Office of Evaluation and Oversight

Corporate Evaluation

Policy-Based Lending at the Inter-American Development Bank

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Acknowledgemets

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Acronyms and Abbreviations

ADB	Asian Development Bank
AfDB	African Development Bank
AP	Approach Paper
Cat DDO	Catastrophe Deferred Drawdown Option
CDF	Contingent disaster financing
CSF	Counter-Cyclical Support Facility
CPE	Country Program Evaluation
CRBS	Crisis Response Budget Support
DDO	Deferred Drawdown Option
DPF	Development Policy Financing
DPL	Development Policy Loan
DSL	Development Sustainability Credit Line
EME	Emergency Lending Category
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IDEV	Independent Development Evaluation
IMF	International Monetary Fund
INV	investment loan
LAC	Latin America and the Caribbean
LBR	Loan Based on Results

M&E	Monitoring and Evaluation
MDB	Multilateral Development Bank
MIC	Middle-Income Countries
OVE	Office of Evaluation and Oversight
OPR	Operational Program Report
PBG	Policy-Based Guarantee
PBL	Policy-Based Loan
PBP	Programmatic Policy-Based Loan
PCR	Project Completion Report
PFM	Public Financial Management
SDL	Special Development Loan
SG	Sovereign Guarantee
SPBL	Special Policy-Based Loan
SPD	Strategic Planning and Development Effectiveness
TC	Technical Cooperation
WB	World Bank

Executive Summary

Policy-based lending was introduced at the Inter-American Development Bank (IDB) in 1989 to support the reform agenda underway in many of its client countries in the framework of the Washington Consensus Reforms supported by all multilateral development banks (MDBs). Policy-based lending has remained relevant through the years, with governments in Latin America and the Caribbean (LAC) seeking to balance market-oriented and socially inclusive policies, reevaluating and adapting their economic strategies to promote inclusive growth to address the diverse needs of their populations in recent decades.

Objective and methods

The objective of this evaluation is to analyze to what extent policy-based lending in the IDB has contributed to its dual objectives of (i) improving debt and liquidity management by providing beneficiary countries with flexible, liquid, and timely funding to meet their financing needs; and (ii) strengthening fiscal management, economic and sector frameworks, and the provision of public services by supporting policy and institutional reform in client countries (see IDB 1989). The assessment of policy-based lending in the IDB is timely, given the importance and increased need to foster reform and improve the development effectiveness of IDB operations and the proposed changes to the instrument currently under discussion.

The evaluation has used mixed methods, including (i) a corporate-level document review; (ii) a project-level review; (iii) semi-structured interviews with country counterparts, Bank staff, and staff from other MDBs (virtual and in-person); (iv) analysis of IDB portfolio databases; (v) country case studies with missions; (vi) analysis of evaluations of the instrument in other MDBs; and (vii) analysis of findings from OVE country evaluations. OVE also benefited from IDB Board Discussions on Management's proposals to improve the instrument. For more details on the sources of information and methods, please refer to the approach paper of the evaluation (OVE 2023b). The evaluation covers all policy-based operations approved between 2005–2022. 2005 has been chosen as a starting point because programmatic policy-based loans (PBPs) were introduced that year.

Policy-based portfolio in IDB

Since the inception of PBPs, policy-based lending has accounted for 32% of IDB sovereign guaranteed approvals, with the share increasing over time. In this period, IDB approved 331 policy-based operations totaling US$58.4 billion. Policy-based lending increased during the 2009–2010 global financial crisis and the Covid-19 pandemic.

All IDB borrowing member countries, except for Venezuela, used policy-based lending between 2005 and 2022, but its relative importance in country portfolios varied. A&B countries (except Argentina and Brazil) tend to have a higher share of approvals (by volume) through policy-based operations. In terms of volume, Colombia and Mexico accounted for 36% of the approved policy-based lending amounts over this period. Colombia and Jamaica had consistently more than 40% of their lending program approved through policy-based operations. Policy-based operations in public sector governance and economic management have dominated between 2005 and 2022 in the number of operations (32.1% of the total) and approval volumes (37.3% of the total).

Policy-based lending among MDBs

Most MDBs use policy-based instruments to provide fast disbursement financing, respond to emergencies, and promote reform agendas. Policy-based lending and its share in total lending have increased in all MDBs, especially during and after crises. Many MDBs have policy-based lending limits, varying from 15% to 30%. The World Bank (WB) has no explicit lending limit on policy-based lending (Development Policy Lending) shares, but historically, they have represented less of or around 30% of its total lending portfolio. However, like most MDBs, the WB allocates more lending, including policy-based lending, to countries with relatively higher income levels and more institutional capacity. During the evaluation period, the WB channeled 48.6% of its lending to LAC as policy-based lending and allocated lower shares to other regions.

Recent evaluations of the instrument have found a general trend in policy-based lending to support less critical reforms, responding more to providing fast disbursement financing rather than supporting reforms. Among MDBs, policy-based operation scale is determined by financing needs, but most aim to anchor the programs in one or a few substantial reforms. Policy-based lending has evolved. Most MDBs have increased their menu of instruments, including stand-alone single-tranche operations, instruments solely focused on liquidity (i.e., emergency lending), and preventive instruments. In comparison, IDB shows a more limited menu of policy-based lending instruments. Since the introduction of the PBPs, the demand from most IDB countries has shifted away from multi-tranche PBLs to PBPs due to their flexibility. Today, only Peru and Uruguay have been using policy-based operations with a Deferred Drawdown Option (DDO). The use of hybrid loans and policy-based guarantees has been limited as well.

Policy-based use in IDB

IDB policy-based lending has fulfilled its objective of providing fast disbursement financing for budget support, debt management, diversification, and insurance. The Bank has also aimed to fulfill its objective of supporting the inception or the implementation of ongoing reform agendas. Nevertheless, this objective has not always been fulfilled due to shortcomings in the design and implementation of policy-based operations. Lack of depth in policy matrices has affected the vertical logic of policy-based programs, and truncation in policy-based programmatic series has affected the carrying out of reforms.

Demand for policy-based lending from borrowing member countries in IDB has been high in recent years (partly influenced by the COVID-19 pandemic); in most countries, it has surpassed Bank supply. On the supply side, from a financial perspective, IDB has a strong incentive to maximize policy-based lending, especially in countries with high credit ratings.

Even though most countries demand PBPs and PBLs for fast disbursement financing to cover budget needs, debt management, debt diversification, or preventive lending, they also highly value the Bank's capacity to support reform design and implementation through its role as a trusted advisor and provider of technical assistance. In country case studies, OVE found that the Bank had provided analytical work and capacity building and engaged in policy dialogue in most areas supported with policy-based operations.

Policy-based lending should only be used when both reform and liquidity support are needed to ensure alignment with its two objectives. When only reform support is required, technical assistance and investment lending, including loans based on results (LBRs), can help the design and implementation of reforms. If liquidity or budget support is the main necessity, the emergency instrument special development loan (SDL) can provide liquidity without forcibly tying it to reform efforts. However, currently SDLs are more expensive and require an International Monetary Fund (IMF) program, making the pure liquidity instrument less attractive to clients.

Finance ministers appreciate the seal of approval and the role that policy-based programs have in leveraging commitments from line ministers to implement reforms through the operations. Most reforms had adequate ownership in the executive branch. Still, some needed ownership in Congress, which affected the depth of policy actions and increased the risk of not completing the programmatic series as planned.

OVE has found that at least one-fifth of policy-based operations consist chiefly of policy actions that lack enough criticality to support the implementation of meaningful reform agendas. These policy actions are insufficient to trigger the implementation of the reforms necessary to achieve the expected objectives of the policy-based operations that supported them. OVE has also found programs that included low-depth, imprecise actions or actions that resemble milestones of an investment loan based on results (LBR), calling into question the choice of instruments used by the IDB to achieve its country program objectives. These shortcomings in selecting policy actions found in Bank programs may be partly explained by insufficient guidance for preparing policy matrices for Bank staff, especially in new areas of policy-based lending. Another factor that may explain this finding is the primacy of providing fast disbursement financing over reform objectives in the programming process of some operations.

Most existing evaluations of policy-based lending among MDBs concur that fast disbursement financing as an incentive to carry out reform agendas may be insufficient to implement a reform agenda successfully, so most policy-based programs need to be complemented with technical assistance to ensure their effectiveness. In the case of IDB, the Bank uses its technical cooperation (TC) funding and the expertise of its sector specialists to support countries in designing and implementing the reform processes, valued by Bank country counterparts as a critical contribution of policy-based lending. However, information on TCs linked to policy-based operations is not always systematically recorded in the IDB systems. In addition, OVE found deficiencies and limited use of investment lending complementing policy-based lending, sometimes reducing the likelihood of achieving the program objectives.

Implementation and results

Interruption of a PBP series (truncation) is a common phenomenon, with significant variation among countries. Between 2005 and 2022, around one-third of the PBP series were truncated. Truncation is more common when a PBP series start at the end of a government period, consists of more operations, or lacks criticality in the first loan. Backloading the reform agenda to the last operation of the series is less of an issue. OVE's assessment of the truncated PBP series shows that many policy actions supported by the series advanced to some degree after truncation. Yet, no government has completed the full set of policy actions planned by the policy-based program.

Management self-evaluations of policy-based operations validated by OVE show that 62% of PBP series and PBL loans couldn't demonstrate that they have achieved their reform results. In self-evaluations of policy-based program performance, around half had deficiencies in monitoring and evaluation that led to incomplete data to assess the achievement of objectives. This mixed performance was also identified in country case studies. The reasons for the low achievement of objectives were linked to political risks to the implementation of reforms that were not adequately taken into account at approval; institutional weaknesses of the sectors in charge of reform implementation; design issues of the operations, with policy actions not critical enough to contribute to stated program objectives; lack of or deficiencies in complementary instruments like investment loans; and unforeseen factors, including the COVID-19 pandemic.

Based on the findings of this evaluation, OVE recommends the following actions:

1. **Strengthen IDB programming and approval processes, ensuring that both objectives of the instrument are met and avoiding using policy-based operations when only liquidity is required.**

   a. Policy-based operations should be programmed only for countries where the Bank has added value in improving the design or the implementation of transformative reforms and must be anchored in one or a few reforms capable of producing a permanent change in policy, regulation, or institutions to address key development objectives.

   b. Management should ensure a solid analysis of the political economy and carefully consider the risk associated with the political cycle when programming the first operations of a PBP series, provide technical assistance before or with the first operation of a PBP series, and maintain policy dialogue over the course of multi-year programs.

   c. Programming should consider the track record of countries in undertaking policy-based lending. In countries with a poor track record on the implementation (truncation issues) or low effectiveness of policy-based lending, the Bank should reduce lending until the factors associated with these shortcomings are addressed.

2. **Revise the use of policy-based lending vis-à-vis other complementary instruments and explore putting alternative instruments in place and increasing the menu of modalities of policy-based operations.**

a. Explore complementing the PBP series with small INVs and using LBRs instead of PBPs to support the implementation of ongoing reforms.

b. Carefully explore the potential demand, incentives for staff and clients, costs, benefits, and risks to put in place new policy-based lending instruments, such as single-tranche policy-based operations, additional contingent policy-based operations, and additional or more flexible liquidity emergency loans (SDL).

3. **Improve the design of PBLs by increasing the parsimoniousness and criticality of policy actions, strengthening guidance to Bank staff, and improving quality control to prepare policy-based operations.** To address weaknesses in the mix of actions supported by policy matrices—either due to insufficient depth or lack of precision in policy action formulation—that affected the effectiveness of policy-based operations. Management should ensure that policy actions supported by policy-based operations are clear enough and have enough depth to achieve the intended objectives of the operations.

4. **Improve the monitoring, reporting, and self-evaluation of policy-based lending.**

   a. Management should report to the Board yearly on the implementation of its policy-based lending program, looking at the truncation of PBP series and the setbacks in the reform processes supported by its operations.

   b. Management should do an in-depth retrospective self-evaluation of the instrument every four years, matching the policy-based lending ceiling cycle. The in-depth evaluation should address implementation issues and the results of its policy-based lending program.

   c. Self-evaluations (PCRs) of policy-based operations should explicitly analyze the consequences and causes of truncation and the issues behind the low effectiveness of operations.

   d. To facilitate the monitoring and design of policy actions, Management should maintain a database of policy actions (by objective, sector, and degree of depth) building on the database created by OVE for this evaluation and a database of TCs.

