



Mid-term Evaluation of IDB-9 Commitments

Macroeconomic Sustainability Assessments

Background Paper



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PREFACE

The Inter-American Development Bank (IDB) is in a period of rapid change, responding to both the economic dynamism of the Region it serves and the increasing competition in the international financial marketplace. Over the past decade, countries in Latin America and the Caribbean have gained greater access to alternative sources of finance and an increasingly ability to generate and share knowledge among themselves. Like other multilateral development banks, IDB is seeking to adapt to this changing international landscape by ensuring that it is responsive to borrowing countries' needs and putting strong emphasis on effectiveness in its use of scarce resources.

In 2010 the IDB's Board of Governors approved the 9th General Capital Increase of the IDB (IDB-9). The IDB-9 Agreement laid out a series of reforms intended to strengthen the strategic focus, development effectiveness, and efficiency of the IDB to help it remain competitive and relevant in the years ahead. As part of that Report, IDB's Office of Evaluation and Oversight (OVE) was charged with conducting a midterm evaluation—to be presented to the Board of Governors in March 2013—to assess IDB's progress in implementing those reforms. The full evaluation is available at www.iadb.org/evaluation.

This paper is one of 22 background papers prepared by OVE as input to the IDB-9 evaluation. It seeks to determine whether one portion of the IDB-9 requirements has been implemented fully and effectively and to offer suggestions to strengthen implementation going forward. The overarching goal of this paper and the entire evaluation is to provide insights to the Governors, the Board, and IDB Management to help make IDB as strong and effective as possible in promoting economic growth and poverty reduction in Latin America and the Caribbean.

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LIST OF PERSONS INTERVIEWED

This background paper was prepared by Juan Manuel Puerta and Cheryl Gray with input from Juan Carlos Di Tata, Thomas Reichmann, and David Suarez. All background papers were thoroughly reviewed and discussed within OVE and shared with IDB Management for comments. The other background papers and full IDB-9 evaluation can be found at www.iadb.org/evaluation.

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
DSF/EPBA	Debt Sustainability Framework/Enhanced Performance-Based Allocation
FSAP	Financial Sector Assessment Program
IDB	Inter-American Development Bank
IDB-7	Seventh General Capital Increase (1989)
IDB-9	Ninth General Capital Increase (2010)
IMA	Independent Macroeconomic Assessment
IMF	International Monetary Fund
LAC	Latin America and the Caribbean
MSA	Macroeconomic Sustainability Assessment
OVE	Office of Evaluation and Oversight
PAE	Projected aggregate exposure
PBL	Policy-based loan
PPD	Programming Preview Document
REA	Regional Economic Advisor
RES	Research Department
VPC	Vice-Presidency of Countries
VPS	Vice-Presidency of Sectors

EXECUTIVE SUMMARY

One of the most debated parts of the IDB-9 Agreement was the requirement that the Inter-American Development Bank (IDB or Bank) enhance its macroeconomic analysis and link it to its country programming to avoid lending in unsustainable macroeconomic situations. The IDB-9 Agreement mandated that the Chief Economist prepare annual Macroeconomic Sustainability Assessments for each borrowing country and that a positive judgment on sustainability be “one of the prerequisites, among others, for maintaining the Bank’s aggregate exposure with the country including both sovereign and non-sovereign operations.”

OVE finds that the MSA requirement has been substantially implemented but faces many difficulties that seriously impede its likely effectiveness. The quality of the MSAs, though reasonable given the resources allocated, lacks depth in many areas, particularly financial sustainability and inflation. More generally, there is no methodology that could reliably do what is expected—predict macroeconomic crises in the near term. There are few checks and balances in the system, and none relating to the Chief Economist’s conclusion and determination of sustainability. The MSA process entails significant costs for the Bank, including in country relations and IDB Board cohesion and collaboration. Though the MSA process has the potential to further the underlying IDB-9 goal of preventing lending in unsustainable macroeconomic situations, the process will not achieve the broader objective of stopping increases in Bank exposure for the foreseeable future: existing IDB disbursement and repayment schedules will lead to increasing exposure in almost all borrowing countries in the coming 5-10 years.

OVE suggests that the Governors, the Board, and Management reconsider the design of the MSA process to align benefits and costs more closely. A useful way to think about changes is to “unbundle” the two rationales for MSAs—limiting IDB’s credit risk and promoting development effectiveness. The credit risk rationale argues for the type of short-term focus and yes-no decision-making used in the MSAs, and Management may wish to strengthen the ability of its risk management group to perform independent credit risk assessment of the sovereign portfolio. The development rationale argues for a more medium-term instrument with a broader focus, as macroeconomic policies are not the only ones that matter for development. One option would be to strengthen the Bank’s Independent Macroeconomic Assessments for policy-based lending, with clear guidelines to ensure their effective coverage and implementation. IDB could also strengthen its macroeconomic and policy analysis through its regular program of economic and sector work. It is clearly feasible for the IDB to have a stronger role than it now has in policy analysis and advice to its borrowing countries.

I. INTRODUCTION

- 1.1 One of the most debated parts of the IDB-9 Agreement was the requirement that the Inter-American Development Bank (IDB or Bank) enhance its macroeconomic analysis and link it to its country programming situations to avoid lending under unsustainable macroeconomic conditions. One of the 13 elements of the Overview Framework of the Cancun Declaration was to “ensure adequate safeguards against lending into unsustainable macroeconomic situations” (Cancun Declaration, AB-2728), with the specific condition that “the Chief Economist and Research Department of the Bank...produce rigorous assessments of macroeconomic sustainability based on objective criteria when called for by country conditions; loans for consideration by the Board of Executive Directors shall meet the criteria.” The IDB-9 Agreement went into greater detail:

Unsustainable macroeconomic conditions will be understood to exist in a country when, whatever their cause, there is a strong likelihood that within the next two years it will experience events such as: (a) inability to fulfill internal or external public debt obligations, (b) shortage of foreign exchange for the normal functioning of external trade, financial, or capital operations, (c) need to rescue financial institutions that threaten fiscal sustainability or the functioning of the payment system; (d) price increases that lead to prolonged and destabilizing inflationary processes. The sustainability analysis, carried out independently by the Bank under the responsibility of the Chief Economist and the Research Department, will be based on objective standard measures and criteria in accordance with the norms and the practices of multilateral lending institutions. When a recent International Monetary Fund report or evaluation is available, it will be taken into account. Terms of access to international financial markets and indicators of international liquidity and fiscal and external sustainability of standard use in the profession will also be taken into account. The macroeconomic sustainability analysis will be performed in the context of the financial programming exercise with the country at least once a year, as one of the prerequisites, among others, for maintaining the Bank’s aggregate exposure with the country including both sovereign and non-sovereign operations.

