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***RE-300***

***Instruments and Development:  
An Evaluation of IDB Lending  
Modalities***

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***Office of Evaluation and Oversight,  
OVE***

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## I. INTRODUCTION

- 1.1 This evaluation is intended to provide input to the deliberations of Executive Directors and Governors regarding the future lending framework to be adopted for the Bank in 2005. In January of 2002, the Board of Governors authorized a new lending framework for the period 2002-2004. That resolution directed the Board of Executive Directors to:

*review the results of implementation of the Lending Framework, report on the findings, and provide recommendations for consideration of the Board of Governors at the Annual Meeting of the Board of Governors to be held in 2005. This review will also include the implementation of: (a) measures to enhance the Bank's development effectiveness; (b) measures to enhance the development effectiveness of each lending category, particularly Policy-Based and Emergency Lending; and (c) the establishment and utilization of new lending instruments.*

- 1.2 With respect to its lending instruments, the Governors' directed that the Bank:

*...adopt measures to strengthen the development effectiveness of all the instruments of its lending categories. These measures shall address the following aspects to improve quality at entry and the quality of the Bank's portfolio: (a) operative aspects of programming and project preparation and execution; (b) internal organization and approval procedures for operations, taking into consideration the recommendations of the Office of Evaluation and Oversight; (c) monitoring and evaluation systems; (d) continued efforts to strengthen country programming by improving country papers and analytical and diagnostic work on public sector management and fiduciary safeguards; and (e) continued efforts to strengthen coordination and harmonization with other bilateral donors and multilateral financial institutions on analytical assessments, policy and procedures, financial sector reforms, and codes and standards.*

- 1.3 The basic objective of this evaluation is to review the range of Bank instruments with respect to the issues of development effectiveness posed by the Governors. The evaluation will focus on the instruments themselves, rather than on the specific operations each instrument has financed<sup>1</sup>. The goal is to understand the possibilities and constraints inherent in each instrument and to examine how these characteristics influence the capacity of the instrument to be effective in meeting the development needs of the borrowers.

- 1.4 Data for the evaluation will be drawn from a desk review of operational policies and loan documents, OVE thematic and country program evaluations, and the

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<sup>1</sup> The scope of the evaluation is limited to lending instruments, therefore it does not include technical assistance.

evaluative findings relating to similar instruments in other institutions. Data for the study will also be drawn from the self-evaluations made by Management provided in the various proposals for revision to the rules applicable to individual lending instruments.

## **1. The Changing Context**

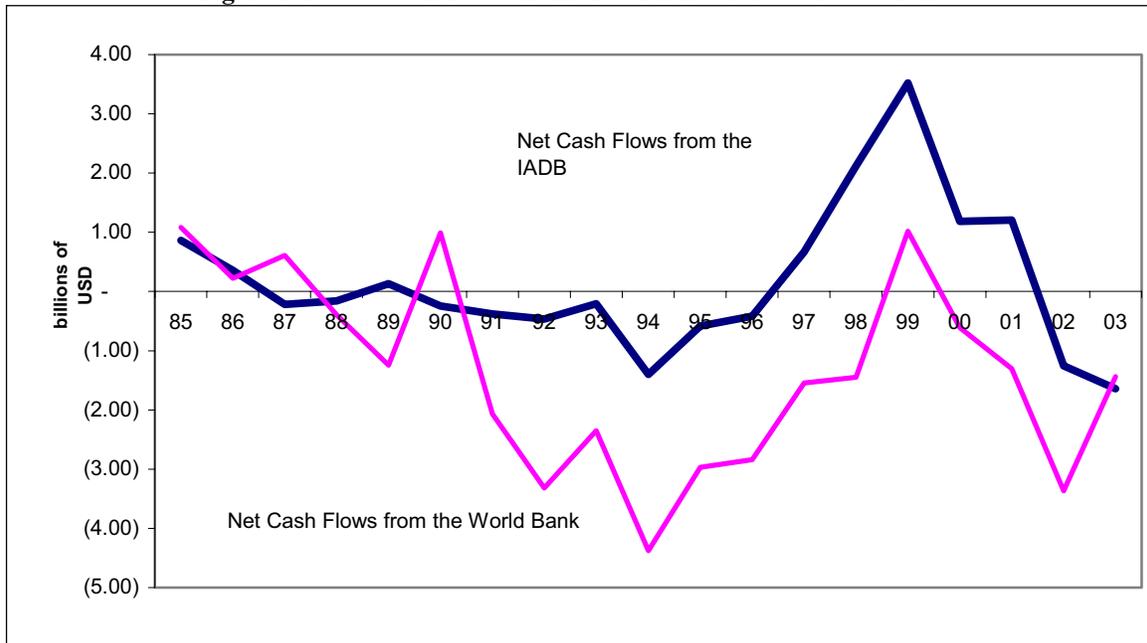
- 1.5 The purpose of the IDB, as established by its Charter is “*to contribute to the acceleration of the process of economic and social development of the regional developing member countries, individually and collectively.*” Instruments are tools deployed by the Bank to accomplish this purpose, and the nature and mix of instruments reflect the basic business model used by the Bank to support the borrowing member countries in their pursuit of development.
- 1.6 For much of its existence, the Bank has followed a business model based on providing long-term debt finance for individual “projects.” Projects are seen as largely self-contained attempts to create productive assets for countries by providing significant net transfers of resources to finance a specific, pre-identified series of expenditures. Projects are designed by the Bank usually in conjunction with country authorities, and executed by the borrower. Lending instruments are designed to finance projects.
- 1.7 The project model demands financial participation from the borrower in the form of counterpart resources, but otherwise tries to separate the Bank’s activities from the general budgetary process of the countries by surrounding project expenditures with an elaborate “ring fence” of rules, procedures and safeguards designed to ensure the integrity of the planned expenditure stream. This approach consciously and deliberately separates the “project” from the ongoing budgetary processes of the country.
- 1.8 The viability of the project model was called into question by the economic crises associated with the “lost decade” of the 1980s. Countries of the region experienced severe financing problems associated with the withdrawal of private investment and needed generalized financing for balance of payments support rather than specific project finance. The Bank responded to these changing needs by creating a new lending instrument—sector loans—that could provide generalized country finance, but the new instrument preserved some of the core features of the existing project model. Sector loans required a pre-specified list of policy reforms to be “financed”, and, initially, formally required that funds be disbursed against proof of imports purchased.
- 1.9 The IDB-8 Agreement, concluded in 1994, was rooted firmly in the concept of the Bank as a project financing institution. It was based on optimistic assumptions regarding future regional growth rates, private capital inflows, and a shrinking need for Bank participation in responding to financial crises. Most importantly, the agreement provided the Bank with sufficient capital to sustain a large program

of net positive resource transfers to the region to support the kind of asset creation envisioned by the project model.

- 1.10 Since 1994, however, economic events in the region and the world have evolved in a way that calls into question the continued relevance of the project model. Six trends are particularly important.
- 1.11 First, the region has continued to experience large, frequent and destabilizing financial crises that are highly disruptive to the kind of stable, multi-year investment programs envisioned by the project model. Crisis finance has played a much larger role in the activities of the Bank than was envisioned in the IDB-8 agreement.
- 1.12 Second, neither the real economy of the region nor private resource flows to it have evolved as predicted. Growth rates have been well below those required for adequate employment generation, and the real economy has not generated the fiscal revenues needed to implement the social agenda central to the IDB-8 Agreement. Private capital flows to the region have also remained well below rates anticipated in 1994.
- 1.13 Third, the combination of frequent crisis and low growth have subjected more and more countries of the region to the fiscal constraints imposed by IMF programs, dramatically reducing the fiscal space available for providing the counterpart funding required under the project model. Prior to 1997, Bank projects were exempt from debt limits established by the IMF, on the grounds that such projects created assets providing future economic benefits, but they have been subsequently been included in country totals. Limits on country debt accumulation, and requirements for mobilizing significant primary surpluses set severe limits to the borrowing capacity of the countries, further undermining the project finance model.
- 1.14 Fourth, most of the major macroeconomic reforms advocated by multilateral financial institutions have been adopted in the region, and the overall pace of reform has stagnated. Current thinking regarding “second generation” reforms stress a slower and more prolonged process of institutional change rather than the “stroke of the pen” reforms that characterized the first phase.
- 1.15 Fifth, analytical thinking regarding economic development has been moving toward greater focus on the contextual complexity of the development process. Issues of timing and sequencing, bottlenecks, completeness of design and synergistic effects are leading toward attempts to discover the right mix of interventions likely to have maximum impact, rather than retaining the old focus on single variables such as investment levels or macro policies. The project model is poorly equipped to address these concerns.
- 1.16 Finally, past lending by multilateral lending institutions has created a large outstanding stock of debt whose service (principal and interest repayments)

constitutes a major fiscal obligation for most borrowers. Repayment obligations are now approximately equal to funds available for new disbursements for the World Bank and the IDB, meaning that neither has the capacity to make significant net positive resource transfers to the region, yet the project model is built around the assumption of such transfers. As presented in Figure 1.1, net cash flow of resources from the multilaterals to the countries have been negative for the countries since 2002, and are likely to become even more so if world interest rates rise.

**Figure 1.1: Net Cash Flows from the Multilaterals to the Countries**



Source: OVE database from IDB Data Warehouse and World Bank Annual Reports

- 1.17 These six trends fundamentally challenge the continued relevance of the Bank’s business model rooted in project finance, and this has profound implications for future discussion regarding lending instruments. The need to consider these implications is heightened by recent changes in lending policy undertaken at the World Bank.
- 1.18 Reacting to the trends noted above, the World Bank, the main alternative source of development finance for Latin America, has radically shifted its business model from one based on project finance through multiple specific lending instruments to one based on the finance of country or sectoral programs through a dramatically reduced number of specific instruments. In this process, the World Bank is eliminating existing constraints built into individual lending instruments and shifting the locus of fiduciary and developmental safeguards to the country program level. (See Chapter VI). The ramifications for the IDB is that “...the competitive pressures for the Bank to follow suit will be immense, as we would

then be squeezed in terms of lower transaction costs by both the World Bank and the subregional development banks. It will force us to change as well”<sup>2</sup>.

- 1.19 In the context of these basic trends, the remainder of this report will analyze the origins, development and use of the Bank’s individual lending instruments, together with proposals made for reforming the instruments in light of changing country needs. While the evaluation of past practice needs to focus on the development effectiveness of individual instruments, **the trends noted above are clearly pointing to a need to re-think the entire business model based on individual projects and individual instruments.**

## II. INSTRUMENTS, DEBT AND DEVELOPMENT

- 2.1 As OVE pointed out in 2002<sup>3</sup>, the range of potential development needs is very broad, and many different possible activities could be seen as contributing to development. The focus of this evaluation, however, is the Bank’s lending program, and lending involves the creation of debt in convertible currencies. Not all possible developmental needs are appropriately financed with debt. Making a loan is a two-sided transaction: funds are made available today that must be repaid (with interest) in the future. As a development institution, the Bank has an obligation to examine both sides of the transaction before proposing to meet country needs with debt finance. If the present value of future benefit flows are less than present value of future economic costs, then the country is worse off for having taken on the debt for financing the specific project.
- 2.2 As a financial institution, the Bank has a fiduciary obligation to shareholders to perform exactly the same calculation. Failure to do so runs the risk of lending a country more than it can afford to repay, creating a situation of potential welfare loss to the countries and potential financial loss for the Bank. This is particularly important in light of the potential moral hazard problems associated with lending to governmental regimes, where the benefits of borrowing accrue to those currently in power while the repayment obligations are likely to fall on some future regime (See Annex 1).
- 2.3 Examining both sides of the transaction means that a development effective loan is one that meets the “prudential debt” test of providing future flows of benefits that exceed future flows of debt service associated with the loan.
- 2.4 While this rule is easy to state in the abstract, it is difficult to apply in practice owing to substantial uncertainty regarding future benefit flows (and future debt service costs on loans financed at variable interest rates). For this reason, the founders of the Bank offered more concrete guidance by focusing the work of the Bank on financing investment. Investment is the act of deploying resources now

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<sup>2</sup> “Instruments and Development, an Evaluation of IDB lending and modalities, Comments by Region 3”

<sup>3</sup> RE-260 Development Effectiveness Report.

- to create assets, both physical and human, which will provide a future return. If properly assessed, this type of asset creation is the kind of country development need that is appropriately matched to the liability associated with taking on debt.
- 2.5 In addition to being appropriately financed with debt, investment is essential for meeting the region's most pressing developmental need—acceleration of the overall growth rate. From 1998 to 2003, the region as a whole grew at an annual rate of only 1.3% per year, in significant part because investment has stagnated. Gross capital formation in 2003 is 12.5% lower than the rate recorded five years ago, and the region as a whole has a lower savings and investment rate than other emerging economies<sup>4</sup>. If the region is to provide employment for its population and make sustainable progress on reducing poverty, faster growth supported by significantly higher levels of investment is essential.
- 2.6 This objective is fully consistent with the Bank's charter, the first several paragraphs of which establish its purpose as "...to contribute to the acceleration of the process of economic and social development of the regional developing member countries, individually and collectively." The Charter then goes on to state explicitly:
- To implement its purpose, the Bank shall have the following functions:*
- (i) to promote the investment of public and private capital for development purposes;*
  - (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;*
  - (iii) to encourage private investment in projects, enterprises and activities contributing to economic development and to supplement private investment when private capital is not available on reasonable terms and conditions;*
- 2.7 Discharging these functions required the Bank to have the analytical capacity to determine which investments would "contribute most effectively" to economic growth, and this in turn requires the capacity to evaluate all possible interventions along a common scale of effectiveness.
- 2.8 This primary focus on financing investment was reaffirmed in 1999 in the Bank's Institutional Strategy, which stated: the principal business of the Bank remains the financing of long-term investments that promote growth with equity in the region.

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<sup>4</sup> Economic Commission for Latin America and the Caribbean Preliminary overview of the economies of Latin America and the Caribbean, 2003.

- 2.9 This was combined in the Charter with an explicit directive to consider the borrower’s capacity to bear future debt service costs:

*...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<sup>5</sup>*

- 2.10 It is worth noting in passing that the World Bank’s Articles of Agreement contained similar language, although it also added what has become known as the “productive purposes” test, which further elaborates on this general theme. Article I section (i) of the Articles states that the purpose of the World Bank is: “(i) *To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes.*”

- 2.11 Both the IDB’s “investment” focus, and the World Bank’s “productive purposes” test convey the same message: developmentally effective interventions are those which yield returns by building productive assets, and the justification for lending must be found not in the outputs financed but the outcomes (flow of benefits) produced.

- 2.12 For the first 25 years of its existence, the Bank followed this guidance by lending almost exclusively for specific projects related to investments in infrastructure (function ii) and for the provision of investment funding to the private sector through multisector credit operations (function iii). The first group of projects were justified by explicit rate of return calculations, while the second relied on private financial intermediaries to make such prudential debt calculations in on-lending to individual borrowers. Both activities were seen as creating assets which were likely to generate future economic returns well in excess of their future debt service costs.

- 2.13 The statement of functions in the Charter did, however, establish a fourth function for the Bank, one that envisioned a role beyond the simple finance of individual projects. The fourth function was:

*(i) 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.*

- 2.14 The underlying rationale was identical to project investment, it simply envisioned the future return in the form of improved utilization of resources, rather than the creation of new physical assets. Bank sector lending operations, initiated under the seventh replenishment, were designed as explicit lending instruments to implement this function. The IDB-7 Agreement defined the instrument in these terms:

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<sup>5</sup> Agreement Establishing the Inter American Development Bank, Article III, Section 7(a)(iii).

*Sector lending would be a flexible modality of fast disbursing funds to support sector or subsector policy and/or institutional changes... The objectives of sector loans are to improve economic efficiency in the sector and to provide resource transfers to help make such improvements possible.<sup>6</sup>*

- 2.15 The Charter thus clearly establishes an evaluative framework for the assessment of the development effectiveness of Bank lending instruments. Bank loans should respond to those country development needs that can be met through asset creation or through the improvement of the efficiency of resource allocation within the borrowing member country. This is the basic evaluative standard to be used in the remainder of this evaluation.
- 2.16 To make this assessment of instruments in a systematic way, this evaluation examines three key questions with respect to each lending instrument:
1. Articulation of developmental intent. How clear a definition of results does the instrument demand, and are these results defined in economic terms related to the future flow of benefits associated with the intervention?
  2. Delivery of financial flows. How efficiently can a loan under a given instrument be developed and its resources deployed, taking into account transaction costs and the volatility, predictability and cyclicity of disbursement flows?
  3. Results achieved. What do the instruments demand in terms of monitoring and reporting on results? What has been the pattern of results demonstrated from past use of the instrument?
- 2.17 Finally, it is important to stress that the development effectiveness of instruments must be evaluated within the context of the Bank's programming process. Instruments are tools for solving development problems, not ends in themselves. The programming process is the mechanism by which the Bank assesses the nature of country development problems and develops the mix of instruments and interventions best capable of responding to those problems.
- 2.18 The IDB-8 Agreement recognized this essential relationship when it starts the discussion of "Bank Instruments" with a section on "Programming as an Instrument." It also established the core objective of strengthening the country focus of Bank operations, noting:

*Bank programs must be fashioned with the recognition that countries are at different stages of development and at different levels of social and political modernization.... Therefore, the Bank cannot have a single, uniform approach applicable to all countries in the region. The specifics of the Bank's role and lending emphasis will vary depending on the*

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<sup>6</sup> AB-1378, paragraph 3.12.

*conditions in each borrowing member country and its stage of development*<sup>7</sup>.

- 2.19 To achieve maximum developmental impact, therefore, Bank lending instruments should be deployed through a country-focused process that identifies those needs that are appropriately financed with debt. The instruments must enable a clear focus on meeting country needs, and must deliver resources to the countries in as efficient a manner as possible.

### **III. IDB INSTRUMENT OVERVIEW**

- 3.1 From the preceding discussion, it is clear that Bank lending instruments are not ends in themselves but rather means for creating both new assets and efficiency gains in borrowing member countries. Instruments are thus tools for solving country development problems in an economically efficient way.

- 3.2 The IDB's toolkit started out with a very limited range of instruments. At its inception, the Charter provided the following guidance on lending instruments:

*loans made or guaranteed by the Bank shall be principally for financing specific projects, including those forming part of a national or regional development program. However, the Bank may make or guarantee overall loans to development institutions or similar agencies of the members in order that the latter may facilitate the financing of specific development projects whose individual financing requirements are not, in the opinion of the Bank, large enough to warrant the direct supervision of the Bank.*

- 3.3 This directive was operationalized by developing three basic types of investment lending instruments: individual project loans, programs of government investment, and financial credits to other development finance institutions. These three instrument types have been tracked by the Bank as "loans for specific projects" (PESP), loans forming part of a governmental multiple works program (PGOM), and global credit operations (PGCR) for the lending of resources to intermediaries who would then on-lend them to finance investment activity.

- 3.4 Investment loans were all subject to a common set of rules, constraints and safeguards. All were limited in terms of what types of expenses were eligible for financing, all were subject to the Bank's rules and procedures regarding procurement, all required the mobilization of counterpart funds by the borrower, and all were subject to detailed supervision by the Bank. These constraints, combined with the characteristics of the activities they were financing (primarily infrastructure) meant that such loans disbursed relatively slowly and were subject to execution delays associated with the safeguards related to expenditure control.

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<sup>7</sup> AB-1704, Paragraph 2.4

- 3.5 The debt crisis of the 1980s created both huge economic losses in the region and a widespread perception that economic policies and institutions were holding back growth prospects for the region. If policies and institutions were not correctly designed, the argument ran, then individual projects would have their possibilities constrained. In such situations, development finance would obtain a bigger payoff from policy and institutional reform than from the simple multiplication of individual projects. This reasoning coincided with severe fiscal and balance-of-payments crises in the region that both increased country-financing needs and limited the fiscal capacity to support large public investment projects.
- 3.6 Responding to these changing needs, the World Bank in the 1980s began to make large loans to countries in support of what was then called “structural adjustment”. Adjustment loans provided large volumes of finance that disbursed very quickly in a few, large tranches, and contained “conditionalities” aimed at inducing profound and often painful changes in tax, tariff, financial, regulatory and labor market policies. Adjustment lending thus financed countries (through large tranches aimed at balance of payments gaps) in return for policy reform.
- 3.7 The IDB soon followed the World Bank, and in 1989, the IDB-7 agreement “sector lending” instruments (tracked in the Bank’s data as PSCT). Like adjustment loans at the World Bank, sector loans were designed to disburse quickly, generally in a few large tranches, and in response to proof of compliance with policy changes, not proof of actual expenditures incurred. In 1991, the Bank identified a Hybrid loan type (PHIB) to record loans having both policy reform and specific expenditure requirements.
- 3.8 Also like adjustment lending, they financed countries through the mechanism of policy conditionality. Unlike the World Bank, sector lending was limited initially to 25 percent of total lending volume, later reduced to 15 percent in the IDB-8 agreement.
- 3.9 With the conclusion of the IDB-7 agreement, the Bank had thus clearly established two basic “families” of lending instruments: those financing specific expenditures, and those financing the countries generally, without reference to specific expenditures. As the Bank’s work in the region evolved, new variations were created within each family in response to changing demands
- 3.10 Within the country finance family, a minor modification to the “sector lending” instrument was made in the IDB-8 agreement, when it was renamed “policy-based lending,” and the share of total lending permitted this instrument was cut from 25 percent to 15 percent. Despite the name change, the Bank’s data continue to track this instrument under the PSCT label, but for clarity of usage, the remainder of this report will refer to these loans as sector/PBL operations.
- 3.11 A much more significant change came in 1998 when the Governors created an “Emergency” variant of the basic sector/PBL lending instrument. These new loans (PEMG) resembled policy based lending operations in that they disbursed

quickly against evidence of policy change, but they carried both a shorter tenor (5 years) and higher interest rate (400 basis points over LIBOR) than other Bank lending instruments. Emergency loans were also subject to a separate quantitative limit of \$8.8 billion, but were not included in the 15% limitation set for sector/PBL operations.

- 3.12 The process of instrument innovation has been far more extensive within the family of loans aimed at financing specific expenditures, and the pace of innovation has been increasing rapidly in recent years. Project loans were designed to finance physical works, and provided only limited support for consulting services and other institutional support dimensions of the project. Funded initially with non-reimbursable resources, these activities were supported by the Bank through technical cooperation projects. As these funds became scarce, the Bank started providing such support through a reimbursable loan for technical cooperation (PCTR). Investment loans were also significantly constrained in their capacity to finance expenses already incurred (retroactive financing), yet many projects required substantial up-front costs from borrowers in the preparation stage. This led to the creation of the Global Pre-investment Loan (PGPR) in the mid 1960s to help prepare different types of groups and projects, and the Project Preparation Facility (PPPF) instrument in 1989 to help prepare individual investment projects.
- 3.13 In response to the wave of privatization of infrastructure providers, the Bank in 1994 created a new instrument enabling participation in loans made directly to private borrowers without government guarantee (PPRV). This was followed in 2000 by the creation of a Guarantee Disbursement Loan instrument (no tracking code: the instrument has never been used) designed to facilitate private financing of projects by transforming disbursements into guarantees. In response to the developmental consequences of natural and unexpected disasters, the Bank created an Emergency Reconstruction Facility instrument (PERF) in 1998.
- 3.14 In 2000, Management brought forward proposals for several new “flexible lending instruments.” These instruments all were designed to finance specific expenditures, but sought to eliminate some of the safeguards and procedural rules surrounding the other expenditure-financing instruments. In 2000, the Board of Executive Directors approved Management’s proposal to create four new instruments:
- Innovation Loans, (PINO) designed to pilot new ideas without significant ex-ante specification of project components
  - Multiphase Loans, (PPFM) designed to support a long-term program of sequenced activities in a specific sector or thematic area
  - Sector Facilities, (PSEF) allowing for the rapid finance of relatively small-scale actions that can respond to short term windows of opportunity for reform in sectors without the delays associated with normal project preparation

- Project Preparation and Execution Facility (PPEF) designed to increase the size of funding available under the existing Project Preparation Facility and make these resources available to support execution start-up as well as project design

3.15 In 2002, a further eight new lending instruments were put forward for discussion. The list included two instruments subsequently approved in 2003 (Performance Driven loans, designed to link disbursements to the actual achievement of development results and conditional credit line for investment projects, CCLIP), and seven instruments still under consideration<sup>8</sup>. The table below, taken from a 2004 Progress Report<sup>9</sup> sent to Governors, shows the instruments under consideration:

**Table 3.1: New Lending Instruments Under Study in 2004**

<i>Instrument</i>	<i>Lending Modality</i>
Sector Reform Investment Loan	Investment Lending
Loans to Subnational Entities w/o Sovereign Guarantees	Investment Lending
Time-Slice Loans	Investment Lending
Deferred Draw-down Option	Policy-Based Loan
Programmatic Adjustment Loan	Policy-Based Loan
Contingency Credit Facility	Crisis Prevention Lending
Currency Swaps	Financial Strengthening Service

Note: The “sector reform investment loan” shown in the table was actually approved in 2003 under the title: “Conditional Line of Credit for Investment Projects” CCLIP.

3.16 The table points to an issue with the process of devising new instruments. The “time slice” loan, shown as under consideration in 2004, has in fact been used by the Bank since 1990, but without a tracking code in the data base to distinguish it from the regular investment loan instrument. This points to some ambiguity in the Bank with respect to when a form of lending becomes a discrete “instrument” and when it is merely a variation on the standard theme.

3.17 Table 3.2 shows the 19 currently approved lending instruments, along with the volume of lending mobilized under each instrument during the IDB-8 period (1994-2004). Not all of the instruments have been used, and the first six lending instruments listed in the table account for 94 percent of total lending over the

<sup>8</sup> Two other instruments not included in the original list were approved: the International Trade Finance reactivation Program (GN-2239-1) and the Lending Program for Trade, Integration and Competitiveness (GN-2266-1); two sector facilities were also approved for Institutional Development (GN-2223) and Transnational Infrastructure (GN-2085-10).

<sup>9</sup> CA-455 Progress Report on the status of new lending Instruments and Operational Policies, 18 March, 2004. Note that the current approach and priorities are reflected in the document “An approach for further development of lending instruments and operational policies” (GN-2272-1) which emphasizes the development of sector wide approach and the review of cost eligibility policy.

period, and thus will be the principal focus of discussion in the remainder of the paper.

- 3.18 What distinguishes one lending instrument from another are the rules and procedures applied to the development, approval and execution of activities. These rules govern what conditions must be fulfilled prior to submission to the Board of Executive Directors for approval, the maximum size of the loan or the share of total lending available to the instrument, what types of activities are to be financed, how disbursements are to be monitored and what types of supervision and reporting are required. These rules and procedures are purposeful: they were built into the instruments in order to provide safeguards for the Bank and borrower to ensure that funds are applied as intended at time of approval.

