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and Growth

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The Macroeconomic Underpinnings of Adjustment Lending

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and
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Macroeconomic policy and sequencing issues increasingly have been addressed explicitly in the design of recent adjustment loans, but there still is scope for: (1) strengthening the analytical framework and macroeconomic policy conditionality in adjustment loans, and (2) greater realism about the time and external resources needed to achieve adjustment and growth objectives.

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This paper is a product of the Macroeconomic Adjustment and Growth Division, Country Economics Department. It was prepared as part of a larger effort in PRE to assess the World Bank's experience with adjustment lending and was a background paper for the Bank's Report on *Adjustment Lending II: Policies for the Recovery of Growth*, submitted to the Bank's Board on March 6, 1990. The paper deals with the theoretical macroeconomic underpinning of adjustment programs and presents the results of empirical work on the design and implementation of Bank-supported adjustment loans. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Aludia Oropesa, room N11-019, extension 39075 (41 pages with tables).

Drawing on conditionality and implementation information for 184 World Bank adjustment loans to 62 countries during the1980s, Jaspersen and Shariff examine the macroeconomic underpinnings of Bank-supported adjustment programs. They conclude that macroeconomic policy reform and improved macroeconomic performance are critical to successful implementation and sustainability of structural reform.

Reducing macroeconomic imbalances is especially important for trade reform. If inflation is not reduced to a manageable level, there is a danger that the exchange rate will be used as a nominal anchor for domestic prices. If sustained over a long period, this may precipitate a balance of payments crisis and make it impossible to liberalize trade.

Reducing macroeconomic imbalances also has an important bearing on implementation of sectoral reforms. To the extent that the government cannot reduce its fiscal deficit by increasing its own savings, there is a greater likelihood that it will cut investment in infrastructure to support sectoral restructuring. Prolonged high real rates of interest that result from unsuccessful stabilization efforts can hurt private investment and the restructuring of sectoral production. If fiscal imbalances have not been eliminated before liberalizing the financial system, it is likely that the government will continue to rely on administrative controls to finance the public sector deficit, undermining financial sector reform.

Analysis of the Bank's adjustment loans indicates that macroeconomic conditionality has been relatively important — and has increased over time. Fiscal policy, including public expenditure reform, has been an important focus of the Bank's adjustment lending. Relatively less emphasis has been given to monetary and exchange rate policies which have been a central focus of IMF programs. Implementation of supply-side sectoral policies has been strongly affected by macroeconomic performance. Where macro balance has not been reestablished, implementation rates have been lower for all conditions. Where progress in eliminating imbalance is taking place, reform inertia has strengthened even after loan disbursement has been completed.

Loan design has also been an important determinant of implementation and sustainability of reform. Where issues of sequencing have been built into the design of adjustment programs, the implementation of sectoral reform has been stronger. Adjustment loan conditions which are precisely defined and legally binding for tranche release have had the highest rates of implementation. For adjustment loans with a large number of conditions, implementation has been highest for the "core" conditions that have been the most critical for success of the program.

After looking at recent experience with macroeconomic conditionality, the authors conclude that macroeconomic policy and sequencing issues increasingly have been addressed explicitly in the design of recent adjustment loans, but there still is scope for: (1) strengthening the analytical framework and macroeconomic policy conditionality in adjustment loans, and (2) greater realism about the time and external resources needed to achieve adjustment and growth objectives.

THE MACROECONOMIC UNDERPINNINGS OF ADJUSTMENT LENDING

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This report was prepared as a background paper for RAL2 by Fred Jaspersen and Karim Shariff. Jaume Ventura provided useful comments and Fernando Garcia provided valuable research assistance. Section III of this paper is based on the data base developed and maintained by the Industry Development Division in PRE. William Steel, Debbie Bateman, Diane Cougan and Mala Hettighe were especially helpful in providing this information.

THE MACROECONOMIC UNDERPINNINGS OF ADJUSTMENT LENDING

I. Introduction: Support of Macroeconomic Objectives Under Adjustment Lending (AL)

One feature of quick-disbursing adjustment lending which distinguishes it from investment lending, which disburses more slowly, is its greater capacity to transfer hard currency resources. Adjustment loans maximize the present value of net transfers from the Bank to the recipient country for a given level of commitment. For this reason adjustment lending is the most appropriate instrument for assisting a country which is experiencing balance of payments problems. In the absence of external imbalance or if such imbalance is the consequence of a transitory terms of trade shock which does not require a re-alignment of macroeconomic policies (i.e., the shock is short-lived and can be covered out of reserves or by short-term, compensatory borrowing), there is no strong rationale for the Bank to employ adjustment lending rather than investment lending since the latter is generally more effective where macroeconomic objectives are not of high priority and where shorter-term compensatory financing is available from other sources. If the external shock is permanent, or the balance of payments problem is the consequence of internal imbalance stemming from mismanagement of domestic macroeconomic policies in the first place, and there is a need to reorient such policies, adjustment lending may be more appropriate.

It is for this reason that the Bank has emphasized that given the quick- disbursing nature of adjustment lending, it is important that there be "a clear and documented understanding with the government on its overall structural adjustment program, including short-term stabilization as well as longer-term development objectives".[1] To ensure this, the Bank has recommended in the two recent reports on adjustment lending that a more explicit and monitorable approach be taken for Board presentation and subsequent tranche release. In particular, "both should be dependent on a documented management judgment that appropriate action was being taken to reduce external and internal financial instability." This judgment, it was noted, "should take into account evidence of actual performance as indicated by available short-term economic and financial indicators and also by the progress recently made in adopting relevant reforms indicated in the general understanding on the country's adjustment program. The judgment and supporting evidence would be included in the President's Report for proposed adjustment loans and in the notification to the Board of all subsequent tranche releases."

The reports on adjustment lending have also noted the circumstances which would tend to increase the likelihood that a government's program be implemented over the medium-term. One such circumstance is that "the government publicly propose and justify the overall strategy of the adjustment program." Without this, it was agreed, the risk of weak implementation and subsequent reversal would be high.

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[1] This approach is to be monitored for 18 months starting in September 1988, after which management would reassess its adequacy with respect to improving performance.

Similarly, it was emphasized that adjustment programs need to be realistic. They hav to be "restrictive enough to be consistent with the financing available, but not so restrictive that it is likely to prove socially and politically unacceptable and therefore unsustainable." This is especially important for countries with a large external debt overhang.

Greater realism was recommended in two additional areas: fuller recognition of (a) the effects of the global economic environment; and (b) the time that might be needed for supply responses. While improved economic performance over the medium-term is clearly a major objective of adjustment lending, unexpected external and internal shocks can adversely affect performance. There are also response lags following policy reform which are ex ante of uncertain duration that will determine the timing of the impact on actual economic performance. It is for these two reasons that policy (and not performance) conditionality is called for. Only over the medium-term would the Bank look for and require as a condition an improvement in performance. In a series of adjustment operations, the policy reform agenda would of course be adjusted in response to economic performance and progress in achieving program objectives.

The most recent report on adjustment lending concluded that the relative macroeconomic performance of AL countries was better than that of those which had not received such loans despite the fact that the former suffered greater external shocks. The exception to this general finding was the Sub-Saharan Africa (SSA) and highly-indebted countries (HICs), where improvement in relative performance between adjustment lending recipients and non-adjustment lending countries is weak. It was concluded that while the SSAs and the HICs had been successful in reducing their external current account deficits after adjustment lending had been initiated, internal imbalances were greater and there was no significant progress toward resumption of adequate growth (in the absence of adjustment programs, of course, this situation is likely to have been much worse). Changes, not only in the design of adjustment programs and their implementation, but also in the existing debt strategy were recommended.

Concerns have been expressed at Board discussions in recent years over Bank initiatives in the macroeconomic area which might duplicate Fund activities. Staff have clarified that because of the requirements of structural adjustment, the Bank has, of necessity, become increasingly concerned with a wide range of macroeconomic issues. Because the success of its adjustment lending will, to a considerable extent, be determined by the existence of a stable macroeconomic environment, the Bank must evaluate the macroeconomic policy framework within which such lending is taking place. Moreover, the Bank as a market-based institution must be concerned with the creditworthiness of IBRD borrowers and must assess their macroeconomic management. The recent agreement between the Bank and the Fund acknowledges explicitly the importance of these issues to the Bank (see paragraph 10, R89-45 of March 31, 1989).

This paper assesses the Bank's experience supporting improved macroeconomic management through adjustment lending. It attempts to draw conclusions about the macroeconomic framework for such lending and about the design and implementation of macroeconomic conditionality in adjustment lending.

Section II presents a conceptual framework for macroeconomic policy under adjustment lending which links stabilization, adjustment and, where relevant, debt reduction. It describes the linkages between macroeconomic policies, i.e., expenditure-reducing policies, expenditure-switching policies, and supply-side policies, and the sequencing of reforms at different stages of the adjustment process. It concludes by placing the macroeconomic objectives of adjustment within the context of a taxonomy of program design for a typical adjustment operation.

Section III focuses on the Bank's experience with the design and implementation of macroeconomic conditionality in 184 adjustment loans to 62 AL countries during the past decade. It identifies some of the key operational issues concerning the macroeconomic framework for these loans and draws conclusions about how the Bank can more effectively support improved design and implementation of this framework.

Section IV examines for macroeconomic content a sample of 23 adjustment operations carried out by the Bank in FY89, the most recent year for which data is available. It identifies those FY89 operations which illustrate "best practice" Bank-wide in supporting improved macroeconomic policy management. It concludes with a summing up of the major issues faced by the Bank in such operations.

II. The Conceptual Framework of Adjustment: Program Design - A Taxonomy of Adjustment Policies

Stylized Facts

During the 1970s and early 1980s many of the countries which became candidates for Bank adjustment lending were pursuing expansionary demand management policies. Such countries typically had large fiscal deficits, rapid monetary expansion, accelerating inflation, unsustainable current account deficits and a large stock of external debt. In a number of these the cumulative effects of weak institutions and policy-induced distortions in factor and goods markets had created rigidities in these countries' economies reducing their capacity to adjust to external shocks.

Distortion-inducing policies included price controls, over-valued exchange rates, administrative controls on interest rates which resulted in negative real rates of interest, and large fiscal deficits. Fiscal deficits were in many cases the consequence of external shocks, but also of unsustainable high levels of government spending, inelastic tax systems, direct subsidies to state enterprises, indirect subsidies to consumers through reduced prices of goods and services provided by the public sector, and of high interest payments on external and internal debt.

Distortions created by these policies were frequently compounded by a trade regime which relied heavily on quantitative restrictions to protect domestic industry and by administrative controls at the sectoral level. Distortions in the financial sector, frequently the consequence of macroeconomic imbalances, were especially serious because of their far-reaching adverse impact on the allocation of resources throughout the economy.