01

Introduction

1.1. Following the debt crisis of the 1980s, most countries in Latin America and the Caribbean (LAC) implemented ambitious reforms with mixed results. The Washington Consensus reforms, influenced by the International Monetary Fund (IMF), the World Bank (WB), and the Inter-American Development Bank (IDB) Group, emphasized market-oriented policies to liberalize economies, privatize public enterprises, increase fiscal discipline, improve financial and labor markets, strengthen pension systems, reduce excessive regulation, strengthen property rights and the rule of law, enhance the business climate, and encourage trade and foreign investment. While these reforms were intended to promote economic growth and stability, their implementation varied widely across countries. Results were mixed, partly due to incomplete reforms; failure to address key structural issues such as low human capital, low productivity, informality, and lack of economic diversification; lack of focus on public sector efficiency and public sector institutional capacity; weak governance; lack of adequate safety nets; reform reversals; and external shocks—among others.

1.2. In this context, policy-based lending was introduced at the IDB in 1989 to support the reform agenda underway in many of its client countries (see IDB 1989). Policy-based operations were anchored in the model of conditional budget support created by the WB almost a decade earlier. Originally called sector loans, IDB's policy-based operations had the dual objectives of promoting policy or institutional reform and helping countries meet their financing needs while supporting macroeconomic adjustment programs and structural reforms.

1.3. In more recent years, LAC governments have sought to strike a balance between market-oriented and socially inclusive policies, reevaluating and adapting their economic strategies to promote inclusive growth to address the diverse needs of their populations. In this context, reforms are still being implemented to improve fiscal policies; enhance the institutional capacity of the public sector and the efficiency of public spending, investment, and the provision of infrastructure services; strengthen pension systems; improve regulation; and enhance the functioning of financial markets, among others. New areas of reform have arisen for improving governance, reducing corruption, improving citizen security, strengthening social safety nets, tackling informality, decarbonizing the economy, adapting to climate change, fostering the digital economy, and promoting gender equality and social inclusion. In the last four decades, policy-based lending has aimed to support reform processes and provide external financing in LAC and other world regions. In the aftermath of the COVID-19 epidemic, there is an increased need for liquidity financing from multilateral development banks (MDBs) due to higher interest rates and lower liquidity in international financial markets. Needs for fiscal reform have also increased after the growth in deficits arising from the need to respond to the pandemic and its economic impacts.

1.4. The objective of this evaluation is to analyze the extent to which policy-based lending in the IDB has contributed to its dual objectives of (i) improving debt and liquidity management by providing beneficiary countries with flexible, liquid, and timely funding to meet their financing needs, and (ii) strengthening fiscal management, economic and sector frameworks, and the provision of public services by supporting policy and institutional reform in client countries (IDB 1989). To answer this question, OVE looked at the use of policy-based lending as an instrument, including the relevance to fulfilling its objectives, its programming processes, and the drivers for its demand. OVE also looked at the implementation, effectiveness, and sustainability of policy-based operations.

1.5. The assessment of policy-based lending in the IDB is timely, given the importance and increased need to foster reform and improve the development effectiveness of IDB operations and the proposed changes to the instrument currently under discussion. Policy-based lending is one of the key elements in the menu of MDBs' financial instruments. In the right context, it can improve development effectiveness by realizing the Paris Declaration Principles for Aid Effectiveness of ownership, predictability, reliance on country systems, focus on results, and harmonization (Fardoust et al. 2023) and the 2021 recommendations of the G20[1] to improve the instrument. Policy-based lending is central to the IDB's toolkit for supporting client countries. In the Annual Meeting in Panama in March 2023, the IDB Governors resolved to mandate the Board of Executive Directors to direct Management to prepare a proposal for a new institutional strategy and a series of operational reforms (IDB 2023a). The new institutional strategy was approved by IDB Governors in the last Annual Meeting in Punta Cana in March 2024 (document GN-3159-12). In this context the Bank is reviewing its lending instruments and exploring ways to strengthen policy-based lending (see IDB 2022b, the Washington Resolution). IDB management is proposing changes to the instrument to be approved by the Board of Directors and the Board of Governors [see Proposal to Enhance Quality and Impact of Policy-Based Operations at the Inter-American Development Bank, new version, GN-3191-1, for the most recent version of the proposed changes].

1 G20 Third Finance Ministers and Central Bank Governors Meeting, July 9–10, 2021, Annex II, G20 Recommendations for the Use of Policy-Based Lending.

1.6. The evaluation has used mixed methods, which include (i) a corporate-level document review; (ii) a project-level review; (iii) semi-structured interviews with country counterparts, Bank staff, and staff from other MDBs (virtual and in-person); (iv) analysis of IDB portfolio databases; (v) country case studies with missions; (vi) analysis of evaluations of the instrument in other MDBs; and (vii) analysis of findings from OVE country evaluations. OVE also benefited from IDB Board discussions on Management's proposals to improve the instrument. For more details on the sources of information and methods, please refer to the evaluation's approach paper (OVE 2023b).

1.7. The evaluation covers all policy-based operations approved between 2005 and 2022. 2005 has been chosen as a starting point because programmatic policy-based loans (PBPs) were introduced that year. The evaluation takes advantage of prior OVE work (see technical note OVE 2023c). The evaluation includes (i) a portfolio analysis of all policy-based operations approved between 2005 and 2022 to gain an understanding of the evolution, focus, and use of the portfolio; (ii) a detailed analysis of loans with an OVE-validated self-evaluation (Project Completion Report, PCR) completed between 2018 and 2023, to assess relevance, effectiveness, and sustainability of operations; and (iii) a detailed review of 2015–2022 policy-based operations in five countries (Barbados, Honduras,Mexico, Paraguay, and Peru) to gain a perspective on the drivers of the use and effectiveness of the instrument at the country level (see paragraph 4.15 and Annex III of the AP of the evaluation -OVE 2023b-, for details on the selection of country case studies).

1.8. The remainder of this evaluation report is organized as follows. Chapter II describes the evolution of policy-based lending in the IDB. Chapter III presents the portfolio of policy-based operations approved between 2005 and 2022 and its distribution by country and sector. Chapter IV reviews policy-based lending use in other MDBs for a benchmarking exercise, their modalities, and findings from recent reports that evaluate the instrument. Chapter V covers the use of policy-based lending in the IDB, its programming, the design of policy actions, the use of complementary instruments, and coordination with other MDBs. Chapter VI looks at the implementation and effectiveness of policy-based lending in the IDB. Finally, Chapter VII concludes and presents OVE recommendations for Management and the Board of Executive Directors of the Bank.

02

Policy-Based Lending in the IDB

2.1 The IDB sovereign guarantee (SG) lending categories include investment lending, policy-based lending, and lending for financial emergencies during a macroeconomic crisis, called special development lending. IDB also guarantees loans made by private financiers for public sector projects. Policy-based lending provides fast-disbursing financial assistance or country budget support conditional on the borrowing country fulfilling a set of agreed-upon policy and institutional actions, while investment loans (INVs) disburse against specific predefined project expenditures or to meet agreed-on development results.[2] Special development loans (SDLs) provide fast-disbursing support conditional on a country being struck by a macroeconomic crisis and must have a lending arrangement with the IMF. The SDL must be part of an international support package (IDB 2017).

2.2 Policy-based lending was introduced at the IDB in 1989 (see IDB 1989) to promote policy or institutional reform and help countries meet their financing needs. Multi-tranche policy-based loans (PBLs) were to be disbursed in several tranches (see Box 2.1 and IDB [2018] for a list of complete IDB lending instruments). When they were created, PBL approvals required a country policy memo to ensure the actions complied with and relied on IMF-supported programs for macroeconomic assessments.

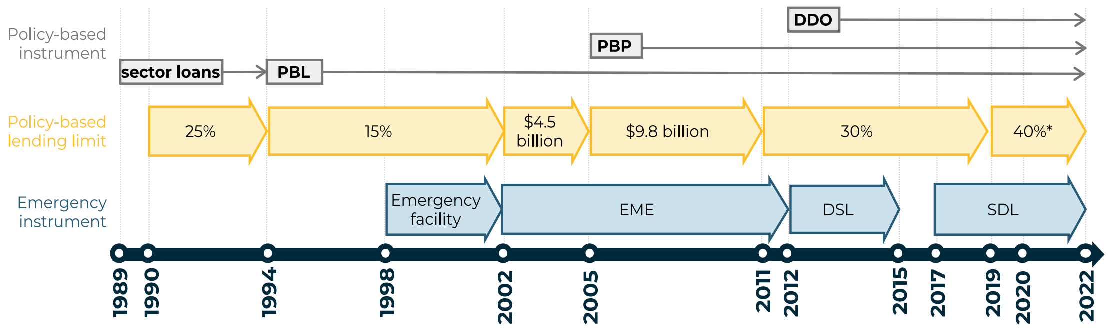
2.3 In the mid-2000s, IDB's internal processes around policy-based lending were changed, and new modalities were added. First, a new modality, the programmatic policy-based loan (PBP), was introduced in 2005 (IDB 2005; see Figure 2.1). PBPs consist of a series of single-tranche operations set in a medium-term framework of reforms. The first operation of a PBP series identifies the policy actions for that operation and indicative triggers for the subsequent loans in the series. Since the triggers can be revisited at loan approval, PBPs allow actions to be adjusted as country circumstances change. Second, the initial 25% cap on policy-based lending of IDB's 1990–1993 overall lending program, established to avoid crowding out investment lending, was repeatedly changed until it reached 30% of non-emergency lending (measured in a four-year period) from 2011 onwards. More recently, with the COVID-19 crisis, the limit was temporarily increased to 40% for 2019–2022, though it returned to 30% for the four years starting in 2023. In 2012, IDB introduced a Deferred Drawdown Option (DDO) to synchronize proceeds with countries' financing needs (IDB 2012a).

2 These are loans based on results (LBRs), a special instrument within the investment category.

Figure 2.1

Evolution of policy-based and emergency lending instruments at IDB

Source: OVE, 2023c.



Notes: *DDO = Deferred Drawdown Option, DSL = development sustainability credit line, EME= emergency loan, PBL = policy-based loan, PBP = programmatic policy-based loan, SDL = special development loan. * Temporary response to Covid-19 pandemic.

Box 2.1. IDB policy-based products

Multi-tranche policy-based loan (PBL): PBLs consist of two or more tranches within a single operation, in which the disbursement actions for each tranche are specified at the beginning of the operation (PR-301).

Programmatic policy-based loan (PBP): PBPs are a series of technically related but financially and contractually independent operations. The independent single-tranche operations are approved on a phased basis (and have their own loan contracts) to support the borrower in achieving the country's reform program, with specified triggers for moving from one operation to the next (PR-301).

Hybrid loans: Hybrid loans provide financial support for sector or subsector policy changes and funds for capital investment. They contain a policy reform (fast disbursement) component to finance expenditures linked to policy changes and institutional reform and an investment component targeted to specific investments in the sector, which helps consolidate these new sector policies (PR-301).

Deferred Drawdown Option (DDO): DDOs can be requested for all policy-based modalities (multi-tranche, programmatic, and hybrid—in this case, to the policy component). The purpose of the DDO is to allow the loan resources to be drawn down over a period so long as the actions that led to approval remain in place. This option allows countries to approve their allocation of policy-based lending in a given year but have access to the financial resources at a time that meets their needs more effectively (IDB 2023c).

Policy-based guarantees: A policy-based guarantee is a policy-based instrument that combines features of the policy-based operation with a guarantee. Once the government complies with the policy reforms, the Bank issues a guarantee to support the guaranteed instrument (IDB 2013).

2.4 Policy-based lending instruments to provide liquidity and support reforms have been complemented over the decades with instruments solely focused on providing liquidity in emergencies. The effects of the Asian financial crisis in 1997–1998 made adhering to the existing policy-based lending cap difficult. They led to the introduction of an emergency loan window, which was not subject to the policy-based lending cap (IDB 2001). This temporary emergency loan window has been replaced by a consecutive series of emergency lending instruments, including the emergency lending category (EME), the development sustainability credit line (DSL), and the current SDL. An SDL is conditional on a country experiencing a macroeconomic crisis and being supported by an existing IMF program. If supported by fresh funds, SDLs cannot exceed US$500 million or 2% of a country's gross domestic product (GDP). It can also be funded by reallocating uncommitted loan balances, provided that at least 60% of the remaining uncommitted loan balances are INVs.