Thus, the salient characteristics of the new Macroeconomic Sustainability Assessments (MSAs) were that (i) they were to be carried out independently by the Chief Economist of the Bank; (ii) they were to determine whether there was a strong likelihood of unsustainable macroeconomic conditions in the next two years by analyzing four areas—debt, external sector, financial sector, and prices; and (iii) they were to be carried out annually in the context of the financial programming exercise as a precondition to, among other things, increasing the Bank’s aggregate sovereign and non-sovereign exposure in the country.

- 1.2 This evaluation seeks to assess whether these requirements are being fully and effectively implemented. The Office of Evaluation and Oversight (OVE) has reviewed all relevant background documents (Cancun Declaration, GCI-9 report, methodology, and process) and minutes and recordings of relevant discussions of the Board of Directors. OVE carefully reviewed final versions of all MSAs

produced in two rounds in 2012 and interviewed relevant IDB staff in the Bank, including managers, country economists, and research economists who worked on the MSAs; relevant staff at other international financial institutions (International Monetary Fund, or IMF; World Bank; Asian Development Bank, or ADB); selected Board members; and counterparts from borrowing countries.

II. CONTEXT

- 2.1 Since the introduction of policy-based lending in the 1980s, the Bank has steadily increased the amount and scope of its macroeconomic analysis. The acute debt crisis in Latin America and the Caribbean (LAC) during the 1980s led the Bank to introduce policy-based loans (PBLs) in the IDB-7 Agreement, which provided that “Management will review the proposals in light of its own analysis of the country’s economic situation, constraints to growth, the adequacy of macroeconomic and sectoral policies, the capabilities of relevant institutions, and the need to coordinate with the lending plans of other donors” (AB-1378, 3.46). It further provided that during the first two years of the new replenishment, all PBLs would be carried out in conjunction with the World Bank. In 1998 Governors added an emergency PBL instrument with shorter terms and higher interest rates to be used in times of crisis (AG-7/98).¹ The operational distinctions among investment loans, PBLs, and emergency PBLs were further clarified in 2002 when Governors approved the New Lending Framework (AG/1-02). Unlike investment lending, PBLs required the Bank to engage in macroeconomic analysis, particularly of countries’ policy frameworks.
- 2.2 In 2004 an OVE evaluation of IDB financial instruments found that PBLs had many policy conditionalities but few macroeconomic safeguards (RE-300), and it recommended strengthening the analytic underpinnings of all Bank operations, particularly PBLs (par. 9.12, 1). Management’s own assessment of the New Lending Framework (GN-2200-13) concurred with OVE and recommended improving the effectiveness of PBLs by—among other measures—recognizing “that PBLs should be based on a sound macroeconomic framework, requiring that the Bank would undertake a PBL in a country only when it has determined that the country’s macroeconomic policy framework is appropriate” (para. 4.57 g). Therefore, to increase the development effectiveness of policy-based lending, in 2005 the Bank adopted new guidelines establishing that the “Bank’s staff will develop an independent view about whether or not conditions are appropriate to place a recommendation for a loan before the Board for consideration” and creating Independent Macroeconomic Assessments (IMAs) (CS-3633).² In

¹ The emergency lending instrument was initially created on a temporary basis. The New Lending Framework of 2002 made emergency lending a permanent lending category.

² It should be noted that the Policy-Based Loan Guidelines (CS-3633) require that “in discharging its institutional and fiduciary responsibilities, the Bank must make an independent macroeconomic assessment to support its lending activities, carried out by the relevant regional department and the Research Department.”

- practice, this required the relevant regional department to produce, with the support of the Research Department (RES), an independent macroeconomic assessment at both the approval and the disbursement stages. Since 2006, over 80 IMAs have been produced, covering all LAC countries except the three that have not requested PBLs during that time.
- 2.3 By 2009 some Directors were becoming concerned that the distinction between PBLs and investment loans was becoming blurred in practice. Certain investment loans submitted for Board consideration seemed to have characteristics inherent to PBLs, allowing for swift disbursement without earmarking to specific tangible investments, yet avoiding the macroeconomic analysis required for PBLs.
 - 2.4 Around the same time discussions were starting for IDB-9. In March 2009, the Governors asked Management to “initiate a review of the need for a general capital increase” (AG-6/09). The first working paper (CA-501, June 2009) did not contain specific actions related to macroeconomic sustainability, but in the second draft (CA-511, February 2010, para. 4.6), macroeconomic sustainability was mentioned as part of the discussion of evaluability standards. This draft stated that the Operations Policy Committee “will also consider, before submitting the loan proposal to the Board of Executive Directors, criteria such as conformity with institutional priorities, compliance with sector policies and macroeconomic sustainability.” One chair, noted that macroeconomic sustainability “applies only to individual PBL operations. Overall macroeconomic sustainability is discussed in the strategy”; this chair proposed alternative wording in line with this observation (GN-2518-19).
 - 2.5 In March 2010, Governors issued the Cancun Declaration (AB-2728) announced the capital increase and providing, among the 13 specific reforms listed in the Overview Framework, the requirement to “ensure adequate safeguards against lending into unsustainable macroeconomic situations.” Between March and June 2010, Management and the Board prepared the final IDB-9 Report (quoted in para 1.1 above). It was agreed, among other things, that the limitation on the Bank’s exposure in case of a negative MSA would apply to new approvals but not to currently disbursing operations, and that the Bank would not impose macroeconomic conditions on its member countries (GN-2518-38). The introduction of this safeguard was met with reservations by several chairs at Cancun, and it has been the subject of continuing controversy in discussions in the Board of Executive Directors.
 - 2.6 After the approval of IDB-9, Management prepared guidelines for the production of MSAs. Under the leadership of RES, Management submitted to the Board a

proposed methodology (GN-2633-5)³ and preparation guidelines (GN-2633-6). The Vice-Presidency for Countries (VPC) prepared a process document (GN-2633-9, superseded by GN-2633-14)⁴ that focused on the programming implications of MSAs. For countries whose macroeconomic situation the Chief Economist deemed “unsustainable,” Management would circulate two documents to the Board: (i) a copy of the MSA for information, and (ii) a Programming Preview Document (PPD) indicating the Projected Aggregate Exposure (PAE)⁵ at the end of the current year, the PAE for the programming year after taking into consideration the projected disbursements and the scheduled repayments, and a recommendation on the country PAE for the programming year. On the basis of that information, the Board would have 10 weeks to advise Management whether they approved the proposed PAE or not. If they did not approve it, Management would propose a revised PAE (2.5.2-2.5.3).⁶ It was further agreed that MSAs would have restricted circulation within Management and even the Board of Executive Directors, with disclosure possible only after 20 years; that MSAs would be carried out for Fund for Special Operations (FSO) countries but would have no programming implications for them (para. 2.7); and that an MSA could be revised if the country’s macroeconomic conditions changed. The final version added that the PAE recommendation should reflect “country dialogue.” However, there continued to be significant disagreement in the Board on the precise link between MSAs and country programming.