Figure 1 shows a typical country where adjustment is required. Policy-induced distortions result in the economy operating below the production possibility frontier (PPF). The level of expenditure (E) exceeds current production (Y). The result is an "ex ante" excess demand for both tradables (T) and nontradables (N). The former results in a current account deficit equal to T_pT_c. The latter gives rise to an increase in the price of nontradables (P_n) in absolute terms and relative to prices of tradables which are determined in world markets. The rise in the price of nontradables will lead to a real appreciation of the exchange rate.

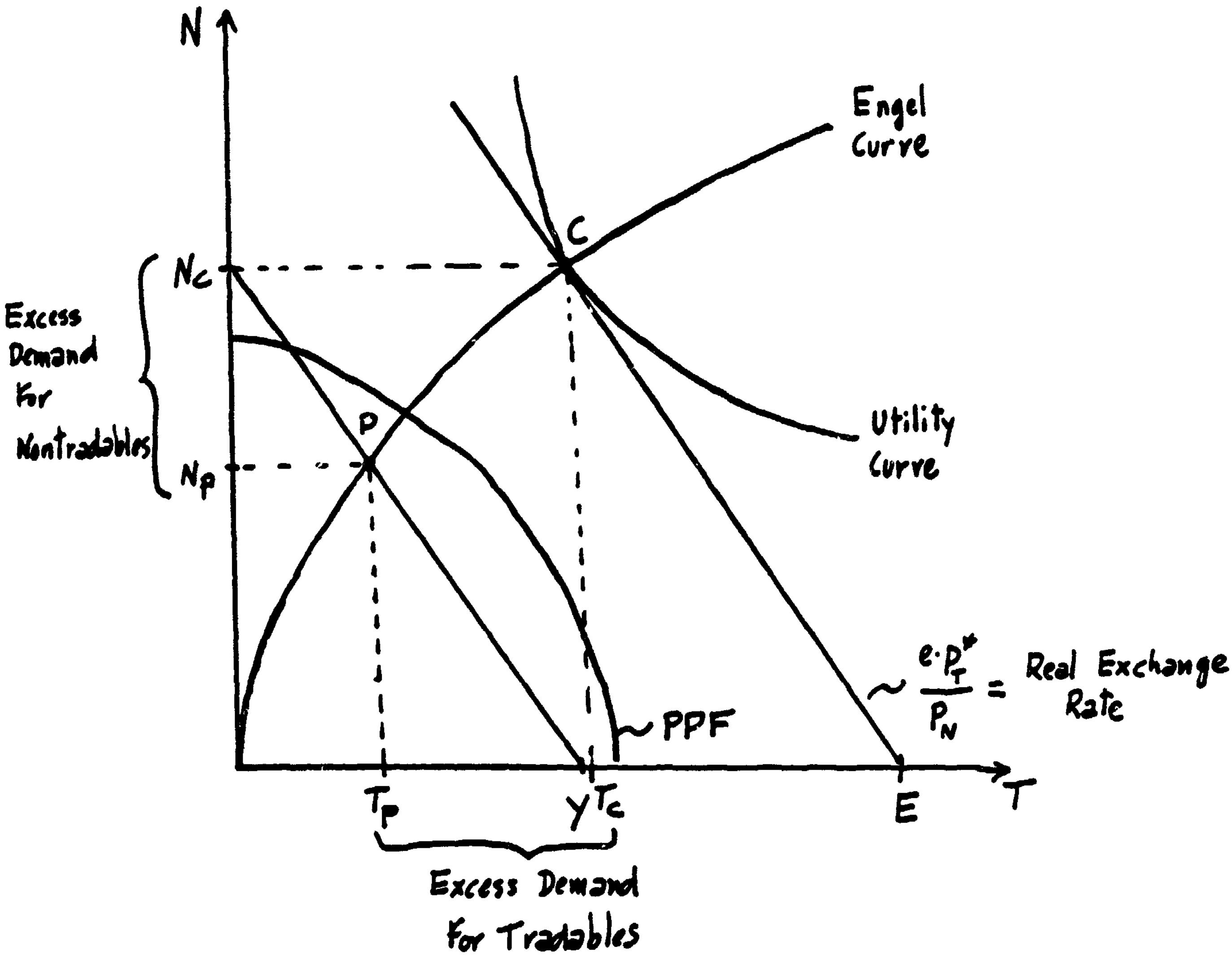
If the resulting current account deficit can be financed -- either by borrowing abroad or by reducing reserves, the real appreciation will stick, switching expenditure from nontradables to tradables and switching production from tradables to nontradables. The consequence is that the excess demand for nontradables will be corrected at the expense of a larger current account deficit. There will be no inflation, only a once-for-all rise in the price of nontradables. If external funds are not available, the nominal exchange rate will depreciate offsetting the increase in the price of nontradables and thereby preventing the real appreciation. In this second case, as long as the excess demand persists, a process of continuous devaluation and inflation will take place. This is the current situation in many of the countries that are now receiving ALs.

For a country in this situation adjustment involves two actions. On the one hand, aligning aggregate demand and aggregate supply, that is, stabilizing the economy. On the other hand, bringing about structural changes that increase the level of efficiency and flexibility of the economy. Typically, a structural adjustment program has three objectives: (a) a reduction of aggregate demand; (b) a change in relative prices and (c) an increase in output.

Reduction of Aggregate Demand

Although in the medium-term the objective is to "grow" out of the crisis, it is not usually possible to raise production enough to correct the initial excess demand. The removal of distortions may even have a negative initial impact on income if rigidities have built-up in the economy. Therefore, the major emphasis in the short run will fall on reducing expenditure. Adjustment lending facilitates this in two ways. First, adjustment programs become more politically acceptable because expenditures will not have to be cut as much as would be the case in the absence of such lending. Second, acceptable investment levels can be achieved during the adjustment period.

Figure 1


N
Engel Curve
C
N_C
Excess Demand for Nontradables
P
Utility Curve
N_P
$\frac{e \cdot P_T^*}{P_N}$ = Real Exchange Rate
PPF
T_P
Y
T_C
E
T
Excess Demand for Tradables

To succeed, expenditure reduction must be selective. Too large a reduction in investment jeopardizes the prospects for future growth. Too large a reduction in private or public consumption imposes an unacceptable social cost and may be politically difficult to implement. A careful balance among the different objectives has to be achieved.

The conventional tools for managing aggregate demand are fiscal and monetary policy. The fiscal deficit found in most AL countries is the major element explaining the initial excess of demand which made the program necessary. A reduction in this deficit is usually central to an adjustment program. If this is achieved, it is possible to reduce the rate of growth of monetary aggregates and bring aggregate demand more in line with aggregate supply. Tight monetary policies must not be overdone, however, since excessively high real interest rates are incompatible with resumption of private investment and growth.

Change in Relative Prices

To complement aggregate demand reduction, policies aimed at bringing about a change in relative prices will help to restore internal balance and moderate the decline in expenditure. By increasing the relative prices of tradable goods to non-tradable goods through a real depreciation of the currency, resources are reallocated or "switched" from the non-tradable goods sector, where there is excess supply, to the tradable goods sector, where they can produce for export or substitute imports. However, prior to the devaluation, it is important to look at the impact that other measures of the adjustment package will have on relative prices. Only after this is done can the amount of depreciation of the nominal exchange rate be determined. Changes in relative prices should be as smooth as possible. Overshooting of the nominal exchange rate (as well as undershooting) should be avoided.

Increase in Output

To the extent that output can be increased by exporting exports and increasing production of import substitutes, the decline in expenditure can be less, or perhaps avoided altogether. There are two ways of doing this: First, by using more efficiently the existing stock of factor inputs by removing distortions. Reforms directed at removing these distortions have been a main concern of the Bank's ALs. Second, by increasing the current stocks of factors of production, i.e., the attainment of a reasonable rate of capital accumulation. A crucial objective of the AL programs is to ensure that an investment level is attained which is compatible with an acceptable rate of growth over the medium-term.

Debt Reduction

Efforts to reduce macroeconomic imbalance have been complicated for countries with a large external debt. For such countries closing the gap between aggregate demand and supply has required a large fall in real expenditure despite efficiency improvements. Because external debt in most of the high debt countries is in large part public sector debt, servicing this debt has aggravated existing fiscal weakness adding to macroeconomic imbalance. For those high debt countries which have lost access to foreign capital markets, there is a need to manage their budgets under tight external financing constraints. Excessive reliance on domestic borrowing has in many of these countries caused real interest rates to rise thereby crowding out private investment. Where governments have relied more on money creation, this has resulted in increased inflation and, in the absence of increased private financial savings, caused foreign exchange reserves to fall.

High levels of external debt service have worsened existing rigidities on the expenditure side (frequently the consequence of a bloated public sector wage bill), thereby further reducing the government's room for maneuver to reduce the fiscal deficit. The consequence is that public sector investment has generally born the brunt of the adjustment. The deterioration of infrastructure and public sector service which has resulted, has had an adverse impact on output further complicating the adjustment process. Viewed from another perspective, interest payments abroad on external debt have reduced national savings, which in the absence of foreign savings have been a binding constraint on investment and growth. For countries in this situation it becomes difficult to restore macroeconomic balance and sustainable economic growth while servicing their external debt. Debt reduction complements the adjustment policies described in the previous section.

Supply-Side Structural Reforms and Efficiency

The typical adjustment lending country faces policy-induced distortions which limit factor productivity, reduce domestic and foreign competition, and prevent goods prices from reflecting their opportunity cost. Such distortions are generally the result of weak institutions and inappropriate policies. Supply side structural reforms aimed at increasing efficiency and reestablishing adequate growth are focused on strengthening incentives and reducing constraints on factor mobility. Empirical work carried out for this paper suggests that such reforms are unlikely to be as successful in countries experiencing large macroeconomic imbalances and financial instability.

Success in eliminating macroeconomic imbalances seems to be an especially important determinant of the survivability of trade liberalization. If stabilization efforts are unsuccessful in reducing inflation, the Government may, out of desperation, use the nominal exchange rate as an anchor for domestic prices[2]. In such cases the real exchange rate will appreciate rapidly if domestic prices continue to rise. If this persists, it may eventually lead to a balance of payments crisis which ultimately undermines liberalization of the trade regime. Where governments are unsuccessful in stabilizing the domestic economy, the real exchange rate is allowed to appreciate and inflation continues at relatively high rates, the real interest rate is likely to rise to excessively high levels. This may reduce investment

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2 In 21 stabilization episodes of AL countries the real exchange rate appreciated in 10 of them (see Jim Nash, Trade Policy in Adjustment Lending, 1989, background paper for RAL2).

and prevent the restructuring of the economy in response to trade policy reform which is necessary if the liberalization is to be successful. Finally, if the government is not successful in reducing the fiscal deficit, sustainability and deepening of trade reform may be jeopardized since there will be pressure to overturn tariff liberalization which results in a loss of import tax revenue[3].

