World Bank Programs for Adjustment and Growth

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by

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Abstract

The experience of developing countries in the last decade has helped dramatize the importance of macroeconomic policies for sustaining economic growth and adjusting successfully to unfavorable external shocks. Although developing countries have responded to external shocks with significant changes in their economic policies in the last few years, as a group they have not been able to recapture their growth momentum. This paper addresses three main questions. First, what should be the main focus and content of domestic policy reform designed to promote sustainable growth in developing countries? Second, what are the implications of past experience with designing policies for adjustment and growth for future World Bank programs in support of developing country policy reform efforts? Third, what kind of financial packages are suitable to support adjustment with growth in different country settings and what are the issues the World Bank faces in putting together such packages? In attempting to answer these questions, the paper explores the analytical underpinnings of, and developing country experience with, policy reforms aimed at adjustment and growth. The last section of the paper presents conclusions and implications of the analysis for future World Bank programs.
# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Introduction</td>
<td>1</td>
</tr>
<tr>
<td>II. The Nature of the Problem of Adjustment with Growth</td>
<td>3</td>
</tr>
<tr>
<td>III. The Analytical Framework of Promoting Adjustment with Growth</td>
<td>7</td>
</tr>
<tr>
<td>A. Stabilization and Adjustment</td>
<td>7</td>
</tr>
<tr>
<td>B. Structural Change and Growth</td>
<td>11</td>
</tr>
<tr>
<td>C. The Strategy of Reform</td>
<td>14</td>
</tr>
<tr>
<td>IV. World Bank Programs</td>
<td>23</td>
</tr>
<tr>
<td>A. Program Instruments</td>
<td>23</td>
</tr>
<tr>
<td>B. The Policy Focus of Structural and Sectoral Lending</td>
<td>29</td>
</tr>
<tr>
<td>C. A Summary View of World Bank Experience with Policy Reforms Under Structural Adjustment Lending</td>
<td>32</td>
</tr>
<tr>
<td>D. Issues Raised by World Bank Programs of Adjustment</td>
<td>40</td>
</tr>
<tr>
<td>V. Links with IMF Programs</td>
<td>47</td>
</tr>
<tr>
<td>VI. The Financial Packages</td>
<td>49</td>
</tr>
<tr>
<td>VII. Conclusions</td>
<td>55</td>
</tr>
</tbody>
</table>
World Bank Programs for Adjustment and Growth  
Constantine Michalopoulos

I. Introduction

The experience of developing countries in the last decade has helped dramatize the importance of macroeconomic policies for sustaining economic growth and adjusting successfully to unfavorable external shocks. The external shocks of the period showed up the structural weaknesses and the limited flexibility in many developing countries' economies -- factors that frequently stemmed from their own economic policies.

Developing countries have responded with significant changes in their economic policies in the last few years. Nevertheless, as we enter 1987, developing countries as a group clearly have not recaptured the growth momentum required to restore the per capita consumption levels of the early 1980s. Some, through the pursuit of effective policies, have by and large avoided the crises of recent years. A few, after sustaining significant declines in income and output, have been able to restore their growth momentum. In far too many others, however, the adjustment process remains incomplete. Moreover, a great deal of the adjustment that has taken place has involved severe compression of investment and imports with detrimental consequences for future growth.

In the aftermath of the Seoul meetings of the World Bank and the IMF in October 1985, an international consensus has evolved that restoration of growth in the developing countries requires the concerted efforts of these countries, international institutions (especially the World Bank and the IMF),
bilateral donors and commercial banks. In particular, it has been recognized that the World Bank and the IMF should play a coordinated role in helping developing countries develop policy packages to restore growth and creditworthiness (Development Committee 1986a).

This paper attempts to answer three main questions. First, what should be the main focus and content of domestic policy reform designed to promote sustainable growth in developing countries? Second, what are the implications of past experience with designing policies for adjustment and growth for future Bank programs in support of developing country policy reform efforts? Third, what kind of financial packages are suitable to support adjustment with growth in different country settings and what are the issues the Bank faces in putting together such packages?

In attempting to answer these questions, the paper explores the analytical underpinnings of, and developing country experience with, policy reforms aimed at adjustment and growth. The emphasis is on a few key policy areas recognizing that the details of policy prescriptions must be adapted to specific country circumstances. Next, the paper examines the experience of recent World Bank programs supporting policy reform in member countries. The lessons of this experience and the issues raised can also be helpful for designing new programs, which is the focus of this paper. But the limitations of this experience should be also recognized at the outset. The available evidence is far less comprehensive than comparable evidence on the project side. Moreover, many of these programs were introduced during periods of massive internal and external disequilibria -- which in turn affected both the emphasis and the effectiveness of programs.
The last section of the paper presents conclusions and implications of the analysis for future World Bank programs. An effort is also made to identify areas where the understanding of the effects of policies is incomplete and additional analysis and research is needed.

The scope of the analysis is limited in that it does not address, except in passing, such critical issues for developing countries' growth and adjustment as: developments in the international economic environment and in industrial countries' policies that impact on the prospects of developing countries; the prospects for commercial bank lending and other private capital flows; the flow of official financing; or issues of debt restructuring. The paper also does not address issues of Bank program implementation, such as the aspects of conditionality, disbursement, monitoring and donor coordination that impact on program effectiveness. It would have been impossible to do justice to these important issues within the confines of a single paper.

II. The Nature of the Problem of Adjustment with Growth

Structural change is the essence of development. Adjustment to changing domestic and international circumstances is a continuous challenge to all countries. At present the international community's attention and the focus of this paper is directed on the acute problems of adjustment and growth facing two specific sets of developing countries -- a group of highly indebted middle-income countries with debt servicing difficulties, and the countries of
Sub-Saharan Africa. 1/ In the former, annual GDP growth in the period 1981-86 averaged 0.6 percent (but -0.5 percent if Brazil is excluded). In the latter, growth over the same period was -0.4 percent. Output per capita fell over this period for both sets of countries.

The level of development, the institutional and political framework and the constraints on structural change and growth vary from country to country. But there are some important similarities.

First, a number of countries in both groups have considerable macroeconomic imbalances, resulting in a high rate of open or suppressed inflation and unsustainable rates of domestic absorption. Macroeconomic stabilization is needed in these countries in order to restore the basis for future growth.

Second, debt burdens are heavy in both sets of countries. Servicing this debt absorbs a significant amount of domestic savings. Restoration of growth requires action to raise the productivity of existing and new capital and to increase the investment rate from current levels.

Productivity, however, is often impaired by distorted factor and market prices; by inefficient public sector enterprises; and by a structure of incentives that has helped create inward-looking uncompetitive industries. To finance higher investment, it is necessary to raise domestic savings. But there are serious constraints on how much savings can increase. Marginal savings rates must exceed 50 percent or more in some highly indebted middle-

1/ For the purposes of this discussion the aggregates presented for the first group relate to the 17 countries identified in Development Committee (1986a). A listing of this country group is included in footnote c to Table 3. The Sub-Saharan group includes all countries south of the Sahara, except South Africa.
income countries for long periods in order to service debt, make up for lower external financing and provide a margin for additional investment. It is difficult to raise marginal savings rates, however, if per capita consumption has been stagnant or declining as it has for some time, especially in Sub-Saharan Africa (Development Committee 1986a).

Third, restoration of growth also requires a rapid expansion of exports in order to be able to transform domestic savings into the payments in foreign exchange. Additional foreign exchange earnings are needed to service their large external debt obligations -- as well as to finance the higher volume of imports typically associated with increases in investment. This in turn requires a change in the composition of output in favor of tradeables. Such a structural shift is especially difficult in Sub-Saharan African countries, which have relatively inflexible and undiversified economic structures. Moreover, the size of the structural change required has been magnified and the problems of adjustment exacerbated by a significant deterioration in the terms of trade of most primary commodity exporters.

Fourth, additional financing from abroad can help restore growth and ease the domestic savings constraint. In middle-income countries, additional foreign borrowing, if utilized efficiently, can stimulate output and domestic savings. Provided domestic savings grow faster than investment (and depending on the productivity of investment and other factors such as the level of international interest rates), net borrowing and the ratio of debt to GNP can decline over time, and these countries' capacity to service existing debt and maintain the momentum of growth can be restored. 2/ But at present, new

2/ For details of the conditions see Selowsky and van der Tak (1986).
private capital inflows, on which these countries have traditionally depended for their finance, are severely limited (World Bank 1987).

Additional capital flows to the low-income countries of Sub-Saharan Africa need to be on concessional terms. Given the level of domestic savings, the existing debt burden and the productivity of the current capital stock and future investment, additional debt on commercial terms could not be serviced even if it were forthcoming, which it is not. But there are limits to the availability of new capital inflows on concessional terms, that is, Official Development Assistance (ODA), which ultimately must be obtained from developed country donors that also face budgetary constraints (Development Committee 1986b).

Finally, implementation of macroeconomic stabilization and structural change can generate transitional costs in the form of unemployment. For example, a change in the structure of incentives is needed in order to promote a reallocation of resources that is more conducive to long-term growth. Productive resources are not redistributed instantaneously among alternative uses in response to changes in relative commodity and factor prices, however, and thus some temporary unemployment could result.

In addition to these general problems of structural change and growth, Sub-Saharan Africa faces other long-term growth constraints. These include weak physical and human infrastructure, inadequate institutions, a rapid rate of population growth and, until recently, severe drought conditions that adversely affected agriculture, the mainstay of these countries' economies (World Bank 1986c).

The adjustment process would be facilitated by a supportive international environment, which in turn depends critically on actions by
industrial countries (Development Committee 1986a). Regardless of the environment, however, promoting structural change and restoring growth necessarily entails further policy reforms by the developing countries themselves. In summary, these reforms should aim to: (i) restore or maintain macroeconomic stability; (ii) raise overall efficiency and factor productivity in their economies; (iii) raise savings relative to consumption; and (iv) restructure production in favor of tradeables.

III. The Analytical Framework of Promoting Adjustment With Growth 3/

Given these domestic policy objectives, what can economic theory and past experience tell us about the kinds of policies that developing countries should pursue? This section provides a summary review of experience on some of the key policy issues affecting structural adjustment and growth.

A. Stabilization and Adjustment

Experience suggests that the presence in any country of prolonged and significant aggregate imbalances -- in the sense that the aggregate demand for resources exceeds the amounts of resources available internally or obtainable from abroad on appropriate terms -- is inimical to longer-term growth. Such imbalances cannot be sustained indefinitely, and the longer the imbalances persist, the greater the subsequent adjustment needed and the likely adverse impact of stabilization on short-term output.

