

**From Project Based Lending to Policy Based
Lending: An Evaluation of Structural Adjustment
Lending Policy of World Bank**

By Gadde OMPRASAD †

Abstract. World Bank lending policies have seen considerable changes in the last half a century. Though the main objectives of establishment of World Bank after the second World War was to provide financial assistance and participate in the reconstruction of the post war devastated economies but within fifty years of its foundation, World Bank has changed its sole objective from providing project based lending to sectoral interference in the economies with policy prescriptions. This policy shift from the World Bank side has witnessed new programmes of lending called Structural Adjustment Loans. This article reviews the original objectives of the Bank and the transformation towards Structural Adjustment Lending which has changed the basic economic policies of many borrower countries and the economies of the world.

Keywords. World Bank, conditionality, Structural Adjustment Loans, Macroeconomic policies.

JEL. E44, E62, F35, H81.

1. Introduction

The Articles of the World Bank provided a framework for understanding the Bank's investment policies and mechanisms. The Bank provides loans through its own funds or participates in lending activities of private investors to the developing countries. Article 4, section 1 (a) provides that the Bank may "make or facilitate loans in any of the following ways" (Bhambri, 1980:58-9): By making or participating in direct loans out of its own fund; By making or participating in direct loans out of funds raised in the market or a member, otherwise borrowed by the Bank; By guaranteeing in whole or in part loans made by private investors through the usual investment channels. The Bank is a lender, a guarantor and participant in funding for development. Since the Bank is lending someone else's capital, it operates under certain protective clauses.

They are: That all loans must be made to governments or must be guaranteed by governments; That the rate of interest be consistent with the prevalent rate in the world's money markets; That repayment be made within ten to thirty five years; That loans be made only in circumstances when other sources are not really available; That investigations be made of the probability of repayment, considering both the soundness of the project and the financial responsibility of government; That sufficient surveillance be maintained by the Bank over carrying out of the

† Sikkim University, Department of Political Science, 6th Mile, Samdur, Tadong-737102, Gangtok, Sikkim, India.

☎. +91 9474979304 ✉. opgadde@cus.ac.in

project to ensure that it is relatively well executed and managed; That loans should not be 'tied' to any specific market of suppliers, and, That loans are sanctioned on economic and not political considerations.

The main purposes of the International Bank for Reconstruction and Development (IBRD) are (Mahendrapal, 1985): Assistance in the reconstruction and development of member countries; Promotion of private foreign investment; Supplementation of private investment where private capital is not available on reasonable terms; Guarantee or participation in loans and other investments made by private investors; Promotion of long range balanced growth of international trade and maintenance of equilibrium in the balance of payments; Encouragement of loans to useful and urgent projects; and Conduct of operations with due regard to the effect of international investment on business conditions in the territories of member countries and to bring about a smooth transference from a wartime to a peacetime economy.

2. Lending Considerations

The basic considerations that govern lending by the World Bank could be derived from the Articles of the Agreement. Some of the considerations are (Reddy, 1985): The World Bank finances only those projects that are related to economic development and does not lend any support to military or political purposes; The World Bank, finances specific development, i.e., projects, though some exceptions are made by lending for programs of structural adjustment; The projects financed by the World Bank must make financial and economic sense. In other words, the financial and economic rate of return has to be acceptable; In addition to acceptable rate of return, there must be a high priority for these projects, assisting the borrowing country's efforts at economic development; The Bank should be satisfied regarding the ability of the governments concerned to discharge their debt- servicing obligations. This would involve an analysis of the soundness of the country's economic management in particular the ability to generate foreign exchange for servicing debts; Loans should be made only in some circumstances in which the sources of financing a reasonable terms to the borrower are not available; The rate of interest must be consistent with the prevalent rate in the world's money market, i.e. interest rate is related to but somewhat lower than market rates; The bank insists on lending only to the government or under government guarantees. Thus over sixty percent of the lending so far was to three sectors – agriculture, power and transportation. Most of these are in the public sector; Loans should not be tied to purchasers or suppliers of any specific member country. This policy is meant to ensure most economical and efficient execution of the project. To achieve the same objective, the Bank staff would maintain continuous supervision of the implementation of the project.

