Office of Evaluation and Oversight, OVE
Inter-American Development Bank

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Summary Report: Evaluation of the Policy-Based Loan Portfolio - Phase III

Office of Evaluation and Oversight

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Abbreviations

ECLAC	UN Economic Commission for Latin America and the Caribbean
EVO	Evaluation Office
IDB	Inter-American Development Bank
IMF	International Monetary Fund
NGOs	Non-Governmental Organizations
OVE	Office of Evaluation and Oversight
PCR	Project Completion Report
PPMR	Project Performance Monitoring Report
PPR	Project Performance Report
SAL	Structural Adjustment Loans

Executive Summary

The purpose of this document is to analyze the way in which the Bank has been supporting sector reform policies in various countries in recent years. It is based on a sample based on the principal evaluation results from 14 sector loans that were approved between 1990 and 1995, in eight member countries of the Bank.

Drawing on elements both of theory and of empirical evidence, the document establishes a set of features that are necessary for achieving sustained growth of the kind that will contribute to reducing poverty. The sector operation evaluations analyzed here focus on the impact of sector lending in supporting policies and institutions in those areas where major efforts are being made to consolidate stabilization and improve growth prospects, and thereby to reduce poverty.

On the basis of an analysis of project execution (Project Performance Reviews - PPR), the report presents its principal conclusions and suggestions for future operations, under the following four headings:

a) *Relevance and consistency of loan design.* The countries examined all had stabilization programs underway, which meant that the conditions were already in place for supporting structural reforms to help strengthen and stabilize the economy and generate sustained growth. The principal recommendations under this heading are: a) to make a greater effort to ensure that the results expected from the reforms proposed in the sector loans, and specific indicators for measuring and verifying them, are included in detail in all operations, and b) to design operations in such a way that short and medium-term reforms can be executed within the established timeframe, which must fall within the mandate of the respective government.

b) *Timing, impact and sustainability of reforms supported by loans.* It was found that all the sector loans were appropriate in their timing, given the status of the reform process in each country. The specific measures called for in the loans were fulfilled within the established time limits, in five of the eight countries studied. For those countries where reforms have not progressed sufficiently, the Bank will need to continue supporting the reform process in order to ensure its success.

c) *Best practices, lessons learned, and solution options.* The lack of clarity in the ex-ante priorities, vis-à-vis possible inability to carry out the program in full, meant that certain priorities had to be redefined during the execution period, using criteria that were not necessarily the same as those adopted originally. Close attention is therefore recommended to aspects relating to the standards, quality and effectiveness of banking regulation and supervision, as well as the supply and disclosure of the basic financial information required, with a view to eliminating shortcomings in banking administration, overcoming informational asymmetries, and avoiding the premature liberalization of the financial system. On the other hand, in public service areas where the state plans to withdraw from the production and distribution of such services, there is a need for investment, as a prior step, in training for the human resources responsible for implementing reforms of this type.

d) *Administration, monitoring and supervision of the Bank's sector lending.* In complex operations, the loan should include procedures for weighting partial compliance with loan conditions and policy implementation in terms of the expected impact and the degree of difficulty in fulfilling them, including on occasions disbursements against conditions fulfilled. Moreover, as an alternative, procedures might be established by which the Bank could restrict further lending in light of country performance in implementing reforms under previous loans. In this manner, two important objectives could be met: a) establishing a mechanism whereby the Bank will continue to lend, provided that countries carry out the agreed reforms in a satisfactory manner, and b) giving priority to loans to countries with a good track record in the reforms required by the Bank in previous operations. Otherwise, support should be limited to technical assistance and policy dialogue, before any loan funds are committed

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Introduction and background

1.1 Since its creation, the IDB has been contributing to the sustained development of its borrowing member countries, through loans, technical cooperation and ongoing dialogue with government authorities regarding economic and social policies. This contribution has been systematically reviewed in evaluation documents, in order to improve the manner in which the proposed objectives are reached.

1.2 In recent years, there has been increasing recognition of the importance of economic policies and the characteristics of institutions in any country's economic development. For this reason, the Bank has for some time been including these concepts in its operations. Thus, since the debt crisis of the early 1980s, the support strategy for member countries has been thoroughly revised. As part of this new strategy, the Bank's contribution to policy and institutional reform has been treated as a key aspect in developing and designing loans. These reforms have been targeted at both the macroeconomic and sector level.

1.3 Since the Seventh Replenishment of the Bank's Ordinary Capital resources, the IDB has adopted the procedure of sector loan programs. Operations were initially cofinanced with the World Bank, and later on an autonomous basis. The Bank has also placed increasing emphasis on supporting policy change in its investment loans and in its new forms of operations. Sector loans are intended primarily to assist in the process of policy and institutional change, in order to promote sustained growth and thereby help to reduce poverty. These programs are based on a theoretical and practical understanding of the determinants of growth and equity.

1.4 The analysis presented below reflects the principal evaluation results for 14 sector loans made by the Bank in eight member countries. It represents the third phase in a series of studies that began in 1994, the purpose of which was to examine the results of these loans more thoroughly. A summary of the first phase was published as EVO Working Document RE-213/96 in 1996. Phase II was summarized in document RE-228 and was considered and approved by the Policy and Evaluation Committee of the Board of Executive Directors, in September 1998.

1.5 The selection of operation evaluations was approved by the Board (see Evaluation Profiles 97/1 and 98/2 in Annex 1), based partially on the conclusions in document RE-213/96, in the sense that the countries of groups B, C and D that had received the greatest net flow of sector lending funds were Peru, Uruguay and Nicaragua, respectively. This defined the cases studied in phase II. Subsequently, under phase III, five loans were examined in countries of group A (Argentina, Mexico and Venezuela), and one country of group D (Dominican Republic). The latter was substituted for the financial sector loan in Mexico, since it was felt that conditions there were not appropriate for such an evaluation, while there was an excellent opportunity to learn lessons from experience with the financial sector reform loan in the Dominican Republic.

1.6 A Project Performance Report was prepared for each operation evaluated. These reports analyze aspects relating to the objectives and rationale of the project, and general issues relating to compliance with conditions, circumstances and characteristics of execution, both of the loan and of technical cooperation transactions when these existed, and individual conclusions and lessons relating to Bank performance and the achievement of goals. The

terms of reference for evaluating the individual PPRs are contained in the evaluation profiles approved by the Board (Annex 1) in the Evaluation Matrix shown in Annex 2. As well, Annex 3 contains a summary of evaluations for each of the 14 loans considered.

1.7 The 14 sector loans evaluated represent 29 percent of all sector loans approved, 42 percent of sector operations approved by the Bank between 1990 and 1995 (see Table 1), and 38 percent of countries that received sector lending during that time. It thus covers a good part of the sectors that were the object of reforms during the period under consideration. Table 2 shows all sector loans approved during this period, classified by country group and sector.

Table 1
Sector Loans, by Country Group 1990-1995
(in US$ millions)

Country Groups	Sector Loans Evaluated (A)		Total Sector Loans Approved (B)		Percentage of A to B	
	No.	Amount	No.	Amount	No.	Amount
A	5	1975.0	12	4690.0	42	42
B	3	956.7	5	1311.7	60	73
C	2	220.5	10	755.5	20	29
D	4	403.4	20	1626.4	18	25
Total	14	3555.6	47	8383.6	29	42

Table 2
Sector Loans Approved, by Country Group and Sector 1990-1995
(in US$ millions)

Country Groups	Agricul ture	Trade	Social Invest-ment	Reform and Modern.	Health	Trans-port	Total
A	200	250	450	3490.0		300	4690.0
B				1311.7			1311.7
C	115			640.5			755.5
D	295.5			1292.4	38.5		1626.4
Total	610.5	250	450	6734.6	38.5	300	8383.6

1.8 In the first phase, a number of operations were analyzed from the viewpoint of experience acquired in processing sector loans with World Bank cofinancing. In addition, the loan in support of public sector reforms in Colombia was evaluated in document PPR-1/96.

The following sector loans were evaluated in the second phase of the project (1997):

- Public Service Enterprise Reform Program, Nicaragua, PPR-13/97
- Finance and Commerce Sector Program, Nicaragua, PPR-14/97
- Agricultural Sector Adjustment Program, Nicaragua, PPR-16/97
- Financial Sector Loan, Peru, PPR-12/97
- Commercial Sector Program, Peru, PPR-15/97
- Financial Sector Program, Uruguay, PPR-10/97
- Investment Sector Reform Program, Uruguay, PPR-11/97

The following sector loans were evaluated during this third phase of the project in 1998:

- Public Sector Reform Program, Argentina, PPR-11/98
- Provincial Bank Privatization Program, Argentina, PPR-10/98
- Investment Sector Reform Program, Argentina, PPR-14/98
- Export Sector Reform Program, Mexico, PPR-9/98
- Financial Sector Reform Program, Dominican Republic, PPR-12/9
- Financial Sector Program, Venezuela, PPR-8/98

1.9 The present analysis is a summary of a more extensive technical document that offers a detailed comparison of specific evaluations, attached as Annex 4. The summary also reflects suggestions and comments received during consideration of the reports on the earlier phases in the Board Matters and Evaluation Committee, the Policy and Evaluation Committee, and the Audit and Evaluation Committee of Management, relating to specific aspects of the evaluations.

1.10 As noted above, the summary document was prepared on the basis of Project Performance Reports (PPR) for the 14 programs evaluated. The object of these specific evaluations is not to analyze or judge the reform policies themselves, but rather the manner in which the Bank has supported sector reforms. In particular, this document examines four central aspects: (1) relevance and consistency of loan design; (2) timing, impact and sustainability of reforms supported by the loans; (3) best practices, lessons learned, and solution options derived from the execution of sector loans, and their implications for state and social sector reform operations; and (4) administration, monitoring and supervision of the Bank's sector lending.

2

Analytical Framework of the Studies

2.1 Theory and empirical evidence both suggest that there are a number of requirements for achieving sustained growth of the kind that will help to reduce poverty. Today, these requirements are part of a minimum professional consensus on the kind of economic policies and institutions that will lead to sustained growth, which is a necessary condition for reducing extreme poverty. This consensus, together with the success of countries that have implemented policies of this kind, and the fact that in recent years a growing number of developing countries have introduced changes to their economic policies and institutions, following a very similar pattern, has given a major impetus to the process of reform and modernization. International financial institutions and regional banks have been providing support both for the design and for the financing of reform programs, and in general have supplemented them with social investment programs for the direct benefit of those groups on whom the reform process has a negative effect.

2.2 Recent literature points to a number of central elements that must be included in any adjustment program, if sustained growth is to be restored and extreme poverty reduced. These elements can be grouped together under six categories:

a) Macroeconomic stability, through policies that are focused on maintaining low and stable inflation rates and a sustainable current account deficit;
b) A properly functioning price system that reflects the economic value of goods and services;
c) The existence and maintenance of adequate physical infrastructure, together with a sound human capital base;
d) An efficient and solid financing system that can evaluate risks, avoid unsustainable expenditure growth, and allocate resources efficiently, and one that has the capacity to absorb shocks from abroad;
e) National investment and savings rates that are consistent with long-term growth expectations for the economy; and
f) An institutional apparatus that will reduce the costs of market transactions, promote a stable and reliable policy framework for encouraging investment, and contribute to increasing the productivity of the economy as a whole.

2.3 In an increasingly globalized and integrated world, changes in the external environment will make themselves felt directly in the domestic economy. Every country will receive, individually, a set of benefits that will depend on the conditions prevailing in the international setting and on the size of its own economy. Thus, in the face of abrupt shifts in the external setting (through deteriorating terms of trade, changes in the conditions of trade, adverse capital movements associated with the "contagion" effect among emerging countries, or slower growth in the regional or global economy as a whole), it will be necessary to establish effective adjustment policies that can absorb these shocks. The six conditions indicated in the previous paragraph will enhance a country's capacity to adapt to external shocks, and in this sense they are necessary, but not sufficient, conditions for achieving sustained growth over the long term.

2.4 The evaluation of sector operations took specific account of the degree to which the reform program in the particular sector was directed at supporting policies and institutions in areas where they could make the greatest contribution to stabilization and improved growth prospects, while reducing poverty. It thus addressed the overall reform process, and in particular the kind of institutional changes that must be implemented over a longer term than the loan execution period itself. Similarly, it is recognized that the reforms supported by Bank sector lending are part of a global reform process, and this calls for examining to what extent they were coordinated with other changes, supported by other international financial institutions or financed solely with domestic resources, intended to consolidate, broaden and deepen the process of modernization. This analysis was based on data derived from each loan, as well as general information from Bank country studies and other sources such as the World Bank, IMF, ECLAC and other available studies on the country.

2.5 The evaluations did not address the social impact of sector loans (on education, health, nutrition etc.) since, generally speaking, the reforms supported by the loans under examination did not have explicit social objectives. In general terms, the loans evaluated were aimed primarily at supporting policies for establishing the elements referred to above. It should also be noted that from a methodological viewpoint it is very difficult to isolate the direct social impact on the economy of any given operation financed by the Bank, and this is particularly true in the case of policy support lending. On the other hand, the Bank does provide support to the social sectors and in particular to low-income groups, through specific operations that can be targeted more effectively.

3

Principal Results, Lessons Learned and Suggestions for Future Operations

3.1 There has been some debate about how much of its resources the Bank should devote to policy reform and modernization operations, and about the effectiveness of such programs[1]. In order to assess the results of sector lending, both from the Bank's viewpoint and that of its member countries, this document summarizes 14 sector operations, which were evaluated in three phases in 1995, 1997 and 1998. On the basis of these evaluations, it may be concluded in general that if the government is committed to a reform program and if it can be carried out within the mandate of that government, sector loans can be highly effective in facilitating the reform process and supporting the country's economic development.

A. Relevance and design of operations

3.2 Since each of the eight countries examined already had stabilization programs underway, the conditions were in place for supporting structural reforms that would help to strengthen and consolidate stabilization and to create conditions for the resumption of sustained growth and the reduction of poverty. In this sense, *the 14 sector loans analyzed were focused generally on areas that were of fundamental importance for the eight countries, involving primarily reforms to the financial sector, external trade, and support for private investment, and within these the focus was on essential measures and policies*. It may be said, then, that the reforms undertaken - in support of private investment and privatization of provincial banks and the public sector in Argentina, the public sector in Colombia, the foreign trade sector in Mexico, the foreign trade, financial, agriculture and public services sector in Nicaragua, the foreign trade sector (including a labor component) and the financial sector in Peru, the financial sector in the Dominican Republic, the financial and foreign trade sectors and support for private investment in Uruguay, and the financial sector in Venezuela - were well selected and covered priority sectors that could make a significant contribution to the overall reform program in each country.

3.3 In the case of several operations cofinanced by the IDB and the World Bank (such as the Provincial Bank Privatization Program In Argentina), a decisive factor was the information that was transmitted to markets about the support that these institutions were providing to the government's economic reforms. This was an important moment of transition, when the country had not yet renegotiated its external commitments and the new economic program was still regarded with some skepticism in certain quarters. Nonetheless, it was also noted that in several cofinanced programs, institutions and officials tended to see the World Bank as being more closely involved in executing those programs, and to view IDB's role as strictly one of providing financing. Certainly, the involvement of the Bank's Country Offices in executing programs should be expanded to include greater participation in analyzing and designing the operation, so that they will feel a greater sense of involvement and can play a more significant role at each stage of those programs.

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[1] Document GN-2004 of 17 December 1997 proposed to the Assembly of Governors that the annual limit on Bank lending in support of sector and institutional reforms should be raised from 15% to 20%.

3.4 The specific design of the operations in question reflected both theoretical and practical considerations. Even so, there were a number of problems. For example: a) the programs in the Peruvian and Dominican financial sectors failed to cover certain key elements such as the securities market; b) there was a lack of clearly quantifiable goals, as in the case of public sector reforms in Argentina; and c) certain special risks were not give inadequate attention in the diagnosis or in the initial conditions in some countries. Among those risks were: institutional and legal weakness and insecurity of property rights in the case of Nicaragua; the possibility that the government would change shortly after approval of the program (Nicaragua, Dominican Republic and Uruguay); involvement of both the Executive and the Legislature in approving conditionality in the Dominican Republic and Venezuela; changes in the authority that was to approve conditionality, from the Executive alone to the Executive plus the Legislative branch (Nicaragua); or labor opposition to certain conditionality terms (Uruguay). *If the institutional situation in any country is not properly addressed, and if the reforms supported are not in line with the circumstances of each country, they may become. "necessary but not sufficient conditions for achieving the general objectives of the operations, or the expected results may be late in appearing.*

3.5 In this respect, *an effort should be made to ensure that the expected results of the reforms proposed in sector loans, and specific indicators for measuring and verifying those results, are included in detail for all operations*. Preparation of the logical framework and the Project Performance Monitoring Reports (PPMRs) reflecting changes in the initial conditions or unforeseen delays are basic in designing and in monitoring and controlling execution, respectively.

3.6 *Operations must be designed so that it is feasible to execute reforms in the short and medium term, within established time limits that must be set within the mandate of the current government*, since it should not be assumed that the successor government will have the same degree of commitment to undertaking those specific reforms, even if there is agreement on the general objectives of the program. One possibility would be to re-examine and renegotiate, during the first months of the new government's mandate, policy alternatives for achieving the objectives proposed in the program supported by the Bank, since what is important is not the individual measures that are taken but the general development objectives that are pursued.

3.7 In some cases, the scope of the issues addressed and the depth of the reforms required were not consistent with the existing technical capacity of countries to contribute to their preparation and to have them accepted by the main domestic stakeholders, nor were they compatible with the characteristics of a quick-disbursing loan. A point to consider at the time of designing reform support programs is *the need for the country to have technical groups that are capable of evaluating and sustaining the type of reforms that are most appropriate to the country*. These groups must fully understand the expected effects of the reforms, so they will be able to help the policy team present them to the general public. In this way, all stakeholders will be committed to implementing the reforms, and will be able to help promote them and ensure their continuity. To achieve this, it would be wise to implement longer-term programs aimed at upgrading professional training in critical areas of government.

3.8 Another important lesson is that *more time and resources need to be invested in publicizing the expected benefits of reforms, and explaining in detail what their short-term costs will be.* It is recommended that the Bank encourage countries to make provision in their policy reforms for measures to compensate those sectors of the population that are negatively affected by such reforms. These measures should be applied efficiently with a view to minimizing distortions to the economy. In this way, a greater proportion of the population will have access to the benefits of faster growth and the consumption opportunities that will flow from the reforms.

B. Timeliness, impact and sustainability

3.9 All of the sector operations were appropriately timed, considering the stage of the reform process in each country. In general, the stated development objectives for the sectors in question were achieved in Argentina, Colombia, Mexico, Peru and Uruguay, but not in Nicaragua and in Venezuela. In the Dominican Republic, there was good progress toward several objectives, but not all were achieved, especially those relating to creating an autonomous central bank institution. The specific measures called for in the loans were generally fulfilled within the established time limits, and planned results were achieved (except for the public service enterprise reform program in Nicaragua and the financial sector program in Venezuela), some to greater a degree than others.

3.10 In the case of several loans to Argentina, Colombia, Peru and Uruguay, it was found that individual measures implemented exceeded those called for under the loan conditions, and were more successful than planned. Generally speaking, in those countries where reforms were successful and the general development objectives of the operations were achieved (Argentina, Colombia, Mexico, Peru and Uruguay) it could be said that reforms have been or are being consolidated and that they enjoy sufficient support. Operations of this kind should be replicated in other countries. In the case of Mexico, for example, the significant reforms undertaken in the external sector should provide for greater flexibility as oil prices are progressively reduced.