III. FINDINGS

A. Full implementation

- 3.1 OVE finds that IDB Management has substantially implemented the IDB-9 requirements for MSAs, though on a slightly delayed schedule and with slightly different rules than originally intended. MSAs were not issued in 2011, but were prepared and finalized for all 26 LAC countries in early 2012 (for the programming year 2012) and again in mid-2012 (for the programming year 2013). The MSAs covered the four substantive areas called for in the IDB-9 Agreement.

³ The Board agreed that the responsibility for developing and updating the methodology belonged to the Chief Economist; thus the document was presented for information (GN-2633-5; updated by GN-2633-15). One change resulting from the discussion at the Board was the dropping of a proposal to use a “simplified” MSA for countries with indicators above a certain threshold (see GN-2633-2, footnote 1). The MSA preparation document (GN-2633-6) was approved by the Board.

⁴ The process document GN-2633-9 was approved by the Board in December 2011. It has since been superseded by GN-2633-14 (June 2012).

⁵ “The Bank’s projected AE (“PAE”) with a country for a particular programming year is defined as the OLB [Outstanding Loan Balance] at the end of the year prior to the programming year plus the projected disbursements for the programming year minus the projected principal repayments for the programming year.” (GN-2633-9, para. 2.2, “projected” is underlined in the original)

⁶ If the 10 weeks elapsed without the Board taking any decision, the programming process would continue on the basis of the recommendation made in the PPD.

In the first round, one country was found to be in an unsustainable macroeconomic situation, and in the second round three countries were judged unsustainable, including the one deemed unsustainable in the first round.⁷ No new loans were approved in 2012 that would increase IDB's aggregate exposure in the country found unsustainable in the first round; however (as discussed below), that does not necessarily mean either no increases in aggregate exposure or no new lending.

B. Effective implementation

3.2 Determining the likely effectiveness of implementation is more complex than determining the extent of implementation. It depends on an understanding of the rationale for the requirements and the likely benefits and costs of the overall process. This section discusses the major issues surrounding MSA effectiveness.

1. The rationale for MSAs

3.3 The rationale for the MSA requirement was not fully delineated in the IDB-9 Agreement. The Cancun Declaration noted that MSAs were meant to “ensure adequate safeguards against lending into unsustainable macroeconomic situations.” The IDB-9 Agreement is very precise on the four areas of analysis and the implications of the MSA mandate—particularly regarding aggregate exposure—but the IDB-9 Agreement does not elaborate further on the rationale.

3.4 The evidence from a review of relevant documents and minutes and from staff interviews points to two rationales for the MSA requirement. The first rationale is to limit the Bank's credit risk by ensuring borrowers' repayment capacity, and thereby to protect the Bank's creditworthiness, as provided in the IDB's founding Charter (Box 1). The second is more development-oriented: the desire to avoid supporting countries with weak macroeconomic policies and/or adding to the debt burden of a country in distress.

3.5 The characteristics of the MSA process support both rationales, and the explicit link between the MSA and the Bank's aggregate exposure to a country is consistent with both. Some aspects of MSAs appear to support credit risk considerations: (i) they have a short-term perspective (less than 2 years); (ii) they conclude with a yes-no decision; (iii) they are focused on “unsustainability,” irrespective of its causes and the country's policies; and (iv) they are treated confidentially. The fact that MSA analysis goes beyond assessing repayment capacity to also cover full debt, external, financial, and price sustainability assessments supports the broader development rationale, as does the need for dialogue with the countries concerned.

⁷ The 2011 round was finalized in February 2012 and had programming implications from January 2012. The 2012 round was finalized in June 2012 and applies to programming from January 2013.

- 3.6 However, the development rationale is incompletely served by the scope of MSAs. While macroeconomic stability and sustainability are necessary for growth and prosperity, they are not sufficient. A solid foundation of microeconomic policies and well-functioning and accountable institutions is also critical for development, yet the MSA process does not address these factors. If the goal is to promote economic development as opposed to limiting the Bank's credit risk, the design of the MSAs arguably puts disproportionate focus on macroeconomic issues compared to broader issues of economic policy and sustainability in considering overall Bank support to LAC countries. This point is addressed further in OVE's suggestions below.

Box 1. MSA and the Agreement Establishing the Inter-American Development Bank

Several articles of the Agreement Establishing the Inter-American Development Bank (GN-1912) may be relevant or have been cited in justifying different points on the wisdom and role of MSAs:

- In the article about operations (Article III, Operations, Rules and Conditions for Making or Guaranteeing Loans, Section, Section 7, a, iii), the Charter established that “in making or guaranteeing a loan, the Bank shall pay due regard to prospects that the borrower and its guarantor, if any, will be in a position to meet their obligations under the loan contract.”
- In the article on Organization and Management (VIII, 5, f), the Charter states: “The Bank, its officers and employees shall not interfere in the political affairs of any member, nor shall they be influenced in their decisions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions, and these considerations shall be weighed impartially in order to achieve the purpose and functions stated in Article I.” Article I reads: “The purpose of the Bank shall be to contribute to the acceleration of the process of economic and social development of the regional developing member countries, individually and collectively.”
- In the article on Functions of the Bank (I,2,a): “To implement its purpose, the Bank shall have the following functions: ... ii) to utilize its own capital, funds raised by it in financial markets, and other available resources, for financing the development of the member countries, giving priority to those loans and guarantees that will contribute most effectively to their economic growth ... iv) to cooperate with the member countries to orient their development policies toward better utilization of their resources, in a manner consistent with the objectives of making their economies more complementary and of fostering the orderly growth of their foreign trade. ”

2. MSA methodology

- 3.7 The likely effectiveness of MSAs is limited by an underlying methodological concern: the consensus among economists is that it is not possible to accurately predict the likelihood of macroeconomic crises in the near term, including the two-year period prescribed in the MSA requirements. Because of the inevitable imprecision, mandatory “yes-no” predictions that have automatic implications for Bank lending are likely to be wrong in a significant subset of cases.