In the case of International Development Association, the lending considerations differ in some respects: According to the articles, in which the purposes of the Association are made clear, it is mentioned that International Development Association (IDA) should promote economic development and thus raises the standards of living of the people in less developed areas. Thus, there is a specific mention of the less developed countries and the need for increasing the living conditions of the poorer section; The loans have to be in softer terms and it is also made clear that the purpose of the association is to further development objectives of the IBRD and supplement its activities; Resources from the IDA cannot be provided if in its opinion, such financing is available from private sources on reasonable terms or can be provided as loans by the World Bank; The funds are to be provided to the recipient only to meet expenses in connection with

the project as they are actually incurred. The IDA makes its credits to the governments of government entities; It may be noted that the considerations of economic efficiency and procurement conditions are in common with the World Bank. With the result, the standards for the IDA projects tend to be similar to those of the IBRD. However, the IDA is more liberal in the extent of financial participation in a project, the nature of projects selected and financing of local costs; In actual application of the lending considerations three principal criteria have been developed to determine eligibility for credits:

- (a) The recipients poverty, measured by per capita income,
- (b) The recipients limited credit worthiness for borrowing from conventional sources; and
- (c) The recipients economic performance, including its ability to make effective use of resources and the availability of suitable projects.

Besides all these, the World Bank for its clients, emphasizes the need for (The World Bank, 2001): Investing in people particularly through basic health and education; Protecting the environment; Supporting and encouraging private business development; Strengthening the ability of the government to deliver quality services, efficiency and transparency; Promoting reforms to create a stable macroeconomic environment that is conducive to investment and long-term planning; Focusing on social development, inclusion governance and institution building as key element of poverty reduction.

3. Aftermath of Shocks in 1970's

In the aftermath of the severe economic shocks of the 1970s and early 1980s, three factors led donors to introduce policy-based lending (Gilbert & Vines, 2000). First, donors perceived that in the poor policy environment, which had built up during the previous decades, project aid was ineffective. By conditioning aid upon policy change they were attempting to rehabilitate the policy environment.

Secondly, because of a combination of poor policy and negative external shocks some countries were facing difficulties serving their debts. In some countries, the government administration was unable to cope with the bureaucratic burden of increased project aid. Much project aid could simply not be disbursed. Hence, defensive lending through increased project aid would be ineffective.

Thirdly, some countries descended into crisis and needed International Monetary Fund programs to extricate them. There was a presumption that the Governments had made serious mistakes, so that it should be required to make policy changes in return for the finance it was seeking. Since donor finance was typically part of rescue package, the development conditionality's with which donors were concerned could simply be tagged on to this existing medium of policy conditionality's.

The World Bank shifted from project based lending to policy based lending in particular through the device of structural adjustment programs. This shift to policy based lending in the early 1980's arose out of the pressing need at that time in many indebted developing countries for balance of payments assistance rather than for project finance. These Structural Adjustment Loans (SAL) permitted rapid disbursement of funds that would at least partially replace absent private sector flows (Gilbert & Vines, 2000).

By the mid-1980s the imperative was to channel dollars to indebted countries to enable them to service their debt. Lending also required justification in terms of a more conventional return on investment and was often justified in terms of the benefits of the policies that were to be imposed through conditionally clauses attached to loans. Policies in effect became projects, with investment in economic

policy-making infrastructure replacing investment in physical infrastructure. Initially, adjustment policies were primarily macroeconomic in nature and were specifically directed towards the balance of payments but, over the period of time included policies with little direct payments impact (Gilbert and Vines, 2000:22). Trade liberalization figured more centrally and later privatization also became a part. Because of the need to mobilize balance of payments support in the wake of the debt crisis, SAL assumed major importance from 1983 on. SAL had two purposes: promotion of reform and provision of flexible foreign exchange. There has been a move towards an increasingly programmatic approach in place of traditional project lending. This has involved new instruments, notably Sector Adjustment Strategies (SASs), which support sector-level government expenditure program rather than individual projects (Gilbert and Vines, 2000:22).

Policy conditionality sees reforms as a precondition for aid, often required for the balance of payments and debt service purposes. In adjustment lending there is a claim that the returns to the policy reform justify the loan. Whereas conditionality based lending sees reforms as increasing project returns to acceptable levels i.e. there is project which might in principle have been financed even in the absence of reforms. Policy conditionality originated with the International Monetary Fund (IMF) and initially had a relatively specific macroeconomic focus, in particular relating to budget targets and the exchange rate regime.

The program was reviewed in 1982, and in fiscal year 1985, a progress report on the World Bank's experience in providing SALs to a number of its borrowers was the subject of review by the Executive Directors. The four major features of structural-adjustment operations relate to the design of the structural adjustment program; the operational linkages with other components of the World Bank's assistance strategy and worth IMF supported operations in each of these four features in turn (The World Bank, 1985:52).