**Table 3.2: Bank Lending Instruments**

Code	Name	Approved 1994-2004
PESP	Loans for Specific Projects	28,659,796,300
PSCT	Sector lending (PBL)	12,818,674,500
PEMG	Emergency	11,300,908,000
PGCR	Global Credit Operations	5,544,400,000
PPRV	Private Sector Lending	3,328,485,644
PGOM	Global Multi Works	3,276,610,000
PPFM	Multiphase loans	2,872,500,000
PHIB	Hybrid loans	979,450,000
PCTR	Reimbursable Technical Cooperation	558,786,750
PINO	Innovation loans	169,695,000
PERF	Emergency Reconstruction Facility	118,500,000
PGPR	Global Pre-Investment	103,650,000
PSEF	Sector Facility	62,890,000
PPPF	Project Preparation Facility	51,922,500
PPEF	Project Preparation and Execution	29,009,072
PEXP	Export Financing	Used until 1982
PMIX	Mixed Loan Type	Used prior to 1989
(NA)	Performance Driven Loan	Not yet used
(NA)	Time Slice Loan	Used but not tracked
(NA)	Guarantee Disbursement Loan	Not yet used
(NA)	Trade and Competitiveness Programs	Not yet used

- 3.19 Safeguards can be applied to any aspect of a loan, but for the Bank's instruments, they have tended to fall into four categories:

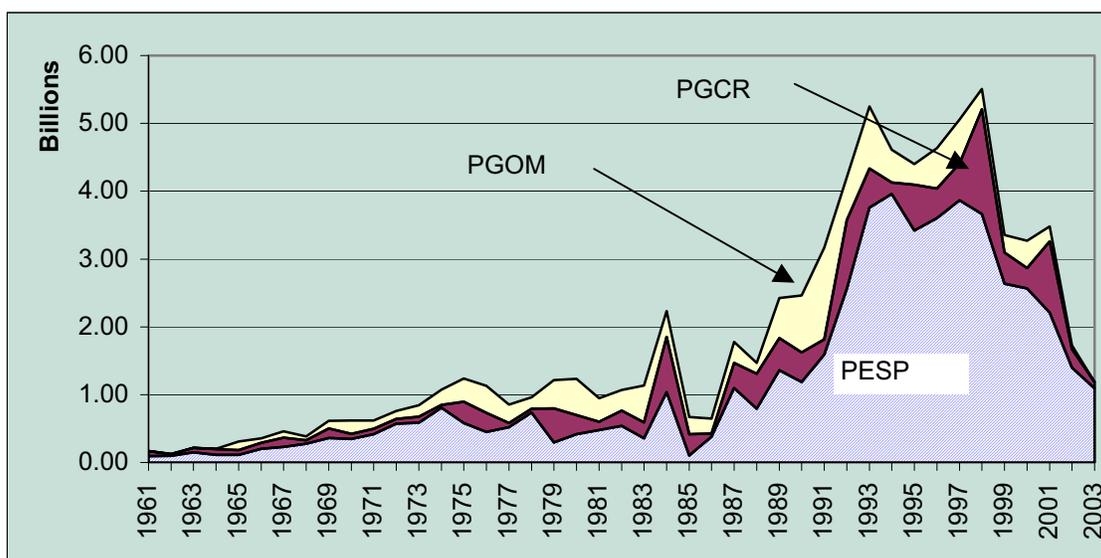
- Safeguards related to the purpose of the loan
- Safeguards related to the procedures that must be followed to assess impact of the proposed activity
- Fiduciary safeguards aimed at ensuring the funds are spent properly
- Safeguards related to the overall use of the instrument by the Bank, and the terms and conditions on which the funds are lent

- 3.20 Although safeguards were purposeful, they also constrain and limit how instruments can be used. To be effective in promoting development, safeguards must be clear and transparent so that Bank staff and country authorities have the same information about the parameters established for each instrument, and for the collective portfolio of instruments.
- 3.21 The safeguard framework also has to be subject to periodic re-examination. As the problems facing the Bank and the region change, the continued relevance of these constraints is called into question, leading to periodic efforts to modify the safeguards associated with each instrument. These efforts are properly seen as a kind of self-evaluation exercise, intended to review experience with the instruments and suggest opportunities for improvement. (See Chapter VI)

#### IV. INVESTMENT LENDING INSTRUMENTS

- 4.1 The oldest and most extensively used instruments are the three that focus on financing investment: loans for specific projects (PESP); loans for global public investments (PGOM), and global credit operations (PGCR).
- 4.2 Figure 4.1 shows the annual approval pattern for these instruments. Two phenomena are immediately apparent from the chart: a very rapid growth in the use of the instruments during the 1990s; and an equally dramatic collapse in use after 1998. Overall, demand for these instruments has dropped by 70 percent from the 1997-98 period to the 2002-03 period. A decomposition of this decline (See Annex 2) shows that while the large declines are concentrated in a few large countries, only 5 countries have actually increased their demand for such loans over the period.

Figure 4.1: Annual Approvals in US\$



## 1. Articulation of Developmental Intent

- 4.3 The PESP instrument traditionally contained one key procedural safeguard designed to ensure a clear and quantitative articulation of development intent. All such loans were required to contain formal cost-benefit calculations, and were generally not sent to the Board of Executive Directors for approval unless they provided at least a 12% return. This ensured that the proposed activity yielded benefits to the country that met or exceeded the returns available from other possible uses of funds. The other original instruments had versions of the same safeguard: Global multiple works projects had to have mechanisms for assessing rates of return in the individual sub-projects, and global credit operations mandated the establishment of positive real interest rates as a device for ensuring that activities with high rates of return were financed with the proceeds of Bank lending.<sup>10</sup>
- 4.4 Cost-benefit analysis as a safeguard was no panacea: the calculations were complex, subject to differences of opinion, and highly sensitive to assumptions, but the logic of the exercise did focus attention on likely future results. It was also a technique particularly suited to the assessment of value in large infrastructure projects. During the 1970s' however, the Bank began to develop operations in other fields, which were less suited to formal cost benefit analysis. For these, the Bank adopted a variety of other ways of specifying intent, including "cost-effectiveness" and "least cost" methods, which moved away from the specification of actual future benefit flows<sup>11</sup>. Cost-benefit and rate of return calculations were still required for infrastructure projects, but these were a shrinking portion of the Bank's portfolio during the 1990s, and the focus on this type of analysis was diluted further after 1994 when the specialized unit concerned with developing methods for assessing and verifying these calculations was disbanded.
- 4.5 In 1998, the Bank's Controller carried out a study on the economic analysis contained in 46 investment loans approved in that year. It found that 57% of such projects contained some form of cost benefit analysis, but that less than half (25% of total investment projects) "presented a good or acceptable analysis of the expected project impact," and concluded that "no systematic efforts exist to promote a more consistent use of economic analysis in support of project design, appraisal and evaluation throughout the Bank."<sup>12</sup>

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<sup>10</sup> "Higher rates of interest on subloans, particularly within the positive range, are more likely to be conducive to the financing of projects with higher financial rates of return. Conversely, excessively low rates of interest, particularly within the negative range, may result in the inefficient allocation of resources through the financing of projects with relatively low financial rates of return." OP-709

<sup>11</sup> "In certain fields such as health, education, electricity, and rural potable water, it is not always feasible to estimate the value of economic benefits. As a consequence, the economic efficiency analysis may be limited to a "least cost" or "cost-effectiveness" approach. This methodology compares the present value of the economic efficiency cost of alternative projects to attain **given objectives**, so as to select the alternatives with the lowest cost." (OP-302-3, March 10, 1981, emphasis added)

<sup>12</sup> The Economic Analysis of IDB Financed Projects, Office of the Controller, March, 1998.p. iii.

- 4.6 For this evaluation, OVE examined a sample of 190 investment loans approved since 1997 for the presence of formal cost-benefit calculations. We found that roughly 39% of the loans (74 out of 190) made some mention of rate of return or cost-benefit calculation. Since the Bank does not have a central repository for this information, OVE requested documentation directly from staff at the originating departments to establish the depth of the analysis upon which these figures were based, for every loan that mentioned rate of return or cost-benefit analysis. At the end of two months, technical background documents were provided on only very few of the 74 projects, making it impossible to determine whether the problems of low technical quality noted in the 1998 Controller's report continued to be an issue.
- 4.7 With only a minority of investment projects containing economic rate of return (and those of uncertain quality), OVE has sought other ways to measure the nature of developmental intent in projects. In 2001, OVE developed and applied a method for determining the "evaluability", of Bank projects. Evaluable projects are defined as those that clearly identified a problem, proposed a logical intervention to address the problem, had adequate indicators to determine progress, and monitored those indicators during project execution to determine whether the anticipated degree of progress was being achieved. The evaluability construct thus allows the tracking of any sort of desired outcome, not merely those outcomes that can be measured in terms of economic rate of return. The results of the 2001 exercise found that evaluability scores for projects were generally low, with the weakest areas generally being the specification of intended outcomes<sup>13</sup>.
- 4.8 For the purposes of evaluating instruments, OVE developed a simplified evaluability assessment tool that measured three concepts: the "ex-ante" evaluability index which looks at outcome indicators in project design; the "ex-post," or "progress," index, which looks at reporting on results as the project executes, and a composite "minimal evaluability" index which measures project outcomes that are both specified in measurable terms at approval and have at least one observation regarding progress toward objectives as the loan executes.
- 4.9 This latter construct was applied to 110 investment projects approved between 1990 and 2003. The results show a slow improvement in the ex-ante index, but a steady and significant decline in the progress index<sup>14</sup>. Objectives that were both defined at the outset and monitored during execution (the minimal evaluability index), approximated zero throughout the period. (See Annex 3). Thus, the Bank provides no information on the achievement of development objectives. Thus, the success or failure of a project regarding development effectiveness cannot be judged.

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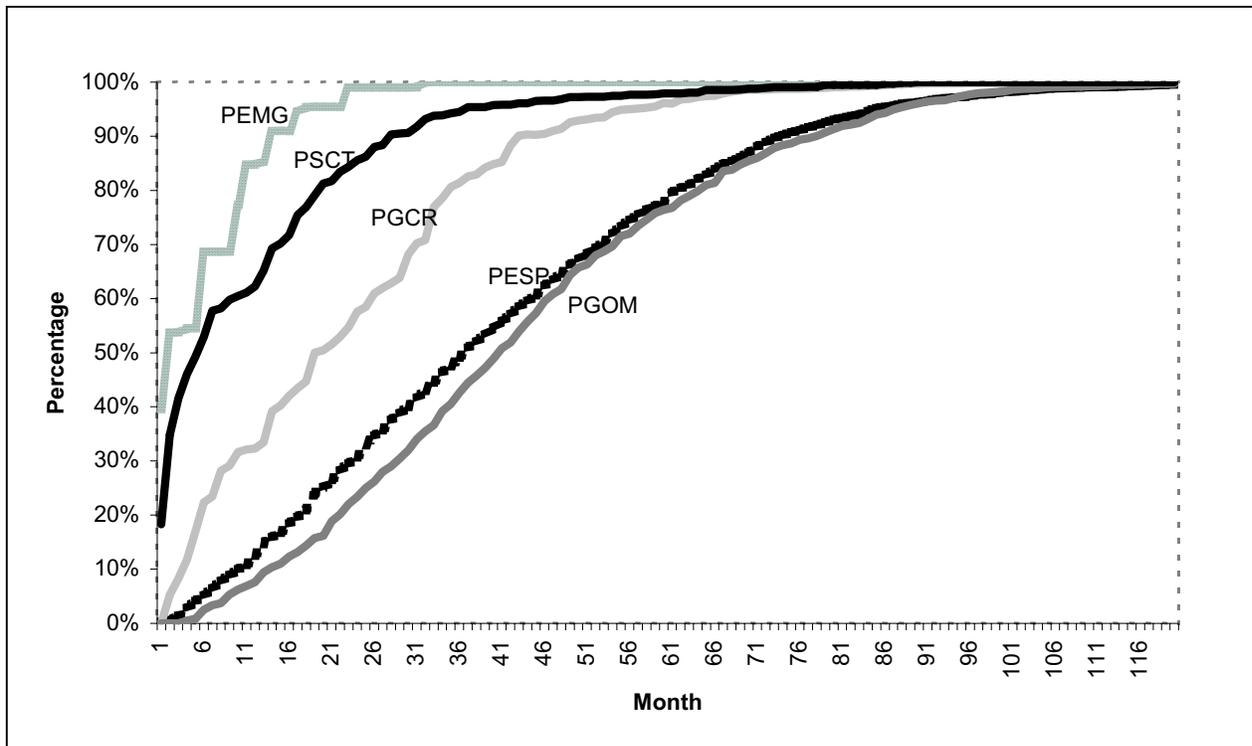
<sup>13</sup> For more information on the results from the evaluability exercise see RE-275.

<sup>14</sup> By definition, this index would be low as it takes time for outcomes to be realized and data collected on them.

## 2. Financial Efficiency

- 4.10 Loans made using the investment lending instrument take the longest time of any to prepare, an average of 39 months from Profile 1 to first disbursement. (See annex 4). This is largely a reflection of the work required to prepare a “complete,” fully specified project and pass it through the review and approval process at the Bank.
- 4.11 Once approved, investment loans also disburse relatively slowly. Figure 4.2 shows the average disbursement performance for the different instrument types. Starting from the approval date, PESP projects require an average of 36 months before they disburse 50% of the originally approved amount, and require an average of six years to reach 90% disbursed.

Figure 4.2: Disbursement By Instrument (1990-2003)

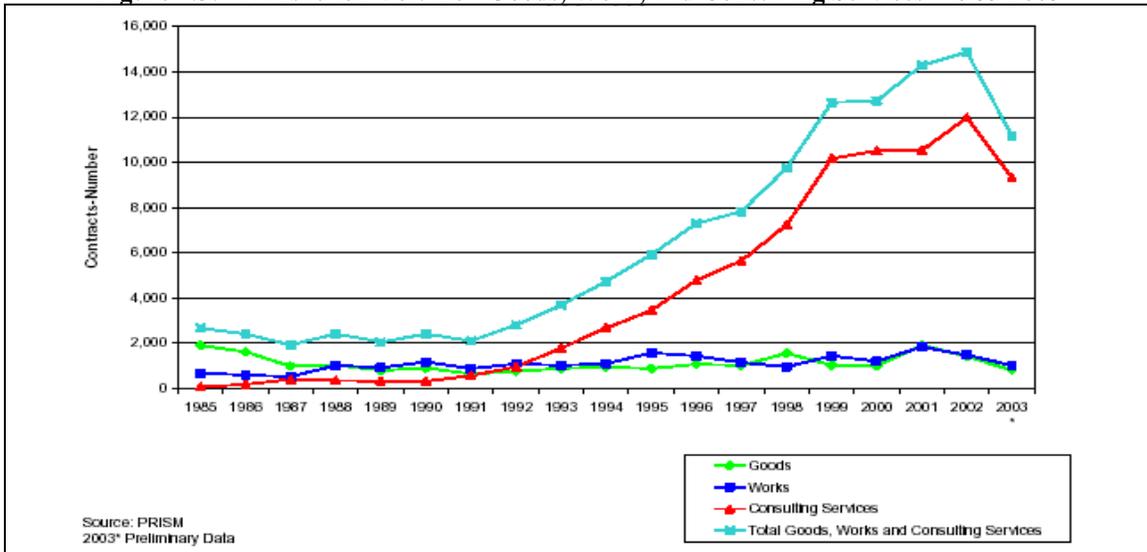


Source: OVE using Data Warehouse

- 4.12 Of potentially greater significance than the slow average pace of disbursement on investment loans is the wide dispersion of possible paths disbursements can take. Annex 5 provides two perspectives on the low predictability of disbursements. The top Figure, shows the disbursement paths on 6 sample loans, compared with the PESP average, while the bottom figure shows the range of possible disbursement percentages observed on the universe of PESP operations 36 months after approval. It is apparent from these data that a country cannot predict with any certainty how soon or how much it will receive from the Bank as the result of an approval of a project financed with the PESP instrument.

- 4.13 Another important financial characteristic of loans is the relative volatility and cyclical nature of their disbursements. Disbursements that exhibit high variability from one period to the next contribute to the already serious problems of volatility and instability in public revenue streams, and this is a particular concern if the variability has a pro-cyclical bias (rising when government revenues rise, falling when they fall). Annex 6 examines the data on volatility and cyclical nature, and finds that disbursements on investment loans are generally more volatile than tax revenue and have a pro-cyclical bias.
- 4.14 There are a number of factors that help explain this disbursement pattern. First is the fact that investment loans demand the provision of local counterpart resources. This was designed as a safeguard to ensure country “ownership” of the project, but it puts Bank-financed investment projects at risk when financial conditions in the country worsen. The literature on public finance in the region generally confirms that fiscal austerity tends to fall disproportionately on public investment, precisely the category of expenditure being financed with Bank loans. Given the frequency of occurrence of events demanding fiscal austerity, it is hardly surprising that Bank loans frequently cite lack of available counterpart resources as an explanation for disbursement problems.
- 4.15 Counterpart requirements are not the only source of disbursement problems. The Bank’s other procedural safeguards associated with investment lending also play a part. Disbursements on investment loans are processed through a detailed process of expenditure control. All such loans are subject to Bank procurement rules that require, among other things, international competitive bidding for contracts above a certain value, and a formal “non objection” by the Bank’s country office to contracts and expenditures involving lower amounts.
- 4.16 These rules and processes were designed when the Bank financed primarily infrastructure projects that generally involved a small number of large and complex construction contracts. As the Bank has moved away from infrastructure, the nature of investment project procurement has changed radically. Figure 4.3, taken from a recent consultant’s report on the Bank’s procurement system, documents the huge rise in the number of transactions currently being supervised by the Bank. It is likely that the sheer volume of transactions implied by the current safeguards is part of the explanation for perceived delays and procedural rigidities.

**Figure 4.3: Transaction Volume - Goods, Work, and Consulting Services - 1985-2003**



- 4.17 Another potential problem area lies in the extensive use of specialized executing agencies to manage the projects and deal with the Bank. Most investment projects, and particularly the relatively large ones, are administered through specialized executing units. Such specialized entities help manage the interface with the Bank and thus are rational from the perspective of the individual project, but they impose important costs of their own. Executing agencies constitute parallel systems of public administration and impede the improvement of the country's own management capacity. They weaken incentives for country oversight of projects, and limit opportunities for learning and improvement in systems of public administration.
- 4.18 For this evaluation, OVE conducted a survey of executing agencies. Survey results indicate that for every dollar disbursed by the Bank, executing agencies consume 7 cents in the performance of administrative and compliance activities required specifically by the Bank, activities that otherwise would not have been performed. In addition, executing agencies spend another 9 cents in activities not directly attributable to Bank requirements. Total costs for executing agencies are thus 16 cents for each dollar disbursed.
- 4.19 The extensive use of executing agencies weakens public administration. Employees of such agencies tend to have career paths that move from one specialized agency to another, rather than move from agency to regular government institutions. Over 50% of coordinators come from the public sector, but 80% of those continue their careers going from one executing unit to another, not returning to public administration posts, possibly because of the earnings deterioration that this would entail as they would be giving up compensations that are 3 to 5 times higher than those of the public sector.

4.20 Finally, the Bank imposes significant transaction costs in the area of fiduciary risk management. A recent OVE study of the Bank's supervision system found a large number of required supervisory events that were not well integrated into a risk-focused supervision system. The result is considerable compliance costs for countries, but with little evidence of improved outcomes as a result (See Annex 7).

4.21 Taken together, the procedures associated with investment lending instruments likely impose significant transaction costs on the borrower. The Bank has not calculated the magnitude of these costs or the returns they are generating in terms of improved project quality and development outcomes, yet. A recent effort at the World Bank has looked at the internal transaction costs imposed on Bank staff and finds them both large (over 100 staff years) and very likely unproductive. (See Box 4.1).

**Box 4.1: Internal Transaction Costs at the World Bank**

For the Bank, the direct fiduciary administrative cost of complying with these policies, and related disbursement procedures, may exceed 100 staff years annually, with further time inputs from task team leaders and other operational staff. The focus on eligibility diverts Management attention and staff resources from the appropriateness of borrower expenditure and more substantive fiduciary concerns. It detracts from attention to results, and limits the Bank's ability to harmonize its procedures with those of other donors.

World Bank Annual Report on Development Effectiveness, 2003

**3. Results Achieved**

4.22 As noted in annex 3, the specification of development results in investment loans is generally not well tracked by the Bank's information system. While project design appears to be improving, tracking of progress on results is low and declining, and virtually no development objectives both have a clear specification in the loan document and are monitored for results achievement during execution.

4.23 In most recent evaluations, both of country programs and individual sectors, OVE has found investment projects that are widely seen by sponsors and beneficiaries as having produced useful results, and some projects have had external evaluations that provide empirical confirmation of success. Such findings, however, do not provide sufficient data to answer the fundamental economic question of whether the returns of the investment were significantly greater than the costs to the country of borrowing the money to finance it.

4.24 Bank projects are required by policy to re-estimate rates of return upon project completion if such calculations were part of the original justification of the loan. In the sample of 190 investment projects examined for this evaluation, none of the few that were completed contained such a recalculated rate of return upon completion.

4.25 Given the information deficit related to project-specific rates of return, some perspective on Bank investment financing can be found in aggregate data. Given

the presumption contained in their title, “Investment Loans”, it is reasonable to ask: “do Bank investment loans contribute to increased public investment?” There is a large and compelling economic literature showing that low public investment, particularly in infrastructure, is a major cause of the relatively poor growth performance of the region.<sup>15</sup> Contributing to asset creation in the public sector should be a major contribution of Bank investment lending.

4.26 OVE has approached this issue from two perspectives. First, macroeconomic data have been examined to look at the impact of disbursements of investment loans on public sector capital formation. At the macro level, if IDB investment lending was, in fact, financing new investment, one dollar of disbursement on such loans should lead to somewhat more than a dollar of increase in public capital formation (the difference being accounted for by country counterpart resources applied to the investment activity). In fact, the data show an average ratio of considerably less than one, with substantial variation among countries. Two different analytical techniques yield the following results:

I) **Panel data Approach:** Controlling by country-specific effects, we find that a dollar increase in total IDB disbursement leads an increase of 35 cents in public capital expenditure. A dollar increase in IDB-investment disbursement leads an increase of 50 cents in public capital expenditure. A dollar increase in IDB sector/PBL disbursement has no statistically significant effect on public capital expenditure.

II) **Country-equations:** When looking at country-by country detail, a more complex pattern emerges. Between 1987 and 2003 there is no statistically significant effect of the disbursement of IDB “investment” loans on public capital expenditure in 10 countries (Argentina, Colombia, Costa Rica, Dominican Republic, Guatemala, Haiti, Nicaragua, Peru, Uruguay, and Venezuela). OVE finds a positive coefficient (less than one) in Belize, Guyana, Honduras, El Salvador, and Trinidad and Tobago. OVE finds a positive coefficient (more than one) in Jamaica and Panama. Finally, OVE finds a negative coefficient in Chile, Ecuador, and Mexico.

4.27 Thus on average, one dollar of investment loan disbursement increases country public capital formation by about 50 cents. Much of this average is due, however, to strong investment responses in a minority of countries. Most of the Bank’s major borrowers exhibit either no correlation between disbursements on “investment” loans and public capital investment (Argentina, Colombia) or a

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<sup>15</sup> Some recent papers that find evidence on this regard include Canning, David and Esra Bennathan (2000), “The Social Rate of Return on Infrastructure Investments,” World Bank Policy Research Working Paper No. 2390; Calderón, César and Luis Servén (2003), “The Output Cost of Latin America’s Infrastructure Gap,” in William Easterly and Luis Servén, *The Limits of Stabilization—Infrastructure, Public Deficits, and Growth in Latin America*, forthcoming; Clements, Benedict, Rina Bhattacharya, and Toan Quoc Nguyen, “External Debt, Public Investment, and Growth in Low-Income Countries,” IMF Working Paper (forthcoming); and, Gupta, Sanjeev, Benedict Clements, Emanuele Baldacci, and Carlos Mulas-Granados, “Fiscal Policy, Expenditure Composition, and Growth in Low-Income Countries,” IMF Working Paper (forthcoming). See International Monetary Fund, *Public Investment and Fiscal Policy* (prepared by the Fiscal Affairs Department), January 2004.

- negative correlation (Mexico). Brazil is a complex case, showing a positive response in some periods and a negative one in others.
- 4.28 The macro data thus do not provide strong evidence that Bank “investment” loans are financing increased public investment, or at least not the kinds of investment that are captured in national income and product account definitions of public sector capital formation.
- 4.29 Alternative data sources paint a similar picture. Data on what is being financed in Bank investment projects can be found in two internal sources: the Cost Table data presented in each loan document, which lists the categories of expenditure to be financed; and the Bank’s procurement data base that contains information on goods and services procured through the Bank’s system.
- 4.30 Bank policies require loans to provide detailed breakdowns of the costs being financed in individual projects, and while loan documents continue to present this information, there has been little supervision or oversight of the system. The result is that there are now over 800 distinct categories of expenditure in this data base, and no consistency in application of categories across projects. While these problems make the data unreliable, OVE has attempted to re-group cost table expenditures into “goods and works” (a proxy for fixed asset creation); “services”, and “uncategorized”. This data show a sharp decline in the “goods and works” expenditure categories, from 66% of total expenditures in 1990-1992 period, to 40% in the 1999-2001 period, while services rose from 26% to 41%, and the “unknown” percentage rose from 1% to 12%.
- 4.31 Procurement data show a similar pattern. While the overall share of Bank disbursements captured by the procurement system has fallen from 59% of the total in 1997 to 37% in 2003, the proportion of procurement contracts in investment loans going to “goods and works” has dropped from 96% of the total in 1990-1992 to 69% in 1999-2001.
- 4.32 Both procurement and cost table data thus confirm a significant shift away from goods and works and toward services in what the Bank is financing with its “investment” loans. Since many of these services are unlikely to be reflected in the NIPA data on public sector capital formation, the shifting composition of expenditures in Bank investment projects may help account for the relatively weak effect observed in the macro data on public investment.

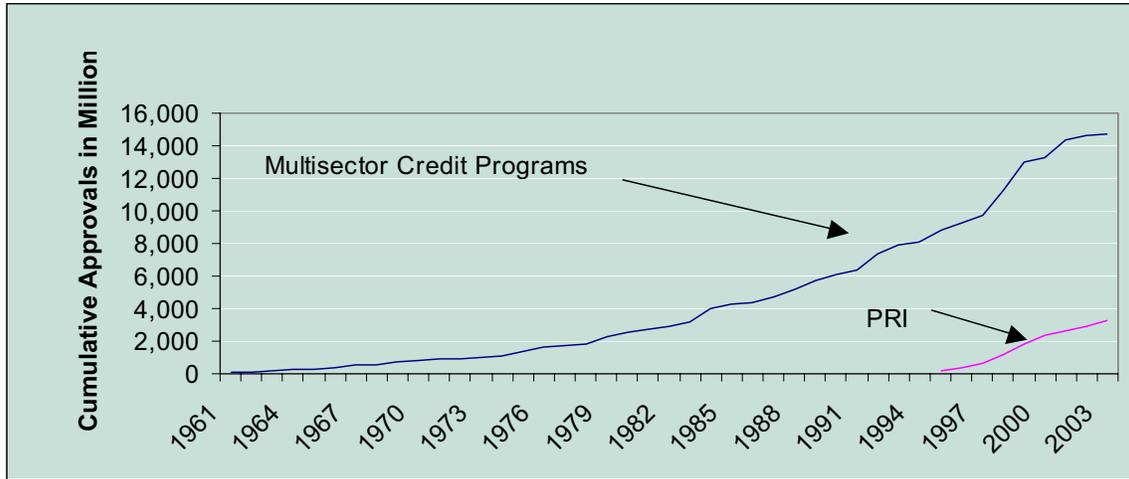
## **V. LENDING TO THE PRIVATE SECTOR**

- 5.1 Lending to finance investment in the private sector is not a new activity for the Bank. While the Bank’s first loan was a \$4 million investment project for water supply in Peru, its second loan was a \$10 million global credit operation designed to support the provision of finance to private borrowers in the agricultural sector

in Bolivia. Since its inception, the Bank has approved over \$12 billion in global credit operations designed to benefit the private sector.

- 5.2 The Bank also experimented early on with directly financing private sector firms. The results of this experiment were disappointing, and the Bank discontinued direct private sector lending operations until the IDB-8 agreement authorized a new such lending instrument in 1994.

**Figure 5.1: Lending to the Private Sector**



- 5.3 Although all borrowing member countries have received at least one global credit operation, both the number of loans and the volume of lending has been concentrated in a few borrowers. Over the entire life of the Bank, two thirds of all national approvals of global credit operations went to five countries: Brazil, Mexico, Peru, Chile and Argentina. During the IDB-8 period, 60% of the total volume of lending under this modality went to Brazil alone, while Mexico and Peru accounted for an additional nine percent each<sup>16</sup>.
- 5.4 After 1994, the Bank had a new vehicle for supporting the private sector, direct lending for infrastructure without government guarantee. Unlike global credits, which do require the guarantee of the government and count in the country's fiscal calculations, the direct lending instrument has no direct impact on the fiscal position of the public sector. The use of the Private Sector lending vehicle has also been concentrated in a relatively small number of borrowing member countries. Since the creation of the instrument, 16 countries have received loans using this instrument, but the majority of lending has gone to four countries. (See Annex 8 for details on the usage of this instrument by country.)