Macroeconomic imbalances usually manifest themselves in high and unpredictable inflation and periodic balance of payments crises. Significant

3/ This section draws in part on Corbo and de Melo (1987 forthcoming) and Development Committee (1986a).
inflation (open or repressed), is itself a source of resource misallocation and an impediment to growth (Fischer 1986, Yeager 1981). Inflation is inimical to raising the savings rate and to channelling savings to productive investment. Uncertainty about future inflation rates leads to concentration of financial transactions in instruments with short rather than long-term maturities, thus reducing the availability of funds for long-term investment. High inflation does not affect all prices and costs uniformly; at the same time, it makes relative prices very volatile, and reduces their information content for purposes of resource allocation. Finally, countries with high inflation frequently introduce interest rate and price controls. Interest rate controls result in negative real rates, which in turn lead to credit rationing, distort investment decisions, and reduce the size of the formal financial system. Price controls, on the other hand, encourage the development of black market profiteering and rent-seeking while discouraging productive activities.

Periodic balance of payments crises result in cycles of expansion and contraction of economic activity which adversely affect investment and long-term economic growth. As part of the stabilization effort, absorption must be reduced to bring it to a level compatible with the level of output plus the sustainable current account deficit. Monetary, fiscal and exchange rate policies are the three main instruments of a stabilization program. Fiscal and monetary policy have mainly absorption-reducing effects while exchange

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4/ What is "significant" varies from country to country and has to do in part with historical experience which shapes future expectations and the actions of economic agents. In Latin America, 25 percent per annum may be used as a rule of thumb; but in South East Asia half this rate may be too high.
rate policy has primarily expenditure-switching effects. 5/ The reduction in absorption needed to reduce inflation and to achieve a sustainable current account deficit will usually be accompanied by a reduction in the rate of growth of output. Indeed, a short-run slowdown in output growth is almost a prerequisite for a successful stabilization, because the success of stabilization depends on applying contractionary pressure to the economy as a whole. The slowdown in the economy will be less pronounced the greater the downward flexibility of product prices and wages and the greater the availability of external finance requiring less recourse to demand management policies.

The key issue for adjustment and growth is to find the combination of the three macroeconomic policy instruments that will, for any given level of external finance, attain stabilization objectives while also being the most supportive of future structural adjustment and the least disruptive to growth. In general, it might be more advantageous if a balanced approach is used and the burden of promoting overall adjustment is not placed on any single policy instrument. Naturally, if the overall macroeconomic imbalance can be traced to a particular cause, action to address that cause should be an important part of any stabilization package.

5/ It should be noted, however, that fiscal and monetary policy also have secondary expenditure-switching effects through their effect on the composition of expenditure, and that devaluation policy also has secondary absorption-reducing effects through its effect on real private wealth.
In recent periods, excessive absorption and inflation in developing countries has often been linked to large government budget deficits. 6/ Action in reducing such deficits is thus usually an important prerequisite to stabilization. However, how these deficits are reduced has a bearing on growth and adjustment. If the burden falls primarily on physical and social infrastructure or essential maintenance activities, then future growth will be compromised.

Moreover, if the reduction in absorption is not accompanied by a change in relative prices in favor of tradeable goods, then demand and output for both tradeable and nontradeable goods will need to be reduced. To minimize the reduction in total output needed to attain any targeted reduction in absorption, it is desirable to have a real exchange rate depreciation to engineer a shift in the composition of output (and expenditures) in favor of tradeable goods (Corden 1981, Dornbusch 1980). Such a shift is also a key objective in trade reforms designed to promote a medium-term restructuring of many developing countries' economies.

If there is neither fiscal deficit reduction nor exchange rate adjustment then the whole burden of stabilization must be borne by monetary policy and it is more likely that long-term growth objectives will be adversely affected. This is because monetary policy will have to be so restrictive as to result in real interest rates high enough to crowd out interest sensitive components of aggregate demand and especially private investment.

6/ In some cases, however, the problem derives from a deterioration of the international environment manifested in sharply declining terms of trade; in many cases, a combination of domestic and international factors has been present.
Finally, any stabilization program should avoid introducing major distortions that could jeopardize successful adjustment. In particular, experience in several Latin American countries suggests that, if a country needs to reduce its anti-export bias and shift resources to tradeables, real exchange rate appreciation and/or export taxes should not be used as a major stabilization device (Corbo 1987 forthcoming).

B. Structural Change and Growth

Stabilization alone does not guarantee growth. The specific components of a policy package that will induce structural change and growth will vary from country to country, depending on its current situation and existing policies, and on the international environment and its future prospects. Recent reviews of the situation in many developing countries, however, suggest that the following policy areas require priority attention.

More resources can be mobilized for development by raising public savings through reductions in government expenditures and/or increases in revenues. Significant deficits persist in many countries and there is considerable scope for the reduction of government expenditures without adversely affecting economic growth and distribution objectives. Public enterprises continue to soak up resources in several countries. Public sector performance can be improved through better public enterprise management, improved pricing policies, and in some cases, the privatization or closing down of inefficient public enterprises. Savings can also be introduced by better targeting of government support programs, e.g., food subsidies, to the groups that truly need them.

Public savings can also be increased by broadening the tax base and improving revenue collection. In the absence of restraint on expenditures,
however, efforts to generate additional government revenues might only result in the continued financing of low priority public sector activities and a reduction of private savings. On the other hand, lowering tax rates and rationalizing the tax system may improve overall incentives and promote social objectives without reducing government revenues (Development Committee 1986a, p.19). 7/

Private savings are stimulated by stable and predictable macroeconomic policies, particularly as they pertain to interest rate policies and inflation. Macro policies alone are frequently not sufficient, however. Raising private savings usually also requires strengthening of domestic financial institutions.

Greater economic efficiency and improved productivity of investment require the elimination of microeconomic distortions, as well as measures to improve the productivity of existing and future public sector investment. The most prevalent types of distortions are price controls, highly differentiated incentives in the trade sector, subsidized interest rates, credit rationing, and impediments to labor mobility and adjustment in the real wage. In highly-regulated economies, resource allocation and productivity can be improved by removing price controls and simultaneously deregulating domestic factor markets. In addition, deregulation of financial markets (subject to appropriate banking supervision rules) improves credit allocation, thereby distributing investment more efficiently. Similarly, the elimination of labor

7/ Jamaica recently instituted a comprehensive tax reform which included the establishment of a single personal income tax rate of 33.5 percent, and a broadening of the tax base, while increasing the minimum exemption level without affecting total government revenues.
market restrictions, which impede labor mobility, promotes more efficient allocation of labor.

Many countries have experienced low yields on the stock of public capital due to poor investment decisions, inefficient operations, or both. Investment cutbacks undertaken by some countries have focused on specific uneconomic projects. In these cases, public investment cutbacks have clearly benefited the economy. For the most part, however, governments have not made such selective investment reductions. Completion of ongoing projects has often been justified without consideration of the project's economic merits, while aggregate public investment expenditures have declined (Choksi 1986).

It is clear that government initiatives should also be aimed at improving the allocation of public investment. Such efforts imply a redistribution of public investment away from sectors such as industry and agriculture in which private investment is as (or more) efficient, and towards activities that have externalities, such as human resource development and physical infrastructure. Similarly, a greater emphasis on the maintenance and rehabilitation of high-return public projects can result in significant expansion of output in many countries.

In order to stimulate a shift of resources and an increase in the supply of tradeables, two sets of policy measures are important: (i) a macroeconomic policy mix resulting in an appropriate real exchange rate, and (ii) a proper incentive structure that is neutral between production for the domestic and the foreign market. The proper incentive structure requires, at a minimum, the elimination of the anti-export bias prevalent in many countries, through liberalization and rationalization of the trade regime involving the removal of quantitative restrictions; reducing tariffs and
eventually attaining relatively uniform tariffs on inputs and outputs; and lowering, and when possible, eliminating export taxes.

The experience of many developing countries has shown that a trade regime that does not discriminate between domestic and export sales not only increases exports but also encourages efficient import substitution industries. Trade liberalization results in the contraction of inefficient sectors and the expansion of new, efficient ones. Over time, a new and more efficient production structure develops which will be better suited to the international environment (Krueger and Michalopoulos 1985). Moreover, the experience of the 1970s and early 1980s has shown that countries with trade regimes characterized by a balanced set of incentives towards exports and import-competing activities, have been far more resilient to external shocks (Balassa 1984, Sachs 1985).

C. The Strategy of Reform

There is broad agreement on the nature of the reform packages discussed in Sections A and B above. Uncertainties become more prominent at the implementation stage, because implementation involves the dynamics of reform -- about which less is known, and which depends partly on initial conditions and partly on political considerations that vary from country to country.

Three important sets of issues need to be addressed: (i) the sequencing of the program; (ii) the speed of the reforms; and (iii) the appropriate macroeconomic policies for transition to a less distorted economy.

**Sequencing of Reforms:** There are two broad sequencing issues. First, the sequencing of policy measures aimed at stabilization and those
which focus on structural adjustment; second, the sequence of reforms to remove distortions when many markets are initially regulated.

There is little disagreement that structural adjustment is easier if it takes place in a stable macroeconomic environment, especially one in which inflation is under control. 8/ The reasons for this stem from the links between stabilization and trade reform, which is usually a key element in promoting structural change over the medium term. On the one hand, successful stabilization depends on applying contractionary pressure to the economy as a whole; on the other hand, the rationalization of trade policies calls for contraction of highly protected import-competing activities and expansion of export-oriented activities (and efficient import-competing ones). With simultaneous application of both programs, the net contractionary pressure on highly protected import-competing activities might be so strong that it could lead to business failures and significant transitional unemployment and other costs, and/or generate strong opposition which undermines the liberalization effort (Mussa 1987).

Another problem might arise because of limited downward price flexibility. A successful trade reform is helped by a quick export response (see below p.18). If product prices are relatively inflexible downward, then the supply response of export activities will be seriously delayed and the whole effort to rationalize the structure of incentives could be put in jeopardy. Of course, the frequent presence of unutilized capacity in the tradeables sector may well minimize this problem in practice.

8/ How much stabilization is needed before trade liberalization and other reform steps are taken is an open question, however.
An initial real devaluation, besides helping achieve demand management objectives, can also support the rationalization of trade incentives needed to achieve the desired improvement in the relative prices of exportables. For those countries which have discriminated against exportables for a long time, an up-front improvement in the relevant incentives may be necessary to move resources toward exportables (Mussa 1987). However, devaluation will also temporarily accelerate inflation or weaken the fight against it. In many countries, the devaluation will also increase the cost of food imports which raises issues about how to deal with the implications of such increased costs for the urban poor (see Section IV, D, 2 below).