- 3.8 The methodology designed by RES is similar to that used by the IMF in its Article IV consultations (see Box 2), but the purposes of the IMF’s surveillance function are very different from the purpose of the MSA. Article IV consultations have the stated purpose of changing medium-term policies. The debt, external, and financial sustainability exercises carried out by the Fund are tailored to that end, and candid discussions with the government and transparent dissemination are seen as essential elements. Article IV consultations do not contain a “yes-no” prediction on future sustainability. As a well-known practitioner has noted, “Governments often change their policies if it becomes clear that they are unsustainable. Thus, the focus of fiscal sustainability analysis is frequently not on default itself—which governments tend to avoid—but rather on the consequences of the policy changes needed to avoid eventual default.”⁸
- 3.9 The methodology is not as effective for the purposes of the MSA. The MSA has a short-term mandate: predicting economic crises within the next two years. The Bank is effectively being asked to estimate the underlying probability distribution of a negative development along any of the four dimensions and to determine the likelihood (using unspecified criteria) of a crisis occurring in each of them. While predicting the timing of crisis has been a perennial goal of economic science, efforts to design early warning systems to predict the likelihood of debt, financial, or currency crises have generally yielded poor results, although they typically have some value in identifying vulnerabilities. As a recent IMF document stated: “Predicting the timing of a crisis has widely been considered a fool’s errand, and crisis models have a dubious record in this regard.”⁹ Regarding debt sustainability, “the literature has not advanced sufficiently at this stage to argue that there is a good approach to estimating default probabilities ... nor has the literature found an adequate way of mapping backward from bond spreads to default probabilities.”¹⁰ Regarding currency crises: “Overall, the consensus is that EWS [early warning system] models have some value in providing early warning about which individual countries are most vulnerable to crisis. However, they generate a lot of false alarms.... In addition, they are less successful at predicting the timing of crises.”¹¹

⁸ Burnside, Craig, ed., (2005), *Fiscal Sustainability in Theory and Practice: A Handbook*, Washington, DC: World Bank. Even when the remark is made about debt (i.e., fiscal) sustainability, it could be argued that it is valid for any “unsustainable” policy.

⁹ IMF (2010), “The IMF-FSB Early Warning Exercise: Design and Methodological Toolkit.”

¹⁰ Burnside, Craig, “Assessing New Approaches to Fiscal Sustainability Analysis,” mimeo, World Bank, 2004.

¹¹ Glick, Reuven (2011), “Currency Crises,” The Federal Reserve Bank of San Francisco, Working Paper. See also Berg, Andrew, Borensztein, Eduardo, and Pattillo, Catherine, “Assessing Early Warning Systems: How Have they Worked in Practice?” IMF Staff Papers, Vol. 52, No. 3.

Box 2. IMF Surveillance Function: Article IV Consultations and FSAPs

The IMF's purpose is to ensure stability in the international financial and economic system. Although the IMF has a role as provider of technical assistance and financing for adjustment programs, its core mandate and function is surveillance. The IMF distinguishes between bilateral surveillance and multilateral surveillance (i.e., systemic spillovers). Bilateral surveillance focuses on individual country policies, particularly the obligations assumed under Article IV of the Articles of Agreement.

The Article IV consultation is the centerpiece of IMF's bilateral surveillance. Although the mandate was originally centered on exchange rate surveillance, Article IV consultations de facto cover a wide array of fiscal, monetary, and financial sector policies. Article IV consultations use models of debt sustainability with alternative scenarios similar to those proposed by MSAs. They also look at the sustainability of the external account and discuss inflation, although they do not specifically aim at assessing "price sustainability."

In addition to Article IV consultations, the other key instrument for bilateral surveillance at the IMF—carried out jointly with the World Bank—is the Financial Sector Assessment Program (FSAP). Begun in the aftermath of the financial crisis in the late 1990s, this program carries out comprehensive analyses of the financial sectors of member countries. These studies have dual objectives: identifying vulnerabilities in the financial sector and fostering national financial sector development. Although the exercise is generally seen to be comprehensive and of high quality, a recent evaluation by the IMF's Independent Evaluation Office found that it is also quite expensive, demanding for national authorities, and lengthy (requiring about one year to final delivery).^a

These IMF surveillance instruments differ from MSAs in objective and process. They focus on policy advice and involve close exchange of views with governments. "The IMF conducts a thorough assessment of relevant economic and financial developments, prospects, and policies for each of its members, and provides candid policy advice based on its analysis."^b Exchanging views and discussing with governments are an essential part of the surveillance task, and "the ability to influence policy making—or traction—is the cornerstone of effective surveillance." "Surveillance is a collaborative process, based primarily on dialogue with country authorities, other stakeholders, and persuasion." The IMF instruments also differ from MSAs in time frame: "[IMF] Staff reports and discussions should take a medium-term view, including a discussion of medium-term objectives and planned policies, especially possible policy responses to the most relevant contingencies." Finally, they differ in degree of transparency: publication of Article IV and Financial Sector Stability Assessments is "voluntary but presumed" under IMF's transparency policy and these bilateral surveillance documents are publicly disclosed in most cases.

Note: See IMF, Bilateral Surveillance Guidance Note, June 13, 2012, [link](#); IMF (2010), Guidance Note on the Fund's Transparency Policy, [link](#). On the methodologies, FSAP handbook ([link](#)) and the guidance notes on assessing sustainability at the IMF ([link](#), and its update [link 2](#)).

^a See IEG-WB (2006), "Financial Sector Assessment Program: IEG Review of the Joint World Bank and IMF Initiative," [link](#).

^b IMF, Annual Report, 2011, p. 17, [link](#).

3. MSA quality

- 3.10 Though OVE found 2011 and 2012 MSAs to be generally of good quality, there were some exceptions and inconsistencies. The analyses of debt and external sustainability were deeper, as these are the areas with more broadly accepted quantitative methodologies. With regard to debt sustainability, important background information—such as the assumptions and the data sources (particularly regarding forecasts, debt definitions, and sensitivity checks)—was partial or missing in several documents. Regarding external sustainability, most MSAs had an adequate discussion of the basic background information needed to assess sustainability, including the exchange rate regime and the recent evolution of the current account. Furthermore, all MSAs reported some international liquidity indicators, although in some cases the indicators were not thoroughly analyzed. In only a few MSAs was an attempt made to quantify the impact of specific shocks on the country's external sustainability.
- 3.11 The analysis of financial sustainability was less thorough. The financial sector sections were generally limited to the presentation of a set of indicators and a broad description of the sector (and, in six cases, the banking sector only). Most MSAs had adequate indicators on capital adequacy, liquidity, asset quality, and, to a lesser extent, foreign currency exposure and profitability, though the majority of the reports did not provide a detailed analysis or prospective view on these indicators. Regulatory aspects were covered in fewer cases, and an analysis of vulnerabilities was often missing. Only six MSAs presented the results of stress tests produced either by the financial stability authority or a recent FSAP, and for some of the exercises the description was somewhat confusing. Indeed, in a few documents the financial sustainability analysis was so superficial that special attention should be given to this area for the future—especially if the Bank decides to disclose parts of the MSAs. Only one MSA had a state-of-art analysis of the financial sector, having benefitted from a recent FSAP and stress testing by the central bank.
- 3.12 The discussion of inflation in the MSAs was relatively informal, reflecting the less developed state-of-the-art in this area. Almost four-fifths adequately described recent trends in inflation in the countries and the main reasons behind them (such as changes in food and oil prices). A significant proportion of the documents contained some information on institutional arrangements, though only about 40% had a thorough description. Virtually all of the documents discussed likely future inflation trends and vulnerabilities to some extent, but only about one-third contained a thorough assessment. Only three MSAs presented econometric inflation forecasts. There was limited evidence that MSAs draw on the sophisticated forecasting carried out by many central banks in the Region.
- 3.13 Finally, OVE found some inconsistencies in the conclusions of the Chief Economist, reflecting the essential element of subjectivity in these judgments. OVE assessed the internal consistency of MSAs both within each document and between the two rounds of MSAs—that is, whether the conclusions of the Chief