Sectoral reforms also depend heavily on reduction of macroeconomic imbalances. The more unsuccessful the government's fiscal deficit reduction effort, the greater the likelihood that public investment in infrastructure which complements sectoral restructuring will be cut. Macroeconomic instability is generally associated with an appreciating or volatile real exchange rate. When the real exchange rate discriminates against tradables or is unstable, sectoral output, profitability and reforms are likely to be adversely affected. Excessively high real rates of interest which are generally associated with unsuccessful stabilization efforts or programs which lack credibility, can have serious adverse consequences for restructuring of sectoral production and ultimately on the sustainability of sectoral reform.

Financial sector reform has also been difficult to carry out in countries experiencing acute macroeconomic imbalance. While macroeconomic instability may have underscored the shortcomings of the financial sector, thereby helping to focus the government's attention on the need for financial sector reform, the high real interest rates which have generally followed liberalization, have generated financial distress among borrowers which in turn has eroded the financial viability of financial institutions leading to a roll-back of liberalization efforts. Protracted excessively high real rates of interest have also complicated macroeconomic management in the short-term by increasing the interest burden of government's domestic borrowing and in the medium-term by requiring an infusion of government resources to shore up the financial system. These adverse effects of high real rates of interest on macroeconomic management and on the financial system itself has led the Bank to place more emphasis on rationalization rather than on decontrol of interest rates.

Efforts to liberalize the financial system before the government succeeds in stabilizing the domestic economy are unlikely to be successful for other reasons. Where the government has failed to bring an underlying fiscal problem under control for a prolonged period, the authorities have generally channeled resources from the financial system to the Government through direct controls which have undermined the viability of the financial system. If the fiscal imbalance has not been eliminated prior to liberalization of the financial system, it is likely that the government will continue to rely on administrative controls to finance the public sector deficit thereby undermining financial sector reform. If the financial system is dominated by government-owned banks and the government controls interest rates directly through its shareholder power in the commercial banks, there will be a further undesirable reduction in the monetary policy role of the Central Bank in favor

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[3] Jim Nash, Trade Policy in Adjustment Lending, 1989.

of the Ministry of Finance. The clear lesson of experience is that far-reaching financial sector liberalization can survive only within the context of macroeconomic stability.

Adjustment Program Design

The following taxonomy classifies adjustment policies according to their principal objective. This classification is used in the next section to assess the relative importance and implementation performance of macroeconomic adjustment policies.

Adjustment Program Design

I. Absorption Reduction Policies

- Fiscal Policy (deficit reduction targets)
- Monetary Policy (money supply targets)

II. Expenditure-Switching Policies

- Exchange Rate Policies
- Wage Policy

III. Supply-Side-Growth Oriented Policies

- Trade Policies
- Sectoral Policies
  - Industry
  - Energy
  - Agriculture
- Financial Sector Reforms
- Rationalization of Government Finance & Administration
- Public Enterprise Reforms
- Social Policy Measures

III. Implementation of Macroeconomic Conditionality In Bank-Supported Adjustment Programs: 1980-89

This section analyzes the Bank's experience with implementation of macroeconomic conditionality in Bank-supported structural adjustment programs. It focuses on the design and implementation of such conditionality in 184 adjustment loans to 62 countries during 1980-89[4]. Specifically, it considers the macroeconomic prerequisites for structural reforms, emphasizing the importance of an appropriate sequence and mix of macroeconomic and supply-side policies to achieve internal balance, external balance and growth-oriented adjustment.

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[4] For a discussion of the methodology see the Appendix.

Background

The Bank began its lending for structural adjustment in 1980. Although at first expected to be short-lived, adjustment lending increased to 31% of the Bank's total lending commitments in FY89. The scope of adjustment lending also widened with the introduction of sectoral adjustment loans (SECALs) which account for almost all of the increase in adjustment lending since FY82. Increasingly, Structural Adjustment Loans (SALs), which contain comprehensive macroeconómic policy conditionality, gave way to more narrowly focused SECALs; increasingly SECALs themselves have included macroeconomic conditionality. In FY89, the Bank undertook 35 adjustment-lending operations, of which 27 were SECALs.

Since 1980, 62 countries have received adjustment loans from the Bank. Because adjustment is a process which in most countries takes a number of years, and because subsequent stages of the process cannot be initiated until the objectives of earlier stages have been substantially achieved, a country will generally need a series of operations, each supporting specific policy actions.

Nature of Bank Conditionality and Implementation

A typical adjustment loan disburses in two tranches. Some conditions are required for effectiveness, some for second tranche release, and some are included as special covenants which are not binding for tranche release. Conditions of disbursement relate to policy instruments that target specific objectives. For example, expenditure and production switching policies encourage both exports and efficient import substitution by raising the domestic price of tradables relative to the price of non-tradables. These policies taken together are designed to reduce macroeconomic imbalance, to improve efficiency, to strengthen institutions and to mobilize additional resources for investment. While conditionality had initially been based on the premise that policies which reduce macroeconomic imbalances and price distortions will stimulate savings, contribute to increased investment, and accelerate growth, the weak growth performance of adjustment-lending countries has heightened awareness that other measures are also needed. These include institutional reforms, programs aimed at reducing the uncertainty associated with the adjustment which private investors face, specific investments aimed at alleviating real constraints in the economy, and where necessary, debt reduction. Each AL with its broad mix of policies is placed within the context of a country's own reform program, which itself is broader and generally includes some elements supported by the Fund.

There is a high degree of variability among conditions with regard to their specificity. The Bank has moved to using more specific conditions, partly guided by experience. More specific conditions have higher implementation rates. The average number of actions has almost doubled from about 30 in FY79-85 to 56 in FY89. About one-third of all actions are legally required and are conditions which appear in loan agreements. The remainder are listed only in the President's Reports. While more than a quarter of all policy actions are precisely specified -- only 10% of the actions are precise and included in the loan agreement, an average of about four conditions per loan.

The data on implementation which is presented in this section indicates the extent to which a condition was fulfilled during the lifetime of a loan. Of the 184 loan sample, only 97 loans have been in place long enough to make it possible to assess the experience with implementation. The sources of information on implementation were mainly Supervision Reports, Tranche Release Documents, and where available, Project Completion Reports and Program Performance Audit Reports. These sources were supplemented by additional information obtained from Bank staff familiar with the country's adjustment program.

While the process of coding conditionality is straightforward, the process of coding implementation is more complex. Progress in implementing each item of conditionality during the period of the loan was classified as: (a) little or no progress; (b) partial progress; (c) substantial progress (substantial steps taken to move progress more than half-way);
(d) implementation fulfilled; and (e) implementation more than fulfilled.

Macroeconomic Conditionality in Program Design

Because of the importance of complementary reforms in different policy areas, recent ALs address a wide variety of policy areas as they did when SALs were dominant. Macroeconomic conditionality defined as demand management or absorption reduction and switching policies has been relatively important in adjustment loans. Table 3.1 indicates that for all adjustment loans which the Bank has made since 1980, fiscal policy conditions were present in 51% of all loan agreements. This has increased over time for the early intensive adjustment lending countries (EIAL)[5] from 47% in FY79-85 to 53% in FY89. For the other adjustment lending countries, fiscal policy conditionality has risen from 33% to 58%. Such conditionality has been especially important in the Sub-Saharan African Countries (69%) where budgetary problems have been acute. Fiscal reforms included measures to reduce the deficit, to enhance the efficiency of raising revenue, and to increase the effectiveness of government expenditure. Reductions in deficit have been at the core of successful AL operations. Relatively less attention has been given to monetary, exchange rate and wage policies, although the importance of these too has been rising over time. Monetary and exchange rate policies have been a central focus of IMF programs. When the Bank and Fund have concurrent programs with a country, a frequent occurrence, these policies are usually left to the Fund. In those cases where there is a concurrent Fund program and exchange rate conditions are also included in the Bank loan, it may be because the Fund has different exchange rate objectives than the Bank.

[5] Defined as countries that have received two SALs or three adjustment operations or more starting in 1985 or before.

Implementation of Macroeconomic Conditionality

More than half (66%) of all conditions in adjustment programs are judged by Bank staff to be implemented fully or more than fully by the time of final tranche release. This rate increases to 84% if conditions on which progress has been substantial are also included. Loans since 1985 have higher average rates of implementation than those made earlier. Table 3.2 shows that performance in implementing conditionality varies widely across types of policies. For the five or six critical actions in the program (coded on the basis of the President's Report), the implementation rates are as good on average as for all conditions in the legal agreement. Implementation of macroeconomic policy conditionality is above the average for all conditions (e.g., 74% of fiscal policy is fully implemented; 82% substantially implemented; 75% of exchange rate policy fully implemented; 85% substantially implemented). This may in part be explained by the additional leverage in support of macroeconomic policy reform from concurrent IMF programs.

Implementation rates of supply-side policy categories have, as noted, been strongly affected by macroeconomic performance. In some instances supply-side policies have been incorporated into adjustment lending conditionality during early stages of the country's adjustment. In a number of cases this has been done before internal or external balance has been reestablished. In these circumstances implementation has been lower than the average for all conditions.

Implementation rates for public enterprise reform have closely paralleled progress in fiscal policy management. Such reforms have been implemented more consistently where fiscal deficit reduction has been an important objective of macroeconomic policy. More than one-third of recent AL contain PE reform measures. Such reforms have made it possible for state enterprises to reduce their drain on the central government budget by cutting their losses through restructuring aimed at increasing efficiency and lowering costs as well as bringing the price of goods and services which they produce more in line with long-term marginal costs. Some countries have made significant progress in divesting public enterprises. In others, it has been difficult to deal with financially-ailing entities: closing them down has meant increased unemployment. Without prior rehabilitation, they are not attractive to potential buyers. In addition, domestic capital markets are frequently unable to support the purchase of such enterprises. The temptation is therefore for governments to continue to run these entities. When the circumstances warrant continued public ownership, reform measures have aimed at improving efficiency and accordingly profitability. Reforming management and allowing competition from private and foreign firms helps to raise efficiency. This was the aim of the 1989 Public Enterprise Reform Loan (PERL) to Mexico, for example.

While the incentive of tranche release motivated policy adjustment, the perceived benefits of adjustment and the desire to have ongoing AL also motivated reform. Indeed, after the final tranche release countries usually sustained or increased the rate of fulfillment. Of the conditions that were not at least substantially fulfilled, about one-third are substantially or completely fulfilled within a year. The tendency for reform inertia to

Table 3.1: Importance of Macroeconomic Conditionality in Adjustment Lending Operations

Share of Loans with loan-agreement conditions or actions in various policy areas (percent)

		All Countries (78)	SSA (110)	HICs (10)	SAL (55)	SECAL (49)	Hybrid (15)	EIAL Countries 79-85 (9)	EIAL Countries 86-88 (56)	EIAL Countries 89	Other AL Countries 79-85	Other AL Countries 86-89	Share of (2) loans w/ actions action in various policy areas [13]
	(183) (84) (84)												
I	**Absorption reduction policies**												
	Fiscal policy	51	69	41	78	34	30	47	51	53	33	58	67
	Monetary policy [Money Supply Targets]	18	14	13	14	16	10	7	16	13	11	24	42
II	**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
III	**Supply-side growth oriented policies**												
	Trade policies	58	58	67	64	55	30	60	69	33	56	55	79
	Sectoral policies												
	Industry	22	30	18	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	50	37	30	44	35	27	89	53	62
	Financial sector	31	28	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	40	33	33	56	65
	Social policy reforms	11	18	9	11	11	10	4	20	0	22	11	24
	Other	28	42	17	33	25	10	7	27	20	33	51	49

Notes: 1. Numbers in brackets ( ) are total number of loans.
2. All countries. All conditions called for in all loan agreements or other actions called for in all Presidents Reports.