03

IDB Policy-Based Lending 2005-2022

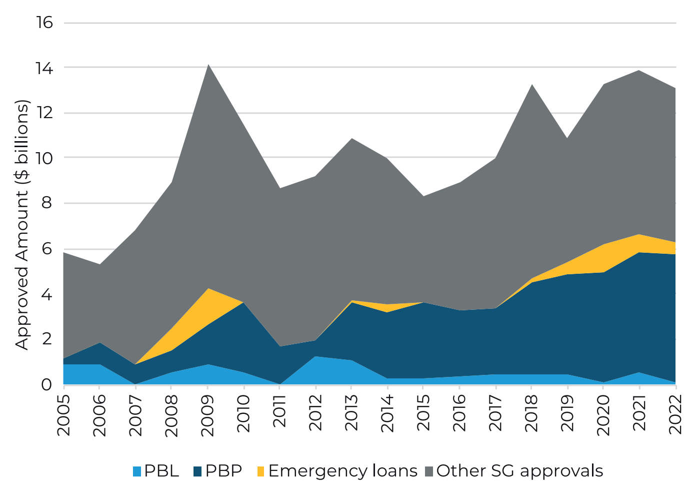
A. Distribution by type of policy-based operation

3.1 Since the inception of PBPs in 2005, policy-based lending has accounted for 32% of SG approvals,[3] with the share increasing over time. Between 2005 and 2022, IDB approved 331 policy-based operations totaling US$58.4 billion.[4] About 85% (US$ 49.5 billion) of these resources were approved as PBPs (including 6.5% for PBPs with DDO), supporting 157 programs. Of the remainder, 15% (US$ 8.4 billion) was approved as multi-tranche PBLs and about 1% (US$0.4 billion) as policy-based guarantees (see Annex I and Figure I.3.1). The 2009–2010 global financial crisis led to a significant increase in the number and amounts of policy-based operations. IDB approved 61 policy-based operations for US$7.8 billion in 2008–2010, compared with only 31 such operations for US$3.8 billion during the previous three years. After falling somewhat in relative importance in 2011–2012, policy-based operations rose again in 2013; since then, IDB has averaged around 20 policy-based operations totaling US$4.4 billion per year (see Figure 3.1).

Figure 3.1

Evolution of policy-based lending, 2005–2022

Source: OVE, based on data from IDB databases.



3.2 IDB's policy-based and emergency lending spiked in recent years in response to the COVID-19 pandemic and its economic effects (see Box 3.1). To facilitate timely approval of operations to help its borrowing member countries respond to the COVID-19 pandemic and related social and economic effects, IDB developed several prototype operations, including one for a policy-based operation supporting fiscal and economic management to help cushion the impact of the economic crisis.

3 Sovereign guaranteed approvals in this context include all SG loan and guarantee operations regardless of funding source.

4 Actual approved amount, which could differ from the original approved amount due to cancelations or modifications of projects. This amount doesn't include US$0.9 billion canceled from the operations BH-L1027, CH-L1022, PN-L1086, and UR-L1076 and US$0.4 billion of the inactive operation EC-U0002.

From 2020 to 2022, IDB approved 65 policy-based operations for US$16.6 billion, of which US$2.1 billion went to 13 prototype operations for eight countries. In addition, IDB approved eight

Box 3.1. Policy-based lending and the IDB response to the COVID-19 pandemic

Policy-based lending was a central element of IDB's COVID-19 response (IDB 2020e, 2020d). The Bank considered this instrument as the most suitable for covering public expenditure and responding to increasing financing needs with large volumes of fast-disbursing resources. Management designed templates for draft project proposals (called prototypes) in four priority areas (immediate public health response, safety nets for vulnerable populations, economic productivity and employment, and fiscal policies for the amelioration of economic impacts) to facilitate a faster approval process and to provide funding to borrowers without much delay.[a] The prototypes included programs to strengthen public policy and fiscal management to address the health and economic crisis.

Considering the anticipated increase in the use of this instrument, the policy-based lending cap was increased to 40%.[b] In addition, approval rules were relaxed to use a no-objection procedure (instead of formal voting) by the Board of Executive Directors.

From 2020 to 2022, IDB approved 65 policy-based operations for US$16.6 billion, of which US$2.1 billion went to 13 prototype operations for eight countries. All policy-based prototype operations were in C&D countries.[c] Most of these prototype operations (seven) were approved in 2020.

By 2021, it was understood that all liquidity provided to countries was part of the response to the effects of the pandemic. Policy-based lending represented most of the IDB's operational response to the COVID-19 pandemic during that year, representing 71% of the COVID-19 response and 43% of total approvals. Between 2021 and 2022, only the continuation of the five programmatic series approved in Barbados, Guyana, Jamaica, Paraguay, and Uruguay were counted as COVID-19 responses.

Independent Country Program Reviews completed during 2022 for Chile, Ecuador, Guyana, Jamaica, and Peru found increased approvals and disbursements from policy-based lending in response to the pandemic in all countries except Jamaica (see Annex I for details).

Sources: IDB COVID-19 Dashboard and IDB's Annual Business Reviews.
Notes: The IDB published a dashboard (IDB 2022c) with information on all the projects in the operational response to the pandemic.
[a] See IDB 2020b. Prototypes of policy-based operations were designed exclusively to support fiscal policies.
[b] In resolution AG 8/20 (IDB 2020a), the Governors resolve: "That the limit of thirty percent (30%) outlined in paragraphs 3 and 4 of resolution AG-9/11, be increased to forty percent (40%) for approvals of Policy-Based Loans to be financed with the Bank's Ordinary Capital resources and Concessional OC resources until December 31, 2022.
[c] The Bahamas, Dominican Republic, El Salvador, Guyana, Jamaica, Paraguay, Trinidad and Tobago, and Uruguay (two operations).

SDLs for US$2.2 billion.

B. Distribution by country

3.3 All borrowing member countries, except for Venezuela, used policy-based lending between 2005–2022, but its relative importance in country portfolios varied. The share of policy-based lending in overall SG approvals increased for all IDB country groups during the period. A few countries have dominated in the number and dollar amounts of policy-based operations received. Historically, more policy-based operations have been approved for C&D countries[5] (see IDB 2022). Nonetheless, A&B countries[6] (except for Argentina and Brazil) tend to have a higher share of approvals (by volume) through policy-based operations. Colombia and Mexico together accounted for 36% of the amounts approved through policy-based lending over this period (see Table I.1.1 in Annex I). Between 2005 and 2022, Jamaica and Colombia had consistently more than 40% of their lending programs approved through policy-based operations. Nine countries (Chile, Colombia, Dominican Republic, El Salvador, Guatemala, Jamaica, Mexico, Panama, and Uruguay) borrowed at least half of their SG envelope in the form of policy-based lending in the 2015–2018 period. Since the onset of the pandemic in 2020, the use of policy-based lending has increased further. In 2019–2022, 19 countries had at least 30% of their approvals in the form of policy-based operations (only Argentina, Brazil, and Bolivia used policy-based lending in a more limited manner).[7] All C&D countries eligible during 2020–2022 used policy-based lending except for Belize (see document GN-3079). Only two countries (Peru and Uruguay) have used the DDO (approvals totaled US$300 million in the last two years in the case of Uruguay and US$900 million in the case of Peru).

C. Distribution by sector

3.4 Policy-based loans in public sector governance and economic management have dominated in the 2005–2022 period. To analyze the sector distribution of policy-based lending, OVE grouped IDB sector classification into six thematic areas: (i) public sector governance and economic management; (ii) financial sector reform and private sector development (with the latter primarily supporting measures to improve competitiveness);

5 Bahamas, Barbados, Belize, Bolivia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Panama, Paraguay, Suriname, Trinidad and Tobago, and Uruguay.

6 Argentina, Brazil, Chile, Colombia, Mexico, and Peru. Venezuela is the only country that did not use policy-based lending between 2005–2022.

7 Policy-based lending was not available to countries that lacked an IAMC.

(iii) social sectors (health, education, social protection, and gender); (iv) infrastructure and utilities (transport, energy, water and sanitation, housing, and municipal infrastructure); (v) environment, natural resource, territorial and disaster risk management, and agriculture; and (vi) other (industry, regional integration, and other). Both in terms of the number of operations (32.1% of the total) and approval volumes (37.3% of the total), policy-based lending in public sector governance and economic management dominated in 2005–2022.[8]

3.5 Since 2010, policy-based lending has become more diverse and used in other sectors. Infrastructure is the second most important area supported by policy-based lending, with utility reforms accounting for 22% of operations and 16.5% of lending volume (see Figure I.1.1 in Annex I). This group grew considerably in importance over the review period, from only ten operations approved in 2005–2009 to 27 operations in 2015–2019 (and ten operations in the shorter 2020–2022 period), driven by support for energy sector reforms. During the recent COVID-19 pandemic, policy-based operations were approved for public sector governance, economic management, and the social sector.

8 Some policy-based operations support reforms in multiple sectors. When assigning a sector code to an operation, IDB goes by the number of policy measures in each sector and does not account for the fact that operations may cover several sectors. Hence the figures presented here may not give a full picture of all reforms supported in each area.

04

Policy-Based lending use among MDBs

A. Policy-based lending use among MDBs

4.1 Policy-based lending's share in total lending has increased in all MDBs during and after crises (2008–2010, 2015–2016, 2020–2021) and has approached (and sometimes exceeded) 30% of their total lending. The World Bank has no explicit lending limit, but policy-based operations have, over the evaluation period, represented less of or around 30% of its lending portfolio. However, the LAC region's share of policy-based lending is much higher. The 26 IDB borrowing member countries received 48.6% of their lending through PBLs between 2005 and 2022, while the share of policy-based lending throughout the entire portfolio was 28% (see Table I.3.2 in Annex I). Within the WB portfolio, the LAC region receives the most policy-based lending of all six regions[9] (see Table I.3.1 in Annex I). Due to its broad portfolio, the WB can compensate for the heavier use of policy-based lending in one region by lower use in other regions, such as Africa, which keeps the institution-wide usage of policy-based lending low.

B. Policy-based lending modalities among MDBs

Box 4.1. Policy-based modalities in the AfDB, ADB, WB, and IMF

The African Development Bank (AfDB) has four modalities of Program-Based Operations (its denomination for policy-based lending): (i) general budget support, supporting policy and institutional reforms that are established in the country's national development plan; (ii) sector budget support, similar to the previous but focused on a particular sector (although financial transfers go through the national budget); (iii) crisis response budget support, which is a fast-disbursing loan or grant to mitigate the adverse impact of political, economic, or humanitarian crisis or shocks; and (iv) import support, used only exceptionally and involving the transfer of financial resources to the Central Bank to boost reserves in the case of a balance of payments deficit. According to its policies, AfDB budget support can be provided by stand-alone operations (single disbursement), programmatic operations (a series of single-year operations in a multi-year framework), and programmatic tranching (single loan operations with a series of tranches set up front).

At the Asian Development Bank (ADB), policy-based operations were gradually modified to replace stand-alone modalities with programmatic series. While the stand-alone was usually arranged in tranches with release policy actions specified upfront, programmatic policy-based operations consist of a series of distinct loans (subprograms) supporting sequenced reforms and connected by a common results framework. Ex-ante policy actions have been gradually substituted by prior actions or policy changes made before loan approval. The ADB has two additional policy-based lending modalities—crisis-response instruments: the Counter-Cyclical Support Facility (CSF) and special PBL (SPBL). CSF helps finance a fiscal stimulus following a crisis, while SPBL supports a country during a balance of payments crisis. The requirements for the instruments include, among others, that conditions must support structural

9 WB regions are Africa, Latin America and the Caribbean, Middle East and North Africa, East Asia and the Pacific, South Asia, Europe and Central Asia.

reforms or countercyclical development expenditure (ADB 2016). In 2019, ADB introduced a contingent disaster financing (CDF) policy that serves as a precautionary instrument in case of a natural disaster. Unlike other forms of conventional PBL operations that involve broader structural reforms, the policy framework required for CDF focuses on legal, institutional, and policy constraints for more effective disaster and health emergency preparedness and response programs (ADB 2023).

The WB has also pivoted from stand-alone single- or multi-tranche policy-based operations (Development Policy Financing [DPF]) toward an approach that provides all the funding up front upon completion of prior actions. Implementing all prior actions is a condition for approval by the Board of Executive Directors. While stand-alone loans may be more appropriate for short-term needs or situations of uncertainty, programmatic operations are preferred at the WB because they can support longer-term reforms more consistently, particularly in a stable policy environment. In exceptional cases, the WB may provide a separate, supplemental DPF to the original operation if an unanticipated gap in financing jeopardizes a reform program (without adding new conditions). The WB offers a DPF to help highly indebted countries reduce commercial debt and debt service as part of a medium-term financing plan to support sustainable growth. The International Bank for Reconstruction and Development (IBRD) Catastrophe Deferred Drawdown Option (Cat DDO) is a contingent financing line that provides immediate liquidity following a natural disaster or health-related event. Countries must be preparing, or already have, a satisfactory disaster risk management program, which the WB will monitor periodically for it to be eligible (WB 2023b).

