



# Lessons from large adjustment loans

*A Quality Assurance Group review of World Bank loans made in response to the recent global financial crisis shows the importance of borrower ownership, country knowledge, and selectivity*

In 1998 the Bank approved a number of extremely large adjustment loans that formed its core response to the global financial crisis that began in Asia, hit Russia, and threatened Latin America. Five of these loans—involving total commitments of \$6,830 million—were recently subjected to Quality at Entry assessments by a Quality Assurance Group (QAG) panel (table 1).

This note presents the lessons from the assessments that are likely to be most useful to country directors and task teams preparing new adjustment operations. In their narrow formulation the key lessons are simple and incontestable—and important enough to bear repetition. The five adjustment loans show that applying these basic lessons is not always straightforward, however, and sometimes involves making tradeoffs among Bank objectives. Considering the application of these basic lessons in the context of each loan yields a richer set of corollary lessons.

The five loans considered by the QAG panel were prepared or finalized under extraordinary time pressure—pressure generated by the need for official financial support as private capital fled emerging markets after July 1997. Despite these unusual global conditions, the lessons from the loans are broadly applicable to the Bank's adjustment operations.

## Build on borrower ownership

An adjustment operation's policy objectives are much more likely to be achieved when there is substantial borrower ownership. Ownership means not only a commitment to the policy conditions among key policymakers but also broad support for the new policy direction among politicians. Even when the Bank knows that borrower ownership is weak or uncertain, it may decide that the risk is worth taking. In that case the Bank must not only acknowledge this in

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TABLE 1 THE ADJUSTMENT LOANS REVIEWED BY THE QUALITY ASSURANCE GROUP PANEL

Country	Name of operation	Board date	Number of tranches	Amount (millions of U.S. dollars)
Argentina	Special Structural Adjustment	November 1998	Three front-loaded	2,525
Argentina	Repurchase Facility Support	November 1998	One	505
Korea, Rep. of	Structural Adjustment Loan II	October 1998	Two equal	2,000
Malaysia	Economic Recovery and Social Sector	June 1998	One	300
Russia	Structural Adjustment Loan III	August 1998	Three back-loaded	1,500

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its documents but also pay special attention during appraisal to government plans for dealing with resistance. When a plausible plan is missing, the Bank should structure its support in a way that narrows differences of view within the country, builds constituencies to overcome resistance, or both.

Among the five operations reviewed, the degree of borrower ownership for the reforms on which the loan was based varied enormously. In Argentina the government team had essentially designed the policy reforms and was committed to their implementation. Moreover, there was broad consensus among leading political parties on the overall policy direction. In the Republic of Korea, although the reforms represented a profound change of policy direction, there was a conviction among the political elite that the reforms were needed to recover from the crisis. In addition, the newly elected government of President Kim Dae Jung appeared to have robust public support for the reform program.

In Malaysia, by contrast, support for the reforms occasionally seemed uneven. And in Russia the economic policy team at the center was deeply committed to the reforms but faced strong opposition within Parliament and among the general public. These diverse experiences generated interesting corollary lessons.

*Establishing support for new policies*

First, building borrower ownership takes time. When time is short, a loan should be used to encourage processes that build ownership. Policy ownership builds up as the result of favorable outcomes of related policies and as the result of internal political dialogue. When financial crisis compels the Bank to provide an adjustment loan quickly, it is unlikely that sufficient time will be available for the Bank to stimulate internal political dialogue and to help build ownership for new policy directions. Second-best options include deferring policy conditions for which ownership is weak to later tranches and putting in place participatory or other political processes that help build ownership.

For example, Argentina's economic program had stopped hyperinflation and

reignited growth, generating widespread support for government policies and making it easy for the government to gain support for new reforms. By contrast, Russia's reforms have not resulted in growth, so government reformers have faced widespread skepticism. The Bank encouraged efforts by Russian reformers to engage Parliament in a dialogue on key issues, but this process was not well advanced when the crisis compelled a decision to move forward with the Structural Adjustment Loan III. Partly because of these circumstances, the Russian loan had three back-loaded tranches, and the Bank pushed for a "permanent institutionalization of a participatory reform process." As it has turned out, the second and third tranches have not been released because political turbulence has inhibited progress on reforms.

*Generating broad political ownership*

Second, ownership of reforms by the core economic policy team is not enough. A broader political base—including sufficient support in the legislature—is required. When such broader ownership appears absent, the Bank needs to ask the economic policy team to articulate a credible political strategy for generating sufficient ownership to implement and sustain the reforms.

In Russia the inner circle of policymakers had impressive intellectual capacity and deep convictions. But their political support, especially in Parliament, was weak. The QAG panel suggested that the Bank should have "required from the authorities a clearer and articulated strategy of how they were planning to deal with . . . implementation issues."

Including political strategy in the country dialogue is difficult. When the core Bank team resides in the country, strong personal relationships may facilitate such discussions. But when the Bank is starting a new relationship with a government whose trust must be won, as in Malaysia, this process is especially difficult. In that case, when the depth of borrower ownership is uncertain and the government does not articulate a medium-term strategy for building political support,

a single-tranche operation—based on actions already taken—makes sense.

