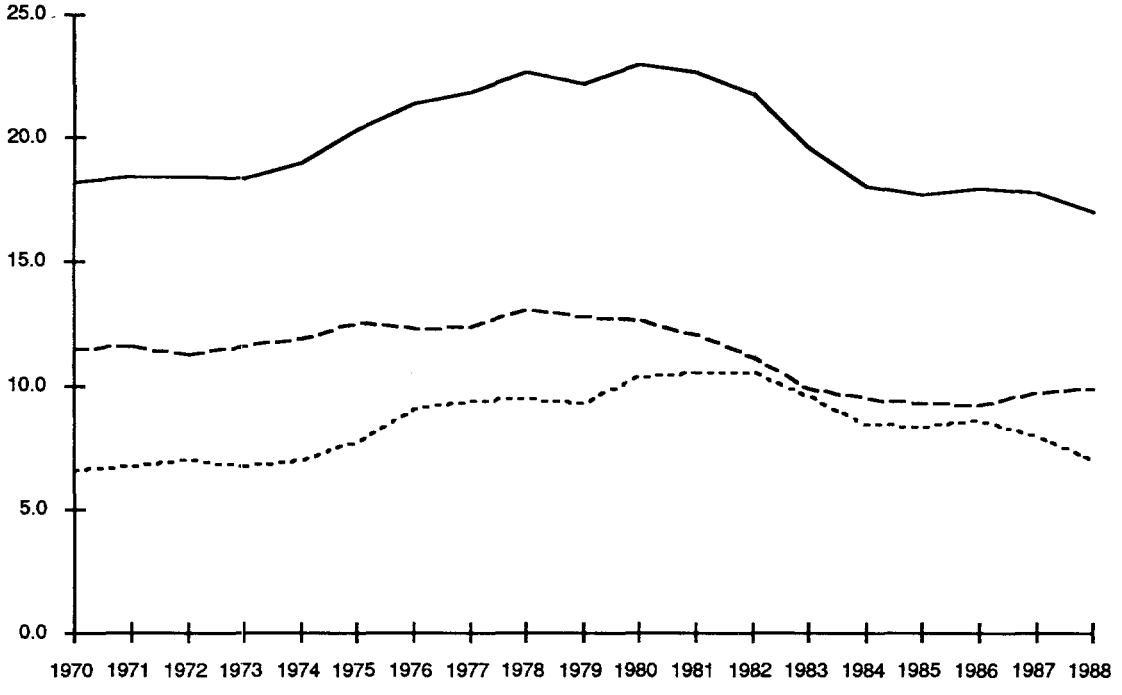
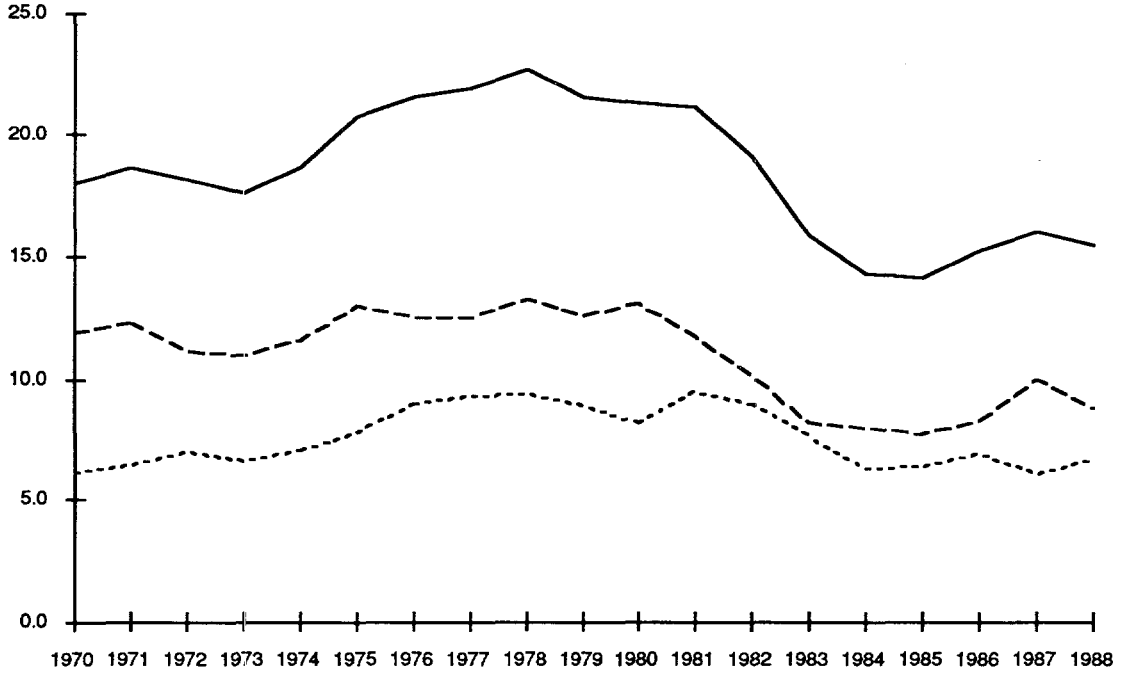


Figure 6.3 Public and private investment for 13 HICs (unweighted average, percent of GDP)



____ Gross domestic investment _ _ _ _ Private domestic investment . . . . . Public domestic investment

able to firms that have access to preferential interest rates and through the interest rates for firms that use the unofficial money market.[4] In Yugoslavia, for example, the inflation-adjusted flow of credit to enterprises from the formal financial system was negative between 1982 and 1986.[5]

6.11 Tight monetary policy often slows economic activity, and the pessimistic expectations of investors during a recession can lead them to postpone investment until there is a recovery. An economy can then get stuck in a low-growth, low-investment equilibrium. To avoid such an outcome, it is important to minimize the output losses during the adjustment — by stimulating net exports through a real depreciation and such institutional changes as export insurance and financing, and by maintaining public investment in transportation and communication infrastructure.

Table 6.3 Public and private investment for a group of 29 developing countries, 1970-88 (percentage of GDP at current prices)

Group	*1970-80*	*1981-82*	*1983-84*	*1985-88*
29 countries				
Total	20.3	22.2	18.8	17.6
Private	12.2	11.7	9.7	9.6
Public	8.2	10.5	9.0	8.0
13 highly indebted countries				
Total	20.1	20.2	15.1	15.2
Private	12.3	10.9	8.1	8.7
Public	7.8	9.2	7.0	6.5

Sample: Argentina*, Bangladesh, Bolivia*, Brazil*, Chile*, Colombia*, Costa Rica*, Ecuador*, Guatemala, Hungary, India, Indonesia, Kenya, Korea, Malaysia, Mexico*, Nigeria*, Pakistan, Peru*, Philippines*, Portugal, Sri Lanka, Thailand, Tunisia, Turkey, Uruguay*, Venezuela*, Zambia, Zimbabwe.
* Highly indebted countries.

Fiscal policy

6.12 The overall effect of a reduction in the budget deficit on private investment depends on the mix of measures — raising taxes, cutting current expenses, or cutting investment. A cut in public investment's impact on private investment depends on whether the cut projects complement or substitute for private investment. If they substitute, a cut in public investment could stimulate private investment. But fiscal adjustment frequently reduces the public investment in infrastructure that complements private investment (roads, ports, telecommunications). Most countries hit by the debt crisis in the 1980s — such as Argentina, Brazil, Mexico, Morocco, and the Philippines — reduced their public investment sharply. And in Africa, low spending on maintenance caused public infrastructure to deteriorate. As a result, private investment declined.[6]

6.13 Tax incentives for investment, while

Table 6.4 Adjustment policies and private investment transmission mechanisms

Policy	*Real interest rate*	*Profitability of capital*	*Price of new capital goods*	*Demand levels*	*Real credit availability*	*Total*	
						Short-run	*Long-run*
Effects of increase in transmission variable on investment	-	+	-	+	+		
Monetary contraction	-	-	+	-	-	-	?
Fiscal adjustment							
Gov't consumption	+	0	0	-	+	-	+
Gov't investment reduction	+	-	+/-	-	+	?	-
Tax increase	+	-	0	-	+	-	?
Devaluation							
Short-run	+/- [a]	+/- [b]	-	-	-	-	
Long-run	0	?	-	+	?		+
Expanded foreign borrowing[c]	+	?	?	+	+	+	+

Note: Signs in the table indicate the direction of the effects of the policy change (row) on investment operating through the specified channel (column).
a. Depends on whether devaluation was anticipated.
b. Depends on relative share of tradables and home goods.
c. Assuming the borrowing is used for productive purposes.

sometimes effective, can have substantial fiscal and distortionary consequences. For example, Argentina offers investment subsidies equal to 2.6 percent of GDP, while private investment is only 6.8 percent of GDP and the primary budget deficit is 3.2 percent of GDP.[7] And in Côte d'Ivoire, Morocco, and Thailand, the partial or total exemptions from corporate taxation seriously reduce government revenue. Investment tax credits and accelerated depreciation allowances are preferable because they can have the same impact on investment but at a lower cost in foregone revenue. In countries with a stable macroeconomic environment but little or no recovery of investment, temporary incentive measures can help revive private investment. Such incentives should be announced and introduced at the same time, and there should be a clear timetable for phasing them out — for they can never substitute for consistent economic policies and economic stability, the basic conditions for investment.

Exchange rate policy

6.14 To reduce the current account deficit, adjustment programs use a combination of expenditure-reducing and expenditure-switching policies. The switching policies usually include a real devaluation, which generally has a negative effect on investment in the short run but a positive effect in the medium and long runs (box 6.1). The real devaluation tends to dampen investment early on by raising the price of capital goods imports and intermediate inputs in terms of domestic goods, increasing the burden of foreign debt. If the higher debt burden and scarcer credit lead to widespread bankruptcies, the recessionary effect of the devaluation will last longer. Devaluation may also constrain investment in the short run through its effect on aggregate demand.[8]

6.15 But by stimulating the production of tradables, the devaluation's effect is eventually the opposite. The time lag depends on such factors as the relative size and cost structure of the traded goods sector, the excess capacity in the economy, and the credibility of the exchange rate policy. Korea devalued in 1980 when it had little slack capacity, and the resultant export boom led quickly to higher demand for investment. Indonesia also experienced a rapid recovery following real devaluation. Elsewhere, as in Turkey in 1980 and Chile after 1982, the process took longer.

Box 6.1 Exchange rate policy and private investment in Chile

From February 1978 to the middle of 1982, Chile used its exchange rate policy to reduce inflation — and thereafter, with fiscal and monetary policies, to preserve internal and external balance and ensure external competitiveness.

Box figure 1 shows the path of the real exchange rate from 1977 to 1987 and the counterfactual path of a steady real depreciation of 1 percent per quarter. Box figure 2 compares a base case simulation of investment using the actual values of the real exchange rate and one using a counterfactual path. Clearly, the private investment associated with the stable real exchange rate is higher than that associated with the actual one. (In the model, investment depends — through profitability — on the level and variance of the real exchange rate.)

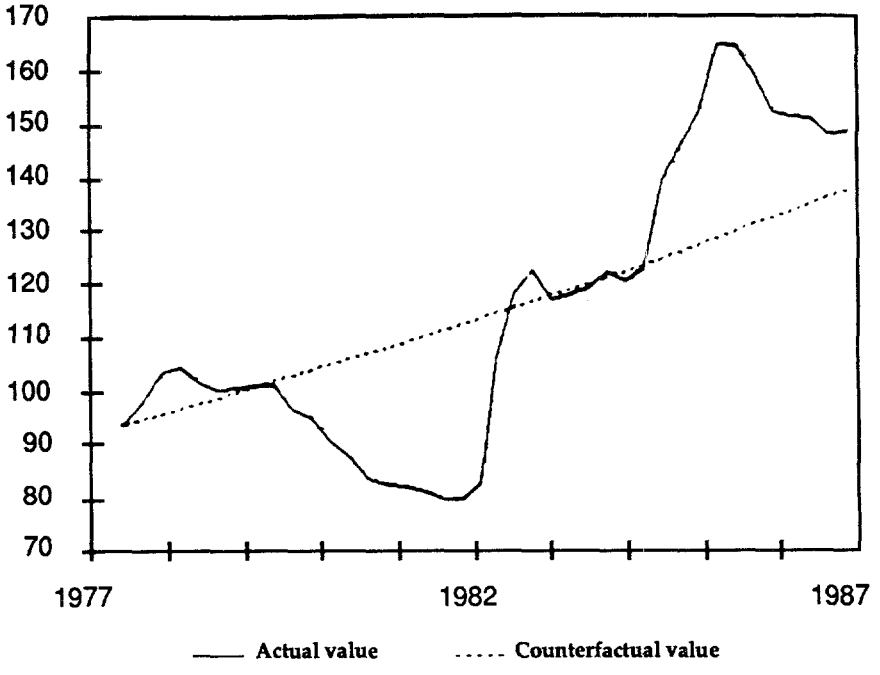
What conclusions can be drawn? One, if the exchange rate policy had supported greater real exchange rate stability during the period, investment would have been higher. But using the exchange rate to reduce inflation contributed significantly to the large external imbalances of 1981-82, imbalances whose correction entailed large cuts in investment.

Two, a reassessment of the fixed exchange rate period of 1979-82 suggests that the overvaluation stimulated investment. A reduction in the price of capital goods, a high level of demand, an increase in the availability of credit, and the speculative hoarding of foreign capital goods were the driving forces behind this result.

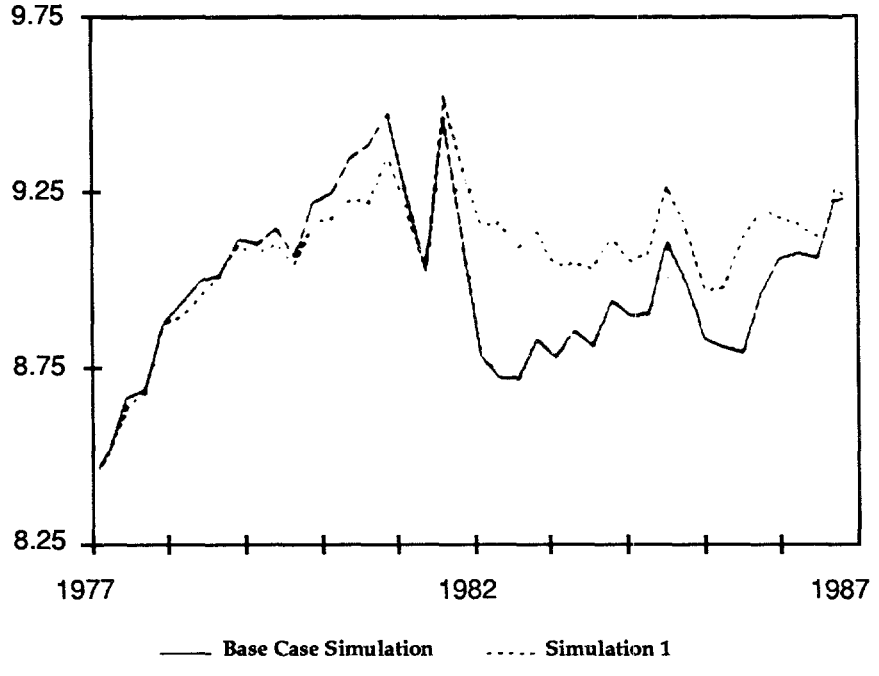
But overvaluation is not a good way to promote investment. Currency overvaluation is unsustainable since it involves a disequilibrium path for the real exchange rate that sooner or later will have to be reversed, and that reversal is likely to entail a sharp cut in investment. Moreover, a real overvaluation (if understood as a transitory phenomenon) may encourage the wrong composition of investment — directing it toward home-good activities and diverting it from the traded goods sector, which has higher social rates of return in the long run.