3.11 In Nicaragua and Venezuela, on the other hand, not all loan conditions were fulfilled, and there were some significant setbacks. It would appear that the extent of compliance with the reforms called for in the loans was determined primarily by the degree of commitment to the reform agenda on the part of the economic and political team, and by the internal capacity to defend and execute the program. *This highlights the importance of investing more time and resources in training local technical teams that can participate in the design, the "selling" and dissemination of reforms, and in their execution.* These three latter ingredients are key to ensuring that national and local authorities establish their "ownership" over the reforms. In Nicaragua's case, where the need for reforms was much broader, significant changes were achieved that should promote the functioning of competitive markets and reduce the distorting effects of state intervention in economic activities, while giving them a more outward looking thrust. But in light of the limited results and the major setbacks that were encountered, these reforms cannot yet be considered sustainable.

3.12 In those cases where reforms to date have been inadequate (Nicaragua, Dominican Republic and Venezuela) the Bank will need to continue supporting the reform process in order to consolidate it, ensuring that the Bank's program for the country includes areas that will yield the greatest benefits in terms of strengthening the consolidation process. To this end, an initial step should be to identify areas where the greatest benefits can be obtained from corrections to the policies or institutions most closely linked to the ultimate success of the reforms.

C. Best practices, lessons learned and solution options

3.13 In several reform programs, involving a broad range of measures of differing degrees of importance, it was noted that when there were no clear ex ante priorities established, and when it was found during the execution period that the program could not be completed in full, priorities tended to be re-defined on the basis of criteria that were not necessarily the same as those envisaged by the designers of the operation. This result again highlights the need to identify those actions that are most important to the success of the reform program, at the very outset, when the loan is being prepared.

3.14 With respect to the financial sector it is clear, based on experience from the recent crisis in Asian countries, that *close attention must be paid to the standards, quality and effectiveness of banking regulation and supervision, and to the supply and disclosure of the required basic financial information, with a view to eliminating shortcomings in banking administration, overcoming informational asymmetries, and avoiding the "premature liberalization" of the financial sector.* These are key issues both in macroeconomic terms and in terms of the efficiency and transparency of financial intermediation, if success is to be achieved in the reform program and the risk of backsliding is to be diminished. They are also important for preventing a banking crisis from becoming a systemic crisis by affecting the securities market and shaking investor confidence, leading ultimately to a full-scale macroeconomic crisis. To this end, financial sector programs must clearly identify and assess existing incentives in the financial sector, and must ensure appropriate supervision and regulation in support of liberalization for the sector. Moreover, it is recommended that the Bank should monitor compliance with both the letter and the spirit of the agreed program, in close operation with the authorities.

3.15 With the first generation of financial sector loans, the Bank provided significant support for liberalization, privatization and greater competitiveness in the financial systems of various countries of the region. *Today, in some of these countries at least, there would appear to be a need for a second generation of financial reforms aimed at: (1) reinforcing systems of regulation, supervision, supply and disclosure of information on the quality of assets and the capital adequacy of financial entities; (2) reining in the excess credit expansion that results from inadequate evaluation of the risks involved (problems of adverse selection and "moral hazard"); (3) restricting the practice of related-party lending and (4) achieving the institutional harmonization of the new, freer and more varied instruments and institutions that now exist (commercial banks pursuing new and freer functions, private pension*

funds, insurance companies, mutual funds, investment banks, securities markets, etc.). This would reinforce the soundness, flexibility, competitiveness and proper functioning of the system, which would then be in a better position to deal with the dynamic process of trade and financial globalization. That process presents ample opportunities but at the same time requires disciplined and more transparent public financial policies, to reduce vulnerability to external shocks. In addition, a better-developed financial system can make a significant contribution to economic growth.

3.16 *In the area of public services, where there are countless opportunities to strengthen competition and enhance efficiency and at the same time to disengage the state from the production and delivery of those services, there is a need for significant prior investment in training the human resources that must implement reforms of this kind. What is required here is theoretical and practical training in the regulation and supervision of public services. Without such minimal training, it is very difficult to understand the logic and the benefits that can be derived for this type of reform. As a corollary, sector loan conditionality with respect to public service enterprises in countries where there are opportunities to introduce reforms with a significant impact on efficiency and equity must take due account of the need to provide prior training for the local human resources responsible for carrying out those reforms.*

3.17 One of the problems detected in the sector loans was that disbursements were not generally used for the direct benefit of the institutions engaged in implementing the reforms. At times these institutions were not even aware of the actions that must be taken to comply with the loan conditions, or else they did not share the immediate objectives of the operation. *In cases where there is no direct relationship between disbursements and the entity that must carry out the reforms, more effort must be made to improve awareness within the government team as to the central role that policy and institutional changes play in the country's development strategy.* In some countries it may be necessary to strengthen analytical and execution units within the ministries of finance or economy, so they can collaborate with participating entities in fulfilling the loan conditions.

3.18 In addition, *it would be more appropriate if the social compensation component of a trade-related or sector reform project were specifically focused on facilitating mobility, retraining and relocation of workers directly affected by the reform program, rather than undertaking general programs of social compensation.* With this type of design, the social cost of reforms could be reduced, as well as the difficult political economy problems that often impede such efforts and can result in backsliding or delays in the execution of priority reforms.

D. Administration, monitoring and supervision

3.19 In highly complex transactions, such as the Public Service Enterprise Reform Program in Nicaragua and the Sector Investment Programs for Argentina and Uruguay, *the possibility should be considered of including procedures in the loans that will allow for objective weighting of partial compliance in terms of conditionality and policy implementation, on the basis of the expected impact and the degree of difficulty of compliance, including in certain cases disbursements against conditions fulfilled.* This would encourage the Executive Branch to pursue its overall reform program even if some aspects are encountering difficulties in the Legislature. Currently, a disbursement application will be rejected or approved in its totality, even if some conditions have not been fulfilled. This undermines the credibility of subsequent conditionality ("moral hazard"), not only for this operation but for other sector loans, in the sense that some authorities may see no incentive to meet conditions because they believe that the Bank will not insist on them. In those cases, decision-makers may assume that the Bank will once again come to their aid if such problems recur. Therefore, a system should be considered that would make partial disbursements possible, according to the degree of compliance with conditionality, as measured in a predetermined and objective manner.

3.20 As an alternative, procedures could be established through which the Bank will pre-notify countries of its decision to continue or restrict its support for certain reforms according to how effectively those countries have promoted and implemented reforms under previous operations. In this way, two primary objectives could be achieved:

a) Establish a mechanism whereby the Bank provides funds only against a commitment to, and satisfactory compliance with, the reforms agreed;

b) Grant priority and maximum cooperation to countries with a sound track record in reforms implemented under previous loans.

In the absence of such guarantees of effectiveness, the Bank should limit its participation to technical assistance and policy dialog, before committing itself to a loan.

3.21 Another problem with sector lending is that while loans are disbursed quickly when certain conditions are met (involving sometimes only executive decisions), the parallel technical cooperation needed to carry out or support previous disbursements may be disbursed more slowly than planned. In many cases, technical cooperation will include the selection of individual advisors or consulting firms under the Bank's normal procurement procedures, which are slow and require several steps of verification and approval. The nature of actions supported by technical cooperation requires that consultants be put in place quickly, and this in turn demands streamlined procedures. *In the future, such procedures should be made more flexible so as to speed up technical cooperation, as has been done for example in certain recent operations where the entire process was verified and approved ex-post, rather than step by step.*

3.22 Finally, project completion reports (PCRs), when they have been prepared at all, have been late and, as with the PPMRs, their structure and content have not reflected the true degree of compliance with the proposed reforms, nor the significant success achieved by certain programs, nor the problems or setbacks that have occurred in others. In future, as some Country Offices have suggested, in light of the importance of PCRs for the Bank's institutional memory on these operations, *independent expert evaluations should be contracted for completion within the regulation period of 90 days.* In light of the importance of the reforms being supported, *regular, detailed and objective evaluations of this kind should be performed so that the Bank's administration can take timely and appropriate action.*

PRINCIPAL RESULTS, LESSONS AND SUGGESTED ACTIONS

ISSUES	*RESULTS AND LESSONS LEARNED*	*SUGGESTIONS FOR ACTION*
Design	The measures and policies in the 14 sector loans analyzed were well received and focused on essential areas that could make a significant contribution to the reform program in each country. Moreover, they were consistent with existing theoretical and practical understanding of these issues.	
	The institutional situation and the initial conditions in each country were not always taken adequately into consideration, and this produced special risks. In these cases the conditionality requirements represented necessary, but not sufficient, conditions.	(1) The initial situation in each country must be taken properly into account in order to prevent conditionality requirements from being merely necessary, but not sufficient, conditions. (2) Prepare a logical framework that reflects the initial assumptions and update the PPMRs regularly to show significant changes during project execution, so that timely and appropriate measures can be adopted.
	Execution of the sector loans met with delays and subsequent problems when it did not coincide with the mandate of the government that originally requested the operation.	Execute reforms within the mandate of the corresponding government.
	There were not always domestic technical groups available with the capacity for proper evaluation and support of the reforms called for under the loans.	(1) Invest more time and resources in publicizing the expected benefits of the reforms and making clear their short-term costs. (2) Support long-term programs to strengthen professional training in critical areas of government.
Timing, Impact and Sustainability	In general, the sector loans were well timed. In countries that have achieved the general sector development objectives, the reforms have been or are being consolidated and enjoy generalized support.	
	Progress with reforms under some sector loans has been inadequate, primarily for lack of commitment on the part of technical groups of the authorities	Ensure that the Bank's country program includes key areas offering the greatest benefits in terms of consolidating the reform process..
Best practices, Lessons and Solution Alternatives for Specific Sectors	Some financial sector operations overlooked the need for effective implementation of banking regulation and supervision rules, and the supply and disclosure of basic information.	Monitor carefully all financial sector loans in aspects relating to banking regulation and supervision rules and the supply and disclosure of basic information.
	The many benefits of and opportunities for privatizing public services were not always realized	Provide specialized personnel training in the theory and practice of regulation and supervision for public services
	Disbursements were not generally used for the direct benefit of the institutions engaged in implementing the reforms. At times, these institutions were neither aware of the immediate objectives nor of the actions to be taken to comply with the loan conditions.	(1) Invest resources to improve the understanding within the government team as to the central role that policy and institutional changes play, in particular in relation to the government entities that share the burden of adjustment and reform costs. (2) The social compensation component in reform programs should be focused on facilitating mobility, retraining and relocation of workers directly affected rather than undertaking general programs of social compensation.

ISSUES	RESULTS AND LESSONS LEARNED	SUGGESTIONS FOR ACCION
Administration, Monitoring and Supervision of Operations	When a complex operation does not include precise conditionality, problems can arise: priorities may not be properly assigned, and difficult issues may not be successfully addressed.	Include procedures that will allow for the objective weighting of compliance with conditionality and policy implementation as a function of the expected impact and the degree of difficulty with compliance, including on occasion disbursement against conditions fulfilled, rather than of the full tranche. Alternatively, the Bank could encourage compliance with agreed conditions by limiting its support for new reforms in light of the effectiveness with which countries have implemented reforms under previous operations.
	Some technical cooperation operations undertaken in parallel with sector loans, and necessary for subsequent tranches, were slow in execution, because of Bank procedures for step-by-step verification and approval.	Make the use of technical cooperation more flexible and streamlined, by verifying and approving the entire process on an ex-post basis rather than step by step
	In general, the PCRs were prepared late and the PPMRs did not adequately reflect the execution of operations.	Contract independent expert evaluations to produce the PCR within the regulation 90 days, and ensure that the PPMR reflects the real degree of compliance with sector loan conditionality

Annexes

EVALUATION PROFILE INCLUDED IN THE EVO WORK PROGRAM FOR 1997

NAME: Evaluation of the Policy-Based Loan Portfolio (PBL). Phase II	No. 97/1

DESCRIPTION:

The scope of phase II of the evaluation of the PBL loan portfolio reflects guidance received from the Board Matters and Evaluation Committee, based on its consideration of report No. RE-213-1 (minutes of meeting 96/11) and from the Bank's senior management (A&EC minutes 96/31).

It will be conducted in three parts:

- First, a review of the literature on IFI experience with PBL, and experience with evaluating such operations.
- Secondly, seven PPRs will be prepared, reviewing the merits of each case by itself and within the socioeconomic and institutional context of each country.
- Third, on the basis of the analyses referred to above, a summary report will be prepared, examining the following aspects:

Sustainability of reforms supported by PBL:

- Have sector reforms continued? Are there cases where policies have been suspended or reversed? If so, for what reasons?
- Is the conditionality of the PBL designed in a manner compatible with the traditional disbursement release mechanism? Were the conditions set for each operation essential to the success of the reforms in question?

Principal issues in the design of PBL operations:

- Are the borrowers receiving adequate support so that they can effectively handle the sector reforms financed by the PBL?

Social adjustment:

- What lessons can be drawn from experience with quick-disbursing loans for social sectors?

The projects indicated below were selected on the basis of the interrelationship between sector loans in a given country, as well as the sequence of liberalization policies undertaken by countries in the region. This sequence begins with operations for the public sector, followed by loans for investments or trade, financial sector reform and, finally, reform of productive sectors.

CLIENTS AND PARTICIPANTS:

- Board of Executive Directors.
- Participating institutions in the borrowing countries.
- Operations Regions (I, II), SDS and DPP.
- Country Offices.

GOALS:

• Design proposal (993/SF-I!; 638/0C/NI; 20/IF/NI; 1/SA-PE; 667/OC-PE; 626/OC-UR;703/0C-UR	2nd quarter 1997
• Field work	3rd quarter 1997
• PPRs (638/OC-NI; 20/IF-NI; 1/SA-PE; 667/OC-PE; 626/OC-UR; 703/OC-UR	4th quarter 1997
• Field work (993/SF=NI)	2nd quarter 1998
• PPR (993/SF-NI)	3rd quarter 1998
• Synthesis of the seven PPRs	4th quarter 1998

RESOURCES: (For 1997)
Person-months: 14 Consultants: $95,000 Travel: $40,000

EVALUATION PROFILE INCLUDED IN THE EVO WORK PROGRAM FOR 1998

NAME: Evaluation of the Policy-Based Loan Portfolio (PBL). Phase III	No. 98/2

DESCRIPTION:

This activity represents the completion of the PBL portfolio evaluation project that began in 1996. During 1997, PPRs were completed for seven sector projects in Nicaragua, Peru and Uruguay, and work began on a document summarizing the results and the principal Solution Options. Those loans were selected on the basis of conclusions contained in the Working Document on the First Stage of Sector Loans: Preliminary Overview of the IDB's Experience with Sector Lending (RE-213-96), in the sense that the countries selected were those within groups B, C and D that had benefited the most from sector loan disbursements.

The conclusions and solution options from the PPRs prepared in 1997 were used to adjust and refine the frame of reference (this evaluation work was supplemented with evaluations of four sector loans in countries of group A: Argentina and Mexico) as well as to update the Financial Sector Reform Loan for Venezuela (PPR 5/95, August 1995) and the Public Sector Reform Loan for Argentina (PPR-4/95, July 1995). The evaluations focused on aspects relating to the need for conditionality, efficiency in the administration of the operations, and the impact of the reforms supported by the loans, including their sustainability.

The document summarizing the PPRs will be examined at a seminar involving experts from the Bank and other international financial institutions, ECLAC, member countries, and professors from the Catholic University of Chile who participated in the evaluation project.

Finally, a report will be prepared with results from the 12 evaluations and a summary of the results and lessons learned.

CLIENTS AND PARTICIPANTS:

- Board of Executive Directors.
- Participating institutions in the borrowing countries.
- Operations Regions (I, II, III), SDS, DPS and OCE.
- Country Offices.

GOALS:

• Summary of the first 7 PPRs	1st quarter 1998
• Field work in Group A countries:	
• Argentina (733/OC-AR and 865/OC-AR	2nd quarter 1998
• Mexico (869/OC-ME and 627/OC-ME)	2nd quarter 1998
• Updating	
• Venezuela (595/OC-VE)	2nd quarter 1998
• Argentina (633/OC-AR)	2nd quarter 1988
• Seminar on results	3rd quarter 1998
• Final Publication	4th quarter 1998

RESOURCES: (For 1998)

Person-months: 6 Consultants: $90,000 Travel: $30,000

EVALUATION MATRIX

Apects Evaluated	**Principal Questions**	**Means of Verification**
JUSTIFICATION AND CONCEPT	• To what extent was the operation based on an adequate and valid diagnosis? • To what extent was the design of the operation consistent with existing know-how (what to do and how to do it) about the reform process in the sector? • How consistent was the design with the Bank's country strategy and with the guidelines for the Seventh Capital Replenishment? • Were critical reforms included to illuminate bottlenecks and distortions (necessity) in the sector, and was the sequencing appropriately designed? • To what extent did the operation consider the capacity of the country, and in particular its institutions, to successfully administer the reforms supported by the loan and the technical cooperation? • To what extent was the operation coordinated with other policy-based operations financed by the Bank, by other IFIs and by the country itself?	• IPES; international agency reports; economic analysis documents for the country. • Recent economic literature, including evaluations of the reform process. • Document for the Seventh Replenishment and country CPs. • Project document. • Same. • Same.
EFFICIENCY	• How much time elapsed between the date of loan approval and the date the first tranche was disburse? • How were the loan and the technical cooperation disbursed? • How many months elapsed between the first and last disbursements, compared with the timetable in the contract?	• Project information systems (PRUS) and Bank disbursements (LIDAS). • Same. • Same.
EFFECTIVENESS	• To what extent were the major macroeconomic, sector and institutional objectives of the operation achieved? • To what extent have the sector reforms contributed to continuity of the reform process in the sector? If policies have been suspended or reversed, what were the reasons? • Were there waivers or splitting of tranches in the disbursement process? • Were there changes or adjustments to conditionality to adapt the operation to changing circumstances?	• Loan and technical cooperation documents; PCRs; interviews with national authorities and the executing agency, officials of the Bank and other international agencies; country studies. • Same. • Approval documents for disbursements and waivers or tranche-splitting. • Quarterly progress reports and PCRs.
IMPACT	• What were the macroeconomic and sector results that could be attributed to the reform process supported by the operation? • What impact have the reforms supported by the loan had on low-income groups?	• Same. • Same.

SUMMARY OF SECTORAL PROGRAMS ANALYZED

Country (PPR No.):	Nicaragua (PPR-13/97)
Loans:	933/SF-NI
Name of operation:	Public Service Enterprises Reform Program (NI-0041)
Executing agency:	Public Enterprises Reform Commission
Sector - Subsector:	Reform – public sector support
Date of approval:	November 1994
Date of first disbursement:	January 1995
Disbursement dates:	
First tranche;	February 1995
Second tranche:	December 1995
Third tranche:	In execution
Planned execution period:	24 months
Duration of execution:	33 months so far
Amount of IDB funding:	US$120,000,000
Total program cost:	US$120,000,000

Strengths: An important reform was undertaken in the area of public service enterprises, separating the planning, operating and regulatory functions, and the institutional and legal foundation has been laid for regulating the major public services that are now to be privatized. The economic situation of the enterprises was also improved, by establishing more appropriate regimes for setting and collecting tariffs.

