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# Issues in Adjustment Lending

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Three major issues have emerged from adjustment lending. One is translating adjustment policies into improved economic performance. The second is reconciling policy reforms with changing external conditions. The third is coordinating the adjustment process itself — coordinating the efforts of all the interested parties, inside and outside the country. In relation to each of these issues, expanding the menu of policy options could make adjustment packages more credible and effective.

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Reaping the full benefit of adjustment packages depends on a government's commitment to reform as well as a variety of complementary factors, many of which have not been duly considered because of the lack of time, resources, and skills.

Most policy packages have focused on adjustment in the following areas: (1) fiscal and investment policy, (2) exchange rate and trade reform, (3) industrial regulation, (4) agricultural pricing, (5) financial liberalization, and (6) institutional development. No small task. Meanwhile, concerns have been voiced that too much is being attempted — or, where sociopolitical issues are ignored, too little.

It is becoming increasingly clear that if these packages are to be more effective and credible, the menu of policy options might be expanded in three areas. One is translating adjustment policies into improved economic performance — the objective of domestic strategy. The second is reconciling policy reforms with changing external conditions to get the most from the external strategy. The third is improving the process of adjustment itself. So, an already onerous set of tasks has to become even broader — or, better, more focused.

*Linking policies to performance.* Although the links among policy change, funding, and economic returns might seem clear, identifying them in practice is complex. Efforts to clarify the expected effects of policy on performance should continue. There nevertheless are practical difficulties, some of them unpredictable. Policies may be better, but financing may be inadequate. Also influencing the effectiveness of reforms are their credibility and sustainability

— and complementary policies and nonprice considerations.

*Getting the most from external strategy.* Much of the Bank's intellectual and financial effort has supported an outward orientation and market liberalization. But confusion remains over what these changes really mean, about what is really being sought, and about how much is being reformed. Needed now is a clearer understanding of the respective roles of domestic policy and external factors in increasing trade and accelerating growth.

*Improving the adjustment process.* Preparedness for the reforms has been important for their implementation and sustainability. Timely financing for the adjustment package has also been a key to acceptability. Building a domestic consensus, essential to sustaining stabilization and adjustment efforts, requires commitment and the ability to experiment. Providing adequate finance requires coordinated rather than fragmented efforts by donors, commercial lenders, and the respective governments.

In sum: attention needs to be placed on the commitment to price reforms and on nonprice areas. Support might increase for the outward orientation of countries — if discussions are extended to consider external factors and if nondistortionary ways of promoting domestic production are explored. There must also be greater government commitment to building support for the reforms — as well as flexibility in the external financing community.

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# ISSUES IN ADJUSTMENT LENDING

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## ISSUES IN ADJUSTMENT LENDING

### 1. An Overview

A combination of unfavorable external circumstances and inadequate domestic policies led to the economic and debt problems of the developing countries in the first half of the 1980s. As the decade progressed, it became clear that for many countries a return to previous long-term growth would require significant adjustments: this was true even for some that had avoided a debt crisis. At the same time, repaying debt and implementing structural adjustments called for increased financing from domestic and external sources. Such financing hinged, however, on changes in the status quo -- not only in domestic policies but also in external financing provided by multilateral, commercial, and government sources.

A major component in the evolution of the World Bank's role in this connection was the expansion of adjustment lending. The development of the Structural Adjustment Loan (SAL) and the Sectoral Adjustment Loan (SECAL) since 1979-80 may also be representative of recent trends in conditionality of adjustment lending in general. 1/ As a percentage of total lending, adjustment lending has grown from an average of 10 percent in FY80-85 to 23 percent in FY87, over four-fifths of the latter constituted by SECALs. Some fifty countries, many of them

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1/ Discussions of the Bank's adjustment lending can be found in World Bank (1988), (1987b), (1987c), (1987d), (1986a), (1986b), Baneth (1983), Please (1984), Stern (1983).

low-income African countries or highly indebted middle-income countries, have received adjustment loans. This type of lending was not, however, a complete break with traditional lending and conditionality, but a development of "program" lending to encompass much greater emphasis on policy reform. 1/

At its inception the SAL was seen as a primary instrument for the Bank's dialogue on the fundamental aspects of development policy with the borrowing members. Adjustment lending differed from traditional lending in its focus on broad economy- and sector-wide policy reform -- and on making foreign exchange available quickly to finance imports not necessarily linked to specific investments. 2/ The approach was to link the increased availability of foreign exchange to expected improvements in economic performance. Such policy-based lending nevertheless identifies several key analytical aspects and some difficult and controversial issues: among them, the relation between policy and performance, the adjustment strategy under changing external conditions, and the political economy of the process. Concerns include

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1/ The Bank has engaged in program lending since 1946 when its Executive Directors determined the consistency of such lending with its Articles of Agreement under "special circumstances." These "special circumstances" were identified with war, natural disaster, precipitous changes in external trade conditions, and cases involving structural constraints or capacity under-utilization. The Executive Directors also accepted at various times the assessment that such program lending might amount to 10 percent of total lending commitments.

2/ Parallel to the development of the SAL was the development of an analogous IDA (interest-free) instrument to support adjustment in lower income countries. This instrument, the Structural Adjustment Credit (SAC), serves the same function as the SAL. But because it is interest free and longer in maturity, it has a higher grant element. "SAL" is used here to refer to both SALs and SACs.

the conditionality of lending and its effectiveness, problems of monitoring, and the sustainability of reform. The concerns sometimes also relate to the speed and scope of reform and the country environment. Some say that too much was attempted (in a so-called Christmas-tree approach), and some, too little (if sociopolitical and ethical issues were ignored).

One major issue in policy-based lending, discussed in section 2, is the link between domestic policy changes and economic performance. Domestic policy changes usually supported by adjustment programs have involved incentives for resource reallocation, inducements for savings and investment, redirection of public investment priorities, and often a variety of sector-level reforms. It has been easier to assess whether conditionalities have been met than how well they have been sustained. It has been even harder to conclude how they have been related to performance or how much worse performance would have been without these efforts. The reason is that performance involves growth rates, external sector and fiscal balances, income distribution, etc. which are the simultaneous results of past policies, new policies, lags in effects, external factors, measurement problems and so on.