Source: Based on analysis of 183 SALs and SECALs to 61 developing countries.

Table 3.2: Implementation of Adjustment Lending Conditionality

	In all loan Agreeements 1/		Critical Actions 2/	
	Fully Imple-mented	At least Substantially Implemented	Fully Imple-mented	At least Substantially Implemented
I Absorption reduction policies				
Fiscal policy	74	82	72	89
Monetary policy [Money Supply Targets]	67	83	61	89
II Switching policies				
Exchange rate	75	85	71	81
Wage policy	45	91	50	50
III Supply-side growth oriented policies				
Trade policies	62	85	56	82
Sectoral policies				
Industry	72	92	53	65
Energy	69	80	72	80
Agricultural	62	81	49	74
Financial sector	73	89	79	92
Rationalization of Gov't finance & administration	63	81	54	68
Public Enterprise reforms	66	80	67	77
Social policy reforms	59	91	55	82
Total				
Loan agreement conditions 3/	66	84	67	83
All conditions or actions 4/	57	77	60	79

Notes: 1/ 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.

2/ Critical actions are so identified because Bank staff designing the operation put particular emphasis on them an because they were expected to make a significant contribution to adjustment in a short time. A total of 194 actions were coded as critical, of which 303 appeared as conditions in the loan agreements.

3/ The implementation rate of conditions that appear in the loan agreement.

4/ 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 in implementation.

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.

continue after final tranche release is especially true for some key macroeconomic policies. Table 3.3 provides information regarding the sustainability of reforms once loan disbursement has been completed. It indicates that reforms initiated in conjunction with Bank-supported adjustment programs generally continue after loan disbursement.

Sustained improvement in implementation has also been the case for fiscal policy. As borrowers have taken steps to carry out administrative reforms aimed at strengthening public sector management generally and have gained greater control over public enterprises, expenditure policy planning, and the budgetary process, fiscal policy objectives have been easier to achieve. It may be unrealistic, however, to view institutional change as monotonic or linear since the likelihood of sustained reform is linked to government commitment which itself varies with the general state of the economy, with political constraints, and with the degree to which leaders agree with the substance of reform measures.

Table 3.4 indicates that loan design is an important determinant of implementation. Actions which are only listed in President's Reports have relatively low rates of implementation (only 49% are fully implemented). Actions which are precisely defined have higher rates of implementation even though they may not be legally binding. Conditions which are both precisely defined and legally binding have the highest rates of implementation (71% are fully implemented). This suggests that the greater the specificity of conditionality and the more legally binding the more likely it is that it will be successfully implemented. This is particularly true of SALs, where the average rate of implementation for actions listed only in the President's Reports is 47% while the rate on precise and legally binding conditions is 73%. Greater detail may require a larger number of conditions. General conditions that summarize the spirit of the adjustment effort are also important.

<u>IMF Programs and Bank Macroeconomic Conditionality</u>

The Bank consults regularly with the International Monetary Fund. The Bank has generally refrained from adjustment lending if a country with macroeconomic instability does not have a Fund Program -- a Standby Agreement, an Extended Fund Facility, a SAF or an ESAF. But the Bank has made its own macroeconomic assessments. Over four-fifths of SALs and over three-fifths of SECALs have Fund programs by the time of effectiveness. In about 15% of these cases the Fund programs are subsequently cancelled[6]. The macroeconomic content of the Bank's adjustment lending is heavily influenced by the commitments which the borrowing country has entered into with the International Monetary Fund. Table 3.5 indicates the conditionality content of the Bank's adjustment loans where there is or is not a concurrent IMF program and the rates of implementation for adjustment programs with and without Fund programs. In those cases where the IMF does not have a program, Bank conditionality emphasizes areas of macroeconomic policy (exchange rate and monetary supply targets) which are areas of primary interest to the Fund.

[6] Half of these are in turn revised probably with less strict requirements.

Table 3.3: Implementation of Conditions prior to and after Tranche Release

	Percentage of Conditions			
	During the Loan Period 1/		Current Situation 2/	
	Fully Imple- mented	At least Substantially Implemented	Fully Imple- mented	At least Substantially Implemented
I Absorption reduction policies				
Fiscal policy	73	78	68	82
II Switching policies				
Exchange rate	78	78	60	90
III Supply-side growth oriented policies				
Trade policies	60	85	67	88
Sectoral policies				
Industry	57	86	73	88
Energy	71	79	92	92
Agricultural	65	85	69	86
Financial sector	78	88	72	95
Rationalization of Gov't finance & administration	56	77	67	90
Public Enterprise reforms	69	75	76	85
Total				
Loan agreement conditions 3/	66	83	70	88
All conditions or actions	56	76	62	81

Notes: 1/ At final tranche release.
2/ At least 12 months after final tranche release.
3/ Based on conditons which appear only in the loan agreements. A total of 658 conditions were monitored.

Source: Based on a subset of 97 SALs and SECALS to 32 countries.

Table 3.4: Implementation of conditions (Average percent at final tranche release)

	All conditions or actions[1]		Loan Agreements[2]		Precise[3]	
	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
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[4]		Actions only in President's Reports[5]	
	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
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	31	95

Source: Based on an analysis of 97 loans to 32 developing countries.

1/ All conditions called for in the loan agreement or other actions called for in the President's Report, except prior actions, are not included because they are said to be fulfilled "prior" to negotiation.

2/ All conditions in the loan agreement.

3/ Precise conditions or actions are specific and usually quantifiable.

4/ Precise and legal conditions are those which appear in the Loan Agreement and are specific in nature.

5/ Actions which appear only in the President's Report (excluding prior actions).

TABLE 3.5 LENDING OPERATIONS WITH CONCURRENT FUND PROGRAM

	Share of loans with loan agreement conditions in various policy areas: Conditionality		Average rates of implementation of loan agreement conditions: Implementation			
	Loans with Concurrent Fund Programs	Loans without Concurrent Fund Programs	Loans with Concurrent Fund Programs: Fully Implemented	Loans with Concurrent Fund Programs: at least substantially	Loans without Concurrent Fund Programs: Fully implemented	Loans without Concurrent Fund Programs: at least substantially
I. ABSORPTION REDUCTION POLICIES						
Fiscal Policy	57	31	74	81	50	100
Monetary Policy (Money Supply Targets)	12	28	75	75	50	83
II. SWITCHING POLICIES						
Exchange Rate	15	23	72	83	100	100
Wage Policy	15	5	46	92	0	100
III. SUPPLY SIDE, GROWTH-ORIENTED POLICIES						
TRADE POLICIES	62	46	63	86	54	92
SECTORAL POLICIES						
Industry	24	13	72	91		
Energy	16	10	47	81	71	78
Agricultural	46	36	61	80	67	86
FINANCIAL SECTOR	30	33	71	92	78	78
RATIONALIZATION OF GOVT FINANCE AND ADMINISTRATION	55	44	61	80	100	100
PUBLIC ENTERPRISE REFORMS	45	36	66	79	50	75
SOCIAL POLICY REFORMS	11	13	58	89	100	100
OTHER	31	21	83	94	85	85
Loan Agreement Conditions			66	83	66	87
All Actions or Conditions			57	76	53	83

Source: Conditionality Data based on an analysis by IENIS of 100 SALs and SECALs to 61 developing countries
(41 loans had concurrent fund programs in place at the Board Date or By Effectiveness.
Implementation data based on a sample of 97 SALs and SECALs.

Interestingly, the data indicates that the share of loans with fiscal policyconditionality is greater where there is a concurrent Fund program. This is in part a reflection of the nature of the lending instrument. Most SALs have Fund programs in place. The Fund has traditionally relied on the Bank to carry out a review of public sector investment programs where it has aprogram. It is likely that this complementarity between the Fund and the Bank results in greater involvement of the Bank in issues of public finance where there is a Fund program.

Supply side policy conditionality is also significantly affected by the presence of a Fund program. Rationalization of Government Finance and Administration and Public Enterprise Reforms receive more emphasis in Bank adjustment loans which are concurrent with Fund programs than those which are not. These areas receive greater emphasis because of the greater attention to fiscal policy in such loans. Financial sector policies are given less emphasis where there are Fund programs primarily because banking system policies and broader financial sector policies are a natural extension of the Fund's primary area of focus. On average, though, there are insignificant differences in rates of implementation of Bank program conditionality with and without Fund programs.

Inflation and Implementation of Macroeconomic Conditionality

Sometimes the macroeconomic environment deteriorates during the course of the program. For example, the Argentine Export Development AL of FY87 was undertaken although inflation exceeded 100% annually during the first four quarters following effectiveness. In total, seven SECALs and one SAL were undertaken despite an inflation rate exceeding 100% annually during the first four quarters after effectiveness. Implementation of adjustment policy is influenced to a great extent by the macroeconomic environment. The results of the empirical work presented in this section confirm that a supportive macroeconomic environment is one of the most important determinants of implementation in adjustment programs. Based on the average share of conditions implemented per loan, Table 3.6 indicates that implementation was significantly lower the more severe the internal macroeconomic imbalance (i.e., the higher the rate of inflation). While the presence of a concurrent Fund program is on average correlated with lower rates of inflation, the result is not statistically significant at the 5% level. Table 3.7 indicates the implementation rates for different types of adjustment policies according to whether the adjusting country has low, moderate or high rates of inflation. It takes a longer view of the inflationary environment and the uncertainty associated with greater price instability. It indicates that macroeconomic policies are more apt to be implemented where there is low or moderate inflation. Policies aimed at changing real relative prices (switching policies) tend to be more difficult to implement, the higher the rate of inflation. Exchange rate policies (real exchange rate targets) were the most adversely affected by high rates of inflation. For this type of conditionality implementation rates fell from 80% implemented with low inflation to 36% with high inflation. It is likely that this reflects the growing concern of policy makers with the inflationary effects of a nominal devaluation and increasing reluctance to use the nominal exchange rate as an instrument of economic policy as inflation rises. Overvalued or unpredictable real exchange rates are common in countries with high inflation, such as Brazil and Yugoslavia. With extremely high rates of inflation governments are more apt to use the exchange rate as a nominal anchor thereby sacrificing adjustment to stabilization objectives. Most supply side policies are also adversely affected by inflation. Trade, agricultural pricing and social policy reforms appear to be the most difficult to implement in a high inflation environment.