In practice, the onset of a balance of payments crisis has been viewed as a politically opportune occasion to undertake a variety of reforms, including trade liberalization. While there are historical examples of simultaneous achievement of stabilization and structural adjustment involving reform of the structure of trade incentives, pursuit of both objectives at the same time presents difficulties. 9/ One of the most extensive studies of trade liberalization reforms has concluded that their failures have stemmed mainly from the failure of the accompanying anti-inflationary programs (Krueger 1978). This conclusion, however, in no way implies that certain other aspects of structural reform, for example rationalization of public sector expenditures including shifts of public sector investment to support expansion in the output of tradeables, should not occur at the same time as

9/ The current Mexico reform program tries to accomplish both sets of objectives; but it is too soon to tell how successful it is going to be.
stabilization. Indeed, the success of stabilization efforts may well depend on such early actions.

Economic theory offers little guidance about an optimal sequence for removing market distortions. Nevertheless, some broad conclusions can be derived from general principles that recognize that the objective of structural adjustment is to achieve a reasonable and sustainable rate of growth.

One question is the sequencing of liberalization of domestic markets relative to liberalization of economic relations with the rest of the world. Little is known on this issue or on the sequencing of domestic reforms, e.g., of agricultural pricing or tax regimes. Much of the analysis of sequencing has focused on liberalization of international accounts. However, experience from some countries, such as Yugoslavia, suggests that domestic factor market liberalization should precede other reforms, because if factor mobility is significantly impaired, the benefits of reforms in product markets cannot be realized.

With respect to international accounts, it is usually argued that the current account of the balance of payments should be liberalized first, leaving the liberalization of the capital account until much later (McKinnon 1982, Frenkel 1982 and 1983, Krueger 1984, Edwards 1985). Two arguments have been put forward for such a sequence. First, since asset prices are determined by the present value of income streams, income streams generated by distorted prices will result in distorted asset prices and thus, trade in

A forthcoming World Bank comparative study on agricultural pricing will be focussing on some of these issues (see Krueger, Schiff and Valdes 1987 forthcoming).
assets will take place at distorted prices (Krueger 1984). For example, incremental capital inflows in an environment of trade distortions may well be channelled to inefficient, protected industries. Second, since asset markets generally adjust much faster than commodity markets, liberalization of the capital account could result in large capital movements with unwanted consequences for the real exchange rate. By the same argument, the need to improve the overall balance of payments requires that the current and capital accounts be brought into line with each other; thus, even though the two accounts tend to respond at different speeds, the overall constraint implies that the two speeds of adjustment must be harmonized. It is much easier to achieve this by slowing down capital flows than by accelerating current account liberalization (Frenkel 1983).

This point could be extended further by arguing that, within the current account, import flows respond faster than export flows: thus, opening up the capital account first could jeopardize the overall process of trade liberalization by producing a sharp increase in import flows much in advance of the export expansion. Thus, some temporary measures to accelerate the supply response of exports could play a central role in a successful trade liberalization. Similarly, external financing can provide the needed cushion until exports do respond.

**Speed of reforms:** The issue is how quickly particular reforms should be implemented. Should trade be liberalized quickly or over 5 or 10 years? Should price controls in agriculture be removed at a stroke or gradually? Should interest rate ceilings be lifted at once or progressively?

In approaching these and other questions of implementation, it is essential to keep in mind the fact that structural adjustment is not an end in
itself. Rather, it is a means for achieving a more satisfactory and sustainable rate of output growth by using existing resources more efficiently, and by encouraging savings, and by raising the efficiency of new investment. As resource allocation depends on expectations about prices, the credibility of any reform is very important. In particular, reform initiatives need to be phased in terms of realistic timetables for reaching their objectives -- which may differ from one policy area to another and from one country to another.

The larger the original disequilibrium and the faster the intended speed of policy implementation, the greater the transitional costs of adjustment. A reform package that ignores the pace at which adjustment to the reforms can reasonably be expected to take place (a variable that is partly determined by political circumstances) runs a serious risk of failure and undermines the credibility of future reform efforts.

The credibilt) af a reform package might be enhanced by including policies aimed to speed up the adjustment called for by the reforms. Indeed, from the rational expectations viewpoint, issues of coherence and credibility are very important in determining the likely effect of a reform package on such variables as the size and direction of new investment, and thus on the success or failure of the program (Calvo 1986a and 1986b).

On the foreign trade side, for example, the main purpose of a liberalization and rationalization of the trade regime is to raise total factor productivity by eliminating discrimination against export-oriented industries (and efficient import-competing industries), and by reducing the variance of incentives across import-competing activities as well as helping to shift resources to tradeables. The speed of liberalization must therefore
depend on the speed with which resources can be expected to be reallocated to
the sectors that have hitherto been discriminated against; otherwise
substantial unemployment could result. Initial conditions specific to each
country will determine the speed at which the redeployment of resources can
take place. For example, the smaller the increment of GNP that is channelled
to new investment, the slower should be the speed of trade liberalization.
Similarly, the greater the extent of labor mobility and the more competitive
the labor market, the more quickly can resources be reallocated, and thus the
faster trade rationalization can proceed. Actual experience in several
countries suggests that unemployment has increased significantly only in a few
cases of trade liberalization (Papageorgiou, et al 1986).

Whatever the initial conditions, a substantial reform which is
undertaken within an agreed and reasonably paced timetable offers major
advantages. First, the required reallocation of resources will not occur
unless the signal given is strong enough and in a clear enough direction to
make the reform credible. Second, an unduly slow pace of reforms will delay
the development of export activities and interest groups whose support for
reform could help counter the antagonism toward reform of existing vested
interests (Papageorgiou, et al 1986). Nevertheless the pace of reform in
trade, for example, does not necessarily imply that the same pace of reform is
appropriate when dealing with, say reform of agricultural pricing. In the
latter case, a large initial change may be politically difficult to implement,
and would in any case need to be cushioned by the establishment of a safety
net to help the urban poor whose food prices would rise.

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11/ What is a "reasonable pace" would obviously vary by country. But
experience suggests that a lot can be accomplished within two to four
years.
The speed of deregulation of financial markets also needs to take into account initial conditions. For example, if regulation has led to a substantial proportion of financial institutions' assets being held at below market rates, and if real lending rates are substantially negative, then deregulation of interest rates will create difficulties for existing financial intermediaries. In particular, if deposit and lending rates are deregulated simultaneously and new entrants are allowed into the financial system, then existing banks will be forced to pay market rates, with the result that they may experience substantial capital losses. This could jeopardize the functioning of the overall financial system. A transition phase may be appropriate when lending rates could be deregulated first, and deposit rates gradually thereafter. In this way, the capital losses of existing banks would be minimized; then, as existing preferential loans come to maturity, controls on deposit rates could be lifted over time. A similar problem could arise if the banking system has in its portfolio a large proportion of nonperforming loans that are being financed by depositors. If no direct action is taken to provide alternative financing for these loans, then financial deregulation could jeopardize existing financial institutions.

Similar considerations apply to deregulation of controls on international capital flows. On the one hand, if deposit rates are below the free market level, rapid liberalization of capital flows will result in capital outflows that would weaken the domestic financial system. On the other hand, if domestic interest rates are free and substantially above international levels (when expressed in the same currency), decontrol of capital flows might result in large capital inflows that would create a real exchange rate appreciation, which might in turn jeopardize the success of
trade liberalization efforts that might have been pursued simultaneously (Bruno 1983, Corbo and de Melo 1987 forthcoming).

**Macroeconomic Policies during the Adjustment Process:** During a liberalization of external accounts, macroeconomic policy has to accomplish a number of complex and difficult tasks; it must simultaneously ensure an appropriate and stable real exchange rate, a low inflation rate, and a sustainable balance of payments position.

The importance of an early devaluation was noted above. Besides exchange rate policy, other elements of macroeconomic policy should also be designed to support the liberalization effort. Thus, for example, where the exchange rate is pegged according to some rule, monetary expansion should be compatible with the rule, so as to avoid a loss of confidence in it that might in turn jeopardize the success of the overall reform package.

Fiscal policy must also ensure that the fiscal deficit is compatible with the domestic credit expansion and the available external financing (Buiter 1986). Also, the part of the deficit that is financed in the domestic capital market should not crowd out the financing of the private sector -- especially in activities that need to expand. Likewise, credit policy should ensure access to credit at competitive rates for the expanding sectors, while simultaneously denying subsidized credit to previously heavily protected import-competing sectors (because its availability could slow down their adjustment). Finally, measures to introduce greater flexibility in the labor market will be needed in order to allow for a drop in the real wage in previously heavily protected sectors, and/or to allow the reallocation of labor toward the sectors that were previously discriminated against.
Otherwise, significant unemployment will result, in turn raising the transition costs of adjustment.

IV. World Bank Programs

A. Program Instruments

The World Bank has always stressed the need to use limited investable resources efficiently, the importance of identifying investment priorities in recipient countries and the restriction of its own role to projects promising a high rate of return. It has also recognized that it is virtually impossible to have a good project in a bad policy environment and has thus consistently tried to promote appropriate pricing policies for public utilities for instance, and later, agriculture -- sectors in which considerable Bank resources were being channelled (Baum and Tolbert 1985). Relatively less emphasis was placed, however, on efforts to support changes in the macroeconomic environment or in other economy-wide policies of developing countries.

As the events of the last decade unfolded, World Bank programs also changed. While project and sector investment activities continued to absorb the largest portion of World Bank loans and credits, new instruments were introduced such as Structural Adjustment and Sector Adjustment Loans and Credits, which focused directly on supporting developing countries' programs and policies of structural reform.

There are currently five categories of Bank lending operations: (i) Specific Investment Loans; (ii) Sector operations, which include Sector Investment and Maintenance Loans, Financial Intermediary Loans and Sector Adjustment Loans; (iii) Structural Adjustment Loans; (iv) Technical Assistance
Loans; and (v) Emergency Reconstruction Loans. In practice, the conceptual distinctions between these categories are sometimes blurred, and specific operations can combine different categories. 12/

Developing country policy issues arise in different contexts in almost all categories of loans. But the focus tends to be different in each. In specific project and sector investment loans (and also in Financial Intermediary Loans), the focus is on specific policies that affect the viability of the project or the entity being assisted, e.g., input and output prices, lending rates to sub-borrowers, etc. Similarly, Technical Assistance Loans focus primarily on institutional strengthening and support. By contrast, the objective of sector adjustment loans is to promote the introduction and effective implementation of the sector policies necessary for sustained economic growth. Finally, Structural Adjustment Loans focus on macroeconomic policies and associated institutional changes at the country level -- although they frequently emphasize reforms of special relevance to particular sectors in which adjustment is most urgently needed. 13/ Thus there is a lending instrument continuum, one end of which focuses on policies and institutions that ensure the viability of a narrowly defined project,

12/ Prior to the introduction of structural adjustment lending in the early 1980s and in some instances thereafter, the Bank has provided a small number of Program Loans and Credits with a similar overall policy focus.