A second major issue, discussed in section 3, is the link between the agreed policy and lending, or more generally between policy and the external environment. The greater the reforms, the greater the returns from external financing. The actual financing depends not only on this increased warranted support, but also on the new financing gap

that results inter alia from the adjustment effort. The financing must also reconcile debt implications, including that of additional borrowing (which are not addressed here.) This connection between policy and financing highlights the special role of trade expansion reforms. If imports respond faster than exports, trade reforms would need to be supported by additional external resources in the short term.

Trade reforms have been the most significant component of adjustment lending and Bank advice in the 1980s. About half the Bank's sector adjustment lending in fiscal 1987 primarily supported trade liberalization in five large borrowers: Argentina, Indonesia, Jamaica, Mexico, and Nigeria. A wide range of studies quoted in World Bank (1987a) concern the positive relationship between trade reforms for greater outward-orientation and performance. Edwards (1985), Frenkel (1982), and Papageorgiou, Michaely, and Choksi (1986) have examined the phasing and sequencing of outward-oriented trade reforms. Corbo and de Melo (1987), Fischer (1986) and Mussa (1987) have been concerned with the interrelations among trade and macroeconomic reforms during adjustment. Dornbusch (1987) and Sachs (1986) have questioned the wisdom of trade liberalization and the effectiveness of the Bank's conditionality. On the whole, much has been written on the merits and problems of trade liberalization. Needed now is a clarification of the concepts and a synthesis of the evidence and operationally useful results.

A third major issue in the process of adjustment is the coordination of domestic and external players (section 4). Consensus-building has been receiving much attention as a domestic element in the

policy adjustment. The reason is that stabilization programs initiated in crisis conditions have usually permitted little input from or flexibility by the recipient. Medium-term programs should for the most part be outside crisis conditions, but in reality a crisis may prompt the policy changes. Experience suggests that the acceptance of conditions in the financing agreement by the member country -- reflecting an agreement on their appropriateness on the part of the policymakers -- is essential for the sustainability of reforms.

There nevertheless are further analytical and practical issues that have yet to be understood adequately. For example, how credible is the government in assuring the irreversibility of reforms? While conditionality defines the program instrument, the intention of the tool is that the financing program is to be agreed on in conjunction with the policies being accepted as beneficial by the country and the external agency. Preferably, the country would adopt stabilization and adjustment measures, and external financing would be provided in support of those measures. There thus is the need for coordination among the recipient country, developed countries, external agencies, and commercial banks in ensuring consistency among policy reforms, financing and debt implications.

Work is now needed to clarify the scope of adjustment lending. First, analytical work relating policy to performance must continue, contributing to an adequate apparatus for evaluation and monitoring of adjustment programs. While the use of well-conceived indicators could help, country applications of small, prototype models are also likely to be essential. Second, in the area of external



policy, there is confusion even about what various concepts mean -- outward orientation, trade liberalization, and export promotion. Nor is it fully clear what exactly has been accomplished: greater efficiency in the import regime, less protection, more uniform protection, greater export incentives, and so on. Third, there is a need to expand the menu of policy options in the discussion of adjustment programs. For external policies, more work is needed on factors that should not be taken as given, or if they are, on what those factors imply for the adjustment effort. For domestic policies, it has been demonstrated that while better price signals are essential, the supply response also depends on getting non-price factors right.

## 2. Frameworks for Policy Reform

### Policy and Performance

A number of papers have set out rationale for stabilization and adjustment and the intended linkage between policy change and financing (see for example Balassa 1982, IMF 1987, Khan 1987, Michalopoulos 1987, Khan 1986, Yagci, 1985, Killick 1984). A broad goal of adjustment is to raise the growth rate of the economy over the medium-term, to return it to its potential path from which it may have diverged and perhaps to facilitate an expansion of the potential itself. Stabilization is consistent with this goal, although the primary focus has often had to be placed upon balance of payments and fiscal disequilibria associated with increased absorption. Policies supported by stabilization programs and adjustment efforts overlap -- for example exchange rate adjustment

for expenditure switching -- and consistency among them is necessary. Viable medium-term programs require attention to expenditure policies associated with stabilization, as part of any effort to promote expenditure switching and improve resource allocation and the structure of production, induce resource mobilization, and promote better investment allocations and sectoral responses -- all of which are part of adjustment programs, or perhaps development strategies. The time frame of analysis of stabilization and adjustment frameworks, however, ought to be long enough to ensure consistency in policy recommendations and in their external financing implications.

While the relation between policy change, funding support and economic returns might seem clear, identifying this linkage in practice is quite complex. From a conceptual point of view, identification of an appropriate policy program is the result of an analysis of economic functions relative to a country's economic objectives. In the neoclassical paradigm of system function, an efficient program is generated by the function of market institutions and market signals. The financial and institutional support by international organizations might constitute an effort to strengthen the market forces, to fill gaps where market mechanisms are not the sole answer and to stress public investment and institutional factors wherever relevant and possible. The latter type of concerted action would sometimes reflect socio-economic objectives, and almost always reflect the effects of externalities associated with institution structures and other relevant aspects of the development. The context for adjustment programs and conditionality is usually the world of the second best.

The theory of function in second best contexts, however, is not well developed and this state of affairs qualitatively changes the approach that must be taken in designing appropriate policy programs. This is in part a result of the fact that changes that will lead to improvements in the first best context may sometimes have the opposite effect in second best situations. This means that policy approaches might be limited to areas where policy effects can be seen as clearly improving the situation. It means that the identification of the relationship between change and outcome must be made also on the basis of the particular country context.

The analysis of policy effects and their measurement has occurred at two levels -- the aggregate (or macro) level and disaggregated (sectoral) level. Some aggregative modelling of the effects has also been tried, with modest results. The aggregate analysis has focussed on broad efficiency issues such as: gains accruing from removing biases between tradeable and non-tradeable activity; public sector investment choices; and effects of financing policy and real interest rates on domestic resource mobilization and allocation. Analysis at the disaggregated level has included institution design, use of quantitative constraints, effects of tax and subsidy wedges, and the role, organization and function of parastatal enterprises. Methods for quantifying the effects of changes at the micro level seem to have more acceptance even if they are approximate. Nevertheless, tracing the sector level effects of macroeconomic policies empirically has proved complex for data and conceptual reasons. Analysis at the aggregate, macro level, on the other hand, has been

subject to more debate: the links between trade regime orientation and growth, for example, have been challenged.