Economic Growth

Table 3.8 relates implementation of conditionality to economic growth. It indicates that where countries have been successful in reestablishing adequate, sustainable rates of economic growth, implementation rates are substantially improved across all policy categories. This suggests a causal relationship between growth and the degree of success a government is likely to have in implementing adjustment policies. An equally plausible case can be made that the more successful a government is in implementing adjustment policies, the better its growth performance will be other things being equal. Causality probably runs in both directions.

IV. FY89 Adjustment Lending

Background

During FY89 adjustment lending continued to grow in importance in the Bank's total lending. The Board approved 34 adjustment operations for a total of $6.4 million, up from 29 for $5.0 million in FY88 (Table 4.1). Adjustment lending as a share of total commitments rose from 26% in FY88 to 30% in FY89. Within total adjustment lending, SECALs continued to grow in importance (20 SECALs were approved in FY89, up from 18 in FY88). The relative importance of adjustment lending was greatest in Latin America (48%), followed by Africa (24%), Asia (14%) and EMENA (14%) (Table 4.2).

The main foci of FY89 SECALs were industry and trade (nine), financial sector (seven), and agriculture (three). SALs continued to focus on broader macroeconomic adjustment policies. In Africa six SALs were committed in FY89; in LAC, four. No slower disbursing, sector loans which finance a time slice of a country's sectoral investment program (which RAL I had noted were a form of lending particularly well suited for dealing with medium-term institutional reforms) were approved by the Board in FY89.

It was initially envisaged that the Bank's adjustment lending to a country would continue for several years through a series of operations (up to five). The number of countries with multiple operations increased further in FY89 (from 40 in FY88 to 47). Turkey had the largest number of multiple adjustment loans (10). The Africa Region had the largest concentration of multiple operations, followed by LAC and EMENA (Table 4.3).

Average rate of Inflation \1	Loan Type	Number	Implementation of Conditionality \2: fully implemented (percent)	and substantially implemented (percent)	Number with concurrent IMF programs at Effectiveness \3	Number with concurrent IMF programs at least 8 of first 12 mths	Number of Adjustment Loans for which the IMF Program was Cancelled \4
LOW							
-10 to 10	SECAL	27	75	92	22	22	3
	SAL	22	72	95	21	15	4
MODERATE							
10 to 20	SECAL	12	61	95	8	8	3
	SAL	15	57	73	12	12	5
HIGH							
20 to 50	SECAL	26	58	76	17	16	6
	SAL	10	59	81	10	8	2
50 to 400	SECAL	18	53	78	12	9	3
	SAL	7	52	64	5	6	2

Notes: (1) The rate of inflation is based on the average annual percentage change of the CPI index for the 4 quarters period beginning the quarter of Loan effectiveness.
(2) 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.
(3) Includes Stand-by arrangements, Extended Fund Facilities, Structural Adjustment Facilities, and Enhanced Structural Adjustment Facilities.
(4) About half of the cancelled Fund Programs were subsequently renewed, within three months, presumably with revisions. Four of five cancelled programs in high inflation situations were renewed.

Source: Based on an analysis by of 135 SALs and SECALs to 61 developing countries. Inflation data based on quarterly data drawn from IFS.

Table 3.7 Implementation and Inflation

Average Rate of Inflation Over Loan Period (1)

	Low (less than 10%)		Moderate (between 10% and 30%)		High (greater than 30%	
	Fully Implemented	and Substantially Implemented	Fully Implemented	and Substantially Implemented	Fully Implemented	and Substantially Implemented
I. Absorption Reduction Policies (2)						
Fiscal Policy	81.0	95.2	79.1	88.4	56.0	80.0
II. Switching Policies						
Exchange Rate	100.0	100.0	84.6	92.3	40.0	80.0
III. Supply-Side, Growth-Oriented Policies						
Trade Policies	84.7	88.2	82.3	86.9	53.3	88.9
Sectoral Policies						
Industry	50.0	71.4	76.5	100.0	100.0	100.0
Energy	70.0	90.0	71.4	71.4	100.0	100.0
Agricultural	76.9	92.3	48.9	68.1	82.9	85.7
Financial Sector	78.3	91.3	75.0	85.0	84.7	100.0
Rationalization of Government						
Finance and Administration	83.3	93.3	56.7	73.3	40.0	68.0
Public Enterprise Reforms	65.7	94.1	69.8	90.8	63.5	80.8
TOTAL						
Legal Conditions	71 8	91 3	66.3	84.8	50.3	77.5
All Conditions of Actions	59.4	80.9	57.4	76.8	49.2	71.8

Note: (1) The sample of adjustment program is divided into three groups -- those experiencing low, moderate, or high rates of inflation during the loan period. Here the interest is in the number of conditions implemented as a share of all conditions over the entire sample. The rate of inflation during the loan period is calculated as the average rate of inflation during the three year period beginning the year prior to effectiveness Inflation data is based odn the percentage change of the CPI

Source Based on a sample of 57 adjustment loans to 26 developing countries.

Table 3.8: Implementation and Growth

	Adequate (4% to 8%)		Low (10% to 30%)		No Growth (0% to -5%)	
	Fully Implemented	At least Substantially Implemented	at Least Implemented	% of Substantially Implemented	At least Implemented	% of Substantially Implemented
I. Absorption reduction policies						
Fiscal policy (Budget Deficit Reduction)	68	82	50	61	56	78
Monetary policy (Money Supply Targets)	80	100	75	750	100	100
II. Switching policies						
Exchange rate	78	100	83	100	36	50
Wage policy	50	83	67	67	0	0
III. Supply-side growth oriented policies						
Trade policies	63	81	50	77	47	89
Sectoral policies						
Industry	50	67	100	100	0	100
Energy	60	86	60	80	77	77
Agricultural	65	80	44	64	29	48
Financial sector	52	81	70	95	43	84
Rationalization of government finance & administration	50	74	61	71	56	87
Public enterprise reforms	50	78	57	88	70	78
Social policy reforms	70	90	46	83	0	0

Note

1/ Growth rate defined as the annual percentage change in GDP denoted in 1980 constant local currency

Source: Based on a subset of 57 adjustment loans

Table 4.1: FY89 ADJUSTMENT OPERATIONS STATUS REPORT/
(as of June 30, 1989)

Board Status	Country	Name	Type	Board Date	Number	IBRD (US$m)	IDA (US$m)	Total (US$m)
Approved	Argentina	Trade Policy II Loan	SAD	10/27/88	1	300.0	.0	300.0
	Bangladesh	Energy Sector	SAD	04/11/89	1	.0	175.0	175.0
		Industrial Sector Cr. Suppl.	SAD	03/13/89	0	.0	2.5	2.5
	Benin, People's Rep.	SAL I	SAL	05/23/89	1	.0	45.0	45.0
	Bolivia	Finan. Sector	SAD	03/13/89	0	.0	11.3	11.3
	Burundi	Agric. Sys.	SAD	05/25/89	1	.0	33.1	33.1
	Cameroon	SAL 1	SAL	06/14/89	1	150.0	.0	150.0
	Chad	Financial Rehab. Cr	SAD	07/27/88	1	.0	16.2	16.2
		Transport Sector Adj	SAD	04/25/89	1	.0	60.0	60.0
	Costa Rica	SAL II	SAL	12/13/88	1	100.0	.0	100.0
	Gambia	SAL II	SAL	06/08/89	1	.0	23.0	23.0
	Ghana	Fin. Sector Adj	SAD	03/13/89	0	.0	6.6	6.6
		SAC II	SAL	04/18/89	1	.0	120.0	120.0
	Guinea Bissau	SAC II	SAL	05/18/89	1	.0	23.4	23.4
	Honduras	SAL I	SAL	09/15/88	1	50.0	.0	50.0
	Indonesia	Private Sector Devt. Loan	SAL	06/06/89	1	350.0	.0	350.0
	Kenya	Financial Sec. Operations	SAD	06/27/89	1	.0	120.0	120.0
		Ind. Sec. Adj.	SAD	03/13/89	0	.0	53.7	53.7
	Lao P. D. R.	Struct. Adj. Credit	SAL	06/14/89	1	.0	40.0	40.0
	Madagascar	Public. Sec. Adj.	SAD	03/13/89	0	.0	1.4	1.4
	Malawi	Ind. Trade Adj.	SAD	03/13/89	0	.0	5.2	5.2
	Mali	Human Resource SECAL	SAD	06/27/89	1	.0	26.0	26.0
	Mexico	Fin. Sec. Adj.	SAD	06/13/89	1	500.0	.0	500.0
		Ind. Restructuring	SAD	04/27/89	1	250.0	.0	250.0
		Ind. Sector Policy	SAD	06/13/89	1	500.0	.0	500.0
		Pub. Enterp. Ref. I	SAD	06/13/89	1	500.0	.0	500.0
	Morocco	SAL I	SAL	12/01/88	1	200.0	.0	200.0
	Mozambique	Rehab. III	SAL	05/18/89	1	.0	90.0	90.0
	Nepal	Structural Adj. II	SAL	06/27/89	1	0.0	60.0	60.0
	Nigeria	Trade & Invest. Policy Loan	SAD	12/22/88	1	500.0	.0	500.0
	Pakistan	Agric. Sector Loan	SAD	08/02/88	1	200.0	.0	200.0
		Energy Sector Loan II	SAD	06/29/89	1	250.0	.0	250.0
		Financial Sector Adj.	SAD	03/28/89	1	150.0	.0	150.0
	Philippines	Financial Sector Loan	SAD	05/04/89	1	300.0	.0	300.0
	Senegal	SAL III	SAL	03/13/89	0	.0	5.5	5.5
	Somalia	SAL/ASAP II	SAD	06/01/89	1	.0	70.0	70.0
	Tanzania	Ind. Trade Adj.	SAD	03/13/89	0	.0	12.5	12.5
		Ind. & Trade Adjust. Cr.	SAD	12/31/88	1	.0	135.0	135.0
	Togo	SAL III	SAL	03/13/89	0	.0	.1	.1
	Tunisia	ASAL II	SAD	06/01/89	1	84.0	.0	84.0
	Uganda	IDA Reflow Supplemental	SAL	03/13/89	0	.0	1.7	1.7
		ERCI Supplemental	SAL	04/20/89	0	.0	25.0	25.0
	Uruguay	SAL II	SAL	06/08/89	1	140.0	.0	140.0
	Venezuela	SAL	SAL	06/15/89	1	402.0	.0	402.0
		Trade Policy Loan	SAD	06/15/89	1	353.0	.0	353.0
Total Approved					34	5279.0	1162.2	6441.2
Total					34	5279.0	1162.2	6441.2

Type: SAL - Structural Adjustment or Program Loan
SAD - Sector Adjustment Loan

Revised 8/2/90

Supplemental and B-Loans are shown as 0 in the number column.