Three, the answer is mixed concerning whether promoting exports through a high real exchange rate crowds out private investment. Since 1982 the government has actively used exchange rate policy, together with fiscal and monetary policies, to keep the real exchange rate undervalued — and thus to correct the large current account imbalances and promote exports. Simulation 1 shows that this policy tended to depress investment, at least initially. In the short run, the devaluation-induced increase in the price of new capital goods dominates the positive effect of a high real exchange rate on the profitability of exporting and import-competing firms. But in the medium run, the positive effect of a high real exchange rate on the profitability of traded goods firms starts to dominate the effect on the price of capital goods, and overall investment is likely to pick up.

Box figure 1 Real exchange rate



Box figure 2 Private investment



The two figures are taken from A. Solimano, "How Private Investment Reacts to Changing Macroeconomic Conditions: The Case of Chile in the Eighties," World Bank PPR Working Paper No. 212, 1989. In box figure 1, an increase in the real exchange rate index represents a real depreciation.

To be an effective adjustment tool, the devaluation must be supported by other macroeconomic policies, especially the reduction of excessive fiscal deficits. Sierra Leone floated its currency in 1986 when its fiscal deficit was 14 percent of GDP. The result: an acceleration of inflation from 57 percent to 259 percent, and the collapse of the adjustment effort.[9]

Trade liberalization

6.16 Trade liberalization, another typical component of adjustment, may reduce the capital intensity of production.[10] But liberalization perceived as temporary tends to distort the timing of investment, as happened during the period of freer trade in Chile, Uruguay, and Argentina in the late 1970s, in Sri Lanka in 1982, and in Israel in 1983. Trade liberalization perceived as permanent is likely to reduce investment in the import-competing sectors that previously were highly protected. The strength of the link to investment demand in the exportable sectors depends on the effect of the cut in trade taxes on the rates of return in the export sector, the rate of capacity use in that sector, and the perceived sustainability of the exchange rate policy.

Direct foreign investment

6.17 Direct foreign investment can be an important complement to the adjustment effort, especially in countries having difficulty increasing domestic saving. In addition to increasing the inflow of foreign resources, such investment facilitates the inflow of technological and management skills, raises employment and labor productivity, and increases export market penetration — if other supporting policies and institutions are in place. The garment industries in Madagascar and Mauritius were established through investments first by transnational firms, and then by local entrepreneurs.[11]

6.18 Stable economic policies — including those for the remittance of profits — and appropriate domestic economic management are the main incentives for foreign investment. Although it is necessary to reduce the barriers to foreign direct investment, small isolated changes in the policies for foreign direct investment are not likely to attract additional investment. Such attempts can even increase uncertainty and deter investors. And massive changes in these policies can make foreign direct investment counterproductive.

Building investor confidence

6.19 Structural adjustment programs change the economy's incentives to increase efficiency and encourage growth. The adjustment measures should increase investment, particularly in the tradable goods sector, thereby providing the connection between adjustment, growth, and external balance that will ensure the sustainability of the adjustment effort. In practice, however, the investment response is often unexpectedly weak and delayed — a problem that increases the cost of adjustment for employment and growth. And a weak investment response can render the adjustment effort socially unacceptable and thus unsustainable.

6.20 The stability and predictability of the incentive structure and of macroeconomic policy may be more important for investment than are tax incentives or interest rates. Under conditions of great economic and political uncertainty, making tax and related incentives high enough to have any significant impact on investment is usually prohibitively expensive.[12] In Argentina, Honduras, Morocco, and even Turkey, investment incentives have substantially enlarged government deficits without appreciably increasing investment. Investment responds slowly because investors are reluctant to make fixed investments when they are uncertain about the future economic environment, particularly the incentive structure. Uncertainty discourages investment decisions because most investment expenditures are irreversible: capital, once installed, can seldom be put to productive use in a different activity, at least not without incurring a substantial cost. Thus a trade reform that is suspected to be only temporary can reduce investment — as economic agents postpone their investment decisions while waiting to see whether the reform lasts.

6.21 An adjustment package may itself increase uncertainty in the short run, as private agents receive mixed incentive signals — some associated with the previous policy rules, some with the stabilization package, and some with the structural reforms aimed at restoring medium-term growth. The possibility of a future policy reversal discourages the investment response to any adjustment program that is not fully credible.

6.22 The relevance of credibility and uncertainty for the effectiveness of macroeconomic policy is difficult to overemphasize. The credibility of policy reforms has two aspects: the internal consistency of the adjustment program, and the

government's commitment to carry it out despite possible short-run costs. When credibility is low, a structural adjustment program may entail larger-than-anticipated social and economic costs, since the investment response will be insufficient to restore growth. A persistent slump may develop before investors become confident that the adjustment measures will be maintained. Resolving the problem of a low investment response may be particularly critical for economies with a history of frequent policy swings or failed stabilization attempts. As the recent experiences of Bolivia and Mexico show, establishing the right economic incentives is a precondition for investment and growth, but it cannot guarantee them.[13]

6.23 The assessment of credibility and uncertainty should influence the choice between gradual and abrupt adjustment. Gradual adjustment involves initially modest objectives that can be achieved with near certainty — and so build the government's reputation. Abrupt adjustment starts with an overadjustment — say, an overdepreciation of the exchange rate because of large cuts in tariffs — aimed at frontloading the incentives for resource reallocation. But this approach also concentrates the costs of the adjustment.[14] The choice appears to depend largely on the specifics of each country, with the social distribution of the adjustment costs and policy experience likely to be important factors.

6.24 Since current private decisions affect the "feasibility" of future policy actions and ultimately determine the sustainability of the adjustment policy, the key question is what policies will lead the economy to resume investment and growth.[15] Sufficient external support for the adjustment effort of a committed government can raise the confidence of investors in the sustainability of the adjustment and can thus enhance the takeoff of investment. Implementation of well-targeted public investment projects that attract private investment may be another important element in getting growth under way (box 6.2).

6.25 Even when the change in incentives is perceived as permanent, a lack of infrastructure or an inadequate institutional framework may also pose significant obstacles for the response of private investment, especially in low-income countries. The implementation of well-targeted public investment projects in infrastructure can then get growth under way by attracting private investment. Institutional reforms and the correction of microeconomic distortions to facilitate the private sector's access to factor and financial markets, improve its entrepreneurial capabilities, and make the legal and regulatory framework more conducive for business can also play an important role in the recovery of investment.[16]

Implications for adjustment programs

6.26 A predictable macroeconomic environment, stable incentives, and adequate external support are the key components of adjustment programs aimed at a high investment response and sustained growth. If adjustment is to lead to a resumption of investment and growth, investors need to believe that incentives will remain in place. The government can play an important role in this process by following stable and consistent macroeconomic policies, maintaining an appropriate incentive structure, and providing

Box 6.2 Private investment in Morocco

During the 1980s, Morocco underwent a major external adjustment that allowed it to reduce the current account deficit from 12.3 percent of GDP in 1981-82 to zero in 1988. The domestic counterparts of this effort were a major increase in saving and a significant decline in investment. Gross national saving rose from 14.9 percent of GDP in 1981-82 to 22.6 in 1987-88, while gross fixed capital formation fell from 26.6 percent of GDP to 20.2 percent in the same period. Such a large reduction in investment may well have negative implications for future growth.

Which policies would lead to a higher rate of investment and to higher long-run growth? Private investment in Morocco is influenced by aggregate demand, capacity use, the volume of bank credit, terms of trade shocks, the availability of public infrastructure, and economic uncertainty (proxied by the foreign debt to GDP ratio). The changes in these variables that would be required to raise private investment by 1 percentage point of GDP are as follows:

- An increase in capacity use (measured as the ratio of current to trend GDP) of 4.8 percentage points.
- Or, an increase in the volume of bank credit to GDP ratio of 1.4 percentage points.
- Or, an increase in the ratio of the terms of trade gain to GDP of 2 percentage points.
- Or, an increase in the ratio of public infrastructure to GDP of 8.3 percentage points.
- Or, a decline in the ratio of foreign debt to GDP of 5.3 percentage points.

Taken from K. Schmidt-Hebbel and T. Mueller, "Private Investment and Private Savings in Morocco," World Bank, 1989.

the infrastructure and the institutional environment necessary for private investment to take off.

6.27 What does this mean for adjustment programs? The findings of this chapter verify the need for an adequate macroeconomic framework to increase the contribution of adjustment lending to resumed investment and growth. This conclusion reinforces the finding in chapter 4 that macroeconomic instability is associated with poorer program implementation and also with reversals of reforms. The findings here also support the importance of rationalizing public expenditure — redirecting it toward investment in projects that complement and encourage private investment and toward investment in human capital. As chapter 4 showed, it is in fiscal rationalization — and social reform, directly related to human capital formation — that the implementation of loan conditions is the poorest.

6.28 For countries that have made satisfactory progress with the macroeconomic adjustment and the removal of large distortions, the adjustment strategy should concentrate on measures to restore sustainable medium-term growth by reversing the decline in investment ratios. Their transition from adjustment to growth could be supported by SECALs focused on measures to address the major obstacles to the recovery of private investment — ill-defined property rights, excessive regulation and licensing, and the lack of factor mobility and infrastructure. They would also monitor the availability of adequate financing for investment and promote a careful analysis of public expenditure and its reallocation toward investments in human capital and other areas that complement private investment. The key here is progress. For countries still experiencing macroeconomic instability and large distortions, this type of SECAL would at best be ineffective and would at worst promote inefficient investments.

7

Policy and saving

Summary

7.1 Saving rates have fallen substantially since 1975 in most developing countries. But they are beginning to recover in adjustment lending countries, and further improvements are possible.

7.2 The most important way for government policies to raise national and domestic saving is to reduce the public deficit, usually through the reform of state-owned enterprises, local government finances, and the central government budget. Deficit reduction, in addition to having a direct impact on public saving, contributes to lower inflation, more stable economic policies, and higher private investment. It also has positive effects on private saving.

7.3 Increasing the private saving rate usually takes longer and depends mainly on increasing the growth rate, and adjustment lending will make a major and lasting contribution to raising private saving mainly as the policy reforms it supports succeed in generating economic recovery. Private saving is sensitive to the business cycle: a recession leads to a drop in the private saving rate as consumers attempt to maintain their pre-crisis consumption levels; a recovery does the reverse. By contrast, private saving usually is not very sensitive to changes in interest rate and tax policy. Raising the real rate of interest or the real return on assets often induces shifts in portfolio composition but has ambiguous effects on aggregate private saving. (An exception is raising highly negative rates of real interest to around zero, which usually improves saving rates.) Similarly, few revenue-neutral changes in tax policies have demonstrated large positive effects on private saving.

Public saving

7.4 To sustain investment for a desirable rate of growth, the adjusting countries have to increase their saving rates. The greatest need for change is in the highly indebted countries, mostly in Latin America and in Sub-Saharan Africa, where saving rates fell significantly in the 1980s (table 7.1).

7.5 Public policies can affect public saving directly, but there are limits to their effect on private saving. Public saving and the way it is financed affect the economic environment — GDP growth and inflation — and this environment affects private saving decisions. So, public and private saving, although analyzed separately here, are closely linked.

7.6 To measure public saving properly requires a comprehensive definition of the public sector that encompasses central and local governments, financial and nonfinancial public enterprises, and quasi-fiscal operations of the central bank. In many countries, the losses of public enterprises contribute to high public deficits. In Bolivia public enterprise deficits reached 5 percent of GDP before the 1987 stabilization. In Argentina they have fluctuated between 2 percent and 7 percent since the early 1980s. And in Zimbabwe they were reduced from 9 percent of GDP in 1982 to 4 percent in 1988. In some coun-

Table 7.1 Gross domestic and national saving ratios in 83 developing countries

Indicator/region	*1970-80*	*1981-84*	*1985-88*[a]
Gross domestic saving/GDP			
Total	0.15	0.12	0.13
Africa	0.11	0.06	0.08
Asia	0.19	0.19	0.21
Europe/Middle East/ North Africa	0.15	0.16	0.15
Latin America and Caribbean	0.20	0.17	0.17
Gross national saving/GNP			
Total	0.14	0.10	0.10
Africa	0.11	0.06	0.06
Asia	0.18	0.18	0.19
Europe/Middle East/ North Africa	0.15	0.14	0.12
Latin America and Caribbean	0.17	0.12	0.11

Source: ANDREX database, World Bank.
Note: Data were not available for Guinea, Hungary, Mozambique, Poland, and Yemen PDR.
a. In a few cases, 1988 data were unavailable; for them, the 1987 saving ratios were assumed.

tries, central bank losses have been even more important than the deficit of the general government or the public enterprises. The losses often result from quasi-fiscal operations, such as emergency loans at subsidized rates to failing domestic financial systems, and from foreign exchange subsidies to domestic holders of foreign debt. In Argentina central bank losses have fluctuated between 2 percent and 6 percent of GDP since 1982, in Chile they were 7 percent of GDP in 1985, and in Venezuela they reached 6 percent of GDP in 1987.[1]

7.7 Changes in the public sector deficit and in public saving result not only from the direct effects of tax and expenditure policies but also from the interaction of fiscal policy with other policies and with foreign economic shocks.[2] For example, an exchange rate depreciation affects all budget items that are fixed in foreign currency or indexed to world prices. A real depreciation increases the budget deficit (relative to GDP) when the public sector has more expenses than revenues denominated in foreign currencies — as in countries where the foreign debt service is a large part of public spending (Brazil, Philippines, and Turkey). In countries where the public sector obtains much revenue from import taxes or commodity exports — oil in Mexico, phosphates in Morocco, and copper in Zambia — a real depreciation tends to decrease the budget deficit.

7.8 A decomposition of Venezuela's public deficits shows that the most important determinants of the strong fluctuations in the 1980s were changes in oil prices and export volumes, domestic inflation and real interest rates, and public investment expenditure (box 7.1). A comparative study of nine Latin American economies found that the persistence of high public deficits results predominantly from expenditure and revenue policies under the direct control of the government.[3] Adverse foreign shocks have played only a secondary role, with their influence concentrated mostly during the early 1980s. Taxes can be particularly effective for mobilizing public and national saving (box 7.2).

7.9 Policymakers control the deficit over the medium term, but it is often neither economically rational nor politically feasible to adjust public spending or revenues immediately to sterilize the impact of a domestic or foreign macroeconomic shock on the deficit. Generally, governments facing domestic or foreign shocks of unknown duration should first treat them as transitory, making only small adjustments in spending or revenue collection. If the shock persists, they should undertake a more significant adjustment. The Asian newly industrialized economies generally reacted this way to the oil shocks.

7.10 Fiscal policies often respond asymmetrically to favorable and unfavorable shocks: the decline in the deficit in response to a favorable macroeconomic shock is usually smaller than the rise in the deficit in response to a negative shock. For example, Venezuela did not accommodate its commodity price shocks symmetrically (box 7.1). Net public spending rose more during the favorable oil price shock in 1979-80 than it fell after the oil price decline in 1986. Commodity-revenue stabilization funds — such as Chile's copper price fund and Venezuela's oil revenue fund — can help avoid excessive or asymmetrical reactions of public spending to commodity-related foreign shocks while also contributing to a higher average public saving rate. Such funds can lead to a more stable real exchange rate and more efficient domestic resource allocation.

7.11 Public deficits are financed by borrowing at home or abroad — or by printing money. Foreign financing tends to cause a real exchange rate appreciation, which is transitory if foreign creditors are not willing to hold increasing amounts of foreign debt, as after 1982 for most developing countries. Increasing reliance on domestic debt

Box 7.1 Public sector deficits in Venezuela

A decomposition of nominal nonfinancial public sector deficits in Venezuela for 1979-86 illustrates the relative influence of macroeconomic shocks and fiscal policy decisions on public deficits (box table 7.1). (Only the partial-equilibrium, first-round effects are considered.*) Of all domestic macroeconomic variables, changes in inflation contributed the most to changes in the deficit. Higher inflation reduced tax revenues and increased the interest payments on domestic debt. In 1984 accelerating inflation pushed the nominal deficit upward by 5.5 percent of GDP. That same year, a massive depreciation in the real exchange rate raised the public sector's net foreign exchange earnings (oil revenue minus foreign interest payments), reducing the deficit by 7.2 percent of GDP.