To achieve the objectives of structural adjustment lending reducing the current account deficit to a sustainable level and maintaining or restoring the momentum of growth-improvements have been sought in four interrelated areas: trade policy, mobilization of domestic and foreign resources, efficiency in the use of domestic resources, and institutional reform. The precise blend of these reforms, the specific measures chooses to implement them, their timing, and the particular sector focus have depended on several factors, in particular, a country's initial economic condition and the strengths and weaknesses of its institutions (The World Bank, 1985:53).

Structural- adjustment lending is a key component of the World Bank's country- assistance strategy. As such it has been closely linked with the World Bank's Country Economic and Sector Work (CESW) and with its project and sector lending. The content and the impact of the former are influenced by the requirements implicit in the preparation of a structural-adjustment program, and, in turn preparation of a SAL requires large inputs of CESW (The World Bank, 1985:54). Supervision is a particularly important aspect of structural-adjustment lending, as to enhance the policy dialogue with governments that is necessary for its success. The World Bank in one of its review of the programmes even opined that the practice of trenching SALs has been effective in providing for a structural review of progress, thereby strengthening the policy dialogue and promoting the timely implementation of structural-adjustment programs (The World Bank, 1985, p. 55).

Any detailed evaluation of the distributional and social impact of SALs is difficult to make, as conceptual difficulties are involved and adequate data are lacking. General analysis indicates, however, that certainly in the medium and longer term and perhaps even in the short term, the negative effects of the

Journal of Social and Administrative Sciences

worsened economic situation on the poor and unemployed would be greater in the absence of an appropriate program of adjustments. Further, because SALs are but a part of the World Bank's overall assistance strategy in which according to the World Bank the alleviation of poverty and distribution effects are important aspects, they should be evaluated in this broader context (The World Bank, 1985:55).

The World Bank has often stressed the need to identify investment priorities and to undertake only projects with a high rate of return. But the World Bank also stresses the importance of the macroeconomic environment. To improve the policy environment the World Bank has supported efforts to adopt appropriate policies in a variety of areas. The World Bank emphasized on mobilizing domestic savings through fiscal and financial sector policies, improving public sector efficiency by rationalizing public investments and improving the efficiency of public enterprises, improving the efficiency of private sector investments by reforming trade and domestic policies, reforming institutional arrangements to support adjustment with growth (The World Bank, 1987:34).

Structural adjustment loans focused on macroeconomic policies and institutional change at the country level- although they frequently emphasize reforms of importance to particular sector in which adjustment is most urgently needed. The purpose of sector adjustment loan, which introduced by World Bank along with SAL, is to promote the introduction and effective implementation of sector policies necessary for sustained economic growth. Most aspects of macroeconomic and sector policy in medium-term adjustment are addressed in World Bank non-project lending (Ibid:35).

Like the structural adjustment operations, sector adjustment lending was designed to support, within an acceptable macroeconomic frame work, sectoral programs of policy and institutional change, including restructuring of capacity, and to increase resource mobilization and the efficiency in the ways in which resources are allocated (The World Bank, 1986:47). Adjustment programs focus mostly on the policy framework needed to promote sustainable growth in the medium term. This has also meant that reforms need to be supported with a series of World Bank lending operations over a period of several years. In all cases, reform programs have required a firm commitment on the part of governments to sustain the course of the reform effort over time.

The objective of sector-adjustment lending is to promote the introduction and effective implementation of sector policies necessary for sustained, rapid growth, depending on the objectives of the operation and country circumstances. This type of lending covers a continuum that ranges from major change in macroeconomic policies to the establishment of an appropriate framework for sector investments (The World Bank, 1986:47). Generally disbursed in between two and six years, sector-adjustment operations are normally trashed, with release of the second tranche being linked to the progress of the sector-adjustment program.

In fiscal year 1986, the Executive Directors, continuing their review of Bank adjustment lending, assessed this particular instrument in their discussion of a management-prepared paper, "Sector-Adjustment lending: Progress Report". Several of the Executive Directors gave their particular approval to the importance that the report placed on assisting member- country governments to identify ways and means to mitigate adjustment costs and, if necessary, to modify the design of the policy and institutional measures under consideration. In sum, sectoral adjustment lending was held to be a flexible instrument for supporting adjustment policies in developing countries. The effectiveness of SALs could be improved by strengthening the World Bank's country economic and sector work to ensure that it generates actionable proposals for adjustment, and by ensuring that the adjustment program is seen in its entirety. The last, so that individual operations are part of a

comprehensive and in-depth reform program, focusing increasingly on detailed and specific measures that raise the supply responsiveness of individual producers and enterprises to policy-reform and sectoral-reform measures (Ibid:48).

