

The Ministry of Foreign Affairs of Japan  
Third Party Evaluation

## Review of Adjustment Lending

— Overview of Structural Adjustment Loans and Sector Adjustment Loans —

### Summary Report

March 2005

## Preface

This report is the summary of review of adjustment lending carried out by the External Advisory Meeting on ODA Evaluation, which is an informal advisory body of the Director-General of the Economic Cooperation Bureau of the Ministry of Foreign Affairs of Japan.

Japan has been one of the top donor countries of ODA (Official Development Assistance) and there have been domestic and international calls for more effective and efficient implementation of assistance. The Ministry of Foreign Affairs, as the responsible ministry of ODA, has been conducting ODA evaluation mainly at the policy level with two main objectives; to support the implementation and management of ODA and to ensure its accountability. This review aims to clarify the results and challenges of adjustment lending to contribute to the decision making on whether to introduce budget support. Accountability which is another purpose of this review should be ensured by publication of this report.

The External Advisory Meeting on ODA Evaluation was formed to improve the objectivity in evaluation. The Meeting is commissioned to conduct ODA evaluation and to report its results and recommendations to the Economic Cooperation Bureau of MOFA. Dr. Yayoi Tanaka, a member of the Meeting, Associate Professor Tokyo University, was in charge of this review.

Mr. Yasunori Fujita, Associate Professor, Keio University and Dr. Yoji Kunimitsu, Chief Researcher, Laboratory of Planning Evaluation, Department of Rural Planning, National Institute for Rural Engineering have made enormous contributions to this report. Likewise, cooperation was received from the Ministry of Foreign Affairs and the Japan International Cooperation Agency. We would like to take this opportunity to express our sincere gratitude to all those who involved in this review. The Aid Planning Division of the Economic Cooperation Bureau of the Ministry of Foreign Affairs was in charge of coordination. All other supportive work was received from Nomura Research Institute, Inc. under the commission of the Ministry of Foreign Affairs.

Finally, we should add that the opinions expressed in this report do not reflect the view and position of the Government of Japan or any other institutions.

March 2005

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## **I . Approach of this Review**

### **1. Background and Purpose**

Recent years, budget support has been prominent in the discussion of international donor communities. Some donor countries and organizations including United Kingdom have been actively promoting budget support to realize an efficient aid and to respect recipient countries' ownership, while others have a doubt in the effect of budget support. Japan is studying carefully whether to introduce budget support after having tried it in some cases.

Based on the background, this review was conducted on the purpose of; (1) clarifying the results and future challenges of the structural adjustment loans (SALs) and sector adjustment loans (SECALs) to contribute to the decision making on budget support, (2) ensuring accountability by publication of this review.

### **2. Object**

In Japan, the word "structural adjustment lending" is often used as synonyms of the World Bank's "adjustment lending", but the meaning is not clear. In some cases, it refers to SALs and SECALs. In others, sector program loans (SPLs) are included apart from these.

The review team set adjustment lending as a main objective and overviewed structural adjustment loans (SALs) and sector adjustment loans (SECALs) which were perceived as adjustment lending. The Poverty Reduce Support Credits (PRSCs) carried out in December 2004 was also referred.

### **3. Methodology and Limitations**

This review was carried out through 3 steps; (1) clarification of the object of this review, (2) overview of the object, and (3) simulations of the effects of PRSCs.

The review team tried to gather necessary information of SALs and SECALs such as titles, dates, amounts, countries, purposes, outcomes, conditionalities and the results of performance evaluation in 1986–2002. However, there were limitations as some programmes in 80's were too old to get information. The information of conditionality and the results of performance evaluation was basically closed to the public.

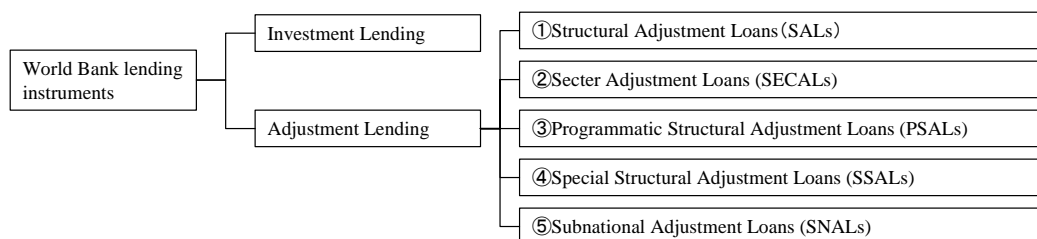
## II . Review of Adjustment Lending

### 1. Outline of SALs and SECALs

#### (1) Positioning of SALs and SECALs in Adjustment Lending

Adjustment lending was first introduced by the World Bank in 1980. The purpose was to help developing countries suffered from severe increase of financial deficit, deterioration of international balance of payment and severe inflation et al caused by 1979 oil shock, sudden rise in the international interest rate and inefficient resources distribution caused by inappropriate economic policy. Adjustment lending was originally designed to provide short-term finance to keep the balance of payments<sup>1</sup>. Then, it has changed its character as an important tool to support social, structural and sectoral reforms<sup>2</sup>. SALs and SECALs being important instruments of adjustment lending have different positioning and definitions in donor countries and institutions.