Higher GDP and lower inflation raised the real value of nonoil tax revenue in Venezuela. Among the remaining domestic macroeconomic variables, fluctuations in the domestic real interest rate had a much larger effect on the public deficit than did changes in total output. Among policy variables, a major determinant of public sector deficits was expenditure on public investment programs.

For Venezuela, with its strong dependence on oil exports, the violent oil price shocks of 1979-80 (positive) and 1986 (negative) were the most significant determinants of changes in the deficit. The favorable and unfavorable shocks did not have symmetrical effects, however. Only half the 1979-80 increase in revenue attributable to the oil price hike was reflected in the decrease in the deficit, but more than 80 percent of the 1986 decline in revenue resulting from the lower oil prices was reflected in that year's increase in the deficit. The volume of oil exports varied significantly and tended to offset the price shocks, particularly in 1980 and 1986. The remaining two international variables — foreign interest rates and foreign debt — played only minor roles compared with the terms of trade shocks.

Thus, among eleven domestic, foreign, and policy variables that explain most of the fluctuations in Venezuela's public sector deficits, the most important determinants were the changes in oil prices and oil export volumes, domestic inflation, real interest rates, and public investment.

* The impact of each variable on the deficit is computed by multiplying the percentage change in the domestic, foreign, or policy variable times the corresponding budgetary variable expressed as a percentage of GDP. For instance, an increase of 10 percent in the price of oil contributes to a 2.5 percent decline in the share of the public deficit in GDP if foreign oil revenues to the public sector constitute 25 percent of GDP. The methodology is based on J. Marshall and K. Schmidt-Hebbel, "Economic and Policy Determinants of Public Sector Deficits," PPR Working Paper 321 (Washington, D.C.: World Bank, 1989).

Box table 7.1 Decomposition of public sector deficits for Venezuela, 1979-86: change in public sector deficit explained by changes in variables (percentage points of GDP)

Variable	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*
Changes in domestic macro variables								
Real output change								
Effect on tax revenue	-0.19	0.26	0.04	-0.08	0.74	0.18	-0.04	-0.69
"Denominator effect"[a]	-0.02	-0.13	-0.02	0.03	0.15	0.03	0.02	0.20
Real interest rate change	-1.64	-0.07	1.61	1.92	-2.59	-2.44	3.73	-0.38
Inflation change	2.94	0.77	-2.33	-2.42	1.04	5.50	-5.60	-1.23
Real exchange rate change	1.73	2.43	0.54	0.09	-0.51	-7.19	-0.86	-1.21
Changes in foreign variables								
Foreign interest rate change	0.11	0.39	-0.16	0.42	-0.03	-0.69	-0.87	0.90
Stock of foreign debt change	0.36	0.36	0.03	0.11	-0.03	0.22	0.83	-0.25
Real oil price (deflated) change	-4.71	-12.68	-1.58	0.33	4.37	1.56	1.38	12.29
Changes in domestic policy variables								
Public sector wage bill change	-0.84	0.51	0.42	-0.19	-0.66	-1.81	0.59	0.66
Public sector investment change	-2.97	-1.17	1.21	2.40	-4.17	-5.14	0.38	5.08
Stock of real domestic debt change	0.10	-0.22	0.37	0.49	0.93	0.10	0.16	-0.21
Oil export quantum change	-4.37	7.63	3.30	5.17	-0.33	1.20	2.98	-6.00
Total change in public sector deficit								
Explained	-9.50	-1.93	3.42	8.27	-1.08	-8.38	2.69	9.17
Actual[b]	-6.78	-1.48	1.88	9.97	-5.69	-9.36	1.13	10.09
Memo:								
Public sector deficit as % of GDP	-0.56	-2.04	-0.15	9.81	4.12	-5.24	-4.11	5.96

Source: World Bank data.
Note: All shares are defined as nominal variables over nominal GDP.
a. An output increase has a positive effect on tax revenue, and therefore a negative sign in this row; the "denominator effect" of an output increase stems from having all variables defined on shares of GDP.
b. The actual change in the deficit is equal to the difference between the current and preceding year levels (see last line of the table).

to finance deficits raises domestic real interest rates and worsens the deficit, perhaps to the point of making borrowing impossible and even inducing a repudiation of public debt. It also increases domestic inflation, sometimes to the point where the revenue from the inflation tax falls and hyperinflation starts.

7.12 Most countries with high public deficits have high inflation rates, high domestic real interest rates, and strongly fluctuating relative prices, wages, and exchange rates. For example, Argentina's average total public deficit of 13 percent of GDP since 1983 has been the main cause of its average annual inflation rate of 329 percent and average annual real interest rate of 17 percent during 1983-88. Countries that started the 1980s with low domestic debt — such as India, Pakistan, and Zimbabwe — have managed to maintain low or moderate inflation and real interest rates while their consolidated public sector deficits (financed mostly by issuing domestic debt) have exceeded 7 percent of GDP almost every year since 1981. The rapid increase of their domestic debt-to-GDP ratios cannot continue indefinitely, however.[4] Countries such as Bolivia since 1987, Chile since 1986, Mexico since 1985, and Morocco since 1983 have carried out major fiscal adjustments that have significantly reduced their public deficits, making their debt-to-GDP ratios sustainable and their macroeconomic environments more stable.

7.13 Raising public saving is the most direct and powerful way the public sector can contribute to higher national saving. The combination of current expenditure cuts and tax increases that is most likely to raise saving depends on each country's initial situation — particularly the overall tax burden, the effi-

Box 7.2 Macroeconomic adjustment and saving in Korea and the Philippines

Successful adjustment leads to growth, which is the most important single factor affecting the saving rate. Increased taxation increases total saving during the transition as long as there is no matching increase in expenditure. By contrast, increasing domestic real interest rates may reduce total saving, because the benefits from any small increase in household saving may be overshadowed by a decline in corporate and government saving. Korea and the Philippines illustrate these patterns.*

Korea has succeeded remarkably in raising its national saving rate in the last quarter century: from less than 10 percent of GNP in 1965 to almost 33 percent in 1986. The increase was not always smooth, however. The saving rate reached 28 percent as early as 1977 but then slipped to 22 percent during the 1980-82 slowdown, before rising sharply again.

The Philippines had greater fluctuations in the saving rate than did Korea. Its national saving rates reached 21 percent during 1963-66 and dropped to 17-19 percent during 1967-72. Although the rate rose to 24 percent during 1976-81, it declined again to 16 percent by 1984-85.

The slowdowns of growth were the major factors behind the sharp drops in the national saving rate in Korea during 1980-82 and in the Philippines during 1984-85. Simulations show that a sustained higher growth rate of one percentage point of real GNP leads, two years later, to an increase in the saving rate of about 1.1 percentage points for Korea and 0.6 percentage points for the Philippines.

Interest rate policy is significant for mobilizing saving in Korea. But in the Philippines national saving tends to be slightly reduced by higher domestic real interest rates, because the positive effect of the real interest rate on household saving is more than offset by its negative effect on corporate and government saving. A one-percentage-point increase in the real interest rate results in a slight (0.03 percentage points) drop in the national saving rate within three years.

Tax policy can mobilize saving, too, but the effect seems to vary by country. In Korea a tax increase, particularly in the corporate income tax, results in lower national saving in the short run, with lower private saving outweighing increased public saving. Over the medium term, however, the initial negative impact of personal direct taxes or indirect taxes on household saving gradually dies out, while its positive impact on government saving remains relatively high, the result being a substantial positive contribution to aggregate saving. In the Philippines, a tax increase in either the corporate or the personal sector leads to higher national saving, even in the short run.

The composition of taxes has an important effect on the saving rate in Korea. When indirect or personal direct taxes equivalent to 1 percent of GNP replace the corporate income tax, the national saving rate in Korea rises by about 0.3 percentage points in the following year and further in subsequent years.

In the short run, accelerated inflation has a weak negative impact on aggregate saving in Korea and almost no impact in the Philippines. In the medium run, inflation seems to help raise national saving for both countries, but even modest inflation rates caused substantial macroeconomic disruption, more than offsetting the limited effects on saving. The reason may be that the business cycle, omitted as an explanatory variable, is positively correlated with inflation and affects positively and strongly the saving rate, as many other country studies indicate.

* Based on Sang-Woo Nam, "What Determines National Saving? A Case Study of Korea and the Philippines," *Journal of Development Economics* (forthcoming).

ciency of public current expenditure, and the likely political costs. Whatever the method, smaller budget deficits have direct and indirect positive effects on national saving. In addition to their main (direct) impact on saving, they contribute to lower inflation and real interest rates and to a more stable macroeconomic and financial environment. This lower inflation reinforces the increase in public saving by raising real tax revenue. Finally, revenue-neutral tax reforms can have secondary effects on private saving.

Private saving

7.14 In most countries the private sector does most of the saving. True, government policy can readily alter the disposable income of the private sector, but in a market economy it has only limited influence on the share of disposable income that the private sector saves. This section considers policies that affect private saving — the rate of return on saving, the level and form of taxation, the rate of inflation, the real exchange rate, the flight of capital, the business cycle, the inflows of foreign capital, and the rate of growth — and the links between these variables and private saving (table 7.2).

Financial liberalization and real interest rates

7.15 Interest rate controls and credit rationing are common in many countries. As a result, real interest rates on deposits and targeted credits are often very low or negative, and loanable funds are in short supply — conditions that effectively ration investment.[5] Financial reforms often raise real interest rates to improve the efficiency of resource use and increase private saving.[6] Such reforms can raise the efficiency of the investment and improve the allocation of saving, which raises long-run growth (see chapter 8). Financial sector reforms are justified on these grounds, although

Table 7.2 Public policy and private saving: effects of intervening variables

	Inflation and relative price stability	*After-tax real rate of return on saving*	*Per capita disposable income*			*Foreign resource constraint*	*Income concentrat.*	*Capital flight*	*Total effect on saving*
			Growth	*Trend*	*Deviation from trend*				
Effect of an increase in intervening variable on private saving	-	+	+	+	+	-	+	-	
Policy									
Financial liberalization		?		+ (L.run)			+		+ ? (L. run)
Fiscal/monetary stabilization	+	?		+ (L.run)	+ (L.run)	- (S.run)			+ (L. run)
Selective tax incentives on particular financial assets		+ ?							+
Shift of taxation from corporations to households							+		+
Shift of taxation from higher to lower income households							+		+
Shift from income to consumption tax		?					+		+
Real exchange rate depreciation			+ (L.run)		- (S.run)			+	+ (L. run)
Foreign capital inflows			+ (L.run)		-				

Note: The signs in the first line indicate the effect of the intervening variable on private saving, while the signs in the remainder of the table denote the fiscal effect of each policy through the corresponding intervening variable. For detailed discussion of the effects, see text.

the higher real interest rates have an ambiguous effect on the level of private saving. The reason is that an increase in the real return on saving has two offsetting effects. First, a higher real interest rate decreases the present cost of future consumption, making it attractive to consume less now and more in the future, and thus to save more today. Second, it is no longer necessary to save as much to achieve a target level of future consumption. A higher real interest rate, therefore, allows greater consumption both today and tomorrow and reduces the need to save today.

7.16 Given the theoretical ambiguity, the effect of the real interest rate on saving becomes an empirical matter. A large body of evidence for both industrial and developing countries shows that, on the average, real interest rates or after-tax real rates of return do not have significant effects on the share of private income that is saved (boxes 7.2 and 7.3).[7] But financial liberalization that allows real interest rates to rebound from very negative to near-zero levels often has a positive impact on measured private saving in financially unstable, high-inflation countries. This effect is due to reduced flight into consumer durables and foreign capital after the interest rate has risen.

Tax policies

7.17 Increasing taxes and improving tax compliance are the most effective methods of raising

Box 7.3 Empirical analysis of household saving

Most econometric analyses of aggregate saving use total national or domestic saving, even though the theories being tested pertain only to the private or household component of saving. The analysis here, however, uses household saving data. The UN national income accounts provide the rate of household saving out of disposable income for nine countries, but the series are too short to permit studying each country separately. So, we pooled the sample and used statistical techniques that take account of the fact that each subseries came from the same country.

The regression results imply that a one-percentage-point increase in the household saving rate results on average from each of the following changes:[1]

- A 4.5 percent increase in the level of the trend per capita disposable income.
- A 1.9-percentage-point increase in the trend growth rate of per capita disposable income.
- A 4.2-percentage-point increase in the ratio of current per capita disposable income to the trend level.
- A 1.5-percentage-point decline in the ratio of money and quasi money (M3) to disposable income.
- A 4.2-percentage-point decline in the ratio of foreign saving (the current account deficit) to disposable income.

All three income variables have positive and statistically significant coefficients: the trend level of per capita disposable income, which is an indicator of permanent income; its growth rate; and its deviation from trend, which measures the transitory component of income. For each extra percentage point of income growth over the previous five years, households saved an extra 0.5 percent of disposable income. This result indicates a persistence of consumption habits, regressive expectations about long-run income levels, or perhaps the tendency of people to save more when there are better real investment opportunities, as proxied by faster real growth. A higher level of (permanent) per capita income in each country over time raises the saving rate — households in this group of countries save more as they get richer. Saving out of the transitory component of income is only 0.24 — substantially less than 1.00.[2]

The ratio of money and quasi money (M3) to disposable income measures the combined impact of precautionary asset holdings, financial wealth, and a relaxation of liquidity constraints — all of which would depress saving. The ratio has a significant negative effect on saving, an outcome that probably indicates the importance of credit-constrained households. If their liquid assets are below the target level for precautionary purposes at the beginning of the year, households save more if their income in the year turns out to be above average — and they dissave less if their income is less.

Foreign saving has a negative and statistically significant coefficient. About a quarter of an extra dollar of foreign borrowing seems to go into consumption rather than investment. But if adjustment programs raise economic growth, the direct negative effect of foreign lending on saving should be more than compensated for by the indirect positive effect on saving through higher growth rates.

1. The household saving rate is defined as the ratio of household saving to disposable income. The coefficients were obtained from panel-data regression results for a nine-country sample comprising Botswana, Colombia, Ecuador, Honduras, Korea, Paraguay, the Philippines, Thailand, and South Africa. No significant influence of the following variables on household income was detected: real interest rate, inflation rate, real exchange rate, dependency ratio, and the rate of urban population. See K. Schmidt-Hebbel, S. Webb, and G. Corsetti, "Household Saving in Developing Countries," World Bank, Washington, D.C., forthcoming.

2. Thus, households save cyclically but smooth consumption less than the permanent income and life cycle hypotheses predict. They vary consumption about three-quarters as much as the transitory fluctuations in income, which the models with credit constraints and high rates of time preference predict.

public saving when public deficits are high and public current expenditure cannot be further reduced. Ample evidence shows that the private sector reduces its saving by only a minor fraction for each dollar it has to pay in higher taxes.[8] Therefore, the main instrument for raising total national saving is to increase aggregate taxation while holding public expenditure constant. Secondary effects on aggregate private saving are sometimes achieved by introducing revenue-neutral changes in the tax structure, modifying the after-tax rates of return on particular assets, or shifting the relative tax burden between sectors.