#### Country Experiences: An Illustration

The six countries (Brazil, Chile, Mexico, Pakistan, the Philippines and Senegal) included in Table 1 are diverse in their structures and the stresses which the external environment has placed on them. While the other countries suffered from changes in terms of trade in 1979-82, Senegal and Mexico benefitted from those changes. Philippines and Senegal suffered serious losses as a result of a slowdown in the volume of world trade while all six countries incurred substantial losses as a result of higher world interest rates. In two areas of policy action, the exchange rate and public sector deficit, it is seen that the relationship between policy and performance at the macro level cannot be simplistically viewed. The complexity of the problem has to be recognized both with respect to overall policy interaction and the dynamic timing of effects. Chile and Pakistan, with depreciated real exchange rates -- but increased fiscal deficits -- have found differing results on the current account deficits and growth. (In Chile the appreciated exchange rate in 1980-82 led to high indebtedness and the need for restrictions, which added to the current account deficit through high interest charges). Philippines with some appreciation in the real exchange rate but reduced government deficit managed to curtail the current account deficit, but this has been accompanied by a severe downturn in overall growth.

**Table 1: EXOGENOUS AND POLICY EFFECTS AND PERFORMANCE — ILLUSTRATIONS**

	I. EXTERNAL EFFECTS				II. POLICY EFFECTS					
	External Shocks as % GNP <u>a/</u> (Average 1979-82)				One Index of Real Exchange Rate <u>b/</u> Average			Estimated Government Deficit (% GDP) <u>c/</u> Average		
	Terms of Trade	Export Volume	Interest Rate	Total	1980-83	1984	1985	1980-83	1984	1985
Pakistan	1.7	0.3	0.8	2.8	100.0	98.5	91.9	5.7	6.0	
Philippines	2.4	2.3	1.7	6.4	100.0	94.0	102.6	2.9	1.8	
Senegal	-3.2	3.1	1.2	1.1	100.0	96.0	105.5	7.3 <u>e/</u>	4.1	
Chile	1.8	4	4.0	7.2	100.0	79.9	61.4	0.1	4.4	
Brazil	3.3	0.4	1.9	5.7	100.0	83.6	82.6	2.6 <u>e/</u>	4.7	
Mexico	-3.9	0.7	2.7	-0.4	100.0	94.1	101.1	8.3	8.3	

  

	III. PERFORMANCE INDICATORS								
	Real Export Growth Rate (%) <u>d/</u>			Current Account Balance (% GDP)			GDP Growth Rate (%)		
	Average 1980-83	1984	1985	Average 1980-83	1984	1985	Average 1980-83	1984	1985
Pakistan	10.5	-12.5	14.2	-2.7	-2.2	-4.0	7.6	5.5	7.8
Philippines	3.3	2.8	-3.9	-6.7	-3.9	0.0	3.3	-6.1	-4.4
Senegal	0.4	-3.0	2.7	-14.8	-11.3	-12.4	3.5	-4.5	3.8
Chile	2.7	3.0	8.0	-9.2	-10.7	-8.3	-0.4	6.3	2.4
Brazil	11.3	24.0	-5.8	-4.8	0.0	-0.1	1.0	5.7	8.3
Mexico	21.0	9.2	-7.1	-2.5	2.5	0.7	2.6	3.7	2.7

a/ External Shocks statistics from Balassa and McCarthy (1984). An increase in the terms of trade index indicates a deterioration in the terms of trade.

b/ A decrease in the index reflects a devaluation. It should be noted that alternative indices give rather different estimates.

c/ The definitions vary a great deal.

d/ Merchandise exports.

e/ Averages for Senegal and Brazil are derived from figures for 1980, 1982, and 1983.

f/ Not available.

Sources: Balassa and McCarthy (1984), World Bank data.

Observed downturns in overall growth seem to be at the heart of objections to adjustment policies. The distinction between stabilization and adjustment is often made, although as noted, these ought to be viewed as part of the same process. Stabilization policy is designed to return the economy to a supportable equilibrium path. Associated with demand management, it presents a short-term trade-off with growth. Empirical evidence on this trade-off, however, is hard to assemble. <sup>1/</sup> Adjustment incorporates additional policies to improve the efficiency and growth of the economy over the medium-term. Such adjustment is consistent and necessary for growth: the exchange rate is one crucial variable and getting rid of overvaluation can boost performance. There is still, among some critics, a perception that the generic adjustment perspective leads to policies which are constrictive and function mainly to support net resource transfers. This criticism has been hard to answer partly because of the previously noted uncertainties in the dynamics of adjustment.

The Bank and the Fund have been heavily involved in this process. One of their roles has been to assist in defining the program and establishing an appraisal mechanism. There is also the role of helping to make resources available through the continued participation by commercial banks and other bilateral and multilateral lenders -- which invariably relates to the debt issue. (Policies of developed

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<sup>1/</sup> Donovan (1982) concluded "that in broad terms, program countries recorded significant reductions in their external deficit while they exhibited only marginal changes in their growth rates of real GDP and consumption..."

countries are also of fundamental concern to the developing countries, particularly in the trade policy area.) Some of these interrelations are mentioned in the case of Colombia in section 4. The greater country detail and the longer time span of data examined also help to disentangle some of the policy effects better than in the overview of six cases in Table 1. World Bank (1988) indicates an association of GDP and export growth with the introduction of reform programs in two-thirds of 16 countries examined. The paper claims no causal connection.

#### Conditionality and Monitoring

In the case of structural adjustment lending the elements of conditionality are macroeconomic, often supported with sectoral aspects. The question whether policy or performance ought to guide conditionality is not an easy one (see Genberg and Swoboda 1987). Four types of cases might be noted: (i) Policies are agreed upon, and performance is good; (ii) Policies are agreed upon, but performance is poor; (iii) Policies are not agreed upon, but performance is good; and (iv) Policies are not agreed upon, and performance is poor.

The first and last cases might be viewed as straightforward, the first suggesting that incremental lending is warranted, and the last that not. The third situation has been used by some to argue in favor of focusing on performance, which independent of policy agreement, is seen as a justification for lending. This could be an instance when the policy to be agreed upon needed to be reconsidered, and actual policy was turning out to be reasonable. However, the good performance might not be sustained in the medium-term and agreement on policy would indeed

be needed for continued good performance. The second case, in some sense, supports the focus on policy (as the first and the fourth). It takes time for policy effects to work themselves out. In such cases, even if performance has not picked up, improved policy could be the basis for additional lending. On the other hand, this case might also signal the need to revise agreements on policy.