#### *Involving an incoming administration*

Finally, engaging the key players in an incoming government before its inauguration can help build ownership for reforms. This approach worked in Korea, for example. The economic crisis hit in November 1997, just before a national election. The Bank initiated dialogue with the incoming economic team of newly elected President Kim Dae Jung, a move that helped assess and nurture deeper ownership of structural reforms.

### **Combine country knowledge and global expertise**

Deep knowledge of a country is essential to quality operations. The Bank's value added is much greater, however, when it contributes knowledge about what has worked elsewhere. The quality of the operations in Argentina was partly due to the considerable knowledge among Bank staff of the country and its institutions—knowledge that created a professional consensus within the Bank and with the borrower on the right policies. In Korea and Malaysia the Bank had been inactive for a number of years before the Asian crisis. Still, in preparing the adjustment operations, the Bank relied on staff who knew a lot about these countries.

#### *Forging local partnerships*

Even when Bank staff members have good knowledge of a country, their understanding can be enhanced by working with domestic research institutions and think tanks. This approach was especially helpful in Korea, where many of the operation's analytical underpinnings were provided by local institutions engaged in policy research. A similar approach was used in Argentina.

#### *Drawing on experience elsewhere*

In addition, the Bank's credibility with government counterparts and value added in policy design are significantly enhanced when it assembles staff with expertise about what has worked in other countries in areas that are of interest to the government. The

Bank team's ability to share good practices from other countries with its Korean counterparts helped establish its credibility and utility. For example, learning about Mexico's *Pacto Solidaridad* helped the Koreans design their own tripartite agreement among government, businesses, and workers.

By contrast, even though Malaysia's government was preoccupied with dealing with the financial crisis, a key mission did not include experts on bank reform—experts who could have added much value to what had been accomplished on an earlier 1998 mission by the Bank and the International Monetary Fund.

#### *Maintaining a minimum knowledge base*

Finally, the Bank should invest in a minimum knowledge base for countries where it is not active but where it might be called in quickly. Even though the Bank had been inactive in Korea and Malaysia for some time, it was able to call on staff who knew a great deal about the politics and economics of both countries. But the Bank might not always be so lucky. For inactive countries that might require assistance quickly, the Bank should at least develop an informed opinion—drawing on third-party work—of the country's key problems.

### **Tilt toward selectivity**

In most cases the Bank needs to tilt away from broad coverage and toward selectivity in the policy reforms supported by a single operation. The five operations assessed involved conditionalities on a fairly comprehensive set of reforms. This approach reflected an understandable tendency by Bank staff to push as many elements of reform as possible through the window of opportunity created by a crisis. But given the need for borrower ownership, analytical clarity, and institutional capacity, this tendency should be resisted. Excessively broad conditionalities may reduce the probability that real progress will be made on key reforms.

#### *Setting priorities and sequencing reforms*

During the design phase the Bank and the government should pay more attention to

Combined, the Bank's country knowledge and global expertise can generate quality operations

setting priorities and sequencing reforms. Doing so may help narrow conditionality. Setting priorities is difficult—especially in transition economies such as Russia, where creating an environment that attracts domestic and foreign investment requires that reforms proceed along an ambitiously broad front. Still, realism about the government’s implementation capacity—both technical and political—requires that priorities be set.

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#### *Sustaining focus on key reforms*

In a multi-tranche operation, selectivity cannot be achieved by excluding from second-tranche conditions sustained performance of conditions from the first tranche. Adequate performance of first-tranche conditions should be a condition for the second tranche, and hence this performance requires consistent monitoring over the life of the operation.

With Korea’s loan, for example, despite the central role of corporate restructuring to the operation’s success and the inclusion of related conditions in the first tranche, monitorable conditions focusing on adequate progress in that area were absent from the second tranche. This approach may give the appearance of selectivity, but it runs the risk of losing focus on reforms that take time to implement. (In Korea corporate restructuring work nevertheless remained prominent in the country dialogue.)

## Conclusion

Stated in their simplest form, these lessons may seem obvious and trite. Yet the QAG’s assessments show that they are sometimes not given sufficient weight in the design of adjustment operations. Furthermore, their application in diverse circumstances requires careful consideration and good judgment. The more specific corollary lessons may be helpful in that regard.

*The Quality at Entry assessments on which this note is based were performed by a panel of experienced Bank staff and an outside economist: Joe Wood, who recently retired as Vice President for the South Asia Region; John Page, then Chief Economist for the Middle East and North Africa Region and now Director, Economic Policy, PREM Network; and Vittorio Corbo, a Chilean economist who has worked in and with the Bank for decades. The panel reviewed the operations’ documentation and interviewed many of those involved, including government officials.*

*This note was written by Daniel Morrow during his tenure as a Fellow in Economic Policy, PREM Network, with assistance from Victoria Elliot (Principal Economist, Economic Policy, PREM Network). If you are interested in similar topics, consider joining the Country Strategy and Performance Thematic Group. Contact Victoria Elliot, x80535, or click on Thematic Groups on PREMnet.*



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