7.18 Under most income tax systems, saving is taxed twice: first when earned income is taxed and again when the stock of saving generates interest income. Some people have argued that avoiding double taxation by converting personal income taxes into taxes on consumption expenditure or value-added taxes on consumption would raise private saving. The evidence on the insensitivity of saving to changes in after-tax interest rates casts some doubt on this argument. But transitory tax changes do affect saving. For instance, an income tax that is expected to be transitory would have temporary but clearly negative effects on saving. Temporary tax surcharges in industrial countries demonstrate such effects.

7.19 Tax provisions on certain asset holdings change their after-tax returns and thereby encourage the private sector to reallocate its portfolio toward the favored assets, usually without much effect on aggregate saving. Nevertheless, some evidence from industrial countries reveals exceptions to this general rule. The removal of tax deductions for interest paid on consumer credit discourages spending on consumer durables and therefore increases saving rates.[9] Tax exemptions for retirement saving — such as individual retirement accounts (IRAs) in the United States — seem to encourage total saving, as do private pension plans.[10] But these and other targeted incentive programs — such as housing-purchase programs and agricultural incentives in developing countries — are appropriate only when they are desirable for microeconomic or social reasons. They seem to work because they are targeted to households with little initial wealth. Their effects on aggregate saving rates seem to be negligible.

7.20 Sectoral changes in the tax structure can sometimes raise the saving rate. Shifting the tax burden from corporations to individuals would not affect total private saving if the individual who owned the corporation saw the additional dollar of retained earnings as a perfect substitute for household saving. But the different rates of personal and corporate saving suggest this is unlikely to be the case. In Korea and the United States, where corporate saving rates are higher than the personal rate, a shift from corporate to personal taxation tends to raise the saving rate (box 7.2).

7.21 Changing the progressivity of personal income taxes can also affect private saving, though not dramatically. Because households with higher incomes often save more of an extra dollar of income, reducing the progressivity of taxes tends to increase the rate of private saving out of disposable income.[11] The main reason for the higher saving propensity of upper-income households is that they are less credit-constrained. In contrast, lower-income groups — particularly in developing countries — have less access to consumer credit because of their lack of collateral, so they are forced to consume below their permanent income levels when they face bad years. Recommending that a country make its tax structure more regressive simply to raise private saving is unlikely to be acceptable, but it is nonetheless important that policymakers be aware of this relationship when changes are being contemplated in the progressivity of taxes.

Inflation

7.22 Inflation is equivalent to a tax levied on holders of base money — currency and bank reserves. Like any other tax on a particular financial asset, inflation causes a shift in the composition of private portfolios — in this case away from base money toward other assets. If interest rates are regulated, as they are in many countries, inflation will cause a flight into real assets, among them consumer durables and housing. Since purchases of consumer durables are treated as consumption in national income accounts, inflation reduces private saving. A second form of asset substitution in response to inflation is toward foreign currency. Capital flight, exacerbated if domestic interest rates and the exchange rate are fixed, also reduces private saving. In addition, very high inflation may affect the saving rate through its effects on output. High inflation rates often contribute to stagnation in output or outright recession, as recently observed in Argentina, Brazil, Nicaragua, and Peru. And stag-

nation of output reduces saving as consumers attempt to maintain their consumption levels.

Exchange rate policies, capital controls, and capital flight

7.23 Adjustment programs frequently call for a reduction in expenditure and a real devaluation of the real exchange rate. A permanent devaluation forces the private sector to reduce its consumption if it makes net payments abroad, typical under adjustment. Because net imports and interest payments on foreign liabilities are more expensive in units of domestic resources after a real devaluation, private consumption will fall by some fraction of the higher payments abroad. Therefore, for given output levels, domestic saving will increase, and national saving will fall.[12] The private sector's opposition to this exchange-rate-induced loss in wealth forced many Latin American central banks to grant exchange rate subsidies after the debt crisis — a move that shifted the need for adjustment to the public sector. Moreover, real depreciations may reduce domestic output during the transition, contributing to a temporary decline in the private saving rate (with saving falling more than output) that lasts until the export response or other factors lead to an expansion.

7.24 Anticipation of an exchange rate devaluation causes higher imports of consumer durables and capital goods and contributes to legal or illegal private capital outflows from developing countries. During 1975-85 the cumulative capital flight to industrial countries and offshore tax havens probably exceeded US$180 billion, more than half of it from Latin America.[13] Although such a portfolio shift need not affect private saving, the situation is hardly sustainable — as shown by the balance of payments crises in Argentina, Mexico, and Venezuela during the early 1980s.

7.25 Where exchange rate and capital controls are in effect, an expected devaluation drives a wedge between the parallel and official exchange rates. This wedge motivates illegal capital flight through false invoicing of trade transactions or outright smuggling. A shift from legal to illegal net exports reduces officially recorded GDP and income. Private consumption is not much affected because total (recorded and unrecorded) private income and wealth do not change. But the measured private saving rate falls sharply, in tandem with measured private income. The reduction in legal net exports puts further pressure on the real exchange rate — pressure that, if not accommodated, raises the parallel exchange rate and reinforces the capital flight. For public finances, lower measured GDP reduces the tax base and therefore contributes to the public deficit. In the end, the required corrections in public expenditures and the real exchange rate are more painful in terms of relative losses in output than would have been the case without capital flight.

7.26 When the anticipated devaluation finally takes place, capital flight and acquisitions of consumer durables decline and measured private saving rebounds. This situation tends to be offset by a temporary saving decline if output falls during the adjustment phase. Over the medium term, however, the first effect should dominate. Corrective real devaluations seem to have had these effects in Chile (1982-87), Ghana (1983-86), Korea (1979-85), Morocco (1981-87), and Turkey (1980-87), where measured saving rates rebounded after the devaluations.

Stabilization, adjustment, and the business cycle

7.27 The design of adjustment or stabilization policies, which sometimes cause transitory output and income losses, should recognize that cyclical downturns reduce private saving. In nine developing countries, a 4.2-percentage-point temporary change in disposable income is accompanied by a 1-percentage-point change (in the same direction) in the household saving rate (box 7.3). Saving does not completely smooth private consumption. Consumption is more volatile than indicators of lifetime income, and lower-income groups and lower-income countries are less able to smooth consumption. The main reasons for the fluctuations in consumption seem to be credit constraints and uncertainty about future income and prices.

Foreign capital inflows and adjustment lending

7.28 Foreign capital inflows to developing countries may reduce saving rates, particularly household saving rates (box 7.3).[14] But foreign capital inflows did not affect national saving rates in some cases, such as in Korea and the Philippines (box 7.2). Even if the general evidence were unambiguous in showing that foreign saving is in part used for private and public sector consumption, this would not mean that foreign loans, and adjustment loans in particular, usually worsen the economic performance of recipient countries. The relevant questions are whether effective

public policies supported by adjustment lending can raise aggregate saving — even if private (or household) saving declines in the short run — and whether those policies can increase private saving in the long run. The answer to both questions is yes.[15] The domestic saving rate rose more in early intensive adjustment lending countries than in all other countries, presumably because public saving increased by more than the decline in private saving (chapter 2). In addition, if adjustment lending is effective in increasing growth, it will have a major positive impact on private saving in the long run.

Growth and the virtuous cycle

7.29 Adjustment programs that count on increased saving tend to benefit from virtuous cycles of success — or to suffer from vicious cycles of failure — because the rates of growth of income and saving are correlated. Several studies find a positive correlation between GDP growth and the share of total or private saving. Several compatible explanations are consistent with the evidence that rapid growth in income causes the saving rate to rise a great deal at first and then to decline a little from its peak after an extended period.[16] People may initially regard the higher growth rate as temporary. Income growth and higher wealth per capita also put additional households above the threshold of credit-constraint. And faster growth may both cause and reflect higher rates of return on investment. Increased investment and efficiency help mobilize more resources from the private sector to feed back into growth, thus closing and supporting the virtuous cycle.

Implications for adjustment programs

7.30 Public policies to raise public saving and hence national saving have a key role in structural adjustment. The evidence shows that the private sector does not reduce its saving one-for-one with tax increases or public spending cuts; it follows that reductions in budget deficits increase national saving. This has profound implications for Bank-supported adjustment lending. As chapter 3 shows, Bank-supported adjustment programs tend to increase per capita private consumption. But chapter 2 concludes that, after controlling for the effect of other factors, the domestic saving rate rose 4 percentage points more in early intensive adjustment lending countries than in any other group of countries. So adjustment programs supported by the Bank have played a significant role in raising aggregate domestic saving and changing its composition in favor of public saving.

7.31 Policy conditions for reducing fiscal deficits and raising public saving have been included in more than half the Bank's loan agreements during 1979-89 (table 4.1 in chapter 4). For countries struggling to establish sustainable macroeconomic policies, the Bank's adjustment operations should increase the emphasis on fiscal conditionality, which has been shown to be highly effective in increasing aggregate saving by raising public saving. For countries that already have achieved basic macroeconomic balances but still have not reached high growth levels, the emphasis of adjustment lending on supply-side, growth-oriented reforms will be conducive to a recovery and subsequent net increase of private saving. This second phase will take longer, however, and its effects on aggregate saving will be slower and less spectacular than those observed during the first phase of fiscal stabilization.

8

Determinants of growth

Summary

8.1 Higher saving and investment generally result in higher rates of growth, but the macroeconomic environment must be stable enough to provide the incentives for investment and for savings to stay in the home country. The efficiency of the allocation of investment also influences growth. Sectoral reforms that establish and maintain an appropriate system of incentives produce a one-time increase in production and increase the rate of growth in the long run. The main shackles on growth are excessive government expenditures, distortionary taxes, excessive regulations, restrictions on free trade, and controls on domestic interest rates. Loosening these shackles can be expected to increase growth, but the degree of loosening matters. Small reductions in high distortions and the elimination of small distortions do little to foster growth. The greatest payoff comes from making big reductions in high distortions.

Growth and the efficiency of saving and investment

8.2 Sustained growth generally has three main requirements: stable macroeconomic conditions, an appropriate price structure and regulatory environment, and efficient institutions to turn saving into productive investments. Adequate levels of saving and investment are also necessary, but neither can guarantee higher rates of growth. The essentials for macroeconomic stability — to induce investment and prevent capital flight — are a low and stable inflation rate, a competitive exchange rate, and clear and sustainable tax rules. A well-developed and sound financial system can also do much to improve the efficiency of transforming saving into investment and forestall capital flight.

Domestic savings and portfolio decisions

8.3 The menu of assets, their real rates of return, and the stability of the macroeconomic environment largely determine the allocation of domestic saving. One manifestation of their inefficient allocation is capital flight, the result of uncertainty about the returns on domestic assets and the overall political situation.[1] Capital flight hampers growth by robbing the country of funds that could finance domestic investment. It also reduces the tax base for public revenues, and the resulting fiscal problems usually lead to more intense and distortionary taxation of the remaining tax base.

8.4 Capital outflows and the income that domestic residents earn on that capital are difficult to measure, but recent estimates of capital flight in developing countries spotlight two findings (table 8.1).[2] First, capital flight was not large for all countries in the sample. Second, the private sector's stock of foreign assets was in some cases very substantial relative to the total stock of financial assets. For Argentina, Mexico, and Ven-

Table 8.1 Estimates of capital flight using alternative definitions, 1974-82, 1980-84, and 1983-87 (billions of dollars)

Country	1974-82		1980-84[a]			1983-87[a]		
	Cuddington (1986)	Dooley et al. (1986)	WDR	Morgan	Cuddington	WDR	Morgan	Cuddington
Argentina	15.3	20.2	19.2	18.9	16.5	6.8	6.2	0.4
Brazil	0.2	11.4	10.5	10.0	1.3	24.6	23.2	7.0
Chile	-2.0	-0.5	na	na	na	na	na	na
Korea	0.6	7.0	na	na	na	na	na	na
Mexico	32.7	36.3	40.1	40.3	30.3	35.3	34.0	17.6
Philippines	na	3.9	1.9	0.9	2.3	na	na	na
Venezuela	10.8	25.5	27.1	26.7	16.8	18.8	18.4	6.2

Source: For 1980-84, *Financial Flows to Developing Countries, Quarterly Review*, March 1989; for 1983-87, R. Dornbusch, 1989, "Capital Flight: Theory, Measurement and Policy Issues," Massachusetts Institute of Technology, Cambridge, Mass.
na indicates not available.
a. The numbers in these columns were calculated for this study using the methodology developed by each author or publication.

ezuela, the value of the stock of foreign assets (calculated from accumulated capital outflows plus interest) is close to or even higher than the stock of domestic financial assets. In a few instances, capital flight exceeded 50 percent of the annual flow of saving.[3] The main reasons for this capital flight were high inflation, artificially depressed interest rates, and the expectation that the overvalued exchange rate would be devalued.[4]

Financial intermediation

8.5 An efficient financial system can improve the prospects for growth by attracting a large portion of domestic saving and channeling it to the more productive sectors of the economy. Some developing countries overregulate their financial sector through controls on interest rates on deposits, restrictions on credit to the private sector, and requirements that financial institutions invest in low-interest government debt — all of which greatly hamper the financial sector's ability to intermediate saving efficiently.[5]

8.6 Although financial liberalization will usually foster growth, it will not be effective if it also creates macroeconomic instability. For example, a reduction in the forced lending to government could increase the availability of financing for private investment. But if the government needed these resources to finance its deficit and resorted instead to inflationary finance (as in Argentina recently), the move could be counterproductive. Likewise, if banking regulation and supervision are not adequate, the result could be the insolvency of financial institutions, as in Chile, Uruguay, Argentina, the Philippines, and Turkey. That is why fiscal adjustment and regulatory reform should precede or accompany financial liberalization.

Distortionary policies and growth

8.7 Increases in current government expenditures, distortionary taxes, trade restrictions, and the controls on domestic interest rates can all hinder long-run growth, just as the removal of such policies can increase it (box 8.1).

Government spending

8.8 Empirical work at the Bank confirms the results of other studies showing that a higher ratio of current government spending to GDP is, on the average, associated with a lower rate of growth for a given level of investment.[6] That is, higher government spending reduces the efficiency of investment. An increase of 10 percentage points in the share of government spending in output is associated with a drop of 1 percent in growth.

8.9 Government spending reduces efficiency through two main channels. One is the way of financing that spending. Differential tax rates on sectors or factors of production reduce the overall rates of return on investment. Higher tax rates hold down the rate of growth and the level of output. Printing money can also lower efficiency by raising inflation, masking the price signals needed for the efficient allocation of capital and other inputs. The other channel is by directly distorting the allocation of resources — for ex-

Box 8.1 Contrasting growth in Thailand and Ghana

Ghana's per capita income was above Thailand's in 1965, yet Thailand's per capita income was more than twice Ghana's by 1987. What happened in the interim? Ghana had severe policy distortions — and Thailand did not.

Thailand

Growth in Thailand's per capita income is estimated to have begun as early as the 19th century.[1] For many decades the economy was oriented toward its profitable rice exports, which grew by 3 percent a year in the first four decades of this century. Government policy consistently favored rice production and exports in general. From 1950 to 1970 the economy began to diversify into other export crops — such as maize, cassava, and rubber — although the export share stayed relatively constant. Industrial growth also began to accelerate in the late 1950s, as government policy shifted from promoting government-owned industry to favoring private initiative. Manufacturing output responded by growing at an average annual rate of 11 percent for the next two decades.

High investment boosted growth during 1965-88 (box table 8.1). The size of government was below average for a middle-income country. Interventions in the financial system were limited, and positive real interest rates for depositors prevailed for the period. Trade policy continued to consistently favor exports — with Thailand classified as a moderately outward-oriented economy in both 1963-73 and 1975-85[2]— and the export share increased strongly.

Macroeconomic policy contributed to economic stability. Government deficits were moderate, the real exchange rate was stable and competitive, external borrowing was held to a minimum, and inflation was low. By the end of the 1980s, Thailand was a potential new member of the exclusive club of Asian newly industrializing economies, with growth at 11 percent a year and massive inflows of direct foreign investment creating an investment boom.