While the foregoing, by and large, support the focus on policy agreements for conditionality, mitigating circumstances also become evident. Perhaps, a desirable focus would be on intermediate objectives in terms of policy performance, which is to be reviewed on the basis of accumulating evidence. Areas for policy performance monitoring comprise macroeconomic and sectoral spheres. There remains a serious gap with regard to the tools of analysis needed for monitoring and evaluation. By and large, these have relied upon available indicators of policy and performance. To a limited extent policy modelling has been carried out at the Bank. 1/ It would seem fruitful to pursue the application of small, prototype models for policy evaluation.

Turning to actual conditionality, the main areas have been trade reform, fiscal, financial and investment policy, sectoral and institutional reforms, but with varying degrees of implementation and effectiveness. Support for change in trade policy is the most common feature in adjustment lending, and it is in direct support of the resource reallocation objective (see Balassa 1982). Typically

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1/ A number of country applications were carried out by EPDCO, see for example Gerken and Boray 1987, Hwa 1987, Obidegwu 1987, Cherif 1986, Clavijo 1986, Yagci and Kamin 1986, Hwa and Cherif 1985.



combinations of exchange rate depreciation, reduced import protection via trade policy and export promotion are supported, with differing degrees of success, as means to switch into production of tradeables. This is natural since a deterioration in the balance of payments and sustainable growth rate of output are basic criteria for the initiation of an adjustment lending program. One focus in such policy change has been the reduction of trade barriers which favor investment in inefficient production activities and create an anti-export bias. Specific actions supported in this aspect of policy changes include reduction in tariff and non-tariff barriers, freer access to imported inputs for use in export production, the strengthening of export marketing and support institutions, and changes in the mechanism for foreign exchange determination.

Resource mobilization and use is a second element of macroeconomic conditionality, again with varying effectiveness. By providing encouragement to savings and investment, by creating channels for a more efficient use of public and private savings in investment activities, productivity is sought to be increased. The policies target reforms of government expenditures and taxation, and include measures for government revenue enhancement. The development of capital markets and elimination of interest rate controls and distortions is another important aspect of those policy changes. Financial sector reforms have been increasingly found necessary to support other adjustments. Rationalization of policies involving resource mobilization often includes the removal of particular taxes and subsidies, recovering of costs through user charges, and the phasing out of price and quantity controls.

A third component has been investment reallocation, particularly as it affects public investment programs. Related are institutional reforms, although these have often been weak components. Policy changes here are meant to target the organization and management of government as well as the activities of public enterprises. Changes in the management and organization of government can strengthen the institutions and staff charged with implementing the adjustment program. The size, extent, and function of public enterprise activity are often related to government subsidization policy, state enterprise pricing, and the availability of current and capital transfers. Thus rationalization in resource mobilization and government investment also implies restraint on the level of public enterprise activity and improvement in the quality and direction of their investment programs. These are related to improvements sought in pricing and institutional policies at the sectoral level. Sectoral pricing reforms have been increasingly important components of adjustment lending. Various adjustment programs have included technical assistance and support, although this has been a particularly weak component in terms of implementation. Such support has either been part of the adjustment loan, or be financed through a separate technical assistance loan (in the case of most SALs).

#### Relatively Neglected Areas

Much has been written in recent years on problems of structural adjustment: who are the participants in adjustment, what should be its magnitude as well as timing and phasing (see for example Streeten 1987,

Sen 1983). It has been noted (Lele 1988) that contrasts in experiences have been overlooked in policy recommendations. For example, while evidence has accumulated on the responsiveness of production and exports to price and exchange rate adjustments, the influence of weather, infrastructure and institutions remains vital in Africa. The supply response of individual crops was high, but that of agriculture in the aggregate was low in many African countries. Moreover, non-price factors deserve greater attention and they include emphasis on management, infrastructure, research and extension. Price and non-price factors are complementary, yet it should also be noted that from a policy viewpoint they may turn out to be substitutes: price and non-price incentives can have opposing budgetary implications, for example in situations where direct taxation is administratively difficult and the government needs to resort to trade taxes to generate revenues to finance infrastructure and irrigation.

Social costs of adjustment are being increasingly addressed in the literature and in the Bank's lending (World Bank 1986c, Demery and Addison 1987, Pinstrup-Anderson 1987, Cornea, Jolly and Stewart 1987). Some country examples also have illustrated the disproportionate costs of adjustment for the poor. The assignment of costs to already existing structural problems and to remedial adjustment measures, however, is far from satisfactory. The question should also be addressed why the effects of a deceleration of growth would trickle down more readily than would the effects of an acceleration of growth. An adequate evaluation of the poverty effects of adjustment should also consider the costs of alternative strategies. But the poverty aspects

deserve to be considered together with the balance of payments and fiscal effects of adjustment. The role of public expenditure policies and how public expenditure programs could be reoriented to benefit the poor, even and particularly during periods of fiscal austerity are subjects of considerable importance.

The size and pace of adjustment is the focus of much attention. It was noted that countries faced an issue of double adjustment in the 1980s -- stemming from domestic policies in the first place, and further compounded by a worsening international environment. Nevertheless, most people seem to argue for gradualism in adjustment, both for phasing adjustment costs and for rendering the program sustainable. On the other hand, persuasive arguments are also made for more drastic actions from a political viewpoint. The announcement or perception of a long drawn out adjustment process is sometimes more unpalatable than a once and for all adjustment; the latter can also deal more effectively with the political opposition of vested interests.

### 3. The External Sector and Strategy

#### Trade Policy Reform

Trade strategy provides an important link between overall policy reform (previous section) and financing for adjustment (next section). Adjustment programs often provide rationale for increased external financing which supports trade expansion as a means to raising economic growth. Aggregate figures indicate that the share of trade in

economic activity of fast-growing countries has been steadily increasing (Table 2). Empirical studies give ample evidence that open, outward-looking developing economies have achieved better growth records than more restrictive ones. 1/ Evidence has also been accumulating on the benefits of low tariffs and fast growing exports on the one hand, and on the costs of pervasive controls and restrictions on the other. The Bank has been forcefully encouraging developing countries to reform their economies gradually and adopt more neutral trade regimes. There is, however, considerable confusion on what precisely is the nature of the recommended liberalization and what exactly is being achieved. More generally, the question is being increasingly asked: "Beyond trade liberalization, what?"