<sup>16</sup> This total includes a US\$1.2 billion global credit to BNDS for on lending to SMEs that was approved under the Bank's Emergency Lending Program.

- 5.5 While they share the common objective of financing private investment in the borrowing member countries, global sector credits and private sector projects are quite different instruments with quite different constraints and possibilities.

### **1. Articulation of Development Intent**

- 5.6 Global Credit Loans are defined by the Bank's operations manual as loans "granted to intermediary financial institutions (IFIs) or similar agencies in the borrowing countries to enable them to onlend to end-borrowers (sub-borrowers) for the financing of multisector projects"<sup>17</sup>. Such operations have two types of objectives: the financing of investment by the ultimate borrowers, and the improvement of the overall performance of a country's financial system. For purposes of comparison with the other lending instruments, this evaluation will focus largely on the first of the two objectives.
- 5.7 The rules governing the instrument prescribe that the proceeds of such loans be used for: "...new investments in the subproject submitted to the intermediary institution for financing. Contributions by subborrowers to finance the recurrent costs of labor, working capital, amounts attributed to investments already made, or contributions in kind will not be recognized"<sup>18</sup> OP 709 directs that funds be used: "...to encourage intermediary financial institutions to become effective vehicles for the mobilization and channeling of domestic and external savings towards investment and other productive uses."<sup>19</sup>
- 5.8 Despite the articulated intent to support new investment, the global credit instrument contains only relatively weak safeguards to ensure that Bank funds flow to these objectives. Rules relating to financial intermediaries eligibility criteria and credit regulations regarding eligibility of users and uses, are written into loan contracts for this instrument, but there is limited evidence of appropriate monitoring and evaluation on their actual implementation of these provisions.
- 5.9 The Bank lends funds to a prime intermediary who then on-lends the funds to other intermediaries or to final borrowers. The global credit instrument requires only that intermediaries report to the Bank the identity of the final borrowers, the sector of activity and limited information on how the loan proceeds were applied, without any information on the results obtained from their application. As would be expected from such an instrument, global credit operations do not offer any formal rate of return justification.

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<sup>17</sup> OP-306 FORMS OF BANK FINANCING AND ASSISTANCE FOR THE MOBILIZATION OF FINANCIAL RESOURCES (MARCH, 1999) – LENDING OPERATIONS. Originally global credit loans were directed through first tier development banks. Today they are through second tier development banks and were originally limited to specific sectors. Today, recognizing market segmentation, they are of a global nature.

<sup>18</sup> OP-309 GLOBAL LOANS TO INTERMEDIARY FINANCIAL INSTITUTIONS - CONTRIBUTIONS BY SUBBORROWERS

<sup>19</sup> OP-709 SUBLOAN INTEREST RATES.

- 5.10 Private Sector operations have a very different specification of developmental intent. They are loans for the financing of specific projects, and much detail is known both about the activity being financed and the private sector participants who are also participating in the project. Private Sector projects have the safeguard that the Bank will finance only 25% of total project cost, most of the detailed specification is done in line with the expectations of the private financial partners, who demand a rate of return calculation as a condition for proceeding with the loan. Private Sector projects thus clearly specify the anticipated future returns of the lending, and score higher than all other instruments on this measure of instrument effectiveness.
- 5.11 While Private Sector projects specify rates of return far more clearly than global credit operations, the key issue with respect to the developmental effectiveness of both instruments is not their rates of return but their capacity to identify and remedy market failures. Commercially viable projects with positive rates of return can be financed by the Bank or by the private sector itself. Simply substituting Bank finance for private finance does not provide a developmental benefit. The developmental justification for the intervention of public institutions such as the IDB in the financing of such projects is when “*market failures arise that require government interventions to improve their functioning and social outcomes*”.<sup>20</sup> It is thus the specification of market failure that defines the developmental contribution of private sector lending, and it is the remedy of such a failure that constitutes the economic “additionality” of Bank lending.
- 5.12 At inception, the direct lending instrument was based explicitly on a market failure argument: specifically, the failure of markets to generate sufficient information to correctly price the risks associated with infrastructure projects carried out by newly-privatized entities. A background paper for the IDB-8 negotiations argued:
- For infrastructure projects of recently privatized agencies which cannot be financed on appropriate terms, either because these agencies lack a track record of successful commercial operations or because the country's own markets are not sufficiently developed to provide longer term finance, the Board of Executive Directors of the Bank could be asked to consider, on a case-by-case basis and with due regard to the country's macroeconomic situation, approval of a limited number of direct loans without government financial guarantees, provided that the Bank's participation in each case is critical to mobilize substantial additional private financing*<sup>21</sup>.
- 5.13 It is on the basis of this reasoning that the IDB-8 agreement directed that the new instrument would channel resources “...*primarily to finance activities traditionally undertaken by the public sector, such as infrastructure projects.*”

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<sup>20</sup> Private Sector Development Strategy. New revised version GN-2270-4, paragraph 4.1

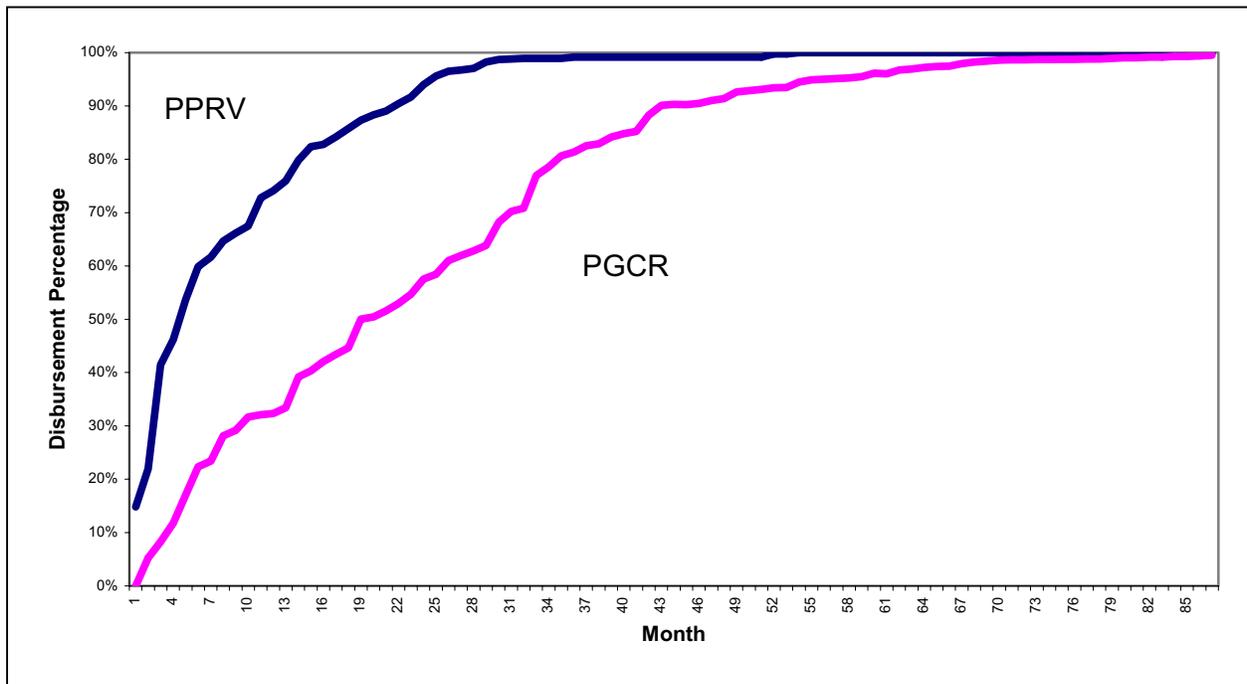
<sup>21</sup> Background papers in connection with the Bank's Eighth General Increase in Resources CS, CS-2620-9, June 18, 1993.

- 5.14 Despite its original grounding in a market failure assessment, actual use of this instrument has generally not included specific assessments of market failure in establishing the developmental intent of individual projects. OVE is currently conducting a review of all direct lending projects undertaken since 1994. A preliminary conclusion of this work is that not sufficient evidence of market failure is provided in the individual project justification of most interventions financed by Private Sector. Usually projects are justified in terms of additionality, containing only a brief assessment on the matter with very limited back-up of data analysis.
- 5.15 The market failure argument is also not made explicitly in each global credit operation but based on a general assumption of non-served or under-served long-term financing. In the early years, global credits went primarily to public development banks, whose very existence was predicated upon a belief in the existence of market failure, but no independent effort was made by the Bank to evaluate such claims. Subsequent operations justify the provision of global credit lines by reference to the term structure and borrower preferences of existing financial intermediaries, but do not attempt to assess these patterns in light of a market failure argument.

## **2. Financial Efficiency**

- 5.16 Both global credit and direct lending operations require preparation times that are significantly faster than traditional Bank investment loans. On average, Private Sector and PGCR projects require 15 months of effort from eligibility to approval. After approval, however, the timing of execution of the two instruments shows a markedly different pattern. Direct lending operations disburse significantly more quickly than global credits, (See Figure 5.2). This is largely due to the fact that Private Sector projects have necessarily a sponsor and a well defined project at time of approval, while global credit operations must move funds through several intermediaries to reach numerous final borrowers. As with investment projects, however, the variance in disbursement speed among global credit operations is substantial. In the universe of project approved since 1990, the fastest global credit operation was almost fully disbursed within 24 months (BR-310), while the slowest required 103 months (BO-088).

Figure 5.2: Disbursement PPRV and PGCR



Source: IDB Data Warehouse

- 5.17 Volatility, predictability and cyclicity are less relevant in analyzing loans to the private sector, since disbursements on such loans go directly to private borrowers and do not figure in public expenditure planning.
- 5.18 Transaction costs are a significant issue in the Bank’s private sector lending instruments. In the case of Private Sector projects, they related to the costs associated with “due diligence” reviews, and the costs associated with complying with Bank policy safeguards (particularly related to environmental and social concerns). For global credit operations, the transaction costs associated with the initial transfer of resources are quite modest, but the rules governing the use of funds by sub-borrowers have been a more serious concern.
- 5.19 Costs associated with Private Sector due diligence reviews have the advantage of being quantified (since the sponsors pay for the assessment), and a standard industry practice. There is no central Bank registry for such costs, however, making it difficult to pin down the exact burden of these costs on the borrower. In the Private Sector loans examined thus far, however, OVE has found that costs average US\$1.1 million per loan, or roughly 2-4% of the total funding supplied, compared with industry ratios of a less than half of that amount. On the basis of this assessment, transaction costs appear to be significant issue, particularly in the area of legal costs, and could prove to be an important factor for smaller operations, particularly in smaller countries. (See Annex 9)
- 5.20 There are two types of transaction cost relevant to global credit operations: the transaction costs borne by the final borrower in trying to access credit, and the

transaction costs borne by the intermediary in its dealings with the Bank. Lowering the first kind of transaction cost is part of the substantive justification for creating global credit operations; yet in reviewing Bank documentation on these operations OVE could find virtually no discussion of the transaction costs facing borrowers before creation of the program, nor any comment on changes in transaction costs resulting from the operation itself. Overwhelmingly, Bank documentation on global credit operations contents itself with a description of loans granted and does not look into transaction cost issues.

- 5.21 The second set of transaction costs have been the subject of considerable discussion and modification over the years. The 1993 High Level Advisory group noted that:

*The imposition of extensive reporting and counterpart requirements on financial intermediaries acts as a disincentive to participate in the program, and discourages lending to small and medium-sized enterprises. We question the utility of imposing formal counterpart requirements in global credit operations, which are not imposed by the World Bank or other international financial institutions. In addition, we recommend that burdensome reporting requirements be streamlined, and that the Bank establish a "dollar window" to enable sub-borrowers to effectively price and hedge the currency risks of on-lent credits.*

- 5.22 These recommendations have been incorporated into recent Bank practice relating to the instrument, including the creation of the dollar window. The result has been that transaction costs imposed on first-tier intermediaries are very low. The Bank generally accepts the credit policies of the first-tier intermediary, transforming Bank global loans into a funding source with extremely low transaction costs.

### **3. Results Achieved**

- 5.23 Direct loans to the private sector can demonstrate the economic returns of the projects they finance, and generally do so. Global credit operations, on the other hand, virtually never demonstrate the actual economic returns to final borrowers. This is because, as a 1999 evaluation report noted, the Bank's monitoring system considers that "merely complying with the disbursement schedule is considered fulfillment of the targets<sup>22</sup>."
- 5.24 Private Sector projects generally show a positive ex-post rate of return at loan completion, albeit at levels significantly lower than estimated in the original project documents. Subsequent events, however, have substantially reduced the returns of a number of operations, leading to one outright write-off (Argentina) and a total of over 30% of the existing portfolio categorized as either on the "watch list" or substantially impaired.

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<sup>22</sup> RE-233 Review of project completion reports received between July 1, 1994, and August 31, 1997: a study of content and quality

- 5.25 But the key result to examine with respect to Private Sector lending is not commercial return but the remedy of market failure, specifically the market failure associated with private sector unwillingness to finance commercially viable but newly-privatized infrastructure concerns. Annex 10 shows data on private infrastructure finance in the region. Multilateral financial institutions account for only a small portion of privately financed infrastructure deals, suggesting that markets for such investment may be working more effectively than imagined at the time the direct lending instrument was created.
- 5.26 Unlike Private Sector projects, global credit operations are, by design, unaware of the results achieved by final borrowers. Evaluations of sector credit operations that have attempted to work their way down to final borrowers have found generally disappointing results:
- A 1984 evaluation on global credit programs for industrial revitalization found that most of the subprojects did worse than expected and that from one quarter to one half of the subprojects experienced economic internal rates of return below the accepted Bank minimum of 12 percent<sup>23</sup>.
  - A parallel evaluation of global credit operations directed toward the agricultural sector concluded that impact evaluation studies: “...do not show a significant correlation between the concession of subloans and the direction of the changes in the net income of those who receive them, both in comparison with control groups or with the situation of the sub-borrowers prior to getting the resources.”<sup>24</sup>”
- 5.27 Typical of recent results reporting are the findings cited in Uruguay’s third multisector credit operation as evidence of success in the prior two such loans. (See Box 5.1). The prior operations were described as “satisfactory,” despite the production of information only on the number, size and sectoral distribution of the sub-loans granted.

**Box 5.1: Impact at the Subproject Level**

The Bank's loan for its first multisector credit program in Uruguay (705/OC-UR) (abbreviated here as MS-I) was fully disbursed by March 1998 with very satisfactory results...The total value of investments funded by MS-I subloans surpassed expectations because the local counterpart exceeded the program's requirement: as of February 2002, loans and recoveries totaled US\$246 million" (IDB share 46.4%, end-borrowers 41.4%, IFIs 12.2%). Two thirds of the initial loans had repayment terms longer than five years; the other third were at shorter terms. Over half (57%) of the loans were for capital purchases of plant and equipment.

The second multisector credit program (1155/OC-UR) (MS-II) has achieved its objectives satisfactorily, the final disbursement having been made in the first quarter of 2002. This operation's impact was measured by reference to: (i) capital investment leveraged; (ii) number and average size of loans approved; (iii) geographical coverage; and (iv) type of projects financed.)

Uruguay. Proposal for a loan for a multisector global financing program III(MS-III) PR-2674 21 May 2002.

<sup>23</sup> Summary of evaluation of global industrial credit programs GN-1505 6 Sept 1984

<sup>24</sup> Summary of evaluations of global agricultural credit programs GN 1493 27 February, 1984

- 5.28 Whether these were prudent loans for the government of Uruguay to assume depends, however, not on the volume of credit granted but on the economic returns generated. If the funds were well applied, economic returns to the final borrower would generate fiscal revenues for the state, as well as repayment of principal and interest on the loans. If the loans were not well used, however, the state could both suffer financial losses on the loans as well as failing to get the fiscal revenue increase to help finance the repayment of the loans to the Bank.

## VI. SECTOR/PBL/EMERGENCY INSTRUMENTS

### A. Sector/PBL Operations

- 6.1 When created in 1989, sector/PBL operations were designed to further the twin objectives of policy reform and financing country balance of payments needs. When it came to constructing the detailed safeguards for the use of the instrument, however, attention was focused largely on the policy reform aspect. Sector loans were constructed on the basis of detailed policy “conditionalities,” contract provisions that spelled out in detail the changes to laws, regulations or institutions that the country needed to undertake. Release of loan tranches were dependent upon certification by the Bank that the conditionalities associated with each tranche had been complied with.
- 6.2 With respect to the country finance objective, the only safeguard formally incorporated into the rules of the instrument was that such loans needed to demonstrate “fulfillment of a satisfactory macroeconomic framework.”<sup>25</sup> This was intended to prevent such loans from financing an unsustainable country program and thus contribute to the creation of a destabilizing debt situation. In contrast to the policy safeguards, however, this safeguard does not require detailed analysis or specification, with the result that such loans provide only a vague and general description of the country’s financial needs that are being met with the proceeds of the loans.
- 6.3 The sector lending instrument contained few other safeguards. Funds did not disburse against evidence of specific expenditure, so the elaborate expenditure safeguards associated with investment lending were absent. Such loans did not require counterpart funding from the borrower, nor were they subject to restrictions on eligible expenses. Sector loans were originally required to be done only in partnership with the World Bank, but this requirement was lifted by the Governors in 1990. To comply with IDB charter requirements, and as interpreted in the provisions of the seventh replenishment (AB-1378), sector loans were designed to disburse “against imports rather than specific project-related costs,”<sup>26</sup> and contained a negative import list, but this safeguard was largely pro-forma and abandoned in the eighth replenishment (AB-1704).

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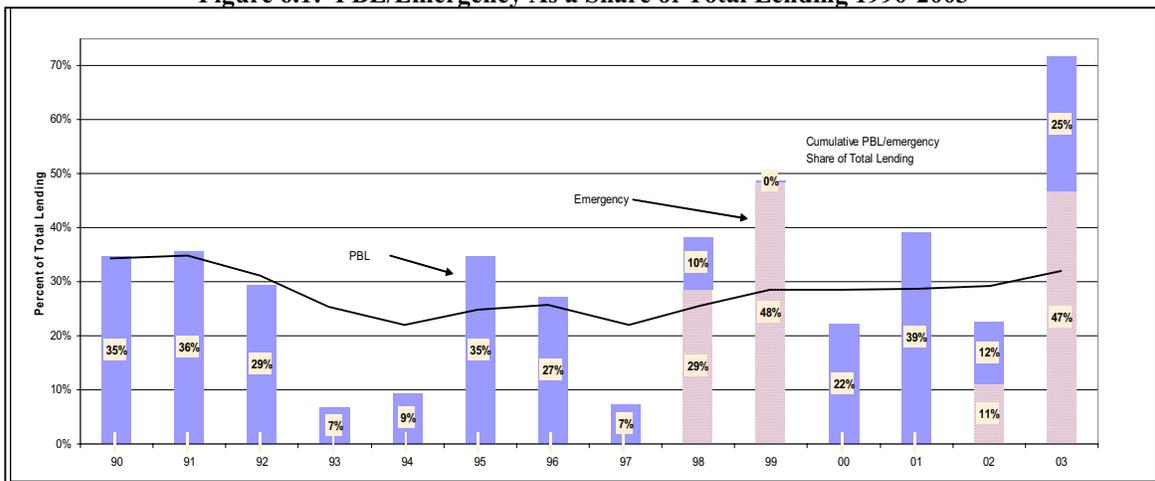
<sup>25</sup> OA-330 Bank Operations Administration Manual, “Sector loans-specific rules” Dated February, 1998

<sup>26</sup> AB-1704 paragraph 3.6

6.4 The Governors did establish an overall safeguard for the use of the instrument, limiting it to 25% of total lending for the IDB-7 period, a ceiling which was reduced to 15% for the IDB-8 period. In the 2002 revisions to the lending framework, Governors substituted a specific dollar value cap on the use of this instrument for the prior percentage of the lending program limitation.

6.5 Since the approval of the sector lending instrument in the IDB-7 agreement, the Bank has approved 101 sector lending operations totaling over \$18 billion. In 1998, the Board of Executive Directors approved an “emergency” variant of PBL, with most of the same design features but with a much shorter maturity profile and a higher interest rate. Figure 5.1 shows the pattern of usage of both variants of the PBL instrument, which have averaged around 27% of the total lending program since 1990, and accounted for 76% of total Bank lending in 2003. This pattern of usage stands in sharp contrast to the usage of “investment” lending instruments (See Figure 6.1)

**Figure 6.1: PBL/Emergency As a Share of Total Lending 1990-2003**



Source: IDB Data Warehouse

6.6 For comparison purposes, Figure 6.2 shows the comparable pattern of approvals for adjustment lending at the World Bank.

**Figure 6.2: Share of Adjustment Lending in Total IBRD & IDA Lending, FY80-03, FY04-06 Projection**



Source: Eligibility of Expenditures in World Bank Lending: A New Policy Framework, Operations Policy and Country Services, March 26, 2004

6.7 Twenty-one of the Bank's borrowers have made use of this instrument in the IDB-8 period. The intensity of use of this instrument has varied substantially across countries. Table 6.1 shows the deployment of this instrument during the IDB-8 period, measured both as a share of each country's total borrowing during the period, and as each country's share of the total use of the instrument.

**Table 6.1: Sector/PBL Use by Country: 1990-2004**

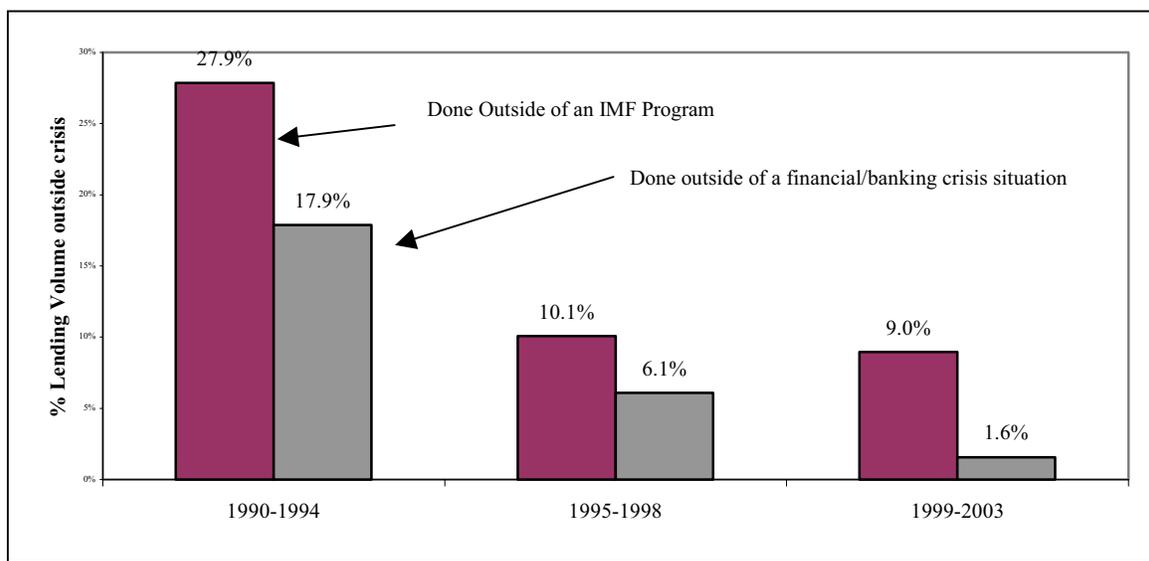
Country	Share of Country Program	Share of Instrument Use
AR	27%	22%
BA	14%	0%
BO	19%	2%
BR	3%	3%
CH	9%	1%
CO	23%	9%
CR	26%	1%
DR	21%	2%
EC	34%	4%
ES	12%	1%
GU	28%	2%
GY	37%	1%
HA	21%	1%
HO	34%	3%
JA	36%	2%
ME	29%	18%
NI	28%	2%
PE	38%	11%
PN	27%	2%
PR	6%	0%
SU	39%	0%
TT	16%	1%
UR	30%	5%
VE	38%	7%

6.8 A third salient fact about this instrument is that it has overwhelmingly been used by countries during periods of exceptional financial need. This is established by two different calculations. First, OVE examined all sector/pbl lending done since 1989 to see which ones were approved at a time when the borrowing country had an IMF program in place. Second, OVE constructed an independent index to measure the occurrence of either "financial pressure" or "banking crisis", both conditions that are likely to give rise to needs for extraordinary finance. Figure 6.3 shows that these instruments have been used by countries almost exclusively during periods of financial stress, confirming that country finance objectives are a key motivation for the use of this type of lending instrument. In fact, in the 1999-2003 period, less than three percent of the lending volume approved using these two instruments was granted to countries outside of either an IMF program or a situation of severe financial stress.

6.9 Quantitative limits on the use of this instrument have also been an issue over the years. The IDB-7 established a limit of 25% of total approvals for this instrument, but usage through 1992 ran well in excess of the limit. The capacity of the Bank to exceed the limit obviously indicated some flexibility, but programming in this period was motivated by a sense of constraint in the possible use of the instrument.

6.10 The limit was reduced to 15% in the IDB-8 agreement, in anticipation of an improved environment for private financial flows. This limit was met in only one year, 1997, and the financial crises that followed led to the creation of a new variant, "emergency" PBL, which, together with ordinary sector/PBL operations has constituted a large share of the total lending program since 1998.

**Figure 6.3: IDB PSCT and PEMG Lending**



Source: IDB Data Warehouse

## 1. Articulation of Developmental Intent

6.11 The instrument was designed to accomplish two distinct development purposes: policy reform and financing balance of payments deficits. The policy reform objective was made explicit: “to improve economic efficiency in the sector and to provide resource transfers to help make such improvements possible,” while the country finance objectives were couched in very general terms. The IDB-7 Agreement creating the instrument was clearly focused on meeting the financing needs of the region in aggregate terms, stating:

*For the IDB, an average level of net capital inflows of USS1.8 to USS2.25 billion a year has been programmed, which corresponds to annual disbursement levels of USS3.2 to USS3.6 billion. .. To achieve this disbursement target, the Bank will have to seek ways to accelerate project execution, and thus loan disbursements, as well as consider new operational modalities<sup>27</sup>.*

6.12 The financing objective was made more explicit in 1990, when the Governors authorized its use to support “debt and debt service reduction” activities. Proceeds of such loans were used to help countries restructure their debt to private commercial banks.

6.13 Both policy reform and country finance objectives are potentially appropriate for debt finance, since the first can yield a future return in the form of increased economic efficiency while the second can improve a country’s long-term growth rate by mitigating the negative effects of severe downturns. (See Annex 11).

<sup>27</sup> Paragraph 2.04

- 6.14 Until recently, the country's financing needs were not analyzed as part of the loan document, although these needs played a critical role in defining the size of the loan and the pace of anticipated tranche disbursements. As the Bank has been drawn into concerted lending operations with the IMF, however, this has started to change. A recent sector/PBL loan to the Dominican Republic made explicit reference to country financing needs, noting:

*To implement the government's macroeconomic program, a package of financial assistance has been planned from international lending agencies of US\$1.2 billion over a 24-month period, including US\$300 million from the World Bank, US\$300 million from the IDB (US\$100 million in the present operation and US\$200 million in an emergency loan to guarantee maintenance of the government's social programs) and US\$600 million from the IMF....The funds envisaged in the proposed operation form an integral part of the financial assistance package agreed on by the authorities, the IMF and the IDB to back the government's comprehensive economic program and, in particular, to strengthen the balance of payments by recouping a large part of the country's international reserves<sup>28</sup>.*

- 6.15 The document does not contain a quantitative analysis of country financing need, however, nor a projection of how meeting that need will generate a positive long-term return to the country, and in this respect reflects the generally poor specification of development intent related to the country financing objectives of sector/PBL operations. The specific reference to the IMF, however, suggests that the Bank has relied upon that institution for financial needs assessment, and is following its lead in defining the size of subsequent Bank lending operations.