Economist went in the same direction and were compatible with the evidence presented in both rounds of papers. All evidence was assessed using the methodology proposed by the Chief Economist to detect unsustainable macroeconomic conditions (GN-2633-5/15). A four-point scale was used: “fully consistent” if the evidence regarding a particular sustainability condition was found to be fully in line with the MSA’s conclusion; “partially consistent” if the evidence had some limitations but still pointed in the direction of the conclusion; “mildly consistent” if the evidence was partial and important questions arose in OVE’s analysis that could qualify the conclusion; and “inconsistent” if the evidence appeared contradictory either between the first- and second-round MSA reports for the same country or internally within one MSA.

- 3.14 OVE found that 20 of the 26 MSAs presented conclusions that were broadly consistent with the analysis carried out and with each other. Of the remaining 6, 3 had one or more dimensions with a mild inconsistency but no full inconsistency. Only in three MSAs did OVE find a conclusion on at least one dimension to be clearly inconsistent—with most inconsistencies in the debt and external sustainability analysis (Table 1).¹² Two of these MSAs were for countries that moved from a positive MSA in the first round to a negative MSA in the second round. OVE did not attempt to judge which conclusion was correct but merely to determine whether an inconsistency existed. It is important to highlight that OVE did not find any evidence systematic bias in these cases, but rather attributed the inconsistencies to the inherent subjectivity of the MSA exercise, magnified by the change in Chief Economist between the two rounds.

¹² Of the three MSAs with at least one “inconsistent” dimension, all of them had problems with the debt sustainability analysis although this dimension was inconsistent in only two of them. The causes were different in each case: in one the analysis in the first and the second rounds were very similar and yet there was a drastic change in the conclusions. This change was motivated by the unfolding of events that—although reasonable—could not be captured by the methodology. In another case consistency was partial due to a large unexplained deterioration in historical fiscal data and unofficial projections, not fully consistent with the DSA methodologies that showed some improvement. In a third case the internal consistency of the document was compromised by the poor quality of the data and the limited acknowledgement of the deterioration of debt indicators. The greater prevalence of inconsistencies in debt and external sustainability may be the result of the more specific guidelines contained in the methodology document (GN-2633-15) regarding these two dimensions. In contrast, it was more difficult to find inconsistencies in dimensions with weaker methodology (financial, price).

Table 1. Consistency Pattern of the Conclusions (Number of Countries)

Area	(1)	(2)	(3)	(4)	(1)+(2)	(3)+(4)
	Full	Partial	Mild	Inconsistent	Broadly Consistent	Some Inconsistency
Debt	19	4	1	2	23	3
External	18	5	1	2	23	3
Financial	18	6	1	1	24	2
Price	23	2	1	0	25	1

4. MSA preparation

- 3.15 Although the Cancun Declaration required that MSAs be independently produced by the Chief Economist, this has not been the practice. Rather, the preparation process has been somewhat similar to that for Independent Macroeconomic Assessments (IMAs), with initial drafting by Country Economists and Regional Economic Advisors (REAs) in VPC and review (and, for MSAs, addition of conclusions and judgments on sustainability) by RES. This process was adopted primarily for reasons of efficiency and feasibility, given the country knowledge of the VPC staff and the limited resources in RES.
- 3.16 The Chief Economist's judgments on sustainability do appear to be made independently. Most country economists reported only limited interaction with RES and none before delivery of the first draft. They generally considered that RES's review of the first draft added value. Once their revised drafts were delivered to RES (without conclusions, which were then added by the Chief Economist), country economists typically reported no further interactions with RES, though some REAs reported informal interactions during the conclusion stage.
- 3.17 The process is notable for the absence of any checks and balances in the final decision-making phase. The entire responsibility for the decision on sustainability rests with the Chief Economist, with no avenue for internal review by any other person or group. While this reinforces independence, it also places a disproportionate responsibility on a single Bank employee for decisions with far-reaching implications for IDB. No other international financing institution follows this approach; the IMF, for example, has a well-developed process for review and comment on its surveillance documents.¹³ OVE acknowledges that the unilateral approval of the document by the Chief Economist is a direct implication of the mandate. However, it carries considerable risk, particularly for inherently subjective documents with major implications for an institution and its stakeholders.

¹³ In Article IV consultations, for example, one department leads the production but joint approvals are required. Decisions over credit risk ratings for sovereigns in comparator institutions are also not taken by an individual person but rather by a committee.

3.18 The dialogue with the government during the preparation of the document also appears limited. OVE’s interviews with relevant counterparts in the countries indicated there was not significant dialogue at this stage, and some counterparts were not even aware of the MSA process. The dialogue that did take place occurred toward the end of the process, when the Chief Economist circulated the “preliminary MSA” (with preliminary conclusions) to country authorities. Any comments submitted within three weeks were to be considered in the final version and attached as an annex. In practice, 23 countries submitted comments in the first round, and 18 (not including 3 of 4 A countries) in the second round. Most comments concerned the quality of the data and analysis.¹⁴ There is also evidence that Management adequately addressed the comments of the country authorities.

5. MSA cost

3.19 The cost of MSAs to the Bank is significant but not enormous. OVE estimates that the first two rounds of MSAs (for which it is difficult to separate the costs, since they were so close together) cost the equivalent of approximately 8 staff years. The overall cost for the institution for the two MSA rounds (including preparation of the methodology) to date is estimated at roughly US\$3.3 million, or some US\$130,000 per MSA. The direct costs of MSA preparation to date are estimated at US\$90,000 per MSA (US\$2.3 million in total).¹⁵ This is not particularly costly in comparison to macroeconomic assessments elsewhere, though costs may rise if the analysis is deepened.¹⁶

3.20 It is important to note that these costs are additional to those incurred by IDB in carrying out other macroeconomic assessments. The number of macroeconomic assessments done by the Bank has increased in recent years—the IMAs (adopted in 2006), Debt Sustainability Framework and Enhanced Performance-Based Allocation (DSF/EPBA) for FSO countries (adopted in 2007), and MSAs (adopted in 2010)—resulting in potential duplications and inconsistencies. IMAs and MSAs are particularly similar in terms of data, methodological approaches, the independent nature of the assessment, and the relationship to similar IMF

¹⁴ Of these comments, 44% concerned the quality of the analysis and 29% concerned data sources, often suggesting corrections. A third type of comments (18%) referred to methodology, including the use of certain models or indicators. The other 9% of the comments referred to the presentation. There were also some comments that challenged the legitimacy of the MSAs.