In 2022, the IMF introduced a new instrument that resembles policy-based lending in the MDBs and focuses on climate change and sustainable growth. The IMF's Resilience and Sustainability Trust provides longer-term, affordable financing to address longer-term challenges, including climate change and pandemic preparedness. To be eligible, countries must have an active IMF program and present high-quality policy reforms addressing the long-term structural challenges of climate change or pandemic preparedness. A reform measure can be a single policy action or a set of closely related actions constituting a single reform. There has been a high demand for the new instrument, especially from the LAC region, as three out of five approved arrangements were for LAC countries: Barbados, US$113 million; Costa Rica, US$710 million; and Jamaica, US$764 million (IMF 2023).

4.2 Most MDBs offer a single-tranche stand-alone policy-based instrument, with the IDB being an exception. At the WB, about 60% of all PBLs are programmatic. However, there were many cases where stand-alone DPFs were more relevant (WB 2021). Stand-alone loans were used in countries re-engaging with the WB or facing an economic crisis. They were also often used for shorter-term reforms, especially by client countries at higher income levels seeking to implement more advanced reforms. At the AfDB, between 2012 and 2019, 66% of policy-based lending was designed as programmatic series or multi-tranche, the rest being stand-alone single-tranche loans. Programmatic models are the preferred option for AfDB because reforms are considered medium-term, and programmatic loans allow development partners more leverage to support reforms (ECG 2023a). AfDB guidelines specify that single-tranche stand-alone operations should be used only in exceptional cases. The ADB single-tranche stand-alone operations are mainly used as a crisis response instrument.

4.3 Compared to the menu of instruments in other MDBs, the IDB has fewer modalities of policy-based operations, and its emergency lending instrument is less flexible (subject to a lending arrangement approved by the IMF). In recent years, the only additions to the policy-based modalities have been the DDO in 2012, which has been used by only two countries, and the policy-based guarantee (PBG), which has only been used by four countries. As shown in Table 4.1, other MDBs offer more policy-based modalities than the IDB. Except for the IDB, which conducts its own macroeconomic and debt sustainability assessments, all MDBs strongly count on the IMF for macroeconomic assessments. Unlike the IDB, emergency lending instruments of the ADB and AfDB do not require an IMF program[10]. Emergency lending instruments that require an IMF program have not been used at the WB, ADB, or AfDB during the recent COVID-19 crisis (CDC 2022 and IDEV 2018)[11]. This indicates that requiring an IMF program may limit the use of emergency instruments in specific crisis scenarios. OVE (2016a) found that the limited use of contingent instruments seems to be rooted mainly in (i) the general stigma of potentially revealing vulnerability to an uncertain future event and (ii) specific instrument design factors, such as pricing and the requirements for drawdown. Most countries have yet to be willing to pay a significant premium over regular lending terms for contingent instruments, especially for standby fees (OVE 2016a).

Table 4.1. Overview of modalities of policy-based lending in different MDBs

	IDB	World Bank	ADB	AfDB
Stand-alone multi-tranche	Yes (PBL)	Yes	Yes	Yes
Stand-alone single-tranche	--	Yes	Yes	Yes
Programmatic	Yes (PBP)	Yes	Yes	Yes
Deferred drawdown option	Yes (DDO)	Yes (IBRD only)	--	--
Countercyclical (only alongside an IMF program)	Yes (SDL)	Yes (Special DPF; IBRD only)	Yes (Special PBL)	Yes (Import Substitution)

10 The ADB and the AfDB have subdivided the emergency window into different instruments: one that requires an IMF program (SPBL in the ADB and Import Support in the AfDB) and one that does not (CSF in the ADB and Crisis Response Budget Support [CRBS] in the AfDB). The WB's only emergency instrument, the Special Development Policy Financing, requires the presence of an IMF program.

11 ADB's SPBL is used to support a country during a balance-of-payments crisis and until 2019 had never been used, despite being introduced nearly 30 years ago; since then, Sri Lanka made use of the instrument in 2023 (ECG 2023).

	IDB	World Bank	ADB	AfDB
Countercyclical (independent from IMF program)	--	--	Yes (CSF)	Yes (CRBS)
Natural disaster	--	Yes (Cat DDO)	Yes (CDF)	--
Supplemental policy-based lending	--	Yes	--	--

Source: OVE based on SPD (2023), WB (2017), ADB (2022), IDEV (2018).

C. Findings on policy-based use among MDBs

4.4 In all MDBs, policy-based lending plays a dual role, providing incentives for reform and budget financing or debt diversification, but—according to findings from recent evaluations—providing liquidity alone cannot achieve policy reform. Evaluations of policy-based instruments in other MDBs (Fardoust et al., 2023) generally conclude that the capacity of policy-based lending to act as an incentive for policy reform has diminished. Evaluations (IDEV 2018 and IED 2018) also found that for MDBs to be effective in policy support, the programs must be complemented with other instruments beyond budget support, including policy diagnostics, technical assistance, and investment loans. Except for IDB, which conducts its own macroeconomic and debt sustainability assessments, all MDBs strongly count on the IMF for macroeconomic assessments.

4.5 MDBs concentrate their policy-based operations in countries with relatively higher income levels and institutional capacity. Middle-income countries (MICs) have consistently made higher use of policy-based lending, relying on them as a source of budget financing even in non-crisis years. ADB's evaluation found that policy-based lending is primarily used by larger, more capable, and more developed countries. At the AfDB, over 75% (by amount) of policy-based lending approved since 2012 has been for operations in MICs, translating to about one-third of the number of operations. Similarly, the WB has historically made relatively more significant use of policy-based lending in MICs than in low-income countries (ECG 2023b). According to the evaluation, this trend reflects the more advanced institutional and absorptive capacities and better-developed systems of public expenditure management and budget planning in MICs.

4.6 Recent evaluations of the instrument find a general trend in policy-based lending to support less critical reforms. Policy-based lending in all MDBs has moved from more politically sensitive reforms to more specialized ones generally connected with public financial management (PFM) (Fardoust et al. 2023). Currently, programmatic policy-based lending is often focused on budget formulation, execution, and audit and is less focused on expanding infrastructure or eliminating significant constraints to growth[12]. This trend provokes an improvement in policy-based operations evaluation scores in project evaluations, as policy actions are within the direct control of finance ministries, which are the primary stakeholders in the policy-based operation design.

12 At the ADB, nearly two-thirds (by value) and more than one-half (by number) of policy-based operations approved since 2008 supported public sector management reforms. At the AfDB, almost two-thirds of policy-based operations approved between 2012 and 2017 were listed as General Budget Support, which typically concentrates on core economic governance areas such as PFM. At the WB, thematic evaluations also show the predominance of prior actions related to PFM within policy-based operations.

05

Policy-Based Lending Use and Design in the IDB

A. Instrument use

5.1 Policy-based lending use in the IDB has fulfilled its objective of providing fast disbursement financing for budget support, debt management, diversification, and insurance, but it fell short of fulfilling its objective of supporting reforms. The Bank has also aimed to fulfill its objective of supporting the inception or the implementation of ongoing reform agendas. Nevertheless, this objective has not always been fulfilled due to shortcomings in the design and implementation of policy-based operations. Lack of depth in policy matrices has affected the vertical logic of policy-based programs, and the truncation of programmatic series has affected the carrying out of reforms.

5.2 In country case studies, interviews with IDB staff and country counterparts, and country products, OVE found that, in most cases, the main driver of policy-based demand has been liquidity, debt management, or debt diversification. But, depending on the country, policy-based programs also aimed to support design and consensus building around reform agendas (Barbados, Honduras, and Paraguay) or the implementation of ongoing reform agendas (Barbados, Mexico, and Peru), or have been used by finance ministries to accelerate and gain commitment from sector ministries for reforms processes (Barbados, Honduras, Mexico, and Paraguay).

5.3 Policy-based operations have aimed to support needed reform agendas in priority sectors. Policy-based operations have mostly been aligned with government priorities, covering key priority sectors and contributing to the objectives of IDB country strategies, and have aligned with corporate priorities. In a few instances, policy-based operations have not addressed countries' most pressing reform needs (including fiscal reforms, labor reforms, and transparency and integrity reforms, among others).

5.4 In country case studies, OVE found that the Bank had provided analytical work and capacity building and engaged in policy dialogue in most areas supported with policy-based operations. Bank counterparts recognize the value of the Bank as a partner for the design and implementation of the reforms. OVE found that policy-based programs have benefited from non-reimbursable technical assistance and technical support from the Bank's in-house specialists and sector experts. Programs have been based on sound analytical work. The Bank has also enabled knowledge sharing with other bank clients who have more experience in reform design and implementation. Even though these have strengthened the vertical logic of the programs, in some cases, they haven't translated into policy actions with enough criticality to bring out the needed reforms to achieve program objectives (see paragraph 5.6 below).

5.5 OVE has found that in most cases, policy-based programs supported reforms that were already ongoing before the approval of the first operations; however, most reforms had received prior technical support from the Bank. IDB supports policy reforms in sectors in which it had previously worked (usually through technical cooperation grants or INVs) and had country-level expertise, continuous policy dialogue, technical assistance, and a role as a trusted policy advisor. Line secretaries highly value the technical and financial support of the Bank through technical cooperation (TC) and knowledge of sector specialists. In four of the five case studies (the exception being Peru), sector specialists had an agenda of cooperation and support with their counterparts, regardless of whether a budget-support loan existed or not. The types of support specialists provide can vary from hiring consultancies for knowledge products and designing and contracting goods to exchanging experiences with ministries and secretariats of other countries. These findings are consistent with the Technical Note in OVE's 2015 Annual Report (OVE 2015), which used social network analysis to map the interaction between policy-based lending and a set of broader but related operations in each country.

5.6 OVE found shortcomings in the vertical logic of Bank-supported policy-based programs. Policy matrices lacked the criticality to achieve intended objectives (see section D below). This is partly because reforms lack adequate ownership, especially in Congress, affecting the criticality of policy actions. Many IDB policy-based programs include presenting laws to Congress rather than its approval and may overestimate the consensus around the reforms supported. Programs also didn't consider other political and institutional risks related to political instability, political cycles, the turnover of ministers and vice ministers, and the low institutional capacity of ministries in charge of the reform processes. These increased the risk of PBP series truncation[13] and affected the likelihood of achieving program objectives.

13 Building on the definition set out by the Office of Strategic Planning and Development Effectiveness (SPD), OVE considers that a PBP series has been interrupted or "truncated" if one of the following occurs: (i) the government formally requests the discontinuation of at least one operation of the series; (ii) there is no loan in the pipeline 24 months after the last disbursement date of the most recent operation; or (iii) a pending loan in the series has remained in the pipeline for more than 36 months after the last disbursement date of the most recent operation (see OVE 2015, para 5.7).

B. Programming of policy-based operations

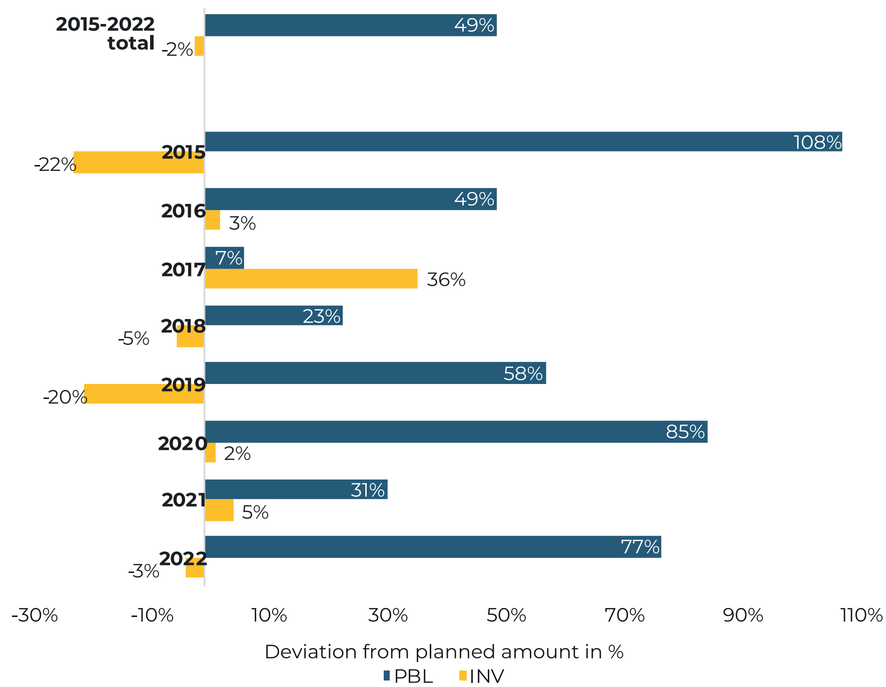
5.7 Policy-based lending shares by country are programmed as part of IDB's biannual envelope exercise, but there seems to be no specific algorithm for allocating them. After the overall lending envelope is decided for each country, the Vice Presidency for Countries assigns an indicative share of the envelope that will be approved through policy-based lending. According to information from interviews, these shares consider the overall 30% cap of policy-based lending, the historical shares of policy-based lending in each country, current client demand, and the country's credit ratings. Initial programmed amounts do not cover the available 30% allocation to leave room for unexpected needs or decreases in overall lending.