- 6.16 On the policy reform side, the Governors included language intended to safeguard a deep analysis of economic return as a requirement for use of this instrument. The IDB-7 agreement noted that deciding factors for use of the instrument should include:

*reasonable assurance that the national economic gains of the program outweigh its economic and social costs<sup>29</sup>.*

- 6.17 When the sector/PBL instrument was modified in 1990 to permit the financing of debt and debt service reduction operations, the Bank's operational manuals contained even more explicit language, requiring that such financing:

*would be based on the estimation that it would have a positive impact upon the prospects for growth oriented adjustment when compared with an alternative use of the same resources. Hence, financing would only be supported if the reduction involved will contribute to a viable external financing plan that achieves the growth objectives of the adjustment program.*

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<sup>28</sup> See PR-2834, paragraph 1.15

<sup>29</sup> AB-1378 paragraph 3.18

- 6.18 It also explicitly recognized that financial transactions of this kind entailed both risks and benefits, stating:

*The costs and benefits to a borrower of using the Facility will depend on a variety of factors that must be carefully examined by the Bank on a case-by-case basis. Only when it is concluded that those benefits clearly exceed the costs of the operation will the use of the Facility be justified by the Bank. In its evaluation, the Bank would review the overall effects of lowering the debt burden and reducing service payments. The appraisal would be based to the extent possible on such considerations as analysis of improvements in external (and internal) cash flows, estimates of rates of return, analysis of the impacts of reduced service payments on increased investment and imports, estimates of enhanced growth and development prospects, projections of when and under what circumstances the country could expect to regain normal access to international capital markets, and a review of the impact of debt reduction on the country's overall credit worthiness.<sup>30</sup>*

- 6.19 In reviewing the documentation on loans approved under this instrument, OVE found very few that complied with these design safeguards. Sector/PBL loans are extremely vague in their articulation of developmental intent. With respect to their policy reform objectives, such loans do not include cost benefit calculations or rate of return estimation, and their evaluability scores for outcomes are low. (See Annex 3).
- 6.20 Analysis of the costs and benefits of the reform program were so infrequently done that the requirement that loans provide “reasonable assurance that the national economic gains of the program outweigh its economic and social costs” was dropped from the Bank’s operations manual in 1997. Loan documents concentrate on defining the policies to be changed (an output), not the economic returns to be obtained from policy change (an outcome).

## **2. Financial Efficiency**

- 6.21 Sector/PBL operations generally disburse very quickly, with an average of 56% of percent of the loan contained in the first tranche which is on average released 9 months after approval. The second tranche of such operations disburses on average 32 percent of the total approved within 30 months of approval.
- 6.22 This pattern of tranche-release suggests that such instruments are heavily “front loaded,” which makes sense from the perspective of crisis-mitigation but is somewhat more problematic from the perspective of inducing policy reform. Front loading suggests that policy conditionalities were either largely complied-with at the time of approval, or not constraining of loan disbursement. This point

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<sup>30</sup> GN-1686-7 22 March 1991 Debt and debt-service reduction facility. Operational guidelines. Annex I

was made in a slightly different form in OVE's evaluation of emergency lending<sup>31</sup>.

- 6.23 In terms of the other measures of financial efficiency, sector/pbl operations provide more predictable disbursements than investment loans, and those disbursements are somewhat less volatile than country primary expenditures. Sector/PBL operations also disburse on average in a more counter-cyclical manner than do investment loans, although this pattern exhibits high variability among countries. (See Annex 6).
- 6.24 Because they do not finance specific expenditures, sector/PBL operations have none of the transaction costs associated with project lending. Instead, transaction costs are associated with the burdens of complying with conditionalities built into the loan. Annex 12 shows the evolving pattern of conditionalities built into Bank sector/PBL operations since 1994. The number of conditions seems to have been going down from an average of 43 conditions per loan in 1990-94 to 27 conditions in 2000-2003 with variations in this interval. Between 1990 and 1995, there were five loans that required more than 100 conditions for disbursement, and after 1995 five loans had between 50 and 70 conditions, but the vast majority of the loans state between 10 and 40 conditions.

### 3. Results Achieved

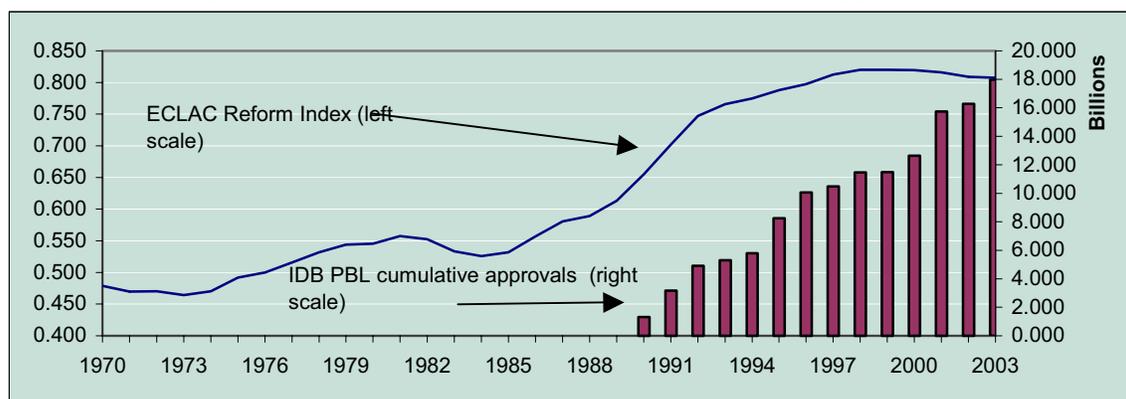
- 6.25 In attempting to assess the results achieved using the PBL instrument, it is important to distinguish among three different types of possible results. First, there are the financial results associated with the country-financing objective inherent in PBL operations. Second, there are the results in terms of the impact of PBL operations on the adoption of policy reform measures. Third are the results of the policy reform measures adopted on the performance of the economy of the borrowing member countries.
- 6.26 **Financial Results:** On the first level, results of PBL operations cannot easily be assessed because of the fact that sector-lending operations do not contain an analysis of the country financing problems they are being used to solve. Lacking an explicit analysis of what was intended in this area, financial results are simply described with reference to the size and timing of disbursements. Figure 4.2 shows that standard sector/PBL operations (PSCT) disburse very quickly, and the emergency variant of PBL disburses even more quickly. As a vehicle for providing country finance, therefore, these instruments are highly efficient.

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<sup>31</sup> "These twin objectives of rapid disbursement and strong conditionality have frequently led to tension. The balance of payments support objective suggests either a single tranche or front-loaded tranching, with conditionality not including factors outside the control of the country's executive. The structural reform objective suggests just the opposite: multiple tranching, downstream loaded, with legal reforms requiring congressional approval and the building of consensus regarding the reforms. The latter implies vertical and horizontal constraints that require time to be eased" RE-251, footnote 3, page 4.

- 6.27 **Adoption of Reform:** With respect to the second question—were PBL operations successful in inducing policy reform—the results are more ambiguous for two basic reasons: attribution to the Bank is difficult; and the link between PBL lending and the process of policy reform is hard to establish.
- 6.28 First, PBL operations are almost always done in concert with others, and the understandings regarding how policy should be reformed are shared widely among the IMF, the IDB and the World Bank. As a result, it is difficult to discern the impact of the Bank from that of other actors with similar agendas and financing programs.
- 6.29 Second the reality is that “policy reform” is a process that can be completely separated from policy based lending. Because there is no necessary connection between loan disbursements and the actual costs of undertaking reform, the loan proceeds are not strictly required to accomplish the desired reform. Through much of the 1990s, there was a broad consensus among governments in the region regarding the need to undertake reform, and the strength of this consensus is probably more responsible for the actual policy reform observed than are the financial assistance packages provided by MDBs in pursuit of reform.
- 6.30 The separation of policy reform from policy-based lending can be seen in the following figure which plots the ECLAC economic reform index alongside Bank approvals of policy-based loans. The chart illustrates that policy reform in the region gained substantial momentum before the Bank initiated PBL activities, and that PBL operations continued to expand significantly in recent years even though the pace of reforms measured by the ECLAC index has stagnated<sup>32</sup>. If sector/PBL operations are equally associated with periods of increasing reform and periods of stagnant reform, it is hard to argue that such loans “cause” reforms to happen

**Figure 6.4: Cumulative Reform Index and PBL/ Sector Approvals**



Source: IDB Data Warehouse and ECLAC

<sup>32</sup> The ECLAC reform index tracks largely the key macroeconomic reforms aimed at improving overall economic management. The stagnation of this index may indicate that the reform agenda has shifted to areas not measured by the index, a topic addressed below.

- 6.31 Attempts to suggest causality have generally run along two different lines. The first argues that such loans provide sufficient inducements to persuade reluctant governments to undertake reforms they would have been unwilling to do otherwise, while the second argues that such loans enable committed governments to implement reforms they are committed to but lack the resources to accomplish.
- 6.32 The “persuasive” argument may have merit when applied to major macroeconomic reforms, since the resources of sector/PBL operations flow directly to the Treasuries, which is responsible for enacting the reforms. But for other reforms, the persuasive argument is less plausible, since line ministries generally do not have any contact with the funds being disbursed. This point was made in a 1998 evaluation of IDB sector/PBL operations in the following terms:
- One of the problems that has arisen with the sector loans is that they generally entail disbursements that do not directly affect the participating institutions, which sometimes are not even informed of the actions they must take to comply with the conditionalities, or do not share their objectives.*<sup>33</sup>
- 6.33 A large, multi-year study by the World Bank on its own adjustment lending made a broader generalization about the capacity of reform loans to persuade reluctant governments to adopt new policies. The study noted:
- Country ownership and reform readiness are key to effective adjustment and sustained development. They require both the commitment and the capacity to implement the reforms supported by Bank adjustment lending. Research on aid effectiveness indicates that when the country’s commitment or implementation capacity is weak, conditionality is unlikely to be effective: **In other words, conditionality by itself cannot lead to the adoption of better policies when there is no consensus for reform.***<sup>34</sup>
- 6.34 The “enabling” argument has greater merit, particularly in cases where reforms have large transition costs, as for example in the case of pension reform where there are substantial initial fiscal costs in moving from pay-as-you-go systems to fully-funded systems. In such reforms, however, the size of the loan is directly related to identified expenditures, making it more like an investment loan than like a sector/PBL operation.
- 6.35 In the standard sector/PBL operation, there is no specific connection between the compliance costs of the reforms being required and the use of loan proceeds. In a recent \$300 million sector/PBL operation to improve competitiveness in Peru, for example, almost all of the compliance costs associated with the proposed reform were to be covered by a \$5 million technical assistance component<sup>35</sup>. The remainder of the funds are not directly associated with the compliance costs of the competitiveness reform.

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<sup>33</sup> Evaluation of the Policy-Based Lending Portfolio, Phase II, January, 1998, overview p. iii.

<sup>34</sup> Adjustment Lending Retrospective, World Bank, June, 2001

<sup>35</sup> See PR-2796

6.36 With respect to the causal link between sector/PBL operations and reform, the conclusion appears to be the following: If a country does not have commitment to a reform agenda, loan conditionalities will not be effective in creating it.<sup>36</sup> If countries have a commitment to reform, they are likely to implement it (since it is seen as in their interest) unless they lack the resources to support implementation. If the problem is lack of resources to finance the costs of compliance, this can be financed with expenditure-based lending instruments and does not require a sector/PBL.

6.37 **The Reform-Results Connection.**

If the evidence is weak that PBL operations cause or condition the reforms, is there evidence that the reforms themselves are effective in meeting the developmental needs of the borrowers, regardless of what caused them to be undertaken?

6.38 As noted earlier, the case for Bank financing of policy reform is built on the premise that policy-induced distortions are keeping countries from achieving their maximum rate of growth in output and employment. Removing such distortions theoretically yields future returns in the form of increased efficiency in resource allocation, with concomitant improvements in overall growth. Yet despite this theoretical argument, sector/PBL operations are not designed with clear specification of the efficiency gains they are seeking to achieve, and such gains are not assessed at the time of project completion.

6.39 In its country program evaluations, OVE has reviewed the results of a number of sector/PBL operations, and finds a mixed pattern of results.

Some loans, particularly those early in the reform cycle, appear to have been

**Box 6.1: A Macro Success Story**

Since borrowers were being asked to adopt policy measures that often involved short term pain, a good deal of care was taken to describe the anticipated long term gain which will flow from adopting these measures. It was expected that these policies would reduce inflation and interest rates, restructure the Peruvian economy to make it more competitive; reorient it towards its comparative advantages which were seen as export of labour intensive goods; increase growth, employment and wages; reduce poverty; reduce the chronic deficit in the current account; strengthen the banking sector; decrease financial intermediation costs; and stimulate investment and capital inflows.

Peru's reforms contributed to impressive success in several areas related to macroeconomic stabilisation. Inflation was subdued (from 7842% in 1990 to double digits by 1992 and continued to fall thereafter), the exchange rate was stabilised, and the fiscal deficit brought under control with improved tax revenue and tough controls on expenditures.

The country's stabilisation efforts not only surmounted the immediate crisis; they also laid the groundwork for future growth. Both international and domestic investment rose strongly. The investment coefficient (Investment/GDP), went from an average of 17.7% of GDP in 1990-92, (not far from its 1970-90 low of 16.0 in 1985), to one of 23.3 % in 1993-98. The growth results of this program were almost precisely those anticipated by the Bank in the 1991 Trade Sector Loan.

Country Program Evaluation: Peru

<sup>36</sup> According to a self-evaluation conducted by RE2 "Development Effectiveness and Policy-Based Lending in Region 2: What have we learned in the last three years? Management has concluded that the Bank can add value through the process of discussing policy reform with the government acting as an "honest broker" and heightening the need for reform in the sector with finance ministry authorities.

associated with significant developmental gains (See Box 6.1), while others have not achieved measurable improvements in country economic performance, and in a few cases, country/sector performance deteriorated following major reform efforts.

6.40 Available macroeconomic data, however, tend to support the proposition that the kinds of reforms promoted by sector/PBL operations yield positive economic benefits to the countries. Reform as measured by the ECLAC index is associated with an increase in output per capita, although some of this effect is offset by a negative impact of reform on investment. The net effect is positive: for a ten-percentage point increase in the reform index the steady state output per capita increases by 1.6, the net result of an increase of 3 percentage point impact on economic efficiency and a negative 1.4 percent on total gross capital formation (see Table 6.2).

**Table 6.2: The Impact of Reform on Steady State Output Per Capita**

Change in reform	Effect via investment	Effect via economic efficiency	Overall effect
10 percentage point increase	-1.4	3.0	1.6
1 percentage point increase	-0.13	0.3	0.2

*These results derive from LAC data but using the techniques and specifications used by A. Bassanini, S. Scarpetta, and P. Hemmings, "The Role of Policies and Institutions: Panel Data Evidence from OECD countries", ECO/WICP(2001) 9, January 2001, OECD. The regressions are available on request.*

6.41 In interpreting these results, it is important to bear in mind that the pace of economic reform has slowed markedly in recent years, while the pace of Bank sector/PBL lending has not. (See Figure 6.4 above). It is very likely the case that recent disbursements on sector/PBL operations will not produce the long term output gains noted in the table.

6.42 Aware of the problems of low systemic treatment of results, when they approved the 2002-2004 lending framework, the Governors directed the Bank to improve the indicators of results included in all PBL operations approved under the new framework OVE has conducted an analysis of the indicators included in all PBL operations approved since the 2002 Governors mandate (see Annex 13). Overall, the evaluability of sector/PBL operations has been improving since 2002, but the slowest progress has been in the most critical areas of baselines and outcomes.

6.43 With respect to policy reform results, the conclusions appear to be the following: IDB sector/PBL operations cannot be shown to have a causal impact on reform processes, given the range of other actors involved and the limited ability of conditionalities to change policy preferences. The reforms themselves appear to have an overall positive impact on country economic performance, but most of the major gains from such reforms have been realized and the overall process of reforming has slowed markedly in recent years.

6.44 Sector/PBL operations are much more successful in delivering financial benefits to the borrowers. Such loans disburse quickly and predictably, help moderate the business cycle, and generate positive impacts on indicators of country financial stress. Their large tranche sizes and predictable disbursement flows make such instruments particularly suited to the growing demand for IDB participation in concerted financing programs prepared for countries under IMF sponsorship.

## **B. Emergency PBL Operations**

6.45 In 1998, “unanticipated” international financial market turmoil persuaded the Board of Governors authorized the creation of a new variant of fast-disbursing policy based lending. The Board of Executive Directors was authorized to waive certain limitations on the lending program to permit the Bank to approve fast-disbursing PBL operations on special financial terms for a period of one year. The rationale for this instrument was elaborated in (GN-2031-1) as follows:

*Countries are victims of contagion and need assistance from the international community, including the Bank, to mitigate the impact on general economic activity, to protect expenditures that primarily benefit the poor and to finance programs that consolidate and extend structural reforms... Where a macro-economic program and its embedded social priorities may be under threat of being undermined by a sudden reversal or severe drying up of capital flows, the Bank will have to deliver PBLs in rapid response mode. In effect, the Bank may have to adopt an emergency PBL as a variant of the standard.*

6.46 In order to deploy this instrument on the scale and at the pace required, the Governors agreed that this new instrument would be exempt from some of the safeguards applied to sector/PBL operations, particularly the 15 per cent limit on fast disbursing lending and the 65 per cent indicative share for lending to A and B countries.

6.47 At the same time, however, the Governors directed that four other safeguards be built into the new instrument: explicit linkage to the IMF; a clear statement of developmental intent; a very rapid disbursement profile, and an assessment of the financial capacity of the borrower to repay.

6.48 The first three safeguards are relatively straightforward and self explanatory. Linkage to the IMF was designed to limit the use of the instrument to support for concerted international financing effort. A clear statement of development intent preserved focus on development as opposed to pure country finance, and the rapid disbursement profile ensured that it would be used to address short-term financial crises.

6.49 The fourth safeguard was included as a counterbalance to the financial terms and conditions set for emergency lending. To provide clear incentives to use this instrument only in emergency situation, to preserve the financial capacity of the Bank for its other operations, and to protect other borrowers from negative

consequences arising from the emergency program, the Governors required that IDB emergency lending be offered on the same financial terms as the World Bank’s special structural adjustment loans (SSALs), which carried a tenor of 5 years and a variable interest rate set at 400 basis points over LIBOR. These terms were considerably more burdensome to the borrower than standard Bank terms, so the fourth safeguard was designed to ensure that countries had the capacity to carry loans with such conditions.

6.50 Use of this instrument came in two phases: an initial phase during 1998 and 1999, and a second phase starting in 2002. The first phase saw approval of eight emergency loans distributed among five countries for a total dollar value of US\$7.4 billion dollars, while the second phase involved \$3.8 billion in financing for six loans to five countries. (See Table 6.3).

6.51 OVE conducted an evaluation of the first phase of the program in 2001. With respect to articulation of developmental intent, the first round of emergency loans all had a crisis mitigation objective, and all had additional specific objectives related to the goals set for the instrument by the Governors, namely that they: *“protect the interest of the poor and sustain reform efforts to maintain or strengthen the process of social, institutional and economic reform”*. None couched this intent in terms of return on the investment of emergency funds.

6.52 With respect to pace of disbursement, the first round showed marked disparities in the speed with which emergency loan funds disbursed. While all the proposed operations had ex ante disbursement profiles that met the 18-month standard, some disbursed very quickly while others took a number of months to disburse fully. The OVE evaluation noted that much of the financial impact of concerted lending programs comes with the announcement of the package, and suggested that full disbursement after the crisis had passed may not have been required to achieve the goals of the program.

6.53 With respect to transaction costs, several of the loans contained “reform” objectives that required a large number of specific conditions. Some of these involved the passage of legislation, a condition that often delays disbursement. The number of specific conditions ranged from a maximum of 107 to a minimum of 9, and averaged 34.

6.54 In the area of results achieved, the OVE evaluation found a mixed picture. There was some evidence that concerted financing packages helped calm financial

**Table 6.3: Emergency PBL Operations**

Project	Amount	Year
First Phase		
AR0254	2,500,000,000.00	1998
CO0202	350,000,000.00	1998
CO0232	300,000,000.00	1999
JA0110	10,000,000.00	1999
PE0202	310,908,000.00	1999
BR0310	1,200,000,000.00	1999
BR0308	2,200,000,000.00	1999
CO0238	550,000,000.00	1999
Second Phase		
UR0151	500,000,000.00	2002
PR0147	30,000,000.00	2003
AR0296	400,000,000.00	2003
CO0268	1,250,000,000.00	2003
AR0295	1,500,000,000.00	2003
DR0159	200,000,000.00	2004

markets and restore growth in the affected economies in relatively short order. There was also some evidence that emergency lending helped increase the resilience of the financial sector.

- 6.55 Policy reform components of emergency loans fared less well. When conditionalities were broad (eg. Protect the level of social spending) the loans encountered few problems. But two emergency loans that were originally programmed as ordinary PBLs (the financial sector in Peru and the electricity sector in Colombia) had complex conditionalities and experienced execution problems, leading to disbursement delays and partial cancellations. Complex reform objectives thus clearly were a poor fit with the emergency financing vehicle.
- 6.56 The evaluation also found some potentially perverse incentive effects associated with the creation of a new instrument. Ordinary sector/PBL operations almost ceased during the initial years of the program, suggesting some “crowding out” of traditional projects by the new instrument, while two complex reform operations initially under preparation as ordinary sector/PBL operations were “crowded in” to the emergency program, with generally disappointing results.
- 6.57 The evaluation also found, however, some significant concerns with respect to the financial burden imposed by emergency lending on the borrowing countries. The evaluation made two points regarding this issue. First, the emergency lending instrument carried financially demanding terms and Governors, aware of this fact, directed that: “...borrowers must be OC-eligible and shown to have the capacity to absorb the proposed loans on the special terms proposed.” The evaluation found, however that fulfillment of this condition was:

*.... difficult to evaluate, because the phrase “shown to have the capacity” is not specific as to how this capacity is to be determined or who is to make the determination. Although the IMF routinely provides an analysis of the medium-term outlook and capacity to repay the Fund in its Article IV reports, no such analysis is contained in any of the documentation associated with the Bank’s emergency lending operations. Thus determining whether this condition was fulfilled is impossible.*

- 6.58 The evaluation could find no evidence of any concerted analytical work by the Bank to establish ex-ante that borrowers seeking access to this instrument had the financial capacity to bear the more demanding financial terms and conditions<sup>37</sup>. This led OVE to defer final judgment on the impact of the emergency lending program until the emergency loans had been repaid, noting:

*Repayment of emergency loans in the next few years will require significant, and unprecedented, efforts by borrowing member countries<sup>38</sup>.*

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<sup>37</sup> It is interesting to note that this safeguard was not incorporated into the revisions to the Emergency Lending Program approved by the Board of Executive Directors in 2002. See GN-2031-10, June, 2002.

<sup>38</sup> For an analysis of the nature of this repayment obligation, see Table 16 in RE-251.

- 6.59 An analysis of subsequent repayment behavior suggests that these concerns were warranted. Annex 14 looks at the financial characteristics of countries that took emergency loans, and finds that, on average, they were in a worse financial position when they were required to repay the loans than they were when they originally contracted for them. The short tenors on emergency lending thus appear not to have allowed countries sufficient time to recover before repayments were due, leading two countries to request a second round of emergency PBLs when the amortizations on the first round came due.
- 6.60 The fundamental evaluative point about emergency pbl is that it imposes the highest financial costs on the countries in the most vulnerable financial situation, and that the fixed repayment schedule bears no necessary relationship to the borrower's future capacity to repay.
- 6.61 It is interesting in this context to note that the staff of the IMF are working on a type of financing that keys repayment obligations to measured improvement in a country's capacity to repay. This is an option that may warrant study by the IDB.
- 6.62 It is also important to recognize that the Bank will likely continue to need some mechanism for financing countries generally, as opposed to specific development projects. This point was made clearly in the Bank's Institutional Strategy, which stated:

*The Bank is likely to be called upon in the future to cope with the consequences of volatility in financial markets. This volatility can express itself in a variety of ways: balance of payments crises, banking system collapses, exchange rate gyrations, debt and equity market selloffs, or confidence crises among portfolio investors. Although some countries in the region have adopted measures to provide some protection from financial volatility, the ability to call upon IDB financing in emergency situations is still an important role for the Bank for most countries of the region. While the Bank must have some ability to respond in emergency situations, the principal business of the Bank remains the financing of long-term investments that promote growth with equity in the region. Any future emergency response should be managed with adequate assurance that the ordinary lending operations of the Bank would not be compromised by an emergency program<sup>39</sup>.*

## VII. REFORMING LENDING INSTRUMENTS

- 7.1 In recent years, the IDB as well as other multilaterals such as the World Bank have been undertaking fundamental revisions to their lending instruments with a view to enhancing the capacity of each institution to meet the development needs of its borrowing member countries. This examination has resulted in proposals

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<sup>39</sup> GN-2077-1, paragraph 3.10

for instrument change in both institutions, and these proposals provide a form of evaluative feedback regarding the adequacy of existing approaches to the design and use of instruments.

- 7.2 Both institutions are attempting to deal with the same sets of problems: demand for traditional investment project lending is falling, borrowers are concerned about the high transaction costs of dealing with the institutions, net flows to the borrowers are declining significantly, as fiscal constraints limit country capacity to borrow.
- 7.3 In responding to these new challenges, both institutions have had to struggle with two basic alternative approaches to instrument reform: proliferation or simplification. Faced with constraints inherent in existing instruments, the institutions can either create new instruments with fewer, different or better constraints, or reduce the number of instruments and allow more latitude as to what can be done within each instrument. The proliferation approach assumes it is possible to design new instruments appropriately matched to country needs, while the simplification approach regards pre-defined instruments as a hindrance to problem solving.