Three major components of trade reform under structural adjustment may be distinguished: removal of impediments to export; substitution of price for quantitative controls; and reduction of protection levels and differentials. The above order may also represent, in many instances, a viable sequence in liberalization, especially in the face of severe foreign exchange constraints. The removal of anti-export bias constitutes a universal element in Bank-supported macro, agricultural and trade adjustment packages. The policy ingredients usually are: reduction in export taxes and restrictions; a real depreciation of the domestic currency; and duty drawback and other export promotion schemes. The question of how much export promotion can

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1/ See for example Little, Scitovsky and Scott (1970), Bhagwati (1978), Krueger (1978), Donges (1976), Balassa (1980), Corden 1987, World Bank (1987a).

Table 2: DEVELOPING COUNTRIES — GROWTH a/ OF GDP, EXPORTS AND IMPORTS  
(percent)

Country Group	1965-81			1982-86 b/		
	GDP	Export <u>c/</u>	Import <u>c/</u>	GDP	Export <u>c/</u>	Import <u>c/</u>
<u>Developing Countries</u>						
Low (<2.5)	2.3	2.9	4.0	-0.1	3.1	-5.9
Moderate (2.6-5.0)	4.2	1.1	5.2	3.1	4.5	-1.1
High (5.1-7.5)	6.3	5.6	7.5	4.9	7.5	5.5
Very High (>7.5)	7.6	10.3	12.3	10.4	12.5	12.9
<u>II. Regions</u>						
Africa	4.3	3.5	6.3	-0.7	n.a.	-9.6
Africa (excl Nigeria)	4.0	3.0	4.3	0.3	n.a.	-7.9
Asia	6.2	9.3	11.0	6.9	9.8	1.0
EMENA	5.7	5.1	6.9	2.9	5.2	1.7
Latin America	4.7	2.3	7.4	1.3	3.6	-7.7
<u>III. Other</u>						
Low Income	5.0	3.7	3.8	7.6	8.7	9.1
High Debt	5.7	2.9	7.9	0.9	2.8	-8.6
35 SAL Countries	5.9	6.9	8.1	2.2	5.0	-3.1
15 Major SAL Countries	6.2	7.8	6.3	2.3	8.6	0.1
<u>IV. Average <u>d/</u></u>						
	5.7	4.8	7.3	3.9	6.5	0.8

n.a. Not available.

At constant prices.

Preliminary.

Goods and NFS from national accounts.

90 country average.

Source: BESD, World Bank.

do for growth continues to be raised, but the positive association between export and GDP growth cannot be denied (Table 2).

The replacement of quantitative restrictions (QRs) by tariffs is also a fairly common policy-proposal. For major recipients of adjustment lending, nearly two-thirds of the loans included the goal of

a relaxation of QRs in their conditionality. Adjustment lending to Jamaica, Panama, Colombia, Morocco, Turkey, Philippines, Cote d'Ivoire and Senegal had specific understandings on QR reduction either in the form of their elimination or transference of items to freer lists. The actual system of restrictions varies widely among countries, and there continues to be much confusion on what exactly is being achieved by the changes. Usually the process has been in several, overlapping, steps; sometimes beginning with conversion of prohibitions to licensing, and licensing to free imports; substitution of tariffs for QRs on imports not competing with domestic production, and then of others. Achievement of reductions and greater uniformity in protection has been a complex goal. Over two-thirds of the adjustment loans to the major recipient countries contained tariff reform provisions. Several cases involved reducing the tariff band to say a minimum of 5-15 percent and a maximum of 50-60 percent: Jamaica, Panama, Morocco, Philippines, Thailand and Senegal are prominent examples. It has sometimes been much easier to liberalize imports of raw materials and intermediate inputs, which in many instances actually raises the effective protection rates (and possibly their dispersion) in the first instance.

Economic analysis and Bank policy have emphasized the role of more open trade regimes in development which has been referred to in this paper. Meanwhile, some authors have criticized the wisdom of such emphasis for achieving export expansion and growth. 1/ Recent trends in

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1/ A forthcoming volume by Overseas Development Institute (London) on Adjustment programs, and a number of papers being processed at WIDER (Helsinki) are cases in point; also Berg and Batchelder 1984, Please 1984, Mosley and Toye 1986.

the world economic outlook have added an important dimension to this discussion. There is growing concern whether the trade policy advice should be revised in view of reduced OECD growth prospects, increased protectionism, and continuing terms of trade deterioration on the one hand, and strategic trade policy behavior by some successful countries on the other (Dornbusch 1987, Krugman 1987). Import substitution seems once again to be assuming a certain degree of respectability as a trade strategy. The adverse implications of slowdown in the developed countries on developing country export growth may be overdrawn (see World Bank 1987). The already compressed import levels imply little prospects for further import reduction. Moreover, developing countries' debt burden and the need to regain creditworthiness add fresh urgency to achieve rapid export expansion.

#### Expanding the Menu of Options

These set of issues concern the core of Bank's policy advice, whose importance has been heightened by the central role accorded to trade reforms in policy-based lending. Much of the Bank's intellectual and financial effort over the last decade has been directed in supporting an outward oriented and market liberalizing approach by individual countries. Over time, however, there appears to be increasing confusion about what is meant by outward orientation and liberalization, about what is sought to be achieved, and about what is being reformed and achieved as a result. The current work programs are addressing these concerns. From this work, a consensus or a set of stylized facts from the conclusions on the effects of the policy



packages would be useful. A synthesis of the evidence in a commonly understood analytical framework would help in evaluating actual reform experiences and guiding future policy.

The purpose of this work is not necessarily to anticipate a revision of the Bank's advice on trade policy. The effort, however, is expected to expand the scope of the policy discussion and the menu of options, and enhance the effectiveness of the advice. In this context, policy work is beginning to address some of the neglected questions that are being raised time and again in and outside the Bank. What are the respective roles of price and non-price policies in eliciting an adequate supply response from trade policy? What is the recommended trade policy in the face of market rigidities and imperfections at the sectoral levels? Going beyond trade policy per se, how do we bring in issues of investment strategies, development of dynamic comparative advantage, technology policy, the role of foreign investment, the regulatory environment, risk management, manpower and training and enterprise development?