Table 4.2: FY89 ADJUSTMENT LENDING

	No. of	SALs	No. of Secals	Secals	Total	% Total Lending
LAC	4	692.0	6	2414.3	3106.3	48.2
AFRICA	6	483.7	8	1039.7	1523.4	23.8
ASIA	3	450.0	2	477.5	927.5	14.3
EMENA	1	200.0	4	684.0	884.0	13.7
TOTAL	14	1825.7	20	4615.5	6441.2	100.0

Table 4.3: NUMBER OF COUNTRIES WITH MULTIPLE ADJUSTMENT OPERATIONS

	Number of Countries with two or more Adjustment Loans	Number of Countries with three or more Loans
AFRICA	22	14
ASIA	6	4
LAC	13	10
EMENA	6	4

REVISED 8/2/90

The Macroeconomic Underpinnings of FY89 Adjustment Lending

To assess the macroeconomic underpinnings of FY89 adjustment lending, economists in the Macroeconomic Adjustment and Growth Division reviewed 23 adjustment loans to 18 countries[7]. The sample includes six SALs and 17 SECALs which are included in the list of countries which the Division covers as part of its on-going review work. Background case studies were prepared for each of these loans and are available on request. They are based on reviews of Initiating Memoranda, President's Reports and Loan Agreements, the agendas and minutes of Operations Committee meetings, and discussions with regional staff. The summary of findings which follows focuses on three areas: (a) the initial macroeconomic conditions at the time the loan was committed; (b) fulfillment of preconditions of adjustment lending; and (c) the design of the Bank's macroeconomic conditionality.

Initial Conditions

To what extent were the countries in the sample experiencing significant macroeconomic difficulties at the time the loan was committed? Reviewers found that almost all of the countries were experiencing some form of macroeconomic imbalance in FY89. These difficulties ranged from hyperinflation, acute external imbalance and accelerated decline of output in Argentina to mild stagflation in Uruguay. In some countries the economy had been stabilized, but thus far it had not been possible to reestablish growth (Bolivia). In some of the sample countries, macroeconomic imbalances were becoming more severe (Brazil, Pakistan and Cameroon). In others, the situation was improving (Ghana, Mexico, Uruguay and Philippines). In all of these countries, with the possible exception of Indonesia, a plausible case could be made that there is a need for Bank support in the form of adjustment lending to either reverse deterioration of the macroeconomic environment or to sustain the adjustment effort and help ensure against policy backsliding.

Of the 18 countries in the sample, only Indonesia appears to have overcome its macroeconomic imbalances. The country had already undertaken a major adjustment effort and now appears to have recovered from the oil price shock of 1986. Growth of non-oil output has been restored to over 5% annually, inflation is under 10%, and the deficit in the current account of the balance of payments has been reduced to under 3% of GDP. The Region's adjustment lending strategy for Indonesia is to use adjustment lending as an ex post reward for actions already taken, rather than as an inducement for undertaking new stabilization or other macroeconomic policy reforms. While there may be special circumstances which justify continuation of adjustment lending for the next several years as envisaged in the Region's

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[7] Even countries with reasonably consistent programs are not without problems. Some high debt countries such as Bolivia are unable to reestablish adequate rates of economic growth despite the existence of a relatively stable macroeconomic environment; in this regard, even for these countries, adjustment programs were not fully consistent.

Five-Year Lending Program, the Indonesia case does raise an important question: At what point following restoration of macroeconomic balance is it appropriate to discontinue adjustment lending?

Preconditions for Adjustment Lending

In analyzing the macroeconomic underpinnings of each adjustment loan in the sample, the assessments focused first on whether the preconditions for adjustment lending had been met. There are three such preconditions: (a) that the government "own" the program; (b) that a consistent macroeconomic adjustment program be in place at the time of Board presentation and that there be a recorded agreement between the Bank and the borrower on the key elements of a medium-term adjustment program, including short-term stabilization measures; and (c) that the program be realistic and adequately financed.

Most countries were found to have met the first precondition of adjustment lending. This was the case for five of the six SALs reviewed and for 13 of the 17 SECALs. However, reviewers encountered practical difficulties in making this determination. First it is difficult in most cases to find direct evidence which provides an unambiguous indication that the government is on the record publicly as "owning" the program. Second, as a consequence of this, reviewers were forced to rely heavily on what they could glean from documents prepared to justify the loan. These documents are part analytical and part advocacy in nature; the presentation is such that it is frequently difficult to distinguish the two. Judgments made by reviewers may reflect the positive interpretation of events which is generally contained in these documents. The results shown above may, therefore, overstate the degree of Government ownership of the adjustment program.

The second precondition has two parts: (a) that a consistent adjustment program exists at the time of Board presentation; and (b) that there be a recorded agreement between the Bank and the Borrower on key elements of the short-term and medium-term program. The reviews indicate that about half of these countries met the first part of this precondition. In a few cases it was reasonably clear that a country had a consistent adjustment program in place at the time of Board presentation (Bolivia, Uruguay, Philippines)[8]. It was equally clear that such a program did not exist in others (Argentina, Brazil, Cameroon, Pakistan). For most countries in the sample, however, the judgment was more difficult.

For some countries, the existence of a Fund program provided some indication that a consistent stabilization program exists. In Venezuela, for example, the government has a strong commitment to adjustment and has in place a reasonably consistent short-term stabilization and medium-term

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[8] Even countries with reasonably consistent programs are not without problems. Some high debt countries such as Bolivia are unable to reestablish adequate rates of economic growth despite the existence of a relatively stable macroeconomic environment; in this regard, even for these countries, adjustment programs were not fully consistent.

adjustment program. The authorities have worked closely with the Fund and the Bank; an IMF Standby Agreement is currently being replaced by an EFF. Negotiations with the commercial banks have not yet been completed, however, and other elements of the external financing program are in doubt. Because of apparent or real political constraints, the government has had to act less forcefully in some areas of reform (liberalization of interest rates) than it had hoped initially. Even where an IMF program did exist in FY89, this did not ensure that a consistent macroeconomic program was in place (Brazil).

To judge whether a consistent macroeconomic program existed, reviewers asked a number of questions to make their determination. These questions and the results are shown in Table 4.4. Reviewers found that for all SALs a Fund program was in place at the time of Board presentation. For SECALs, Fund programs existed in only two- thirds of the FY89 AL countries. The practice which currently exists in Operations is for the Bank to reach its own independent judgment of the consistency of the macroeconomic program which is being supported by the Fund. Reviewers found that in most cases, this appeared to have been done (about 80%).

Reviewers then turned to the quality of the analytical work done by staff to assess the consistency of the macroeconomic framework. For all of the Bank's borrowers, a Revised Minimum Standard Model (RMSM) had been prepared. The standard RMSM, however, does not ensure consistency between the budget, the public enterprises, the monetary sector, the external accounts, the private sector and the national accounts. It is not possible to check the macroeconomic consistency which underpins an adjustment loan with the RMSM. To ensure the consistency of short-term and medium-term macroeconomic policies a more sophisticated model is required ("RMSM-X" or "XX"). Reviewers determined whether a flow of funds consistency model (or other model which incorporates behavioral structure) had been used by the Bank to evaluate the macroeconomic framework. The results indicate that in about 60% of the AL sample countries this had not been done.

For the second part of the precondition (that there be a recorded agreement between the Bank and the borrower regarding the adjustment program) reviewers looked at Letters of Development Policy which had been prepared for each adjustment operation (Table 4.5). While the Letter of Development Policy has no legal standing, it is the principal vehicle for recording understandings which are reached between the Bank and the borrower. The findings were that in many cases (73%) the Letter of Development Policy does contain a general understanding on overall macroeconomic policy. However, in only about one-third of the cases do these letters record understandings on short-term stabilization policies.

Finally, reviewers evaluated the extent to which the third precondition had been met by assessing the adequacy of external financing and the realism of the analysis. In about half of the cases the analysis was judged to be unrealistic. While this judgment might be questioned as being excessively demanding of the country projections, it is more favorable than the results of a similar assessment of realism recently carried out by central staff in Finance which concluded that only 25% of the country projections are realistic.

Table 4.4: ADEQUACY OF MACROECONOMIC FRAMEWORK IN FY89 AL COUNTRIES

		SALs	SECALs	Total
Was there a Fund Program in place?	Yes	100	66.7	76.2
	No	0	33.3	23.8
Did the Bank evaluate this Program?	Yes	83.3	77.8	78.6
	No	16.7	22.2	21.4
Did the Bank use a consistency model to check the macroeconomic framework?	Yes	33.3	41.2	38.1
	No	66.7	58.8	60.9
Was the analysis done by the Bank realistic?	Yes	50.0	58.8	56.5
	No	50.0	41.2	43.5

Table 4.8: FY89 ADJUSTMENT LOANS: AGREEMENT ON MACROECONOMIC POLICY CONTAINED IN LETTERS OF DEVELOPMENT POLICY

Country	Loan Name	General Agreement on Macroeconomic Consistency of the Program a/	Agreement on Short-Term Stabilization Policy b/
Argentina	Trade Policy	N	N
Bangladesh	Energy Sector	N	N
Benin	SAL I	Y	Y
Burundi	Agricultural	N	N
Cameroon	SAL I	Y	Y
Chad	Transport Sec	N	N
	Financial Rehab	Y	N
Costa Rica	SAL II	Y	Y
Gambia	SAL II	Y	N
Ghana	SAC II	Y	Y
Guinea-Bissau	SAL II	Y	Y
Guinea	SAL	Y	Y
Honduras	SAL I	Y	Y
Indonesia	Private Sector Development	Y	N
Kenya	FINSL	Y	N
Lao P.D.R.	SAL I	Y	Y
Mexico	Ind. Pol.	Y	N
	PE	N	N
	FINSL	Y	N
	Ind. Restructuring	Y	N
Morocco	SAL I	Y	N
Mozambique	Rehab. Cr. III	Y	Y
Nepal	SAC II	Y	Y
Nigeria	Trade/Inv. Pol	Y	Y
Pakistan	Energy Sec	N	N
	Agric. Sec	N	N
	FINSL	Y	N
Philippines	FINSL	Y	N
Somali	Agricultural	Y	N
Tanzania	Ind. Trade Adjustment	Y	N
Tunisia	Agricultural Sector II	N	N
Uruguay	SAL II	Y	Y
Venezuela	Trade	Y	N
	SAL I	Y	Y

a/ This column indicates whether there is (Y) or is not (N) a general agreement on macroeconomic policy. The agreement on macroeconomic policy covers the following areas: exchange rate, tax, wage, debt management, budget deficit, public current and capital expenditures, subsidies and money supply policies.

b/ This column indicates whether there is (Y) or is not (N) a specific agreement on short-term stabilization policies.