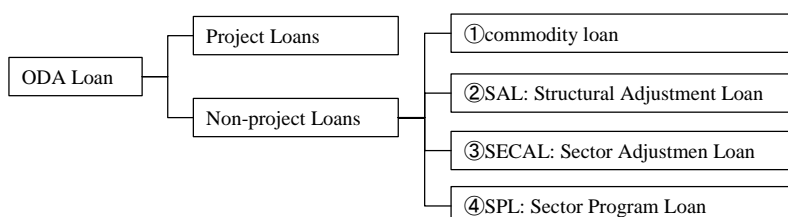
Figure 1. Positioning of SALs and SECALs in Adjustment Lending ( World Bank)



Note: By update of operational directive in August 2004, SALs, SECALs, PSALs SSALs and SNALs have been replaced to Development Policy Lending. PRSCs may continue to be called the same because this is a well established name.

Source: World Bank, "Adjustment Lending Retrospective Final Report", 2001, p.7,8.

Figure 2. Positioning of SALs and SECALs in ODA Loans (Japan)



Source: Ministry of Foreign Affaires

#### (2) Definition of SALs and SECALs

##### a. SALs: Structural Adjustment Loans

\* Please see figure 3.

SALs are designed to support economic structural reform in developing countries.

<sup>1</sup> World Bank, "Adjustment Lending Retrospective Final Report", 2001, p.8.

<sup>2</sup> World Bank, "Adjustment Lending Retrospective Final Report", 2001, p.23

Each country and organization has their own definition of SALs. Japan defines it as a loan to support economic policy and institutional reform in the indebted country. The resources are normally allocated to buy imported commodities and, where necessary, to consultancy services for implementing Structural Adjustment Programs<sup>3</sup>. The World Bank adopts the definition that SALs is designed to support reforms which promote growth, efficient use of resources and sustainable balance of payments in the medium and long term.

Despite of slight changes in accordance with the needs in the times, the purposes of SALs have been to reduce imbalances of payments in a short term and to improve economic structure and fundamentals in the medium and long term. SALs were introduced with an assumption that these purposes will be achieved by a promotion of free trade, financial structure reform, public sector reform, and finance sector reform based on the system designed by neoclassical economics.

SALs are normally provided by several tranches. The amount of the next tranche depends on the extent to which the conditionality attached is implemented. SALs' another feature is a policy dialogue between the donors and the recipient country.

#### **b. SECALs: Sector Adjustment Loan**

\* Please see figure 4.

SECALs were introduced by the World Bank in 1982. The purpose was to support sector-specific reforms<sup>4</sup>. The definition in Japan is that SECALs are designed to provide support for overall policy improvement and institutional reform in specific sectors. SECALs normally finance the purchase of imported commodities. In some cases, the resources are confined to buy imported goods and services necessary for the development activities in the sector. The World Bank mentions that SECALs supplement SALs by realizing detailed activities in the specific sector rather than overall economy<sup>5</sup>.

The purpose of SECALs is to support overall policy improvement and institutional reform in a specific sector. SECALs, like SALs, were introduced with an assumption of neoclassical economics where the purpose could be realized by mainly transition to a market economy in a specific sector.

In SECALs, as well as SALs, the conditionality is set after a policy dialogue and resources are provided by multiple tranches.