4. Financial Sector Reforms

If well developed and efficient, a country's financial system can be an important contributor to economic growth. It can facilitate capital accumulation by acting as an intermediary between borrowers and lenders, transform the size, maturity, and risk characteristics of assets, and thus enhance the willingness of savers with short term perspectives to buy long-term assets. It can also affect the allocation of resources by channeling funds to projects with high yields. The World Bank opined that, finance thus enhances growth, both in increasing the savings ratio and by reducing the capital-to-output ratio (Ibid:30).

The suggested World Bank policy to this financial sector sought to increase the relative emphasis on the development and performance of the whole financial system. With this emphasis, World Bank support to the financial sector has been designed to assist in the development of strategies, policies, and institutions that would increase domestic resource mobilization. This is done by providing a variety of depository and non-depository instruments that pay competitive returns, encourage the development of more resilient and robust financial structures, both at the level of the enterprise and of the financial system. In the latter, further measures are carried out that, for instance, would increase the availability of long-term capital and improve the balance between debt and equity, improve resource allocation by reducing fragmentation. Financial intermediation, through increasing competition and enhancing market discipline, improve the auditing framework and the institutional infrastructure for financial information so as to make financial transactions more transparent and increase trust in the system. The legal, supervisory, and regulatory environment of the financial system are simultaneously strengthened to foster financial prudence and discipline and competitive arms-length relations among financial institutions, borrowers and savers (Ibid).

In applying the Articles of Agreement to loans the World Bank has adopted policies on the management of its loan commitments that are designed to ensure that its volume of disbursed and outstanding loans rather than commitments does not exceed its subscribed capital and reserves (The World Bank, 1987:53). Although guarantees form part of the World Bank's commitments, they represent a contingent obligation and hence carry a different risk. It was recommended and subsequently endorsed by the World Bank's Executive board that the World Bank would provide full capital backing to all outstanding guarantee commitments at their current value (Ibid:54). This means that the management of all new World Bank commitments would be arranged so that even if all guarantees are called on the first possible call date, there would be enough capital and reserves to cover the total amount of disbursed loans (net of repayments) and of all such guarantees. This recommendation was also adopted for the purpose of calculating the World Bank's sustainable level of lending and guarantees would be integrated into the World Bank's sustainable lending level policy by treating them as "loans" that disburse fully at the time of the first call date (Ibid:54).

Guarantees are characterized by their unambiguous nature with respect to commitments to disburse. Given, therefore, their unconditional nature, all guarantee commitments should be counted in full at the time they become callable with regard to limits on country exposure. But, since guarantees have been, and would continue to be, made on a very selective basis, especially in concerted-lending situations, and as guarantees have been kept at a relatively small

percentage of a country's overall financial needs, they have not had a material effect on the World Bank's lending programmed (Ibid:55).

5. Conclusion

World Bank suggests that macroeconomic stability is a precondition for successful liberalization of financial markets, seeking macroeconomic stability by cutting government expenditure requires care to protect essential spending on health, education, and the maintenance of infrastructure. Improving the efficiency of public enterprises so as to reduce the need to subsidies them should also help to cut the budget deficit and aid stability (The World Bank, 1987a:169).

For efficiency in resource allocation, prices should reflect the true costs of production. So price controls should be reduced as quickly as possible and eliminated altogether over the medium term. Direct investment by foreigners is usually controlled even more stringently. If, as far as possible, World Bank opined that, governments offer similar incentives to all investors, they would increase competition, promote efficiency, and help business select technology that fits the country's resource endowments. If developing countries are to adopt the reforms proposed, most would need increased external finance to sustain their adjustment efforts (Ibid:170).

References

- Bhambri, C. P. (1980). *The World Bank and India*. New Delhi: Vikas Publishing House.
- Gilbert, Christopher L and Vines, David (2000). *The World Bank Structure and Policies*. UK: Cambridge University Press.
- Mahendrapal (1985). *The World Bank and Third World Countries of Asia*. New Delhi: National Publishing House.
- Reddy, Y. Venugopal (1985). *World Bank: Borrower's Perspective*. New Delhi: Sterling Publishers Pvt. Ltd.
- The World Bank (1985). *Annual Report*. Washington D.C.: World Bank.
- The World Bank (1986). *The World Bank Annual Report*. Washington D.C.: Oxford University Press.
- The World Bank (1987a). *Annual Report*. Washington D.C.: Oxford University Press.
- The World Bank (1987b). *Development Report*. Washington D.C.: Oxford University Press.
- The World Bank (2001). *Knowledge and Resource for Development*. Washington D.C.: The World Bank.



Copyrights

Copyright for this article is retained by the author(s), with first publication rights granted to the journal. This is an open-access article distributed under the terms and conditions of the Creative Commons Attribution license (<http://creativecommons.org/licenses/by-nc/4.0>).