¹⁵ The calculation of costs is an approximation and should be interpreted with caution, as the underlying information is poor, particularly the data on staff time reporting (TRS). Also, it is difficult to separate the one-time (methodology development) from the recurring costs using IDB budget data for 2011. In interviews with the main participants, OVE asked explicitly about the time spent in drafting MSAs. Computing cost based on the time reported to OVE did not yield significantly different estimates. As the process became more organized in 2012, an independent product code was created for each MSA, which should make budget accounting easier going forward.

¹⁶ MSAs are considerably less expensive than Article IV consultations of the IMF, which involve four or five economists and a 2-week mission to the country and are estimated to cost in the neighborhood of US\$250,000 each. An average FSAP costs much more—on the order of US\$600,000 to US\$700,000 each.

reports. There are differences in focus, however, as IMAs focus on the effect of policies while MSAs emphasize “sustainability” regardless of the country’s policies.¹⁷ IMAs also include an assessment of the likely medium-term evolution of the economy. Significant efficiencies could be gained through closer harmonization of IMAs and MSAs; OVE understands that Management is working on new guidelines to that effect.

- 3.21 One of the reasons for the modest cost is the very heavy reliance on IMF data, particularly for forecasts. Every country economist interviewed for this evaluation noted that the main source of forecasts was the IMF’s World Economic Outlook.¹⁸ The joint IMF-World Bank FSAP was the leading source for financial assessments, provided it had relatively been updated, along with any available stress tests from central banks or the relevant regulator and the government’s historic debt data. Few other sources of data were used. This reliance on IMF reports and forecasts, though reasonable from an efficiency perspective, raises some questions about the *de facto* independence of the exercise.
- 3.22 Knowledge benefits for the Bank seem to have been modest. The MSA process contributed to systematizing macroeconomic analysis at the Bank, particularly the debt sustainability analyses carried out with the “template” prepared by Management. Country economists indicated that the process was beneficial in increasing their experience with macroeconomic assessments. However, many of them did not see these benefits as outweighing the potentially negative effects of the MSA process on their relationship with the client.

6. Confidentiality of MSAs

- 3.23 To date MSAs have been handled as highly confidential documents in IDB, though the rationale for this is not entirely clear to OVE. OVE’s review of the documents confirmed that almost all of the information in the documents is publicly available, most of it on the Internet. The single most cited document is the IMF Article IV consultation, and over 90 percent of Article IVs are publicly disclosed.¹⁹ About two-thirds of FSAP summary documents were publicly disclosed in 2009, and this rate is likely to have increased since.²⁰ When data or

¹⁷ According to the guidelines for MSAs, “The document will be as factual as possible, its main objective being, not to provide general judgments about the “quality” of policies or to give policy recommendations, but to assess whether there is a “strong likelihood” of each of four types of events defined by the GCI, ‘whatever their cause’” GN-2633-5.

¹⁸ Indeed, many of them lamented that the March deadline for submitting the first draft to the Chief Economist made it difficult to use the updated figures that would come out in April. The Economist Intelligence Unit was mentioned in a few cases.

¹⁹ See Transparency at the IMF, Factsheet. Accessed on July 12, 2012, [Link](#). The figure is similar for IDB’s member countries (92% for reports finalized between 2009 and 2011).

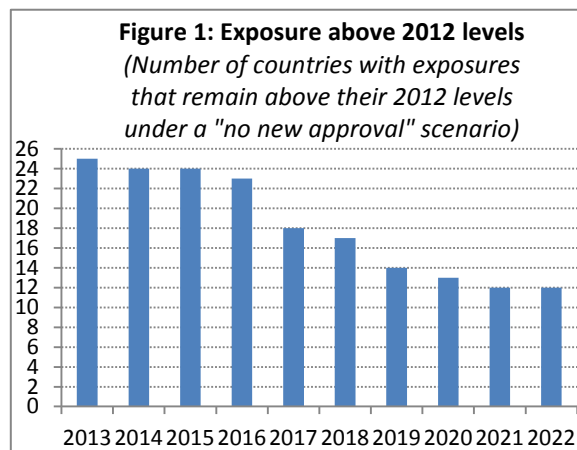
²⁰ The FSSA is the overview paper of the FSAP study. The figure for FSSAs comes from the Review of the Fund Transparency Policy—Background Paper. [Link](#). In the Fund’s last transparency policy, FSSAs’ disclosure was also encouraged (“voluntary, but presumed”). See IMF’s transparency policy. [Link](#).

calculations were included that were not available online, in most cases such data would be available soon (as, for example, data to be disclosed in the IMF’s World Economic Outlook) or were not sensitive or restricted. The main part of the MSA that appears confidential is the conclusion on sustainability by the Chief Economist. If there is a concern that this conclusion would have an effect on financial markets, it would presumably be possible to disclose immediately—or after a short lag—other parts of the MSAs but withhold the conclusions for a longer period.

7. Programming implications

3.24 The IDB-9 Agreement establishes a clear link between the MSA and the Bank’s aggregate exposure in the country, saying that the MSA will be performed as “one of the prerequisites, among others, for maintaining the Bank’s aggregate exposure with the country including both sovereign and non-sovereign operations.” The Board decided that following a negative MSA, Management should submit a PPD proposing an aggregate exposure (PAE), and the Board would accept or reject the proposal. Although in earlier versions of the process document the PAE was not to be increased for countries with negative MSAs, the final approved version introduced no specific guidance as to what the final PAE should say. It was up to Management to propose an exposure as it saw fit—and to the Board to approve it or not.

3.25 In practice, none of the four PPDs available so far have programmed new operations that would result in increased exposure in the country; however that does not necessarily mean no increases in exposure or no new lending. Two PPDs are for countries whose exposure will increase even without new approvals because of the schedule of disbursements and repayments of existing loans.²¹ In the third country exposure would fall without new approvals, so new operations were programmed that would not increase aggregate exposure even if immediately disbursed.²²



²¹ Exposures are expected to increase 12% and 5% in the two countries even without new approvals.

²² Exposure under the “no new approvals” scenario would have decreased 3% and 1% in 2012 and 2013, respectively. Management proposed new approvals amounting to US\$38 million in the first MSA (compared to an expected US\$42.4 million decline in exposure with no new approvals) and US\$6 million in the second (compared to an expected US\$13.9 million decrease in exposure with no new approvals).