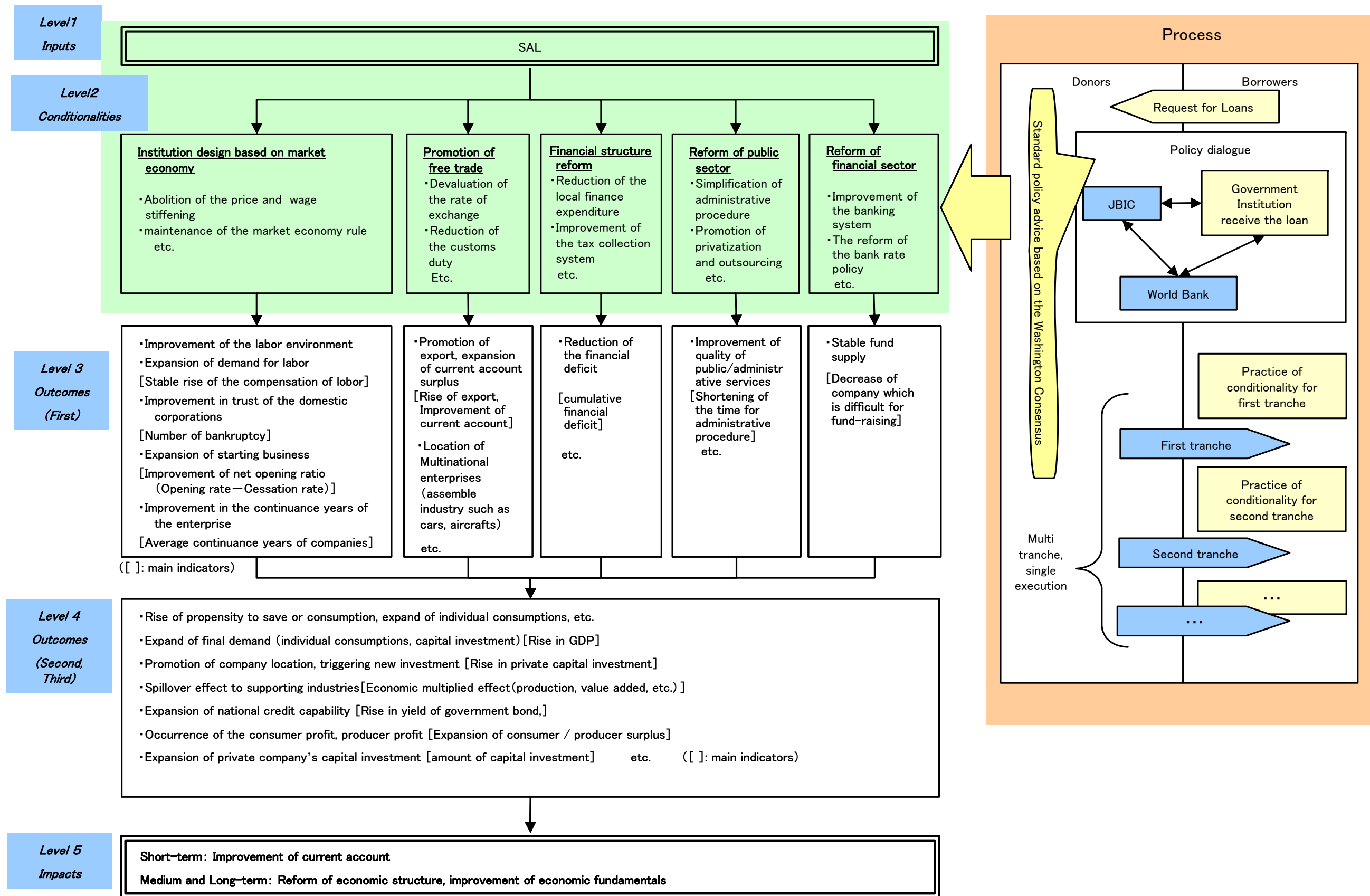
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<sup>3</sup> Ministry of Foreign Affaires.

<sup>4</sup> World Bank "Adjustment Lending Retrospective", 2001, p.viii.