13/ The Bank's Operational Manual defines structural adjustment lending as "non-project lending to support programs of policy and institutional change necessary to modify the structure of an economy so that it can maintain both its growth rate and the viability of its balance of payments in the medium term" (Operational Manual Statement No.3.58, Annex II, November 1982).
while the other is concerned with the overall macroeconomic policies and institutions of a country.

The above does not exclude addressing macroeconomic policies through specific projects. Indeed, heightened concern about the policy framework can and does substantially affect the context and focus of project operations, which are likely to continue to absorb the bulk of Bank's future lending. Moreover, under certain circumstances, it might be advantageous to promote macroeconomic policy reform through the relatively lower key instrumentality of a specific project operation. But, "structural (and in its own way sectoral) adjustment lending enables the Bank to address basic issues of economic management more directly and more urgently than before" (Stern 1983, p.91). It is on these sectoral and structural adjustment operations and the policies they support that is the focus of the rest of this Section.

Tables 1-3 show the growing importance of sectoral and structural adjustment lending in World Bank operations. From an annual average of under 4 percent for the FY79-80 period, these categories combined grew to 19 percent in 1986 (See Table 1). 14/ With regard to the two sets of countries identified earlier in this paper, sector lending has grown especially fast in Sub-Saharan Africa 15/, while Structural Adjustment Loans have shown the sharpest percentage increase within total commitments to the highly indebted developing countries. In the West Africa, Europe/Middle East/North Africa and Latin America regions, the two lending instruments combined represented about

14/ Structural Adjustment Loans are quite lumpy; thus, the percentage that they represent of total World Bank lending to a particular region or in the aggregate can vary substantially from year to year.

15/ Loans to financial intermediaries are sometimes included in Sector Loans. While in some respects they contain features of other non-project lending they are excluded here, primarily because their policy focus usually tends to be narrow.
### Table 1: Distribution of World Bank Loans and Credits by Lending Instrument
(in percent)

<table>
<thead>
<tr>
<th>LENDING INSTRUMENT</th>
<th>FY75</th>
<th>FY79-80</th>
<th>FY81-82</th>
<th>FY83</th>
<th>FY84</th>
<th>FY85</th>
<th>FY86</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPECIFIC INVESTMENT LOANS</td>
<td>58.5</td>
<td>58.5</td>
<td>44.7</td>
<td>39.4</td>
<td>41.1</td>
<td>49.6</td>
<td>45.2</td>
</tr>
<tr>
<td>SECTOR INVESTMENT LOANS</td>
<td>15.9</td>
<td>22.5</td>
<td>26.3</td>
<td>24.6</td>
<td>26.4</td>
<td>27.0</td>
<td>19.0</td>
</tr>
<tr>
<td>FINANCIAL INTERMEDIARY LOANS</td>
<td>16.7</td>
<td>13.1</td>
<td>18.6</td>
<td>20.6</td>
<td>13.3</td>
<td>9.6</td>
<td>12.4</td>
</tr>
<tr>
<td>SECTOR ADJUSTMENT LOANS</td>
<td>0.0</td>
<td>0.5</td>
<td>0.5</td>
<td>4.4</td>
<td>8.5</td>
<td>10.3</td>
<td>14.0</td>
</tr>
<tr>
<td>PROGRAM &amp; STRUC. ADJUST. LOANS a/</td>
<td>8.8</td>
<td>3.3</td>
<td>8.0</td>
<td>9.6</td>
<td>8.4</td>
<td>1.1</td>
<td>5.0</td>
</tr>
<tr>
<td>TECHNICAL ASSISTANCE LOANS</td>
<td>0.2</td>
<td>0.4</td>
<td>1.7</td>
<td>1.2</td>
<td>2.1</td>
<td>1.4</td>
<td>1.4</td>
</tr>
<tr>
<td>EMERGENCY RECONSTRUCTION LOANS</td>
<td>0.0</td>
<td>1.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.3</td>
<td>1.0</td>
<td>3.1</td>
</tr>
<tr>
<td>TOTAL b/</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

**a/** Includes both Program and Structural Adjustment Loans and Credits (see footnote 12, p. 24).

**b/** May not add exactly due to rounding.

Source: Planning and Budgeting Department, The World Bank
Table 2: Regional Distribution of World Bank Loans and Credits by Lending Instrument
(in US$ million and percent)

<table>
<thead>
<tr>
<th>Region</th>
<th>Average FY75</th>
<th>Average FY79-80</th>
<th>Average FY81-82</th>
<th>Average FY83</th>
<th>Average FY84</th>
<th>Average FY85</th>
<th>Average FY86</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TO EAST &amp; SO. AFRICA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (US$ million)</td>
<td>656.5</td>
<td>720.9</td>
<td>794.4</td>
<td>1129.8</td>
<td>1186.6</td>
<td>786.0</td>
<td>915.9</td>
</tr>
<tr>
<td>1) Sector Adj. (% of total)</td>
<td>0.0</td>
<td>3.8</td>
<td>3.2</td>
<td>17.3</td>
<td>6.3</td>
<td>8.3</td>
<td>17.5</td>
</tr>
<tr>
<td>2) Program &amp; Struct. Adj. (% of total)</td>
<td>9.4</td>
<td>3.8</td>
<td>8.9</td>
<td>11.6</td>
<td>12.2</td>
<td>0.0</td>
<td>4.9</td>
</tr>
<tr>
<td>1+2 (% of total)</td>
<td>9.4</td>
<td>7.5</td>
<td>11.3</td>
<td>28.9</td>
<td>18.5</td>
<td>8.3</td>
<td>22.4</td>
</tr>
<tr>
<td>TO WEST AFRICA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (US$ million)</td>
<td>419.2</td>
<td>644.0</td>
<td>1012.6</td>
<td>664.2</td>
<td>1181.7</td>
<td>811.3</td>
<td>1130.6</td>
</tr>
<tr>
<td>1) Sector Adj. (% of total)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>6.0</td>
<td>29.4</td>
<td>12.3</td>
<td>4.3</td>
</tr>
<tr>
<td>2) Program &amp; Struct. Adj. (% of total)</td>
<td>0.0</td>
<td>27.2</td>
<td>33.6</td>
<td>6.0</td>
<td>21.2</td>
<td>3.4</td>
<td>28.4</td>
</tr>
<tr>
<td>1+2 (% of total)</td>
<td>0.0</td>
<td>27.2</td>
<td>33.6</td>
<td>12.0</td>
<td>50.6</td>
<td>15.8</td>
<td>32.7</td>
</tr>
<tr>
<td>TO EUROPE, MIDDLE EAST AND NORTH AFRICA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (US$ million)</td>
<td>1223.7</td>
<td>2378.7</td>
<td>2407.5</td>
<td>2535.6</td>
<td>3125.8</td>
<td>2429.2</td>
<td>2304.8</td>
</tr>
<tr>
<td>1) Sector Adj. (% of total)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>7.7</td>
<td>16.5</td>
<td>32.5</td>
</tr>
<tr>
<td>2) Program &amp; Struct. Adj. (% of total)</td>
<td>5.7</td>
<td>7.4</td>
<td>14.1</td>
<td>22.7</td>
<td>12.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>1+2 (% of total)</td>
<td>5.7</td>
<td>7.4</td>
<td>14.1</td>
<td>22.7</td>
<td>19.7</td>
<td>16.5</td>
<td>32.5</td>
</tr>
<tr>
<td>TO LATIN AMERICA AND THE CARIBBEAN</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (US$ million)</td>
<td>1215.0</td>
<td>2474.4</td>
<td>3070.6</td>
<td>3459.6</td>
<td>3025.6</td>
<td>3698.2</td>
<td>4771.2</td>
</tr>
<tr>
<td>1) Sector Adj. (% of total)</td>
<td>0.0</td>
<td>0.6</td>
<td>0.6</td>
<td>11.7</td>
<td>21.7</td>
<td>9.7</td>
<td>26.3</td>
</tr>
<tr>
<td>2) Program &amp; Struct. Adj. (% of total)</td>
<td>0.0</td>
<td>3.6</td>
<td>1.6</td>
<td>1.7</td>
<td>2.0</td>
<td>3.6</td>
<td>5.2</td>
</tr>
<tr>
<td>1+2 (% of total)</td>
<td>0.0</td>
<td>4.3</td>
<td>2.3</td>
<td>13.5</td>
<td>23.6</td>
<td>13.4</td>
<td>31.5</td>
</tr>
<tr>
<td>TO EAST ASIA &amp; PACIFIC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (US$ million)</td>
<td>951.4</td>
<td>2249.3</td>
<td>2540.9</td>
<td>3708.6</td>
<td>3302.0</td>
<td>3100.6</td>
<td>3565.2</td>
</tr>
<tr>
<td>1) Sector Adj. (% of total)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>12.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2) Program &amp; Struct. Adj. (% of total)</td>
<td>10.5</td>
<td>0.0</td>
<td>11.8</td>
<td>12.9</td>
<td>9.1</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>1+2 (% of total)</td>
<td>10.5</td>
<td>0.0</td>
<td>11.8</td>
<td>12.9</td>
<td>9.1</td>
<td>12.0</td>
<td>0.0</td>
</tr>
<tr>
<td>TO SOUTH ASIA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (US$ million)</td>
<td>1189.6</td>
<td>2256.7</td>
<td>2827.6</td>
<td>2979.2</td>
<td>3700.6</td>
<td>3559.1</td>
<td>3631.0</td>
</tr>
<tr>
<td>1) Sector Adj. (% of total)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.9</td>
<td>0.0</td>
<td>0.0</td>
<td>5.0</td>
<td>1.9</td>
</tr>
<tr>
<td>2) Program &amp; Struct. Adj. (% of total)</td>
<td>24.4</td>
<td>2.8</td>
<td>5.4</td>
<td>3.7</td>
<td>4.6</td>
<td>0.0</td>
<td>5.9</td>
</tr>
<tr>
<td>1+2 (% of total)</td>
<td>24.4</td>
<td>2.8</td>
<td>6.3</td>
<td>3.7</td>
<td>4.6</td>
<td>5.0</td>
<td>7.4</td>
</tr>
</tbody>
</table>

a/ See footnote a in Table 1.