5.8 In most countries, the demand for policy-based resources is higher than the amounts approved. Both Bank staff and counterparts interviewed by OVE highlight that demand for financing through policy-based instruments is always higher than the amounts initially programmed. Policy-based lending's total volume, as indicated in the Operational Program Report (OPR), is often surpassed, and policy-based operations may have higher approved amounts than initially programmed. When policy-based operations are not expected to be approved within a year, the resources freed are allocated to other existing loans in the pipeline to maintain a level of policy-based lending approvals. OVE found that, in 2015–2022, the actual approved amounts for policy-based lending were about 50% larger than planned in the OPR. On average, the approved amount for investment operations was the same as indicated in the OPR (see Figure 5.1). From interviews with other MDBs and document reviews, OVE found that no MDB has an explicit methodology to link the size of a policy-based operation to the reform because of the difficulty quantifying them.

Figure 5.1

Difference between amounts indicated in operational programming report and actual approved amount, by lending instrument and year

Source: OVE's elaboration based on OPR documents 2015–2022.



Note: PBL stands for all types of policy-based lending; INV stands for investment lending.

5.9 On the supply side, from a financial perspective, IDB has a strong incentive to maximize policy-based lending, especially in countries with high credit ratings. Lending to countries with higher credit ratings, which tend to prefer policy-based operations, improves the risk profile of the Bank's balance sheet, thereby protecting IDB's AAA rating.Policy-based operations are less costly to prepare and execute for the Bank (see Annex II) and disburse and get repaid faster, allowing for more intensive use of capital. Under current loan charges, all these factors improve the Bank's profitability.

5.10 Sector selection for policy-based operations involves a collaborative process with the country, considering factors such as country needs and preferences, previous Bank support, and the presence of government's reform agendas. The sectors and the reforms to be supported with policy-based operations are agreed upon in dialogue with the country after the lending allocation and the policy-based lending share have been set. Sector selection varies by country but considers country needs and preferences and the areas where the Bank has supported policy improvements, typically through TC, INV, or support from IDB sector experts.

C. Choice of modality

5.11 Most countries demand PBPs instead of PBLs due to their flexibility and lower costs, and demand for DDOs, hybrids, and policy-based guarantees has been limited. Both IDB staff and counterparts found PBPs more attractive than PBLs. PBPs are less expensive than PBLs since the credit commission is charged for the undisbursed tranches of PBLs. Clients and staff also appreciate the flexibility of PBPs in changing policy actions when circumstances change. Only Peru and Uruguay have demanded DDOs. A solid fiscal situation and low public debt levels made contingent lending more attractive. For other countries, short-term fiscal and debt management and diversification needs took priority over protection from risks.

5.12 Policy-based guarantees (PBGs) have been used sparsely in the IDB but with a noticeable increase in use in the last three years. Between 2005 and 2022, the IDB approved only five PBGs. However, three were approved in 2022 and have been used for debt-for-nature swaps[14] or bond issuance[15]. PBGs are similar to policy-based operations in that a guarantee is granted upon completion of all policy actions, which can be used to back another debt instrument, such as a bond. Unlike in a policy-based loan, where the use of funds cannot be prescribed to specific activities, in PBGs, the use of savings generated by the PBG can be restricted to particular activities such as conservation funds (IDB 2022b).

5.13 According to interviews, demand for PBGs exists, but the capacity to meet the demand is partly limited by the 30% cap for policy-based lending and other factors. As OVE outlined in its Guarantees Evaluation (OVE 2022a), clients tend to prefer PBPs over guarantees because the capital adequacy rules and pricing principles for PBGs are similar to those for comparable PBLs. This leads borrowers to choose loans over guarantees. Guarantees have higher transaction costs. Counterparts and IDB staff have greater familiarity with loans, and disbursements are more predictable when using a loan. The lending cap of 30% for policy-based lending also applies to PBGs, which forces clients and IDB into a tradeoff between PBPs and guarantees.

14 BA-U0001 and EC-U0005.

15 BH-U0001.

D. Policy actions

5.14 Although adequate analytical work, technical assistance, and policy dialogue have strengthened the vertical logic of policy-based programs, they haven't necessarily translated into policy actions with enough criticality to bring out the needed reforms to achieve program objectives. OVE found that 24% of policy-based operations had a policy matrix where the majority (50% or more) of their policy actions were rated low depth (see Box 5.1, Table 5.1, and Annex III). The number of policy actions is weakly positively correlated with the prevalence of low-depth actions (correlation coefficient of 0.14), meaning that a policy matrix with more policy actions tends to be less deep. Low-depth policy actions call for basic one-off measures or simply express reform intentions (OVE 2015). For example, an action would commit a line agency to an independent operational audit of a feeding subsidy or call on an agency to prepare terms of reference for the design of a methodology to analyze the outcomes of a national investment plan.

Box 5.1. Methods used to assess the depth of policy actions

Policy actions were assessed according to their criticality, i.e., **their capability to trigger long-lasting policy and institutional changes.** OVE's analysis reviewed the content of each policy action and assigned it to one of three categories:

Low depth. Policy actions that would not, by themselves, bring about any meaningful changes. Low-depth actions are usually process-oriented and often involve preparing action plans or strategies and announcing intentions.

Medium depth. Policy actions that can have an immediate but not a lasting impact. These include actions calling for one-off measures that can be expected to have an immediate and possibly significant effect, but that would need to be followed by other measures for this to be lasting. Submission of draft legislation to Congress, reaching a target or benchmarks, and organizational changes are examples of medium-depth policy actions.

High depth. Policy actions that could, by themselves, trigger long-lasting changes in the institutional or policy environment. Policy actions in this category include legislative changes, government decrees, or lower-level actions that complete a critical reform process. High-depth policy actions also include measures that require specific fiduciary measures to be taken regularly or permanently, even when legislation is not needed.

This analysis was supplemented by assessing the programs' overall vertical logic and coherence. OVE evaluated the sequencing of the policy actions across PBL tranches or across PBPs by looking at the extent to which the policy actions included in each tranche of a multi-tranche PBL, or in each PBP, followed a logical sequence over time by supporting different stages of the reform process cycle (i.e., formulation or design, adoption or approval, implementation, monitoring, and evaluation). OVE also assessed the program's vertical logic: the coherence between policy actions and the reform program objectives. While OVE's analysis of the depth of policy actions and their sequencing allowed it to gauge the progress of the reform program supported by a policy-based operation, the methodology did not measure IDB's technical additionality to the reform program or the extent to which the impetus for reforms could be traced to IDB actions.

Table 5.1. Depth of policy actions in policy-based operations

	Number of operations	%
75% or more of the policy actions are low depth	8	4,6%
50%–74.9% of the policy actions are low depth	34	19,5%
25%–49.9% of the policy actions are low depth	63	36,2%
Fewer than 25% of the policy actions are low depth	69	39,7%
Total	174	

Sources: OVE (2015) and depth of policy actions from 2015–19 in OVE country products.

5.15 OVE found policy actions that are not deep enough to ensure reform implementation and may affect the fulfillment of the operation's objectives. Policy actions that are not formulated precisely could allow measures to be adopted that fall short of what was intended. Examples of such policy actions are "advances in the implementation of the training plan," "updating information on the platform," and "strengthening the agency by improving its internal procedures, coordination with actors, and budget and personnel allocations." OVE also found policy actions that resemble milestones of loans based on results (LBRs)[16], focusing more on strengthening reform implementation but subject to risks related to the allocation of budget resources to achieve them. In this case, other instruments, such as LBRs, could also be considered to support actions to strengthen the implementation of reform agendas. Lack of buy-in by Congress also translates into policy actions that don't guarantee the approval of legislation needed to carry out the reform programs.

5.16 Policy actions gain in depth as the program advances, which reduces effectiveness if the program is truncated. Analysis of OVE found that policy matrices of PBPs gain in depth as the series advances. This was also the case among country case studies, except for Mexico. On aggregate, 41% of policy actions in the first PBP of a programmatic series were found to be of low depth, while this proportion decreased to 29% in the second loan and 20% in the third loan of a series (see Figure 5.2)[17]. While this pattern may support a progressive reform agenda, it creates challenges when the PBP series is interrupted, as some of the

16 LBRs link the disbursement of funds directly to the achievement of predefined, sustainable results. The aim is to help countries improve the design and implementation of their own (new or existing) development programs and achieve lasting results by strengthening good governance and fostering a management culture based on results.

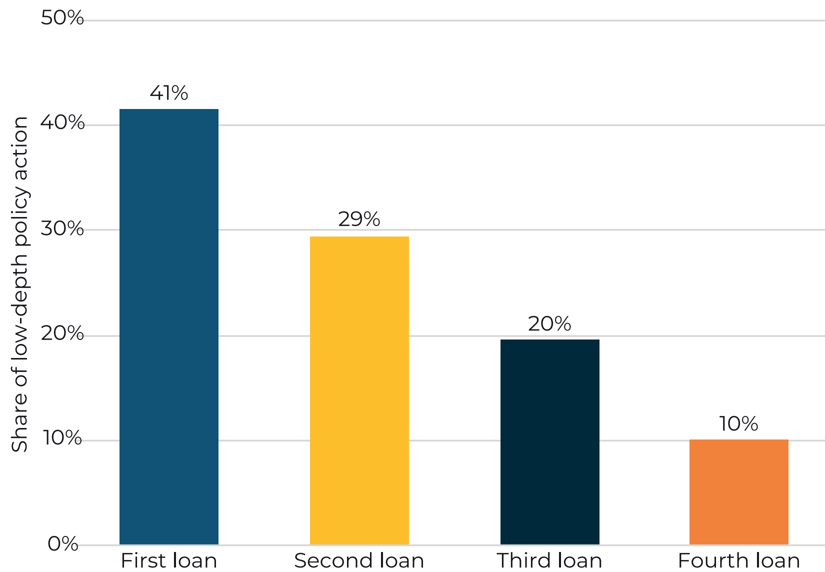
17 This analysis relies on data from OVE (2015) and country program evaluations and reviews (see previous footnote). The results between the different types of sources do not differ significantly. Results from OVE (2015) were that 43% of actions in the first PBP in a series were of low depth, while this proportion decreased to 30% in the second loan and 16% in the third.

most consequential reforms might never be implemented. Between 2005 and 2022, 32% of the PBP series were truncated (see Section V on implementation for more details).

Figure 5.2

Depth and loan order (PBP series)

Sources: OVE (2015) and OVE country evaluations and reviews published between 2015 and 2022.



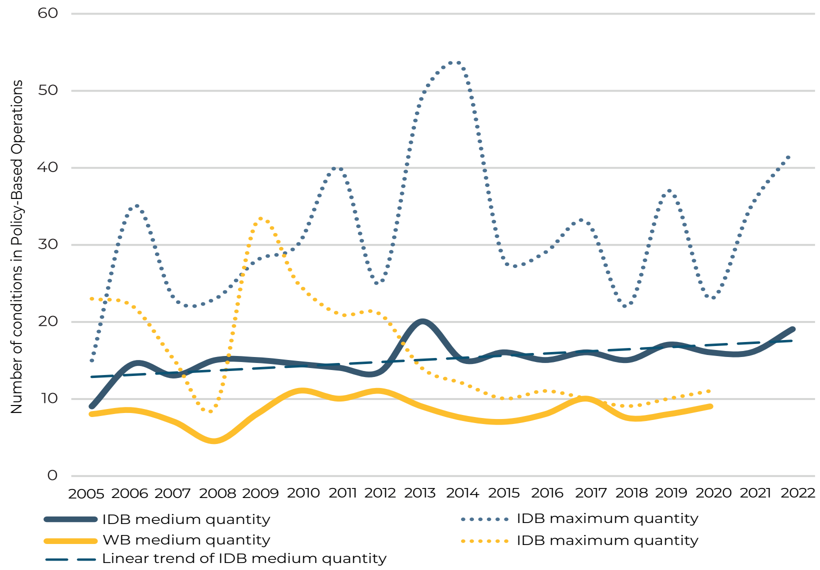
Note: Values shown are the percentages of low-depth policy actions among all policy actions from first, second, third, and fourth loans in a PBP.