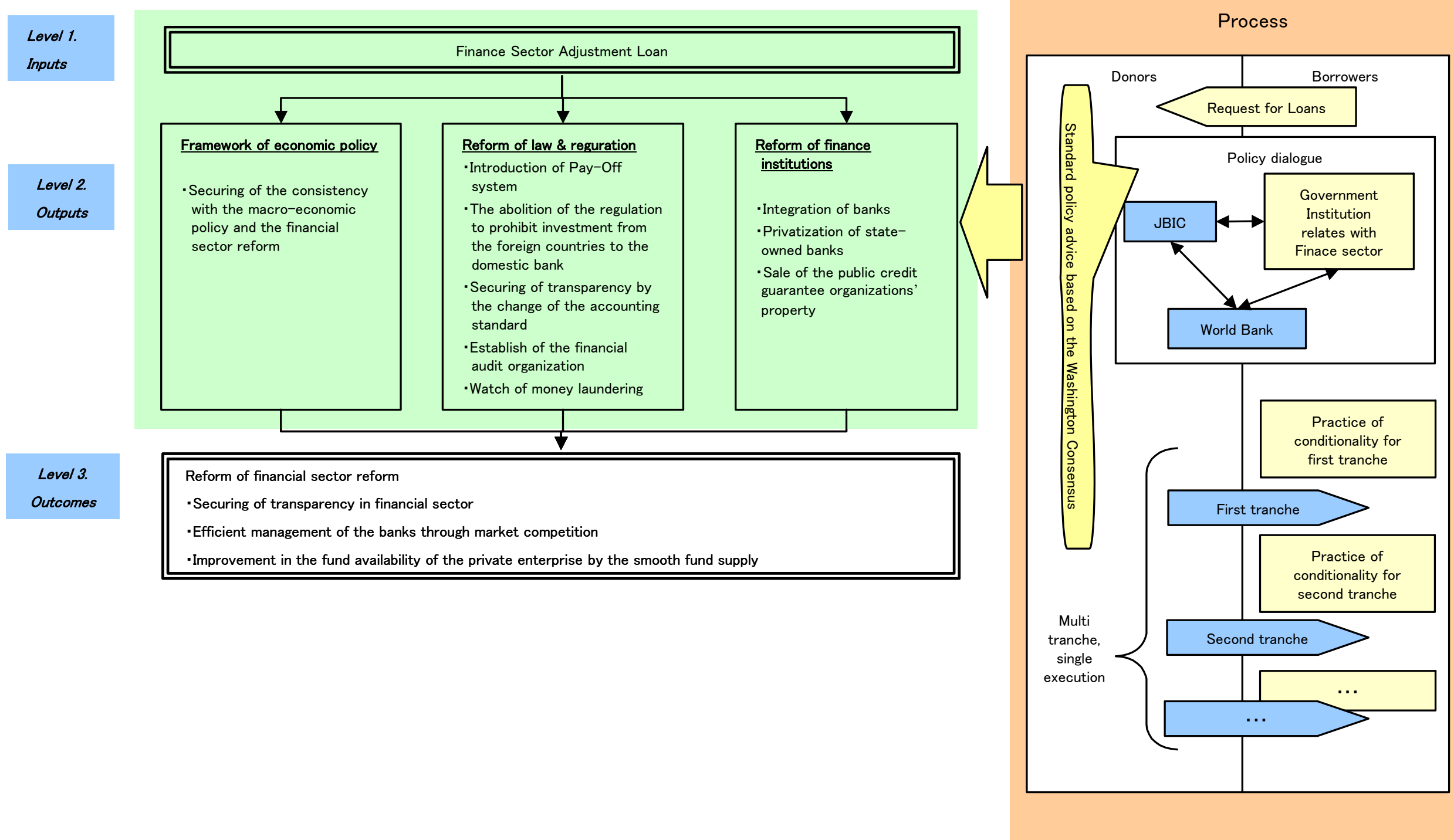
<sup>5</sup> Ministry of Foreign Affaires.

Figure 3. Logic Model of SALs



Source: Various Sources

Figure 4. Logic Model of SECALs (Finance Sector)



Source: Various Sources



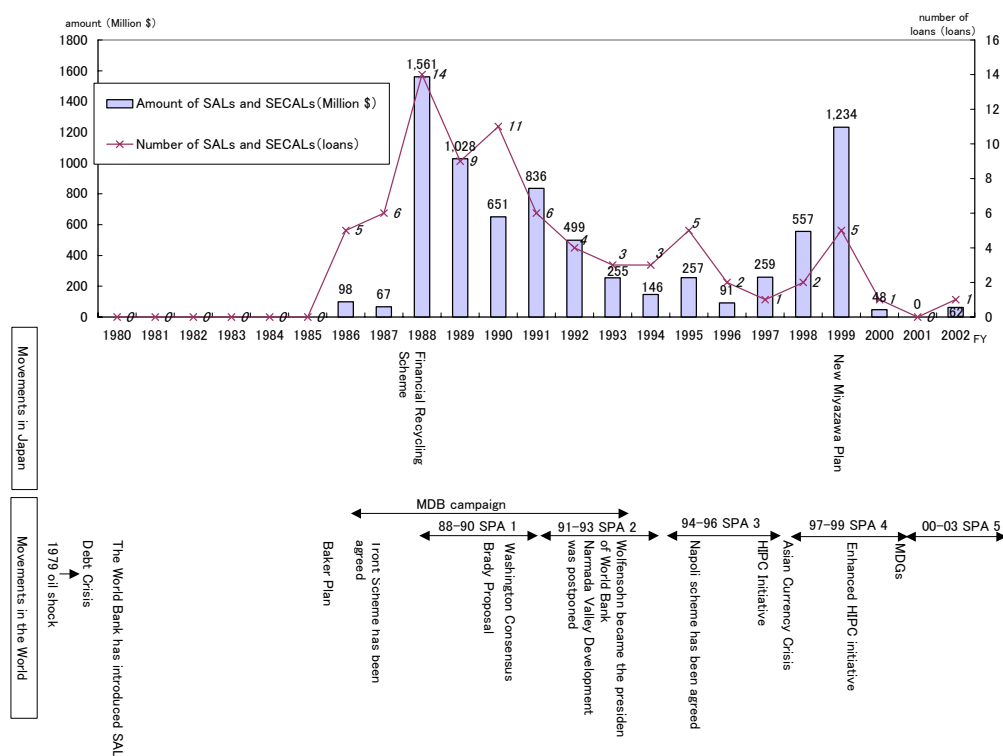
## 2. Trend of Japan's SALs and SECALs

### (1) Overall trend and background

Adjustment Lending was started by the World Bank in 1980. The original instruments were SALs and SECALs designed to help developing countries suffered from financial crisis caused by 1979 oil shock and sudden rise in the international interest rate. Adjustment lending is normally jointly financed with other donors. Japan is the biggest partner with the World Bank.