Weaknesses: Macroeconomic imbalances and conflicts and uncertainties over property rights and the effectiveness of the judicial system have held up progress with privatization.
Trained human resources are insufficient to support the economic framework with which public services are expected to operate.
The loan's specific objectives were too broad and the policies supported too numerous.
There were major inconsistencies or ambiguities in some recent key laws.

Conclusions: The Bank will need to pay continued attention to regulation and privatization in this important area of public services. It is difficult to achieve sustainable objectives in a complex and troubled political and economic environment, within the relatively short period of the loan. In addition the scope of the issues covered and the depth of the required reforms is not consistent with the nature of a fast-disbursing loan.

Country (PPR No.):	Nicaragua (PPR-14/97)
Loans:	638/OC-NI, 864/SF-NI, and 874/SF-NI
Name of operation:	Trade and Finance Sector Program (NI-0012)
Executing agency:	Central Bank of Nicaragua
Sector - Subsector:	Reform – public sector support
Date of approval:	October 1991
Disbursement dates:	
First tranche;	November 1991
Second tranche:	September 1992
Planned execution period:	36 months
Duration of execution:	24 months
Amount of IDB funding:	US$132,500,000
Total program cost:	US$132,500,000

Strengths: A basic institutional framework was established for a market economy. Progress was made in privatizing the financial and external trade systems and in re-establishing the Central Bank as an independent entity for monetary regulation and stabilization.

Weaknesses: The program's design failed to take account of some major risks (institutional weakness of the judicial system, lack of definition of property rights, and privatization of the state banks), and these impeded achievement of the program's general objectives. The design was not sufficiently precise in certain measures and components (reducing the role of state financial intermediaries). Some measures were not strictly or consistently applied (import licenses, customs exemptions). The commitment of the authorities to the reforms was not sufficiently credible.

Conclusions: The institutional framework must be sufficiently stable that trade and financial measures such as those supported can achieve their full results, i.e. these are necessary but not sufficient measures. Some of the proposed measures were accomplished, but there were delays and backsliding in others (reform of the state development banking system, use of import licenses and customs exemptions) and some of the general development objectives of the program were simply not sustainable.

Country (PPR No.):	Nicaragua (PPR-16/97)
Loans:	20/IF-NI, 724/OC-NI, 725/OC-NI and 897/SF-NI
Name of operation:	Agricultural Sector Adjustment Program (NI-0020)
Executing agency:	Ministry of Finance
Sector - Subsector:	Agriculture – agricultural development
Date of approval:	December 1992
Disbursement dates:	
First tranche;	December 1992
Second tranche:	October 1993
Planned execution period:	36 months
Duration of execution:	10 months
Amount of IDB funding:	US$54,850,000
Total program cost:	US$100,000,000

Strengths: Most of the specific objectives of the program were achieved.

Weaknesses: The specific objectives that were achieved were necessary but not sufficient for achieving the principal objective of the program, which was to establish an institutional framework and a set of policies appropriate for the sustained growth of agriculture. Output growth has been achieved on the basis of increasing the area under cultivation, rather than raising productivity.

Conclusion: Most of the program's specific objectives were achieved, but these were not sufficient to achieve the important general objectives. In addition, there were reversals in some areas (rural financial systems) and partial setbacks in others (customs tariff levels) that further impeded achievement of the program's over all development objectives.

Country (PPR No.):	Peru (PPR-12/97)
Loans:	677/OC-PE and 678/OC-PE
Name of operation:	Financial Sector Reform Program (PE-0033)
Executing agency:	Ministry of Economy and Finance
Sector - Subsector:	Reform – financial sector development
Date of approval:	March 1992
Disbursement dates:	
First tranche;	18 February 1993
Second tranche:	17 December 1993
Third tranche:	14 December 1994
Planned execution period:	48 months
Duration of execution:	33 months
Amount of IDB funding:	US$221,835,000
Total program cost:	US$229,135,000

Strengths: The general objectives and most of the specific objectives of the operation were achieved. In some key areas, the specific objectives were significantly exceeded (e.g. eliminating the state development banking system). The para-fiscal deficit was also eliminated.

Weaknesses: There was insufficient definition and progress on the issue of banking regulation and supervision, an area that could create potential difficulties. The securities market was not included in the operation.
There were significant delays in execution of the parallel technical cooperation element. Nonetheless, this was useful in achieving certain specific results.

Conclusion: The loan contributed to strengthening and deepening the financial system, and helped Peru to integrate itself into the international financial system, as well as to consolidate the process of economic stabilization.

Country (PPR No.):	Peru (PPR-15/97)
Loans:	1/SA-Pem 665/OC-PE and 631/OC-PE
Name of operation:	Trade Sector Reform Program (PE-0029)
Executing agency:	Ministry of Economy and Finance
Sector - Subsector:	Reform – public sector support
Date of approval:	September 1991
Disbursement dates:	
First tranche;	September 1991
Second tranche:	July 1992
Third tranche:	August 1993
Planned execution period:	24 months
Duration of execution:	24 months
Amount of IDB funding:	US$429,900,000
Total program cost:	US$429,000,000

Strengths: The program's general objectives were achieved, in terms of the country's international re-integration, consolidating economic stabilization, and opening the country to international trade. Certain policies and conditions, such as customs reform, were more successful than expected and exceeded the goals of the program.
In addition, the Bank approved other operations that served to reinforce the structural component of the program and that further strengthened its results.

Weaknesses: Levels of customs protection and phytosanitary barriers were retained at levels higher than those programmed, and there was no progress towards a uniform customs tariff.
Administration of the program was complicated by its diversity, and its design implied a serious risk of creating supervision problems and made a continuous and in-depth evaluation of progress under the program difficult and costly. Nonetheless, the support and commitment shown by the government to the policies supported by the program meant that, despite its complexity, the program has been very successful.

Conclusions: The timing of the operation was such that it made an important contribution to the process of re-integrating and opening the country internationally, and to the consolidation of Peru's economic stabilization.

Country (PPR No.):	Peru (PPR-10/97)
Loans:	626/OC-PE and 664/OC-PE
Name of operation:	Financial Sector Program (PE-0031)
Executing agency:	Ministry of Economy and Finance
Sector - Subsector:	Financial
Date of approval:	August 1991
Disbursement dates:	
First tranche;	December 1991
Second tranche:	February 1993
Planned execution period:	18 months
Duration of execution:	18 months
Amount of IDB funding:	US$151,700,000
Total program cost:	US$151,700,000

Strengths: The solvency and stability of the financial system were restored. The competitiveness of financial institutions was improved. The regulatory framework for the financial system was improved and strengthened and the accounting system of the Central Bank was extended. Supervision and enforcement mechanisms were established. A contribution was made to reducing and restructuring the external debt.

Weaknesses: There was no attempt to restructure or modernize the public banking system. The increased efficiency and competitiveness of the financial sector has not been reflected in any significant reduction in interest rate spreads, nor in the differentials between loans in domestic and foreign currency. Not enough attention was paid to labor rigidities in the banking sector. There were delays in execution of the technical cooperation component.

Conclusions: 1. It is important that the design of operations of this type should supplement and reinforce measures adopted under structural adjustment programs, the objective of which is to consolidate growth and ensure price stability.

2. The execution schedule for activities that require technical cooperation should take account of the time required to process and execute that component.

Country (PPR No.):	Uruguay (PPR-11/97)
Loans:	703/OC-UR and 704/OC-UR
Name of operation:	Investment Sector Reform Program - PRSI (UR-0057)
Executing agency:	Ministry of Economy and Finance
Sector - Subsector:	Reform – Private sector promotion and investment
Date of approval:	November 1991
Disbursement dates:	
First tranche;	April 1993
Second tranche:	June 1993
Third tranche:	In execution
Planned execution period:	30 months
Duration of execution:	60 months to date
Amount of IDB funding:	US$68,800,000
Total program cost:	US$68,800,000

Strengths: The PRSI had a decisive impact on reform of the social security system. It also made an important contribution to opening the insurance market, reforming the securities market, and launching reforms of the state.

The program made a highly significant contribution in the area of macroeconomic stability.

There has been insufficient time to observe any significant effects on investment and savings.

Nonetheless, there are indicators pointing to increased total factor productivity and higher returns on investment, which allow for some optimism as to the future course of investment and growth in Uruguay.

One very important factor for the success of any program as ambitious as the PRSI is that it was undertaken by mutual agreement with the government of Uruguay, which was fully committed to the policies supported by the program.

Weaknesses: The number of components and executing agencies involved, and the inadequate resources provided to the program coordinating unit, resulting in a significant delay in meeting the policy conditions of the loans.

These same design characteristics created supervision problems and made it difficult to assess the program's progress on a continuous and in-depth basis.

The program attempted to address too many fronts at the same time, meaning that it was very likely that certain conditions would go on fulfilled. At the same time, the program failed to establish *a priori* the importance of complying with the conditions and policies in each area. The problems that this lack of definition created for execution of the program were compounded when the government that negotiated it left office.

Conclusions: Despite the problems indicated, the results of the program may be considered satisfactory, since they have made an important contribution to the country's long-term macroeconomic stability, as well as strengthening key markets, and improving the investment climate.

Country (PPR No.):	Argentina (PPR-11/98)
Loans:	633/OC-AR
Name of operation:	Public Sector Reform Program (AR-0215)
Executing agency:	Ministry of Economy and Public Works and Services
Sector - Subsector:	Reform – Public sector
Date of approval:	October 1991
Disbursement dates:	
First tranche;	December 1991
Second tranche:	March 1993
Planned execution period:	24 months
Duration of execution:	16 months
Amount of IDB funding:	US$325,000,000
Total program cost:	US$650,000,000

Strengths: The program contributed to reducing the chronic macroeconomic instability that had been holding back Argentina's economic growth. There was progress on implicit objectives such as improving social indicators. There was also significant progress on the fiscal deficit, and tax collections and expenditure control were improved.

Weaknesses: The program did nothing to resolve major problems in the targeting of social expenditure, and in the efficiency of public services provided by the state. Moreover, there were areas where objectives were not met, such as those relating to approval of the Public Procurement Law and the cutbacks in public employment called for under the administrative reform.

Conclusions: Performance under this program may be considered satisfactory, since it had a clearly positive impact on the performance of the Argentine economy, particularly through the signal it gave that a coherent economic model was being established, reflecting a real concern to safeguard fiscal and macroeconomic equilibrium.

Country (PPR No.):	Argentina (PPR-14/98)
Loans:	773/OC-AR
Name of operation:	Investment Sector Reform Program (AR-0057)
Executing agency:	Ministry of Economy and Public Works and Services
Sector - Subsector:	Planning and Reform
Date of approval:	December 1992
Disbursement dates:	
First tranche;	June 1993
Second tranche:	June 1994
Third tranche:	December 1996*
Planned execution period:	18 months
Duration of execution:	42 months
Amount of IDB funding:	US$350,000,000
Total program cost:	US$450,000,000

Strengths: The program helped to consolidate the price stability that had been achieved with convertibility. It was particularly important for the support it provided to the autonomy of the Central Bank and the Superintendency of Banks, and to strengthening the capacities of the latter institution. The loan had a strong impact on the securities market, especially in the futures and options markets.

Weaknesses: The loan failed to call for more profound reforms in the labor market, which might have generated greater flexibility and thereby overcome the principal cause of persistent unemployment. There was a lack of precision in some of the conditions, which led the parties to interpret them differently. The time period that was allowed for execution of the loan was clearly inadequate in light of the nature of program.

Conclusions: Performance under this operation may be said to be satisfactory, in light of the support it provided to the government in protecting its reform achievements against unforeseen events.

*In November 1994, the government asked that the third tranche be divided into two sub-tranches, whereby the first would be disbursed immediately and the second would await compliance with the only clause of the loan still outstanding, that relating to adoption of an appropriate patents system. Although no law was approved to this effect, the fourth disbursement was declared acceptable to the Board of Executive Directors in December 1996.

Country (PPR No.):	Argentina (PPR-10/98)
Loans:	865/OC-AR
Name of operation:	Provincial Banks Privatization Reform Program (AR-0187)
Executing agency:	Ministry of Economy and Public Works and Services
Sector - Subsector:	Private Sector Promotion and Investment
Date of approval:	May 1995
Disbursement dates:	
First tranche;	June 1995
Second tranche:	December 1995
Third tranche:	March 1997
Planned execution period:	24 months
Duration of execution:	21 months
Amount of IDB funding:	US$750,000,000
Total program cost:	US$1,500,000,000

Strengths: The program was suitably designed to give effect to the proposed objectives. In particular, the execution sequence of the conditions required of the provinces for privatizing the banks was suitably designed, as was the system of incentives and penalties for ensuring an efficient process of winding up the provincial banks, thereby avoiding unproductive attempts at privatization.

Weaknesses: While the program was designed for the most part at Bank headquarters, it appears that there was relatively little involvement by the Bank in its execution, and participants in the program tended to see a closer association with the World Bank, which cofinanced the program, while the role of the Bank was perceived as purely one of financing.

Conclusions: Performance under this program may be considered satisfactory, since the general reform objectives for the provincial public sector were achieved, as were those relating to privatization of the public banking system and the improvement of the provinces' public finances.

Country (PPR No.):	Mexico (PPR-9 /98)
Loans:	670/OC-ME
Name of operation:	Export Sector Reform Program (ME-0112)
Executing agency:	National Bank for Foreign Trade (BANCOMEXT)
Sector - Subsector:	Reform – Trade Sector
Date of approval:	August 1991
Disbursement dates:	
First tranche;	December 1991
Second tranche:	July 1992
Third tranche:	December 1992
Planned execution period:	24 months
Duration of execution:	24 months
Amount of IDB funding:	US$250,000,000
Total program cost:	US$250,000,000

Strengths: The general objectives of the program were achieved in terms of continuing support for reforming and opening Mexico's trade, giving BANCOMEXT a greater market orientation, eliminating the interest rate subsidy mechanism, and implementing customs reform. Some of the conditions, such as those calling for rationalization, simplification and modernization of customs procedures proved, after some initial delays, to be more successful than expected, by extending the new system to all points of entry and exit for foreign trade. The specific goals of the program were thereby exceeded.

Weaknesses: There were delays in creating cost centers and in transforming BANCOMEXT into a "second tier" Bank. Nonetheless, its export promotion services now include mechanisms for recovering and minimizing costs, and for insuring greater overall efficiency.

Conclusions: The timing of the operation was such that it made an important contribution to opening and reforming Mexico's trade, simplifying and modernizing customs procedures, and consolidating BANCOMEXT as an entity for financing small and medium-scale exporters. In this respect, the operation may be considered to have performed satisfactorily.

Country (PPR No.):	Dominican Republic (PPR-12 /98)
Loans:	773/OC-DR
Name of operation:	Financial Sector Reform Program (DR-0016)
Executing agency:	Central Bank
Sector - Subsector:	Reform – Financial Sector
Date of approval:	September 1993
Disbursement dates:	
First tranche;	December 1995
Second tranche:	June 1996
Planned execution period:	24 months
Duration of execution:	In execution
Amount of IDB funding:	US$102,000,000
Total program cost:	US$102,000,000

Strengths: Some of the general objectives and most of the specific objectives of the operation were achieved. In some key areas there was slow but steady progress towards specific program objectives (regulatory standards of discipline and control and supervisory capacity of the commercial banks) that have been reflected in reduced spreads and lower interest rates, in the consolidation of many of the banks in the system, and in the reduced risk index of the banks. Important progress was also made towards achieving economic stability and rationalizing monetary and credit policy.

Weaknesses: The program did not include the securities and insurance markets, nor certain specific issues (offshore banking and the market risk inherent in mismatching currencies), despite the fact that the operation was designed to produce a broader and deeper financial market. There is still further consolidation to be done in the banking system.

Conclusions: The loan contributed to rationalizing and deepening the banking sector, making it sounder and more solvent. It also helped to modernize monetary policy and consolidate the economic stabilization process in the Dominican Republic. Although it is too early to assess the impact of the program, and all not all conditions have been met, the operation may be qualified as satisfactory.

Country (PPR No.):	Venezuela (PPR-8 /98)
Loans:	595/OC-VE
Name of operation:	Financial Sector Adjustment Program (VE-0071)
Executing agency:	Central Bank of Venezuela and CORDIPLAN
Sector - Subsector:	Reform – Financial Sector
Date of approval:	October 1990
Disbursement dates:	
First tranche;	December 1990
Second tranche:	December 1991
Third tranche	December 1993
Planned execution period:	36 months
Amount of IDB funding:	US$300,000,000
Total program cost:	US$300,000,000

Strengths: Significant progress was made in areas related to liberalizing the financial system. The basic institutions were established for a sound banking financial system, operating with market rates of interest. Progress was made in privatizing the banking system and in strengthening the Central Bank as an independent body for monetary regulation and stabilization. The basic framework was established for banking supervision and regulation.

Weaknesses: The design of the program did not take adequate account of certain important risks (which the laws on banking supervision and regulation did not properly address) and these prevented the program from achieving specific objectives in this important area. There was a lack of commitment to the agreed reforms on the part of the authorities. From the administrative viewpoint, the various tranches of the loan were disbursed against formal compliance with conditions relating to improved supervision and regulation, rather than against real progress in these matters. Indicators of the Venezuelan market's financial depth are still low, and the banking sector is less well developed than that in other countries of the region that have similar levels of income.

Conclusions: (1) A stable economic and institutional environment for banking supervision and regulation is required if financial liberalization measures such as those adopted to date are to fulfill their objectives. This means that those measures by themselves are necessary, but not sufficient. (2) Despite the second Bank operation to deal with outstanding banking regulatory and supervisory issues, the necessary measures have still not been taken in this field. Thus, some of the objectives of the program have still not been achieved, while those that have been undertaken cannot be considered sustainable. In 1995, the IDB performed an evaluation of the financial sector loan granted to Venezuela in 1990, to see if it had met its objectives. That study found that "the general outcome of this operation must be classed as unsatisfactory" (document 595/OC-VE, August 1995, p. 25). On October 11, 1995, the Bank granted reimbursable technical assistance (893/OC-VE) for US$14 million to deal with outstanding issues under the Financial Sector Adjustment Program. Nonetheless, as of 31 October 1998, only 4% of funds had been disbursed, and the only satisfactory progress was in the area of banking regulation and supervision.

Country (PPR No.):	Colombia (PPR-1 /96)
Loans:	615/OC-CO
Name of operation:	Public Sector Adjustment Program
Executing agency:	National Councils on Economic and Social Policy and Fiscal Policy
Sector - Subsector:	Reform – Public Sector
Date of approval:	December 1990
Disbursement dates:	
First tranche;	June 1991
Second tranche:	July 1992
Third tranche	December 1993
Planned execution period:	24 months
Amount of IDB funding:	US$300,000,000
Total program cost:	US$604,000,000

Strengths: Most of the specific objectives of programs were achieved, in terms of raising productivity in the public sector, specifically in a number of public enterprises and decentralized agencies. Sector reforms and performance contracts were two instruments that proved very effective in achieving these objectives. In several sectors, reforms have shown themselves to be sustainable over time, and have made a notable improvement to the competitiveness of the economy.

Weaknesses: Some of the conditions included in the loan related only marginally to the public sector, butt were established because of the active presence of the state in certain economic activities. These measures would have had greater effect if they had been included in specific reform programs for those sectors (e.g. agriculture, trade or finance). Measurements of the operation's effectiveness focused on compliance with certain actions that did not guarantee the achievement of objectives. Similarly, the liberalization of prices and tariffs, and efficiency improvements in the public sector, were measured in a diffuse manner, and there were no indicators to measure progress against the objective of liberalizing markets.