A second set of questions relate to global trade patterns and trends, which in turn have a bearing on developing country policy (see Bradford and Branson 1987, Krugman 1987). One can point to both elements of greater openness and opportunities in world trade as well as an increasing inward orientation and protectionism. Questions regarding the true evolving nature of international trade, who the dominant participants are and what is likely to drive market penetration on the part of different country groups and product groups are crucial to any long term trade strategy. A few of these issues are currently being

addressed in PPR. The purpose of this work is not to envisage a global coordination of production and trade but to bring out overriding factors that will determine the effectiveness of individual countries' trade strategy. A better perspective on the respective roles of domestic policy as opposed to external factors in increasing trade is expected from the ongoing work. Similarly, improved understanding should result on who the gainers and losers are likely to be from various trade related initiatives.

#### 4. Reform Process and Financing

##### External Participants and Changing Roles

The discussion to this point has focussed mostly on the roles of the member government and the World Bank, used in this paper as the example of the external agency. There are, of course, almost always other actors in to the process. Included among these are the Fund, other official lenders, bilateral lenders, commercial banks -- foreign and domestic -- the private business community, and relevant participants in the political system, both in and out of government. Sometimes financing arrangements are established under the auspices of Aid Consortium Group meetings for the countries in question.

Adjustment programs are often initiated in countries in the process of macroeconomic stabilization. The Fund enters the dialogue in establishing the link between the medium-term program and resolution of short-run disequilibria. In general, the resolution of short-term problems and support for medium-term adjustment are not separable.

Short-term stability depends on actions contingent on expected future conditions. Medium-term possibilities depend on the path taken in reaching the future. While there is no cross-conditionality between Fund facility agreements and Bank adjustment lending, the implicit consistency of stabilization and adjustment programs implies a linkage to the extent that analyses of policies required to reach an equilibrium position are correct.

Coordination with other lending sources also plays an important role in the dialogue process. The Fund and Bank program analyses often provide the framework within which coordinated official action is predicated. External commercial banks also depend on such program analyses. The dialogue on debt restructuring and issuance of new capital is not necessarily centered on the Bank-member dialogue, but to the extent that creditworthiness is linked to economic viability the adjustment dialogue and program are critical. Relating policy conditionality to these players indicates additional roles which macroeconomic-based development aid plays. In particular, the conditionality in adjustment lending may provide an assurance of ongoing participation by the external agencies in evaluating the evolution of economic conditions and assisting in the design of policy to meet those conditions.

The changes that have been taking place in the Bank with respect to policy-based lending reflect more than a change in such lending from 10 percent to over 20 percent of total lending. The conceptual change that has been taking place may have wider relevance to other agencies, and it seems to have three legs. The first of these is

the view towards the economic environment. When project lending was the main development activity there was an implicit approach of designing the best possible project given the economic environment in which it was going to operate. It has been recognized that, in many cases, for development to succeed the overall economic environment must also be made viable and that in the absence of such an economic environment project development alone is not likely to lead to the desired objective.

Second, the perspective of development aid may have been becoming more forward looking and probabilistic. Going beyond the inputs from research and planning, the type of vision that is meant here may be one that has grown out of changes in economics as a whole -- a view in which it is recognized that economic action of individuals (and, hence, of economies as a whole) are conditional on expectations about the future as well the past and present. This is important because it has made clear that for policies to work there must be economic institutions and structures capable of influencing and being influenced at the level of the individual.

The third change has been a heightened awareness of the value of coordinated action on the international level. The Bank has cooperated with other international organizations and donor agencies for a long time, but planning and coordination among those groups has been limited. The effects of limited coordination in project lending are well known to everyone with experience in the area. A vast collection of non-standard production tools and infrastructure projects lay rusting and crumbling around the world. In view of the importance and

sensitivity of adjustment lending, the Bank and the Fund have been drawn into opening effective lines of communication and an effort to understand each others' economic perspective. Donor governments have been finding it necessary to reconcile their project financing with public investment programs which result from adjustment program processes. The lines of communication and structure of coordination are far from being completed, but the needed direction has been becoming clearer.

#### Country Dialogue and Consensus

Conditionality also plays a key role in the domestic acceptance of stabilization and adjustment programs. On the one hand, the role of an external agency in program design can lend credibility to the program's necessity. This facet of conditionality can blunt pressures arising from required changes in organizational structure. It can also play a role in buffering political and popular opposition to necessary change. This role is sometimes an aid and sometimes a hindrance. Thus, on the other hand, opposition groups portraying conditionality as external pressure can, at times, succeed in blocking the adoption of an adjustment program or in changing its characteristics. It is sometimes observed, however, that the credibility of an external institution can assist a government in meeting domestic pressures. Clearly the handling of conditionality is a delicate process.

Consensus building, which is essential to sustaining stabilization and adjustment, requires time and the ability to experiment. The pace of reforms has to take into account the

sustainability of change especially when various interest groups are affected. Taking as an example Colombia's experience, private interests were represented in the government decision process in a number of ways: the participation of private sector representatives on the boards of government bodies; management of the Coffee Fund by the coffee producers together with the government; and rotation of personnel between the public and private sectors. The requirement for broad consensus dictated by the broad representation of interests in the process meant that policy changes were gradual. In the case of Colombia there has been a premium on gradualism in policy change, and on balancing economic, political, and social considerations in order to avoid costly policy reversals.

#### The Case of Colombia

Every country situation is different. The data in Table 1 gave some idea of how different the contexts for adjustment programs can be. Economic activity may be strong or sputtering -- thus Chile with no growth for 1980-83 and Pakistan with over 7 percent for that same period. Similarly, the external environment can have varied effects on the situations -- for example, Mexico and Senegal enjoying terms of trade gains, Pakistan, and Brazil relatively unaffected by the slowdown in international trade and Chile especially hurt by interest rate changes in the 1979-82 period. The resolve to take action, and the socio-political situation needed to support such action also differ from country to country. It is not surprising, therefore, that the observed adjustment varies widely in their scope, and the results obtained are not always comparable.