Source: Planning and Budgeting Department, The World Bank
Table 3: Distribution of World Bank Loans and Credits by Country Group  
(in US$ million and percent)

<table>
<thead>
<tr>
<th>DESTINATION</th>
<th>FY75</th>
<th>FY79-80</th>
<th>FY81-82</th>
<th>FY83</th>
<th>FY84</th>
<th>FY85</th>
<th>FY86</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL LENDING TO ALL COUNTRIES</td>
<td>5895.9</td>
<td>10746.1</td>
<td>12653.5</td>
<td>14477.0</td>
<td>15522.3</td>
<td>14384.4</td>
<td>16318.7</td>
</tr>
<tr>
<td>Sector Adj., Program &amp;</td>
<td>520.0</td>
<td>403.3</td>
<td>1082.4</td>
<td>2035.6</td>
<td>2619.8</td>
<td>1637.9</td>
<td>3099.5</td>
</tr>
<tr>
<td>Structural Adj. Loans a/</td>
<td>8.8</td>
<td>3.8</td>
<td>8.6</td>
<td>14.1</td>
<td>16.9</td>
<td>11.4</td>
<td>19.0</td>
</tr>
<tr>
<td>As a percent of total</td>
<td>8.8</td>
<td>3.8</td>
<td>8.6</td>
<td>14.1</td>
<td>16.9</td>
<td>11.4</td>
<td>19.0</td>
</tr>
</tbody>
</table>

| TO LOW-INCOME COUNTRIES b/       | 2051.2 | 3270.2  | 3965.4  | 4906.4 | 6164.7 | 5771.5 | 6046.1 |
| Sector Adj., Program &           | 350.0  | 122.5   | 290.0   | 445.9  | 574.5  | 574.5  | 725.0  |
| Structural Adj. Loans            | 17.1   | 3.8     | 7.3     | 9.1    | 6.1    | 9.5    | 9.5    |
| As a percent of total            | 17.1   | 3.8     | 7.3     | 9.1    | 6.1    | 9.5    | 9.5    |

| TO MIDDLE-INCOME COUNTRIES b/    | 3844.7 | 7476.0  | 8688.1  | 9570.6 | 9357.6 | 8612.9 | 10272.6|
| Sector Adj., Program &           | 170.0  | 280.8   | 792.4   | 1589.7 | 2172.3 | 1283.4 | 2525.0 |
| Structural Adj. Loans            | 4.4    | 3.8     | 9.1     | 16.6   | 23.2   | 14.9   | 24.6   |
| As a percent of total            | 4.4    | 3.8     | 9.1     | 16.6   | 23.2   | 14.9   | 24.6   |

MEMO ITEMS:

| TO HIGHLY INDEBTED MIDDLE-INCOME COUNTRIES c/ | 1803.4 | 3403.7 | 4428.4 | 4668.3 | 4398.6 | 4558.4 | 6070.5 |
| Sector Adj., Program &               | 0.0    | 98.3   | 231.6  | 1042.8 | 1396.1 | 745.0  | 2105.0 |
| Structural Adj. Loans                | 0.0    | 2.9    | 5.2    | 22.3   | 31.7   | 16.3   | 34.7   |
| As a percent of total                | 0.0    | 2.9    | 5.2    | 22.3   | 31.7   | 16.3   | 34.7   |

| TO SUB-SAHARAN AFRICA d/            | 1075.7 | 1374.4 | 1807.0 | 1794.0 | 2368.3 | 1597.3 | 2046.5 |
| Sector Adj., Program &              | 60.0   | 230.0  | 429.8  | 406.5  | 818.2  | 192.9  | 574.5  |
| Structural Adj. Loans               | 5.6    | 16.7   | 23.8   | 22.7   | 34.6   | 12.1   | 28.1   |
| As a percent of total               | 5.6    | 16.7   | 23.8   | 22.7   | 34.6   | 12.1   | 28.1   |

a/ See footnote a in Table 1.

b/ Countries with per capita income less than US$400 in FY87 dollars are considered low-income countries; those above that level are classified as middle-income countries.

c/ The 17 countries in this category are: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia. Lending to this group is also included in that of middle-income countries.

d/ This group covers all countries south of the Sahara, except South Africa.

Source: Planning and Budgeting Department, The World Bank
one-third of total commitments to each region in FY86. In the East Asia and
Pacific and South Asia regions, on the other hand, sectoral and structural
adjustment lending accounted for zero and less than 8 percent of the
respective regional aggregates in FY86 (see Table 2).

B. The Policy Focus of Sectoral and Structural Lending

The main purpose of Bank Sector and Structural Adjustment Loans is to
facilitate the adjustment required to achieve sustainable growth and the
mobilization of external financing needed to support the country's adjustment
efforts. Although the ultimate objective is to achieve sustainable growth
compatible with available resources (including foreign financing) this is a
medium-term target. Thus, adjustment loans focus on the annual steps to be
taken in support of the policy reforms needed to promote sustainable growth in
the medium term. Subsequent steps are supported by additional loans of
various kinds, so that the implementation of a reform package is supported by
a series of Bank lending operations over a period of several years (Stern
1983).

Most aspects of macroeconomic and sector policy have been the focus
of nonproject Bank lending in one country or another over this period. 16/
This has been done in coordination with the IMF and in ways which supplement
the IMF programs (see Section V below). While the Bank has deferred to the
IMF in monetary and exchange rate policy, it has sometimes been involved in
the institutional reforms pertaining to exchange rate management (as in the

16/ This review focuses on structural and sector adjustment lending by the
Bank through calendar 1985. It is based in part on the findings of a
major review of 15 Structural Adjustment Loans to 10 countries over the
case of setting up foreign exchange auction systems in Nigeria and Somalia); it has also worked closely with the IMF on matters pertaining to interest rate policy reform (as in the case of Jamaica).

Individual programs have emphasized different policy issues reflecting country priorities and objectives. But within the broad array of potential policy concerns the Bank's emphasis has been on the following interrelated areas.

(i) Mobilization of domestic resources through fiscal, monetary and credit policies. This includes support for both revenue-enhancing and expenditure-limiting measures, and for efforts to restrict public sector or external borrowing and/or to decontrol or restructure interest rates.

(ii) Improving the efficiency of resource allocation and use by the public sector. This includes support for rationalizing of public sector investment; strengthening the operational efficiency of public sector and parastatal enterprises, and rationalization of public sector programs -- including divestiture of public holdings in enterprises.

(iii) Reform of the structure of economic incentives in order to reduce distortions, promote more efficient resource allocation, and thus create a more productive economic structure. Within this area, two sets of policy issues are receiving the greatest attention.

a. Trade regime reforms designed to reduce the bias against exports, and to lower the level and rationalize the pattern of protection. Since most developing countries protection manifests itself in a large variance of incentives within the manufacturing sector (and between manufacturing and
agriculture), such reforms usually focus on raising industrial productivity and competitiveness. 17/

b. Price system reforms designed to make prices more accurately reflect opportunity costs. These reforms usually focus on the incentives affecting production and distribution in agriculture; but energy and state enterprise pricing has also received attention.

(iv) Institutional reforms supportive of adjustment with growth. 18/

There is little distinction between the policy focus of Structural Adjustment Loans (SAL) and Sectoral Adjustment Loans (SEL). The main difference lies in the comprehensiveness of the policy and institutional reform involved. Relatively few countries have prepared comprehensive and implementable adjustment programs that can be supported by SALs. On the other hand, there are certain policy areas, for example fiscal reform, that are best tackled through an economy-wide approach. In several cases, Sector Adjustment Loans have been used to initiate the adjustment process which, as it gains in comprehensiveness may be supported by a SAL. In Ghana, for example, two Reconstruction Import Credits in FY83 and FY85 and an Export Rehabilitation Credit in FY84 were followed by a SAL in FY86. In some other cases, sector adjustment loans serve to deepen the adjustment process initiated by the SALs. Examples of this include Turkey, where a series of SALs in 1980-84 was followed by an Agricultural Sector Loan in 1985; and Korea where a Financial Sector Loan in 1985 followed the earlier SAL (World Bank 1986a).

17/ With some exceptions, e.g., the Agricultural Sector Loan to Argentina in 1986 focused on trade reforms in that sector.

18/ The fact that the subsequent analysis will not focus significantly on institutional reform in no way detracts from the importance of such reform to the success of all the policy reform efforts.
C. A Summary View of World Bank Experience with Policy Reforms Under Structural Adjustment Lending

While the World Bank and member governments have conducted a longstanding policy dialogue on various economy-wide issues, the 1980s have seen policy reform emerge as the main component of an increasing number of lending operations. It is worth briefly reviewing this development for two reasons. First, it is useful to determine whether the focus and content of policy based lending are consistent with the factors identified in Section III as being prerequisites for restoring growth in recipient countries. Second, it is helpful to identify any lessons that may emerge for future World Bank programs, which are continuously evolving in the light of experience.

The review of policy issues in this Section should not be viewed as an evaluation of the "impact" of past World Bank SALs and SELs. Such an analysis lacks a credible counterfactual, i.e., it is impossible to determine what would have been the recipients' policies and performance in the absence of the programs. This is a familiar problem, which reduces most analyses to contrasting country performance after the assistance to performance before (Please 1984). Such "before compared to after" analysis is dangerous because: (i) it assumes that countries would have made no policy changes to improve their situation in the absence of the World Bank programs, while in fact their policies may have been unsustainable, and (ii) it does not take into account changes in the international environment or other exogenous events that influence country performance. In addition, it is difficult to isolate the effect of World Bank programs from those of the IMF, which has been actively working in almost all the countries which the Bank is assisting through SALs or SELs (see below). Finally, the analysis also does not address a number of
implementation issues, such as the size of SALs, tranching, the scope of
conditionality and the like, all of which have a bearing on the question of
program effectiveness. 19/

Perhaps the most general conclusion that can be drawn from the World
Bank's experience to date is the importance of the recipient's commitment to a
particular course of reform for the ultimate success of the policy package.
The most successful cases of reform supported by the World Bank have involved
countries (e.g., Korea and Turkey) that have adopted a series of reforms over
time and stuck by them. The least successful were those where, for a variety
of reasons, policies were reversed after a time and the direction and purpose
of reform was confused and uncertain (Guyana, Bolivia and Senegal in the early
1980s). Some of the main lessons of policy reform in particular areas are
discussed in the Sections below.