Source: President's Reports, Letters of Development Policy

Macroeconomic Policy in Program Design

The analysis next turned to the macroeconomic content of Bank-supported adjustment programs and to an assessment of the extent to which key macroeconomic policy elements of the program were incorporated into the conditionality of the adjustment loan. Two-thirds of the loans were found not to have introduced (or to have been introduced only partially) the key elements of the macroeconomic policy framework.

Table 4.6 lists for all of the adjustment loans committed in FY89 all of the legally binding macroeconomic conditionality. Eleven loans, including one SAL had no such conditionality. Only five loans had three or more legally binding conditions. One loan, the Cameroon SAL, had a total of 275 conditions of which only three were legally binding macroeconomic conditions. These three conditions were general ("adopt the public investment program in FY89 and FY90" and "provide adequate funding for the execution of the program").

The Bank frequently has included macroeconomic policies in President's Reports as a "desired action" (i.e., not legally binding). Reviewers focused on program content to identify which macroeconomic policies have most frequently been part of overall program design. As discussed in Section II and applied in Section III, policies were classified as expenditure reduction, switching and, supply-side policies.

Fiscal deficits are frequently the driving force behind inflation and balance of payments deficits. They contribute to high real rates of interest, lower levels of investment and declining growth. To what extent did the Bank's FY89 adjustment loans contain fiscal deficit reduction as a condition for second tranche release? It was found that about two-thirds of the operations reviewed had such conditionality; in most cases, this was not legally binding.

Switching policies were given less importance in the loans reviewed. For 60% of all SECALs there was no mention of exchange rate policy. While a large number of SALs included exchange rate policy in the program, there were no instances where it was a clearly specified legally binding condition.

The most important focus of the Bank's FY89 adjustment lending continues to be supply-side policies aimed at increasing output (Table 4.7). Legally binding conditions are much more important in areas related to supply-side policies. About half of the FY89 loans reviewed contained legally binding conditionality related to public sector and financial sector reform. Such conditionality was also found to be important in policy areas dealing with trade and pricing policy reforms; this was included in about one-third of the loans.

Many of the conditions included in an adjustment loan are complementary; some may be potentially conflicting. For example, liberalization of the trade regime which includes tariff reduction may conflict with budget and current account deficit reduction. Reviewers

Table 4.6: LEGALLY BINDING MACRO-CONDITIONALITY FOR FY89 ADJUSTMENT LOANS

Country	Loan Name	Conditions	Legal a/	Critical b/	Text of Conditions
Argentina	Trade	44	22		Maintain competitiveness of the real exchange rate.
	Trade	44	21		Consistency of Government's fiscal and monetary policies with policy framework.
Bangladesh	Energy Sector	8			None.
Benin	SAL I	39			None.
Burundi	Agr. Svs.	7			None.
Cameroon	SAL I	278	22		Adopt the public investment program for FY89.
	SAL I	278	23		Adopt the public investment program for FY89.
	SAL I	278	23		Provide adequate funding for the execution of the program.
Chad	Trans. Adj.	19			None
	Finan. Rehab.	28	22	1	Adopt its three-year PIP.
	Finan. Rehab.	28	22		Implement supplementary budget.
	Finan. Rehab.	28	22		Adopt its 1989 budget for current expenditures.
Costa Rica	SAL III	82	22		Do not propose new legislation establishing earmarked tax revenues during FY88.
	SAL III	82	22	1	Freeze public sector employment and implement policy of real negative wage increase.
	SAL III	82	22		Reach level of public savings of 5.7% of GDP by 1988.
	SAL III	82	23		Reach level of public savings of 6% of GDP by 1989
	SAL III	82	23	1	Establish budgetary target to keep public savings not less than 6% of the GDP for 1990.
	SAL III	82	22		Executed the projected 1988-90 investment program.
	SAL III	82	23		Do not approve any direct price subsidies to consumer.
Gambia	SAL II	69	28		Maintenance of the liberalized exchange rate system.
	SAL II	69	22		Prepare a medium-term public expenditure program.
Ghana	SAC II	121	22	1	Implement 1989 program of pay reform for civil service.
	SAC II	121	22		Agree with IDA on 1990-92 public investment program.
	SAC II	121	22	1	Agree with IDA on 1990 recurrent expenditure allocation.
	SAC II	121	22	1	Agree with IDA on tax proposals in 1990 budget.
Guinea-Bissau	SAL II	65	22	1	Adjustment of the official exchange rate.
			22		Implementation of the fiscal and monetary program for FY89.
Guinea	SAL II	181	22		Adopt PIP for the period 1989-91.
	SAL II	181	22	1	Establish a central corporate taxpayer file on basis of a census of corporate taxpayers.
	SAL II	181	22		Enact the 1989 budget.
Honduras	SAL I	80	22	1	Reduce the aggregate expenditures for 1988 by no less than 40 million of lempiras.
	SAL I	80	22		Reduce the deficit of the public sector by 65 million of lempiras.
	SAL I	80	22		Improve tax collection system.
	SAL I	80	22	1	Agreement B/W Government and the Bank on an investment program for FY89.
Indonesia	Priv. Sec. Dev.	70			None
Kenya	FINSL	49	22	1	Satisfactory performance in FY90 against agreed targets for budget and domestic financing.
Lao P.D.R.	SAL I	62	22	1	Adopt tax reform measures to increase the generation of tax revenues.
Mexico	Ind. Pol.	98	22		Continue progress obtaining adequate financing for Mexico requirements for 1990.
	PE	44	22		Present guideline about sector ministries development plans.
	FINSL	28			None.
	Ind. Restructuring	34			None.
Morocco	SAL I	55	21	1	Restructure institutions responsible for external debt.
	SAL I	55	22		Establish objectives of target investment program for 1989.
Mozambique	Rehab. Cr. III	137	28		Progress achieved on the review of the Borrower's public expenditure program.
Nepal	SAC II	95	22	1	Adoption of the budget for FY90.
	SAC II	95	28		Gradual elimination of the five-year income tax exemption.
Nigeria	Trade/Inv. Policy	22	22		Operate FOREX marketing according to marketing principles.
	Trade/Inv. Policy	22	22		Provide adequate provisions for 1989 external financing requirements.
	Trade/Inv. Policy	22	23		Maintain consistency of 1989 budget with macro balance targets.
	Trade/Inv. Policy	22	23		Prepare public investment program for 1989.
Pakistan	Energy Sector	88			None.
	Agric. Sector	27			None.
	FINSL	48	23	1	Further reduce Government deficit/GDP ratio for FY90.
Philippines	FINSL	80			None.
Tanzania	Ind. Trd. Adj.	28	22		Reduce tariff and sales tax exemptions.
	Ind. Trd. Adj.	28	22	1	Prepare action program of sales tax improvement.
Tunisia	Agr. Sec. II	40			None.
Uruguay	SAL II	99	22	1	Prepare action plan to implement tax reform and increase effectiveness of tax collection.
	SAL II	99	22	1	Reduction of public sector deficit to 1.3% of GDP.
	SAL II	19	23		Update public investment program for years 1989-90.

a/ Legal variable indicates if the condition is in the legal agreement and when compliance is required.
21 = Loan effectiveness 22 = Second tranche release
23 = Third tranche release 28 = Legal condition not related to tranche release.
b/ 1 = Indicates if the condition is a key component of the loan.

Table 4.7: SUPPLY-SIDE POLICIES IN FY89 ADJUSTMENT LOANS

	SALs (%)	SECALs (%)	Total (%)
Public Sector Reform			
Legally binding	66.7	35.3	43.5
Desired	33.3	29.4	30.4
None	0.0	35.3	26.1
Trade Policy Reform			
Legally binding	66.7	23.5	34.8
Desired	16.7	35.3	30.4
None	16.7	41.2	34.8
Financial Sector Reform			
Legally binding	33.3	52.9	47.8
Desired	50.0	11.8	21.7
None	16.7	35.3	30.5
Pricing Policy Reform			
Legally binding	66.7	17.6	30.4
Desired	0.0	52.9	39.1
None	33.3	29.4	30.4

assessed the degree to which there were potentially conflicting conditions contained in an operation. Numerous examples of such conflicts could be identified. Conflicts among financial reform and budget deficit reduction were present in Brazil and Nigeria. Trade liberalization conflicted with budget deficit reduction in Argentina and Cameroon. Finally, exchange rate policy and the decision to maintain ceilings on interest rates in Venezuela seem to be inconsistent. Overall, about one quarter of FY89 loans reviewed were found to contain such conflicts.

Related to potential conflicts in the program is the issue of appropriate sequencing. Sectoral reforms may not be effective unless they are preceded by adequate progress in stabilization. In addition, adjustment costs can be minimized if the program is designed in a way that avoids giving contradictory signals to producers by overshooting of exchange rate or price adjustments, if this is achieved, the movement to the new equilibrium will be as smooth as possible.

Reviewers found that about one-third of the FY89 SECALs had been made before there was adequate progress in stabilizing the economy. In about half of all adjustment loans reviewed they had questions about the sequencing of the measures proposed which were not addressed in the loan documents.

Table 4.8 indicates those countries which reviewers considered to be examples of best practice in ensuring an adequate macroeconomic policy framework and in resolving key issues in the use of adjustment loans.

Conclusions and Issues Identified in the Case Studies

A substantial amount of case study material was generated as an input for the paper. The following is a summary of issues and conclusions identified in the case studies:

(a) Analytical Framework. Adjustment lending should fit into a medium-term macroeconomic framework which ensures consistent demand management, switching, supply-oriented growth policies, and adequate external financing packages. This framework should at a minimum be based on a quantitative analytical structure which links stock and flow variables for the non-financial public sector, the monetary sector, the balance of payments, the national accounts and the private sector. The emphasis should be on financing the government budget and the external sector. Resources, time and data permitting, this quantitative framework would be extended to include a behavioral structure which would permit disaggregated simulation of the effects of adjustment policies. Analysis carried out by the IMF will be useful in elaborating the macroeconomic framework. However, the Bank and the Fund differ with regard to objectives and priorities. For these reasons the Bank must form its own judgment of the

Table 4.8: ASSESSMENT OF MACROECONOMIC UNDERPINNING OF FY89 ADJUSTMENT LENDING: "BEST PRACTICES"

I. Preconditions for Adjustment Lending	
Government ownership of program	Uruguay, Mexico, Indonesia, Ghana, Cameroon
Existence of an adequate macroeconomic framework	
(a) Consistent macroeconomic program	Uruguay, Mexico
(b) Recorded agreement on short and medium-term macroeconomic policies	Uruguay, Cameroon, Guinea
Realism of projections and adequacy of external financing	Uruguay, Indonesia, Ghana, Bangladesh
II. Loan Design: Macroeconomic Conditionality	
Quality of Bank's macroeconomic analysis	Mexico, Venezuela, Pakistan
Focus of conditionality on key macroeconomic problems a/	Mexico, Pakistan, Uruguay
Policy action prior to loan effectiveness	Venezuela, Indonesia
Appropriate inclusion of demand management policies	Venezuela, Uganda, Bolivia, Mexico
Appropriate inclusion of exchange rate policy	Venezuela, Uruguay, Ghana
Focus on supply-side measures	Venezuela, Ghana, Mexico, Philippines
III. Key Issues in Program Design	
Adequate treatment of conflicts among objectives	Mexico, Morocco
Realistic timing of reform	Bolivia, Mexico, Indonesia
Correct sequencing of reforms	Bolivia, Ghana
Appropriate use of SECALs	Mexico, Morocco, Pakistan, Ghana

a/ For loan effectiveness or legally binding for second-tranche release.

consistency of the short-term stabilization component as well as the medium-term structural policy reforms. Given that the Fund has an increasingly mixed record to its programs achieving their objectives, it is also not sufficient for the Bank to rely on a Fund program to ensure that stabilization policies are adequately implemented.