The case of Colombia is atypical. The country had not over-borrowed in the 1970s and never faced severe debt-service problems. Its debt-service ratio in the early 1980s was around 30 percent. While its terms of trade declined sharply in the early 1980s from their high levels during the coffee boom (1976-79), they were similar to the levels experienced in the first half of the 1970s.

Colombia followed a relatively outward-looking, growth oriented strategy from the mid-1960s to the mid-1970s with good results (Table 3). Non-coffee exports, in particular, took advantage of the export promotion policies with expansion in a wide variety of products. Developments in the second half of the 1970s, however, were dominated by the boom in earnings which resulted inter alia from the jump in coffee prices. Colombia's outward-looking policies began to weaken, at least in part, as a result of that boom. The policies undertaken in the boom period led to certain structural weaknesses which were further compounded by developments in the early '80s. First, higher disposable incomes generated by the boom led to an increase in the price of non-tradeable goods resulting in an appreciation of the real exchange rate. Second, the accumulation of foreign exchange, not fully offset by higher imports or sterilization, produced increased domestic credit expansion, higher inflation, and added to the appreciation of the real exchange rate. The growth in aggregate demand was maintained through higher public expenditures and foreign borrowing after the coffee boom ended. These actions sustained both Colombia's inflation and a continuing appreciation of its real exchange rate.

**Table 3: COLOMBIA — ECONOMIC PERFORMANCE, ADJUSTMENT, AND GROWTH, 1970-86**  
(Annual averages, figures are percentages unless otherwise noted)

	Export-led	Coffee	Growth Recession		Adjustment with Growth		
	Growth 1970-75	Boom 1976-80	1981-83	1983	1984	1985	1986 <u>a/</u>
<b>I. External Factors</b>							
Nominal coffee price index <u>b/</u>	84	133	88	89	98	99	135
Net capital inflow (US\$m) <u>c/</u>	284	543	1,699	1,014	710	1,576	1,000
OECD growth rate	2.1	3.6	3.3	2.3	4.7	3.0	2.0
<b>II. Domestic Policy</b>							
Real exchange rate index <u>d/</u>	89	85	75	75	82	107	112
Money base growth	23	35	18	14	18	27	28
Public sector deficit/GDP ratio	3.0	5.5	6.8	7.6	7.6	3.7	1.0
Imports <u>e/</u> /GDP ratio	15	15	17	16	14	16	17
<b>III. Performance Indicators</b>							
GDP growth	5.7	5.5	1.3	1.6	3.2	2.9	5.0
Export growth <u>e/</u>	6.9	7.4	-5.2	-11.9	9.8	13.9	25.0
Import growth <u>e/</u>	2.2	11.1	3.2	-8.4	-7.8	0.8	1.0
Inflation rate	17.1	24.5	24.9	19.8	16.4	24.0	20.0
Current account/GDP ratio	-2.9	1.2	-6.5	-7.3	-5.3	-3.9	0.0
Reserves (months of imports)	2.7	8.1	7.9	5.0	3.1	3.5	5.5
Debt-service ratio <u>f/</u>	22.7	14.7	31.1	36.9	37.2	38.2	34.0

Sources: Colombian Ministry of Finance, IMF and World Bank estimates, and OECD Outlook.

a/ Preliminary. Note that the significant improvement estimated in the balance of payments in 1986 was partly the result of the coffee boom.

b/ 1970 = 100.

c/ Capital account balance, including errors and omissions.

d/ The calculations are based on a trade-weighted currency basket, with 1975 = 100. An increase is defined here as a depreciation of the peso.

e/ Goods and nonfactor services.

f/ As a proportion of exports of goods and services.

Data as of early 1987.



These policies, together with worsening external conditions -- falling commodity prices and tighter capital markets -- created serious difficulties for Colombia's external sector. Mainly in view of Latin America's debt problems, Colombia suffered cuts in trade credit lines and commercial bank lending. Non-coffee exports declined and international reserves fell sharply. Colombia began to lose ground not only in commodities experiencing falling prices, but as a result of the appreciation in the real exchange rate, in such items as textiles in which it traditionally had a comparative advantage.

In light of this, Colombia's trade regime needed reform in several ways: correction of the exchange rate, a reduction in import restrictions, better functioning of duty drawback schemes, the removal of export barriers and improvements in export quality. Equally fundamental, the underlying fiscal deficits had to be reduced, along with domestic credit expansion, in order to permit a reduction in inflation and an improvement in competitiveness. Medium-term support for such macroeconomic reforms needed to be provided through better public investment programming and sectoral policies. Adjustment lending has supported these policy reforms and facilitated additional financing.

##### 5. Appraisal of Adjustment Effects

It is difficult to judge the success of many adjustment programs in part because the goals of those programs lie in the medium-term and in many cases, that point still lies in the future. The speed of actions also varies: one might, for example, compare the gradual

changes in Colombia with more dramatic adjustments in Chile. The analysis is also complicated by the fact that the external world is continually changing. Since programs are designed ex-ante, the success of an approach has to be measured relative to other ex-ante design processes. The measure of success in terms of outcomes has to be measured relative to the outcomes which might have resulted if other posited approaches had been followed. The evaluation of the latter is not straight-forward.

The difficulty of this appraisal does not justify ignoring the issue. The Bank has attempted to assess its experience with both structural adjustment and sector adjustment lending. World Bank (1986a) limited its analysis to fifteen loans in ten countries initiated during 1980-83 for which project performance audits had been undertaken. A general conclusion reached was that these early programs did not fully meet the expectations of the Bank or the adjusting countries. The reasons for this are not completely understood but at least three factors stand out: not enough was known about the span of time required for policy changes to become effective at the time of program design; many policy changes were incompletely or unevenly implemented; and the period of implementation (1980-83) was one in which the world economic environment facing these countries deteriorated.

Reaction to those factors has already been incorporated in most of the programs which followed these early efforts. Although more effort is now taken in understanding the impact of policy reforms, program conditions have included qualitative targets as well. The number of targets specified in a program has also tended to decrease.

The latter two trends reflect a heightened awareness for the need for flexibility in the implementation of adjustment programs. In conjunction with the trend from quantitative to qualitative conditions, efforts have been made to improve the clarity of intermediate goals in programs. This has also allowed for a greater flexibility in making mid-course corrections when outcomes in terms of intermediate and final objectives do not seem to coincide with program goals.