Box table 8.1 Growth indicators for Thailand and Ghana

Indicator	*Thailand*	*Ghana*
1965 per capita GNP (1987 dollars)	350	430
1987 per capita GNP (current dollars)	1000	400
Average inflation rate		
1965-80	7	26
1980-87	3	50
Average annual per capita GNP growth (1965-87)	4.1	-1.7
Average annual GDP growth (1965-88)	6.9	0.8
Average annual investment/GDP (1965-88)	25	10
Change in export share[a]	8.7	-10.6

Source: World Bank data.

a. Defined as the average export/GDP ratio from 1982 to 1988, minus the average export/GDP ratio from 1965 to 1970. The ratio is an indicator of the direction of trade policy.

Ghana

Growth in per capita income in Ghana also began early, starting around the turn of the century as it became the British colony known as the Gold Coast. Early growth, as in Thailand, was spurred by a profitable export commodity, cocoa. When internal self-government began in 1951 (followed by full independence in 1957), Ghana benefited from a relatively well-educated populace and an infusion of development funds, growing at about 4 percent annually in the 1950s.

After 1960, the economy began to deteriorate, with growth slowing to 2.8 percent in the 1960s and to -0.1 percent in the 1970s. Food output per capita declined by 18 percent from 1970 to 1980. Cocoa exports fell precipitously, even before the drop in world prices in the late 1970s, but the economy failed to diversify into other exports. What went wrong?

The poor performance was associated with highly distortionary economic policies. Trade policy was strongly biased against exports. The cocoa marketing board held the producer price of cocoa far below the world price. In part, this was due to the worsening overvaluation of the cedi, whose exchange rate was fixed in nominal terms despite high inflation. Cocoa smuggling was a serious problem, and black market activities were pervasive. Although government expenditure was relatively low, revenue collection was even lower. Successive governments relied heavily on money creation, which contributed to high inflation. Nominal interest rates were controlled, so depositors faced highly negative real interest rates.

Since 1983, a major reform program has reduced the overvaluation of the cedi, increased producer prices for cocoa, increased revenue collection, and reduced government deficits, among other measures. The reform program has been supported by substantial aid and soft loans from external agencies. The average growth rate from 1983 to 1988 was above 5 percent. Although the economy continues to face challenges, this recovery gives hope of more satisfactory growth performance as the problems that contributed to the earlier decline are being resolved.

[1] G.L. Reynolds, *Economic Growth in the Third World* (New Haven, Conn.: Yale University Press, 1985, p. 157).
[2] World Bank, *World Development Report 1987* (New York and London: Oxford University Press, 1987).

ample, through subsidies for particular sectors or production inputs. These subsidies shift resources from areas where they could generate the highest economic rate of return. And private entrepreneurs devote their time and resources to lobbying for the subsidies rather than to production, further reducing efficiency.

8.10 Although higher government spending generally reduces growth, it can increase growth if it raises the productivity of private capital — through spending on basic education, health, and such essential infrastructure as roads, water supply, and communications. Public investment in railways and highways has been a key factor in the growth of mountainous countries such as Colombia and Mexico, while the lack of such investments has hampered growth in Myanmar.[7] And the lack of public infrastructure in Nigeria has hampered growth by requiring firms to invest in their own inefficient electrical generators, boreholes for water, and water treatment plants.[8]

Trade policy

8.11 A country's openness to trade is positively associated with growth.[9] For example, growth is positively associated with an increase in exports as a share of output. Over 1950-80, 15 of the 19 countries with the highest per capita growth rates had a higher export share in 1980 than 1950. Countries whose export share fell — such as Ghana, India, Tanzania, Uganda, Zaire, and Zambia — had the lowest growth rates.[10] Studies have also found a positive association between growth and a subjective measure of the outward orientation of a trade regime.[11] Nine of 13 countries with "strongly inward-oriented" trade policies are below the average growth-investment line — that is, their investment yields less growth than average (figure 8.1). Although this result is more tenuous because of the subjectivity of the trade-orientation measure, it confirms the many country studies that show outward-oriented countries outperforming inward-oriented ones — in all regions and all time periods. Argentina grew rapidly during its outward-oriented phase before 1930, but growth slipped as the country turned inward after World War II. Growth in Brazil and Colombia accelerated with an outward opening in the 1960s.[12] In Asia, outward-oriented Thailand and Malaysia have outperformed inward-oriented Myanmar and India.

8.12 The openness to trade raises growth through several channels:

- Broader markets that raise the efficiency of domestic production through increased specialization.
- Access to advanced technology from abroad.
- Competition from foreign producers that fosters adoption of modern technologies at home.
- Access to a greater variety of inputs for production.

In contrast, trade interventions such as tariffs or quotas change the pattern of social returns to alternative types of capital goods and attract capital and labor into activities that are less valuable in international prices — reducing the overall productivity of capital and thus reducing growth.

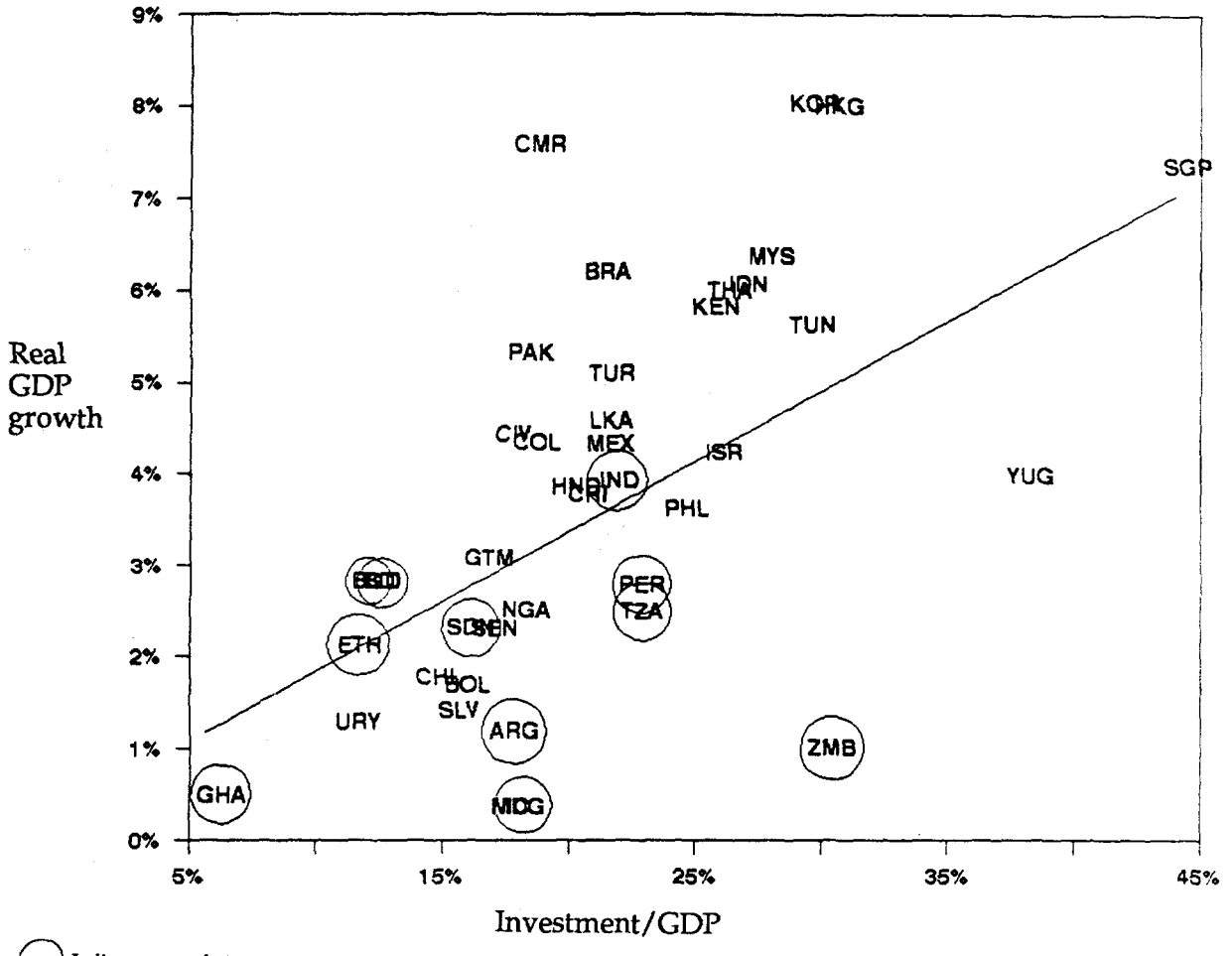
Financial sector policy

8.13 Empirical analysis shows a clear negative relationship between financially repressive policies and economic growth, confirming earlier work.[13] In 11 of 14 countries with strongly negative real interest rates, the efficiency of investment has been below average (figure 8.2). The results suggest that financial repression (defined as controls on interest rates leading to an average real interest rate over a 20-year period of below -5 percent) lowers growth on average by about 1.7 percentage points a year. Even rapidly growing Korea experienced some negative effects from interventions in the financial system in the late 1970s.[14]

Institutional development

8.14 Institutional factors that influence growth — private entrepreneurship, public administration, and political stability — are very difficult to measure but nonetheless crucial. In low-income countries, the lack of well-developed public and private institutions may be an important hindrance to growth even if trade and financial incentives are not distorted. A stable system of civil liberties, well-defined property and contractual rights, and predictable and equitable regulation is widely believed to be particularly important in harnessing the energies of entrepreneurs in Africa.[15] A comparison of long-run growth experience among many developing countries concluded that government administrative competence was the single most important factor explaining growth differences.[16] Political stability and the safeguarding of civil liberties have also been found to determine growth.[17]

Figure 8.1 Real GDP growth and investment ratios: trade policy sample, 1971-86



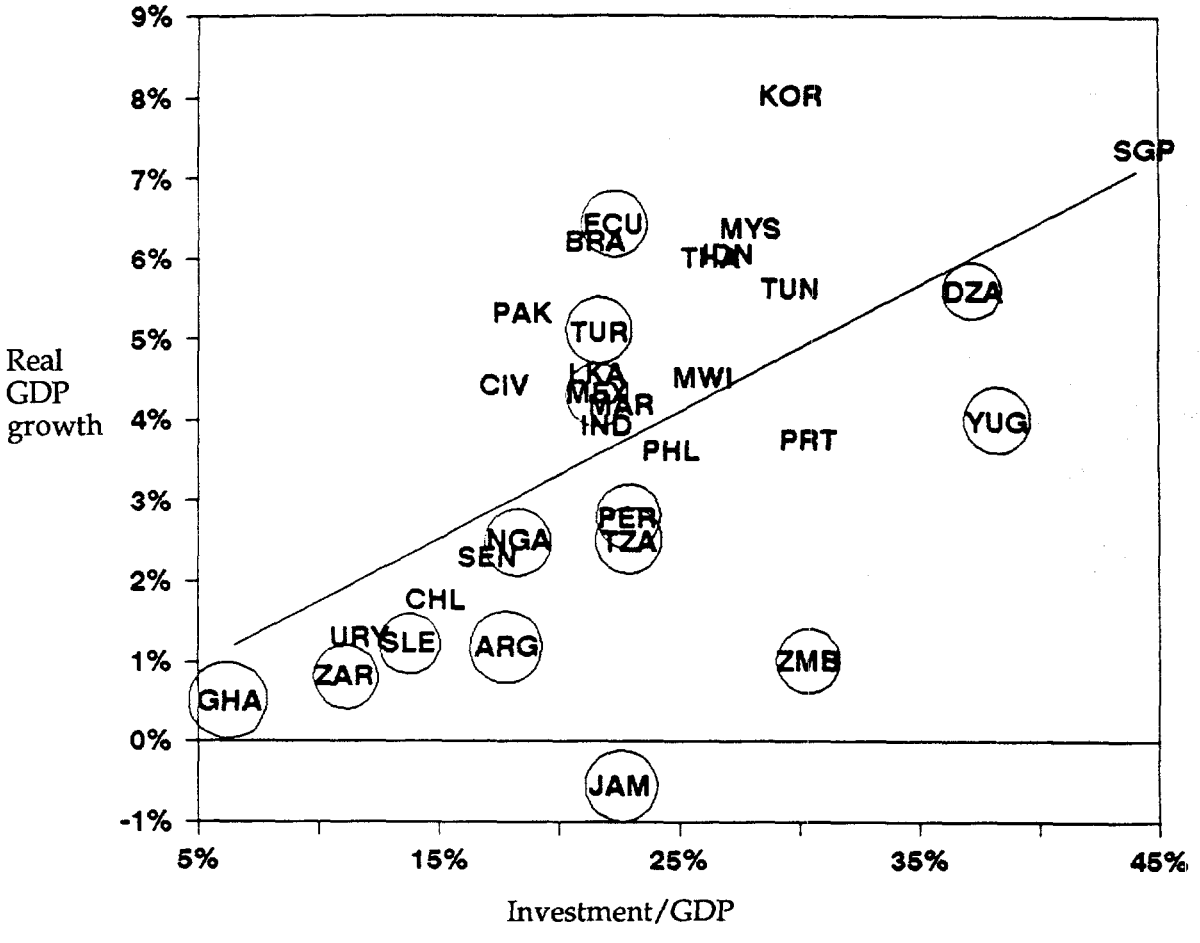
◯ Indicates strongly inward-oriented countries

Source: WDR 1987 and World Bank data.

The effects of reducing distortions

8.15 The efficiency of investment is greater with relatively nondistortionary policies. Therefore, policy changes that reduce the distortions in resource allocation tend to raise growth in the long term — with the size of the initial distortion and the magnitude of the reduction affecting how much growth will respond. Such policies include lowering tariffs, relaxing import quotas, raising or decontrolling domestic interest rates, reducing reserve requirements or mandatory government bondholdings, reducing government subsidies for consumption or production of particular goods, and reforming taxes to reduce or eliminate differential treatment of sectors or inputs. The reforms can proceed in several steps. For example, tariffs can initially be substituted for quotas, both to increase the transparency of incentives and to raise public revenue. Later, tariffs can be reduced as other revenue sources are expanded. But institutional development might be necessary to strengthen the private responses to such changes in incentives.

Figure 8.2 Real GDP growth and investment ratios: financial policy sample, 1971-86



Indicates strongly negative real interest rates (less than - 5%)

Source: Gelb (1989), *WDR 1989* and World Bank data.

How changes in distortions affect growth

8.16 Neither a small reduction in high distortions nor the complete removal of small distortions does much to foster higher long-run growth — conclusions based on examination of country experience and simulation of a structural model of growth. Since policymakers often have a limited amount of political capital for correcting distortions, they should concentrate their efforts on the changes that have the largest payoff in increased growth rates. The largest payoff comes from changing high distortions into low ones. And if more than one distortion exists, all should be reduced together.