Conclusions: The loan conditions, some of which were based on implementing reforms in the public sector and others in the private sector, must be interpreted in the broader context of the macroeconomic reform process that the government of Colombia has undertaken. Generally speaking, performance under the program may be considered satisfactory, since it helped the government in its efforts to modernize the state.

ANNEX 4

SUMMARY TECHNICAL REPORT

Evaluation of the Policy-Based Loan Portfolio – Phase III

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1

Introduction

1.1 From their earliest days, international financial institutions, and the IDB in particular, have been constantly seeking the best way to contribute to the sustained development of their borrowing member countries. Their contributions have been made both through loans and technical cooperation, as well as through dialogue on economic and social policies.

1.2 In recent years there has been a growing recognition of the role that economic policies and institutions play in a country's economic development. Thus, at the outset of the debt crisis in the 1980s, the Bank undertook a complete revision of its support strategy for member countries. Part of this new strategy was to incorporate the role of policies and institutions much more directly into the development and design of loans. This revision of the policy role took place at both the macroeconomic and sector levels.

1.3 This review of the Bank's support strategy did not take place in a vacuum, but built upon recent developments regarding the determinants of sustained economic growth and the most effective way to enhance equity and reduce poverty. There is a growing literature on the role of economic policies and institutions in development, both at the macroeconomic and the sector level, from which it is clear that achieving sustained development requires: (1) macroeconomic and sector policies that will promote stability (low and predictable inflation rates, sustainable current account deficits); (2) policies and institutions that will allow for expanded investment in physical and human capital; and (3) policies and institutions that will encourage the efficient use of resources, including the adaptation and application of new technologies.

1.4 As a result of its review of support programs for developing countries, the IDB's seventh and eighth replenishments included programs for sector loans and the Bank has been placing increasing emphasis on the role of policy in its investment loans and in its new operating modalities[1]. The central purpose of sector loans is to support policy and institutional changes and aimed at ensuring sustained growth while reducing poverty. These programs have been based on a theoretical and practical understanding of the determinants of equitable growth.

1.5 This summary document presents evaluations of 14 sector loans that the Bank made in eight member countries, with a view to analyzing their effectiveness. The selection of operations for evaluation, as approved by the Board of Executive Directors (see Evaluation Profiles 97/1 and 98/2 in Annex 1), was based on one of the

[1] "During the period of IDB-7, 1990 to 1993, the Bank will enter the sphere of sector development financing, in which it is not always possible to determine precisely the impact on low-income groups. Nonetheless, the Bank must adopt measures to ensure that members of these groups participate more fully in the benefits generated by these sector operations, and that any disadvantages that these people may suffer are reduced" (paragraph 3.30 of document AB-1378). "Policy lending during the eighth replenishment will continue to support economic adjustment programs for those countries still in need of such financing, but greater emphasis will be placed on reforms in the public sector and promoting reforms and sectors neglected in the general adjustment process, in particular the rehabilitation and modernization of social sector infrastructure and delivery systems. The Bank will continue to use investment sector loans as part of its support for the development and growth of the private sector. The policy-based lending with modalities now in use are adequate for dealing with the special problems of the social sectors. However, some adjustments will be necessary to reflect the different nature and generally longer time horizon needed for effective sector policy reforms". (Paragraph 2.52 and 2.53 of AB-1704).

conclusions from the document on the first evaluation phase (RE-213/96), in the sense that the countries of groups B, C and D that had received the greatest net flow of sector lending funds were Peru, Uruguay and Nicaragua, respectively (paragraph 2.26). Subsequently, in 1998, five loans were included in countries of group A (Argentina, Mexico and Venezuela), and one in a group D country (Dominican Republic), which was substituted for a loan in Mexico. In this respect, it was agreed that conditions were not appropriate for an evaluation of the Mexican financial sector, while there was an excellent opportunity to learn lessons from experience with the financial sector reform loan in the Dominican Republic. The terms of reference for the evaluations of the individual PPRs are found in the Evaluation Matrix, attached as Annex 2. As well, Annex 3 presents a synopsis of the evaluation of each of the 14 programs assessed.

1.6 The 14 sector loans evaluated represent 29 percent of all sector loans approved, 42 percent of sector operations approved by the Bank between 1990 and 1995 (see table 1), and 38 percent of countries that received sector lending during that time.

Table 1
Sector Loans, By Country Group 1990-1995
(In US$ millions)

County Groups	Sector Loans Evaluated (A)		Total Sector Loans Approved (B)		Percentage of A to B	
	No.	Amount	No.	Amount	No.	Amount
A	5	1975.0	12	4690.0	42	42
B	3	956.7	5	1311.7	60	73
C	2	220.5	10	755.5	20	29
D	4	403.4	20	1626.4	18	25
Total	14	3555.6	47	8383.6	29	42

1.7 The following sector loans were evaluated in the second phase of the project (1997):

- Public Service Enterprise Reform Program (NI-0041), PPR-13/97
- Finance and Commerce Sector Program (NI-0012), PPR-14/97
- Agricultural Sector Adjustment Program (NI-0020), PPR-16/97
- Financial Sector Loan (PE-0033), PPR-12/97
- Commercial Sector Program (PE-0029), PPR-15/97
- Financial Sector Program (UR-0031) PPR-10/97
- Investment Sector Reform Program (UR-0057), PPR-11/97

1.8 The following sector loans were evaluated during this third phase of the project in 1998:

- Public Sector Reform Program (AR-0215), PPR-11/98
- Provincial Bank Privatization Program (AR-0187), PPR-10/98
- Investment Sector Reform Program (AR-0057), PPR-14/98
- Export Sector Reform Program (ME-0112), PPR-9/98
- Financial Sector Reform Program (DR-0016), PPR-12/9
- Financial Sector Program (VE-0071), PPR-8/98

1.9 The scope of this Summary Report also reflects guidance received from the Board Matters and Evaluation Committee, relating to lessons learned and successes achieved by the Bank with this instrument, coordination among the various financial institutions, the social impact of sector loans, and compliance with disbursement conditions, based on its consideration of Report RE-228 from the Evaluation Office (EVO) of September 10, 1998, as well as suggestions from the Bank's management. Report RE-228 presented a summary of the seven sector loans evaluated in 1997.

1.10 This document, based on the Project Performance Reports (PPRs) for the 14 programs evaluated, examines four central aspects: (1) the relevance and consistency of loan design; (2) the timing, impact and sustainability of reforms supported by the loans; (3) best practices, lessons learned, and solution options for the problems encountered, derived from the execution of sector loans, and their implications for state and social sector reform operations; and (4) administration, monitoring and supervision of the Bank's sector lending. Sections 2, 3, 4 and 5 of this document deal with each of these components in detail.

1.11 As noted, adjustment programs in general, and the IDB's sector lending programs in particular, are conducted within a frame of reference derived from the theory and practice of design and implementation for reform programs aimed at increasing growth and reducing poverty. Below is a summary of the analytical framework that used as the starting point in designing the individual studies. [2]

1.12 Theory and empirical evidence both suggest that there are a number of requirements for achieving sustained growth of the kind that will help to reduce poverty. Today, these requirements form part of a conceptual framework that is widely employed in the design and evaluation of economic and institutional policies intended to promote sustained growth while reducing extreme poverty. This conceptual framework, taken together with the success of countries that have implemented policies of this kind, and the fact that in recent years a growing number of developing countries have introduced changes to their economic policies and institutions, following a very similar pattern, has given a major impetus to the process of reform and modernization. International financial institutions and regional banks have been providing support both for the design and for the financing of reform programs, and in general have supplemented them with social investment programs for the direct benefit of those groups that are negatively affected by the reform process.

1.13 A recent Bank study shows that, to the extent that structural reforms have contributed positively to restoring income levels, productivity and investment in physical capital, they have thereby forestalled even greater income gaps, but that existing inequality and poverty will not be significantly reduced without resorting at the same time to a broader range of policy instruments and measures intended to promote education, to reduce the growing inequality of educational assets, and to ensure broader access for low-income groups to other productive assets. (Szekely and Londoño, 1997).

1.14 Recent literature points to a number of central elements that must be included in any adjustment program, if sustained growth is to be restored and extreme poverty reduced. These elements can be grouped together under six categories:

a) Achieving and maintaining macroeconomic stability, with low and predictable inflation rates and a sustainable current account deficit;

b) An appropriate price system that reflects the economic value of goods and services;

c) Adequate physical infrastructure, together with a sound human capital base;

d) An efficient and solid financing system that can evaluate risks properly, avoid unsustainable expenditure growth, and allocate resources efficiently;

e) High rates of domestic investment and savings; and

[2] See also EVO, Framework Document, May 31 1997.

f) An institutional apparatus that will reduce the costs of market economy transactions, promote a stable and reliable policy framework for encouraging investment, and contribute to increasing the productivity of the economy as a whole.

Appendix provides a more detailed description of the role played by each of these six elements.

1.15 The six conditions indicated above are necessary, but not sufficient, conditions for achieving sustained growth and reducing poverty. Latin American experience during the 1990s shows that countries are liable to receive external shocks, through deteriorating terms of trade, changes in the conditions of trade, adverse capital movements associated with the "contagion" effect among emerging countries, or slower growth in the regional or global economy as a whole, and that these can have a negative impact on a country's growth and well-being. Yet, thanks to the maintenance of macroeconomic equilibrium and greater flexibility in allocating resources, countries that have adopted the reforms indicated have reduced their vulnerability and have been better able to face and absorb such shocks, at lower economic and social cost than countries that have not done so.

2

Relevance of design

A. Objective

2.1 This section examines the degree to which the design of the 14 programs and their principal components has supported reforms that were of priority for consolidating stabilization, rekindling growth and reducing poverty in the recipient country, taking due account of initial conditions and the principal obstacles to be overcome. In this respect, it analyzes whether the general development objectives of the loans were effectively fulfilled, and whether these were reasonable in light of the particular circumstances and the knowledge available when they were designed, as viewed in light of the recent advances in our understanding of the reform process. The background material consulted included the *Report on Economic and Social Progress in Latin America,1996*, especially parts I and II; the *Report on Economic and Social Progress in Latin America,1997*, especially part II; the World Bank's *World Development Report 1997*; and the specialized articles found in the Bibliography of this document.

2.2 Specifically, the study examines, in each case, to what point the reform program covered by the sector loan was directed at supporting change in areas where, on the basis of a careful study of the country's circumstances, it might be concluded that the loan could make the greatest contribution to consolidating stabilization and improving growth prospects, while reducing poverty in the recipient country. In this respect, it was recognized that the reform process as a whole, and especially the institutional change component, requires a horizon that extends beyond the execution period of the loan. Similarly, reforms supported by IDB sector loans are part of a broader, global reform process, and the study must also determine to what point these were coordinated with other changes supported by other international financial institutions, or financed solely by the country itself, that also contributed to consolidating, broadening and deepening the process. This analysis was based on the loan review in each case, as well as on general information found in the Bank's country studies and other sources: World Bank, IMF, ECLAC, and other available country studies.

2.3 The evaluation studies also examined to what point the loan and its accompanying technical cooperation took into account the country's capacity for successful administration of the reforms supported by the loan. In cases where this capacity was considered initially inadequate, during preparation of the loan, the actions proposed in the loan and the technical cooperation to deal with the situation were also assessed.

B. Initial conditions in the respective countries and program objectives

<u>Argentina</u>

2.4 During the 1980s, Argentina experienced a period of great economic instability, characterized by low growth in output, a lack of fiscal discipline (both at the central and the provincial government levels), and high rates of inflation. The constant pressure of fiscal deficits, added to the high level of public debt, created a setting propitious to high inflation, in which the central government was virtually incapable of implementing any successful stabilization program. The economy was isolated from international trade through a variety of tariff and non-tariff

restrictions. The state was deeply involved in the market for various goods, through a broad range of state enterprises, and it intervened heavily in resource allocation through industrial subsidies and restrictions on various services.

2.5 The administration of President Alfonsin attempted to stabilize the economy, but its efforts failed because of the persistent fiscal problem. The major difficulty in adjusting the fiscal situation arose from the lack of coordination between the central government and local governments, which were slow to reduce their expenditures because they were able to obtain financing by borrowing from their own provincial banks, and this allowed them to avoid adjusting their expenditure levels. On the other hand, the existing high level of public debt, and particularly external debt, made monetary and exchange policy management more difficult, and also created problems on the fiscal front. As a further element in this unfortunate macroeconomic scene, the severe crises experienced in previous years had led to a worsening of the indicators of poverty and indigence, generating a climate in which the public was increasingly unhappy with economic management. This delicate economic situation also reduced government revenues, and new taxes were introduced that generated further distortions and complicated revenue management.

2.6 In addition to the above difficulties, there was another series of elements that impeded economic growth. For example, there were serious shortcomings in the regulation of the financial system (and in particular of the banking system, where the basic regulatory standards of the Basle Agreement were not applied) and there were severe distortions in the taxation of foreign trade. These included a series of non-tariff import restrictions, and high and varying tariff rates, a tax on exports, and other measures that frustrated the efficient allocation of resources in the tradable goods sector.

2.7 In July 1989, a new government took office in Argentina and immediately embarked on a program of economic adjustment. It also proposed a series of structural reforms to Congress, including privatization, reducing subsidies and expenditures, cutting off-budget transfers to the provinces, reforming the charter of the Central Bank, and making reforms to trade and to the tax system. The stabilization program was based on rationalizing the fiscal accounts, setting a fixed exchange rate, negotiating a price freeze with business, and arranging an implicit understanding with labor not to demand wage increases higher than those called for under the program.

2.8 The stabilization program, however, failed. In particular, it failed because the government was once again unable to live up to its commitments with respect to the fiscal deficit, and because of the limitations that the high level of government indebtedness placed on its monetary management. By late 1990, the stabilization program had broken down and a new effort was necessary to rein in inflation and stabilize the economic setting. In addition, the financial system was facing a run on the banks for the fifth time since the adjustment plan had been introduced.

2.9 Apart from stabilizing the economy, and in particular reducing inflation and preventing runs on the banks, a reform of the public sector had become an urgent necessity by the beginning of 1991. What was needed was a reform that would rationalize the state role in the country's economic life and reduce the large number of market distortions. In this respect, the public finances had to be rationalized and the state downsized, so as to reduce the need for revenues and allow a series of highly distorting taxes and duties to be eliminated. It was also necessary to introduce a series of measures to guarantee fiscal discipline, in order to ensure lasting stability.

2.10 In early 1991, a new adjustment program was announced, based primarily on a reduction of the public sector deficit and on a public commitment to make the currency convertible. At the same time, restrictions were placed on the capacity of provincial governments to issue their own debt. In this way, the deficits of the provincial governments were brought under control. A currency board was introduced to lend credibility to the country's stabilization policy, which had suffered repeated episodes of sharp instability and failed recovery plans. The program was successful in reversing the trend of inflation, bringing the annual rate down to the single-digit level by 1994. Until the end of 1994, the performance of the Argentine economy was very satisfactory, with high growth rates in investment and output, and significant progress in adopting the structural reforms that were needed to sustain economic growth over the long term. Nevertheless, it was unable to avoid steadily rising unemployment. The unemployment problem was due in part to the crisis of the 1980s. As the economy was liberalized, a portion of the initial underemployment began to show up as an increase in open unemployment.

2.11 In late 1994 and early 1995, the Argentine economy began to feel the effects of the Mexican crisis. This brought with it a series of problems for maintaining the exchange rate scheme, and also provoked capital flight, a lack of business confidence in the sustainability of policies, and problems with refinancing the shorter maturities of the public debt. This climate of instability forced the government to adopt severe austerity measures, in order to alleviate pressures on the peso and reduce the current account deficit. Moreover, the situation of the financial sector became shaky, and speculative pressures increased the risk of another run on the banks. The downturn in economic activity, together with higher interest rates during the first quarter, caused the quality of the banking portfolio to deteriorate. Efforts to keep the fiscal accounts in order were complicated by the decline in fiscal revenues, by restrictions on financing, and by the need to seek coordination between efforts of the central government and those that the provincial governments were supposed to carry out. Several of these governments faced the need to cover deficits generated by their own provincial banks, and this imposed a heavy burden on their finances.

2.12 In light of the above elements, there was an urgent need by early 1995 to reform the financial system, and in particular to address the ownership and administration of the provincial banks, in order to keep the deficits of those banks from imposing a continued burden on the finances of local governments. Moreover, it was clear that these banks had serious problems with their resource allocation mechanisms, especially in terms of measuring project risk, and this led to an inefficient allocation of resources for investment. In fact, even before the onset of the Mexican crisis, non-performing loans amounted to 30 percent of the total portfolio. Nevertheless, the process of winding up these banks or transferring them to private hands implied certain costs to local governments, which they could ill afford under the prevailing economic circumstances. It was therefore necessary to establish a fund to support the provinces as they undertook this process.

Colombia

2.13 The Colombian economy had until the 1980s been considered the most stable economy in Latin America. This stability was supported by a record of sound fiscal management. Nevertheless, a long history of moderate inflation rates (between 15 and 25 percent per year) had generated a kind of inflationary inertia, in particular with respect to wages and the exchange rate. Colombia also stood out from the rest of Latin America in that its external debt levels were lower than the average, despite the fact that it too had suffered the consequences of crisis in the early 1980s. During the last years of that decade, the Colombian economy experienced accelerating inflation, which in 1990 reached a peak of more than 30 percent, for the first time in nearly 30 years. This accelerating inflation was accompanied by an increase in fiscal deficits and a deterioration in the terms of trade.

2.14 In an effort to enhance its growth prospects, the Colombian economy was subjected to a serious and profound process of reform during the first four years of this decade, in which many of the existing constraints on the country's economic and social development were eliminated. Reforms were introduced in the external trade sector, the financial sector, the pensions sector, the taxation sector, and the labor market, and the fiscal sector was rationalized, supported in part by the IDB sector loan discussed in this study. Nevertheless, amendments to the Constitution led to a process of government decentralization, which was undertaken without first ensuring proper rules to impose discipline on local governments. The decentralization and the expansionist policies of recent years resulted in a sharp decline in fiscal discipline.

2.15 The stabilization program that was launched at the beginning of the 1990s sought to bring about a reduction in the rate of inflation, primarily by ensuring a sound fiscal stance that would prevent uncontrolled growth in aggregate demand, with its attendant inflationary pressures. A key factor in this regard was the introduction of a tax reform that led to an increase in fiscal revenues while amending and improving the administration of income taxes, value added taxes, and specific consumption duties, reducing customs tariffs, and in general enhancing the efficiency of resource allocation. Monetary policy during this period was characterized by a prudent approach that included maintaining cash reserves of 100 percent, in order to control monetary expansion and in this way to reduce upward pressures on domestic spending. All of this took place within a framework in which unemployment was kept to reasonable levels and there was little interference from restrictive policies. Moreover, the charter of the Central Bank was reformed, guaranteeing independence in its management of the economic variables under its control.

2.16 The financial reform was implemented by establishing a suitable system of regulation and supervision, which allowed for the reduction of state intervention in interest rates and resource allocation (through directed

lending) and at the same time maintained the soundness of the financial system. In addition, a new pension system was adopted, which helped to deepen the capital market and at the same time to provide economic agents with greater domestic financing opportunities.