Japan started SALs in 1986 and had provided a total of 967.6 billion yen of 78 SALs and SECALs by 2002. The average amount of one programme is 12.4 billion yen.

Figure 5. Change of Japan's SALs and SECALs



Note: For converting Yen data to \$ data, used annual average of monthly spot rate released by the Bank of Japan.

Source: for the graph: Loan lists by JBIC and MOFA for the movements: various sources

Figure 5 shows SALs and SECALs reached a peak in terms of the number and the amount in FY1988 (14 loans, about 200 billion yen). At that time, adjustment lending was utilized in a series of international supports because of the severe problem in international balance of payment in many developing countries. “Baker Plan” and Special Program of Assistance for Africa (SPA) established as a support framework for Africa were major reasons for the high level disbursement of SALs and SECALs. It is assumed that Japan increased its SALs and SECALs along with these international movements.

During the first half of 1990s to 1996, SALs and SECALs showed slow decline in terms of the number and the amount. In the background, there would be a rising criticism against the failure of structural adjustment to achieve the original purpose. The expansion of debt relief and decrease of needs in Asia were also related to the trend.

In 1997, Japan increased SALs and SECALs again, and most resources were directed to Southeast Asia such as Indonesia, Philippines, Thailand and Vietnam in the background of the currency crisis started in Asia in 1997.

After 2000, SALs and SECALs have been decreased in the light of mitigating Economic crisis in Asia and increasing focus on poverty reduction.

In August 2004, the World Bank updated operational directive and renamed SALs and SECALs to Development Policy Lending so that its financial instruments could be more focused on social development. The Ministry of Foreign Affairs in Japan has taken PRSCs and general budget support into careful considerations and has started PRSCs for Vietnam in December 2004. Thus, the focus of support is shifting from structural adjustment loan to poverty reduction strategy today.

## **(2) Trend in instruments**

There is no special trend in the proportion of SALs to SECALs. These numbers and amounts were roughly equal during 1986 to 2002.

On the other hand, the World Bank approved more SALs than SECALs in first half of 1980s. The trend reversed in the latter half of 1980s. Then SALs became bigger again after 1997. There seems to be 3 factors for the trend in the second half of 1980s; (1) recipient countries' unaffordable transaction cost caused by the multiple conditionality<sup>6</sup>, (2) the change of priority from adjustment of overall macro economy to a specific sector<sup>7</sup> and (3) the characteristic difference that SALs were required to attach IMF's Stand By Arrangement while SECALs were not<sup>8</sup>. The increased needs for cross-sectoral adjustment loans after the outbreak of currency crisis in Asia would be a cause for the trend after 1997<sup>9</sup>.

## **3. Trend in the purpose and conditionality**

### **(1) Trend and background**

In order to analyze the trend, review team temporarily categorized the purposes of Japan's SALs and SECALs into 4 categories: (1) support for balance of payment, (2) support for economic and industry sector reform, (3) support for public sector reform and

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<sup>6</sup> Mosley, Paul, et al., *Aid and Power: The World Bank and Policy-based Lending Volume 1*, 1995, p.43, para.3.

<sup>7</sup> Nicholas, Peter, "The World Bank's Lending for Adjustment", 1988, pp.13-17.

<sup>8</sup> Mosley, op. cit., p.43, para1.

<sup>9</sup> World Bank, op. cit., (2001), p.9, para.2, l.7.

(4) support for social development. When a loan programme has more than 1 purpose, it is classified into other category of support which has multiple purposes.

The review team examined 35 loan programmes, in which detail information was available, in three periods of 1980s, 1990–96 and after 1997. In 1980s, most of them had single purpose such as balance of payment support or economic and industry sector support. From 1990 to 96, the programmes aiming to support for public and social sector development increased in addition to that for the economic and industrial sectors. After 1997, the programmes which account for the major share were of multiple purposes such as payment support, economic and industry sector support and social development support.

In the background of the trend in the late 1980s, there were needs for the resources disbursed quickly in a short term decrease imbalances of payment in the recipient countries. The idea of neoclassical economics which seeks small government was another reason for the trend.

In the early 1990s, the purpose of macro economic policy support remained to be centered in accordance with Washington Consensus<sup>10</sup> while some programmes for social development support were adopted in the light of many criticisms against adjustment lending.