#### **1. Instrument Reform at the IDB**

- 7.4 In order to address problems with the existing investment loan instruments, IDB Management has since 2000 put forward for consideration at least 12 new variations on the investment lending theme. The new modalities include:
- Innovation Loans
  - Multiphase Loans
  - Sector Facilities in
    - Education
    - Health
    - Institutional development
    - Transnational infrastructure
    - Trade
  - Project Preparation and Execution Facility
  - Conditional Credit Line for Investment Projects
  - Performance Driven Loans
  - Loans to subnational entities without government guarantee
  - Guarantee Disbursement Loans
  - Time slice loans
- 7.5 Most of these new instruments were subsequently approved by the Board of Executive Directors, adding significantly to the Bank's mix of possible lending instruments. The main document justifying the creation of flexible lending instruments makes the following case for the new modalities:

*Traditionally, the Bank's support of investment loans in the public sector has focussed on the conventional time-tested project cycle approach. This linear-type planning defines all parts of a multi-year program ex-ante, and generally assumes that most variables will remain constant over the years, with contractual conditions and monitoring parameters built into ongoing project supervision and implementation. The reality is that while this approach may work for large infrastructure-type projects with fairly well defined procurement and construction schedules, and tangible (physical) outcomes, it does not always adapt well to (i) areas of action where the situation is dynamic, and less complex responses are needed; or (ii) more intricate reform and consensus-building programs where exact processes and outcomes are less easily planned or predictable within a specific timeframe. This means that there should be more flexibility built into design and the ongoing implementation framework, greater emphasis on results-oriented monitoring and learning, and adequate provision for mid-course correction as needed.*

- 7.6 This critique focuses on three key limitations of the investment lending instrument: the slow response inherent in ex-ante project specification; the inability to finance “intricate reform and consensus building programs;” and inadequate emphasis on “results-oriented monitoring and learning”.
- 7.7 Four of the new lending modalities were approved in 2000: innovation loans, sector facilities, multiphase loans and the project preparation and execution facility. These instruments have been used enough to provide some basis for evaluation, and were assessed by Management in 2002 as a part of a Board of Executive Directors review of the new approach.
- 7.8 The project preparation and execution facility merely extends the existing project preparation facility into the time period between completion of design and actual disbursement of project funds. Innovation loans and sector facilities are limited in size (\$10 million per operation for PINO and \$5million for sector facilities), and aim to speed up the approval process by demanding far less specificity in loan documentation. Through April of 2004, 23 innovation loans and 14 sector facility loans had been approved.
- 7.9 By far the largest and most significant of the new flexible instruments is the multiphase loan. Unlike innovation loans and sector facilities, there are no quantitative limits on the use of multi-phase loans, and 30 loans totaling more than \$2.8 billion have been approved. Multiphase loans are designed to support a multi-year program of investments while approving only an initial phase. Subsequent phases would be “triggered” by changes in key indicators monitored through the initial phase.
- 7.10 With reference to the three evaluative criteria, none of the new instruments contain provisions to improve the quality of developmental intent. Operations

- using the new instruments do not include rate of return analysis, and their evaluability scores are essentially identical to standard PESP loans. (see annex 3)
- 7.11 In terms of financial efficiency, innovation loans and sector facilities require significantly less time for approval, and move to disburse quickly. Multiphase loans require about half as much time as standard investment loans to move from profile 1 to first disbursement. After approval, however, multiphase loans disburse significantly more slowly than standard investment loans. (See annex 15). The reasons for this pattern are not entirely clear, but they could relate to the novelty of the instrument or to the fact that disbursements continue to be managed through the Bank's standard procedures, themselves the source of significant delays in disbursement.
- 7.12 Specification of results, however, has been problematic in all of the new lending instruments. Management's 2002 review found that "Innovation loans have extensive log frame indicators, but many of these need to improve the focus on the broader objectives and outcomes of the operations," while in multiphase loans "75% of all operational staff indicated that Multi-Phase Loan procedures and triggers should be more clearly defined during project preparation."<sup>40</sup> OVE reviewed all 30 multiphase loans and found 224 specific trigger indicators, only 28% of which related to outcomes. The vast majority of trigger indicators relied on simple output measures.
- 7.13 It would appear, therefore, that the new investment lending instruments primarily improved on the speed of processing of initial approvals. Significant improvements in the specification of developmental intent, financial efficiency and results specification have not yet materialized.
- 7.14 Reform of sector/PBL operations has been less successful; it was based on many of these same themes that animated investment loan reform. A 1996 proposal from Management for substantial reform of the sector/PBL lending instrument rested on two premises. First, the nature of needed reforms in the region was changing from large, dramatic "stroke of the pen" reform of laws and regulations to a more complex and time consuming process of changing institutions. Such long-term reform processes entail significant fiscal costs, and supporting countries in reform requires instruments that finance expenditures rather than simply providing balance of payments support.
- 7.15 Second, the document noted an inherent problem of having the same instrument pursue two different objectives. "The balance of payments motivation for policy based lending often creates an environment in which the policy elements of loan become secondary to the primacy of balance of payments concerns"<sup>41</sup>. To reinforce the point, GN-1955 quoted a paper by professor Gustav Ranis who put the problem in theoretical terms:

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<sup>40</sup> Operational assessment of the flexible lending instruments

<sup>41</sup> GN-1955 Adjustment processes and IDB policy-based lending, 22 November, 1996

*One of the inherent difficulties which needs to be addressed is that, as Tinbergen tried to teach us generations ago, it is impossible to achieve two objectives with one instrument. If, in the wake of the Brady Plan, the MDBs are asked to pump out the money on behalf of debt relief we should not expect the obiter dicta concerning policy change to be taken very seriously by either party.*

- 7.16 This observation led Management to propose a new reform-oriented instrument, the Institutional Adjustment Loan (IAL) that would remove many types of policy reform from the sector/PBL instrument and placed them in a new instrument designed to finance the specific expenditures associated with reform objectives

*IALs in conjunction with traditional investment loans can finance a full range of actions that fall under the umbrella of a well-structured **sector** reform plan. The blueprint of this plan, developed and agreed upon with the borrower, addresses all major policy, institutional, and financial aspects needed to implement the reform, and it is the analytical tool to conceptualize, design, and execute the reform. Under the IAL items eligible for financing could include one-time expenses and, under specific circumstances, recurrent costs. An IAL could take the form of a stand alone operation, or it could be a component within a traditional investment loan.*

- 7.17 The sector reform plan was to be based on economic analysis to ensure that the proposed lending operation “will produce a substantial economic rate of return to the borrowing member country by significantly improving the efficiency and effectiveness of a given sector.”
- 7.18 The proposed new instrument would have only a reform objective, not a balance of payments one, and thus the size of the loan can be directly related to the costs of the reform being undertaken. Disbursements on such loans would be made directly to the executing agency in response to proof of actual expenditures, not to the Finance Ministry or Central Bank in response to proof of general imports. This would give the Bank much more control over the process of actual institutional change than is provided by a policy matrix.
- 7.19 Management’s efforts at reforming the sector/PBL instrument did not win the approval of the Board of Executive Directors, largely because the new vehicle was proposed to be offered within the 15% overall limit on sector/PBL operations at a time when demand for the instrument was running well in excess of the limit.
- 7.20 Both the successful effort to create new investment lending instruments and the unsuccessful effort to create a new reform instrument reveal a substantial range of common concerns with the existing set of instruments. Both attempts rest on the premise that the rules and constraints in existing instruments act to impede the joint efforts by Bank and country to devise effective solutions to development problems. Both emphasize the need to integrate policy reform with specific

expenditures, and both stress the need for designing and monitoring interventions in terms of results produced.

- 7.21 Finally, the most important commonality between the two efforts is their joint stress on programmatic and sector approaches as opposed to individual projects. The value of programmatic approaches was also stressed in the Board of Executive Directors' 1999 Institutional Strategy, which noted:

*The Working Group recommends that the Bank look closely at the creation of a "program loan" instrument which would permit the funding of both investment and reform components on a multi-year basis, with initial direction-setting by the Board of Executive Directors, periodic reviews of progress, and an expedited approval of subsequent phases of the program. Essential to the design of such an instrument is an explicit recognition that program loans should be adaptable to changing circumstances, provided that the adaptations serve to further the basic objectives of the loan. Given their broader design and the expectation of continued support over longer periods of time, program loans should be more closely tied to expected development outcomes and should be subject to impact assessment<sup>42</sup>.*

- 7.22 The successful efforts to create new investment lending instruments has, however, created a measure of confusion as to the precise nature of the instruments and the differences between them. Sector facilities, for example, closely resemble existing reimbursable technical cooperation loans, and it is not completely clear what activities can be supported only with the new instruments rather than the existing ones. Three of the proposed new instruments, sector reform investment loans, programmatic adjustment loans and time slice loans all share the common objective of financing a long-term program of expenditures in a given sector, rather than specific individual projects. They also share this objective with multiphase loans and sector facility loans already approved. Time Slice Loans, shown as "under study" in the 2004 progress report to Governors, are in fact already included in the Bank's operations manual as an existing lending instrument, and have been used since the early 1990s, albeit without being tracked as a separate instrument in the Bank's project data base.
- 7.23 Instrument proliferation thus creates its own potential problems. A Bank with multiple instruments, each with its own purposes, constraints and safeguards, requires its staff to approach country problems with the available instrument mix in mind. Problems will be assessed in terms of which instrument most closely matches the need, and where the match is imperfect, the rules and procedures governing the approval process will encourage adjustment of the need to fit the instrument. Where the need finds no match, staff face a choice between requesting a waiver of the rules of a specific instrument, devising yet another new instrument, or moving on to another problem better matched to available instruments.

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<sup>42</sup> GN-2077, paragraph 6.45

7.24 Requesting waivers and designing new instruments are time-consuming and complex activities, with uncertain prospects for success, giving staff strong incentives to approach problems with an eye to past precedents. A project that looks similar to already-approved projects using existing instruments has a much easier time moving through the review process, creating strong incentives to “sell” the borrower an existing approach rather than designing a customized solution. In conducting country program evaluations, OVE has repeatedly heard from country authorities the concern that the Bank promotes precedent-based solutions rather than custom-designing a new intervention.

7.25 This dynamic is very likely one of the major causes of the problem of expectations noted in the Bank’s Institutional Strategy:

*An ongoing concern for many of the Bank’s borrowers is that it is difficult to develop clear expectations about what the Bank can and cannot do. Countries often seek assistance in areas where the Bank has no clear policy, and staff are not always able to communicate clearly what is likely to be involved in bringing a new idea to a successful conclusion in the loan approval process. As a result, the Bank is seen as sympathetic, knowledgeable and approachable, but also capable of disappointing the high expectations raised by these relationship qualities<sup>43</sup>.*

7.26 Paradoxically, the very attempt to meet emerging needs with new instruments encourages the perception that the Bank has an instrument for every need and the only task of programming is to find the right match.

7.27 This potential problem with instrument proliferation has been recognized by Management. In a 2003 document discussing the issue of “flexibility in lending”, the following cautionary note was raised:

*The growing inventory of lending instruments, each with its own set of conditions, increasingly threatens to become as difficult to manage as the numerous technical cooperation trust funds administered by the Bank on behalf of their sponsors<sup>44</sup>.*

7.28 This recognition signals an important potential shift in thinking at the IDB, a shift that is in many ways similar to the responses made at the World Bank to the same problematic.<sup>45</sup>

## **2. Instrument Reform at the World Bank**

7.29 Much the same dynamic regarding reform of instruments has been played out at the World Bank. Changing country needs were met by designing new instruments, and by 2002 the World Bank had 16 specific lending instruments,

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<sup>43</sup> GN-2077-1 Paragraph 4.1

<sup>44</sup> CC 5876 Flexibility in Lending, 21 July, 2003

<sup>45</sup> For an elaboration on the current thinking in the Bank on this question, see GN-2272-1 “An approach for further development of lending instruments and operational policies”

divided into the same two basic “families” of investment lending and adjustment lending. Many of the instruments are virtually identical to those offered by the IDB. (See Annex 16).

**Box 7.1: Modernization of the Operational Policy Framework for World Bank Lending**

The Bank’s current work on modernizing the operational policy framework for investment lending and adjustment lending is part of a broader reform effort that has several key objectives common to both instruments:

- ***A more efficient and user-friendly operational policy framework.*** Despite updates and additions during the past two decades, the Bank’s operational policy framework remains fragmented, difficult to use, and, in some cases, outdated. The reform effort aims to provide staff and clients with a clear, coherent, and comprehensive policy framework for investment lending and adjustment (policy-based) lending.
- ***Modernized lending instruments that can more flexibly respond to today’s client demands and varying country circumstances.*** Client-responsive lending requires adaptable tools for providing financing to address clients’ diverse needs—whether for tangible impact at the local level or broad policy-based reforms. It also requires the ability to finance the wide range of expenditures needed to achieve development objectives.
- ***Faster processing of projects/operations.*** Client responsiveness also requires the provision of timely financing. Simplified procedures, clearer guidelines, and better documentation are expected to help reduce unnecessary delay without compromising quality or compliance with the Bank’s policy standards.
- ***Greater emphasis on country systems and country capacity.*** The policy modernization is intended to recognize and codify the progress made in recent years in complementing the traditional project-specific approach to the application of fiduciary and safeguard policies with recognition of the benefits of a country- and sectorwide perspective and a capacity-building approach. The aim is to strengthen and broaden the impact of the Bank’s fiduciary and safeguard policies through greater attention to country systems and country ownership, with appropriate measures for country and sector diagnostics, capacity building, and, where appropriate, reliance on country systems.
- ***More effective implementation and results on the ground.*** Bank-financed projects need to be implemented with a stronger focus on outcomes, rather than merely on inputs and outputs. This will require new efforts by borrowers to measure outcomes and use this information in project management. The Bank will need to reorient its supervision of projects toward results.

**FROM ADJUSTMENT LENDING TO DEVELOPMENT POLICY LENDING: UPDATE OF WORLD BANK POLICY, March, 2004**

7.30 In the past few years, however, the World Bank has undertaken a comprehensive review of how it conducts business, and this process has generated a profound change in the way that institution addresses issues of lending instruments.

7.31 The basic elements of the new strategy are shown in the Box 7.1, taken from the recent updating of the World Bank’s adjustment lending policy. It is based on a “country business model” that builds a program of support on the country’s institutions and development agenda<sup>46</sup> and substantially eliminates earlier constraints and safeguards built into individual lending instruments.

7.32 The most obvious change is the elimination of instruments. The new adjustment lending policy (March, 2004) eliminates existing specific instruments--sectoral

<sup>46</sup> “The approach is embodied in the Bank’s country business model, which takes the country’s vision for growth and poverty reduction as the point of departure for the Bank’s business strategy, with Bank support closely coordinated with that from the IMF and other development partners” From Adjustment lending to Development Policy Lending.

adjustment loans (SECALs), structural adjustment loans (SALs), rehabilitation loans (RILs), and programmatic structural adjustment loans (PSALs)—in favor of a single adjustment lending instrument called a Development Policy Loan. The new instrument has no pre-defined limits on what could be financed, nor on the number of tranches, and contains a presumption in favor of fewer conditionalities and more selectivity<sup>47</sup>.

7.33 The new Development Policy loan retains, however, one feature of the existing adjustment lending instruments: the dual role of supporting both policy reform and country balance of payments needs. In the operational policy matrix, such loans are described as providing: “*financing in support of a program of policy measures, based on actual or anticipated financing needs that stem from balance of payments or fiscal origins*”. Unlike the IDB’s proposed Institutional Adjustment Loan instrument, the Development Policy Loan instrument thus retains the “two objectives, one instrument” problem noted by professor Ranis.

7.34 At the same time, major changes have been introduced into investment lending instruments. In March of 2004, a thorough review of the costs imposed by existing rules on eligible expenditures found that most of these did not contribute to development, and many were in fact counter-productive. It concluded that “*...over time, a clear disconnect has emerged between expenditures that borrowers need to incur to achieve their development goals, and those that the Bank may finance under its current policies.*”

7.35 On the strength of these arguments, the World Bank eliminated most rules on eligibility in favor of a simple set of guiding principles. (See Box 7.2).

**Box 7.2: Guiding Principles on Eligible Expenditures**

The proposed new eligibility policy rests on three guiding principles: (a) expenditures to be financed in whole or part by Bank loan proceeds should be judged to be productive; (b) the impact of Bank-supported operations on fiscal sustainability should be assessed and judged to be acceptable; and (c) each activity financed by Bank loan proceeds should have acceptable oversight arrangements, including fiduciary oversight arrangements, to ensure that loan proceeds are used only for the purposes for which the loan is granted, with due attention to considerations of economy and efficiency.

*Eligibility of Expenditures in World Bank Lending: A New Policy Framework, Operations Policy and Country Services, March 26, 2004*

7.36 From the point of view of instruments, these new rules on expenditure eligibility were explicitly designed to eliminate a number of key

<sup>47</sup> “Current operational policy has no specific requirement about the number of conditions, but recent research has revealed a negative relationship between the number of loan conditions and loan outcomes, especially in countries with weak capacity and below-average policies.<sup>63</sup> Since conditionality must by nature be country- and operation-specific, it is proposed that the new operational policy would leave the number and nature of conditions to be determined at the operational level. At the same time, reflecting research findings and experience to date, good practice guidance to staff would suggest limiting the number of conditions and focusing them on priority actions that are fully owned by the country and essential for achieving the objectives and outcomes of the operation—shifting Bank practice from a presumption of breadth and comprehensiveness of conditions to a presumption of greater focus

distinctions between adjustment lending and investment lending. The rationale for this change was that different eligibility rules in the two instruments created potentially perverse incentives that could encourage countries to make inappropriate development choices simply because of differences in eligibility rules in the instruments:

*The choice of instruments, particularly between investment and adjustment loans, has at times been unduly affected by differing rules on eligibility for financing. Yet these rules obscure the similarities between the two types of instruments, in terms of how funds actually flow and in their ultimate financing of balance of payments and budget support. This suggests that, at the country level, the current eligibility framework for investment lending adds little if any substantive value, while its procedural intensity and costs may at times lead borrowers to prefer adjustment lending when investment lending would be more appropriate.*

- 7.37 Finally, the document that compressed all adjustment lending into a single instrument also suggested that a similar change would be made for investment lending instruments, stating:

*The modernization program also is expected to include a carefully designed proposal to replace the current multiplicity of rigid, specialized investment lending instruments with a more flexible, client-responsive product. Preliminary thinking is that there should be a single investment instrument with features that can be “mixed and matched” according to the objectives of the project and the client’s assessed capacity.*

- 7.38 The World Bank has thus committed itself to a radical simplification of lending instruments, opting for just two basic types, one for financing investment and one for financing policy change.

- 7.39 On the issue of fiduciary safeguards, the World Bank recognizes their continued importance, but is looking to move the locus of such safeguards from the individual instruments to the country program level. (see Chapter VIII). The new approach is seeking to reduce the safeguards and attendant transaction costs built into individual projects, and seek instead to integrate the financial oversight of World Bank financial flows with the country’s own procurement and fiduciary management systems.

## **VIII. PROGRAMMING, INSTRUMENT MIX, AND COUNTRY FOCUS**

- 8.1 In this final chapter, the evaluation will explore the Bank’s processes for deploying its various instruments to meet country development needs. As noted earlier, the IDB-8 Agreement begins the discussion of Bank lending instruments with a section titled “programming as an instrument,” suggesting that the first task of the Bank is to use such a process to appropriately match Bank instruments to

- country need. The primacy of this process is often called “country focus,”<sup>48</sup> and improving country focus has been the principal objective in all recent reforms of Bank organization and practice.
- 8.2 Country focus means programming the use of instruments to solve problems effectively. Good programming starts with a deep understanding of the causes of observed problems and moves from there to the design of interventions that yield a clear flow of benefits to the country. A complete programming process would also allow the Bank to compare all proposed interventions along a common scale of value (such as the present value of their future flows of benefits), so as to be able to select the package of interventions that, in combination, yields the largest benefit to the country in relation to future debt service costs.
- 8.3 Finally, a complete programming process would also closely integrate proposed Bank actions with the country’s own planning and resource allocation systems. Since domestic resource flows dwarf Bank disbursements in virtually any area of activity, the developmental payoff of an operation can be multiplied if it can spark efficiency improvements in the existing flow of domestic resources.
- 8.4 The need for this kind of integrated approach is confirmed by the recent literature on economic development which is placing heavy emphasis on coordination failures, timing and sequencing of actions, network effects and synergistic reinforcement effects in designing successful strategies for national economic development.
- 8.5 This kind of programming process is, however, only in the early stages at the IDB. New guidelines for country strategy preparation were approved by the Board of Executive Directors in 2002, and these move the Bank in the direction of increased rigor of programming. The actual practice of programming, however, remains some distance away from these objectives.
- 8.6 Over the past three years, OVE has analyzed the programming process itself, conducted 17 country program evaluations (and another 6 under development), and in 2004 is conducting an evaluability assessment exercise for all new country strategies being presented to the Board of Executive Directors. These exercises describe a current programming process with the following characteristics:
- Problem diagnosis for the countries is inadequately connected to analytical economic and sector work. This leads to vague and non-specific descriptions of country problems and development needs.
  - There are few outcome goals established for the Bank’s engagement with the country at the program level, and projections of future benefits are infrequent.

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<sup>48</sup> The Bank’s Institutional Strategy notes: “*It is an essential tenet of this report that, instead of attempting to do everything in every country, the IDB should concentrate in doing different things in different countries. In other words, the IDB should substantially increase the country focus of its operations*GN-2077-1 paragraph 6.22.

- In the absence of program-level specifications of country need, each individual operation establishes its own framework of needs to be addressed.
- Programming does not compare the various proposed interventions with one another in terms of a common scale of value (e.g. economic rate of return). This makes prioritization a subjective and not an analytic exercise.
- Private-sector operations are poorly integrated into country programming, and generally are not programmed with an adequate understanding of the market failure they are designed to remedy. Lacking such analysis, they are generally unable to specify clearly their additionality.
- Most country strategies do not contain an analysis of the financial capacity of countries to bear the debt service costs associated with the proposed program of Bank lending, and thus provide adequate safeguards against the financial risks to both the Bank and the borrower.
- Projects tend to be islands, one-off interventions largely isolated from larger budgetary processes in the country.

8.7 Consequently, country programming has yet to provide an adequate approach to developmental needs assessment that would allow the Bank to set priorities, evaluate trade-offs, make strategic choices among alternative approaches, integrate with domestic resource flows or evaluate the financial prudence of increasing country indebtedness.

8.8 Although the World Bank does not meet all of the criteria for a fully complete programming process, its new “country business model” discussed in the previous chapter places a dramatically increased set of responsibilities on the country programming process. After the significant revision of policy in 1995, CAS reports are required: to focus on “*the four or five most critical development issues in the country*”, thus forcing prioritization; to include detailed treatment of economic and sector work used to construct the Bank’s program; to provide an assessment of “*creditworthiness and exposure*,” ensuring a full treatment of financial flows and debt carrying capacity; and for countries undertaking major structural adjustment, to evaluate “*the sequence and timing of reforms*” and to establish triggers in the CAS itself that link the size of the overall World Bank lending program to progress on policy reform<sup>49</sup>.

8.9 Parallel to these developments in the CAS, the World Bank has also substantially increased its efforts to integrate its program with existing budgetary resource flows in the country. A majority of adjustment lending operations are now supported by public expenditure reviews<sup>50</sup>, a reflection of the view noted earlier

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<sup>49</sup> Quotations in italics are taken from the World Bank Operations Manual, section BP2.11 Annex A Country Assistance Strategies.

<sup>50</sup> Adjustment Lending Retrospective, paragraph 13.

- (see Box 7.1) that loans providing fungible resources for budget support to the country are developmentally effective only to the extent that overall public expenditures are efficiently and effectively managed.
- 8.10 To further the objective of improving the country's own resource allocation process, new assessment tools have been developed. The Country Financial Accountability Assessment (CFAA) and the Country Procurement Assessment Report (CPAR) are designed to both improve resource management in the country and establish the basis for substantial delegation to the country of fiduciary responsibilities in the management of World Bank resources. Such delegation, in turn, facilitates the closer integration of World Bank activities with country budgetary processes.
  - 8.11 At the World Bank, therefore, major changes in the approach to country programming have provided the context within which reform of individual lending instruments takes place. The trend toward relaxing restrictions at the instrument level, noted earlier in this report, has been accomplished in a context where programming is more analytically rigorous and where assessment of accountability and procurement systems in the countries support increased operational flexibility.
  - 8.12 At a conceptual level, these changes are shifting the locus of safeguards from individual instruments to the programming process. CAS triggers start to replace policy conditionalities in adjustment loans, procurement assessments allow replacement of World Bank systems with country systems, programmatic approaches to a sector start to replace individual project interventions.
  - 8.13 Such changes are moving the World Bank toward a situation where **there are no instruments**, there are only countries with development needs. Those needs are addressed with programs of financial assistance integrated with country budgetary processes that provide a clear positive economic rate of return by supporting a combination of policy reform, asset creation and efficiency improvements in existing resource flows. What matters is the return provided by the package, not the individual elements in it.
  - 8.14 The IDB has approached a similar set of issues with a somewhat different approach, as the World Bank did at an earlier stage creating new instrument varieties to respond to emerging needs. Programming becomes a process of matching country needs to the constraints and possibilities inherent in individual lending instruments. The risk in this approach is that it can substitute "instrument focus" for "country focus" in the relationship between the Bank and the countries.
  - 8.15 The economic realities of the region are, however, too complex for such a simplistic approach, and programming involves much more analytic effort than simply matching problems to existing instruments. This is made abundantly clear in the challenges posed to the Bank by the evolving financial dynamics with the borrowing member countries.

- 8.16 Historically, the Bank was a significant net supplier of financial resources to the borrowers. Bank disbursements added to the resource envelope available for deployment through the budget by country authorities. Programming in such an environment could easily focus on adding value through turning positive net flows into productive assets in the countries.
- 8.17 Since 1994, however, the Bank has significantly expanded its net lending as it has grown into the lending capacity created by the IDB-8 capital replenishment. As the Bank has grown, so has its stock of debt outstanding upon which interest must be paid. Payments to the IDB of both interest and principal have risen sharply in response to the past growth in lending, and in 2003 these repayments more than offset all of the new disbursements made by the Bank. Net loan flow (disbursements of principal minus repayment of principal) has declined sharply from its peak in 1999, while net cash-flow (net loan flow minus interest payments) has actually turned negative, transforming the Bank from a significant net supplier of resources to being a net taker of resources (See Figure 1.1).
- 8.18 A considerable part of the observed shift is accounted for by emergency lending and may thus be temporary, but the underlying trend is pushing the Bank steadily in the direction of becoming a net taker of resources. Once the Bank exhausts the lending authority created under the IDB-8 agreement and reaches its “sustainable level of lending”, the best it can do for the region as a whole is match principal repayments with new principal disbursements (loan flow neutral), while being a taker in cash flow terms due to interest on the outstanding loans. These changes are an inevitable consequence of past lending, and the negative cash flow picture is likely to worsen if interest rates on the large corpus of outstanding debt rise in the future.
- 8.19 In a world of neutral or negative transfers, programming can no longer assume that Bank resources are going into new asset creation. Since money is fungible, in a net neutral situation, it cannot be determined with precision whether new disbursements are simply financing repayments of principal or creating new assets. If the multilateral banks are to provide value added in a context of net neutral resource flows, programming will need to find economic returns to the country in the form of efficiency gains in the country’s own flows of resources.

## **IX. FINDINGS AND RECOMMENDATIONS**

- 9.1 This evaluation has reviewed the Bank’s lending instruments in light of the goals set for the institution in its Charter, and in subsequent decisions of its Governors regarding the role and purpose of the Bank. These guidance documents establish that development impact for a loan-making institution is achieved by financing both asset creation and efficiency improvements that together generate a future flow of benefits to the country that exceeds the future costs of debt service

- 9.2 Existing Bank instruments do not contain adequate safeguards to ensure that these objectives are met. A majority of investment loans are not designed with future rates of return in mind, and disbursements on investment lending do not appear to flow exclusively to public sector capital formation. Investment loans to the private sector tend to have reasonably well-specified project-level rates of return, but generally fail to identify the market failure they are addressing and thus fall short in terms of specifying the additionality of Bank finance to the project.
- 9.3 Sector/PBL instruments (including emergency PBLs) have dual objectives of providing country finance in times of stress and supporting policy reforms. They have been generally successful in accomplishing their country finance objectives, although the long-term returns to this activity are difficult to establish. It is even more difficult to establish their effectiveness in inducing policy change, given the multiple determinants of such change, the changing nature of desired reforms, and the nature of the link between policy reform and economic results.
- 9.4 If the current instrument safeguards do not ensure the development effectiveness of the instruments, they do contribute to some obvious problems. The costs of compliance with Bank procedures are high, both in terms of finance and in terms of time, and these costs are highest for investment lending instruments. As a result, disbursements on investment loans tend to be volatile, unpredictable and pro-cyclical, and the transaction costs associated with dedicated executing agencies are relatively high.
- 9.5 Sector/PBL loans have more predictable and countercyclical disbursement patterns, and thus provide finance more efficiently, but quantitative limits on both “regular” and “emergency” operations have led to crowding effects which have on occasion generated some inappropriate matching of instruments to country needs. In addition, the safeguards relating to tenor and pricing of the emergency instrument—designed to limit its use—have created their own financing problems for countries using the instrument.
- 9.6 Attempts to address problems with existing instruments have led to significant proliferation of new instruments, particularly in the area of investment lending. A number of common reform themes recur across the instruments: greater focus on results, improved monitoring and evaluation, a linking of reforms to expenditures, and the adoption of a programmatic as opposed to a project focus.
- 9.7 Many of the same issues have arisen at the World Bank, which had initially responded with a proliferation of new instruments, but has in the past few years made a significant shift toward instrument simplification and a strengthened country programming process. Their approach has moved safeguards from the individual instruments to the Country Assistance Strategy, and has sought to replace instrument-based fiduciary safeguards with the country’s own accountability and procurement systems to ensure responsible use of World Bank funds.