(i) **Domestic Resource Mobilization**

Past Bank involvement with resource mobilization has mainly focused
on supporting government efforts to reduce budget deficits through revenue
raising or expenditure reducing measures. Bank efforts typically supplement
IMF programs in this area. In all instances Bank programs aim to strengthen
public sector performance and to reduce, directly or indirectly, public sector
deficits which tend to crowd out private investment and to produce financial
and balance of payments disequilibria. Reforms in this area have focussed on
raising public agencies' revenues or reducing their expenditures by, for
example, raising prices of services or establishing user fees, and/or

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19/ For a discussion of some of these issues see Berg and Batchelder (1985)
and World Bank (1986b).
eliminating or retargetting subsidies, so as to reduce public sector expenditures. In other cases, Bank efforts have focused on administrative reforms of the tax system or the introduction of new taxation. Deficit reduction and reform of parastatals has often required public sector employment cuts; in a period of stagnant growth, such cuts have entailed transitional costs with which governments and the Bank have had to deal. 20/

In addition to fiscal reform, resource mobilization has been pursued through efforts to improve the functioning of the financial sector and to eliminate of distortions in interest rate policy. Examples of such activities include the Industrial Finance Project in Korea and the Morocco Industrial and Trade Policy Loans. The financial systems of many developing countries have also been severely strained in the last five years by being required to handle the debts of financially ailing enterprises -- sometimes in the public sector. This has prompted World Bank Sector Loans designed to support rehabilitation of the financial system in a number of countries such as Chile and the Philippines.

Broadly speaking, the key issues that have arisen from the Bank's experience with financial market and banking sector reforms are those discussed in Section III, that is the need to ensure an orderly transition for banking systems saddled with a lot of nonperforming loans, sometimes of public enterprises, and the liberalization of previously controlled lending and deposit rates. Financial reforms have also been difficult in cases such

20/ But not all governments have faced such problems (see Section IV, D below).
as Korea where the government has used financial incentives to promote exports and offset the bias of continued domestic protection.

(ii) Improved Efficiency and Resource Use by the Public Sector

This effort has included three main components: (i) rationalization of public investment programs; (ii) improved public sector enterprise performance; (iii) rationalization of the size of the public sector, including divestiture of public holdings.

Since 1977, the Bank has undertaken about 50 public investment reviews. A large number of them were undertaken in conjunction with IMF programs that required or depended on them. The scope of these reviews has varied considerably -- ranging from analyses involving only a few staff weeks to major SAL-related reviews in Turkey and Jamaica. Nevertheless, many of these reviews have had common characteristics: (i) they were crisis induced -- they were undertaken in the context of a need to reduce public sector spending and limit investment to available resources; (ii) they focused on big, existing operations with the potential of being large drains on the government budget, and on identifying quick yielding projects, e.g., ones which could be readily completed; and (iii) as there were few resources available for new starts relatively little attention was directed to the ranking of new projects (Husain 1986).

Most reviews recommended changes in investment priorities. In addition to overall resource constraints, the key problem usually was that ongoing projects were not accompanied by the actions in other fields that were required for project viability. In some cases, especially in Africa, the reviews recommended ways of restructuring expenditures so as to permit financing of maintenance and recurrent costs. In general, the reviews have
been most effective when they have been based on indepth Bank sectoral
analyses and have actively involved member government participation (Kavalsky
1986).

For the future, an important dimension of the Bank's role should be
to strengthen (and in some cases to help create) the institutional capacity
that would permit developing countries to undertake effective investment
reviews as an ongoing process rather than as a form of damage control in
crisis situations. It will also be important to link such reviews to other
elements of government policy: pricing policy and policies for reallocating
resources toward export and efficient import-competing sectors are of special
importance in this context. Finally, these investment reviews can greatly
strengthen the process of aid coordination. All too often -- especially in
Africa or other countries where the internal investment review process has
been weak -- donors have supported activities without taking into account the
budgetary implications of their maintenance and recurrent costs.

Improving the financial performance of public sector enterprises has
also been an objective of many SALs (e.g., for Turkey, Jamaica, Senegal). The
effort has focused both on better internal management of parastatals (e.g.,
Jamaica) and on raising prices (i) to reflect marginal production costs and
(ii) to reduce the drain on the public budget. While there is evidence that
objectives in this area have been achieved in some cases, the experience has
been less encouraging in others. In Jamaica, for example, reductions in
public sector enterprise deficits were in part substituted by higher central
bank losses. In Turkey, higher prices in some state enterprises that provide
inputs to other entities under monopolistic conditions has harmed export
competitiveness. Meanwhile, considerable progress is being made in Africa
with reforms of state enterprises involved in marketing and distributing agricultural products (e.g., Senegal).

More generally, the Bank has also been helping member countries to reassess the role of government as an owner or operator of specific public enterprises. In several cases this has led country authorities to undertake divestiture programs. Such programs have been announced by many countries -- Mexico, Brazil, Costa Rica, Chile, Jamaica, the Philippines, Malaysia and Turkey are examples -- but progress has been difficult. One of the problem areas has been the handling of financially ailing entities: closing them down has meant increasing unemployment during periods of crisis; without prior rehabilitation, the sale option is unattractive; domestic capital markets are frequently thin, and foreign acquisition is not always welcome -- even if there was interest by foreign investors, which usually is not the case. The temptation is therefore for the government to continue to run the entity, even though it may no longer believe it to be desirable or appropriate to have the entity in the public sector.

(iii) Reform of Trade Regimes

Reform of the structure of incentives affecting the production of exports and import-competing goods has been a key feature of almost all SALs and many sectoral loans. On the export side, emphasis has been placed on two sets of measures: (i) the provision of financial incentives through tax rebates, subsidies on imported inputs to offset import controls, and preferential access to imports and credit (e.g., Turkey, Jamaica, the Philippines, Senegal); and (ii) reform of administrative procedures and the establishment of better institutional support for exporters (e.g., Kenya, the Philippines, Jamaica).
In most instances the competitiveness of exports was expected to be enhanced by parallel liberalization and rationalization of systems of protection for import-competing activities. For example, the SALs for Jamaica, Kenya, the Philippines, Thailand and Turkey supported the reduction of quantitative restrictions and the lowering and liberalization of tariffs. Sectoral loans to Mexico and Colombia in FY83 and FY85 and to Argentina in FY86 have also focused on correction of the anti-export bias of incentives by promoting export rebates, import liberalization, etc., and by strengthening of the institutional base for export development.

Finally, the trade reform components of SALs and SELs were expected to be buttressed by changes in other policies that would result in a supportive real devaluation. Most of the loans referred to the maintenance of competitive exchange rates as an essential condition for the success of the loan, and monitoring of such provisions was left to the IMF.

The results of the early lending operations have been mixed. Of all the countries assisted perhaps Turkey, and more recently Chile and Ecuador, have made the most progress in reforms. The financial incentives were introduced on schedule or with small delays in most cases. Progress in improving institutional support was generally slow, however, and, while most countries took some steps to rationalize the trade regime, the process was frequently halted short of the desired objectives or even reversed (World Bank 1986b). In about half of the countries that had received a SAL before 1985, the real effective exchange rate appreciated within a year of the relevant SAL commitment.

On balance, this experience confirms the earlier conclusion that implementation of trade reforms is not very successful when it is not
accompanied by other measures to assure a shift in the real exchange rate -- which is needed to produce the desired shifts in incentives. Experience also suggests that future reforms ensure that export expansion programs be accompanied by significant import liberalization and action on the exchange rate. An early export supply response is obviously helpful to import liberalization. Until the supply response occurs, external financing can help with the influx of imports as a consequence of import liberalization. Experience, however, does not in our view suggest that import liberalization should be undertaken only after export reforms have increased the supply of foreign exchange. This kind of sequencing is likely to be self-defeating, since it is extremely difficult to reorient producers towards export markets as long as heavily-sheltered domestic markets offer them sizeable assured profits.

(iv) Other Pricing Policies

Changes in agricultural and energy pricing were also common features of many SALs and SELs. Agricultural pricing reforms almost invariably focused on raising producer prices closer to international market price equivalents, and on cutting input and consumer subsidies (e.g., Senegal, Pakistan). Agricultural sector loans to Morocco and reconstruction credits to Ghana had a similar reform focus. The same kinds of objectives were pursued with respect to energy pricing in the SALs to the Philippines, Turkey, Kenya and Jamaica.

Experience with these loans suggests that most of these reforms, especially those related to the energy sector, were implemented with significant benefits to the recipient. In several cases there has been evidence of increased agricultural production and improved rural incomes
(e.g., Ghana, Zambia, Thailand), and of increased conservation and efficient import substitution of energy resources.

The key issue in this area is how to deal with the transition costs entailed by raising the foodstuff prices paid by politically powerful urban consumers. This issue has caused serious difficulties in at least one recent case (Zambia).

D. Issues Raised by World Bank Programs of Adjustment

Both internal and external reviews have raised a number of issues about World Bank SELs and SALs. We will address two basic issues here: (i) the view that Bank programs are not based on a coherent and consistent medium-term model of adjustment with growth, partly because such a model does not exist, especially when it comes to questions about the pace and sequencing of reform (Yagci, et al 1985, Heillener 1986), and (ii) the concern that Bank adjustment programs have not taken the social costs of adjustment fully into account (Overseas Development Council, 1986).

(i) The Need for a Strengthened Analytical Framework

The analytical framework discussed in Section III provides a good basis for the design of adjustment policies in most countries. But it falls short of providing a quantitative structure for linking inputs (policy actions) and outputs (macroeconomic performance). The Bank uses a quantitative framework to ensure consistency in its projections of financial "requirements", but this framework has very few behavioral relationships linking proposed policy steps to future outcomes (Khan, et al 1986). Indeed, the framework has little to say about the quantitative impact of key components of policy reform (e.g., trade reform, improvements in pricing, public investment reviews and the like) on medium-term economic performance
(on which the Bank usually focuses). Thus, as suggested in Section III, one can be more confident about the long-term outcome of policy packages than about the precise dynamic profile of results following the introduction of specific reforms.

Similarly, it is desirable to develop quantifiable indicators of progress for programs with medium to long-term objectives. All Bank programs have contained commitments to specific monitorable actions by the recipient. These have usually involved government commitments to specific policy steps at different points over time. Until recently, however, there was little effort to use quantitative performance indicators of progress that could form a framework for monitoring the effects of policy reform. The Mexico package does contain such indicators, but experience with them has been limited.

The above should not be viewed as a criticism of past programs. The state of the art in identifying meaningful indicators of progress is underdeveloped (Genberg and Swoboda 1986). A number of the reforms being pursued are of an institutional nature and their impact is inherently difficult to measure. Measuring supply side responses to particular measures and assessing the quantitative impact of efficiency and productivity gains is also very difficult.