5.17 The number of policy actions has increased over time and is higher than in the WB. Analysis of the number of policy actions in IDB shows that, per loan, the number of policy actions has increased from around 13 actions in 2005–2010 to about 17 in 2019–2022 (see Figure 5.3). The WB collects information on each prior action, including on sector and thematic areas, while such a database does not exist at the IDB. In the WB, the number of policy actions has remained constant over the years at around eight actions, showing a more sparing use of policy actions. As shown in Figure 5.2, the variation in the number of policy actions is less extreme in the WB than in the IDB, and the variation has decreased over time at the WB while it has remained high at the IDB. A more compact matrix may be easier to understand and manage for IDB staff and counterparts, facilitating accountability, reducing the risk of misinterpretation of conditions, and helping streamline communication around critical aspects of the reform agenda. On the other hand, finance ministries may prefer more extended matrices to set up more commitments with line ministries for reform implementation.

Figure 5.3

Number of policy actions in policy-based operations in IDB and WB

Source: OVE and WB prior action database.



Note: Median and maximum quantity refer to the median or maximum number of policy actions in all policy-based operations approved in the respective year.

5.18 There is insufficient guidance for preparing policy matrices, especially in new areas of policy-based lending, which may have contributed to the deficiencies in policy actions described earlier. Based on interviews with IDB staff, OVE identified that the lack of specific guidance on the number and quality of policy actions and the perceived need to include a certain number of policy actions to justify loan approval are possible reasons for these phenomena. Team leaders in sectors with higher shares of policy-based lending (public sector governance and economic management, social, and energy, for example) tend to rely on their experience or previous operations to design policy matrices. Guidelines tend to be general and don't provide specific guidance for the design of matrices of policy actions, which is needed for sectors with a limited track record on policy-based lending (environmental sustainability and climate change, gender and diversity, and land use, for example). Unlike other MDBs, IDB does not have a repository of policy actions. Such a repository can help team leaders formulate policy actions, and it could be used for monitoring purposes. Many team leaders mentioned that guidance on the number and content of policy actions would be helpful.

E. Complementary instruments (TCs and INVs)

5.19 Reforms are usually supported through analytical work and technical cooperation (TC) from the Bank; support with INV is less frequent. Clients value the TC support and the expertise provided by the IDB. The IDB has a distinctive advantage in sharing examples of successful reforms, the best global and regional practices, and lessons learned from peer countries. In country case studies and from document review, OVE found that, while TC operations and analytical inputs were provided to support the execution of policy-based programs, approval of INVs was much more limited. Small INVs may have helped accompany the implementation of the reforms supported by the PBP series.

5.20 An analysis of a random sample of policy-based operations approved after 2015 shows that the information on TCs and INVs linked to policy-based operations is not systematically recorded despite finding evidence that about 80% of operations have at least one TC. This is consistent with OVE's 2015 note on policy-based lending. Looking at policy-based operations approved between 2015 and 2022 using IDB databases, OVE found lower use of TCs with policy-based operations (only about one-third of policy-based operations are linked to a TC in Bank systems in the period); however, IDB databases may not adequately capture the relationship between TCs, INVs, and policy-based operations (see Annex I). Out of 160 policy-based operations approved between 2015 and 2022, 121 had no TC or INV linked to the operation in the IDB internal data marketplace[18].

5.21 Many OVE country program evaluations and reviews have included recommendations for improving the lending instrument mix in country programs. As noted in OVE's review of lending instruments (OVE 2020), the Country Program Evaluation (CPE) for the Dominican Republic (2013–2016) recommended tailoring the supply of loan modalities to balance IDB support between (short-term) financing support and (long-term) support to country strategies' development objectives. The CPE for Suriname (2011–2015) recommended adopting a more effective and complementary instrument mix that combines policy reform with technical support for implementation, ensuring the completion of the PBP series in progress. The CPE for Uruguay (2010–2015) recommended ensuring a better balance between contingent and investment lending.

18 In a stratified random sample of 43 of these 121 operations, 86% included a related TC in the loan proposal. In 40% of them, a TC was linked in Convergence or the Development Effectiveness Matrix. In 22 cases, there was a link to an INV, and in 15 out of 22 operations, the INV was complementary to the policy-based loan and supported the reform.

F. Coordination with other MDBs

5.22 Finance ministries have led coordination with other MDBs for policy-based operations, focusing more on TC than structuring complementary lending programs. In all cases reviewed by OVE, the finance ministry coordinates policy-based lending allocation and complementary technical assistance for reform processes.

5.23 Parallel lending with other agencies is less frequent than parallel support through TC, but in the fiscal sector, there is enhanced coordination with the IMF, and many operations have been approved in the framework of IMF programs. A simultaneous WB policy-based operation in the same sector was found in one out of five operations[19]. In the early years of policy-based lending, operations used to be approved when the borrowing country had an IMF-supported program in place—90% of policy-based lending approvals between 1995 and 2003 were granted to countries with an IMF program. This proportion has decreased substantially since then, partially because of the decreasing presence of IMF-supported programs in LAC. For 2005–2022, 42% of all policy-based lending operations were approved when an IMF program was active (IDB operations are not necessarily linked to the IMF program and could occur simultaneously). The econometric analysis also found that an IMF program increases the likelihood of approving policy-based operations (see Annex IV). There are instances where IDB has continued to support policy-based operations in the context of an IMF program, including operations for Argentina, Barbados, Ecuador, and Jamaica in recent years.

19 A policy-based loan is considered implemented alongside a WB Development Policy Loan (DPL) if the IDB policy-based loan was approved in the years a WB DPL was active in the same country and sector. This does not necessarily mean that both operations supported the same reform, as some sectors are broad, such as reform and modernization of the state, and could support different reforms.

06

Implementation and Results

A. Truncation

6.1. Truncation of a PBP series is common but has decreased in recent years. Of the 157 PBP series approved between 2005 and 2022, 79 (50%) have been completed, 50 (32%) have been truncated, and 28 (18%) are still ongoing (see Figure 6.1 and Table 6.1), resulting in a truncation rate of 39%. Of the 82 series approved between 2005 and 2014, 45 (55%) were completed, and 37 (45%) were truncated. Of the 74 PBP series approved between 2015 and 2022, 18% have been interrupted, and 46% have been completed, which implies a truncation rate of 28%.

Figure 6.1

Status of PBP series, 2005–2022 approvals

Source: OVE, based on data from IDB databases.

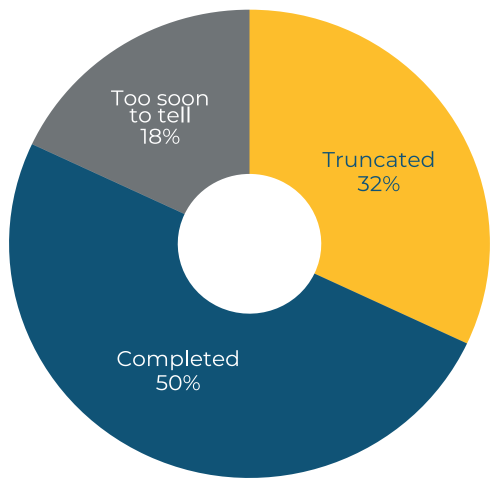


Table 6.1. Status of PBP series by program size, 2005–2022 approvals

Number of Planned Operations in Series	Completed	Too Soon to Tell	Truncated	Total
2	52	25	26	103
3	26	3	22	51
4	1	0	1	2
5	0	0	1	1
Total	79 (50%)	28 (18%)	50 (32%)	157

Source: OVE, based on data from IDB databases.
Note: The cutoff date for the analysis is December 31, 2022, which means that only operations that fell under the truncation criteria at that date are shown here as truncated.

6.2. There are significant variations in truncation across countries and somewhat less variation across sectors. For example, Colombia had 20 PBP series approved between 2005 and 2022, and nine of them were not completed (truncation rate of 45%), while Peru, with a similar number of programs (16), only failed to complete one series (truncation rate of 6%). Similarly, with six approved series, Trinidad and Tobago truncated five series (truncation rate of 83%), while Guyana, with three approved PBP series, completed 100% of them. Sectors with the highest prevalence of truncated PBP series in the 2005–2022 period are transport (4 out of 7 series not completed), agriculture (2 out of 3), and private firms and SME development (5 out of 12). The sectors with more than two PBP series with the lowest truncation rates were reform and modernization of the state (13 out of 45) and trade (0 out of 4). OVE CPEs suggest that, in countries with high numbers of truncated series (e.g., Colombia, Dominican Republic, and Panama), IDB often engaged in a new series in a different sector after a series was truncated.

6.3. Truncation is more common for PBP series that start at the end of a government period, those with a lower approved amount, those consisting of more operations, and those with lower criticality. OVE compared the characteristics of 132 PBPs, approved between 2005 and 2022, that were either completed or truncated. Truncated PBPs are usually approved at the end of government terms: truncated series were approved when governments had, on average, 1.66 years left in their mandate, compared to 2.33 for the completed series. Additionally, series with a higher number of operations have a higher probability of being truncated: 33% of series with two operations were truncated, compared to 47% for series with three or more operations. The truncated series had a lower approval amount than the completed series: US$196 million versus US$396 million, on average. Truncated PBP series show a higher prevalence of low-depth policy actions in the first loans. This suggests that the reform process may not have progressed sufficiently to incorporate more medium- or high-depth policy actions. Truncated series also have a lower proportion of high-depth policy actions in loans in later stages (see Table 6.2 and Annex III). This suggests that backloading of the reforms (i.e., overly high reform burden at the latter stages of the reform) is not a key driver for truncation. Instead, it may indicate that overall readiness for reform was overestimated.

Table 6.2. Comparison of depth ratings for completed and truncated PBP series

	Truncated PBP series	Completed PBP series
Average share of **low-depth** policy actions in the first operation	46.1%	40.0%
Average share of **high-depth** policy actions in last operations	14.3%	21.0%

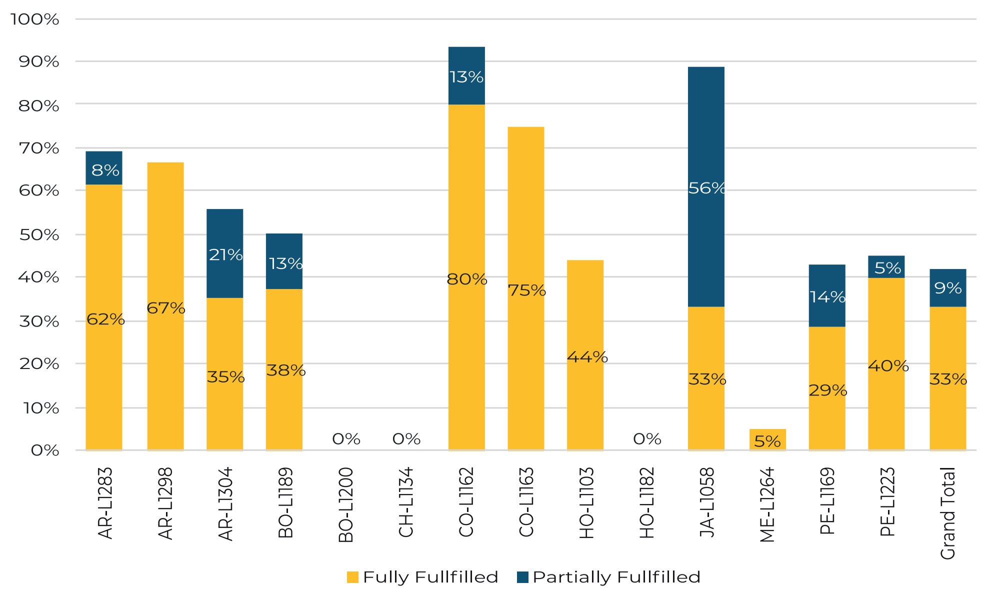
Sources: OVE based on 2015a and country products.
Notes: In the first row, N=16 for the truncated series vs N=33 for the completed series; in the second row, N=16 for the truncated series and N=42 for the completed series. The second row compares loans that were never approved (truncated loans) and all approved loans after the first operation in a series of all completed series.

6.4. Most policy actions supported by truncated PBP series advanced to some degree after truncation, yet no series completed all policy actions. OVE requested and validated information on the progress of policy actions in operations that were approved since 2015 and classified as truncated by 2022. For three series, the status of policy actions after truncation is either unknown or no information was provided (Figure 6.2). In the other truncated series, governments advanced on implementing policy actions, particularly Colombia (75%–80% of policy actions completed) and Argentina (62%–67% of policy actions completed). On average, 36% of all policy actions were completed (46% if the three operations without information are excluded). However, no country completed all the policy actions of the truncated series. This limited completion of policy actions likely affected the effectiveness of the series.