- 9.8 These changes suggest that the World Bank is moving rapidly to alter its fundamental business model from one based on individual projects financed with multiple discrete instruments, to one based on country and sectoral programs financed with a few, very broad instrument types. A “country business model” is replacing the World Bank’s traditional project business model.
- 9.9 Country needs are also evolving in a way that challenges the continued relevance of the project model of development finance. Fiscal restraints make it harder to manage the interface between domestic budgetary systems and internationally-financed, stand-alone projects, and the transaction costs associated with the project model make less sense in a world of increased fiscal accountability and transparency at the national level. Countries need for development finance institutions to integrate more effectively with domestic budgetary and accountability systems, and to combine policy and institutional reform with the financing of specific expenditures required to make reform effective.
- 9.10 Finally, fiscal limitations at the country level are matched by limitations in the capacity of the Bank to finance significant positive net resource flows. The legacy of past lending creates large debt service obligations that are approximately equivalent to available new disbursements, leading to a situation of rough neutrality in resource flows between the Bank and the region. In a “net neutral” world, the Bank and the borrowers will need to find ways of working together that provide measurable economic gains in how the countries deploy their existing budgetary resources, a task for which the project business model is not particularly well suited.

## **1. Recommendations**

- 9.11 On the basis of these evaluative findings, OVE believes that the Bank must adjust its practices in significant ways to respond to the changed environment. While the Bank needs to consider the practices of other comparable institutions in making these adjustments, it must find its own new model, built on the needs of the region and the comparative advantages of the institution.
- 9.12 To further this process, OVE would make the following recommendations to the Board of Executive Directors regarding the design of the lending framework for the next lending period.
1. Deepen substantially the analytical underpinnings of all Bank operations. All proposed interventions, whether focused on new investment or on efficiency gains through policy reform, should describe clearly the future economic and financial returns anticipated, and compare those returns analytically to the future costs of the debt acquired to finance them.
  2. Focus on countries rather than instruments. Instruments are tools for producing economic gains for the countries, and it is the generation of gains, not compliance with rules and procedures built into instruments that should be the focus of Bank activity. This requires further efforts to

strengthen the country programming process taking as a point of departure the guidelines set by the Board of Executive Directors in 2002. Country strategies should focus on a strategically-selected, limited range of problems and propose an integrated package of shorter and longer term solutions that provides the highest possible return to the country, without regard to pre-defined notions of appropriate instrument mix.

3. Seek greater integration of Bank activities with those of the country through the implementation of program-focused rather than project-focused interventions. The task of development is to maximize the economic returns of the combined efforts of the Bank together with the borrower, not simply those of the Bank.
4. Fiduciary safeguards on the use of Bank resources need to be maintained, but a strong case can be made for joining with other multilateral organizations in developing and applying best practices for assessing country fiduciary management capacity and delegating such functions to those countries whose oversight institutions are deemed adequate. This would move such safeguards from the level of individual projects and instruments to the level of the country as a whole. The Bank should work closely with the countries to ensure an effective transition to this new approach for addressing the issue of safeguards.
5. In light of a strengthened country programming process, the Board of Executive Directors should consider a significant simplification of the Bank's instrument mix. Since both policy reform and specific investments are components of effective programmatic approaches, both should be financeable with the same instrument, thus ending the distinction between investment loans and sector/PBL loans.
6. A separate instrument will likely continue to be needed to address issues of country finance in exceptional circumstances. While such financing is the principal responsibility of the IMF, the Bank has been called upon in the past to co-finance such lending and should have an efficient and streamlined instrument for providing whatever degree of participation the Board of Executive Directors agrees to provide. Given that such financing is needed at times of particular financial vulnerability, the current practice of charging higher rates and requiring shorter amortization periods on such lending should be re-examined and possibly be replaced with terms and conditions more suited to borrower capacity to repay.

## **DEBT AND DEVELOPMENT**

Over the past several years, the Bank, along with the UNDP, CEPAL and numerous other institutions and researchers have documented a vast range of development needs in the region. Attention has focused on inadequate growth, slow progress in poverty reduction and human development, ineffective institutions of governance, stagnant competitiveness, inadequate physical and human capital, persisting high inequality and a range of other issues. Each of these has merit, and all are legitimate objectives for attention by those concerned with development. In theory, a development institution could create interventions designed to address any of them, and could demonstrate its “development effectiveness” by producing measurable progress in whatever areas it chose to address.

In the case of the Bank, however, the development of loan operations to address development needs must take into account the particular features of debt as a source of finance for development. Loans create both current positive financial flows (of both interest and principal) some years after disbursement. Unlike grants, debts must be repaid by the borrower out of future income, and this creates a number of issues that are uniquely associated with debt-financed development aid.

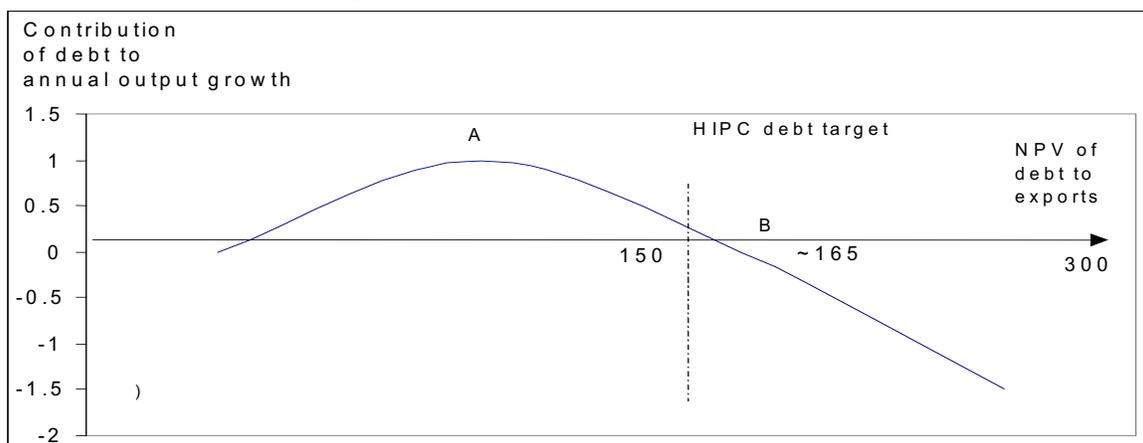
The first of these has to do with the inter-temporal nature of the debt contract. Debt creates the capacity to spend today by creating a claim on income tomorrow. For households and firms, the same individuals are on both sides of the transaction, both receiving the current proceeds and being liable for future repayments. In the public sector, however, the inter-temporal nature of debt creates a potential moral hazard, since regimes can contract debt and undertake spending today, secure in the knowledge that some other regime will be responsible for picking up the costs of debt service in the future.

These incentives lead to a second problem with debt, namely that it is possible for a country to take on more debt than it can manage. While all debt allows for an expansion of current spending, the future debt service obligations can potentially exhaust either the capacity to mobilize domestic resources (a fiscal issue), or the capacity of the economy to generate sufficient export earnings to cover hard-currency repayment obligations (a transfer issue). Historically, such situations have arisen frequently in the region, leading to either formal default or negotiated debt reductions such as the HIPC initiative.

For this reason, both the IMF and the World Bank have developed elaborate “debt sustainability” models that are designed to identify and forecast situations where countries run the risk of having more debt than they can service. A review of the empirical literature on debt sustainability suggests that there is a curvilinear relationship between debt and growth: in the early stages of debt accumulation, taking loans contributes to GDP growth. However, after a turning point estimated to be in the neighborhood of 120% of the net present value of debt to exports (point “A” on Figure 1), further debt accumulation has diminishing returns and at some point, taking on debt

has a negative impact on economic growth (point “B”).<sup>51</sup> Recent empirical work by IMF staff has strongly suggested that the threshold past which debt burdens become problematic may in fact be very much lower, perhaps as low as 15% of GDP in “debt intolerant” countries.<sup>52</sup>

Figure 1: Relation Between Debt and Growth



This relationship is derived from cross-sectional analyses of many countries, and it is difficult to predict precisely where a given country is on this continuum at a given point in time. Recent empirical work at the IMF suggests that high levels of debt act to depress future GDP growth through two different effects on investment. A large debt overhang raises uncertainty regarding the future stability of the country, and thus depresses private investment. High debt service costs directly impinge on available public sector resources, and thus “crowd out” public sector investment spending. These two investment effects also have the result of lowering total factor productivity growth in countries with a large debt burden<sup>53</sup>.

It is important to note that debt problems are defined by the ratio of debt to such variables as GDP or exports, and it is these ratios that hold the key to the prudent use of debt for development purposes. If countries take on debt to finance activities that improve growth in GDP or exports, then such debt accumulation poses little threat to the future economic health of the country. Calculating the return on investments financed with debt is thus an essential exercise in assessing the sustainability of debt assumption over time

<sup>51</sup> On the construction of the curve, see Cohen, Daniel, 1993, “Low Investment and Large LDC Debt in the 1980s,” *American Economic Review*, Vol. 83, No. 3 (June), pp. 437–49. For empirical confirmation on the relationship, see Pattillo, Catherine, Hélène Poirson, and Luca Ricci, 2002, “External Debt and Growth,” IMF Working Paper 02/69 (Washington: International Monetary Fund). See also Hansen H., and F. Tarp “Aid Effectiveness Disputed” *Journal of International Development*, vol.12, no.3, pp. 375-398. 2000, R. Lensik and H. White “Is there a Aid Laffer Curve” *Credit Research Paper*, No.99/6, University of Nottingham, 1999, and “Are there Negative Returns to Aid” *Journal of Development Studies* Vol. 37, No. 6, 2001.

<sup>52</sup> “Debt Intolerance,” Carmen M. Reinhart, Kenneth S. Rogoff, and Miguel A. Savastano NBER Working Paper No. 9908 August 2003

<sup>53</sup> Benedict Clements, Rina Bhattacharya, and Toan Quoc Nguyen External Debt, Public Investment, and Growth in Low-Income Countries *IMF Working Paper* WP/03/249, Fiscal Affairs Department, 2003

The consequences of not attending carefully to debt sustainability can be seen clearly in the HIPC initiative. HIPC acknowledges that multilateral creditors, including the IDB, lent a number of poor and vulnerable countries more than they could afford to repay. Stated another way, past multilateral lending had failed to create the assets that would have allowed the country to grow in a manner adequate to service their external debt obligations. To restore debt sustainability, IDB estimated that it needed to grant approximately \$1.1 billion in present value of debt relief.<sup>54</sup> Thus the countries suffered losses associated with piling up unsustainable debt, while the Bank suffered losses as a result of having to grant debt relief.

While the HIPC countries have been an extreme case of debt obstructing development, a recent CEPAL report suggests that the potential problematic consequences of debt accumulation may affect a number of other countries in the region as well.

*The gross external debt of Latin America and the Caribbean as of December 2003 totals some US\$ 744 billion, which represents a 2.4% increase. This result signals a break with the nominal declines seen in 2001 and 2002. The level of the debt is thus similar to what it was in 2000 (see table xx). ...Although the increase in the external debt has been manageable in the short run, thanks to low international interest rates, the size of the debt is a worrisome structural factor, and the debt's management will become a more difficult proposition if international interest rates and risk premiums rise in the future.*

Even if debt accumulation does not lead to a financial crisis, a large debt burden can severely hamper a country's ability to address social needs and poverty reduction, a key overarching goal of IDB operations. A recent report on the HIPC initiative by the World Bank's evaluation department noted that: *The underlying and plausible premise is that excessive debt is an impediment to the broader development goals of sustainable economic growth and poverty reduction.* This impediment arises from the need for countries to use public revenues to run significant "primary surpluses" (revenues minus all expenditures except debt service) in order to service their large past debt obligations. Overall, the region's primary balance increased by almost 1% of GDP in 2003, (from a deficit of 0.3% to a surplus of 0.6%) limiting the capacity of governments to use fiscal policy as a stimulative tool despite weak overall growth rates.

Concern regarding debt is a major focus of IMF surveillance and support activities. Fund Article IV consultations for most countries in the region focus heavily on public sector debt, and IMF financial support programs generally contain specific targets for both overall and primary fiscal balances. Prior to 1997, multilateral lending had been excluded from IMF fiscal balance calculations on the grounds that such lending financed asset-creating "investment" which should be excluded from current deficit calculations because they would yield future fiscal returns., Since 1997, however, multilateral lending has been included in IMF calculations, a fact which has constrained country capacity to borrow from the IDB and other IFIs.

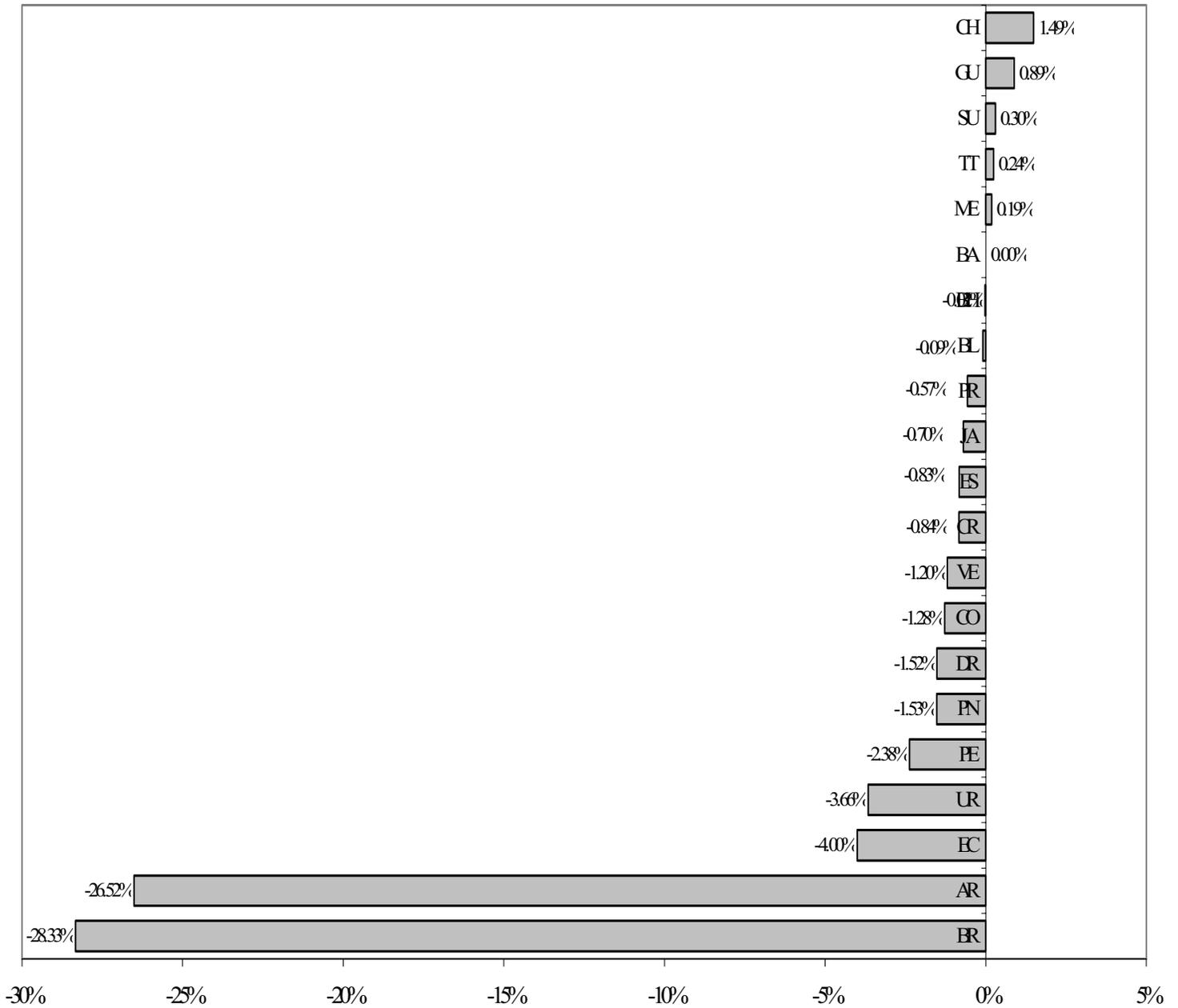
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<sup>54</sup> GN-1970-32

### DECOMPOSITION OF INVESTMENT LENDING DECLINE

The following chart shows a decomposition by country of the overall 70% decline in investment lending approvals between 1997-98 and 2002-03. The five countries at the top of the chart increased their acceptance of investment loans (thus lowering the total decline) while the remaining countries are shown with their individual contributions to the overall decline.

Figure 1



## EVALUABILITY

To determine whether projects articulate their anticipated results clearly and provide mechanisms for determining whether these results are achieved, OVE has developed a variety of approaches to assess project “evaluability.” In 2002 OVE used a multi-dimensional evaluability assessment tool to examine each project sent to the Board of Executive Directors for approval in 2001. Projects generally achieved low scores on this measure, with the weakest areas being the specification of current baselines and anticipated results at the outcome level.

For this report, a simpler approach to evaluability assessment has been used. This approach reviews each development objective declared for a project, then looks to see if this objective has four key components:

- indicators and metrics to measure progress;
- a baseline statement of the current condition to be improved upon,
- targets for anticipated improvement from the baseline,
- milestones to indicate the anticipated pace of progress.

Aggregating these assessments for every development objective in a given operation gives the “ex-ante” evaluability index for the project as a whole.

As the project executes, the Bank’s PPMR system is designed to track and report on progress. To determine whether information is being reported on outcome achievement, a second “progress index” is constructed, which again looks at each developmental objective for evidence of monitoring and reported on results.

Finally, a “minimum evaluability” index is computed, showing for each loan the percentage of developmental objectives that have both a baseline specification ex ante and information on progress during execution. The presence of these two data points constitutes a minimum base of information to assess developmental results.

These tools were applied to a sample of projects approved since 1990, and found the following results:

- (i) Ex ante evaluability –at the approval stage and implementation stage - has fluctuated from 33% to 55% with no discernable pattern of improvement.
- (ii) There are not much differences between instruments.
- (iii) The progress index is low and falling over time.
- (iv) Minimum evaluability (existence of two information points) remains practically zero
- (v) Although not formally assessed for this exercise, reading the loans and PPMRs suggests that the above face value calculations would be significantly reduced if outcomes were checked for quality.

Thus the Bank’s Monitoring and Evaluation system is not generally generating the minimum information to demonstrate development effectiveness, despite a number of

initiatives to enhance the quality of the Bank's monitoring and evaluation system and the time consuming review process during project preparation.

Figure 1: Simplified Evaluability

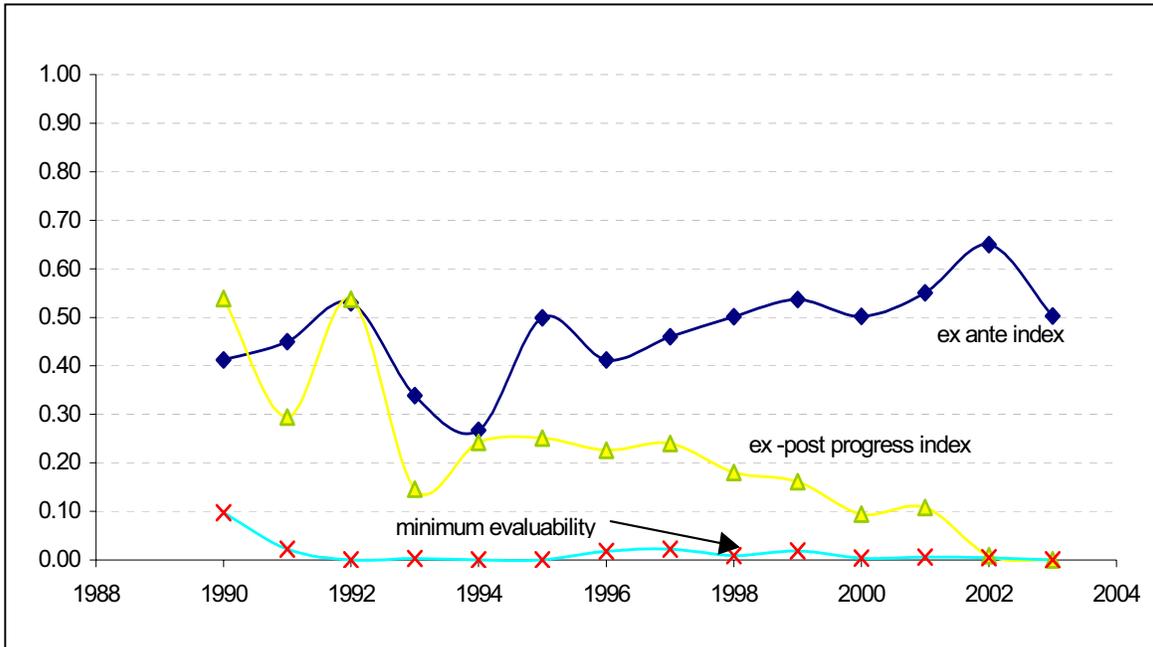
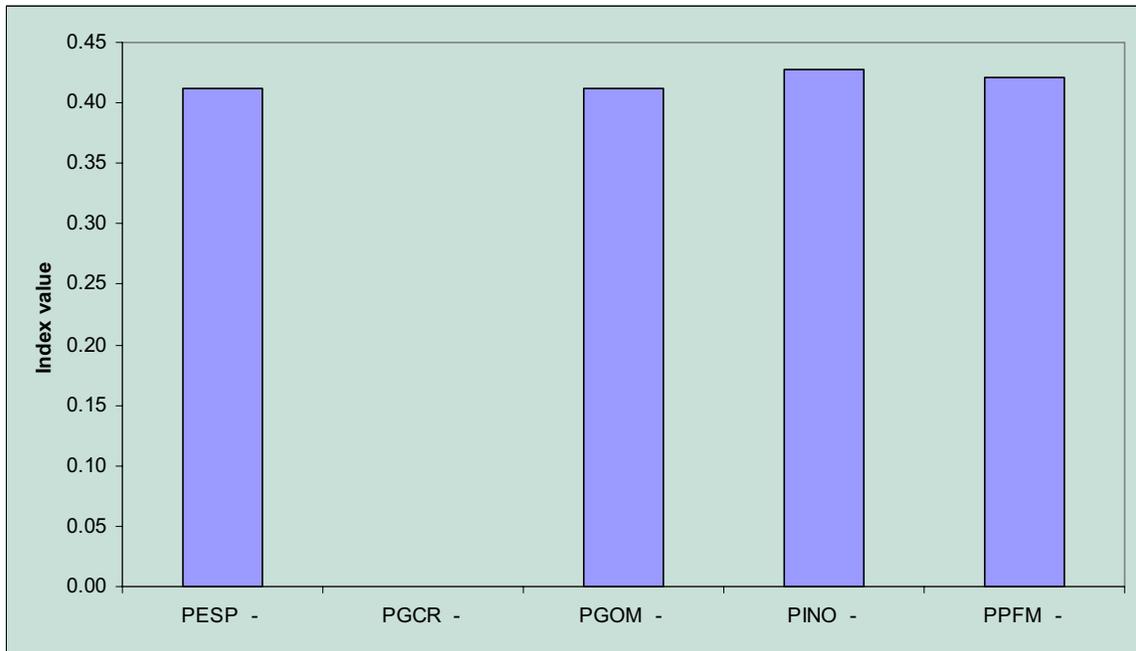


Figure 2: Ex-Ante Evaluability Scores



## 2. Description of Index

For the results based evaluability the following table is created and used in determining the quality at entry evaluability index, the minimum demonstrability index.

**Table 1: Results Framework**

Objectives	Indicators	Baselines 1	Milestones 2	Targets 3	Status 4
<i>Outcomes</i> <i>Goals</i> * * <i>Purpose</i> * *					
Outputs * * *					
<i>Note for the quality at entry evaluability index: (i) calculations are based on columns 1 to 4 that have been mapped from the Project's Loan Document; (ii) at the implementation state the same columns are mapped from the PPMR. The minimum results evaluability index uses information from column 2 and 4 derived from the project's PPMR. Only rows pertaining to outcomes are used in this report. Note that the distinction between goals and purposes begins to be made only after 1995 when the Bank adopted a "logical framework" for its investment loans.</i>					

The following steps are made:

- (i) The Results Framework is mapped to one with binary information: unity if there is data information, and zero if there is no information. The result is a  $N \times K$  matrix, i.e. with  $N$  rows and  $K$  columns, where  $a_{ij} = \{0,1\}$ ,  $i \in N$  and  $j \in K$ .

- (ii) The quality at entry results evaluability index is defined as  $EEI = \frac{\sum_{i=1}^n \sum_{j=0}^3 a_{ij}}{4N}$ ; where  $N$  is the total number of indicators of goals and purposes, represented by rows in the matrix as specified above.

- (iii) The minimum evaluability index is  $MEI = \frac{\sum_{i=1}^n a_{i1} \times a_{i4}}{N}$ , i.e. the ratio of those outcome indicators with information for both baseline and status, respectively in columns 1 and 4, over the total number of outcomes indicators ( $N$ ).

**PREPARATION TIMES**

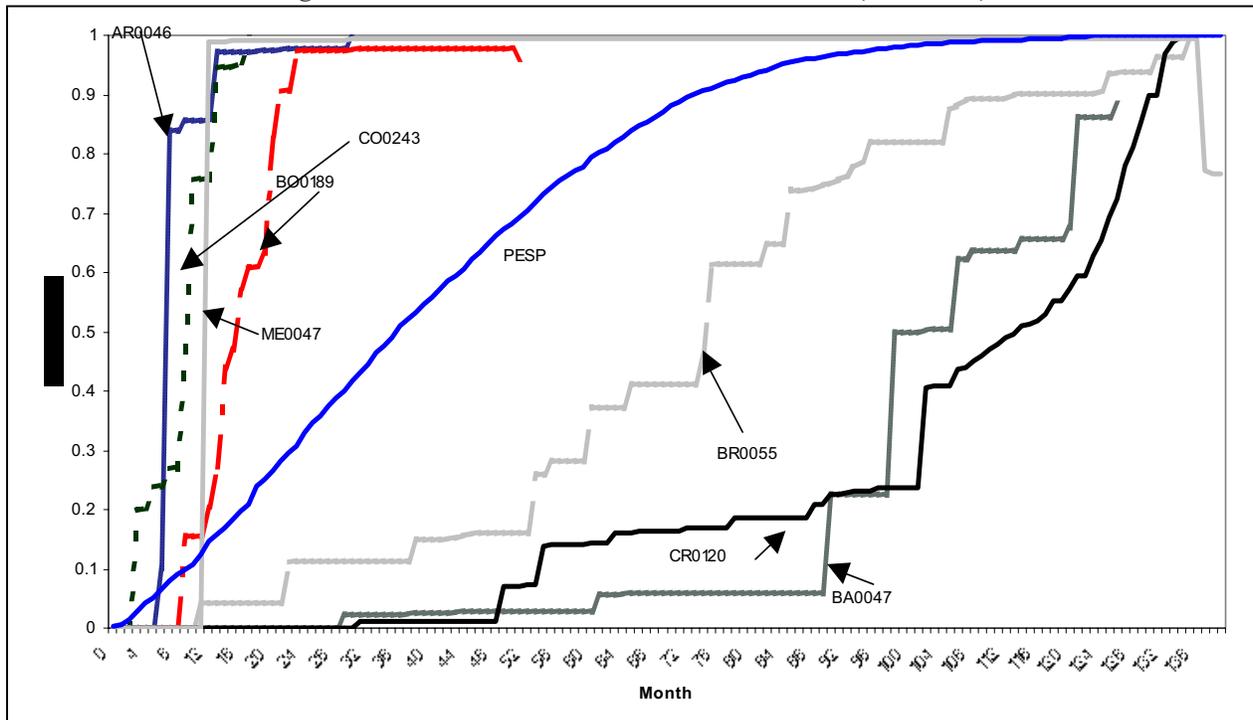
**Table 1: Preparation and Execution Time: Averages by Instrument**  
Averages in  
Months

<b>Instrument</b>	<b>Profile I To Approval</b>	<b>Approval To Signature</b>	<b>Signature To First Disbursement</b>	<b>First Disbursement To Close Date</b>
PCTR	13.93	4.49	12.10	58.23
PEMG	5.13	1.92	0.64	14.08
PERF	0.00	2.13	2.25	17.20
PESP	22.35	4.35	12.88	73.84
PGCR	21.06	5.57	10.87	57.97
PGOM	22.74	4.57	11.48	79.37
PGPR	12.18	3.55	14.60	82.16
PHIB	20.26	1.74	9.66	81.68
PINO	7.79	3.32	7.68	n/a
PPEF	0.00	1.91	4.36	19.74
PPFM	15.79	2.63	9.44	n/a
PPPF	24.56	1.83	4.82	28.75
PPRV	14.38	6.18	2.28	16.88
PSCT	12.54	2.13	4.32	44.71
PSEF	7.19	4.73	5.26	n/a

### DISBURSEMENT PATTERNS

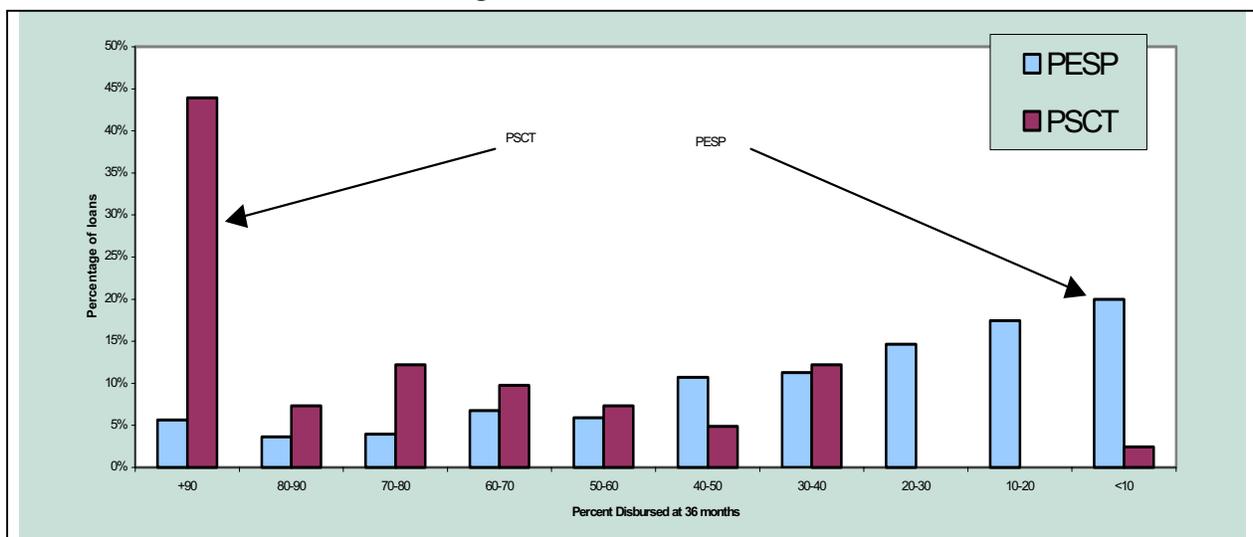
The first chart below shows the considerable range in possible disbursement patterns for investment loans (PESP). The fastest disburse like emergency loans, while the slowest can take as long as 9 years to achieve a 50% disbursement level.