2.17 Colombia's external situation was sound during this period, thanks to continued fiscal and monetary austerity. The flourishing export sector gave a sharp boost to the trade balance. This was reinforced by the discovery of oil in Cusiana and by rising revenues from coffee exports (despite the cutback in its international quota).

2.18 The public sector reform program was supported by the Bank through one of its first sector loans. It was executed between 1991 and 1993. The objective of the operation was to enhance productivity in the public sector by creating incentives for the efficient supply of services and by ensuring that specific activities of decentralized state entities were compatible with medium-term macroeconomic objectives and goals.

Mexico

2.19 Toward the end of 1987, Mexico was attempting to bring about a real depreciation in its exchange-rate, against the backdrop of a highly indexed economy and a fiscal situation that was still precarious, with the final result that inflation accelerated sharply. Prices were rising by around 200 percent a year, and this posed a threat to the structural reforms undertaken early in the administration of President De La Madrid. The government thereupon decided to launch a frontal assault on inflation. It introduced a stabilization program, based on the Economic Solidarity Pact that was negotiated in late 1987, and continued under the Economic Stability and Growth Pact in subsequent years.

2.20 The following measures were among those introduced:

1. Reforming the public finances to achieve a fiscal deficit consistent with stability.
2. A restrictive monetary policy, to remain in place until growth and stability expectations were achieved.
3. A change in the wage settlement system, shifting from short-term contracts indexed on the basis of past inflation, to long-term contracts indexed to future inflation.
4. Further trade liberalization, through wide-ranging trade policy reforms, supported by an exchange rate policy aimed at retaining competitiveness.
5. A combination of monetary and fiscal policies aimed at controlling aggregate demand and avoiding pressures on inflation and on the current account of the balance payments.
6. An income policy through agreement on price controls set in parallel with salary adjustments.

2.21 As a means of underpinning stabilization, a policy was adopted for gradual convergence of the exchange rate towards a fixed-rate scheme. This was done by means of the so-called "crawling peg" mechanism, with previously announced devaluations in declining degrees.

2.22 In support of the public finance reform, a tax reform was undertaken between 1989 and 1991, with a view to reducing distortions by lowering the maximum tax rates on individuals and businesses and broadening the tax base for both groups.

2.23 During 1990 and 1991, the Mexican economy received a boost from higher oil prices, which allowed fiscal revenues to increase and the external debt to be renegotiated. In particular, the term structure of the debt was amended: this allowed for greater revenues and reduced the need for external financing to cover debt service payments. All these elements bolstered confidence in the economic situation, and led to lower interest rates and an inflow of foreign capital. Nevertheless, the country's future development was bound to require a stronger export base to support the process of economic growth.

2.24 In terms of opening the economy, an effort that was supported by the sector loan examined in this report, Mexico adopted as a central objective for the 1990s the goal of integrating its economy more thoroughly into the world economy. The main purpose of this reform was to take advantage of the benefits, both static and dynamic, flowing from a more open economy. To achieve this purpose, trade policy reforms were introduced, reducing average and maximum tariff levels and eliminating the requirement for import permits. Moreover, at the same time efforts were made to enhance the efficiency of foreign trade services (customs, transportation and storage, export promotion) and a start was made on negotiating a free-trade treaty with the United States and Canada.

2.25 Mexico enjoyed steady development until 1994, which was a year of severe crisis. A common element of most attempts to explain this crisis is the weakness of the financial system, along with the growing para-fiscal deficit caused by an expansion of investment by state entities not covered by the budget, and a sharp increase in short-term debt. Political problems in 1994 no doubt played an important role in the emergence of the crisis. The more open external stance itself had little to do with the crisis, and the fact that it was retained did much to facilitate subsequent recovery.

2.26 In fact, the rapid recovery that began in 1996 was based on growth in Mexico's non-oil exports. This expansion was made possible by the growing export base resulting from the trade liberalization policies implemented after 1985.

Nicaragua

2.27 In the late 1980s, Nicaragua found itself in a very difficult economic situation. The economy was experiencing hyperinflation, and there were severe distortions in the prices of goods and services, property rights were under increasing question and the external accounts were sharply out of alignment. A series of reforms was introduced in 1989, and these resulted in a major turnaround in economic performance. In particular, considerable progress has been made in controlling inflation and in laying a stable basis for sustained economic growth. Major structural reforms have been undertaken and the success of the stabilization effort is no longer in question. Inflation is now at less than 10 percent per year.

2.28 Since then, the handling of fiscal, monetary and exchange policies has resulted not only in low and predictable inflation, but also in a fairly stable exchange rate. As well, there has been impressive progress in restructuring the system of incentives and in improving the regulations governing productive activity. In terms of incentives, the economy has been re-opened to international trade, eliminating most of the non-tariff barriers and reducing substantially the level and variance of import tariffs. Price and interest rate controls have been illuminated, and the role of state distribution mechanisms has been reduced.

2.29 As a result of the policies that it has pursued during the 1990s, Nicaragua has made major progress in stabilizing its economy and in resolving the balance of payments crisis that arose towards the end of the last decade. In addition to the progress that has been made with pacification, the country has also advanced in the dismantling of the planning system and in the establishment of a market economy. A start has also been made at integrating the economy into the world economy: import tariffs have been reduced (although with some reversals) and non-tariff barriers have been dismantled. A significant number of public enterprises has been privatized, and steps were recently taken to begin privatizing the largest of the public enterprises in the areas of electric energy and telecommunications. Progress has also been made in establishing the basic institutions for the functioning of a social market economy, by giving more independence to the Central Bank and by establishing a regulatory and supervisory framework for both the private and state commercial banks. Nonetheless, progress has been slow when it comes to defining and enforcing property rights.

3.30 The recent performance of the major macroeconomic aggregates reveals that the economy has been growing, albeit slowly, since 1994. Nicaragua has also achieved great success in reducing inflation, which declined from 13,490 percent in 1990 to rates below 20 percent in 1993-1994, and is under 10 percent currently.

2.31 Despite this progress on the stabilization front, Nicaragua has since 1994 faced increasingly less favorable prospects in terms of the availability of external financing. This has forced it to continue with the gradual cutback of excessive spending, and to establish clear priorities for the composition of public expenditure, in order to promote growth. To keep the aggregate deficit on a downward trend has required a combination of policies to reduce private

expenditure and policies to remove obstacles to investment and sustained growth. Measures of this kind had to be focused in particular on agriculture, where the rise of agro-industry held out prospects for significant increases in production, employment and exports.

2.32 In the case of Nicaragua, then, the situation at the time the loans were prepared was one that required reinforcing stability and reducing dependency on external aid, and at the same time continuing the transition to a market economy, not an easy task in light of the sharp expansion of the state that had occurred under the Sandinista government.

2.33 In terms of reforms to promote efficiency and investment, the priorities were to proceed with external liberalization, to improving the definition and enforcement of property rights, and to enhance agricultural incentives. There was also a long way to go in improving competitiveness in the provision and distribution of public utility services and in withdrawing the state from the production of private goods, so that it could concentrate its efforts on the provision of public goods. During these years, special attention was to be paid to increasing the opportunities for low-income people to improve their education, nutrition and health.

2.34 For a small country like Nicaragua, external openness was a high priority, both as a means for seizing the advantages of specialization and benefiting from industrial economies of scale, and for exposing the domestic producers of tradable goods and services to competition. But this was not all: the domestic political conflicts of the 1980s had caused private investment to collapse and had undermined respect for property rights, particularly in rural areas. As a result, it was also necessary to create a framework of policies and institutions more favorable to the expansion of private investment.

2.35 A review of Nicaragua's policies and institutions, undertaken when the sector loan process was beginning, identified the following priority areas in need of reform:

a) Comprehensive trade policy reforms to eliminate distortions in the allocation of resources, improve the competitiveness of the tradable goods sectors, and make a substantial improvement to Nicaragua's integration in the world economy.

b) Greater opportunities for agricultural growth, through a better definition and enforcement of property rights, both with respect to land and water use, the supply of public goods required for agricultural extension, and rural infrastructure including roads and irrigation works. The high priority placed on agriculture in Nicaragua relates also to its importance as a source of employment, and the fact that much of the poorer population is concentrated in rural areas.

c) Creation of a regulatory framework to promote competition, facilitate privatization and encourage private investment in the sectors of telecommunications, electricity, water and sanitation, ports, and transportation of freight and passengers.

d) Improving access to and quality of education and primary health care for the poorest groups of the population.

e) Strengthening the institutions that promote competition and that will facilitate the definition and enforcement of property rights.

Peru

2.36 In the late 1980s, the Peruvian economy was experiencing hyperinflation, it was burdened by an extensive system of price controls, and it was isolated from external competition by a series of tariff and non-tariff barriers, in addition to a system of multiple exchange rates. Moreover, the country was in arrears in servicing its debt to international financial institutions.

2.37 The government of President Fujimori, which took power in August 1989, was persuaded from the outset of the need to stabilize the economy, to undertake structural reforms to create a setting more favorable to long-term growth, and to reinstate the country's credibility with the international financial community. International financial

institutions, on the basis of the new government's programs, declared themselves willing to provide financial and technical support for the reform process. The stabilization program called essentially for reducing the fiscal deficit, by adjusting the prices charged by public enterprises, unifying the exchange rate, eliminating subsidies, and imposing a restrictive monetary policy.

2.38 The central objective of the stabilization program, as announced on August 8, 1990, was to achieve a drastic reduction in inflation. To this end, the program called for decisive action to reduce the fiscal deficit, to control the growth of the money supply, to unify and stabilize the exchange rate, and to adjust public prices in order to eliminate the losses of state enterprises. In light of the severe distortions resulting from the price controls introduced by the previous government, prices were to be freed. Fiscal adjustment took the form of reducing expenditures and increasing revenues.

2.39 Significant progress has been made under the stabilization program. Inflation declined from a level of 12,375 percent in August 1990 to 57 percent in 1992, and has reached single-digit figures in recent years. Net international reserves switched from a negative balance of $100 million in August 1989 to a surplus of more than $2 billion at the end of 1992, and over $9 billion by the end of 1998. The public sector deficit declined from 16 percent of GDP in 1990 to 4 percent of GDP in 1992, and currently stands at zero.

2.40 As progress was made under the stabilization program, the government began to consider an agenda of profound structural reforms, intended to consolidate stabilization and return the country to sustained economic growth. An evaluation of Peru's existing policies and institutions at the beginning of 1990s, when preparation of the IDB loans was beginning, identified a series of priority areas requiring in depth reform. These included:

a) A tax reform that would help to support stabilization and eliminate distortions. A VAT (consumption tax) was introduced at a rate of 18 percent, and tax administration was streamlined.

b) A trade policy reform to reduce the level and complexity of customs tariffs.

c) A financial reform that would create a more competitive financial system and deregulate the capital market.

d) Pension system reforms to control the growing fiscal deficit under the old pay-as-you-go scheme, and thereby resolve the problem of the low pensions provided by the current system, while helping to create a much deeper and more competitive capital market.

e) Labor reforms to enhance access to the labor market for a larger portion of the workforce and to reduce the distortions that were artificially constraining employment opportunities.

f) Liberalization and deregulation of the market for land, in order to improve access from low-income groups to this market.

g) Restructuring the public sector to remove it from the production of private goods, enhance the efficiency of state administration, and contribute to a sustainable fiscal balance.

2.41 The structural reforms have made clear and decisive progress. Measures to promote commercial openness have included the elimination of non-tariff barriers and the reduction of tariffs to an average rate of 17 percent, with only two levels, set at 15 percent and 25 percent. The state monopoly on the import of foodstuffs was abolished, the goods market has been almost completely liberalized, and wages and interest rates have been freed. Progress has also been made in modernizing customs and ports administration, deregulating domestic transport, and approving a new banking law.

2.42 Since 1993, reforms have been made in the areas of social security, health and the education system. Progress in the area of privatization was initially slower, and only 10 public enterprises were sold in 1992. Since 1997, however, a much more aggressive program has been pursued in this area.

2.43 Thus, when work began on the sector loans supported by the Bank, it was clear that Peru would need to make further progress in consolidating its fiscal position, as well as in pursuing its integration into the world economy, accelerating the withdrawal of the state from the provision of private goods, and undertaking a profound transformation of the financial system in order to make it sounder and more competitive. On the fiscal front, there was a need for further restructuring, liquidation and privatization of public enterprises, and better coverage and administration of the taxation system. On the trade front, further progress was needed in eliminating non-tariff restrictions and in reducing the level of average and peak of tariffs. In the financial sector, there was a need for significant improvement in banking regulation and supervision, and for introducing greater competition in the sector.

2.44 The high level of real interest rates could be explained in part by uncertainty over the fiscal situation and the outlook for future inflation, but in fact the difference between lending and borrowing rates resulted in excessively high intermediation spreads. The high interest rates charged on loans in *soles* tended not only to depress economic activity and postpone investment, but also encouraged an excessive inflow of foreign capital and exerted downward pressure on the real exchange rate.

2.45 Under these circumstances, financial sector reform was a high priority. This was not a simple undertaking, since the Peruvian banking sector's loan portfolio was heavily in arrears, as a result of the assumption of unduly high risks, compounded by the major recession that afflicted the country between 1988 and 1992, during which time GDP contracted by a total of 22 percent. The excessive degree of risk resulted from the combination of a very weak bank regulatory and supervisory system (with little information on the related-loans portfolio and on the quality of loans) and the existence of a *de facto* system of deposit insurance.

2.46 To deal with the crisis in the financial system, it was necessary first to begin restructuring, liquidating and privatizing the state banks. To make the banking system sounder and more competitive it was also recommended that private banks, including foreign banks, be allowed to take over some of the state banks. This increasing competition would force restructuring of the banking industry and allow intermediation spreads to be reduced, thereby countering the high level of interest rates on domestic loans.

Dominican Republic

2.47 The Dominican economy began to show pronounced signs of macroeconomic disequilibrium in the second half of the 1980s, and this trend became more acute by 1990. In that year, the Dominican economy betrayed a disturbing instability: high fiscal deficits, payments arrears on the foreign debt, output falling at a rate of 6 percent, inflation close to 80 percent, international reserves practically exhausted, successive devaluations, and a financial system in great difficulty and showing clear signs of disintermediation. To this delicate macroeconomic situation was added the lack of any strategy for dealing with the declining terms of trade that the country had been suffering since the late 1970s, or any plan in general for returning the country to sustained growth.

248 At the same time, the country was burdened with a series of policies and institutions that were little conducive to high levels of efficiency and competition. On one hand, there were a great number of tariffs, and the maximum tariff rate stood at 200 percent. On the other hand, markets suffered from distortions and low levels of competition, due in particular to the heavy hand of the state in the distribution and production of services and natural resources, where in many cases it had a monopoly or imposed strongly projectionist regulations. The labor market situation was no better, thanks to a number of regulatory provisions that induced high levels of rigidity and impeded change, thereby increasing real costs at a time when adjustment was essential. In the face of this situation, a program of stabilization and reforms was designed to return the country's economy to health.

2.49 The year 1990s saw the introduction of a program of stabilization and structural reforms. This program called for gradual adoption of a series of measures intended to provide stability and to generate a climate suitable for economic growth. Among the measures provided for were:

a) The elimination of fiscal deficits.

b) Establishment of a new, unified, market-determined exchange rate.

c) A more restrictive monetary policy, eliminating interest rate and administrative controls over the financial system.

d) Reform to the external trade sector, eliminating quantitative restrictions, lowering the peak level of tariffs and reducing the complexity of the tariff structure.

e) Reforms to the taxation system and the public administration.

2.50 Nevertheless, despite progress on these fronts, there remained a series of features that threatened to undermine financial and economic equilibrium during the first years of this decade. These included:

1. The Central Bank had little independence from the executive branch .

2. The financial system was weak, and the fact that it had been liberalized before the completion of trade reforms and the implementation of an efficient regulatory and supervisory system did not improve the situation.

2.51 During the second half of 1993, and throughout 1994, the Dominican economy fell back into a period of instability that made itself felt in a rising fiscal deficit, higher inflation, a sharp drop in net international reserves, and steady depreciation of the currency (despite massive intervention by the Central Bank). At the end of 1994 another stabilization program was introduced and this one, with the help of certain external circumstances, succeeded in restoring stability to the economy.

2.52 With this crisis overcome, there was a clear need to reform the financial sector, and in particular to modify the institutional structure of the market, deepening it and reducing the cost of intermediation so that it could serve as an efficient intermediary in the allocation of resources. Moreover, there was a need for a proper regulatory system that would eliminate the risks associated with a weak financial system in the midst of an open and growing economy: this meant establishing a supervisory office with real authority and capacities. As with any program of financial reforms, it was essential that there be a solid regulatory and supervisory system in place when the financial system was liberalized, and it was also important that the foreign trade sector be largely free of distortions. Nonetheless, in the Dominican case this sequence was not followed and a number of problems arose during 1994, in particular because of the continued failure to secure real independence for the Central Bank and to provide sufficient clout to the supervisory bodies.

2.53 Thus, when the financial loan was being prepared, one of the most acute problems in the Dominican Republic was the weakness of its financial system, and the loan therefore treated this area as a priority. As international experience has clearly shown, financial crises generally end up destabilizing economies and creating high costs in terms of the resources necessary to finance the crisis and to support future growth.

Uruguay

2.54 In the latter years of the past decade, the Uruguayan economy presented a panorama of acute macroeconomic instability, characterized by high rates of inflation, soaring fiscal deficits (in especially in the public financial sector) and insufficient levels of investment and savings, aggravated by high levels of foreign debt service and the tenuous economic situations in Argentina and Brazil. One of the principal sources of macroeconomic instability was the government's heavy social spending, poorly focused and inefficient as it was, and in particular the generous pension system, which placed a heavy burden on the government to the detriment of the public finances. In fact, in the early 1990s, Uruguay found itself with a high public deficit, a heavy state apparatus, a relatively closed economy (given its small size), high levels of wage indexation, high inflation and low growth.

2.55 In addition to this untenable macroeconomic situation, there was a high degree of distortion in the allocation of resources, thanks to constant intervention by the state in the form of subsidies and regulations. At this point, after many years of pursuing a policy of import substitution, the government adopted a policy of export promotion. Because it was based once again on the provision of direct incentives, however, it represented no significant improvement in terms of opening the economy: the government failed to undertake the required liberalization of foreign trade and to eliminate internal distortions in the allocation of resources. Given the

relatively small size of the country's domestic market, heavy state intervention had a significant effect on allocation resources, and this, together with low investment levels, made it difficult to undertake adjustment and raised the costs of such policies.

2.56 It was clear that any reform program would have to begin by bringing inflation gradually down to single-digit levels and laying the basis for sustained economic growth. For an economy as small as that of Uruguay, greater efficiency requires competition in the provision and distribution of tradable and non-tradable goods alike. Priority was placed therefore on opening the economy again to external competition in order to achieve the first objective, and to preparing a regulatory framework that would allow progress with privatization and would promote competition in the delivery of public utility services. Stabilization efforts, and the greater efficiency resulting from competition and privatization, were expected to help increase investment and total factor productivity, resulting in greater economic growth.

2.57 The Uruguayan financial sector was characterized by a low degree of development and intermediation and, at the same time, a process of dollarization that showed no signs of abating. The principal failing was the lack of adequate regulation and supervision, both with respect to the banking system and to monetary policy. The central objectives of Uruguay's financial reform, therefore, were to achieve more efficient financial intermediation by addressing the problems of financial legislation, banking regulation, monetary regulation and supervision, and to continue with efforts at stabilization, opening the economy to the world, and reducing the role of the state in the provision of private goods.