- 3.26 Indeed, OVE’s calculations indicate that a negative MSA would fail to reduce aggregate exposure in the majority of Bank members until about 2019 (Figure 1). Using existing data and assumptions on expected disbursements and repayments, OVE estimated²³ that the Bank’s absolute exposure would increase for all but one of the 26 borrowing member countries under a “no new approvals” scenario.²⁴ This is consistent with the Bank’s relatively young portfolio and the increase in approvals since 2008. On average, the Bank’s aggregate exposure to the Region would increase until 2015 and fall back to 2012 levels by 2019. Virtually all countries would have a higher exposure in 2016 than in 2012; about half would have high exposure still in 2019; and 12 countries still in 2022. These dynamics would be accentuated in FSO countries, given FSO’s long maturity and low repayments.
- 3.27 Under current rules a negative MSA applies only to the following year, with approvals and resulting increases in aggregate exposure still possible in the current year. In June of each year the Chief Economist determines whether countries are sustainable. The MSA does not have any effect between June and December of that year and only affects programming for the following year. PPDs for the additional two countries declared unsustainable in June 2012 proposed no new approvals in 2013. However, for one of the countries, two loans were approved in September 2012 which, if immediately disbursed, would add US\$400 million of exposure—20% of the existing exposure in the country as reported by the PPD. (It should be noted that both of those operations were included in the Bank’s operational program before the country was deemed unsustainable by the Chief Economist.) An operation that would have almost doubled exposure was being considered for the second country, though it has been recently removed from the pipeline.
- 3.28 The MSA process introduces additional uncertainty and tension in IDB’s annual programming process. IDB lending amounts need to be reallocated and individual programs reconfigured during the year to reflect MSA findings. And a country with a negative MSA can request a revision at any time,²⁵ possibly leading to yet more reallocations and reconfigurations of individual programs. The process has generated a high level of conflict within the Bank’s Board and with borrowing countries, and the short time period provided between each stage

²³ This calculation is similar to that done by VPC in the production of the PPDs, using Finance Department data (<http://fin>) as of November 1, 2012. Note that disbursements tend to be frequently updated and the exact calculations depend on the exact date of the data. Repayment data tend to be more stable.

²⁴ Even for the only country whose exposure would be reduced in 2013 without new approvals, the available schedule of disbursements indicates that it would rise again in 2014. Only in 2017 exposure would go back again below the 2012 level.

²⁵ The exact condition is: “[t]he highest ranking representative of the country at the Board may request a revision of an MSA during the programming year if merited by material changes in the macroeconomic conditions of the country” (GN-2633-14, par. 2.5.4). To date a new MSA has been requested in one out of three cases, although there are expectations for revisions in other countries.

of the process has exacerbated tensions. Though such a process requires discipline if it is to move forward, the disruptions and tensions are costs to be considered.

- 3.29 The Board of Executive Directors specifically excluded the FSO countries from the programming implications of the MSAs, though this exclusion was not part of the IDB-9 Agreement. After a protracted discussion in the Board, it was agreed that FSO countries would be excluded from the programming implications of MSAs, and that the only applicable instrument would be the DSF/EPBA (which has a debt sustainability component similar to that of the MSA).
- 3.30 Finally, it is still unclear how the MSA will interact with other instruments of the Bank, particularly the new contingent lending instruments for financial crises.²⁶ The new contingent instrument follows the PBL guidelines by requiring an IMA at approval and another at disbursement—upon the realization of the negative shock (see AB-2890, Table 2). After a shock occurs, it is quite likely that the IMA and any Bank MSA would determine the macroeconomic situation to be unsustainable. According to the policy on contingent instruments,²⁷ “the IMA may consider it prudent to proceed with disbursement if there is an IMF Borrowing Arrangement with the corresponding borrowing member country.” Yet under the wording of the mandate, the Bank would be lending into an unsustainable macroeconomic situation. Moreover, the IDB-9 mandate does not allow crisis lending if it increases aggregate Bank exposure, no matter the reasons for the crisis or the presence of an IMF agreement. OVE’s interviews with IDB managers and Board members confirmed that this inconsistency had not been fully resolved.

²⁶ See the background paper on *Operational Instruments*. In October, Governors approved a two new contingent instruments (AG-9/12), a Development Sustainability Contingent Credit Line (for financial crises) and a Contingent Credit Line for Natural Disasters. The focus of our discussion is the first, which is the successor to the former Emergency Lending instrument.

²⁷ AB-2890, para.4.12

IV. CONCLUSIONS AND SUGGESTIONS GOING FORWARD

4.1 OVE finds that the MSA requirement has been substantially implemented but faces many difficulties that seriously impede its likely effectiveness.

- Most importantly, it does not appear possible for IDB to do what MSAs are expected to do effectively—that is, to predict the timing of macroeconomic unsustainability. The MSA methodology, though highly professional, is not adequate to this task, and there is no other methodology that would necessarily do it better. Indeed, the general consensus of economists is that short-term predicting is fraught with uncertainty. The IMF uses a methodology that is similar to the MSA's, but for a different and more appropriate purpose—to analyze and discuss medium-term policy issues with governments in order to help them with policy reform.
- The quality of the MSAs, though reasonable given the resources allocated, lacks depth in many areas—most notably financial and price sustainability. They draw very heavily on IMF data and analysis, particularly Article IV reviews and FSAPs. OVE found a few cases of inconsistency, both within documents and between documents for the same country in the first and second rounds.
- There are few checks and balances in the system, and none relating to the Chief Economist's conclusion and determination of sustainability. It is unusual to give responsibility for decisions of such importance for the institution and its member countries to a senior official without an opportunity or requirement for internal review. While this broad discretion may have been seen as necessary for independence, the inherent weakness of the methodology and inexact nature of any resulting judgments makes it particularly risky. The limit on accountability resulting from this lack of due process is further exacerbated by the secretive nature of the current process, which does not seem warranted by the information contained in MSAs, most of which is public and available on the Internet.
- The MSA process entails significant costs for the Bank. From a purely financial standpoint the costs are not exorbitant for IDB as a whole, but the process imposes a disproportionate burden—not aligned to normal and expected job responsibilities—on the Chief Economist of the Bank. The significant overlap between MSAs and IMAs is likely to lead to unnecessary duplication and wasted resources. More broadly, the existence of negative MSAs can cause significant disruptions in the Bank's annual programming process as efforts are made to rearrange lending allocations and individual programs. The costs to country relations and IDB Board cohesion and collaboration are also considerable.