Figure 6.2

Policy actions progress in truncated series, 2015–2022

Source: OVE's elaboration based on responses from project team leaders.



Note: A policy action is partially fulfilled if the government progresses to some extent with the policy action but does not cover all aspects. For example, a law could be passed that is not as broad as planned in the policy matrix, or a regulation could be under preparation but has yet to be approved.

6.5. Truncation creates transactional costs for the IDB. The cost of designing a PBP series is front-loaded, suggesting—from the Bank's perspective—efficiency gains in continuing the series (see Figure I.5.1 in Annex I). Preparing the first loan of a series is more expensive than preparing subsequent operations, as most of the diagnostics work is done before the start of the series, and second and third loans do not require compliance with some of the project cycle milestones (identification missions, Project Profile preparation, etc.). Therefore, the truncation leads to sunk costs for the Bank.

6.6. Truncation of a PBP series is rarely explicitly mentioned in self-evaluations and some truncated series lack self-evaluations (PCRs). Of the 11 truncated PBP series, only one self-evaluation used the word *canceled or truncated*. The other self-evaluations of the truncated PBP series do not explicitly state that the programmatic series is truncated or off-track; instead, they often revert to statements that indicate that the second loan was not requested[20]. Most self-evaluations do not explain why the operation was off-track or to what degree the reforms continued despite being off-track. Also rarely discussed is how the lack of continuation of the PBP series affects the effectiveness and sustainability of the supported reform. Of the 13 PBL or PBP series without a PCR in the Bank system, 3 are PBLs and 10 are truncated PBP series.

B. Effectiveness

a. Liquidity support

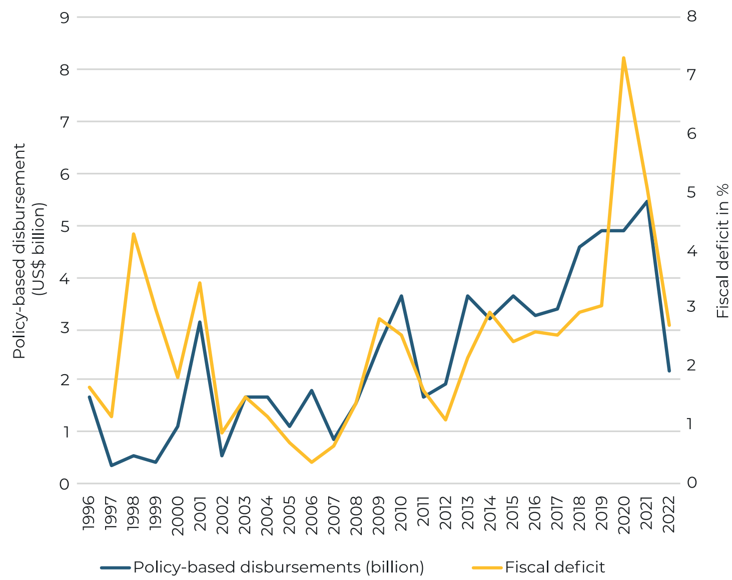
6.7. The predominant driver of the demand for policy-based lending has been liquidity for budget support, debt management or diversification, or, in fewer cases, preventive borrowing. Despite the range of reasons for using policy-based lending across countries, fast-disbursing financing is the predominant reason. This conclusion arises from country case studies, OVE's review of recent country products, and the findings from OVE's note (2015), suggesting that while countries valued the policy dialogue and technical expertise that came with IDB policy-based lending, the policy elements were usually secondary to the primacy of budget support. Figure 6.3 shows that the fiscal deficit of countries that use policy-based lending positively correlates with its disbursed amount. A 2022 paper by the Office of Strategic Planning and Development Effectiveness (SPD) also finds evidence that policy-based lending provides support when countries face fiscal distress, and an IMF program is active (IDB 2022).

20 Such as "*Cabe destacar que, si bien el diseño original del programa consistía en dos operaciones, únicamente se implementó la primera [...], dado que el [gobierno] no solicitó el segundo tramo previsto*" (PE-L1169).

Figure 6.3

Link between policy-based operations disbursements and fiscal deficits

Source: OVE



Note: Average fiscal deficits are only included for those countries that received approval for a policy-based operation in the respective year.

6.8. According to econometric analysis, policy-based lending has not been counter-cyclical, although its use increased during the COVID-19 and 2009 global financial crises. OVE didn't find evidence of policy-based lending following either pro-cyclical or counter-cyclical behavior. Annex VI shows the results of multiple country and time fixed-effects regressions controlling by relevant variables and a post-double selection model, and there is no statistical relationship between policy-based lending and the economic cycle. These results show that neither approvals nor disbursements have a counter-cyclical role for governments in the region. These findings are consistent with results from SPD in empirical studies (Avellán, Galindo, and Lotti 2022; Avellán et al. 2022), which also encountered no evidence that supports a clear relation between approvals and the economic cycle[21].

6.9. The use of policy-based lending for budget support purposes is particularly pertinent for small economies. They tend to be more vulnerable to external economic shocks, and IDB financing could be decisive in helping them weather the storm (OVE 2015). The instrument's ability to affect macroeconomic conditions in larger countries is limited by the small size of the loans in relation to their overall economies. For small economies, policy-based funding can cover a significant portion of government expenditure (11%–14% of government spending; see Figure 6.4). The highest disbursements occurred around times of crisis, such as the COVID-19 pandemic or the financial crisis of 2007–2009.

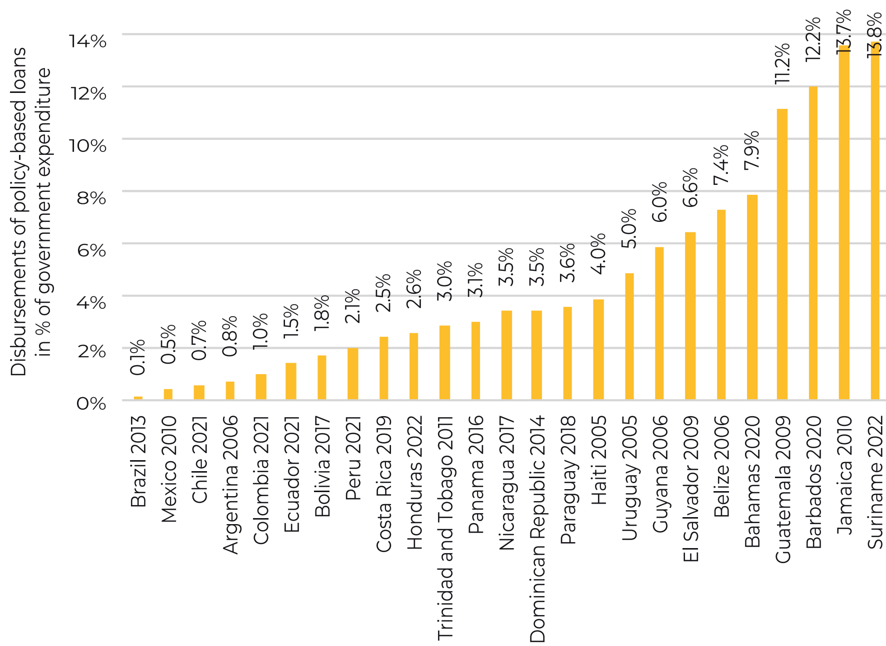
21 These authors study cyclicality of the approvals of policy-based operations but they didn't explore disbursements as in this evaluation. They found a somewhat statistically significant role of policy-based operations around credit crisis. Nevertheless, these results are only significant at 10%, and their sample covers the 1990–2015 period, which limits the robustness of the results.

Conversely, for large economies, including some that make extensive use of policy-based lending like Colombia or Mexico, it can, at best, play a marginal role in financing government expenditures (policy-based disbursements covered at a maximum of 0.5%–1% of their government expenditures).

Figure 6.4

Share of policy-based operations disbursements in % of government spending—highest share by country 2005–2022

Source: OVE



Note: Graph shows each country's highest share of policy-based operations disbursements.

b. *Reform support*

6.10. OVE's validated self-evaluations of policy-based operations indicate that two-thirds of PBP series and PBLs couldn't show that they have achieved their reform objectives. Data is available for 38 PBP series, six stand-alone PBLs[22], and four hybrid operations, totaling 48 validated evaluations between 2018 and 2023[23]. These validated evaluations show that 4% fully achieved all their reform objectives, and 33% achieved at least 80% (see Box 6.1 and Figure 6.5). Of policy-based programs, 21% achieved less than 50% of their reform objectives. Eleven PBP series were truncated, and their effectiveness ratings are slightly lower than those of the completed series (36% with a positive rating). Thirty-eight percent of PBLs and PBPs vs 29% of INVs showed positive results[24].

22 Four of these PCRs rated hybrid operations that combined policy-based operations with an INV or TC, which are excluded from the sample, resulting in 27 PBP series and 3 PBLs for the analysis.

23 Following OVE 2023a, OVE excluded PCRs from the 2017 cycle due to diverging methodologies.

24 See Annex I for a discussion of performance ratings of policy-based operations in other MDBs and why a comparison with their results is difficult.

Box 6.1. Criteria for effectiveness and sustainability ratings of PBLs in IDB's self-evaluation systems (PCR)

Effectiveness: Assesses the extent to which the programs achieved their reform objectives as stated in their results matrices. Programs set indicators, baselines, and targets to measure the achievement of each objective. Projects that fully achieve all their objectives are rated as excellent. Those that achieve at least 80% of their objectives are classified as satisfactory. Those that achieve between 50% and 80% of their objectives are rated as partly unsatisfactory. Those with fewer than half of their objectives achieved are rated as unsatisfactory.

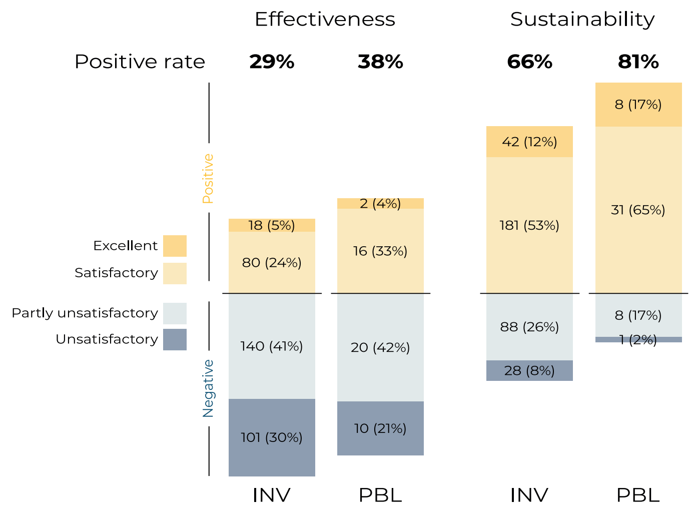
Sustainability: Assesses the conditions that could influence the continuation of the results already achieved and the achievement of future expected results during the project's lifecycle. Sustainability is determined by both the probability and the impact of various risks to the continuation of results beyond the completion of the project (ex-post project implementation), considering how these were mitigated during the project's life. The PCR assessment considers the operational, sector, and country context in projecting how risks may affect the results.

Sources: OVE 2022b and PCR Guidelines, 2020 update document IDB 2020c.

Figure 6.5

Results of validated self-evaluations 2018–2022

Source: OVE, based on validated PCRs.



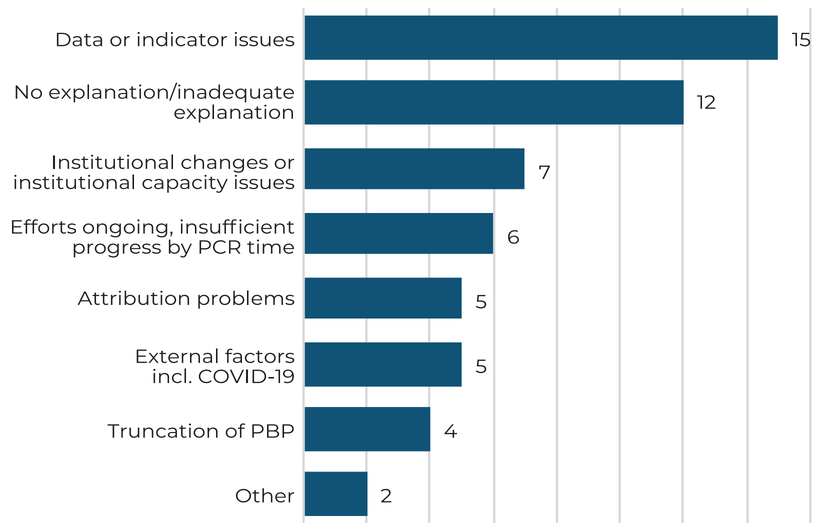
Note: N = 387 SG operations with PCRs validated by OVE during 2018–2023, of which 339 are investment operations, 44 are policy-based operations, and 4 are hybrid operations (hybrid operations are counted as policy-based operations since 85% or more of their approved volume is dedicated to the policy-based component).