2.58 A stabilization policy was adopted in 1991, based primarily on reform of the public sector, which sought to reduce the rate of inflation and return the economy to a sustainable growth path. The result of this plan was encouraging in terms of the performance of economic growth and the fiscal deficit, but although the inflation rate was significantly reduced it still stood at 45 percent in 1994. In 1995, there was a sharp change in the situation: instability in the Argentine economy that year had a heavy impact on Uruguay, occasioning higher unemployment and falling output and investment, and these trends were accentuated by the slowdown in the Brazilian economy that began in the second half of 1995.

2.59 In 1996, the economy returned to its growth trend, there were further reductions in the inflation rate, and the fiscal deficit was brought under control, despite the increased financial costs of the structural reform program. There was a slight expansion in investment, and in the amount of external finance available, and there was success in reducing the level of external indebtedness and debt service payments, both public and private, thereby keeping the current account deficit to moderate levels (less than 2 percent of GDP) without affecting external flows. In 1997, the economy once again performed well, the inflation rate was brought down to just over 15 percent, and the fiscal deficit was kept to acceptable levels. Nonetheless, there remained a number of elements that needed improvement: the financial system was heavily dollarized and had little depth in terms of the local currency, intermediation costs were high, and the public banking sector still played too great a role.

2.60 A worrying element for the performance of Uruguayan economy is its high level of dependence on the economies of Brazil and Argentina, thanks in particular to the preponderance of trade through MERCOSUR. One important task for the future, therefore, is to diversify the destination of exports and to attract investment and tourism from other parts of world.

Venezuela

2.61 The Venezuelan economy presented a disturbing scenario in 1988, with declining international reserves, a growing fiscal deficit, accelerating inflation, a rising exchange premium, and deficits on the current account. The origin of these imbalances lay in the adoption of expansionist policies in an effort to stimulate economic growth through greater state participation in economic activity. Mention should also be made of the excessive dependence of the economy on revenues generated by oil exploitation, which made the country extremely sensitive to fluctuations in oil prices.

2.62 In 1989, a serious stabilization program was launched, which included a restrictive monetary policy, reduction of the fiscal deficit, sharp increases in interest rates, adjustments to the price of services delivered by public enterprises, and a nominal currency valuation. These policies initially induced a sharp drop in GDP and a

rapid increase in inflation, but they allowed the current account deficit to be eliminated and the general state of the economy to improve. The stabilization policies were supplemented by adoption of a series of other measures intended to reduce existing distortions, and thereby to enhance the overall deficiency of the economy and allow markets to function properly. Among these measures were the liberalization and unification of the exchange rate, reform of the external trade sector, fiscal reform, and reforms to the financial system and social policies.

2.63 Implementation of these reforms was recognized as absolutely necessary, given the high degree of state intervention in productive sectors which, together with quantitative restrictions and the high level of prevailing tariffs, produced distortions to relative price signals. If to this scenario we add a weak financial system and ineffective fiscal spending, in particular the portion devoted to social services, the result is an economic situation that can be described as highly inefficient, with a barely functioning market and a state apparatus incapable of fulfilling its fundamental role.

2.64 The financial reform program was successful in liberalizing the financial system. Nonetheless, it failed to deepen the system or to promulgate and enforce meaningful regulations. Moreover, the depth of the financial system declined between 1988 and 1996, which suggested that there were elements in play that had not been correctly addressed during initial execution of the reform, and that could moreover be considered as possible causes of the financial crisis that occurred in 1994.

2.65 During 1992 there was an outbreak of severe political unrest in Venezuela, including two armed insurrections, one in February and the other in November. These events had two important consequences: they led to relaxation of the formerly strict economic policies, and this was aggravated by the lack of coordination between fiscal and monetary policies and a loss of public confidence in the traditional political apparatus. The major cause of this popular unrest could be traced to the beginnings of the reform program undertaken by the government of President Perez, which produced high social costs that were not adequately compensated by subsidies or assistance policies. Apart from their lack of focus, they were hampered by high levels of corruption within the state apparatus. In the regional elections of 1992, this change of outlook on the part of the Venezuelan electorate was clearly expressed; nonetheless, public discontent continued unabated, particularly after the removal of the President in May 1993, the takeover by a provisional government, and the launching of the December election campaigns, in which a number of economic policy changes were announced. All of the foregoing served to cloud the future outlook for the economy, and the level of uncertainty rose further when pressures from the public and from political leaders forced the authorities to suspend various measures included in the original plan, such as the privatization process, a move that led to a sharp deterioration in the public accounts.

2.66 The Venezuelan economy underwent significant changes during the first years of implementation of the reforms. Nevertheless, fiscal policy began to relax after 1992, and this led to an increase in the fiscal deficit, which was aggravated by a decline in the terms of trade. Finally, in 1993 inflation began to accelerate, accompanied by a sharp rise in interest rates, due to heavy the emissions of domestic debt needed to finance the fiscal deficit; the net effect of this was to reduce a growth in output to zero. In 1994 a financial crisis erupted, fed by the uncertainty generated by macroeconomic policies and the absence of efficient regulatory measures. The cost of this crisis was put at more than 15 percent of GDP, and the decline in GDP was accompanied by accelerating inflation, rising unemployment, and a soaring fiscal deficit (13.3 percent of GDP). During 1995, the economy showed some signs of recovery, but it was still clear that there were macroeconomic imbalances that had not been adequately addressed.

2.67 In 1996, the Venezuelan government adopted an adjustment program, known as Agenda Venezuela, which called for the elimination of price and exchange rate controls, a nominal devaluation, a reduced fiscal deficit, the privatization of public enterprises and the reinforcement of banking regulation. The severity of this adjustment process led to a drop in GDP for that year. In 1997, however, the economy once again showed signs of recovery, and GDP grew by 5.1 percent, unemployment stabilized and there was a fiscal surplus. The government's inflation goal was not achieved, however. In 1998, the economy suffered the effects of the Asian crisis and the falling price of oil, which affected growth prospects and dashed hopes for any major cut in the inflation rate.

2.68 In all of these eight countries there was also a need to pursue deregulation of the labor market, in order to reduce barriers to the entry of informal workers and those with little vocational qualification, and to remove barriers so that businesses could restructure to take advantage of the expected benefits of the reforms. In general, labor has been the most difficult area for introducing reforms, not because of any problems of conceptualization or design, but

rather because of the strong opposition that they have encountered from protected groups of formal workers. In particular, labor market rigidities have been an important obstacle both to the privatization of public utility enterprises and to reforms in the social sector.

C. Results, lessons learned and solution options

2.69 From the discussion in the foregoing paragraphs, and the summary found in Annex 3, *the 14 sector loans analyzed were focused generally on areas that were of fundamental importance for the eight countries, and within these the focus was on essential measures and policies.* This is a topic that is dealt with in detail in each of the 14 Project Performance reviews (PPR-1/96, PPR-10/97 to 16/97, PPR-8/98 to 12/98 and PPR-14/98). It may be said, then, that the reforms undertaken - in support of private investment and privatization of provincial banks and the public sector in Argentina, the public sector in Columbia, the foreign trade sector in Mexico, the foreign trade, financial, agriculture and public services sector in Nicaragua, the foreign trade sector (including a labor component) and the financial sector in Peru, the financial sector in the Dominican Republic, the financial and foreign trade sectors and support for private investment in Uruguay, and the financial sector in Venezuela - were well selected and covered priority sectors that could make a significant contribution to the overall reform program in each country.

2.70 The sector loans had a clearly positive impact on the performance of the Argentine economy during the 1990s, and made an important contribution to consolidating the economic reform program initiated by the Argentine government at the start of the decade. This program in effect changed the economic situation and outlook for the country, after decades of impoverishment and dramatic bouts of hyperinflation. It did so not only through its direct impact on the policies supported, thanks to the mechanism of conditionality, but also through the signal it gave that there was now a coherent economic model in place, one that reflected a real concern to safeguard fiscal and macroeconomic equilibrium. A decisive factor was the information transmitted to markets about the support that both the IDB and the World Bank were providing to the government's economic reforms, at an important moment of transition, when the country had not yet renegotiated its external commitments and the new economic program was still regarded with some skepticism in certain quarters. In addition, the Provincial Bank Privatization Program was successful in supporting the reforms undertaken in the provincial public sector, with respect both to the privatization of the public banking system and the efforts to strengthen the provinces' overall public finances. This latter action proved to be crucial when the Asian crisis broke out, placing sudden constraints on the availability of external financing.

2.71 The public sector reform loan granted by the Bank to Colombia supported a major role for the private sector in the provision of various public services, as well as a greater degree of decentralization of public enterprises, and thereby helped to enhance their economic efficiency and increase the overall competitiveness of the economy.

2.72 The Bank's sector loans to Nicaragua focused on four of the five areas identified above and thus may be considered to have been targeted at removing the principal obstacles to achieving sustained growth and a permanent reduction in poverty. It may also be argued that, once significant progress is made in these areas reform, it would be advisable to focus future cooperation on consolidating stability in the event of a possible cutback in external aid, and on supporting in-depth reform in the areas of education and health. This latter set of reforms should be directed at improving the quality and coverage of education and health services for the poorest sectors of the population.

2.73 In Mexico, the Bank successfully supported a trade policy reform aimed at strengthening small and medium-scale exporters, as well as simplifying customs formalities.

2.74 In the case of Peru, the trade and financial reforms, together with elaboration of a regulatory framework to foster competition and efficiency in public utility services and deregulation of the labor market, were the priority areas. The Bank's sector loans supported reforms in three of these four priority areas, two of them in depth.

2.75 In the Dominican Republic, the Bank supported a financial sector reform for giving autonomy to the Central Bank and revising the country's monetary policy, as well as strengthening regulation and supervision of the domestic banking system. Significant progress was made with respect to banking regulation and supervision, but efforts to give autonomy to the Central Bank encountered stiff resistance in the Legislature.

2.76 In the case of Uruguay, there was a close relationship between reform of the pension system and creation of a more favorable investment climate, since the former was an integral part of any effort to reduce inflation from the high levels it had reached at the start of the decade, when the fiscal deficit exceeded 7 percent of GDP.

2.77 In Venezuela, the Bank supported a decisive move to liberalize the banking system, through its financial sector loan. Nonetheless, and despite the subsequent approval of a reimbursable technical cooperation loan, it was not possible to install a proper banking regulation and supervision framework, and this impeded progress toward the desired broadening and deepening of the country's financial system.

2.78 It may also be said that the identification of reform areas, and the priorities assigned to them, were consistent with the existing consensus on the distribution of tasks for each country among the international financial institutions. Part 2 of the Report on Economic and Social Progress in Latin America, 1997, makes clear the important and lasting contribution that financial and trade policy reforms, in which the Bank focused its sector activity, have made to the process of economic recovery and growth in those countries that have adopted them.

2.79 The sequence of reforms, in general, may be considered adequate, starting with macroeconomic considerations of stabilization and moving on to promoting commercial openness and a healthier and deeper financial system. To the extent that stabilization reforms were successful, the second generation of sector loans (trade and financial) tended to complement the initial reforms, and to reinforce them. In the cases of Colombia's public sector and Venezuela's financial sector, it must be admitted that the fiscal sector was decentralized, and the financial system liberalized, without having established in advance an adequate framework of fiscal regulations and of banking supervision and regulation, respectively, and it may be considered in retrospect that both the fiscal decentralization and the financial liberalization were premature. Nonetheless, in both these cases the problem was essentially one of execution rather than design of the operations.

PRINCIPAL RESULTS, LESSONS LEARNED AND DESIGN SOLUTION OPTIONS

RESULTS AND LESSONS LEARNED	SOLUTION OPTIONS
The 14 sector loans concentrated on central areas, and within these on essential measures and policies, and identification of the reform areas and the priorities assigned to them for each country were consistent with a consensus on the distribution of tasks among the international financial institutions, and with existing theoretical and practical understanding of the issues. The sequence of reforms, in general, was appropriate, starting with macroeconomic considerations of stabilization and moving on to promoting commercial openness and a healthier and deeper financial system.	
In some cases, certain special risks were given adequate consideration in the country diagnoses.	The particular institutional situation of each country (initial specificities) must be taken into account to ensure that the reforms supported are appropriate to the general objectives of the operations, and that there are no undue delays in implementing them. A logical framework needs to be prepared, specifying the initial assumptions and the PPMRs should reflect the expected outcome of the reform and the specific indicators for measuring and verifying them
The sector reforms have at times suffered delays and difficulties when their horizon was not congruent with that of the government initiating them.	Design sector loans so that they can be executed within the mandate of the current government. Establish a dialog with new government, to adapt the pending reform package to the new circumstances.
The reforms did not always produce benefits in terms of greater growth and consumption opportunities .	Invest more time and effort in publicizing the expected benefits of reforms and their short-term costs. Economic policy requires greater creativity and stability in introducing measures to provide social compensation for the "losers" from reforms.

2.80 The specific design of the operations in question reflected existing understanding of the issues at both the theoretical and practical levels. Even so, a number of problems arose from failure to consider certain special risks in the diagnosis or the initial conditions, such as the weakness of judicial institutions and the insecurity of property rights in the case of Nicaragua; possible changes of government before reforms were completed (Nicaragua, Dominican Republic and Uruguay); the risk that reforms might have to be approved by legislation and not solely by the executive (Dominican Republic and Venezuela); changes in the authority that must approved the conditions, from the executive alone to the executive plus the legislature (Nicaragua); or labor opposition to certain conditions (Uruguay). This type of risk means that *if the particular institutional situation in any country is not properly addressed, the reforms supported may become merely necessary but not sufficient conditions for achieving the general objectives of the operations, or there may be delays in achieving the expected outcomes.* This is an issue that stands out clearly from the evaluations of loans for the agriculture and public enterprise sectors in Nicaragua (PPRs 16/97 and 13/97) and the financial sector in Venezuela (PPR-8/98).

2.81 For this reason, the expected outcome of the reforms proposed in the sector loans, and specific indicators for measuring and verifying them, must be included in detail for all operations, and must be closely monitored. Preparation of the logical framework and the PPMR can be very useful in designing, monitoring and controlling execution, respectively.

2.82 Some of the sector operations failed to identify certain basic issues, as with the Public Sector Reform Program in Argentina; certain substantial issues were not covered, as was true of the securities market in the financial operations undertaken in Peru and Dominican Republic, or the exchange risk inherent in the mismatching of financial assets and liabilities in the financial sector loan for the Dominican Republic; or issues failed to receive due attention, as in the case of banking regulation and supervision in the financial sector loan for Peru, and particularly in the financial sector loan for Venezuela. Nevertheless, it should be noted that the Bank subsequently undertook an MIF operation to address the securities market issue in Peru.

2.83 *Operations must be designed so that it is feasible to execute reforms within the established time limits, which should be set within the mandate of the current government*, since it should not be assumed that the successor government will necessarily have the same degree of commitment to undertaking those specific reforms. One possibility would be to allow new governments to adjust implementation of the package of outstanding reforms, since what is important is not the individual measures that are taken but the general development objectives that are pursued.

2.84. In some cases, the scope of the issues addressed and the depth of the reforms required were not consistent with the characteristics of a quick-disbursing loan. A point to consider at the time of designing policy-based programs is *the need for the country to have technical groups that are capable of evaluating and sustaining the type of reforms that are most appropriate to the country.* These groups must fully understand the expected effects of the reforms, so they will be able to help the policy team present them to the general public. In this way, all stakeholders will be committed to implementing the reforms, and will be able to help promote them and ensure their continuity. To achieve this, it would be wise to implement longer-term programs aimed at upgrading professional training in critical areas of government.

2.85 In the sector loans for Public Service Enterprises in Nicaragua and Investments in Uruguay, it would appear that the operations attempted to make too many changes simultaneously without ensuring that certain minimal initial conditions were in place, and in these cases the internal sequence of the operation does not appear, *a posteriori*, to have been the most appropriate. Moreover, it would seem that not enough attention was paid to training local personnel to understand the importance of the reforms under consideration. Thus, domestic officials were not sufficiently prepared to assert "ownership" over the net benefits of the reforms, and to "sell" them to the public

3.8 Another important lesson is *that more time and resources need to be invested in publicizing the expected benefits of reforms, and explaining in detail what their short-term costs will be. Economic policy may also have to be more creative in introducing measures to provide social compensation for the "losers" from reforms, and in this way ensure that the country as a whole can reap the benefits of greater growth and consumption opportunities that will flow from the reforms.* In this area, there have been some interesting experiments with privatization where shares were sold at preferential prices to workers, thereby mollifying their opposition and in this way allowing the country as a whole to reap the benefits of greater competition and better delivery in services of this type.[3]

2.87 The reforms in the individual sectors selected attempted to reinforce their impact in some cases with reforms in other sectors, as in the case of the trade sector operation in Peru, which promoted reforms in the labor area, aimed primarily at moderating the impact of the cost of dismissals (providing for annual payments to be made to workers' accounts and for more flexibility in the permanent or temporary contracting of workers), which no doubt

[3] A similar position is expressed in the World Development Report 1997 from the World Bank, which points out that broad-based ownership can help to win public acceptance of privatization. One strategy for achieving this, applied in Mongolia, the Czech Republic and Russia, is to distribute privatization coupons to individuals, who can exchange them for shares. Another system, adopted in Argentina, Chile and the United Kingdom, is to make an initial public offering of shares to citizens at competitive prices. Both systems can be designed to allow for a strong strategic partner who will have the incentive and the know-how needed to restructure the enterprise effectively. (World Bank, 1997, page 74).

served to increase the chances of success of the measures supported, although at the same time they complicated the management and monitoring of the loan.

2.88 Technical cooperation operations, in general, took due account of the country's capacity to successfully administer and execute the reforms supported by the programs, but in the case of the Public Service Enterprises Reform Program in Nicaragua (PPR-13/97), the technical cooperation has proven inadequate in its scope and slow in its execution, factors that have delayed achievement of some important objectives of the operation. There have also been significant delays in execution of these components of the financial sector operations in Nicaragua and Venezuela.

3

Timing, Impact and Sustainability of the Reforms Supported by Sector Loans

A. Objectives

3.1 This section begins with an assessment of the timeliness, impact and degree of compliance of the conditions established in the loans. Next, it examines to what extent adaptations or waivers of these conditions for the second or subsequent disbursement tranches were appropriate to enhancing the effectiveness of the overall operation, taking into account the country's changing circumstances, both internally and externally.

3.2 With respect to impact, the study examined to what extent the loan and the technical assistance contributed to achieving the desired development objectives. Since there are some methodological difficulties in isolating the effect of a loan on certain macroeconomic and sector aggregates from that of other factors that may also have affected the outcome, but that are exogenous to the loan, the evaluation focussed on the macro and sector results by examining the principal indicators. This analysis attempted, through a partial adjustment technique, to isolate the effects of shocks and other external and internal conditions that might also have affected the performance of the variables studied.

3.3 Finally, the study looks at the sustainability of reforms supported by the loan, analyzing the situation as it existed at the time of evaluation, on the basis of written reports and interviews with economic agents engaged in the reform areas supported by the loan.

B. Results, lessons learned and solution options

3.4 All the sector operations were timely, considering the stage of the reform process in each country, and the specific measures established in the loans were fulfilled within the planned timeframe (except for the Public Service Enterprise Sector Loan in Nicaragua and the Financial Sector Loans in the Dominican Republic and Venezuela), some to a greater degree than others. In several cases in Argentina, Colombia, Peru and Uruguay, individual measures comfortably exceeded the requirements of the loan conditions, and were more successful than expected.