Moreover, even the most sophisticated model that tries to analyze the impact of alternative policy packages on economic performance at the country level should be used with extreme caution. As the rational expectation perspective suggests, there are endogenous changes in the behavior of economic agents in response to changes in policy actions, and these changes cannot be readily captured by models built on previous experience.
The lack of an aggregate model to link policy action with economic performance should not distract the World Bank from the main task of designing programs based on the framework discussed in Section III and the World Bank experience reviewed in Section IV. It seems clear that understanding of the optimal pace and sequencing of reforms is far less complete than understanding of the direction policy reforms need to take. It is also evident that reform strategy needs to take into account the initial conditions in an individual country, the transition costs of reform, and the country's political and social situation. There is no evidence, however, that the Bank has suggested uniformly paced or sequenced reforms in member countries. On the contrary, individual programs are tailored to individual country situations. This is not to say that misjudgments have not been made or will not be made in future. What does seem true is that past (and possible future) misjudgments are not due to the Bank's indiscriminate application of preconceived notions of the appropriate pace or scope of reforms.

For the future, two parallel approaches are needed: First, the Bank should continue to support policy reforms. Uncertainties about the quantitative impact of specific policies and developments in the international environment mean that flexibility and willingness to adjust objectives should be a key element in all programs. Second, in parallel, additional analytical work is needed if we are to continue to strengthen our understanding of the sequencing and timing of particular policies and to improve the quantitative framework for projecting economic performance in the medium term.

(ii) Distribution Issues

A key concern raised by several reviews of Bank programs in support of adjustment and growth has been the extent to which such programs have
adequately addressed issues of income distribution (Overseas Development Council 1986). Several issues usually get mixed up in this discussion. The first is the question of whether the programs undertaken produce a short-run decline in output and incomes which is somehow excessive, e.g., whether, given the amount of financing available, alternative programs would have permitted more gradual adjustment over time and required less demand restraint which is inimical to growth. Second is the issue of whether the poor have suffered disproportionately in the adjustment process, in the sense that their incomes have fallen by more than those of other groups. A variation on this issue is the suggestion that the adjustment process has resulted in significant absolute declines in the levels of income of the poor, and has meant that many more families' incomes fall below a "poverty" standard. Third is the issue that government policies and, in particular, patterns of reductions of government expenditures, have disproportionately affected the poor.

The first question is not really about distribution but about the path of adjustment and the restoration of growth. It is, however, of central importance to the question of what happens to the absolute level of incomes of the poor over time. Reliable evidence about changes in the size distribution of income over time does not exist. Thus, it is difficult to say what happened to the relative income changes of different groups in developing countries over the last several years. On the other hand, it is quite clear that the absolute levels of income of the poor have declined in a large number of developing countries, including many with Bank programs. But in some countries, incomes had to be reduced because the level of overall absorption was not sustainable. Of course, if a higher amount of financing were available, less reliance could have been placed on demand restraint programs...
which entail reductions in output, the pace of adjustment would have been slower and supply enhancing policies would have played a greater role in the stabilization effort.

The key question about the past, however, is the counterfactual: Was there an alternative policy set that could have been pursued (with the same amount of external financing) that would have resulted in higher output and income in general, and hence in less hardship for the poor? It is not possible to reach general agreement on this question, and in any event the answer would tend to vary in different countries.

What about the impact on the poor of specific government adjustment supported by the Bank? The Bank's approach has been to include in its lending operations an assessment of the implications for the income of the poor of the policy reforms supported. In many instances in Sub-Saharan Africa, the Bank's reviews of public expenditure programs have focused on strengthening the capacity of domestic institutions to deliver services to the poor, especially in health and education. But the Bank has eschewed specifically conditioning its SALs and SELs on distributive objectives. The fundamental rationale for this position is the premise that in general, for any given original distribution of assets, the policies that would tend to promote more efficient use of resources would also be beneficial to employment and a more equitable distribution of income.

Take trade reform, for instance. There is abundant evidence that a more outward-looking development strategy emphasizing the reduction of protection and expansion of exports would tend to benefit employment and a more equitable income distribution (Krueger 1983).
The question of pricing reform, especially in agriculture, is more complex but the presumption is similar. Raising producer prices tends to benefit the rural sector which in most countries (the exceptions include some countries where the distribution of land assets is unequal) tends to have lower incomes than the urban sector. There is strong evidence, for example, that the recent structural adjustment in Cote d'Ivoire has resulted in a significant shift favoring the lower income rural sector within the context of the overall adjustment effort of the last several years (Addison and Demery 1986). The Bank's approach has also stressed the elimination of general consumer subsidies via the price mechanism and overvalued exchange rates in favor of targeted subsidy programs benefitting the poor. Experience in Sri Lanka and Jamaica, among others, suggests that such programs are both effective and economical in addressing social objectives of the urban poor.

The effects of fiscal reforms on the poor are complex: On the revenue raising side, there is increasing evidence that the tax system is not a practical vehicle for promoting finely targeted distributional objectives except in very broad terms, e.g., by excluding the lowest income groups from payment of any income taxes. On the expenditure side, the evidence of the past several years suggests that expenditure cuts have tended to fall primarily on investment and maintenance rather than on consumption expenditures; at the same time, public sector employment in several highly indebted countries in Latin America has tended to rise \textit{pari passu} with employment cuts in the private sector. 21/ Thus, the problem may have been

\footnote{Pfeffermann 1986. But this has not necessarily helped the very poor. It is believed -- but on the basis of little concrete information -- that the beneficiaries were in the "middle class".}
that governments have tended to compromise future growth relative to current consumption. This is, of course, understandable in situations where consumption is being squeezed from already low levels. On the other hand, there is some evidence, especially from Latin America, that the pattern of government consumption expenditures has benefited primarily the middle-income urban classes and that reduction in maintenance expenditures has adversely affected the delivery of public services to the poor (Pfefferman 1986).

Finally, it is clear that many adjustment programs entail some transitional costs, especially in employment. It is necessary to distinguish, however, between temporary employment losses resulting from reductions in unsustainable previous levels of absorption, and losses resulting from trade or other price reforms, rationalizing of public sector activities, etc. In the latter case especially, it is important to examine what can be done to help governments address the problems through resettlement and training programs, etc. Recent experience with ILO-assisted programs in Guinea-Bissau, Gambia and Senegal offers examples of what can be done to improve employment access to workers displaced as a consequence of public sector or other adjustments efforts (Addison and Demery 1986).

It seems reasonable to conclude that future Bank programs in support of adjustment and growth that emphasize policies to improve efficiency and increase productivity would benefit the poor through the restoration of overall growth. There is also a presumption that such programs would have a positive effect in promoting a more equitable distribution of income. The Bank has also designed programs specifically aimed at poverty issues related to adjustment. Greater attention needs to be directed to the distributional impact of public sector consumption expenditures, however, as well as to
designing employment assistance programs that would ease the burden of structural adjustment in the short term.

V. Links with IMF Programs

It is clear from the discussion in earlier sections that there are close links between the policy concerns addressed by World Bank and IMF programs. There are two fundamental reasons for such linkages: Bank programs focusing on increasing aggregate supply and raising productivity are far more likely to succeed if they are pursued in the context of a stable macroeconomic environment promoted through an IMF program. At the same time, the presence of a Bank program contributes to IMF efforts to support adjustment with growth, in that it permits the IMF to rely less on demand restraint measures in restoring external equilibrium, and thus in turn reduces the likelihood that IMF supported programs would adversely affect growth in the short term. This comes about both because of the direct impact of Bank programs on the supply side and through the provision of financing that permits the adjustment process to be stretched out, and thus to require relatively less reliance on demand management for the restoration of equilibrium.

All countries that have received a SAL either already had, or were awaiting imminent approval of, an IMF standby or extended arrangement. The same was true for 30 of the Bank's 35 Sector Adjustment Loans. Of the remaining 5, one had an IMF monitoring arrangement and another had a first tranche drawing. Programs in which the IMF undertakes Structural Adjustment Facility operations are based on studies of the macroeconomic framework and adjustment prospects jointly developed with the Bank.
There are extensive linkages between the activities of the two institutions in specific areas of policy reform, such as fiscal and monetary issues. The success of trade reform hinges critically on the macroeconomic environment, and especially on the maintenance of an appropriate real exchange rate. Bank supported programs in fiscal and monetary policy are also coordinated with those of the IMF. For example, the IMF may focus more on targets for cutting the overall public sector deficit while the Bank might focus on developing priorities for expenditure reductions, or improvements in the performance of public sector enterprises. In monetary matters, the IMF might focus on overall credit ceilings while the Bank might concentrate on the elimination of distortions in a specific market, or help facilitate the extension of credit to priority sectors. Finally, as noted earlier, the IMF relies on the Bank to undertake public sector investment reviews that are used as inputs in IMF medium-term programs (Khan and Knight 1985).

The policy problems of restoring growth in the medium term are far too complex and our understanding of the impact of policy on economic performance is far too incomplete for differences not to arise in the approach of the two institutions. Two illustrations of this point may be worth noting. In cases where there is a need both to reduce absorption in the short run and to stimulate growth, the Bank has tended to place greater reliance on exchange rate adjustment relative to fiscal or monetary contraction as a means of demand side adjustment, because of the potential benefit that exchange rate adjustment could have to medium-term restructuring of the economy. Similarly, there have been instances where an urgent need to reduce fiscal deficits has resulted in IMF programs that support increased taxation in the trade sector, without parallel increases of taxation in nontradeables. When such measures
are not lifted quickly, they tend to run contrary to efforts to promote a more outward orientation of the economy and a shift of resources to tradeables. Where such divergent views have arisen at the staff level, the two institutions have developed mechanisms designed to reconcile differing views, so as to avoid presenting member countries with conflicting advice (Stern 1983, Hino 1986).

VI. The Financial Packages

The development of suitable packages of external finance to support policy reform is the other leg on which adjustment with growth in developing countries must stand. Reforms are possible without financial support but, given the current financial situation in many developing countries, they alone cannot go far in restoring growth. Additional investment in productive activities is difficult to finance through further cuts in consumption. Indeed a recent study (Selowsky and van der Tak 1986) showed that additional external finance in the initial years of a reform could be an essential component of a strategy designed to restore long-term growth while also maintaining per capita consumption in the interim. At the same time, care needs to be taken to ensure that financial support is not an alternative to adjustment, but rather that it is used to stretch the adjustment process out over time while permitting a modicum of short-run growth. It is hard for developing countries to persevere with necessary but politically difficult reforms without some prospects of a recovery in incomes and consumption in the near term. Finally, the financial packages need to be tailored to the circumstances of individual countries.
The Bank's experience with financial packages in support of adjustment with growth dates back to its early work in the context of consortia and consultative groups. But this experience primarily involved coordination of official flows, especially of ODA. It is only recently that the Bank has become actively involved in more comprehensive packages involving commercial bank lending as well as debt restructuring. In addition, the international situation (and especially the commercial banks' attitude towards increased exposure to developing countries) has changed. Thus, experience with the early SAL financial packages offers limited guidance for the future.