The growth-distortion relationship

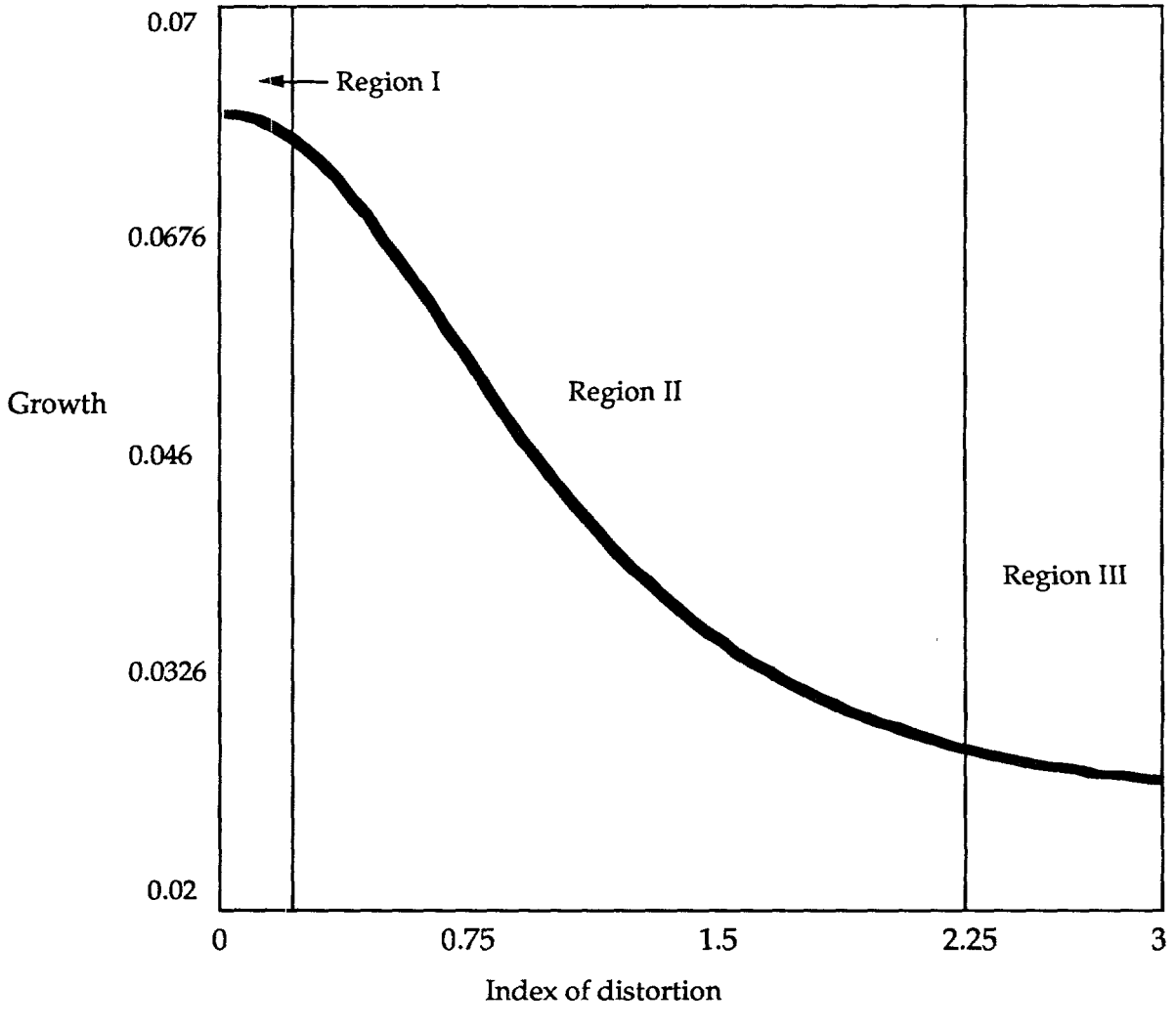
8.17 Distortions often penalize the use of some forms of capital.[18] When many people evade taxation on the income from capital, there is a penalty on the use of formal, more visible capital. In Argentina, for instance, 80 percent of gross income was not reported, and only 30 percent of people eligible to pay taxes on nonwage income actually did so.[19] The structure of the formal tax system can also create such distortions. In the United States, the cost of capital was 17 percent higher for the corporate sector than for the noncorporate sector because of different tax treatment.[20] Some governments consciously tax differ-

ent sectors at different rates. In Malawi, the tax rate is 20 percent higher on manufacturing than on nonmanufacturing assets, and Ghana, Nigeria, and Zaire tax their export commodities heavily.[21] Government intervention in credit allocation can also impose implicit penalties on the use of some types of capital. In the early 1980s, three-quarters of all loans from the Turkish financial system were made at preferential interest rates or at government mandate. As a result, real interest rates on nonpreferential credit were as high as 50 percent, compared with highly negative real interest rates for housing purchases.[22]

8.18 Simulated long-run growth rates associated with alternative levels of distortion (taxes on capital) are displayed in figure 8.3. A striking feature of the curve is that it is very flat at the beginning (Region I) and at the end (Region III) of the distortion range, indicating that changes within the very low or very high distortion range have little impact on growth.

8.19 This pattern reflects two fundamental economic phenomena. The first is diminishing returns — as more and more of the type of capital favored by policy is used, it yields smaller and smaller increments in output. When a distortion is initially increased from zero, this effect will not be very important — small distortions are not very costly in terms of lost growth potential. But the effect becomes more serious as larger distor-

Figure 8.3 Growth and distortion



tions force the use of more and more of one type of capital. For example, in the Philippines, the economic cost of raising revenue from tariffs increased sharply as the tax rate increased.[23]

8.20 The second phenomenon underlying the growth-distortion relationship is the disappearance of the type of capital being penalized. As the distortion gets extremely large, the use of the capital being penalized gets very close to zero, so that increases in the level of distortion will make little difference. Thus, reductions in very high levels of distortion make little difference until the level becomes low enough to promote substantial use of the penalized capital. Reducing a prohibitively high tariff rate, for example, has no effect until it reaches a level at which imports begin.

8.21 The disappearing capital also implies a limit on how much damage a distortion can do. The most a distortion can do—no matter how large—is to eliminate the use of the type of capital being penalized. If another capital type can serve as a rough substitute, growth will continue at a certain level. For instance, in countries in which large distortions severely disrupt formal sector production, the informal sector often continues to grow. In Uganda during 1970-78, formal sector production fell at 2 percent a year because of the distortions caused by the highly interventionist and unstable military government, but subsistence production continued to grow at 3.4 percent a year. Similarly, output in the distorted formal economy of Tanzania grew only 2 percent a year over 1971-77, while the growth in subsistence production was an estimated 6.5 percent a year.[24] Such substitution may be particularly important in Africa, where more than half the urban employment is in the informal sector.[25]

8.22 If the damage from distortions is limited, albeit large, some increase in saving (and investment) rates could offset its effect. Thus, a high rate of growth is possible under a high level of distortion, although the cost to the population of permanently maintaining a higher saving rate would be severe. In this way, countries with severe levels of distortion can grow rapidly if saving is high — as have the centrally planned economies during industrialization, or China during the last two decades.

8.23 Modest reform of highly distorted economies is not likely to increase growth significantly. A strategy of limited reductions of high distortions may have low short-run political costs, but also low economic benefits. Conversely, excessive preoccupation with small distortions may divert policymakers from far more beneficial fundamental reforms.

Taxes, government, and growth

8.24 When the distortion is a tax, the relationship between the size of government and growth is more complicated than with the simple negative relationship cited earlier. Some tax rate distortion is inevitable: few nondistortionary taxes are available to finance government spending for essential public services and infrastructure. What this means for growth is that the policymaker faces a tradeoff between two types of distortions — that from taxation and that from insufficient public infrastructure. The policymaker will accept the loss in efficiency attributable to additional taxes if it is offset by a gain in useful government infrastructure. By contrast, increases in tax rates that generate efficiency losses greater than the gain from the spending they finance will lead to a larger public sector at the expense of lower growth.

8.25 Moreover, tax rate increases above a certain level can reduce revenue if reductions in the type of capital being taxed more than offset the increased tax rate.[26] A special case in this category is the inflation tax — the tax on money from high inflation. In Argentina and Brazil, the decline in money balances in response to inflation has been severe enough to lower the "revenue" from high rates of inflation. Taxes beyond this point no longer involve a tradeoff between the size of government and growth. Instead, a decrease in the tax rate would lower distortions, increase growth, and raise public revenue. Finally, when the tax rate is so high that the capital being taxed is close to zero, increases in the tax rate are nearly meaningless.

8.26 The policy implications of this analysis are clear. Many tax rates are so high that the gain from government services is more than offset by the efficiency loss caused by the taxes. Tax rates that are too high to generate maximum revenue should undoubtedly be reduced. But again, small reductions in extremely high tax rates make little difference. A tax reform that lowers tax rates and extends the tax base can increase growth in two ways: by increasing revenues to finance productive government spending and by lowering the distortions that come with high tax rates.

Implications for adjustment lending

8.27 The evidence has important implications for the sequencing and scope of sectoral reforms in structural adjustment programs. In many countries, restoring macroeconomic balance requires a reduction in government expenditures, so fiscal reform must accompany any structural adjustment measures. Financial liberalization should be accompanied by deficit reduction where the government has relied on implicit taxation of the financial system to finance its budget deficit and no alternative financing means are available. Likewise, trade liberalization should go hand in hand with fiscal reform in countries where the government derives much of its revenues from import and export taxes. And institutional reform may be necessary to facilitate the response to such liberalization.

8.28 Sectoral reforms to reduce distortions, to be effective, must reduce distortions below some critical level. Sectoral reforms that increase efficiency will generally lead to a one-time increase in the level of production and to a long-run increase in the rate of growth. These gains will not materialize, however, if the program aims at only modest changes in highly distorted economies. For example, tariff reductions on imported capital goods will not increase efficiency much unless the reductions are large enough to permit substantial imports of capital goods. Reducing some distortions while leaving others untouched is also of dubious value and can even be counterproductive. The policy program most likely to raise long-run growth is a major reduction in all significant distortions, supported by complementary measures to develop institutions and to provide a predictable business environment.

8.29 What do these principles mean in practice? Chapter 2 showed that the early intensive adjustment lending countries boosted the growth rate of GDP by close to two percentage points on average between 1981-84 and 1985-88. At the same time, their investment fell, so efficiency must have increased. Although this is only a short-run effect, it augurs well for long-term growth in these countries.

8.30 Some countries receiving adjustment loans did better than others, with Korea, Mauritius, Morocco, Ghana, and Thailand especially successful. Of these, only Korea also had an exceptional investment performance, suggesting that the others significantly improved efficiency — partly by reducing major distortions, as this chapter recommends. For example, Ghana initiated major macroeconomic stabilization (including the correction of an extremely distorted exchange rate) with Bank and Fund support and began correction of other major distortions with support from trade and financial sector adjustment lending by the Bank. Mauritius, after a successful stabilization with Bank and Fund support, took measures to address fundamental trade distortions by lifting quantitative restrictions, reforming tariffs, and encouraging direct foreign investment.

8.31 Other countries receiving adjustment loans did worse than expected — Nigeria, Philippines, Malawi, Côte d'Ivoire, and Mexico. But, except for Mexico, they had an exceptionally poor investment performance. In such countries, reviving investment is an especially high priority to get back on the growth path, and that requires, above all, macroeconomic stability.

8.32 The lack of macroeconomic stability in some countries may have reflected insufficient fiscal reform. The analysis of conditionality of adjustment lending in chapter 4 showed that only 16 percent of the conditions addressed issues of fiscal policy and rationalization of government finance and administration, compared with 54 percent for trade, financial, and sectoral reforms. However, it should also be mentioned that in some of these cases there was a concurrent program addressing the need for stabilization. The two financial sector adjustment loans in Turkey were not fully successful because of insufficient attention to fiscal disequilibria. A trade policy loan in Argentina failed for the same reason. Lack of sufficient complementary fiscal reform contributed to the failure of the attempted exchange rate reform in Zambia in 1985. Fiscal reform is important, too, because some of the largest distortions may be fiscal.

8.33 Adjustment lending has also tended, as chapter 4 indicated, to be most successful in countries that addressed the largest distortions with sufficiently strong measures. Ghana is a good example of a successful program that addressed major distortions on all fronts. Specific policy reforms such as trade liberalization have also worked better with drastic institutional changes such as Chile's elimination of quantitative restrictions. Agricultural reforms have shown the same principle at work. Nigeria's abolition of marketing boards and Mexico's elimination of a parastatal monopoly on food imports are examples of sufficiently drastic reforms.

Endnotes

Chapter 1

1. In the context of IDA-9 replenishment, the donors considered it important for IDA to continue to play a central role in developing and supporting adjustment programs, both through quick-disbursing adjustment loans and through investment lending. The donors underlined the need to maintain an appropriate balance between quick-disbursing adjustment lending and investment lending, which were seen as mutually reinforcing, with the right mix to be determined on a country-by-country basis. As in IDA-8, the share of quick-disbursing adjustment lending should remain around 25 percent for IDA-9 and should not exceed 30 percent of total IDA lending. The donors requested that the regular reports on adjustment lending prepared by the Bank pay special attention to the IDA countries as a group, so as to facilitate careful monitoring of the implementation of adjustment programs.
2. Chapter 2 analyzes the performance of 25 countries — early, intensive adjustment lending (EIAL) countries — that had at least two SALs or three adjustment loans (SALs or SECALs) starting before 1986. Program effects are evaluated by comparing a set of indicators in 1985-88 relative to 1981-84 and 1980.
3. The drop in the investment share in GDP is much more pronounced when comparing 1985-88 with 1970-80 than when comparing 1985-88 with 1981-84. The drop is higher for constant-price shares, indicating that the relative price of investment goods rose during adjustment.
4. The 97 loans for the sample coded for implementation had been approved by the Board in FY79-88.
5. *Sub-Saharan Africa: From Crisis to Sustainable Growth*, World Bank, 1989.

Chapter 2

1. We choose 1970-80 for the base period because it preceded the major shocks of the early 1980s and is not dominated by the situation in a particular year or two. We also compare performance in 1985-88 with that in 1981-84.
2. We use groups of countries and periods that are different from those of RAL-1. The group of EIAL countries include all the intensive adjustment lending countries of RAL-1 plus 13 more countries. Because we can now consider an extra year of performance, the RAL-2 category of intensive adjusters added countries whose second or third adjustment loan came after 1985. Within each group a breakdown is made between low- and middle- income countries. Low-income countries are defined as all the IDA countries (including those receiving a blend of IDA and IBRD loans) and the middle-income countries are all the rest.
3. A common feature of economic policies in these countries was the public investment boom, financed by easy access to external borrowing. The boom often led to high inflation and increasing external debt to GDP ratios.
4. In 1981, indebtedness ratios such as those in Table 2.1 were not seen as cause for alarm about a potential debt crisis; see for example Solomon, R. (1981, "The Debt of Developing Countries: Another Look," *Brookings Papers on Economic Activity*, No. 2.)
5. The association of large fiscal deficits with low inflation is related to the foreign financing of these deficits.
6. The increase in international interest rates occurred only at the end of the 1970-80 period.

7. Comparing 1981-86 with 1976-78, RAL-1 found that the countries grouped as intensive adjustment lending in that report — a subset of IAL countries — had experienced the largest negative external shock. The difference in the findings is due to the different periods of comparison and the larger number of countries included in IAL.

8. The interest payments on public debt expressed in domestic currency rose because of higher international interest rates, larger debt (especially in countries where the public sector assumed responsibility for servicing the private sector's foreign debt), and large real devaluations undertaken to improve the resource balance. William Easterly (1989), "Fiscal Adjustment and Deficit Financing During the Debt Crisis," in I. Husain and I. Diwan (eds.), *Dealing with the Debt Crisis*, World Bank Symposium. World Bank.

9. The saving, investment, and export shares are measured in both current and constant prices. The current price measures are better indicators of the allocation of current resources, while the investment ratio at constant prices is a better indicator of the addition to the capital stock, and the constant price export ratio is a better indicator of the export response to a program.

10. The ratio in real prices corrects mainly for the effects of real devaluation and terms of trade changes, which change the price of investment goods (mostly imported) relative to the average price of GDP.

11. Details of the methodology are presented in the annex to this chapter.

12. The effect of programs on the national saving rate is also positive, but it is statistically significant at the 5 percent level only when comparing performance in 1981-84 with 1985-88.

13. Statistical support for the hypothesis that, given the investment ratio, the efficiency of policies affects the rate of growth of the economy is presented in Chapter 8.