3.5 In general, in those countries where the reforms were successful and the overall objectives of the operations were achieved, (Argentina, Colombia, Mexico, Peru and Uruguay), it may be said that reforms have been or are being consolidated and that they enjoy widespread support. Operations of this kind should be replicated in other countries. In the case of Mexico, the reforms allowed the country to cope more flexibly with the recent decline in oil prices. In the case of Uruguay, the practice of seeking broad consensus before implementing a reform (including the holding of plebiscites), while it may have slowed the reform process, also made it more sustainable. In the cases of Argentina and Peru, the success of the reforms in terms of generating growth and stability, after many years of crisis and setbacks, won for them a broad degree of support.

3.6 Specifically, in Peru's case the impact of the sector loans was highly positive with respect to the general development objectives pursued, and major advances were made in the indices relating to economic openness, reducing average tariff levels, monetizing the economy, and rationalizing and reducing spreads in the financial sector, thereby lowering the costs of intermediation and enhancing competitiveness. These achievements were presumably a contributing factor to the rising growth and decelerating inflation that Peru has experienced since launching itself decisively into the economic reform process in 1990.

3.7 In the case of the Dominican Republic, there was good progress towards several general objectives, but not all were achieved, in particular those relating to strengthening the institutional autonomy of the Central Bank. In the cases of Nicaragua and Venezuela, on the other hand, not all conditions were fulfilled, and there were in fact several major reversals: for example, in Nicaragua the rationalization of the state development banking system was compromised by the continuing use of import licenses and customs duty exemptions. It would appear that the degree of compliance with the reforms called for in the loans was determined primarily by the degree of commitment of the local economic and political teams to the reform agenda, and by the internal capacity to defend and execute the program. *This highlights the importance of investing more time and resources in training local technical teams that can participate in the design, the "selling" and dissemination of reforms, and in their execution.* These three latter ingredients are key to ensuring that national and local authorities establish their "ownership" over the reforms.

PRINCIPAL RESULTS, LESSONS LEARNED AND RECOMMENDATIONS ON THE TIMING, IMPACT AND SUSTAINABILITY OF REFORMS

RESULTS AND LESSONS LEARNED	SOLUTION OPTIONS
The reforms were timely and the conditions in general were fulfilled within the established time frame. Where reforms were successful, they have been or are being consolidated and enjoy widespread support.	
The degree of fulfillment was determined by the commitment of the technical and political teams to reform, and the internal capacity to defend and execute the program.	Invest more time and resources in training local technical teams that can participate in the design, the "selling" and dissemination of reforms, and in their execution
In some cases the results of the sector reforms were inadequate.	Ensure that the Bank's country programming includes areas where the chances for successful consolidation are greatest, focusing on a (few) key areas and insisting on full compliance with the agreed conditionality
Some countries, despite recent deregulation and greater financial competitiveness, still have weak financial institutions and regulatory and supervisory systems.	Support a second generation of financial reforms aimed at strengthening regulatory and supervisory systems, and at harmonizing the new and freer instruments of established institutions

3.8 In the case of Nicaragua, initial conditions were much more difficult and complex, both in economic and political terms, and the reform agenda was much more ambitious. While there was significant progress with the changes needed to allow competitive, outward-looking markets to function and to reduce the distorting effects of state intervention in economic activities, such successes were limited and there was some serious backsliding, which means that the reforms cannot yet be considered sustainable.

3.9 It should be noted that the government of Nicaragua, after several failed attempts, adopted important measures in late 1997 to liquidate or privatize the state banking system, to eliminate tax exemptions and to deal with property ownership issues, and these steps removed some of the major obstacles and problems identified in PPR-13/97, PPR -14/97 and PRI-16/97.

3.10 *In those cases where reforms to date have been inadequate (Nicaragua, Dominican Republic and Venezuela) the Bank will need to continue supporting the reform process in order to consolidate it, concentrating perhaps in a few key areas and insisting on full compliance with the agreed conditionality. To this end, a first step would be to ensure that the Bank's program for the country includes areas where the greatest benefits can be obtained from corrections to the policies or institutions directly linked to the ultimate success of the reforms.*

3.11 When the summary of the second phase was prepared (document RE-228 of January 1998), it was believed that Latin America had made sufficient progress in the process of economic reform, primarily through reforms to the external sector, the financial sector, and the conditions for promoting private investment, and that it was now appropriate to proceed with reforms to the state and social sectors, in order to ensure that growth was accompanied by a reduction in poverty and by greater equality of opportunity. Yet the Asian crisis, which began with devaluation of the Thai *bhat* on July 2, 1997, and the subsequent crisis in Russia, once again highlighted the urgent need to ensure that financial systems are sound and efficient. Weak financial systems leave a country open to domestic crisis and at the same time increase its vulnerability to crises originating elsewhere in the world. This new reality requires stronger financial institutions, and greater priority should be placed on loans of this kind for countries where they are needed. This will mean, in some cases, consolidating financial reforms more effectively (broadening and deepening them), strengthening and modernizing the financial system through more appropriate regulation and supervision, and helping these countries to prepare themselves for integration into regional and international financial markets, before addressing those further areas of reform[4]. Moreover, the decisive adjustments made by Argentina and Mexico to deal with the "tequila effect" of 1995 and the so-called "Asian flu" of 1997 and 1998 point the way to overcoming the kind of weaknesses that characterized those economies. On the other hand, Brazil's experience shows the vulnerability that comes with persistent high fiscal deficits and high levels of short-term domestic indebtedness.

3.12 The first generation of financial sector loans approved by the Bank contributed to significant liberalization and privatization and to greater competitiveness in the financial systems of several countries in the region. Now, at least in some of them, a second generation of financial reforms would seem called for, aimed at: *(1) reinforcing systems of regulation, supervision, supply and disclosure of information on the quality of assets and the capital adequacy of financial entities; (2) reining in the excess credit expansion that results from inadequate evaluation of the risks involved (problems of adverse selection and "moral hazard"); (3) restricting the practice of lending between related entities; and (4) achieving the institutional harmonization of the new, freer and more varied instruments and institutions that now exist (commercial banks pursuing new and freer functions, and private pension funds, insurance companies, mutual funds, investment banks, securities markets, etc.*). This would reinforce the soundness, flexibility and competitiveness of the system, enhance the transparency of information and improve its functioning, and the system would then be in a better position to deal with the dynamic process of trade and financial globalization. That process presents ample opportunities but at the same time requires disciplined and more transparent public financial policies, to avoid needless vulnerability[5]. In addition, a better-developed financial system can make a significant contribution to economic growth..

3.13 The crisis in Asian countries, where the coverage of basic social services was broader, private and public savings rates were higher, and many countries were running a public sector surplus, shows how important it is to have a sound, disciplined, efficient and transparent financial sector that is flexible and dynamic enough to adjust to external shocks (sharp reversals in the terms of trade or sudden capital movements) or severe recessions, so that their effects will not spill over into the real sector and thereby convert a financial crisis into a crisis of confidence in the economy itself.

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[4] In 1998, Region I established a working group to monitor the economic situation in countries of that region on a permanent basis, since they appeared to be particularly exposed to the "contagion" effect of lower growth, instability and financial volatility generated by the Asian crisis.
[5] See for example M. Obstfeld: "While private financial mismanagement and inadequate supervision bear much of the blame for the recent capital market crisis in developing countries, one should not conclude that international capital markets are necessarily stabilizing in the absence of underlying vulnerabilities.... capital flows can be volatile and subject to herding effects". (1998, page 26)

4

Best practices, lessons learned and solution options for specific sectors

A. Objectives

4.1 In recent years there has been widespread recognition of the importance of extending policy and institutional reforms to the areas of social policy and the reform of state management and administration, particularly in the sectors of education and health. This change has resulted not only from the growing urgency of improving the quality of these services, but also from the need to provide greater access to them for the poorest groups in society. This is not merely a question of equity, but is in fact an integral part of growth strategy for countries where the productivity of investment in human capital is high, and particularly in countries where investment in this area has long been inadequate. The role of the state here is to improve access for low-income groups to education, health and nutrition services, and at the same time to enhance the quality and of the services to which they have access. This does not necessarily imply that the state must be the provider of these services, however, and indeed the efficient use of resources may require in many cases that financing and delivery be separated, with the state playing a central role in providing the funds, and private or nongovernmental organizations looking after supply and distribution.

4.2 This section examines experience with the 14 operations analyzed, as well as that gained from the design and implementation of other sector loans and technical cooperation programs in this area, to highlight best practices, lessons learned, and options for resolving the problems identified, for possible extension to the social sectors and to reforms of the state. In particular, it places special emphasis on enhancing the participation of decentralized entities, the private sector and NGOs on the supply side of these services, as well as developing new institutions for the purposes.

B. Results, lessons learned and solution options

4.3 In the case of reform programs that called for a broad array of measures of varying degrees of importance, when there are no clear ex ante priorities established, and when it is found during the execution period that the program cannot be completed in full, priorities will tend to be defined on the basis of criteria there are not necessarily the same as those envisaged by the designers of the operation. Moreover, experience with the 14 operations examined here shows that when they address a broad range of policies and involve a number of co-executing agencies, it is difficult to coordinate and execute them as quick-disbursing operations. These inherent design difficulties reduce the probability that conditions will be fulfilled.

4.4 The introduction of precisely quantified goals can also be useful as a more objective indicator of government management, and as an instrument for fending off pressures from specific interest groups.

4.5 Recent experience in Asia provides a clear indication of how a poorly regulated and unharmonized financial sector encouraged the misallocation of a high portion of domestic savings, reducing the efficiency of

investment and producing a macroeconomic crisis and a collapse of confidence that affected all sectors of the economy and society.

4.6 Drawing on experience from these recent crises, it is clear that in financial sector loans *close attention must be paid to the standards, quality and effectiveness of banking regulation and supervision, and to the supply and disclosure of the required basic financial information, with a view to mitigating the effects of informational asymmetries, eliminating shortcomings in banking administration, and avoiding the premature liberalization of the financial sector.* In particular, special care must be taken in evaluating existing incentives within the financial sector and their compatibility with the need for sound financial systems. These are key issues both in macroeconomic terms and in terms of the efficiency and transparency of financial intermediation, if success is to be achieved in the financial reform and modernization program, if the risk of backsliding is to be diminished, and if a financial crisis is to be prevented from becoming a systemic crisis that will affect the securities market and undermine investor confidence, thereby leading to a full-scale economic crisis. To this end, financial sector programs must clearly identify and assess existing incentives in the financial sector, and must ensure appropriate supervision and regulation in support of liberalization for the sector, following the Basle recommendations. Moreover, it is recommended that compliance with both the letter and the spirit of the program should be monitored closely.

4.7 *A financial sector program must not overlook issues concerning the securities market.* The financial sector operation in Peru addressed these issues only indirectly, through technical cooperation with the AFPs [pension fund administrators]. In the Dominican Republic, the financial sector loan did not deal with them it all. In fact, an entire component could be based on such questions as: licenses, issuing of securities, basic information requirements, rules governing related investments, standards on insider information and conflicts of interest, and accounting rules and audit requirements, etc., which might serve to strengthen other components of the operations. Nor was attention paid to insurance and other specific topics such as offshore banking and exchange risks from currency mismatching, which have repeatedly plunged some Latin American countries into banking crises since the 1980s. As noted earlier, in the case of Peru, the securities market was subsequently addressed more thoroughly through an MIF operation. If such omissions appear again, the Bank should use the same or similar instruments at its disposal to redress these shortcomings in financial sector programs.

4.8 The governments of Argentina and Peru were outstandingly successful in their approach to restructuring the provincial banks and the state development banking sector, respectively. The former was privatized and the latter eliminated, moves that went well beyond what was called for in the sector program. In other countries that have retained sizable state development banking sectors, as in the case in Nicaragua, they have become even more active, creating fiscal problems that have ultimately forced a decision to liquidate or privatize them. In this respect, *it is recommended that future financial programs should analyze the experience of various countries and examine the options for privatization, downsizing, or elimination of the state development banking sector.* Once again, this is an area that deserves much more time and effort in studying, "selling" and publicizing the idea before trying to put it into effect.

4.9 *With respect to the public treasury function played by some provincial or state banks (for example the Banco de la Nación of Peru), it is not clear that this is absolutely essential, since it could be performed instead by the private banking sector.* Although this is clearly a delicate political issue, future financial sector programs should explore the possibility of reducing or eliminating the state banking system if it cannot provide efficient and competitive services, in comparison with a private Bank operating under similar conditions.

4.10 The conditionality in sector loans relating to public service enterprises, in countries where there are serious imbalances or legal gaps (ineffective stabilization, lack of clear property rights, institutional weaknesses in the justice system, as in the case in Nicaragua), *should be less ambitious and more clearly focused on the formation of human capital, in order to create a critical mass of adequately trained personnel, especially in the less developed countries,* so that when it comes to identifying the basic conditions for privatization they will be able to manage the process, prepare the appropriate legislation, and perform the required regulatory and supervisory work. As well, drawing on experience with the Public Service Enterprise Sector in Nicaragua (PPR-13/97), the focus of conditionality, at least initially, should be on restructuring the so-called "ministry enterprises", in terms of separating the planning, regulatory and operating functions, and in terms of improving their management and financial organization and setting a tariff structure that is in line with the costs of these public service enterprises.

4.11 In the area of public services, where there are countless opportunities to strengthen competition and enhance efficiency and at the same time to disengage the state from the production and delivery of those services, there is a need for significant prior investment in training the human resources that must implement reforms of this kind. What is required here is a sounder theoretical and practical grounding in the regulation and supervision of public services. Without such minimal training, it is very difficult to understand the logic and the benefits that can be derived for this type of reform. As a corollary, sector loan conditionality with respect to public service enterprises in countries where there are opportunities to introduce reforms with a significant impact on efficiency and equity must take due account of the need to provide prior training for the local human resources responsible for carrying out those reforms.

4.12 One of the problems detected in sector loans was that disbursements did not generally flow to the direct benefit of the institutions engaged in implementing the reforms. At times these institutions were not even aware of the actions that must be taken to comply with the loan conditions (for example PPR-12/97, par. 3.77, and PPR-15/97, par. 3.27), or else they did not share the immediate objectives of the operation. *In cases were there is no direct relationship between disbursements and the entity that must carry out the reforms, more effort must be made to improve awareness within the government team as to the central role that policy and institutional changes play in the country's development strategy.* In some countries it may be necessary to strengthen analytical and execution units within the ministries of finance or economy, so they can collaborate with participating entities in fulfilling the loan conditions.

4.13 The Bank has designed special, simple and streamlined administrative rules and procedures for sector loans, in order to ensure that they can be disbursed quickly. This means that such operations are not only easy to disburse, but controlling their accounting and audits is also straightforward, especially since the requirement for import lists as part of the supporting documentation for disbursements was abolished in 1998. The only specific problem remaining is to check conditionality compliance, and audit requirements.

4.14 On the other hand, the new operations for reform and modernization of the state and the social sectors, which also include policy conditionality components and sometimes go hand in hand with reforms supported by sector loans, are generally governed by the administrative rules and procedures for regular Bank operations. Yet some of them may involve several sectors, they may be highly targeted on low-income groups, and they may be intended to provide new, non-conventional services, which are commonly executed by decentralized public entities (for example municipalities), NGOs or private bodies. Given the small size of the expenditures they typically finance, and the kind of service contracts employed, as well as the nature of their executing agencies, special difficulties may arise when it comes to submitting supporting evidence for disbursements, keeping accounts and meeting audit requirements, and ensuring proper control and supervision by the Bank over the operational, technical, financial and institutional aspects of execution.

PRINCIPAL RESULTS, LESSONS LEARNED AND SOLUTION OPTIONS: BEST PRACTICES FOR SPECIFIC SECTORS

RESULTS AND LESSONS LEARNED	SOLUTION OPTIONS
Where a reform program calls for a broad array of measures of varying degrees of importance, if there are no clear ex ante priorities established, when it became clear that the program cannot be completed in full, priorities will tend to be defined on the basis of criteria there are not necessarily the same as those envisaged by the designers of the operation	Establish procedures for objectively weighting compliance with conditionality and policy implementation as a function of the expected impact and the degree of difficulty of compliance.
Some financial sector operations overlook key areas, such as the securities and insurance markets	Financial sector loans should pay close attention to meeting banking regulation and supervision standards and basic information requirements. They should include the securities markets, with such topics as: issuance of securities, licensing, rules on related investments, basic and privileged information requirements, conflicts of interest, accounting rules and audit requirements
Not all public service enterprise sector loans have met their general development objectives	1. Focus the early stages on separating the planing, regulatory and operating functions, improving financial management and setting tariffs in line with costs. 2. Train personnel to have a critical mass capable of managing the privatization process, preparing sector legislation and performing regulatory and supervisory activities.
Disbursements were not generally used for the direct benefit of the institutions engaged in implementing the reforms. At times, these institutions were neither aware of the immediate objectives nor of the actions to be taken to comply with the loan conditions. The social compensation component of some sector loans has been too diffuse.	(1) Invest resources to improve the understanding within the government team as to the central role that policy and institutional changes play, in particular in relation to the government entities that share the burden of adjustment and reform costs. (2) The social compensation component in reform programs should be focused on facilitating mobility, retraining and relocation of workers directly affected rather than undertaking general programs of social compensation.
Essential advisory services and studies resulting from technical cooperation have not always been available for proper execution of sector loans	Make Bank rules and procedures for hiring individual advisors and consulting firms more flexible.
Public spending must be strictly controlled and resource allocation improved, given existing fiscal constraints.	Establish or strengthen a social evaluation system for public sector projects and programs to examine the need for capital or current expenditure by the public sector, and monitor the efficiency of executing such expenditure.
There have been problems with trade liberalization aspects in some foreign trade sector loans.	Trade reform conditionality should be consistent with the recipient country's commitments under any international treaties to which it is party.

4.15 The Bank's regular procedures were designed for large-scale procurement purchases and for the contracting of consulting services to undertake complex analyses of public sector entities. They generally require at least three quotes for small purchases and the consideration of at least three candidates for individual consulting contracts. These procedures are intended to control the inputs acquired to generate the goods and services financed, but they may be excessive for these new types of operation and their new executing agencies. They should be amended and made more flexible to enhance the effectiveness and quality of execution, where the emphasis should be primarily on achieving results and meeting goals in a highly changeable context.

4.16 The Bank has been making occasional but not systematic changes to these rules and procedures for some operations involving social sectors and modernization of the state. For example, it has agreed to review the entire consultant contracting process on an ex post basis, (a decision that may be taken at the outset, or after the review of a few initial contracts); it has allowed the use of Annex D in operations contracts or agreements to contract certain services that are not strictly speaking consultant services, a step that considerably simplifies such contracting; it has employed operating regulations to establish ad hoc administration procedures; it has established simplified records for submission with disbursement requests; and it has contracted specialized services to supervise operations.

4.17 It is clear that if sector loans can be readily disbursed while social investment operations are slower-disbursing, for the reasons indicated, the Bank could most effectively overcome the negative effects of the reform and ensure more vigorous action on the social front by simplifying procedures for the administration and execution of these operations, in order to speed up their execution.