(b) Realism of Projections. A frequent shortcoming of recent adjustment programs is excessive optimism about: (i) the level of resources needed and investment required for switching to occur and growth to be restored; and (ii) the lag between policy change and response of economic agents (i.e., even where adequate resources are available, investment and growth may not occur given uncertainties about the lag structure in a number of key areas). Lack of realism has frequently led to underfunded programs which are reflected in either excessive compression of absorption (most frequently of investment) or in substantial divergence between unrealistic ex ante program objectives and ex post macroeconomic performance in which external balance is achieved at the expense of internal balance and growth.

(c) Focus on a Few Key Policy Conditions (Avoidance of "Christmas Tree" Effect). Macro conditionality in both SALs and SECALs should focus on a few key conditions. These conditions should, as appropriate, be time-bound, legally binding and as specific/precise/quantitative as possible so that there is no ambiguity about the Bank's commitment to implementation of the key macroeconomic policy conditions. An excessive number of conditions which dilute the key conditions may in practice make it more difficult for the Bank to use its leverage to support policy reform in key areas (e.g., if 75 of the 80 conditions of an Agricultural SECAL have been implemented, the Bank may appear to be unreasonable if it does not agree to second tranche release even though a few macroeconomic conditions -- albeit key ones -- have not been met).

(d) Need to Record and Monitor Implementation of Macroeconomic Component of Adjustment Program. Agreement between the Bank and the AL country on specific elements of the macroeconomic program should be recorded for all SALs and SECALs so that there exists a point of reference for monitoring subsequent macroeconomic performance. This should be done in sufficient detail that key elements of the macroeconomic program are made explicit. Without this (i.e., that the Bank generally "is satisfied" with implementation progress), there is a danger that insufficient weight will be given to ensuring implementation of key macroeconomic conditions and excessive weight will be given to other objectives such as avoiding a negative net transfer and fulfilling lending targets.

(e) Proper Sequencing of Structural Adjustment Measures. Since some components of an adjustment program will be ineffective or will have perverse effects if they are not preceded by improvements in macroeconomic performance, proper sequencing in the design of adjustment programs is important. For example, efforts to bring about shifts in relative prices are unlikely to be effective if high and volatile rates of inflation exist or are expected (relative price signals will be swamped by the general price increase and will not induce the desired switching response). Similarly some sectoral adjustment objectives will be impossible to achieve if they are not preceded by adequate macroeconomic policies and institutional reforms. Efforts to liberalize the financial sector (reduction of reserve requirements, elimination of forced holding of government paper, liberalization of interest rates and relaxation of cumbersome banking regulations) are unlikely to be successful unless the government's fiscal deficit is under control, inflation (and inflationary expectations) has been reduced to a manageable level and administration of the commercial bank regulation framework has been improved.

(f) Sequencing of Stabilization Policies. Macroeconomic policies themselves must be properly sequenced if they are to have the desired effect. For example, freeing of interest rates before large fiscal deficits are brought under control, the exchange rate regime is liberalized and inflationary expectations are broken, is likely to result in excessively high real rates of interest which are inconsistent with efforts to reduce the fiscal deficit and to reestablish an adequate rate of economic growth. Similarly, current account deficits in the balance of payments must be brought under control, interest rates liberalized and a more market determined exchange rate be put in place before the capital account can be opened. Otherwise, destabilizing capital flows (capital flight if real interest rates are negative in real terms or massive, destabilizing capital inflows if real interest rates are high and the exchange rate is fixed) which make it difficult for the government to achieve its other macroeconomic objectives are likely to occur.

(g) Relationship between Stabilization and Financial Sector Reform. The financial sector is a primary conduit of macroeconomic policy with the rest of the economy. Conflict often arises when high real interest rates are part of the stabilization process since they can result in financial distress of borrowers and generalized deterioration of portfolio quality across the financial sector. If this problem becomes acute, restructuring and recapitalizing the financial sector becomes necessary and this can undermine the fiscal restraint necessary to achieve stabilization objectives.

(h) Reducing the Supply Response Lag. Productive sectors respond with lags to changed incentives; these lags vary between sectors because of their technology and institutions. Lags are apt to be especially long during the period of stabilization. A key issue is how to design adjustment programs so that institutional reform and sectoral policy are used to enhance sectoral supply response.

(i) Use of Heterodox Macroeconomic Adjustment Policies. Use of "heterodox" measures in stabilization programs is an important consideration in program design. Heterodox approaches used by countries experiencing chronic inflation, such as Brazil (Plan Cruzado) and Argentina (Plan Austral), initially appeared to be successful in arresting the inertia of rising prices without sacrificing growth. Such approaches focus on use of price controls (wage, price and in some cases exchange policies), to slow inflation and to control expectations. The conclusion from these experiences is that while heterodox measures can help to overcome inertial inflation and can be an effective tool in managing inflationary expectations, they are unlikely to be successful unless they are supported by orthodox stabilization policies, especially by tight fiscal management.

(j) Need for Contingency Mechanism for Responding to External Shocks. An important issue in program design is use of a contingency mechanism in targeting net international reserves. If this variable is to be targeted, there is need for a contingency mechanism to isolate the effect on net international reserves of temporary external shocks. In the absence of such a safeguard there is a danger that rolling adjustment program targets will be tightened excessively in response to external shocks and that this will derail efforts to reestablish growth.

(k) Real vs. Nominal Targets. If nominal targets are used and the inflation target is missed, all other nominal targets become irrelevant. Since inflation is not controlled by any one policy instrument, but is the outcome of many simultaneous forces (i.e., the result of both policy intervention and exogenous shocks), including expectations about future inflation, forecasting of future inflation r tes is exceedingly imprecise. This is particularly true of the high and volatile inflationary situations in many of the middle income high debt countries at present. However, if real targets are used there remains the problem of selecting the appropriate nominal anchor. Currently there is no clear consensus within the economics profession on this point. This subject is one of the major priorities of future macroeconomic policy research.

(1) <u>Dealing with the Debt Overhang</u>. There are important issues of program design which stem from a large debt overhang. Service payments on external debt require a twin transfer of resources (external and domestic). Because the public sector is ultimately responsible for servicing the external debt, but savings are usually being generated in the private sector, there is a need to transfer resources from the private to the public sector. Because there are limits on the size of transfer which can be achieved, many highly-indebted countries end up resorting to use of the inflation tax. In such circumstances the government may have to resort to use of high real interest rates to induce the public to hold government paper. As a consequence, many highly-indebted countries have experienced excessively high rates of interest for long periods of time which have the effect of crowding out private investment and impeding resumption of growth. This has frequently eroded the sustainability of adjustment programs. If not dealt with directly, the problem is likely to become more severe with time. There are solutions to these problems but their implementation is usually difficult. One solution is to cut Government expenditures. The difficulty with this is that in practice investment spending is usually the easiest to cut. While it is possible to identify some public sector investments which should not be undertaken, further investment cuts beyond this may make it more difficult to carry out switching and to resume sustained growth. The conclusion is that sustainability of adjustment programs will depend upon proper handling of the debt restructuring process. For some countries, debt reduction is a <u>sine qua non</u> of program design if the adjustment program is to succeed.

APPENDIX

Coding, Conditionality and Implementation

The tables in this paper are based on the Bank's Industry and Energy Department (IENIN) Adjustment Lending Conditionality and Implementation Database (ALCID). The sample covers 184 adjustment loans to 61 countries. Twenty-six of these countries had three or more adjustment loans during the 1980-89 period[9]. For each given country adjustment program, two sorts of information were considered: (1) the specific conditions attached to each Bank-supported program; and, where available, (2) the implementation status, or extent to which these conditions have been fulfilled. The conditionality and implementation were classified according to general information about a given loan and a given borrower (for example, the fiscal year and the dollar amount of the loan) and to more specific information about each condition. The sources of information on conditionality were legal agreements and President's Reports.

Characteristics of conditions were coded on six dimensions: (1) firmness, whether a condition is precisely specific and perhaps quantifiable; (2) legality, whether the legal agreement requires the condition for disbursement; (3) timebound, whether a condition has to be fulfilled within a given timeframe; (4) importance, whether the ALCID coder considered a condition central to the adjustment process; (5) policy area; and (6) performance objective. Pakistan's 1989 Financial Sector Adjustment Loan provides an example of a condition which is specific, legally-binding for second tranche release, timebound and important: "reduce the government's budget deficit to 6.5% of GDP in FY89."

The data on implementation indicates the extent to which a condition was fulfilled at last tranche release (during the lifetime of a loan) at loan completion report, and current status (Summer 1988 or Spring 1989). In the 184 country-program sample, only 97 loans have been in place long enough to have any information on implementation. The sources of information on implementation were mainly supervision reports, tranche release documents, and where available, Project Completion Reports and Program Performance Audit Reports. These sources were supplemented by additional information obtained from Bank staff familiar with the country's adjustment program. While the coding resulted from subjective judgments, there were several checks at each stage to assure consistency of standards.

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9 In Asia -- Indonesia, Korea, and the Philippines; in Europe, the Middle East and North Africa -- Morocco, Pakistan, Tunisia, Turkey and Yugoslavia; in Latin America and the Caribbean region -- Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Jamaica, Mexico and Uruguay; in Sub-Saharan Africa -- Code d'Ivoire, Ghana, Kenya, Malawi, Nigeria, Senegal, Tanzania and Zambia.

The implementation of each was graded: (1) little or no progress; (2) moderate progress (some steps taken but not much progress); (3) significant progress (substantial steps taken to move progress more than half-way); (4) implementation fulfilled; and (5) implementation more than fulfilled.

Such a grading process has its limitations. First, it involves judgment; the appropriate "grade" was not always clear. Second, while full implementation is a desirable objective ex ante, it may not always remain desirable. Both economic and political circumstances can change unexpectedly, causing a shift in policy instruments to fit the changed economic environment. Third, it is worth noting that the grading process does not consider whether conditions differ in their implementation difficulty and the strength of their impact on the economy[10].

[10] In this regard, we have considered as well descriptive information drawn from PCRs and PPARs, which goes behind aggregate data.

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