14. On the role of incentives and uncertainty on exports, see R. Caballero and V. Corbo (1989), "The Effect of Real Exchange Rate Uncertainty on Exports: Empirical Evidence," *World Bank Economic Review*.

15. This result comes from the identity that investment minus saving equals imports minus exports.

16. See M. Goldstein and P. Montiel (1986), "Evaluating Fund Stabilization Programs with Multicountry Data: Some Methodological Pitfalls," *IMF Staff Papers*, Vol. 33, No. 2, pp. 314-44 for descriptions of these approaches. At the individual country level, one can also use counterfactual simulations derived from a fully specified model. The latter approach was used in V. Corbo and J. de Melo [in "External Shocks and Policy Reforms in the Southern Cone: A Reassessment in G. Calvo, et al. (editors), *Debt, Stabilization and Development*, Basil Blackwell, 1989] to assess the role of policies and external shocks in the crisis of the Southern Cone countries in the early 1980s.

17. This definition of effectiveness is used by Goldstein and Montiel (1986) and it is also used by Khan, M. (1988), "The Macroeconomic Effects of Fund-Supported Adjustment Programs: An Empirical Assessment," IMF.

18. Goldstein and Montiel (*see note 16*) outline a procedure for removing sample-selectivity bias from control group estimates when the selection of program countries is non-random. Shariff [K. Shariff (1988), "International Monetary Fund Sponsored Stabilization Programs in Africa: A Formal Framework for Evaluation," unpublished BA Thesis, Department of Economics, Amherst College], following the Goldstein and Montiel model, develops another modified control-group estimator which produces consistent estimates of program effects.

19. See J. Heckman (1978), "Dummy Endogenous Variables in a Simultaneous Equation System," *Econometrica* 46: pp. 931-60 and B. S. Barnow, G. G. Cain, and A. S. Goldberger (1981). "Issues in the Analysis of Selectivity Bias," in W. E. Stromsdosger and G. Ferkes (eds.), *Evaluation Studies Review Annual*, vol. 5, pp. 43-59. Beverly Hills: Sage.

20. This last variable was never statistically significant and therefore was excluded from the final regressions.

Chapter 3

1. Some recent empirical analyses of the poverty impacts of adjustment are by J. Behrman and A. Deolalikar (1989), "Impact of Macroeconomic Adjustment on the Poor and on Social Sectors in Jamaica," Special Supplement in OED Program Performance Audit Report on Jamaica," Report No. 8015, World Bank; M. Blejer and I. Guerrero (1988), "The Impact of Macroeconomic Policies on Income Distribution: An Empirical Study," IMF Working Paper WP/88/57, IMF; F. Bourguignon and C. Morrisson (1989), *External*

Trade and Income Distribution, Paris: OECD; F. Bourguignon,W. Branson, and J. de Melo (1988), "Macroeconomic Adjustment and Income Distribution: A Macro-Micro Simulation Model," Paris: OECD; P. Glewwe and D. de Tray (1988), "The Poor During Adjustment: A Case Study of Côte d'Ivoire," LSMS Working Paper 47, and (1989), "The Poor in Latin America During Adjustment: A Case Study of Peru," LSMS Working Paper 56, World Bank; A. de Janvry, A. Fargeix, and E. Sadoulet (1989), "Economic, Welfare, and Political Consequences of Stabilization Policies: A General Equilibrium Approach," University of California at Berkeley; N. Kakwani (1989), "Poverty and Economic Growth with Applications to Côte d'Ivoire," Welfare and Human Resources Division, World Bank, (forthcoming LSMS Working Paper); R. Kanbur (1988), "Poverty Alleviation Under Structural Adjustment: A Conceptual Framework and its Application to Côte d'Ivoire." SDA Unit, World Bank; K. Laraki (1989), "Food Subsidy Programs: A Case Study of Price Reform in Morocco," LSMS Working Paper 50, World Bank; M. Ravallion and M. Huppi (1989), "Poverty and Undernutrition in Indonesia during the 1980s," PPR Working Paper 286, World Bank.

2. See G. A. Cornia, Richard Jolly, and Frances Steward, eds. (1987), *Adjustment with a Human Face: Vol. 1, Protecting the Vulnerable and Promoting Growth,* New York: Oxford University Press.

3. Samuel Preston (1986), Review of Richard Jolly and Giovanni Andrea Cornia, eds., *The Impact of World Recession on Children,* in*Journal of Development Economics.*

4. Jere A. Behrman and Anil Deolalikar (1989), "Impact of Macroeconomic Adjustment on the Poor and on Social Sectors in Jamaica." Special Supplement in OED Program Performance Audit Report on Jamaica, Report No. 8018, World Bank.

5. The central topic of the *World Development Report 1990* (forthcoming) is poverty. This report includes additional analyses of the impact of adjustment programs on poverty.

6. An alternative classification of countries groups them into those that actually did adjust through appropriate policies, versus those with worsening policy performance in the late 1980s compared to the early 1980s. The rankings were based on changes in the quality of economic management, as evaluated by Bank staff. This classification was also examined for the data in this chapter. For the group of adjusters, per capita consumption growth was higher on average in 1985-88 than for non-adjusters; mortality improved consistently; nutrition improved throughout the 1980-86 period (data is not available after 1986); health expenditure shares were constant and education shares declined in the 1980s; real health expenditures per capita decreased on average in 1981-84 but increased in 1985-87 and real education expenditures per capita increased in both periods; immunization for polio and measles increased on average; and primary school enrollment ratios *increased.*

7. These data are from country background papers written for the *World Development Report 1990.* The change in poverty (+ or -) is sensitive to the years that are selected. In particular, if the first year selected is after the crisis of the early 1980s, then initial poverty may be high. Where possible, years were selected just prior to adjustment lending and after adjustment lending. The data for Brazil are particularly controversial because high inflation leads to unreliable price indices which are then used to adjust the poverty line.

8. Countries are categorized according to the number of loans they received (see chapter 2). Country groupings are as follows: early intense adjustment lending countries (EIAL), other adjustment lending countries (OAL), and nonadjustment lending countries (NAL). NAL- countries had an average negative per capita real GDP growth rate from 1981-88 and NAL+ countries had a positive rate. These groups are further subdivided into low-income (LIC) countries that received IDA loans in FY89 and middle-income (MIC) countries that did not receive IDA loans in FY89.

In addition to the 78 countries used in chapter 2, the following 10 countries are included in chapter 3, where data permit: OAL: Chad, Gabon, Gambia, Nepal, and Uganda; NAL: Lesotho, Mozambique, Poland, South Africa, and Yemen PDR.

The private consumption data analyzed throughout chapter 3 are from the World Bank database. They do not match the appendix of macroeconomic indicators, which uses "private consumption plus discrepancy" data.

9. See the annex to chapter 2 for a description of the methodology. Results were almost identical for per capita real consumption growth and for real consumption growth.

10. The result is statistically significant. For the period 1985-88 compared with 1981-84, the effect of programs on changes in per capita consumption growth is positive (2.5 percentage points) but not statistically significant.

11. Calculation of a nutrition index based on use of the FAO average calorie requirements for a reference man or woman in different countries has been challenged on the grounds that it wrongly assumes the same requirements for all individuals. While the use of calorie norms to estimate the global number of adequately nourished people does have serious limitations, a nutrition index can be employed to assess *changes* in nourishment over time at an aggregate level.

The calorie intake is computed by dividing the calorie equivalent of net food supplies in an economy by the population. Net food supplies comprise domestic production, imports less exports, and changes in stocks; they exclude animal feed, seeds for use in agriculture, and food lost in processing.

12. The FAO data on calorie and protein intake are only available to 1986. Data on the prevalence of malnutrition are available for a few countries in Africa up to 1987. These data reveal no systematic relationship between adjustment lending and the prevalence of malnutrition in Africa.

For Africa, there are two broad trends: for Benin (NAL), Burkina Faso (OAL), Ghana (EIAL), and Togo (EIAL) there was a rising incidence of malnutrition to 1983-84, followed by a recovery to pre-crisis levels by 1986, with some worsening in 1987 for Benin and Ghana; for Lesotho (NAL), Madagascar (EIAL), and Niger (OAL) there was a trend of rising malnutrition. Data for Latin America and Asia are more infrequent and are not comparable across countries. See United Nations (1989), "Update on the Nutrition Situation," ACC/SCN, United Nations.

13. The infant mortality rate from the World Bank database is the number of deaths per thousand for infants aged 0 to 1 year. These data are five-year averages ending in 1977, 1982, and 1987. In some cases the data are derived or interpolated from demographic models; the data, however, are not biased in a systematic way. The later discussion on child mortality uses data that are based on actual censuses.

14. The DHS data are produced by the Institute for Resource Development, Columbia, Maryland and are based on actual surveys. DHS infant mortality rates are generally much lower than those from the World Bank.

15. Cultural differences among countries in weaning practices (longer/shorter than 1 year) put newborns at risk at different times in their lives and make comparisons of infant mortality rates difficult. The child mortality rate used here is the number of deaths per thousand for children aged 0 to 5 years. This avoids the problem mentioned above, caused by the cut-off age of one year.

16. The U.N. child mortality data were carefully cleaned by Hill and Pebley to eliminate "fillers" (interpolations) and data of dubious quality and were grouped into the earlier country categories (EIAL, OAL, NAL), using those countries (only 28) for which the change in child mortality from 1970-75 to 1975-80 and 1975-80 to 1980-85 could be calculated. See Hill and Pebley (1989), "Levels, Trends, and Patterns of Child Mortality in the Developing World" (unpublished).

17. Even a reduction in total public and private expenditure on social services may not lead to an immediate reduction in the amount of services provided. For instance, a freeze on wages for doctors and teachers may not reduce services at all in the short run, although in the long run inadequate salary levels may severely reduce the quality of services. Maintaining employment and salary levels by reducing funds for equipment, drugs, school books, and other essential complementary inputs, on the other hand, could hurt the poor who rely on public social services.

18. The data are for the consolidated central government and are taken from the IMF's *Government Finance Statistics*. Countries were selected if they had social expenditure data for 1981-86. "Other" welfare expenditures include social security and welfare affairs and services, housing and community affairs and services, and recreational, cultural and religious affairs and services. The large reallocation of social sector spending in Costa Rica accounts for much of the change in the average for the EIAL countries.

19. A recent study by the IMF examined whether fiscal adjustments required by most countries since the late 1970s have led to a significant shift in expenditure priorities. The methodology was to calculate an "expected" expenditure share (of GDP) and compare this to the actual expenditure share. The "expected" shares control for demand factors (such as changes in

the population profile), technology factors, and budget constraints. For the EIAL countries, the actual expenditure shares for education in 1984-86 were 7 to 10 percent *higher* than what would have been expected. Actual health expenditures by the EIAL countries were 11 to 16 percent *higher* than what would have been expected. See Heller and Diamond (1989), "Government Expenditure Policies in the LDCs in the 1980s, International Expenditure Comparisons Revisited: 1975-86," mimeo, IMF.

20. However, there is some circularity: if education expenditure reductions cause complementary inputs (such as textbooks) to decrease, parents may remove their children from schools if they perceive education quality to have declined. Thus supply decreases can *cause* demand decreases.

21. Immunization data are from the World Health Organization, "Expanded Program on Immunization," 1989.

22. These are the findings of the *World Development Report 1990*.

23. For more details on the Bank's experience with social measures in adjustment programs see the forthcoming *World Development Report 1990*; World Bank (1989), "How Adjustment Programs Can Help the Poor," mimeo, SPR, World Bank; World Bank (1988), "Targeted Programs for the Poor During Structural Adjustment: A Summary of a Symposium on Poverty and Adjustment;" and Development Committee (1987), *Protecting the Poor During Periods of Adjustment*, Development Committee Pamphlet No. 13.

24. More specifically, since 1987 the Bank's Operational Guidelines require President's Reports to "pay particular attention to . . . an analysis of the short-term impact of the adjustment program on the urban and rural poor, and measures proposed to alleviate negative effects."

25. The data are based on an analysis of 183 SALs and SECALs to 64 developing countries. Chapter 4 explains the database.

26. For countries categorized as early intensive adjusting countries, there was no social sector reform conditionality in loan agreements in FY89. In the FY86-FY88 period, however, social sector reform conditionality in these countries was 8 percent of all conditionality in their loan agreements. This was mostly due to a few education SECALs such as in Ghana and Morocco.

Chapter 4

1. On the economics of structural adjustment, see Vittorio Corbo and Jaime de Melo, "Lessons from the Southern Cone Policy Reforms," *World Bank Research Observer*, Vol. 2 (July 1987), pp. 111-142. Stanley Fischer, "Issues in Medium-Term Macroeconomic Adjustment," *World Bank Research Observer*, Vol. 1 (July 1986), pp. 163-82.

2. The first report was based on an examination of 51 adjustment loans to 15 countries. This Chapter relies on a database on conditionality and implementation developed by Industry Development Division with support from Macroeconomic Adjustment and Growth Division. One hundred ninety-three loans to 61 countries were coded for conditionality in the loan agreement and President's Report. A subset of 97 loans to 32 countries has been coded for implementation. All of these loans had final tranche release by summer 1989. The chapter also draws upon background studies on adjustment lending in various sectors and on the political economy of adjustment.

3. The underlying data on implementation are drawn from the database coded by IENIN, with support from CECMG. The coding of implementation tried to reflect consistently the judgment of those managing and supervising the loans, who may well have incentives to give adjusting countries the benefit of the doubt. Coders did not try to correct for this or make independent assessments. The fulfillment rate for quantified or otherwise unambiguous conditions was higher than for more impressionistic conditions, where the supervisory missions had greater latitude for judgment. This suggests that the recorded evaluations are not excessively biased on average. The implementation rates in table 4.3 are about the same as those in the first report.

4. For 73 SALs and SECALs, we could compare implementation data with total external shocks over a two-year period, beginning with the year of effectiveness, and measuring shock analogously to chapter 2. For loans to countries with negative terms of trade and interest rate shocks in excess of 5 percent of GDP per year only 74 percent of conditions were implemented at least substantially, while the implementation rate averaged 89 percent with positive shocks exceeding 5 percent of GDP. With little or no improvement in external conditions, implementation averaged 83 percent.

5. This increase took place even though the EIAL countries that did little or no borrowing after 1985 had above average implementation rates before 1986.

6. Table 4.4 probably understates the negative effect of macroeconomic instability on the quality of policy reform, because loan conditions are designed to be fulfilled given some informed expectations about the likely inflation situation.

7. Demetrios Papageorgiou, Michael Michaely, and Armeane M. Choksi, 1988. "Trade Liberalization: The Lessons of Experience," Internal Discussion Paper, LAC Series, The World Bank.

8. It would be a mistake to construe these relationships in reverse. Controlling prices or keeping the nominal exchange rate from depreciating, at the expense of allowing real appreciation, are only temporary ways to hold down inflation, and they have very negative side effects on exports, savings, and growth. See chapters 7-8.

9. The first report recommended a precondition that "...there should be an understanding with the government on its overall structural adjustment program. This understanding would cover the short-term stabilization and longer-term development objectives, the macro and the micro policies, and the needed institutional changes." (p.11) Recent experiences in Yugoslavia, Turkey, Brazil, and Argentina indicate that sometimes the understanding on macroeconomic aspects of the program was not explicit enough.

10. For instance, there were seven SECALs and one SAL where the second tranche was released although inflation was over 100 percent annually during the first four quarters after effectiveness — Argentina (Export Development AL FY87, Agriculture SECAL FY84, Agriculture SECAL FY86), Mexico (Trade SECAL FY87), Turkey (SAL FY80), and Uganda (Economic Recovery FY88). In the Argentine and Brazilian cases, as well as several cases with inflation of 50-100 percent, the macroeconomic program went seriously off track in the medium term.