6.11. Lack of results in policy-based programs is associated with poor monitoring and evaluation (M&E). A closer look at the 30 validated self-evaluations with low effectiveness ratings (see Figure 6.6) shows that half had issues related to missing data or inadequate indicator choices, and many validated self-evaluations (12 or 40%) do not explain outcome shortfalls, which indicates that validated self-evaluations are not always able to highlight significant barriers to success. Institutional changes or institutional capacity issues were found in seven of these operations, and truncation was found in four of the series. Five projects suffered attribution issues, as result indicators measured broad effects that can be influenced by many external factors (e.g., child mortality at the country level).

Figure 6.6

Factors behind negative effectiveness ratings of policy-based operations

Source: OVE 2023a.

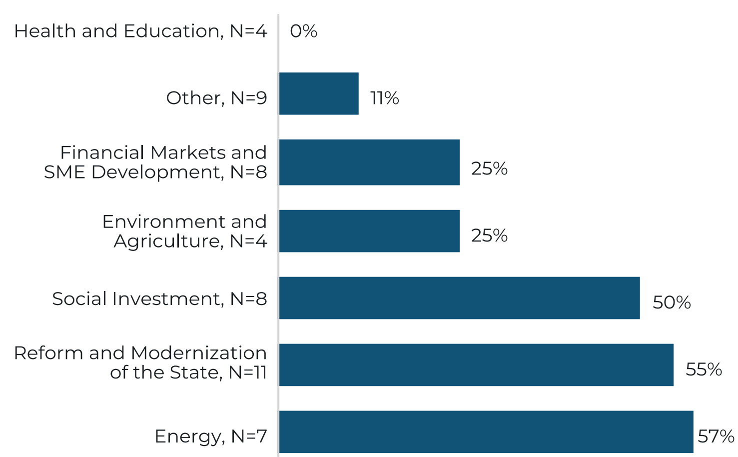


6.12. Policy-based operations in energy, reform and modernization of the state, and social investment have been more effective than loans in other sectors. Of all series with a positive rating, 78% were in one of those three sectors. Nevertheless, none of these sectors reach a positive rating higher than 57%. The ratings are notably low in education, health, and sectors with limited use of PBLs, such as trade, science and technology, and urban development and housing. This suggests that experience or better guidance using the instrument in a sector is important to achieve positive results (see also paragraph 5.18) and that reform processes may be more mature in some sectors than others.

Figure 6.7

Percentage share of policy-based operations rated excellent or satisfactory by sector

Source: OVE based on PCR validations.



Note: The category "Other" includes Urban Development and Housing, Transport, Water and Sanitation, Trade, Private Firms and SME Development; Reform and Modernization of the State; Science and Technology, and Science. "Environment and agriculture" includes Environment and Natural Disasters and Agriculture and Rural Development. "Financial Markets and SME Development" includes Financial Markets and Private Firms and SME Development.

6.13. Case studies confirm that the results of policy-based programs active during 2015 and 2022 have been mixed, and they identified the following interrelated contributing factors:

- **Political risks.** A lack of political appetite around the continuation of a reform agenda may explain the truncation of a PBP series or reform reversals. Political risks to the continuation of reform agendas tend to be underestimated when a PBP series starts at the end of a government period. This has been especially true for complex modernization of the state reforms (Paraguay), health reforms (Honduras), and energy reforms (Mexico and Honduras). Some finance ministries had tried to lock in reform agendas by requesting a PBP series at the end of an administration, with mixed results.

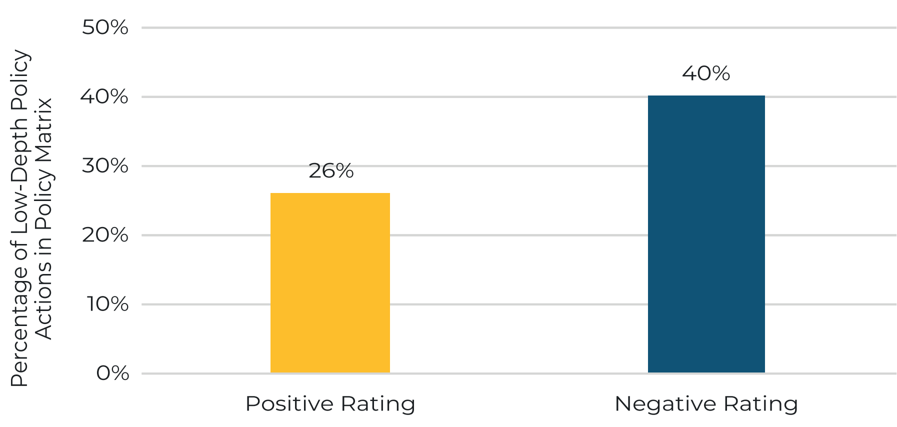
- **Sector institutional weakness.** Low sector capacity and high turnover may affect the carrying out of complex reform agendas. This has been the case in Honduras and Peru.

- **Design issues of actions supported by policy-based operations.** Although in completed PBP series all the policy actions in the series were carried out, an abundance of medium- or low-depth actions, especially the presentation of a law to Congress, present risks to the effectiveness of the series, which depend on the law being enacted. OVE found many instances in which the law approval did not materialize or was delayed. In its statistical analysis of the depth of policy actions, OVE also found that a higher prevalence of low-depth actions is associated with lower effectiveness ratings (see Figure 6.8 and Annex III for details).

Figure 6.8

Comparison of low-depth policy actions in operations with positive versus negative PCR effectiveness ratings

Sources: OVE (2015) and depth of policy actions from 2015-19 in OVE country products.



- Deficiencies in complementary instruments (TCs and INVs). TCs contributed more to achieving the results than INVs. Lack of complementary INVs or delays in executing INVs supporting policy-based operations have affected the investments needed to achieve the expected results of reform programs.

- The external shock of the COVID-19 pandemic shifted priorities in client countries. Some reform processes were delayed or became a low priority with the onset of the COVID-19 pandemic.

6.14. Most of the results achieved by the policy-based operations (81%) are sustainable, according to the program's self-evaluations validated by OVE (see Box 7.1 for methodology). Country case studies confirm that most of the results achieved are sustainable since they have been achieved through long-lasting policy and institutional changes. Risks to continuation of results arise mainly from reform reversals and lack of continuation of complementary investments. Truncation negatively influences sustainability. Three truncated series (27% of truncated series) received a negative rating (compared to 15% for non-truncated series).

07

Conclusions and Recommendations

7.1. While IDB uses policy-based lending to support reform agendas, fast disbursement financing is the main driver for the instrument's demand. Even though most countries demand IDB's PBPs and PBLs for fast disbursement financing, they also highly value the Bank's role as a trusted advisor and provider of technical assistance. Finance ministers also appreciate the seal of approval and the role that policy-based programs have in leveraging commitments from line ministers for reform implementation through the operations.

7.2. To ensure alignment with its two objectives, policy-based lending should only be used when reform and liquidity support are needed. When only reform support is required, technical assistance and investment lending (including LBRs) alone can help the design and implementation of reforms. If liquidity or budget support is the main necessity, the emergency instrument SDL can provide liquidity without forcibly tying it to reform efforts. However, currently SDLs are more expensive and require an IMF program, making the pure liquidity instrument less attractive to clients.

7.3. Compared to other MDBs, IDB has a more limited menu of policy-based lending instruments. Policy-based lending has evolved, and most MDBs have increased their menu of instruments, including stand-alone single-tranche operations, instruments solely focused on liquidity (i.e., emergency lending), and preventive instruments. IDB countries have demanded traditional PBPs due to their flexibility and lower costs; only two countries have been using DDOs, and demand for hybrid loans and PBGs has been limited.

7.4. Demand for policy-based lending has been high in recent years (partly influenced by the COVID-19 pandemic), and, for most countries, it has surpassed Bank supply. On the supply side, from a financial perspective, IDB has a strong incentive to maximize policy-based lending, especially in countries with high credit ratings.

7.5. In many cases, the Bank has aimed to strengthen reform agendas that have already been enacted or are being implemented. In these cases, OVE found that the sectors leading the reform implementation had received prior technical support from the Bank through TC or advice from specialists.

7.6. Design issues and implementation challenges have affected the effectiveness of policy-based lending in promoting meaningful reforms. Even though, as part of its sector work, the Bank has provided analysis, policy dialogue, and capacity building to support needed reform agendas, in some cases these haven't translated into policy actions with enough criticality to bring out the reforms required to achieve program objectives. OVE has found that at least one-fifth of policy-based operations consist chiefly of policy actions that lack enough criticality to support the implementation of meaningful reform agendas. This lack of criticality may be explained by deficiencies in staff guidance to design operations, quality control, primacy and urgency to provide fast disbursement financing, and lack of ownership of reform processes in Congress.

7.7. On implementation challenges, truncation is still a common phenomenon, and, in most cases, it increases the risks of the PBP series failing to achieve their results. Between 2005 and 2022, around one-third of the PBP series were truncated. Truncation is more common when PBP series start at the end of a government period and have more operations. OVE's assessment of the truncated PBP series shows that many policy actions supported by the series advanced to some degree after truncation. Yet, no government has completed the full set of policy actions planned by the series.

7.8. OVE's validations of management self-evaluations of policy-based operations show that two-thirds of the PBP series and PBLs couldn't demonstrate that they achieved their reform objectives. This mixed performance was also identified in country case studies. In self-evaluations of project performance, around half of policy-based programs had M&E deficiencies that led to incomplete data to assess the achievement of objectives. In country case studies, the reasons for low achievement of objectives were linked to political risks that were not adequately taken into account at approval; institutional weaknesses of the sectors in charge of reform implementation; design issues of the operations, with policy actions not critical enough to contribute to stated program objectives; lack of or deficiencies in complementary instruments like INVs; and unforeseen factors, including the COVID-19 pandemic.

7.9. From the findings of this evaluation, OVE recommends these actions:

1. **Strengthen IDB programming and approval processes, ensuring that both objectives of the instrument are met and avoiding using policy-based operations when only liquidity is required.**

    a. Policy-based operations should be programmed only for countries where the Bank has added value in improving the design or the implementation of transformative reforms and must be anchored in one or a few reforms capable of producing a permanent change in policy, regulation, or institutions to address key development objectives.

b. Management should ensure a solid analysis of the political economy and carefully consider the risk associated with the political cycle when programming the first operations of a PBP series, provide technical assistance before or with the first operation of a PBP series, and maintain policy dialogue over the course of multi-year programs.

c. Programming should consider the track record of countries in undertaking policy-based lending. In countries with a poor track record on the implementation (truncation issues) or low effectiveness of policy-based lending, the Bank should reduce lending until the factors associated with these shortcomings are addressed.

2. Revise the use of policy-based lending vis-à-vis other complementary instruments and explore putting alternative instruments in place and increasing the menu of modalities of policy-based operations.

a. Explore complementing the PBP series with small INVs and using LBRs instead of PBPs to support the implementation of ongoing reforms.

b. Carefully explore the potential demand, incentives for staff and clients, costs, benefits, and risks to put in place new policy-based lending instruments, such as single-tranche policy-based operations, additional contingent policy-based operations, and additional or more flexible liquidity emergency loans (SDL).

3. Improve the design of policy-based operations by increasing the parsimoniousness and criticality of policy actions, strengthening guidance to Bank staff, and improving quality control to prepare policy-based operations. To address weaknesses in the mix of actions supported by policy matrices—either due to insufficient depth or lack of precision in policy action formulation—that affected the effectiveness of policy-based operations. Management should ensure that policy actions supported by policy-based operations are clear enough and have enough depth to achieve the intended objectives of the operations.

4. **Improve the monitoring, reporting, and self-evaluation of policy-based lending.**

    a. Management should report to the Board yearly on the implementation of its policy-based lending program, looking at the truncation of PBP series and the setbacks in the reform processes supported by its operations.

    b. Management should do an in-depth retrospective self-evaluation of the instrument every four years, matching the policy-based lending ceiling cycle. The in-depth evaluation should address implementation issues and the results of its policy-based lending program.

    c. Self-evaluations (PCRs) of policy-based operations should explicitly analyze the consequences and causes of truncation and the issues behind the low effectiveness of operations.

    d. To facilitate the monitoring and design of policy actions, Management should maintain a database of policy actions (by objective, sector, and degree of depth) building on the database created by OVE for this evaluation and a database of TCs.

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