**Figure 1: Fastest and Slowest PESP Disbursement (1990-2003)**



The second chart looks at the distribution of disbursement percentages at 36 months after approval. Over 40% of the total number of investment projects were less than 20% disbursed by 36 months, while over 50% of sector/PBL operations were over 80% disbursed at the same point in execution.

**Figure 2: Disbursement Deciles**



### CYCLICALITY AND VOLATILITY

The potential development effectiveness of Bank's operations would be enhanced if disbursements can be characterised as having low relative volatility and are counter-cyclical. If in contrast, disbursements have high relative volatility and are pro-cyclical, this disbursement pattern would imply a lower than potential development effectiveness.

The indicators used in this study are:

- (i) *relative volatility*, that is the value of the coefficient of variation of loan disbursements to the coefficient of variation of tax revenue
  - A value greater than unity then disbursements are more volatile than tax revenue
- (ii) *cyclical*ity, that is the coefficient relating change (in logarithm) of tax revenue to change in (log) of IL disbursements:
  - A positive value of the coefficient indicates a pro-cyclical pattern; a zero coefficient showing a-cyclical relation; and negative coefficient indicating an anti-cyclical relation.

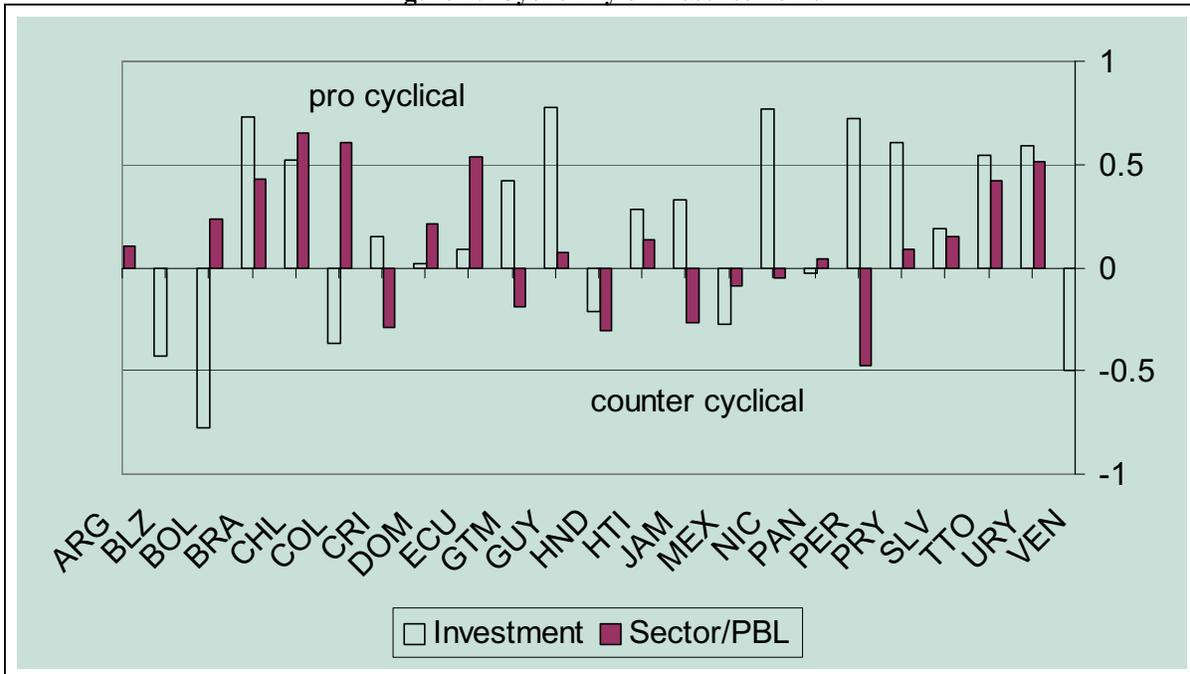
We find that IDB's disbursements (total and projected) are relatively more volatile than fiscal revenues and are generally pro-cyclical. For the period 1990-2003, the average coefficients for Latin America are 6.99 and 0.18. Differences are not very important when different subperiods are considered. Similarly occurs when we look either at investment loans or sector/PBL loans. For both instruments, volatility is higher than one and the coefficient of procyclicality is positive. As expected, PBLs are, on average, more volatile and less procyclical than investment loans.

**Table 1**

	<b>Relative Volatility</b>	<b>Cyclical</b> ity
Total	6.99	0.18
Investment Loans	6.40	0.20
Sector/PBL	16.72	0.11

Looking at country data, we found that for all borrowing countries relative volatility is greater than unity, that is disbursement volatility is greater than tax revenue volatility. The same evidence holds for investment and PBL loans. With respect to the cyclical of loan disbursements, there is substantial variation across countries, and while investment loans tend to disburse in a more pro-cyclical manner, sector/PBL operations also have such a bias in several countries.

Figure 1: Cyclicity of Disbursements



## SUMMARY OF FINDINGS ON SUPERVISION

During 2003, OVE conducted a study of the use of supervision instruments in the Bank. The report, Document RE-293, found that Supervision at the IDB is expected to serve two purposes: i) provide the Board of Executive Directors and Senior Management with the means of managing the risks that affect Bank-financed operations and ii) determine the extent to which such operations contribute to the accomplishment of the institution's development goals.

The evaluation focused on a quantitative assessment of Management's compliance with currently mandated formal supervision instruments, not with the qualitative results arising from these instruments in terms of improving project ability to produce result.

The evaluation concluded that:

- The Bank does not have an integrated and independent supervision system to anticipate risk. This renders management of much of the portfolio and the Bank's decision-making process ineffective.
- As there is no formal system of consolidated supervision, it is not clear who is responsible for risk supervision and management and how the different instruments relate to one another.
- Because project management is not based on risk assessment, the supervision instruments that exist are inconsistent with the supervision function and therefore inefficient and less cost effective.<sup>55</sup>
- There is no integrated, transparent, and readily accessible information system that can be used to anticipate and manage risk as well as to verify the extent to which supervision and internal control functions have been fulfilled.
- The Board of Executive Directors and Senior Management are not kept regularly informed on these specific issues.
- That shortcomings have been identified in the present system does not mean that the Bank does not monitor its operations but that institutionally, supervision is ineffective.
- As supervision is based mainly on mitigating contingencies as they arise, the procedures set out in Bank manuals and standards are not fulfilled and mechanisms not formally approved but considered more suitable by Management to correct such contingencies come into play.
- Informal contact is a fact of life in the field, but if information is not recorded formally, the institution loses its ability to hold staff accountable for performing supervision, as well as the ability to record lessons in a form accessible to the Bank as a whole.

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<sup>55</sup> The mandatory supervision instruments are compulsory for all operations, and are accorded equal importance with a similar level of risk in all operations, which minimizes the impact of the risks on portfolio management.

- The Bank's present supervision system is not in line with the best practices of other multilateral development banks, bilateral aid agencies, and governments in the member countries. In recent years, these bodies have been incorporating various practices to improve the quality of management and internal control supervision well as coordination of such controls with institutional objectives.

**PRIVATE SECTOR LOAN APPROVALS**

**Table 1: Approvals for Loans to the Private Sector**

	<b>Multisector Credit</b>			<b>Direct Lending (PRI)</b>	
	<b>US\$</b>	<b>Share of Total</b>		<b>US\$</b>	<b>Share of Total</b>
BR	3,759,700,000	29.96%	BR	952,364,113	28.61%
ME	1,823,800,000	14.53%	AR	516,063,000	15.50%
PE	895,925,882	7.14%	ME	403,078,612	12.11%
CH	890,719,386	7.10%	DR	375,000,000	11.27%
AR	846,200,000	6.74%	PE	253,085,360	7.60%
CO	571,855,029	4.56%	CH	207,000,000	6.22%
UR	510,172,796	4.07%	RG	189,000,000	5.68%
VE	487,214,047	3.88%	BO	127,000,000	3.82%
EC	465,078,200	3.71%	CO	109,450,000	3.29%
BO	385,408,333	3.07%	PN	60,294,559	1.81%
ES	375,300,000	2.99%	JA	30,000,000	0.90%
DR	251,820,000	2.01%	GU	25,000,000	0.75%
CR	222,702,700	1.77%	HO	24,200,000	0.73%
NI	210,230,000	1.68%	CR	23,700,000	0.71%
PR	166,947,400	1.33%	UR	22,500,000	0.68%
PN	141,800,000	1.13%	NI	10,750,000	0.32%
HO	138,700,000	1.11%	Total	3,328,485,644	
GU	132,400,000	1.06%			
JA	100,500,000	0.80%			
HA	87,900,000	0.70%			
TT	34,250,000	0.27%			
BH	27,000,000	0.22%			
BA	17,250,000	0.14%			
GY	6,000,000	0.05%			
Total	12,548,873,774				

*Note: Table excludes global loans to multilateral finance institutions and loans made under the Bank's emergency lending instrument.*

## **TRANSACTION COSTS FOR PRIVATE SECTOR PROJECTS**

Transactions cost associated with Private Sector projects are commonly reported by sponsors<sup>56</sup> as relatively high compared to those normally incurred in private deals or those associated with other development institutions. The typical transaction cost of a PRI project cost starts with US\$100,000 for analysis fee, charged to sponsors when the “Mandate Letter” is signed after the project receives eligibility for IDB financing, once approved by the Private Sector Coordination Committee<sup>57</sup>. This initial fee is only a small portion of several project related charges associated with the preparation of PRI projects and other charges associated with the financing<sup>58</sup>.

Additionally, PRI projects require the out-sourcing by the Bank of an important range of services that are also paid by the sponsor. PRI Officials and Sponsors interviewed reported the total amount of these services for project preparation it is usually around US\$1 million. The main components of this amount are: (i) Independent Engineer; (ii) Environmental Consultant; (iii) Economic Study; (iv) Insurance Consultant; (v) Local Legal Counsel; and (vi) US Legal Counsel. This last item is the biggest expense of all typically ranging from US\$700,000 to more than US\$1 million. Therefore a typical project, not counting special complexities in the contract or environmental or social issues, involves out-pocked expenses from the sponsors of US\$1,1 million or more. Considering that the average IDB financing per loan approved from 1995-2003 amounted US\$43 million, these costs involved approximately 2,6% of the amount lent by the Bank. This percentage increases to a 4,2% level for loans in C&D countries, which average is only US\$26 million, becoming an additional difficulty for conducting business in smaller countries or in smaller operations. The issue of cost is also reported by sponsors as a critical point during execution of PRI projects, particularly in environmental and social consultants, and specially in legal counsel costs.

Comparable institutions like the IFC often include the majority of the expenses as part of an appraisal fee charged to the borrower, in the range of US\$300,000. This institution relies on a greater amount of services provided as part of in house staff, charging only a limited amount of additional expenses for specific issues. Several sponsors interviewed reported that that type of approach in addition to less transaction costs provided more certainty and control on the total costs expected in association with the development and execution of a project.

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<sup>56</sup> In recent Missions to Chile, Dominican Republic, Mexico, Brazil, and Perú transaction costs associated particularly with the preparation, and also with the execution of Bank’s private sector projects are reported to be higher than those normally incurred in private deals or in financings from institutions such as the IFC. This fact is also being revealed in a survey that has been conducted by OVE from sponsors.

<sup>57</sup> Before 2003, this approval was granted by the Programming Committee of the Administration of the Bank.

<sup>58</sup> Other charges associated with the financing, consistent with business practices by other institutions (i.e. IFC) are: (i) supervision fees (normally US\$5,000 per B lender, up to US\$50,000); (ii) upfront fee 1%; (iii) commitment fee of 0.5% between signature and disbursement; (iv) structuring fee of 0.5. In commercial deals these charges change depending on the market conditions and the client relationship with the institution.

**PRIVATE FINANCING OF INFRASTRUCTURE IN THE REGION**

The following table, prepared with data supplied by a private investment research firm, shows that funds mobilized through public development finance institutions for the financing of private infrastructure account for slightly less than 20% of total private financing. While the aggregate totals show a level of private investment that is far below the region's needs, the data do suggest an active and functioning private market for infrastructure finance.

**Table 1: Private Sector Infrastructure and “Development” Institutions  
(1995 – 2004, % total financing y millions of USD)**

	<b>Préstamos directos</b>	<b>% (1)</b>	<b>Fin. Total</b>	<b>% (2)</b>	<b>Leverage (3)</b>
PRI-BID	1,857	1.49%	5,516	4.41%	33.7%
IFC	962	0.77%	5,823	4.66%	16.5%
CAF	212	0.17%	1,150	0.92%	18.4%
OPIC	827	0.66%	2,990	2.39%	27.7%
BNDES	3,865	3.09%	8,003	6.40%	48.3%
EIB	303	0.24%	443	0.35%	68.4%
EBRD	80	0.06%	80	0.06%	100.0%
MIGA	-	0.00%	578	0.46%	ND
CDB	-	0.00%	5	0.00%	ND
Development	(a) 8,106	6.48%	(b) 24,589	19.68%	32.97%
Total	14,117		(c) 125,095	100.00%	11,28%

(1) (Institution's bilateral loans)/(c)  
(2) (Institution's financing)/(c)  
(3) (Institution's bilateral loan)/(Institution's financing)

(a) Sum of bilateral loans granted by the above listed “development” institutions;  
(b) Sum of financing granted “under the umbrella” of the above listed “development” institutions;  
(c) Sum of loans, guarantees, and equity.

Source: Prepared by OVE based ProjectWare-Deallogic

## THE ECONOMIC RETURNS TO CRISIS FINANCE

A key issue underlying the discussion of the new lending framework is whether the Bank should continue to meet the borrowers' needs for *exceptional financing* during a crisis and if so whether the existing instruments are adequate to meet this challenge. This issue in turn is frequently embedded in the assumption that short-term financing has no development effects. In this annex we try to respond to these questions.

The IDB responds, normally as part of a package with other multilaterals, to exceptional financing needs derived from crisis using PBLs and EMGs. Even though PBLs, since 1992, are not formally tied to an IMF program (while EMGs are so by policy), there is high *de facto* coordination in terms of approvals and disbursement: the percentage of approvals and disbursements outside an IMF program is low and has fallen during the nineties while approvals coinciding with the IMF and WB has increased post mid nineties (see Table below).

**Table 1: Percentage of Approvals and Disbursements Outside an IMF Program**

		1990-2003	1990-1994	1995-1998	1999-2003
PBLs	Operations	17.1%	20.0%	22.2%	9.1%
	Dollar value (Approved)	17.5%	27.9%	10.8%	12.7%
	Dollar value (Disbursed)	21.7%	28.0%	22.0%	15.6%
PEMG	Operations	25.0%	n.a.	33.3%	22.2%
	Dollar value (Approved)	7.2%	n.a.	8.9%	6.6%
	Dollar value (Disbursed)	23.4%	n.a.	6.7%	25.4%
Memo:	% operations'approvals that coincide with IMF-program and World Bank PBLs				
PBLs & PEMG		48%	43%	58%	50%

To judge whether the IDB met borrowers extreme financing needs (to anchor it to crisis) the following simple indicator (“in crisis”) was constructed: for each year, a country is considered in crisis if there was a systematic banking crisis<sup>59</sup> and/or a foreign exchange crisis<sup>60</sup> and/or a sudden stop in capital inflows<sup>61</sup>. Also, a country is considered in “crisis

<sup>59</sup> Source: Caprio, Gerard and D. Klingebiel (2003), “Episodes of Systemic and Borderline Financial Crisis”. World Bank: Financial Sector. Washington, DC.

<sup>60</sup> Source: IMF (2002), “Global Financial Stability Report”

The indicator of foreign exchange crisis was constructed following the IMF guidelines: IMF (2002), “Global Financial Stability Report” Source: IMF (2002), “Global Financial Stability Report”. Crisis is defined to occur if the exchange market pressure index- a weighted average of monthly percentage depreciations in the nominal exchange rate and monthly percentage declines in foreign exchange reserves - exceeds its mean by more than 1.5 standard deviations.

<sup>61</sup> A sudden stop in capital inflow is based on the methodology in: Calvo, Guillermo; A. Izquierdo; and L.F. Mejia (2004). “On the Empirics of Sudden Stops: The Relevance of balance-Sheet Effects”, NBER, Working Paper 10520. Empirically, a sudden stop is defined if it contains at least one observation where the year-on-year fall in capital flows lies at least two standard deviations below its sample mean. The

plus” if the country was “in crisis” and/or there was an IMF program. Using this indicator (see Chart X) on average about 7 countries were simultaneously “in crisis” (ranging from a maximum of 13 and minimum of four) while 14 were so in “crisis plus.” Of these, the Bank’s PBLs and EMGs covered most of them.

Figure 1: Number of LAC Countries in Crisis and Those Receiving Bank Support

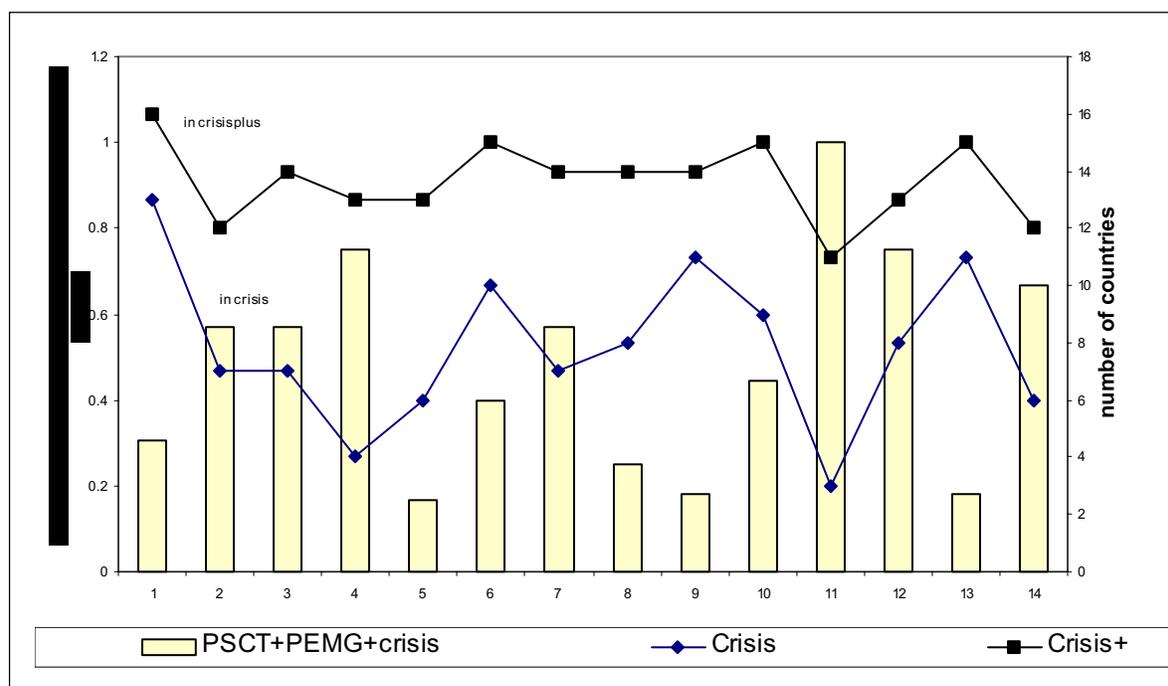


Table 2: The Percentage of Number of Operations, their Dollar Value of Approvals and Disbursement Outside Crisis Episodes

		1990-2003	1990-1994	1995-1998	1999-2003
PBLs	Operations	12.9%	13.3%	16.7%	4.5%
	Dollar value (Approved)	10.7%	17.9%	9.9%	4.0%
	Dollar value (Disbursed)	11.7%	16.1%	11.4%	7.8%
PEMG	Operations	0.0%	n.r.	0.0%	0.0%
	Dollar value (Approved)	0.0%	n.r.	0.0%	0.0%
	Dollar value (Disbursed)	0.0%	n.r.	0.0%	0.0%

The empirical evidence of the effects of volatility and crisis is unambiguous. The effect is negative if it is measured in terms of welfare or poverty or economic growth: all critical dimensions of development. Additionally, the crisis’ contemporaneous negative development effects could also have negative long-term effects if the extreme negative shocks result in hysteresis effects via, for example, the reduction of gross capital formation or the withdrawal of children from schooling. The size and path of the impact

sudden stop phase ends once the annual change in capital flows exceeds one standard deviation below its sample mean.

depends on the nature of the shock (size and duration), the structure of the economy, and also depend on the government's response. However, some illustrations show that the impact is not insignificant.<sup>62</sup>

Terms of trade shocks perhaps best illustrate the contemporaneous and medium term effect on GDP growth. The direct income loss from a negative export price shock average about 7% of GDP in the year of the shock, the loss of income through the reduced growth channel over a four year period amount to about 14% of GDP. The secondary impact is not only greater than the immediate effect but also asymmetric, as positive price shocks do not increase the rate of growth significantly.<sup>63</sup> Further, the overall negative link between volatility and growth appears to be quite robust but with differences in the elasticity of growth with respect to volatility.<sup>64</sup> Regarding the welfare effect, the incipient but growing literature on developing countries suggest that the costs of volatility may in fact exceed the welfare cost of significantly lower growth.<sup>65</sup> Regarding poverty, with the poor more vulnerable to covariate shocks and public safety nets constrained by resources to expand, the negative impact of volatility falls disproportionately on the poor.<sup>66</sup>

Summarizing, the evidence suggests that “writing a check” could have a development effect per se by smoothing consumption and/or GDP volatility. If, additionally, the instrument is effectively tied to an IMF program, the loan could have an additional value added derived from the implementation of the IMF program.

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<sup>62</sup> Not all these cover the Region, but there is no strong argument why in effects would be different.

<sup>63</sup> See: Collier, P., and J., Dehn “Aid, Shocks, and Growth”, WB, WP # 2688, 2001.

<sup>64</sup> See Hnatkovska, V., and N. Loayza “Volatility and Growth”, Mimeo, WB, 2003; Ramey G., and V. Ramey “Cross Country Evidence on the Link Between Volatility and Growth”, American Economic Review, pp 1138-1151, 1995, and Acemolglu D., S., Jojinson, J. Robinson, and Y., Thaicharoen “Institutional Causes, Macroeconomic Symptoms: Volatility, Crisis and Growth.

<sup>65</sup> See S. Pallage and M. Robe (2000)

<sup>66</sup> See Wodon, et al, “poverty and Policv in Latin America and the Vcaribbean, WB Technical Paper # 467, 2000.

## CONDITIONALITIES IN SECTOR/PBL OPERATIONS

### A. Conditions

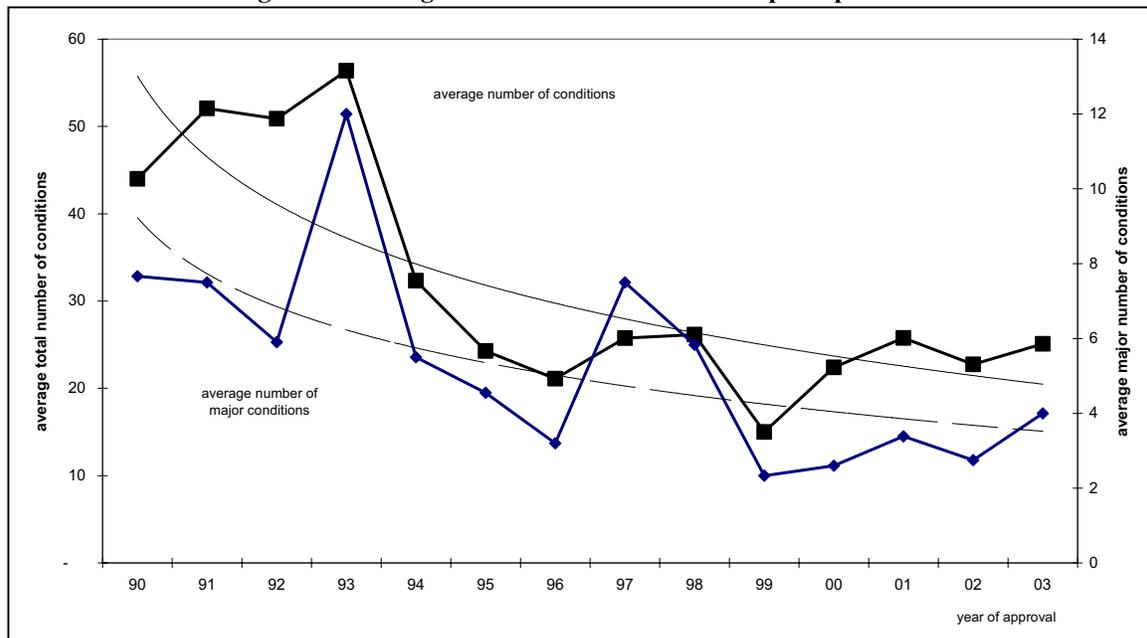
PBLs have gone through a simplification process throughout the nineties (see Chart 12.1) in that the average number of conditions and the average number of major conditions per operation has fallen dramatically over the nineties. They fell by half from an average of 43 (1990-94) to an average of 27 (2000-03).

The average number of conditions (see Chart 12.2) fell significantly (almost by half) for the first and second tranches in mid-nineties and thereafter remained steady while the average number of conditions for the third tranche has continued to fall.