After 1997, the programmes with multiple purposes became eminent to meet various needs. The currency crisis in Asia in 1997 demanded resources disbursed in a short term. It was widely accepted that the support to vulnerable people was necessary.

## **(2) Trend in conditionality**

Conditionality, which is achieved by the recipient countries to make disbursement, is perceived to reflect the purpose and intention of a loan programme. It is therefore necessary to grasp the trends of conditionality to analyze SALs and SECALs. In this review, 37 programmes available to the review team were examined.

In the analysis, conditionality attached to the programmes was categorized into sectors with reference to the World Bank's classification mentioned in Adjustment Lending Retrospective. The sectors were further put into 3 broad groups; (1) macro economy, (2) social development and (3) public sector reform.

In the late 1980s, there were many conditions related to macro economy such as financial sector, economic policy and private sector. Then, the conditionality of social development and public sector has gradually increased.

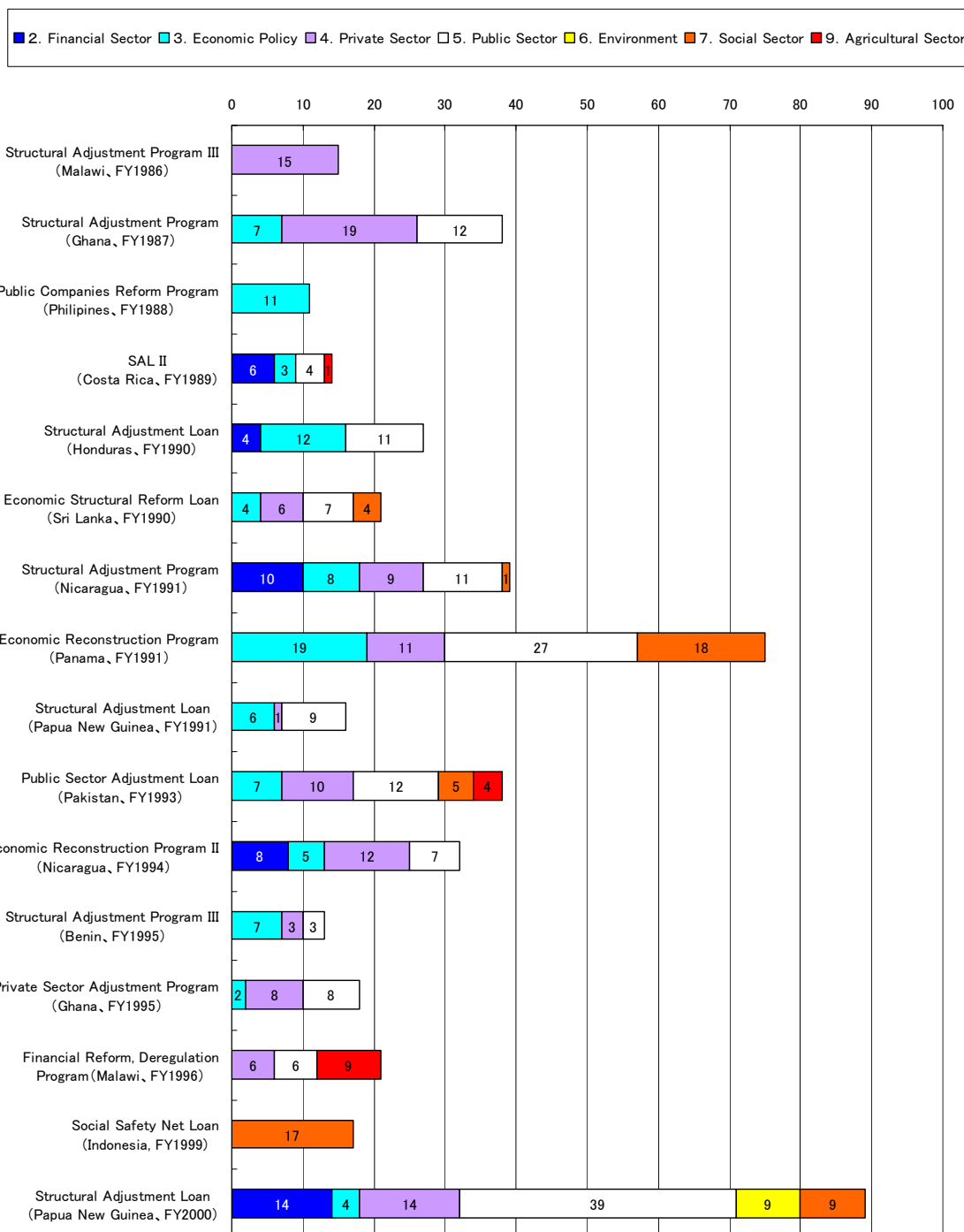
When we look at single loan programme, the attached conditionality was related to the

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<sup>10</sup> Washington Consensus is a summary of economical adjustment policies by J. Williamson in 1990. He made it to summarize the main opinion in Washington D.C.: US Ministry of Finance, FRB, the World Bank and IMF). It includes 10 instruments like trade liberalization, privatization, etc.

small number of sectors such as macro economy including private sector and economic policy et al in the 1980s. Since then, the number of conditionality has increased to 4 or 5 sectors. It was observed that a loan programme became designed to support for several sectors.