Two of the early SALs, those to Turkey and Jamaica, were quite comprehensive in their scope but the Bank's involvement with commercial bank rescheduling and new money arrangements in the development of the packages was relatively limited. Recent experience is quite different. The Bank played a major role in the formulation of the financial packages for Nigeria and Mexico, for example; in both cases, implementation of the Bank's adjustment programs as well as the IMF's was made a condition for commercial bank funding.

At present, two broadly different types of financial package can be distinguished, each of which reflects the financial circumstances and prospects of the countries assisted and the character of their existing debt obligations. The first type is associated with middle-income developing countries, primarily in Latin America, whose outstanding debt is mostly owed to commercial banks, and to a lesser extent to official export credit agencies on commercial or close to commercial terms. In these countries, restoration of growth and creditworthiness over time can be expected to permit them to rely on private market for future capital inflows. The second type of package
is suitable for low-income countries, primarily in Sub-Saharan Africa, which owe proportionately more of their debt to official creditors (including the international financial institutions), and which will have to continue to rely indefinitely on concessional assistance for the bulk of their foreign capital inflows, since their capacity to service credits on commercial terms is likely to be quite limited even as they develop a significant growth momentum.

The financial packages that have been developed in support of recent adjustment programs in both middle and low-income countries have some common features which can be summarized as follows:

(i) The financial packages are based on programs of stabilization and medium-term reform agreed with the IMF and the World Bank. In the low-income countries these programs are in turn based on joint IMF/Bank analyses of a medium-term framework agreed with the governments.

(ii) The packages establish explicit linkages between restructuring of debt owed to official and commercial bank credits or, the provision of new financing, and comprehensive adjustment programs supported by World Bank resources.

(iii) Linkages between the commitments of the Bank and those of other sources of finance are becoming more frequent. This involves joint agreements by the Bank, the IMF and other sources of financial support to disburse funds; it also involves the need to review the overall financial packages in the light of progress in the recipient country, or in the light of international developments that are likely to affect the prospects for success of the original package. Stronger links with private capital flows have sometimes taken the form of increasing cofinancing or World Bank guarantees (e.g., Chile, Mexico) when necessary to complete the financial package. Strengthened
ties with official lending sources are being pursued through enhanced coordination with official donors in consultative groups, especially in the context of Sub-Saharan Africa.

The Bank's role in these packages is threefold. First, it assists member governments in the design of policy reforms aimed at restoring growth. Second, it provides additional amounts of its own resources. In this connection, recent packages in middle-income countries (e.g., Mexico) have involved an increase in the future net exposure of the Bank relative to that of the commercial banks. Third, it acts as a catalyst in mobilizing additional capital flows from private and official resources. The mobilization of official resources is obviously of special importance in the context of low-income countries in Sub-Saharan Africa.

While significant progress has been made in designing financial packages, several issues for further action have also arisen. A common problem for both types of package has been the overall difficulty of mobilizing additional financing. In the case of highly indebted middle-income countries this problem basically stems from commercial banks' decisions to reduce net exposure to those countries. While packages have been funded, there have frequently been difficulties and delays in reaching agreement on the size of the commercial banks' contribution. As banks have strengthened their financial position, they have seemed increasingly reluctant to mobilize additional financing. This has been especially true in the case of smaller borrowers whose existing debt is not significant in the total portfolios of the commercial banks. Apart from the US$6 billion commitment to Mexico and a much smaller new money arrangement with Nigeria, there has been very little new commercial lending to highly indebted middle-income countries. While
increasing World Bank guarantees may be appropriate in specific cases, it cannot be viewed as a substitute, because the guarantees involve additional official (rather than private) exposure.

Meanwhile, ODA commitments in Sub-Saharan Africa have grown significantly. Nevertheless, World Bank estimates indicate that despite this growth and additional future commitments by bilateral donors, a further US$1.5 billion a year of bilateral concessional assistance and debt relief are needed to support developing countries' reform efforts (World Bank 1986c). 22/

Debt restructuring has continued to play an important role in financial packages. In 1986 there were 9 restructurings with commercial banks; 5 (for Mexico, Côte d'Ivoire, Uruguay, Dominican Republic and the Congo) were multi-year restructuring arrangements (MYRAs). There were 18 restructuring arrangements with the Paris Club, of which those with the Côte d'Ivoire and Yugoslavia were MYRAs.

Some limitations of debt relief, even in the context of MYRAs, are emerging, however. For example, even after MYRAs are concluded and even though the terms of reschedulings are softening, massive amounts of domestic resources are needed to pay interest on outstanding debt. In some cases, these amounts are so high that the level of savings alone (e.g., without new money) is inadequate to finance essential investment in export-oriented and efficient import-competing activities. In still other cases, obligations to international institutions form such a large portion of the total that restructuring other debt offers very limited scope for relief, unless interest

\[22/\text{While the methodology for developing such estimates is rather crude, it is difficult to avoid the conclusion that generation of growth momentum in Africa will require significant additions to current aid levels.}\]
is also rescheduled on concessionary terms -- something that has not happened yet.

In cases where new money on commercial terms is either not forthcoming or should not be relied upon, country options are sharply limited. The only possible avenue is increased concessional lending -- which itself is growing only slowly. In addition, much of the ODA resources of bilateral donors are allocated without explicit reference to the economic policies of the recipient. An additional problem has arisen in Sub-Saharan Africa, where export credit agencies of industrial countries have proposed credits for projects that promote their own exports frequently without regard for the priority these projects have in the country's investment program, or even the recipient's future capacity to repay.

New ways to deal with existing debt are needed and some are emerging. The chief alternative that has emerged in 1986 is conversion of debt to equity. Costa Rica, Chile, Mexico, Brazil and the Philippines are all using this approach in varying degrees. Others, such as Nigeria and Argentina are considering plans for the same purpose. To date, only about US$5 billion of a total of about US$300 billion of debt to commercial banks has been converted (World Bank 1987), but well conceived and managed programs of debt-equity conversion are promising vehicles for reducing servicing costs and repatriating capital, especially to middle-income countries.

Old approaches are also worth reviving. For example, developing country policies to encourage new direct private capital investment can significantly assist adjustment with growth. Such policies can be supported by international assistance through the IFC and the newly established MIGA.
Finally, better coordination among official creditors, including both aid and the export credit agencies of industrial countries is clearly essential for designing effective financial packages to promote adjustment with growth in developing countries.

VII. Conclusions

This review of appropriate developing countries' policies for promoting adjustment and sustainable growth, and World Bank programs for supporting them, suggests the following main conclusions:

(i) Adjustment and growth can best be promoted in an environment of relative domestic economic stability. Significant instability, manifested in high rates of inflation, makes the already difficult task of achieving adjustment and sustainable growth almost impossible.

(ii) The policy mix used to promote stabilization can have a bearing on the success of parallel or subsequent efforts to promote adjustment. In general, a balanced use of the main instruments of macroeconomic policy for stabilization is more likely to be conducive to later efforts to promote growth than a stabilization program that relies too heavily on any one policy instrument.

(iii) There is widespread agreement on the nature of the policies that developing countries need to adopt when pursuing adjustment and sustainable growth under the constraints imposed by a large external debt servicing burden. Such policies include efforts to promote resource mobilization that will raise domestic savings and investment rates; efforts to increase the overall efficiency and productivity of the economy; and efforts
to restructure production in favor of tradeables. While these reforms are also likely to help alleviate poverty in the longer term, they sometimes entail short-term transitional costs for the poor.

(iv) There is much less certainty on the pace and sequencing of reforms in particular situations. A lot will depend on the initial conditions in the economy, including its flexibility, the extent of the original disequilibrium, and the political and social structure of the country.

(v) The review of World Bank lending operations and their policy thrust showed that the Bank has a variety of lending instruments with which it can support policy reform in member countries. Over the last six years, the Bank has increased the proportion of its total commitments represented by sectoral and structural adjustment lending in support of broad economic and sectoral policy reforms. The increase has been especially pronounced for the two sets of economies currently facing the most serious problems of adjustment and growth, e.g., the countries of Sub-Saharan Africa and the heavily indebted middle-income countries.

(vi) Experience suggests that consistent pursuit of the kinds of policy reforms the Bank has supported in recent years will promote adjustment and growth in member countries. Given the problems facing developing countries today, the thrust of policy reforms already pursued by the Bank should be maintained. Reforms must be tailored to the circumstances in individual countries. Moreover, in the light of uncertainties about the appropriate pacing and sequencing of such reforms, it is also important to maintain maximum program flexibility. This means that country reform programs should be reviewed frequently to ensure that they are on track, and that the Bank should be prepared to support modifications in policy reform packages in
the light of both domestic and international developments. Where policy reform to promote generally desirable structural change gives rise to transitional costs for the poor, the Bank needs to continue to work with governments to develop programs targeted to address the problems.

(vii) The success of policy reforms supported by the Bank is intimately related to and depends on adjustment policies supported by the IMF. Given the uncertainties surrounding the appropriate policy mix for effective medium-term adjustment, differences in views on specific adjustment programs are bound to arise in individual cases -- both between the two institutions and between them and the developing country concerned. The key objective in such cases should be to work jointly with the developing country's authorities to develop an agreed program of reforms that can be supported by all parties.

(viii) The policy reforms supported by the Bank and the IMF need to be complemented by additional flows of resources to developing countries if the objective of sustainable growth is to be achieved. While some progress has been made in developing new sources of financing for highly indebted countries and additional flows of concessional assistance for Sub-Saharan Africa, still more funding is clearly needed.

(ix) The policy reform programs the Bank has been supporting are based on sound analytical underpinnings. However, the formal quantitative model that it uses to ensure the consistency of its medium-term projections does not embody a significant number of behavioral relationships on key aspects of the policy reforms it is supporting. A lot of the supply side and institutional reforms the Bank is supporting are difficult to quantify and
incorporate in an aggregate econometric model. Nonetheless, additional analytical efforts are needed to enrich the basic consistency framework employed by the Bank and to develop meaningful quantitative indicators linking policy reforms to actual progress.

(x) The Bank should continue to play an active role in helping coordinate concessional assistance efforts and, together with the IMF, in ensuring that total net flows of resources to individual countries -- including new funds and debt relief -- are adequate to support developing countries' efforts to restore sustainable growth.
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