- 4.2 On the benefit side, the MSA process may have some potential to further the underlying IDB-9 goal of preventing lending in unsustainable macroeconomic situations. However, it is also possible that it will shift lending forward or backward as much as it will limit its magnitude. MSAs will not achieve the broader objective of stopping increases in Bank exposure for the foreseeable future, as existing IDB disbursement and repayment schedules will lead to increasing exposure in almost all LAC borrowing countries in the coming 5-10 years.
- 4.3 These findings suggest that the costs of the MSA process as currently designed are quite high and may be disproportionate to the benefits gained. In light of these findings, OVE would suggest that the Governors, the Board, and Management reconsider the design of the MSA process to align benefits and costs more closely. In OVE's view a useful way to think about changes is to "unbundle" the two rationales discussed earlier in this paper – credit risk and development effectiveness. Both are important goals and deserve careful consideration, but they are not necessarily best accomplished with one instrument. Depending on which rationale Governors decide to pursue, they might want to implement the following suggestions.
- 4.4 The credit risk rationale argues for the type of short-term focus and yes-no decision-making used in the MSAs. In line with other comparator institutions (notably the World Bank), Management may wish to strengthen its ability to perform independent credit risk assessment of the sovereign portfolio. This would be done by a credit risk unit within the Bank, independently from Management, in a confidential manner, and with the sole purpose of protecting the Bank's creditworthiness. In addition to the financial implications of such an assessment (e.g., provisioning), the risk assessment could potentially inform the discussions over the country program envelope during the discussion of the Country Strategy.
- 4.5 The development rationale argues for a broader and more medium-term instrument for policy analysis. Many aspects of a country's public policy and institutional framework are important to development; macroeconomic sustainability is an important one, but not the only one. All aspects of Bank lending and non-lending assistance should take into account policy frameworks for development effectiveness, with policy-based lending being the most obvious. OVE therefore suggests that Management consider strengthening the IMAs rather than duplicating them through the MSAs. The IMAs are done at an appropriate time—before approval and disbursement of PBLs—and their focus on medium-term policy considerations is highly development-oriented.
- 4.6 But IMAs need to fulfill their proper role if they are to be used effectively to achieve the development objectives underlying IDB-9. Clear guidelines should define policy-based lending—or, if desired, even a somewhat broader category of lending to be covered by IMAs—and the Bank should not be able to circumvent these guidelines by relabeling quick-disbursing loans as investment lending.

IMAs should also be subject to the presumption of disclosure to create incentives for quality and accountability.

- 4.7 If Governors do not consider the above combination of credit risk analysis and strengthened IMAs sufficient to achieve the IDB-9 objectives, they could consider strengthening macroeconomic and policy analysis at the IDB more broadly through the Bank's regular program of economic and sector work. Strong economic and sector work can serve a very useful role in the design of Country Strategies, the prioritization of country programs, and the design of PBLs and investment lending. Governors, the Board, and Bank Management will need to consider what resources they wish to devote to this area of work and how it can be best utilized for development advice and support. It is clearly feasible for the IDB to have a stronger role than it now has in policy analysis and advice to its borrowing countries.

LIST OF PERSONS INTERVIEWED

- Roberto Vellutini, Vice-President for Countries
- Santiago Levy, Vice-President for Sectors
- Jose Juan Ruiz, Chief Economist, and two senior advisors at RES
- Eduardo Lora, former Chief Economist
- Four Regional Economic Advisors
- Sixteen Country Economists
- Ten members of the Board of Executive Directors
- Counterparts of the Bank in selected countries

Management Comments



Mid-Term Evaluation of IDB-9 Commitments
Background Paper: Macroeconomic Sustainability Assessments
Management Response

I. INTRODUCTION

- 1.1 Management welcomes this paper and wishes to thank OVE for the constructive dialogue with Management and staff during its preparation. This paper will contribute to the Bank's efforts to more effectively discuss and implement the macroeconomic safeguards objective as mandated under the Ninth General Capital Increase in Resources (IDB-9).
- 1.2 Management provided comments to OVE on an earlier draft of this paper and is pleased to see that some of its suggestions were incorporated in the final version.

II. OVERALL FINDINGS AND SUGGESTIONS

- 2.1 The background paper provides insights into the limited ability of economic models to predict the timing of macroeconomic unsustainability, and the tensions that the Macroeconomic Sustainability Assessment (MSAs) system has generated. Management welcomes these comments and agrees that there is ample space to improve the way in which the macroeconomic safeguards objective of IDB-9 is currently implemented.
- 2.2 While we welcome OVE's conclusions and suggestions, the paper could have benefitted from further clarification on several issues, namely: (i) the suggestions regarding the Independent Macroeconomic Assessments (IMA) and MSA circulation within the Bank and disclosure; (ii) the applicability of an MSA to a specific programming year; (iii) the relation to crisis lending; and (iv) the suggestion that risk assessments could potentially inform the discussions on the country program envelope contained in the Country Strategy. In that regard, Management would like to provide additional information on each of these points:
 - i. The current practice for the circulation of the confidential MSA documents has been widely discussed at the Board and within Management. OVE draws parallels to the IMF's Article IV consultations; however an Article IV consultation does not result in a Yes/No decision akin to the MSA process. Moreover, the fact that the most cited document in this area is an Article IV (which may be public if that is agreed to by the country) does not necessarily imply that the MSAs (or IMAs) that contain IDB staff opinions on sensitive issues should be public. The trade-off between being a trusted advisor and writing public documents with opinions regarding sensitive issues is well-known. The advisory role of the IDB is different from that of the surveillance role of the IMF, so it is likely that the Bank would have a different approach to making these types of assessments public. It is useful to note that, under the IDB's Access to Information Policy, MSA documents are considered "deliberative information", subject to disclosure after 20 years. The Bank has also deemed that IMAs are confidential documents for similar motives.

- ii. Under the current rules, each programming year is indeed governed by a MSA. The MSA in effect from June to December is the same one which is applicable to that specific programming year. Changing the program in the middle of a programming year as a result of a negative MSA would substantially alter the commitments agreed-upon with the country. As such, Management notes that the approval of the two specific operations mentioned in paragraph 3.27 was fully consistent with current policies.
- iii. While Management agrees with the paper's finding that IDB-9 does not differentiate regular lending from crisis lending, it does not believe, as suggested by OVE, and that there exists an automatic link between the MSA and aggregate exposure. The current approved MSA Process Document reflects the Board's vision that a negative MSA should not automatically impact the Bank's exposure with a country.
- iv. In relation to the suggestion of implementing independent credit risk assessments of the sovereign portfolio, Management believes that using credit risk considerations to determine the country program envelope would require a much deeper analysis, an evaluation of associated costs and discussion with the Bank's shareholders.

2.3 Management welcomes OVE's findings that, despite the difficulties that impede the mandate's likely effectiveness, the IDB has "substantially implemented" the requirement to ensure adequate safeguards against lending into unsustainable macroeconomic situations, and that there is no overall bias or problem of quality in the MSA reports.

III. LOOKING FORWARD

3.1 Management looks forward to working with the Board on further consideration to OVE's findings and recommendation to improve the current way in which the macroeconomic safeguards objective of IDB-9 is currently being implemented.