### B. Waivers

The number of waivers rose from 1992, remained high during 1998-2000 and thereafter has fallen (see Chart 12.3). Waivers by tranche mainly occur in the second tranche while for major waivers each subsequent tranche suffers more major waivers (see Chart 12.4). A low waiver rate for the first tranche reflects that for most PBLs the tranche release date and Board of Executive Directors approval are the same. A probit model shows that the probability of a waiver increases by 22% in a crisis<sup>67</sup> situation compared to a non-crisis episode (see Table 12.1).

Figure 1: Average Number of Conditionalities per Operation



<sup>67</sup> See Annex 11 for the definition of crisis episodes.

Figure 2: Average Number of Conditionalities by Tranche

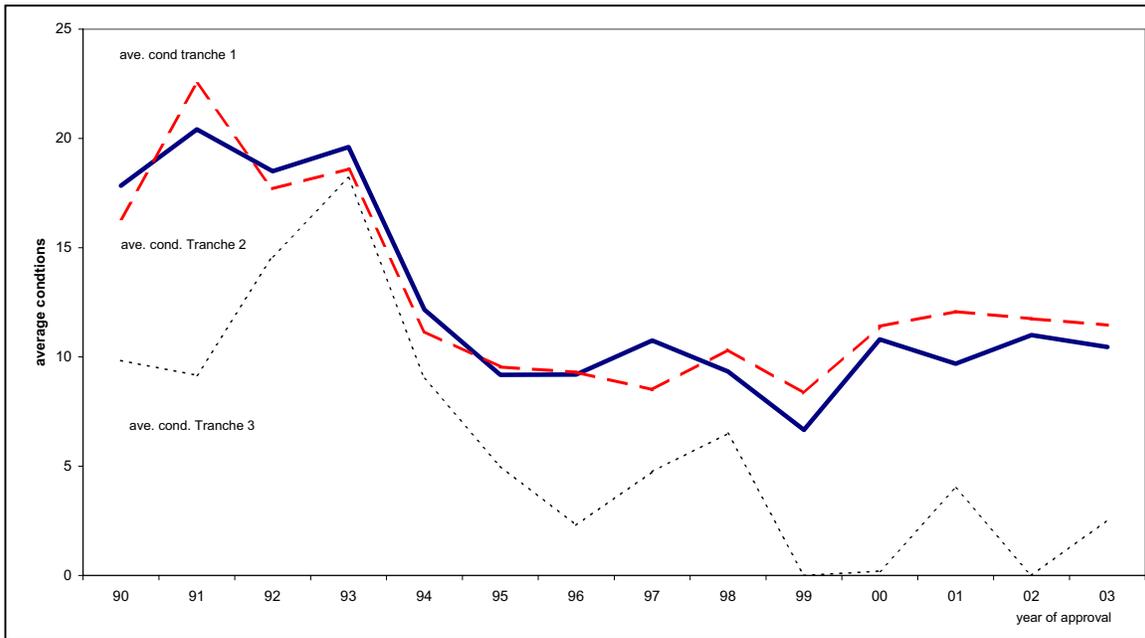


Figure 3: Average Number of Waivers by Year of Waiver

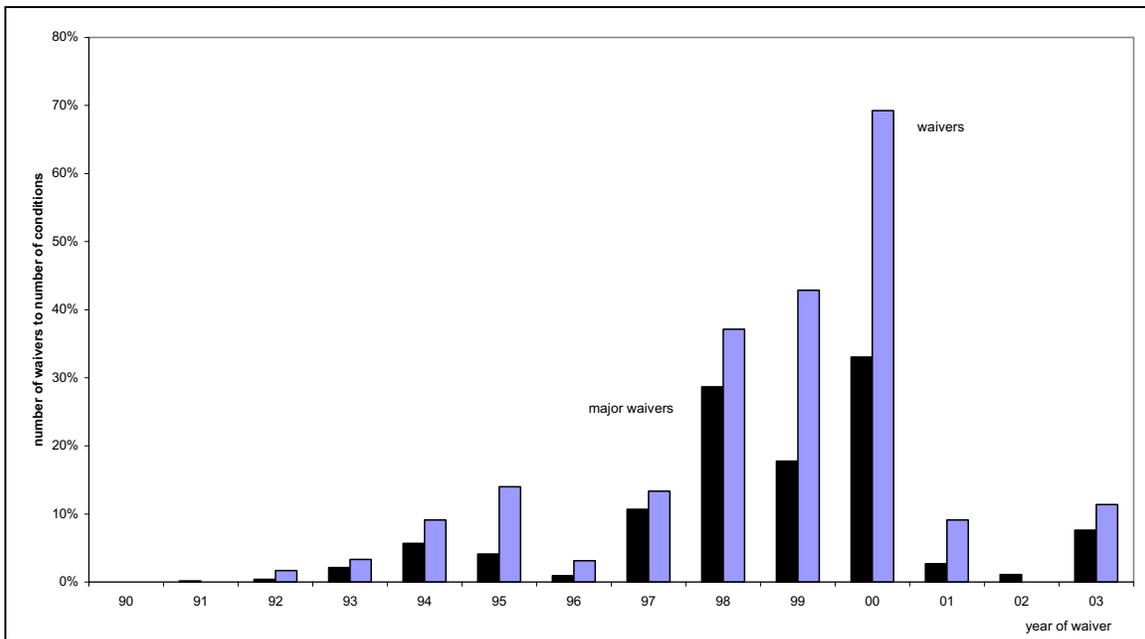


Figure 4: Average Number of Waivers by Tranche

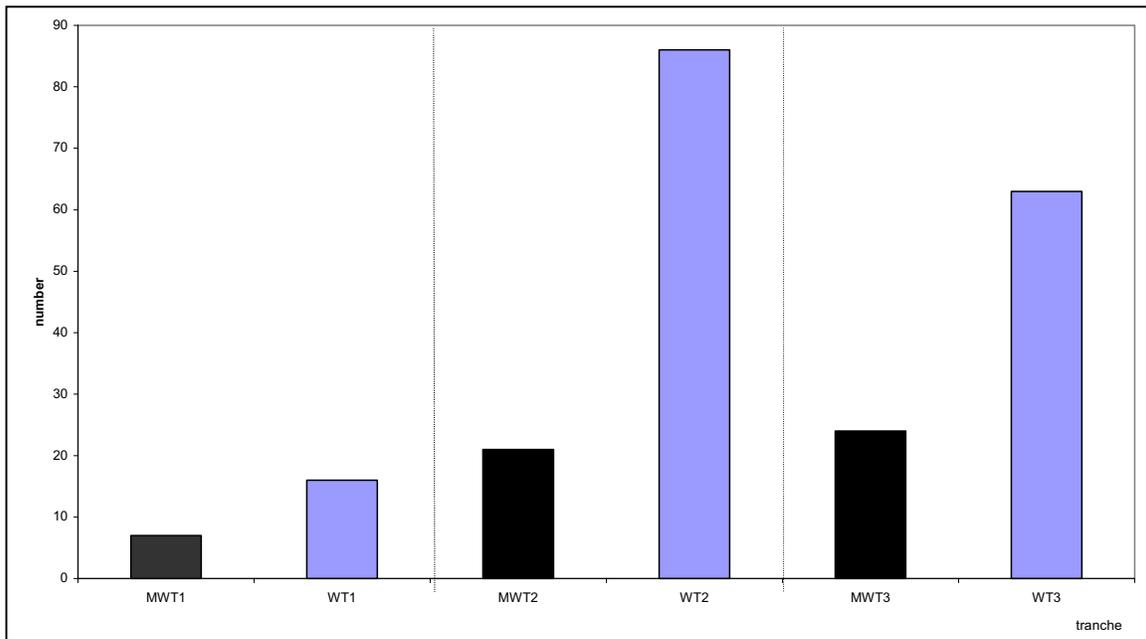


Table 1: Probability of a Waiver During a Crisis Compared to Non-Crisis Period

	Waiver		Major Waiver	
	Coefficient	dF/dx	Coefficient	dF/dx
Crisis	0.55740 ** (0.2848)	0.21849 ** (0.1082)	0.12948 (0.2896)	0.04682 (0.1051)
Constant	-0.18001 (0.1801)		-0.50687 *** (0.1877)	
Obs	83		83	
Log likelihood	-55.54		-52.26	
LR chi2	3.88		0.37	
Prob > chi2	0.0489		0.5429	
Standard error are in parentheses. * significant at 10%; ** significant at 5%; *** significant at 1%.				

### EVALUABILITY SCORES ON SECTOR/PBL OPERATIONS

Looking at the results from the evaluability exercise for the Sector/PBLs approved since 2001, most of the values for the period 2002 and 2003 seem to have improved substantially with respect to the values of 2001. The sustainability of the change, however, is not very clear given that for most of the indicators values were higher in 2002 than in 2003. Particularly relevant to highlight are the improvements of the indicators and metrics, as well as the specification of anticipated outputs. Significantly less progress has been realized, however, in the most critical areas of baselines and outcomes. Since these are the dimensions of projects most closely associated with “results,” the slow improvements in these areas are a source of concern.

**Table 1**

	<b>2001</b>	<b>2002</b>	<b>2003</b>
INDICATORS AND METRICS	0.15	0.69	0.70
BASELINE	0.05	0.62	0.29
TARGET	0.15	0.54	0.49
INFORMATION SYSTEM	0.11	0.33	0.21
OUTPUT	0.36	0.69	0.63
OUTCOME	0.26	0.31	0.35

For a sample of Sector/PBLs was calculated an ex ante evaluability index.<sup>68</sup> The minimum evaluability index (MEI) measures the percentage of all the objectives of the sample that have a metric indicator, a baseline and target for the objective.<sup>69</sup> The MEI has improved over time: from 0.2 to 0.5 but remains low. If the “macro condition is excluded the MEI index fall for each sub-period. The number of PBLs that had either a cost benefit analysis; internal rate of return or fiscal deficit information or debt analysis has also risen significantly. On the other hand the number of operations that propose an ex post evaluation has fallen.

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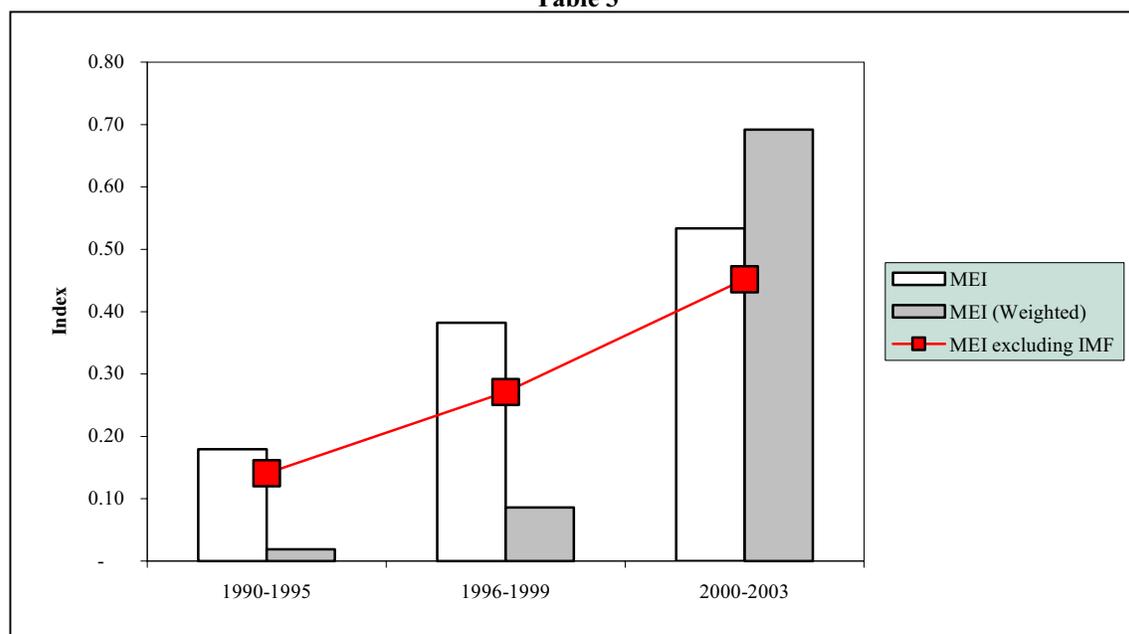
<sup>68</sup> The sample was conformed by selecting two projects for each year between 1990 and 2003, considering country beneficiaries and size of the loan. The main objective was to have the most representative sample of Bank operations. The sample then covers thirteen countries and fifty one percent of the sector/PBL lending between 1990 and 2003.

<sup>69</sup> The index of minimum evaluability measures the degree of information available in a project or group of projects necessary to be able to conduct a “naive” evaluation. More specifically, it measures whether the document contains the minimum elements that adequately describe the original state of the world, baselines, and the expected outcomes or targets to accomplish. The “MEI” reflects the ratio of outcome indicators that have baselines and targets to project objectives, weighted by the importance of those indicators. The index has a value of one if all the objectives have indicators with baselines and targets, and a value of zero if all the objectives have no indicators or the information for all of them is incomplete.

Table 2

	1990-1995	1996-1999	2000-2003	1990-2003
Projects	12	8	8	28
Amount (US\$ MM)	3,329	5,831	5,022	14,183
MEI	0.18	0.38	0.53	0.34
MEI (Weighted)	0.02	0.09	0.69	0.28
MEI excluding IMF	0.14	0.27	0.45	0.27
MEI (weighted) excluding IMF	0.02	0.19	0.85	0.28
CBA/IRR/FG/DEBT	0.17	0.50	0.63	0.18
Ex post evaluation	0.50	0.13	0.13	0.04

Table 3



**FINANCIAL CAPACITY AND EMERGENCY PBL OPERATIONS**

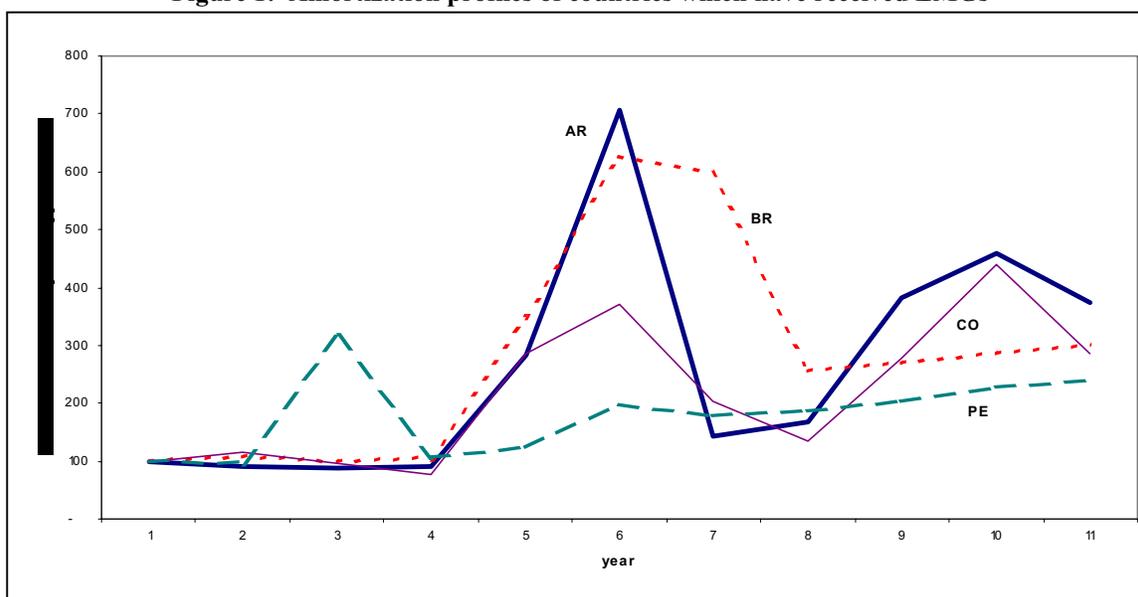
Financial capacity can be gauged by a number of indicators commonly used like the external debt to GDP ratio, external debt to tax revenue, and external debt to exports of goods and non factor services. Tax to GDP and primary surplus to GDP can also be used. The following table shows the percentage change in the indicators between the average for the four years prior to an EMG approval and the average value of the period(s) during repayments for four countries for which data is available. From the table, it is evident that according to most indicators capacity to pay was lower during the repayment period than before the EMG approval. Specifically, the four countries had higher public external debt as a share of GDP and tax revenues, and only Brazil and Peru had improved the ratio when compared to exports. This evidence would indicate that countries had to repay their loans at a moment where they had lower capacity than the time at which they took the loan.

**Table 1**

Percentual Change: four years before PEMG Approval-to-Repayment period					
	Public External Debt (% GDP)	Public External Debt (% Tax Revenue)	Public External Debt (% Exports)	Tax Revenue (% GDP)	Primary Surplus/Deficit (% GDP)
ARG	28%	149%	10%	-7.6%	948%
BRA	57%	19%	-17%	30.2%	104%
COL	76%	34%	22%	33.4%	30%
PER	1%	10%	-15%	-11.2%	-389%

Unlike the other instruments EMGs are loans for five years with three years of grace. A key feature is that their repayments create peaks in amortization on top of the country's normal rising (due to the age structure of the country portfolio) trend of amortization.

**Figure 1: Amortization profiles of countries which have received EMGs**

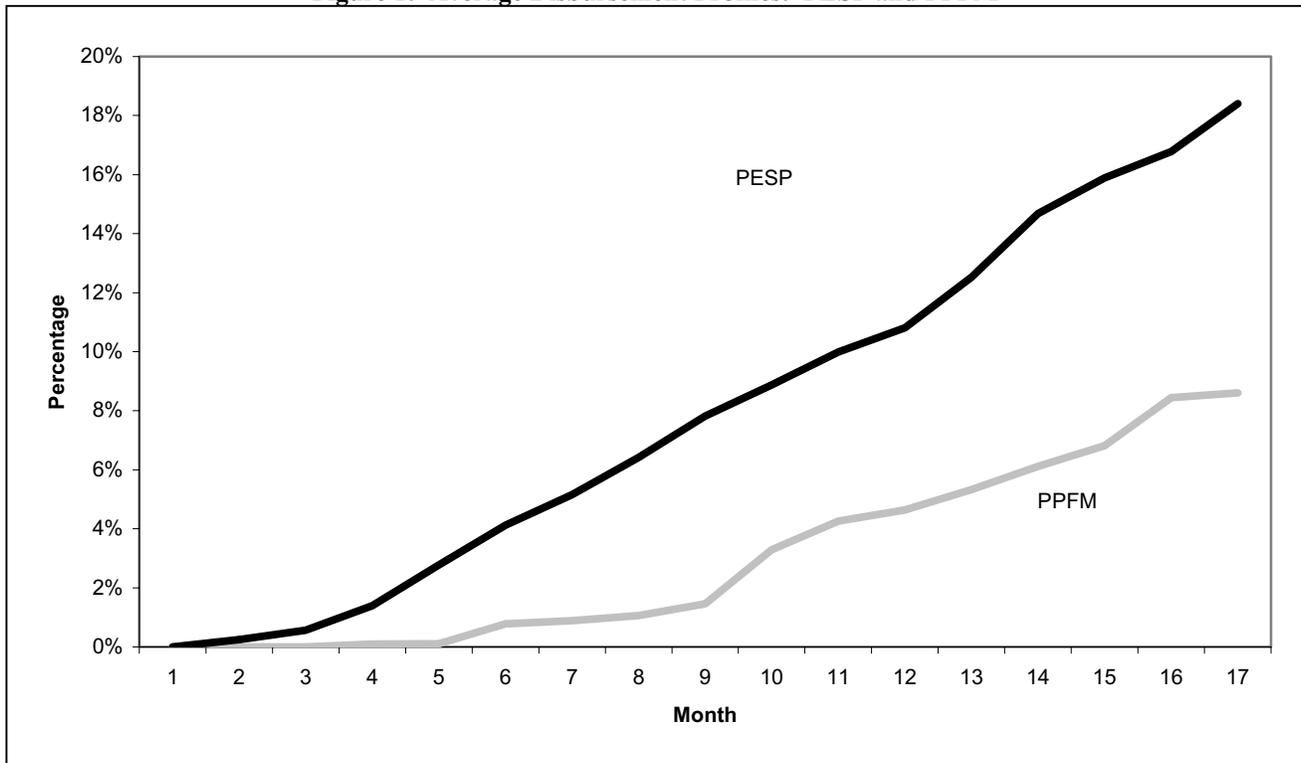


As it can be determined from the previous Table, Brazil and Colombia responded in part by increasing their revenues, Argentina had to drastically cut expenditures, and Peru had to contract new operations with the Bank. Summarizing, it is quite evident that there was not an improvement in countries' economic conditions and thereby countries had to make exceptional effort to repay.

**AVERAGE DISBURSEMENT PROFILES: PPFM LOANS**

Of the 30 multiphase loans (PPFM), 25 have had disbursement periods of at least 18 months. The average pattern of disbursement of those 25 loans is shown on the chart below, along with the average disbursement profile of standard investment loans (PESP). Multiphase loans have thus far disbursed at a significantly slower pace than the standard instrument.

**Figure 1: Average Disbursement Profiles: PESP and PPFM**



## WORLD BANK OPERATIONAL INSTRUMENTS

### A. Lending Instruments

2. There are two types of lending instruments facilitated by the World Bank: *Investment Loans* and *Adjustment Loans*. Investment loans have a long-term focus (5-10 years), and finance goods, works, and services in support of economic and social development projects in a broad range of sectors. Adjustment loans have a shorter-term focus (1-3 years), and provide quick-disbursing external financing to support policy and institutional reforms. Both investment and adjustment loans are used flexibly to suit a range of purposes, and are occasionally used together in hybrid operations.

Table 1

INVESTMENT LOANS	ADJUSTMENT LOANS
Adaptable Program Loans (APL)	Deferred Drawdown Option (DDO)
Emergency Recovery Loans (ERL)	Debt Reduction Loans (DRL)
Financial Intermediary Loans (FIL)	Poverty Reduction Support Credit (PRSC)
Learning and Innovation Loans (LIL)	Programmatic Structural Adjustment Loans (PSAL)
Specific Investment Loans (SIL)	Rehabilitation Loans (RIL)
Sector Investment and Maintenance Loans (SIM)	Structural Adjustment Loans (SAL)
Technical Assistance Loans (TAL)	Sector Adjustment Loans (SECAL)
Sub-National Adjustment Loans (SNAL)	
Special Sector Structural Adjustment Loans (SSAL)	

### B. Investment Lending

Adaptable program loans (APLs) provide phased support for long-term development programs. They involve a series of loans that build on the lessons learned from the previous loan(s) in the series.

Emergency recovery loans (ERLs) support the restoration of assets and production levels immediately after an extraordinary event—such as war, civil disturbance, or natural disaster—that seriously disrupts a borrower’s economy. They are also used to strengthen the management and implementation of reconstruction efforts, and to develop disaster-resilient technology and early warning systems to prevent or mitigate the impact of future emergencies.

Financial intermediary loans (FILs) provide long-term resources to local financial institutions to finance real sector investment needs. The financial institutions assume credit risk on each subproject.

Learning and innovation loans (LILs) support small pilot-type investment and capacity-building projects that, if successful, could lead to larger projects that would mainstream the learning and results of the LIL.

Specific investment loans (SILs) support the creation, rehabilitation, and maintenance of economic, social, and institutional infrastructure. In addition, SILs may finance consultant services and management and training programs.

Sector investment and maintenance loans (SIMs) focus on public expenditure programs in particular sectors. They aim to bring sector expenditures, policies, and performance in line with a country's development priorities by helping to create an appropriate balance among new capital investments, rehabilitation, reconstruction, and maintenance. They also help the borrower develop the institutional capacity to plan, implement, and monitor an expenditure or investment program.

The technical assistance loan (TAL) is used to build institutional capacity in the borrower country. It may focus on organizational arrangements, staffing methods, and technical, physical, or financial resources in key agencies.

### **C. Adjustment Lending**

The Deferred Drawdown Option (DDO) is available to both IBRD and Blend countries to whom the Bank makes a single-tranche adjustment loan. The DDO gives borrowers access to long-term IBRD resources to manage ongoing structural programs if market borrowing becomes difficult and unforeseen financing needs materialize.

The debt reduction loan (DRL) supports government policy reform programs aimed at creating an environment conducive to private sector investment, where foreign exchange is required for urgent rehabilitation of key infrastructure and productive facilities. The focus is on key short-term macroeconomic and sector policy reforms needed to reverse declines in infrastructure capacity and productive assets.

The Poverty Reduction Support Credit (PRSC) program is expected to consist of a series of operations, typically two or three, which together support IDA countries' medium-term policy and institutional reform programs to help implement their poverty reduction strategies. Its specific structure depends on country circumstances, including the objectives and nature of the country's reform program that it supports and the timing of the requirement for assistance.

The programmatic structural adjustment loan (PSAL) is provided in the context of a multiyear framework of phased support for a medium-term government program of policy reforms and institution building.

The rehabilitation loan (RIL) supports government policy reform programs aimed at creating an environment conducive to private sector investment, where foreign exchange is required for urgent rehabilitation of key infrastructure and productive facilities. The focus is on key short-term macroeconomic and sector policy reforms needed to reverse declines in infrastructure capacity and productive assets.

The structural adjustment loan (SAL) supports reforms that promote growth, efficient use of resources, and sustainable balance of payments over the medium and long term.

The sector adjustment loan (SECAL) supports policy changes and institutional reforms in a specific sector.

The special sector structural adjustment loan (SSAL) supports structural and social reforms by creditworthy borrowers approaching a possible crisis, or already in crisis, and with exceptional external financing needs. These loans help countries to prevent a crisis or, if one occurs, to mitigate its adverse economic and social impacts.

The Sub-National Adjustment Loan (SNAL) supports reforms that promote growth, efficient use of resources, and sustainable balance of payments at a sub-national level.

#### **D. Non-Lending Instruments**

Analytic and Advisory services (AAA) include both standard Economic and Sector Work (ESW), less formal just-in-time policy advice such as Policy Notes, and non-ESW activities including workshops, seminars, conferences etc. The descriptions provided below illustrate the core diagnostic economic and sector works that examine social and structural policies and fiduciary issues in client countries.

#### **E. Core Diagnostic Reports**

##### **1. Country Economic Memorandum (CEM) and Development Policy Review (DPR)**

The CEM and DPR analyze key aspects of a country's economic development, such as growth, fiscal reform, public administration, foreign trade, financial sector development, and labor markets. They are flexible analytic instruments whose structure and content are largely dependent on country circumstances. Their aim is to provide an integrated view of a country's development priorities and a framework for designing development strategies.

##### **2. Country Financial Accountability Assessment (CFA)**

The CFA evaluates the overall quality of a country's public financial management system, covering budgeting, accounting, reporting and auditing, and external scrutiny of public finances. They have twin objectives: (1) improve a country's public financial management by developing and following up action plans agreed with the government and (2) enable the World Bank to judge the level of fiduciary risk to its funds that may be provided to a country, particularly in the context of adjustment lending.

##### **3. Country Procurement Assessment Report (CPAR)**

The CPAR diagnoses the health of a country's procurement system and practices and aim to generate a dialogue with governments on needed reforms.

##### **4. Poverty Assessment (PA)**

The PA provides information on the causes and consequences of poverty in a country and examines how public policies, expenditures, and institutions affect poor people. The Assessment describes the poor, details their living conditions, describes their changing situation over time, and clarifies the main challenges facing poor people when they try to

emerge from poverty. The Assessment also considers how labor-intensive growth, human resource development, and social protection programs can alleviate poverty.

### **5. Public Expenditure Review (PER)**

The PER examines government resource allocations within and among sectors and assesses the equity, efficiency, and effectiveness of those allocations in the context of the macroeconomic framework and sector priorities. In addition, it identifies the reforms needed in budget processes and administration to improve the efficiency of public spending. Public Expenditure Reviews plays a central role in shaping World Bank lending decisions that have an impact on the public resource envelope.

### **6. Integrative Fiduciary Assessment (IFA)**

The IFA provides integrated analysis of countries' public expenditure, procurement, and financial management systems. It integrates the work normally carried out through a Public Expenditure Review (PER), Country Procurement Assessment Review (CPAR), and Country Financial Accountability Assessment (CFA).