11. The share with IMF programs at the date of effectiveness rises to 87 percent for SALs and 66 percent for SECALs.

12. It may be more efficient for the actual construction and maintenance to be contracted out to the private sector.

13. The IMF's advice and technical assistance in the area of tax reform has often been an important input to programs supported by adjustment lending.

14. Thomas L. Hutcheson, "Political Economy of Trade Policy Reform," World Bank, February 16, 1990.

15. Papageorgiou and others (see note 6).

16. Hans Binswanger, "How Agricultural Producers Respond to Prices and Government Investments," *World Bank Economic Review.*

17. See the *Report of the Task Force on Financial Sector Operations*, 1989, R89-163.

18. Analysis of a smaller number of loans for the first report did not reveal this pattern.

19. Actions that are described as required in the President's Report but that do not appear in the Loan Agreement are effectively conditions for negotiation or Board Presentation. Not surprisingly, their implementation rates are high: 71 percent of these conditions were fully implemented and 89 percent at least substantially implemented.

20. The designation of a condition as critical was made by the coders for the ALCID. Most but not all of the conditions coded as critical were in the loan agreements. Critical conditions may include measures like tariff rate changes and tax increases, but not usually the preparation of studies.

21. Front-loading conditionality, as in one-tranche operations, can help with this problem, but only when it is technically feasible to implement the reforms quickly and when the fait accompli of reform results in political acceptance and ultimately support.

22. Merilee S. Grindle. 1989. "The New Political Economy: Positive Economics and Negative Politics" Harvard Institute for International Development. Cambridge: Harvard University. Thomas M. Callaghy. "Lost Between State and Market: The Politics of Economic Adjustment in Ghana, Zambia, and Nigeria." In Joan Nelson (ed.), *Economic Crisis and Policy Choice: The Politics of Adjustment in Developing Countries.* New Jersey: Princeton University Press, 1990.

23. Although letting crises play out their natural course has lead to more authoritarian rule on some occasions, recent experience in Bolivia, the Philippines, Argentina, Mexico, Venezuela, and Eastern Europe indicates that the political process of democratization can survive and advance during periods of economic crisis.

Chapter 5

1. Côte d'Ivoire and Nigeria, together accounting for 6.5 percent of adjustment lending, appear in both of these groups.
2. The IMF's Compensatory and Contingency Financing Facility also provided an important risk-sharing mechanism to a broad class of countriers.
3. Chapter 4 addresses these two issues.
4. The 26 countries are the largest 22 EIAL countries plus four other adjustment lending countries that had three or more adjustment loans (post-1986).
5. See "A Review of Procurement in Policy-Based Lending," Operations Evaluation Department, January 19, 1990.
6. See also "Authorized Purposes of Loans Made or Guaranteed by the Bank," Legal Memorandum of the Vice-President and General Council, SecM 88-517 (May 10, 1988).

Chapter 6

1. This chapter looks only at physical investment. It does not examine the determinants of human capital accumulation, another important factor for growth.
2. The breakdown of investment into private and public components draws on G. Pfeffermann and A. Madarassy, "Trends in Private Investment in Thirty Developing Countries," IFC Working Paper No. 6, 1989. They calculated private investment by subtracting from the national accounts data the investment of the consolidated public sector. The latter was obtained from World Bank reports and government sources.
3. W. Easterly, "Fiscal Adjustment and Deficit Financing during the Debt Crisis," in *Dealing with the Debt Crisis*, edited by I. Husain and I. Diwan, (Washington, D.C.: the World Bank, 1989).
4. On this point, see S. Van Wijnbergen: "Credit Policy, Inflation and Growth in a Financially Repressed Economy," *Journal of Development Economics* 13 (1983); and "Interest Rate Management in LDCs," *Journal of Monetary Economics* 12 (1983).
5. W. Easterly, "Fiscal Adjustment," op. cit.
6. Some empirical evidence that public investment in infrastructure is complementary to private investment is provided by M. Blejer and M. Khan, "Government Policy and Private Investment in Developing Countries," *IMF Staff Papers* 31 (1984). For the case of Mexico, complementarity is also found by A. Musalem, "Private Investment in Mexico: an Empirical Analysis," World Bank PPR Working Paper No. 183, 1989. See also B. Balassa, "Public Finance and Economic Development," World Bank PPR Working Paper No. 31, 1988.
7. Figures refer to 1987 and are taken from World Bank, "Argentina: Tax Policy for Stabilization and Economic Recovery," 1989.
8. For empirical studies on the contractionary effects of devaluation, see S. Edwards, "Are Devaluations Contractionary?", *The Review of Economics and Statistics* 2 (1986); and A. Solimano: "Contractionary Devaluation in the Southern Cone: The Case of Chile," *Journal of Development Economics* 23 (1986).
9. World Bank, *World Development Report 1988* (New York and London: Oxford University Press, 1988, box 3.5, p. 77).
10. Anne O. Krueger. *Trade and Employment in Developing Countries: Synthesis and Conclusions*, (Chicago: NBER, 1983).
11. World Bank, *Sub-Saharan Africa: from Crisis to Sustainable Growth* (1989, p. 145).
12. See R. Pindyck, "Irreversibility, Uncertainty and Investment," World Bank PPR Working Paper No. 183, 1989.
13. See R. Dornbusch, "From Stabilization to Growth," MIT, 1989. A survey on this and related topics is presented in L. Serven and A. Solimano, "Private Investment and Macroeconomic Adjustment: An Overview," World Bank PPR Working Paper No. 339, 1989.
14. On these topics, see M. Kiguel and N. Liviatan, "Inflationary Rigidities and Orthodox Stabilization Policies," *The World Bank Economic Review* 3 (1988); and A. Solimano, "Inflation and the Costs of Stabilization: Country Experiences, Conceptual Issues, and Policy Lessons," World Bank PPR Working Paper No. 226, 1989, also *The World Bank Research Observer*, July 1990 (forthcoming).
15. Credibility introduces an externality that creates a wedge between the social and private returns on investment. In fact, higher aggregate investment helps sustain the adjustment and therefore results in higher returns on investment, a mechanism that the individual investor will, however, ignore.

16. For a thorough discussion of these issues, see World Bank, *Sub Saharan Africa: from Crisis to Sustainable Growth*, op. cit. See also G.M. Meier and W.F. Steel, eds., *Industrial Adjustment in Sub-Saharan Africa* (Oxford University Press, 1989).

Chapter 7

1. J.C. Lerda and J. Marshall, "La Crisis Fiscal en America Latina: Sintesis Preliminar acerca de su Origen y Desarrollo," ECLAC manuscript, 1989, for Argentina, Bolivia, Chile, and Venezuela; and World Bank data for Zimbabwe. For a practical way of measuring central bank quasi-fiscal losses, see M.O. Teijeiro, *Central Bank Losses: Origins, Conceptual Issues, and Measurement Problems*, PPR Working Paper No. 293 (Washington, D.C.: World Bank, 1989).
2. Public saving and the deficit are directly linked: the public deficit is defined as public investment minus public saving.
3. Lerda and Marshall, op. cit.
4. M. Kiguel and N. Liviatan, "The Inflation-Stabilization Cycles in Argentina and Brazil," World Bank, Washington, D.C., 1989, for Argentina; and World Bank data for India, Pakistan, and Zimbabwe.
5. For a recent review of financial systems and financial liberalization in developing countries, see the World Bank, *World Development Report 1989* (Oxford University Press, 1989).
6. This policy prescription is taken from R. McKinnon, *Money and Capital in Economic Development* (Washington, D.C.: Brookings Institution, 1973), and E.S. Shaw, *Financial Deepening in Economic Development* (New York and London: Oxford University Press, 1973).
7. Among the growing evidence on the interest-insensitivity of saving in developing countries see, for instance, A. Giovannini, "Saving and the Real Interest Rate in LDCs," *Journal of Development Economics* 18 (1985). For an alternate view, see M.J. Fry, *Money, Interest and Banking in Economic Development* (Baltimore: Johns Hopkins University Press, 1988) and the survey by B. Balassa, "The Effects of Interest Rates on Saving in Developing Countries" (Washington, D.C.: World Bank, 1989).
8. R. J. Barro, "Are Government Bonds Net Wealth?", Journal of *Political Economy* 82 (1974), raised the possibility that the private sector would reduce its saving to offset exactly any increase in tax payments aimed at cutting the public deficit. This hypothesis, suggested initially by David Ricardo, has been widely rejected in empirical studies for industrialized countries. P. Montiel and N.U. Haque, "Ricardian Equivalence, Liquidity Constraints, and the Yaari-Blanchard Effect: Tests for Developing Countries," IMF Working Paper (1987), reject the Ricardian equivalence proposition for fifteen of a sample of sixteen developing countries.
9. A recent study found that the saving rate in a group of countries with the least generous tax provisions for deductions of interest paid on consumer credit was on average almost three times that of the group of countries with the most generous provisions. See V. Tanzi, "The Tax Treatment of Interest Incomes and Expenses in Industrial Countries: A Discussion of Recent Changes," *Proceedings of the 80th Annual Conference*, (Columbus, Ohio: 1988).
10. S.F. Venti and D.A. Wise, "IRAs and Saving," in M. Feldstein (ed.), *The Effects of Taxation on Capital Accumulation* (Chicago: Chicago University Press, 1987).
11. This is consistent with the evidence in Box 7.2, which shows that the saving rate increases with the trend level of household income.
12. National saving equals domestic saving plus net factor income plus current transfers from abroad. Therefore, higher net payments abroad (in domestic resource units) directly affect only national saving, while consumption affects both national and domestic saving.
13. R. Dornbusch, "Capital Flight: Theory, Measurement and Policy Issues," manuscript (Massachusetts Institute of Technology, Cambridge, Mass., 1989).
14. However, one should consider that the relation and causality between national and foreign saving depends on the foreign credit regime. If countries have free access to voluntary foreign lending (as observed in many developing countries during the late 1970s and up to 1982), national saving behavior could determine foreign credit flows. Under restricted access to foreign loans (as frequently observed after 1982), credit inflows tend to affect national saving.
15. H. Chenery and A. M. Strout, "Foreign Assistance and Economic Development," *American Economic Review* 56 (1966), found this positive long-run effect.
16. See in particular S. Collins, "Savings Behavior in 10 Developing Countries," NBER Con-

ference on Savings, Maui, 1989, and A. Mason, "Saving, Economic Growth, and Demographic Change," *Population and Development Review* 14 (1988).

Chapter 8

1. A working definition of capital flight is that it consists of capital outflows that cannot be explained by "normal" portfolio diversification. This definition is similar to that presented by D.R. Lessard and J. Williamson, *Capital Flight and the Third World Debt* (Washington, D.C.: Institute of International Economics, 1987).
2. See for example, J.T. Cuddington, *Capital Flight: Estimates, Issues and Explanations*, Princeton Studies in International Finance No. 58. (Princeton, N.J.: Princeton University Press, 1986); M.P. Dooley, "Capital Flight: A Response to Differences in Financial Risks," *IMF Staff Papers* (Sept. 1988): 422-436; Dooley et al., "An Analysis of External Debt Positions of Eight Developing Countries Through 1990," *Journal of Development Economics* 21 (May 1986); D.R. Lessard and J. Williamson, *Capital Flight and the Third World Debt*, op. cit.; and J. Williamson and D.R. Lessard, "Capital Flight: The Problem and Policy Responses" (Washington, D.C.: Institute for International Economics, 1987).
3. Based on M.P. Dooley et al., "An Analysis of External Debt," op. cit. Capital flight in Argentina during 1980 and 1981 and in Venezuela in 1982 and 1983 represented over 50 percent of domestic saving. In Mexico the share was smaller—closer to one fourth of domestic saving.
4. See, for example, J.T. Cuddington, "Capital Flight," op. cit., and R. Dornbusch "Capital Flight: Theory, Measurement and Policy Issues" (Cambridge, Mass.: Massachusetts Institute of Technology, 1989).
5. See, for example, World Bank, *World Development Report 1989* (New York and London: Oxford University Press, 1989).
6. The empirical findings and references to other empirical studies are contained in W. Easterly and D. Wetzel, "Policy Determinants of Growth: Survey of Theory and Evidence," background paper for this report; see also B. Balassa, *Public Finance and Economic Development*, PPR Working Paper No. 31 (July 1988); R.J. Barro, *A Cross-Country Study of Growth, Saving and Government*, NBER Working Paper No. 2855 (Cambridge, Mass.: National Bureau of Economic Research, 1989); and P.M. Romer, "Cross-Country Determinants of the Rate of Technological Change," background paper for this report.
7. G. Lloyd Reynolds, *Economic Growth in the Third World, 1850-1980* (New Haven, Conn.: Yale University Press, 1985), p. 148 (Burma), p. 100 (Mexico), p. 115 (Colombia).
8. K.S. Lee and A. Anas, "Manufacturers' Responses to Infrastructure Deficiencies in Nigeria: Private Alternatives and Policy Options," INU Discussion Paper No. 50 (Washington, D.C.: World Bank, 1989).
9. See especially B. Balassa, "Development Strategies and Economic Performance," *Development Strategies in Semi-Industrialized Economies* (London: Oxford University Press, 1982); A. O. Krueger, *Liberalization Attempts and Consequences* (Cambridge, Mass.: National Bureau of Economic Research, 1978); M. Michaely, "Trade Liberalization Policies: Lessons of Experience," paper presented at the Conference "For a New Policy Towards Foreign Trade," Brazil, April 1988; J.N. Bhagwati, "Export-Promoting Trade Strategy: Issues and Evidence," *The World Bank Research Observer* 1 (January 1988); World Bank, *World Development Report 1987*, op. cit.; World Bank, "Trade Policy Review" (Trade Policy Division, Washington, D.C., 1989).
10. Reynolds, "Economic Growth," op. cit.
11. The classification of trade policy is from World Bank, *World Development Report 1987*, op. cit.
12. Reynolds, "Economic Growth," op. cit., p. 90 (Argentina), p. 96 (Brazil), p. 119 (Colombia).
13. See especially A. Gelb, "A Cross-Country Analysis of Financial Policies, Efficiency and Growth" (Financial Policy Division, World Bank, Washington, D.C., 1989); World Bank, World *Development Report 1989*, op. cit.; B. Balassa, "Financial Liberalization in Developing Countries," background paper for the *World Development Report 1989*; and W. Branson and S. Schwartz, "Financial Markets and Investment Efficiency," background paper for this report.
14. World Bank, *World Development Report 1989*, op. cit., p. 59.
15. World Bank, *Sub-Saharan Africa: From Crisis to Sustainable Growth* (Washington, D.C., 1989).
16. Reynolds, "Economic Growth," op. cit.
17. R.C. Kormendi and P.G. Meguire, "Macroeconomic Determinants of Growth: Cross-Country Evidence," *Journal of Monetary Econom-*

ics 16 (1985): 141-163; Gerald Scully, "The Institutional Framework and Economic Development," *Journal of Political Economy* 96, no. 3 (June 1988).

18. The details are presented in W. Easterly, "Policy Distortions, Size of Government, and Growth," PPR Working Paper No. 344 (Washington, D.C.: World Bank, 1989).

19. World Bank, *World Development Report 1988* (New York and London: Oxford University Press, 1988), p. 85.

20. J.G. Ballentine and H. Galper, "The Practical Importance of Tax Distortions," background paper for the *World Development Report 1988*.

21. World Bank, *World Development Report 1988*, op. cit., pp. 91-92.

22. World Bank, *World Development Report 1989*, op. cit., p. 56.

23. World Bank, *World Development Report 1988*, op. cit., p. 85.

24. Reynolds, "Economic Growth," op. cit., p. 239 (Uganda), p. 248 (Tanzania).

25. World Bank, Sub-Saharan Africa, op. cit., p. 10.

26. This is the well-known "Laffer Curve" phenomenon.

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