

Structural (Social) Adjustment Lending: The Good, the Bad & The Ugly

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In this talk I'd like to make two points:

- 1) SA (Policy-Based) Lending causes huge Debt Overhangs (rising Debt/GDP ratios) that slow development and increase Dev. Country dependency on ROW. (Size of loan and creditworthiness go in opposite directions.)
- 2) WB Policy Lending Makes Private Sector Dependent on Govt. But, Should be the Reverse: Governments Should Be (fiscally) Dependent on Private Sectors.

I. What Is Policy-Based Lending and Why?

(WB Lends to Government Only)

A) What Came Before? –Project Lending

1) Commit Loans for **Projects** W/ Good **Projected** rates of return (RRs) that would improve country CREDITWORTHINESS. That is, projects should earn returns that service the lending (so Debt/GDP ratios don't rise). Make Loan if project Improves Country Creditworthiness. RR criteria **inversely** links size of loan to success – smaller loans generally have higher RRs.

2) Problems:

a) Publicly Acknowledged

1) Projects had too low, frequently negative **ex post** RRs (possibly because loans were too large). Staff were fudging projected RRs.

2) Disbursements too slow and too small. Un-disbursed Commitments (“the pipeline”) too big.

b) Internally Recognized Problem – Overall WB lending too small for goal of Institutional Aggrandizement. WB lending about \$2 billion a year, wanted to lend \$10 – 20 B a year.

c) Needed a New Lending Instrument

B) Policy-Based Lending Involves Committing **Much Larger** Loans (i.e., project lending X 10) to “Buy” Government Adoption of

Better Policies (Trade Liberalization, Privatization, Better Governance Practices, etc.). Besides, policies in many dev. countries are manifestly poor, if not awful (like the Bush policies).

- 1) For Example, SA loans consist of two parts. One = **\$300 million loan commitment**. Second = **policy menu** (e.g., Macroeconomic and trade liberalization of 100 specific actions). Disbursements in two tranches: 20 to be done before first tranche release of \$150 million and 80 more to be done by 18 months later at second tranche release of balance of \$150 million. These would (supposedly) raise RRs for all investments and speed GDP Growth.
- 2) Policy-Based lending separates size of loan and creditworthiness issues. Creditworthiness depends on quality and extent of Government's adoption of policy menu **and** how country's private sector reacts to policy changes.
- 3) Note three things.
 - a) Creditworthiness still negatively affected (Debt/GDP ratios rise) by larger loans **unless** quality of policy menu and extent of adoption **increase** with loan size.
 - b) There's still an **ex anti/ex post** problem: Bank Staff could still lie about the projected impact of the policy menu and the extent of adoption to get new loan commitments through Board.
 - c) No one had any idea how Private Sector would react to any particular loan.

II. What's Wrong With Policy Based Lending?

A) Theoretically it's the same as for Technological Change: countries get faster growth in GDP without any more resource cost. Better policies are a "free" way to increase GDP growth with out any (further) degradation in the environment.

1) Adopting better policies (like innovation) is an unambiguous good. Don't argue against adopting better policies. Anyway, policies stink in many developing countries. Policy changes would be good.

2) Unfortunately, just like technical change, no one really knows enough about what good policies are and how they adopted to be sure that **exogenous introduction** of particular policy changes will increase GDP. (I feel can't introduce policy change exogenously.)

- B) You can't argue that adopting better policies is bad. You can only argue that the lending is bad and that:
- 1) The proposed policy changes (the policy menus) are bad or can't be implemented; and/or
 - 2) Taking the loans without changing the policies is bad: and/or
 - 3) The private sector reacts negatively to either the policy package and/or the increased Government indebtedness.
- B) Re-examination of 1, 2 and 3 Above.
- 1) There is agreement on what good policies are, but the lesson of the past 15 years is that policy-based lending is not resulting in adoption of good policy changes: i.e., the (few) policy changes that are taken do not increase GDP growth over what it would have been without them. Sometimes the proposed changes aren't adopted: the Governments take the money and don't do the policy changes. This is done with the complicity of WB Staff who know they can have a second, third, etc. loan for the same policy menu. More frequently the policy menu is adopted in a half-assed fashion that's not credible and, so, doesn't work. I think this is because the presumption of policy-based lending is that policy change is an exogenous process, whereas, I believe it is an **endogenous process** (just like technical change).
 - 2) Taking loans to make policy changes is unambiguously bad, but worst when indebtedness (the Debt/DGP ratio) increases without policy change. Good governance means adopting better policies: why encumber the gains by borrowing from the WB? That is, the loans reduce the gains from adoption of better policies and increase the costs of non-adoption of better policies.
 - 3) Indeed it is true that private sectors react negatively to virtually all WB policy-based lending operations. First, they are not credible, primarily because they increase rather than reduce (as they are supposed to do) government intervention in the economy. Also, they increase private investor **uncertainty** (as do Bush's economic policies). Debt overhang & financing more (not less) govt. intervention.

III. Conclusion: WB policy-based lending increased institutional aggrandizement at significant costs to developing countries. Lending increased debt/GDP ratios and slowed growth because it financed govt. dominance over private sector.

- A) An alternative involving **endogenous** policy reform.
- 1) WB's (exogenous) approach involves paying government to change itself. Stupid. WB thinks improved governance will improve private sector. Wrong.
 - 2) It's the other way round: A strong, growing private sector will force government to change/improve.
- B) How to strengthen the Private Sector so as to improve Governance.
- 1) Targeted Investor Subsidies (TIS): Small, in-kind subsidies to investors to help them find and exploit markets.
 - 2) TIS must improve collateral of firms (Hernando De Soto) **and** there must be asset markets so that firms can be bought and sold (e.g., by banks if default).
 - 3) Government must allow private trading of foreign exchange and domestic currency bonds, including government bonds. (This means government should borrow from own people rather than WB & IMF).

IV Questions

- 1) How does Govt. foreign borrowing hurt private sector development?
- 2) Is faster development constrained by lack of credit or lack of markets?