Figure 6. The Structure of Conditionality in each SALs (number of conditionality)



Source: Loan lists by JBIC and MOFA

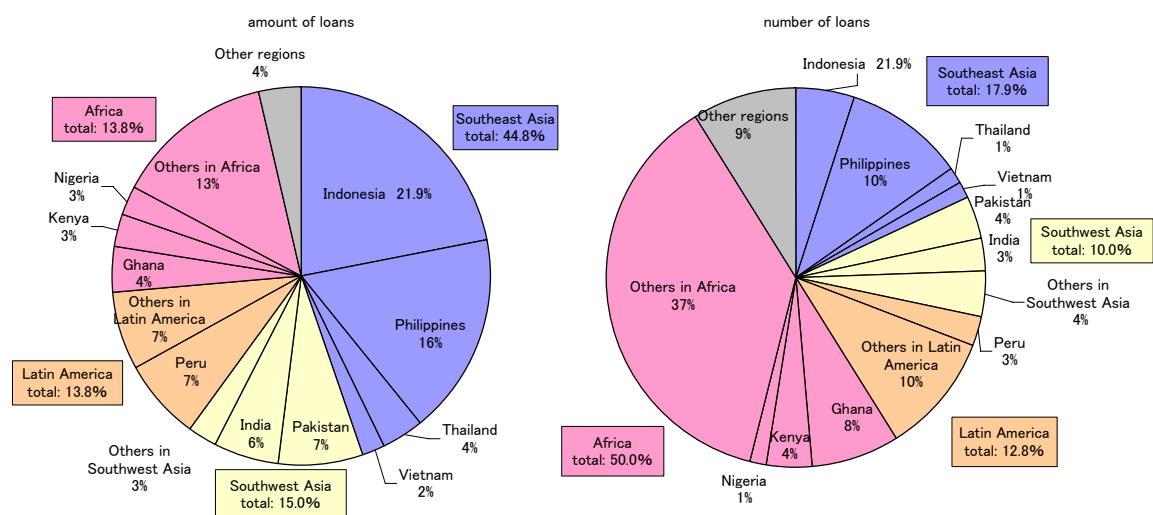
#### 4. Trend by countries and regions

##### (1) Overall Trend

Figure 7 shows the regional trend of Japan's SALs and SECALs that 44.8% is directed to Southeast Asian countries and 22.6% to African region. In each region, the loans were directed to a few countries in which the economy and poverty were not as serious as others. It is said that the programme is selected on the basis of the request from recipient countries. However, this study could not clarify the core principles and criteria to choose a programme if there are different programmes requested by these countries.

On the other hand, the World Bank directed its resources to the countries in Latin America, Southeast Asia and the former East Europe where currency crisis and serious imbalance of payment had happened.

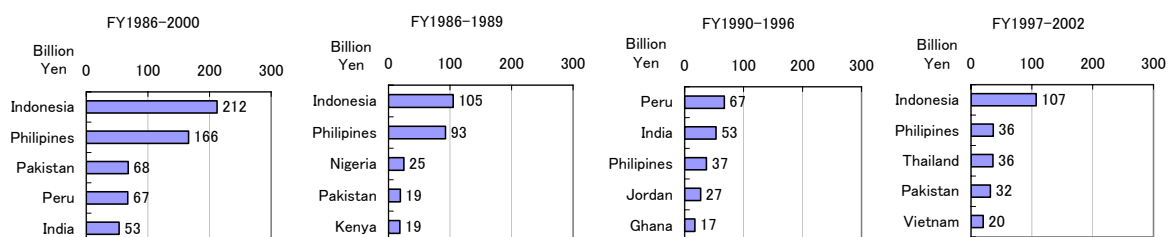
Figure 7. Structure of Borrowers of Japan's SALs and SECALs.  
(Loan agreement commitment, FY1986-2002)



note: Countries' names are pointed out whose component ratio is more than 2.5% in amount of loans. (except Vietnam which is only one country whose component ratio is less than 2.5% in Southeast Asia.)