The Bank's role through the SALs has come under criticism from the outside (see Mosley and Toye 1986, for example). A constructive point concerns the need to account for individual country circumstances more fully, and to use performance targets in addition to policy targets in conditionality and evaluation. There is now a general perception that too much has been attempted without adequate preparation and, greater attention to political feasibility and a more cooperative process of negotiations would produce more sustainable results. There are appealing arguments for gradualism, more careful attention to non-price factors and greater emphasis on expenditure programs to protect the poor, as well as better coordination between macroeconomic and sectoral policies. Continued emphasis on project lending has also considerable validity.

One has to be cautious, however, about inconsistencies in some of the criticisms. While also arguing that the SALs were overburdened with conditionality, some urge the Bank's involvement in a variety of new socio-political and ethical areas connected with adjustment. Inconsistencies are also apparent on many of the criticisms on trade policy. Trade liberalization is often blamed to have hurt domestic

production and external balances. At the same time, little liberalization was achieved, according to others. Table 4 indicates that during 1982-86 the SAL countries have increased their export shares significantly, while their import shares in GDP have increased modestly. Liberalization seems to have been selective, applicable in the first instance to inputs needed in production. Although there are individual examples of excessively rapid liberalization, this by no means seems to have happened in general.

Table 4: TRADE SHARES IN GDP  
(in percent)

	<u>1965-73</u>		<u>1974-81</u>		<u>1982-86</u>		<u>1965-81</u>		<u>1965-86</u>	
	EXP	IMP	EXP	IMP	EXP	IMP	EXP	IMP	EXP	IMP
Africa	23.4	22.9	26.2	26.9	22.7	23.7	24.7	24.8	24.3	24.6
Africa (excl Nigeria)	24.4	24.0	26.1	28.2	26.3	27.2	25.2	26.0	25.4	26.2
Asia	12.5	13.1	21.0	21.5	27.3	26.5	16.5	17.1	19.0	19.2
EMENA	16.6	22.0	20.2	29.7	24.7	31.1	18.3	25.6	19.8	26.9
Latin America	12.2	12.1	13.7	15.0	16.0	13.1	12.9	13.5	13.6	13.4
Low Income Countries <u>a/</u>	6.9	7.5	8.4	10.8	9.7	13.0	7.6	9.0	8.1	9.9
High Indebted Countries <u>b/</u>	12.8	12.8	15.0	16.6	16.6	14.2	13.8	14.6	14.5	14.5
35 SAL Countries <u>c/</u>	12.8	13.8	15.9	18.1	19.1	18.2	14.2	15.9	15.3	16.4
15 Major SAL Countries <u>d/</u>	13.2	15.0	16.6	20.3	23.3	22.0	14.8	17.5	16.7	18.5
Developing Country Average <u>e/</u>	13.2	14.4	17.6	20.1	20.7	21.1	15.3	17.1	16.5	18.0

a/ Based on WDR 30 low income countries.

b/ Based on World Debt Tables classification.

c/ Based on the World Bank's structural adjustment lending countries.

Chile, Colombia, Cote d'Ivoire, Jamaica, Kenya, Korea, Malawi, Mauritius, Mexico, Morocco, Panama, Philippines, Senegal, Thailand, and Turkey.

e/ Based on WDR 90 countries.

Source: BESD, World Bank

More generally, the Bank has become more sensitive to the limitations of its understanding with respect to adjustment policies. Its experience has shown the complexity inherent in designing measures to deal with sector and system-wide problems. The continuing fundamental importance of good project lending is being increasingly noticed. Just as a sound macroeconomic environment was found essential for successful project lending, so is the latter needed to carry out vital assistance that cannot be provided by the former. It has also become more aware of the uncertainties associated with the international environment and their effects on economic performance. Accumulated experience has also led to increased awareness of the political sensitivity of particular policy choices and the effects such sensitivities can have on the speed of policy implementation.

Although recent experience with program lending may not have been fully satisfactory, it should not be inferred that such lending was not worthwhile. World Bank (1988) is an interim report on the accomplishments of adjustment lending as well as areas for continued improvement. Some programs have been extremely successful. Turkey, which has had five structural adjustment loans and three sector loans, is probably one example of such success, and Colombia, Ghana, Korea and Thailand are perhaps others. Other programs, while not completely meeting expectations, have made important contributions to the development potential of the adjusting economies. In a number of cases improved performance is already noted, although a causal relation between policy and performance is hard to establish. Among the contributions has been the institution building which has accompanied

adjustment lending. Institution building has not only included the streamlining of bureaucratic structure and strengthening of planning and budgeting capabilities. It has also included the introduction and upgrading of research and development capabilities. The effects of such changes may not be obvious in the near term, but their successful implementation is critical for development viability over the longer-term.

Concomitant with institution building there has come a heightened awareness on the part of governments. An awareness not restricted to the effects of adjustment related policies, but rather an understanding of possibilities of moving from the status quo. An awareness that economies could be opened and benefit from external interface without sacrificing political, social, or cultural identity and characteristics. There has also come a nascent understanding of incentive mechanisms and the potential for growth arising from more efficient resource use. Along with such understanding has come an awareness of the countries' abilities to affect development.

The past decade has removed any residual naivete and all of the participants in the development process now recognize that development is not just a matter of building enough hydro-electric schemes or adding miles to a railroad network. Everyone now knows that development entails "completion" in a fuller sense. It means finding the way in which countries can realize their potential. This means individuals within countries acquiring information and skills in transforming their environment. It means the development of a system which can coordinate and promote the activities of those individuals. It may also mean

finding ways in which countries can gain from and contribute to the activities which take place outside their borders.

Many countries have engaged in adjustment dialogue only because the future without the resources that dialogue could bring seemed too dire. Other countries have not reached a point where choices between the status quo and change seem so clearly to be needed. Everyone, however, is paying close attention to the performance of those who have made changes in the policies that govern the function of their economies. Thus adjustment lending has brought about a chance to demonstrate the potential effects of adjustment policies -- and more generally, of sound development policies. It provides a test both for how much policy change is feasible and for its effects. Its results also depend on cooperation among governments, international organizations, and the commercial institutions. It requires the patience to listen to and understand differing perspectives. It requires the flexibility to consider an expanded menu of options for development. It requires insight and luck. But there seem to be no acceptable alternatives to this course of action.

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