4.18 The inclusion of technical cooperation in the design of operations has been a positive step in ensuring that they can be properly executed, particularly in the relatively less developed countries. These components have had the following specific objectives:

a) To provide governments with the technical support they need to meet the conditions established in the policy matrix;
b) To provide the necessary advisory services, studies and local teams to ensure effective implementation of those policies and reforms;
c) To provide operational mechanisms that will allow for the efficient and effective execution and monitoring of planned activities.

4.19 Nevertheless, in light of the delays experienced in executing technical cooperation in general, *Bank rules and procedures should be made more flexible so that individual advisers and consulting firms can be contracted more easily and quickly*. For example, reviewing compliance with procedures, up to a certain ceiling, could be performed on an ex post basis for the entire process, with proper control, as has been done ad hoc in a few recent operations, rather than ex ante, step-by-step. The timely provision of advisory services and studies is indispensable for proper execution of sector loans, especially when the disbursement of subsequent tranches depends on an a parallel technical cooperation component (see for example PPR-14/97 on the Trade and Finance Sector Program in Nicaragua, paragraph 5.7).

4.20 At a time of fiscal restraint and strict control over public expenditure, *it is essential to establish or reinforce a social evaluation system for public sector projects and programs to examine whether capital or current expenditure by the public sector is required or appropriate* (PPR-11/97 and PPR-16/97). Such spending should also be closely monitored to ensure that it is executed effectively and efficiently.

4.21 It would be more appropriate if the social compensation component of a trade reform project, or of sectoral projects in general, were specifically targeted toward facilitating the mobility, training and relocation of workers who are directly affected by the sector reform program, as opposed to general programs of social compensation. The type of design proposed would reduce the social cost of reform, and with it the difficult political and economic problems that can impede execution, and can even lead to the eventual reversal of priority reforms.

4.22 A general lesson that arises from the analysis of trade reforms is that conditionality must be consistent with international treaty obligations that the country may have accepted. In the cases of Mexico, Nicaragua and Uruguay, customs and tariff issues must be examined in light of the North American Free Trade Agreement, the Central American Common Market and MERCOSUR, respectively. Although these agreements allow for greater degrees of protection with respect to third countries then might be optimal for the country concerned, it is clear at the same time that they are contributing to the reduction of non-tariff barriers and of both average and peak tariff levels. Subsequent stages, in which tariffs will be lowered further and equalized, will have to be undertaken after further discussion at the regional level about the benefits of integrating these regional agreements more closely into the world economy.

5

Administration, Monitoring and Supervision of Operations

A. Objectives

5.1 This portion of the study reviews the roles of Headquarters and the Country Offices, and their interaction in monitoring operations (approving conditionality, waivers, tranche splitting). It also examines the lessons learned and the solution options for future operations, as derived both from the weekly progress reports (PPMRs) and the Project Completion Reports (PCRs), and from interviews with personnel of the Bank and the executing agencies.

B. Results, lessons learned and solution options

5.2 In general, decisions approving conditionality or requests for waivers or tranche splitting for sector loans have been taken at headquarters, while the Country Offices have been responsible for monitoring the operations, in contact with the local coordinators. There is now a better and closer relationship and interaction between headquarters and the Country Offices with respect to the administration, monitoring and supervision of sector reform operations, since the reorganization of the Bank in September 1994 and the creation of regional management offices. Execution is now better managed, and the former dichotomy, whereby sector loans fell under the Planning and Programming Department while the Country Offices reported to the Operations Department, and for technical purposes to the Project Analysis Department, has been overcome. Nonetheless, *it would be preferable if the project team or the Bank's technical unit responsible for the operation were more closely involved in the project during execution, and could conduct regular missions and exert quality control over consultants' reports, particularly for complex loans covering several areas, such as the reforms to the public sector in Argentina and Columbia and the trade sector in Peru, or the investment sector in Argentina and Uruguay, where the Country Offices cannot be expected to have the required technical capacity.*

5.3 *While the design of sector operations has generally been undertaken for the most part at Bank headquarters, the Country Offices need to be involved to a greater extent in the analysis and execution of these programs. Among the participants in some programs that were cofinanced by the World Bank, the World Bank was seen as being more closely involved with execution of those programs, while the IDB tended to be relegated to a purely financial function (e.g. see PPR-10/98, paragraph 21). Clearly, while the Country Offices need to be involved more closely in executing programs, they should also have a greater role in the analysis of these operations, so they can feel themselves full participants in all aspects of the program.*

5.4 *Some of the quick-disbursing loans were not properly executed, because the conditions on which their diagnosis was based were subsequently changed (investment sector in Uruguay and financial sector in the Dominican Republic), or they were simply very slow in execution, even though they constituted a second stage (technical cooperation in Venezuela).*

5.5 It is clear that, given the nature of a sector operation, the coordinator plays a role that is critical to proper performance of a reform program, which means that the Bank should pay special attention in filling this position and in assigning it the necessary resources.

5.6 *In highly complex transactions*, such as the Public Service Enterprise Reform Program in Nicaragua (PPR-13/97) and the Sector Investment Programs for Argentina (PPR-14/98) and Uruguay (PPR-14/97), or where the initial situation changes, as in the Financial Sector Operation for the Dominican Republic, *the possibility should be considered of including procedures in the loans that will allow for objective weighting of partial compliance in terms of conditionality and policy implementation, on the basis of the expected impact and the degree of difficulty of compliance, and in certain cases allowing tranches to be split into separate disbursements, as conditions are fulfilled.* This would be an alternative to the practice where disbursement of a tranche will be rejected or approved in its totality, or waivers will be granted, even if some conditions have not been fulfilled. That approach can undermine the credibility of subsequent conditionality by increasing the "moral hazard", not only for this operation but for other sector loans, in the sense that some authorities may see no incentive to meet certain conditions because they believe that the Bank will not insist on them. In those cases, decision-makers may assume that the Bank will once again come to their aid if such problems recur. This suggests that consideration should be given to allowing partial disbursements to be made, according to the degree of compliance with conditionality.

PRINCIPAL RESULTS, LESSONS LEARNED AND SOLUTION OPTIONS: ADMINISTRATION , MONITORING AND SUPERVISION OF SECTOR OPERATIONS

RESULTS AND LESSONS LEARNED	SOLUTION OPTIONS
In some sector loans there have been delays in disbursing tranches	The project team or the Bank's technical unit should be involved in sector project execution, and could conduct regular missions and exert quality control over consultants' reports, particularly for complex loans covering several areas where the Country Offices cannot be expected to have the required technical capacity.
In complex sector loans with various policy areas of differing degrees of difficulty, priorities tend to be redefined during the course of execution	Include procedures that will allow for objective weighting of partial compliance in terms of conditionality and policy implementation, on the basis of the expected impact and the degree of difficulty of compliance. Considering disbursing against conditions fulfilled, instead of whole tranches, in some cases
In some sector loans, there have been significant reversals of economic policies	Make the amortization term of sector loans adjustable in light of compliance with conditionality
Some parallel technical cooperation components that were necessary for subsequent tranches were slow in execution, because of Bank procedures requiring step-by-step review and approval.	Make use of technical cooperation smoother and more flexible, by reviewing and approving the entire process ex post rather than step by step.
In general, PCRs have been prepared late and PPMRs do not adequately reflect execution.	Prepare PCRs within the regulation 90 days and ensure that PPMRs reflect the real degree of compliance of the proposed reforms, so that the Bank can take timely and appropriate steps.

5.7 Sector loans have been designed to be disbursed in tranches, to encourage the more-or-less simultaneous adoption of a set of reform measures or institutional changes, and thereby ensure synergy among them. In general, if a set of different measures is adopted all at once, the resulting benefit may well be greater than the sum of the individual measures, since many of them will be mutually reinforcing. Moreover, in some specific cases, some measures may have to be adopted as a pre-condition for others. Nevertheless, when unforeseen situations make it difficult to adopt one measure or another, the reform process as a whole should not be held up by such a limitation.

In some cases, therefore, it might be preferable to split tranches on the basis of an objective weighting, instead of granting a waiver, in light of the moral hazard that this can involve.

5.8 The proposed approach would reduce the cost of any ex post negotiation between the Bank and the executing agency in the event of failure to meet certain of the less important conditions. It would also avoid apparently contradictory situations where the executing agency may have complied with nearly all the conditions and yet cannot secure a waiver or even a tranche split (Private Investment Sector Loaned in Uruguay or Financial Sector Loan in the Dominican Republic and), or where the executing agency has obtained numerous waivers for unfulfilled conditions (Financial Sector Loaned in Venezuela and Public Service Enterprise Loan in Nicaragua). As well, a system of the type proposed would require prior study and agreement on the importance of each policy and condition, and this would help improve the design of the operation and focus it more closely on issues essential for achieving the development objectives of the loan.

5.9 The issue of safeguards to avoid backsliding is a difficult one, but there are several ways of addressing it. For example, the loan amortization period could be shortened, and the amount of re-payment installments consequently increased, if policies that formed part of the original conditionality are subsequently reversed. Or, eligibility for future loans could be denied for countries that have reversed policies that were part of the conditionality of previous loans.

5.10 Another problem that has arisen with sector lending is that, while loans are disbursed quickly when certain conditions are met (involving sometimes only executive decisions), the parallel technical cooperation may be disbursed more slowly than planned, since it may include the selection of individual advisors or consulting firms under the Bank's normal procurement procedures, which are slow and require several steps of verification and approval. *In the future, such procedures should be made more flexible so as to speed up the use of technical cooperation, as has been done for example in certain recent operations where the entire process was verified and approved ex-post, rather than step by step.* Otherwise, care must be taken to ensure that the execution schedule for technical cooperation is more realistic (see for example paragraphs 23 and 6.5 of PPR-10/97 and paragraph 17 of PPR-11/97).

5.11 Project completion reports (PCRs), when they have been prepared at all, have been late and, as with the PPMRs, their structure and content have generally not reflected the true degree of compliance with the proposed reforms, nor the significant success achieved by certain programs, nor the problems or setbacks that have occurred in others. In future, as some Country Offices have suggested, in light of the importance of PCRs for the Bank's institutional memory on these operations, *independent expert evaluations should be contracted for performance within the regulation period of 90 days.* Moreover, in light of the importance of the reforms being supported, *regular, detailed and objective interim evaluations of this kind should be performed so that the Bank's senior management can take timely and appropriate action* (PPR-10/97, paragraph 6.8), *in order to avoid situations like those of the Investment Sector Loan in Uruguay (PPR-11/97) and the Financial Sector Loan in the Dominican Republic, where progress was made on some of the loan conditions, but no disbursement was made under the third tranche – a situation that can discourage the authorities from pursuing further measures.*

Appendix

Analytical framework for the studies: A development strategy for an emerging economy

A. Macroeconomic stability with low and predictable inflation and a sustainable current account deficit

1. Macroeconomic stability requires that the fiscal situation be in equilibrium, or that any fiscal deficits should be temporary and, duly discounted, can be offset over time by fiscal surpluses. Monetary and exchange rate policies, together with fiscal policy, must moreover be conducive to low inflation and to a real exchange rate that is consistent with a sustainable current account deficit in the balance of payments. Stability will also help ensure a sound financial system (see section D below).

B. An appropriate system of incentives to promote a more efficient allocation of resources

2. In an emerging economy, adequate incentives require, in the case of non-financial goods and services, that domestic prices for tradable goods (goods that compete with imports or that can be exported) should be at or close to their prices on international markets, and that public utility services should be efficient, with prices that reflect their marginal production costs. In particular, integration into the world economy, through the elimination of non-tariff barriers and the adoption of low and uniform tariffs, is the best means for ensuring adequate incentives and, through the signals delivered by these incentives, for structuring production and consumption in ways that will take full advantage of the opportunities offered by international trade and specialization.

3. In fact, small countries with highly distorted trade regimes and a goods market where there is little competition have much to gain over time from abandoning uncompetitive practices and liberalizing their trade. These gains go well beyond the conventional advantages of specialization that international trade allows, and include efficiency gains through access to better-quality inputs and through the continuous pressure for innovation that competition imposes.

4. In the area of non-financial services, a regulatory framework needs to be established that will foster competition, private initiative and efficiency in such sectors as telecommunications, electricity, gas, water and sanitation, and ports, airports, and the transport of freight and passengers. Recent technological advances and the creation of a competition-promoting regulatory framework will help enhance efficiency in these areas while at the same time freeing the public sector to concentrate its activity on priority areas where it has a central role, such as preschool education and primary health care for the poor and nutrition for at-risk groups, and a targeted social assistance network.

5. In terms of factor markets, the labor market needs to be deregulated in order to facilitate economic adjustment and promote job creation, especially for unskilled workers whose employment prospects are generally diminished by labor practices that limit their entry into the market.

C. An adequate physical infrastructure, together with a sound human capital base

6. Improvements in infrastructure and in the quality of human capital require a profound restructuring of the public sector, so as to encourage private initiative in these areas and to make room for such expenditures within the public budget. In particular, public sector participation needs to the reduced in those activities that can be performed by the private sector in a competitive setting. Some countries have developed schemes to encourage private sector participation in activities that until now were conducted solely by the public sector. Chile and Argentina are the Latin American countries that have made the greatest progress in this direction, by fostering private sector participation in public utility services (telephones, electricity, gas, water and sanitation) and also in education, health and social security services.

7. These countries have also made progress in promoting private sector participation in infrastructure works, and they have developed an appropriate framework to facilitate private sector investment in this area.

D. An efficient and sound financial system

8. Achieving a sound financial system requires the development and reinforcement of institutions responsible for regulating and supervising the sector. These institutions must have the capacity to evaluate the quality and risks of banks' asset portfolios, and they must also have the political support needed to control non-arm's length lending practices, to insist on adequate capitalization of banks and to ensure that institutions that have lost a significant portion of their capital (enough to pose significant problems of moral hazard or adverse selection) are forced to suspend operations or to capitalize themselves appropriately.

9. Integration into the world economy includes integration into international capital markets, a move that presents both risks and opportunities. Greater integration into international capital markets imposes more discipline on monetary and fiscal policy, while allowing risks to be diversified and making financing available so that a country's investment rate can exceed its domestic savings rate. At the same time, countries must also be aware that integration into international capital markets will radically alter the effectiveness of macroeconomic policies and may exacerbate problems with financial markets.

10. In systems with a fixed or pre-set exchange rate, integration into international capital markets reduces the effectiveness of monetary policy significantly, while in systems with flexible exchange rates, although the effectiveness of monetary policy is high, changes in these policies will have significant effects on the level and volatility of the nominal and real exchange rate. The effects on the real exchange rate, however, will tend to dissipate over time.

11. In order to maximize the net benefits of integration into international capital markets that arise from prudent macroeconomic management, it is important to ensure that sharp inflows of capital, to finance increased consumption levels rather than investment, do not lead to a drop in the domestic savings rate, an acceleration of inflation, and a sizable and unsustainable decline in the real exchange rate, as happened in some Asian countries in 1997-1998. Once again, the soundness of the domestic financial market is a prerequisite for successful integration into international capital markets and for reducing vulnerability to sudden capital movements.

12. The Asian crisis highlights once again the importance of having a financial system that is sound, transparent and competitive, one that will lay the basis both for maintaining stability and for allocating resources efficiently.[6]

E. Higher rates of investment and domestic savings

13. Achieving a sustainable increase in the investment rate requires, in addition to the policies indicated above, a sustainable increase in the domestic savings rate. In fact, countries have rarely been able to finance an excess of investment over savings greeter than 4 or 5 percent of GDP, over any extended period of time. The only exceptions to this rule in the last 30 years have been Korea and Singapore, countries that between 1953 and 1980 received capital inflows at an annual average rate of 8 percent of GDP.

14. When it comes to policies for encouraging domestic savings, empirical evidence suggests that private savings rates are not very sensitive to policy measures and, in particular, to real interest rates. Nevertheless, negative real interest rates are probably a disincentive to savings, besides reducing the efficiency of financial intermediation and encouraging capital flight. If there is no way to stop the leakage of private savings, one of the surest ways of increasing national savings is to raise the level of public savings. In fact, empirical evidence shows that public savings have contributed significantly to raising national savings rates, especially in the first stages of a successful development program. These results highlight once again the key importance of maintaining a sound fiscal balance.

[6] A feature of this crisis is that it had its roots in very weak financial systems which, combined with greater access to external financing, exacerbated the problems of moral hazard and adverse selection. The result was a real estate and stock market boom that quickly evaporated when the nonperforming portfolio of the banks created doubts about their capacity to service their debts. The exchange rate crises were a consequence of the crisis unleashed in these financial systems. (See IMF, 1997, and Krugman, 1998).

When an economy begins to grow, a virtuous circle comes into play, since the higher growth rate will result in a higher savings rate.

F. **An institutional apparatus that promotes a stable and reliable policy** framework for investment and that contributes to raising the productivity of the economy as a whole

15. Raising the rate and the efficiency of private investment depends essentially on maintaining a stable macroeconomic setting and on clear and predictable tax policies and property rights. It also requires an adequately capitalized financial sector, subject to suitable regulation and supervision, with a sufficient degree of solvency and efficiency that it can channel financial resources from net savers of funds to net users of funds. This means that there must be incentives for the development of a banking and financial system with the capacity to evaluate projects and measure their risk. Nevertheless, it must be recognized that with the introduction of an adjustment program, the structure of incentives changes continuously, and this will introduce great uncertainty as to what the permanent structure of incentives is likely to be. Under these circumstances, it is not surprising that investors prefer to wait until they have a clearer idea of the probable trend in relative prices, before they commit themselves to an investment. This delayed response on the part of investors is a common characteristic of most adjustment programs, and particularly of reform programs that start out (and sometimes end up) with little credibility. Hence the importance of launching reform programs decisively and with clear intentions.

16. In short, under this new development strategy the state has a key role, which is to create an institutional framework that will guarantee macroeconomic stability; facilitate improvements to health services and to preschool and primary education, both in terms of their quality and their accessibility, so that low-income groups can accumulate greater human capital; ensure the existence of a regulatory framework that promotes competition, both in basic services and in the economy as a whole; facilitate (or undertake directly, when there is the public good involved) the development of basic infrastructure; enforce respect for property rights: and design and implement policies targeted at reducing extreme poverty.

17. It must always be remembered that governments are just as able to adopt policies that promote growth as those that obstruct it. Governments can create positive growth effects by undertaking activities in the areas identified in the previous paragraph, just as they can create negative effects on growth and welfare if they squander resources on projects of no economic value, or on bloated bureaucracies, and if they establish taxes and regulations that distort decision-making by savers and investors.

18. The Asian crisis lends yet greater validity to the kind of strategy outlined above. The principal lesson to be drawn from that crisis is the importance of maintaining a system for allocating investment resources that is based on market criteria, and a well regulated and supervised financial system that exerts strict control over directed or non-arm's length lending practices and ensures that institutions are adequately capitalized.

19. An additional point for consideration when designing programs in support of policy reform is the need for the recipient country to have a technical group that is capable of evaluating the kinds of reform that are most adequate for that country. These groups must fully understand the expected effects of the reforms, so they will be able to help the policy team present them to the general public. In this way, all stakeholders will be committed to implementing the reforms, and they will feel a sense of ownership over them and help promote them and ensure their continuity. To achieve this, it would be wise to implement longer-term programs aimed at upgrading professional training in critical areas of government.

20. The objective of policy-based sector loans is to facilitate political and institutional changes in the directions indicated above, so that the country receiving the loan and the technical cooperation can pursue a reform strategy for achieving sustained growth of the kind that will reduce poverty.

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