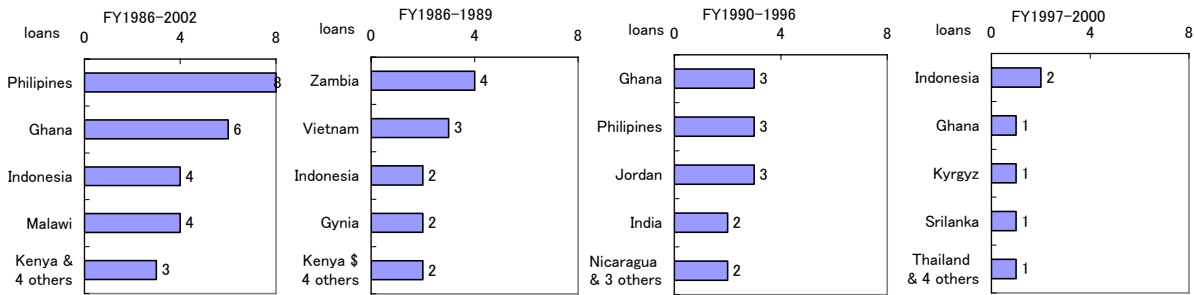
Source: Loan lists by JBIC and MOFA

Figure 8. Top Borrowers of Japan's SALs and SECALs (billion Yen)



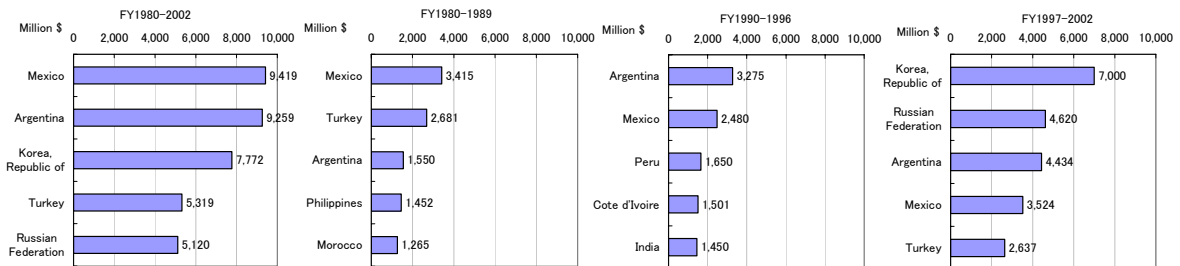
Source: Loan lists by JBIC and MOFA

Figure 9. Number of Japan's SALs and SECALs by Country (Top 5)



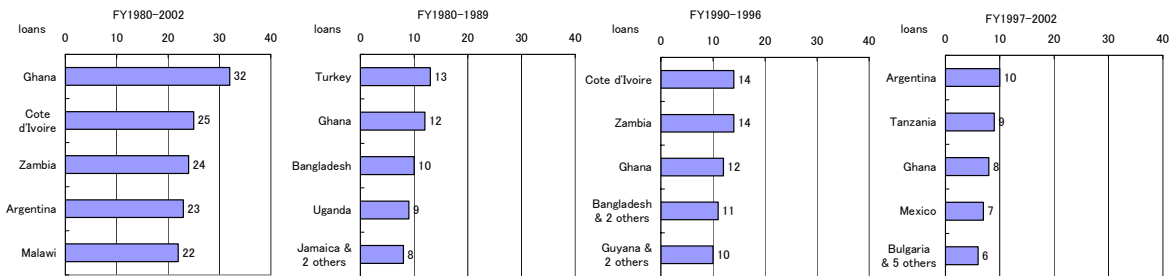
Source: Loan lists by JBIC and MOFA

Figure 10. Top Borrowers of the World Bank's SALs and SECALs (million \$)



Source: Project database in the World Bank website

Figure 11. Number of the World Bank's SALs and SECALs by Country (Top 5)



Source: Project database in the World Bank website

### III. Quantitative Analysis (Case in Viet Nam)

#### 1. Purpose

This analysis by the macroeconomic model was conducted to assess the extent to which PRSCs's spillover effects on activities in each sector, social capital, national economy and poverty reduction.

- (1) To rebuild the PRSCs logic model through an assessment of the system in which PRSCs have spillover effect on the macro economy and poverty reduction.
- (2) To give broad suggestions for PRSCs in the future through an assessment of which sector is the most effective to the poverty reduction.

## **2. Limitations and Risks**

This is a trial and supplemental analysis although there are following limitations and risks.

(1) There are some opinions that policy supports and conditionalities should be integrated into the model as variables to assess the effects of PRSCs properly. However, this study adopted the amount of the governmental investment as input because quantitative measurement of these variables was difficult. The purpose of this analysis is to figure out the effects of the investments toward the economic development and the poverty reduction in different sectors.

(2) This analysis was carried out with only 9 year time-series data. However, it is assumed that 9 samples are too short to conduct the regression analysis. This model has a risk that the causal links are explained by simply tracking the effect or the correlation of variables.

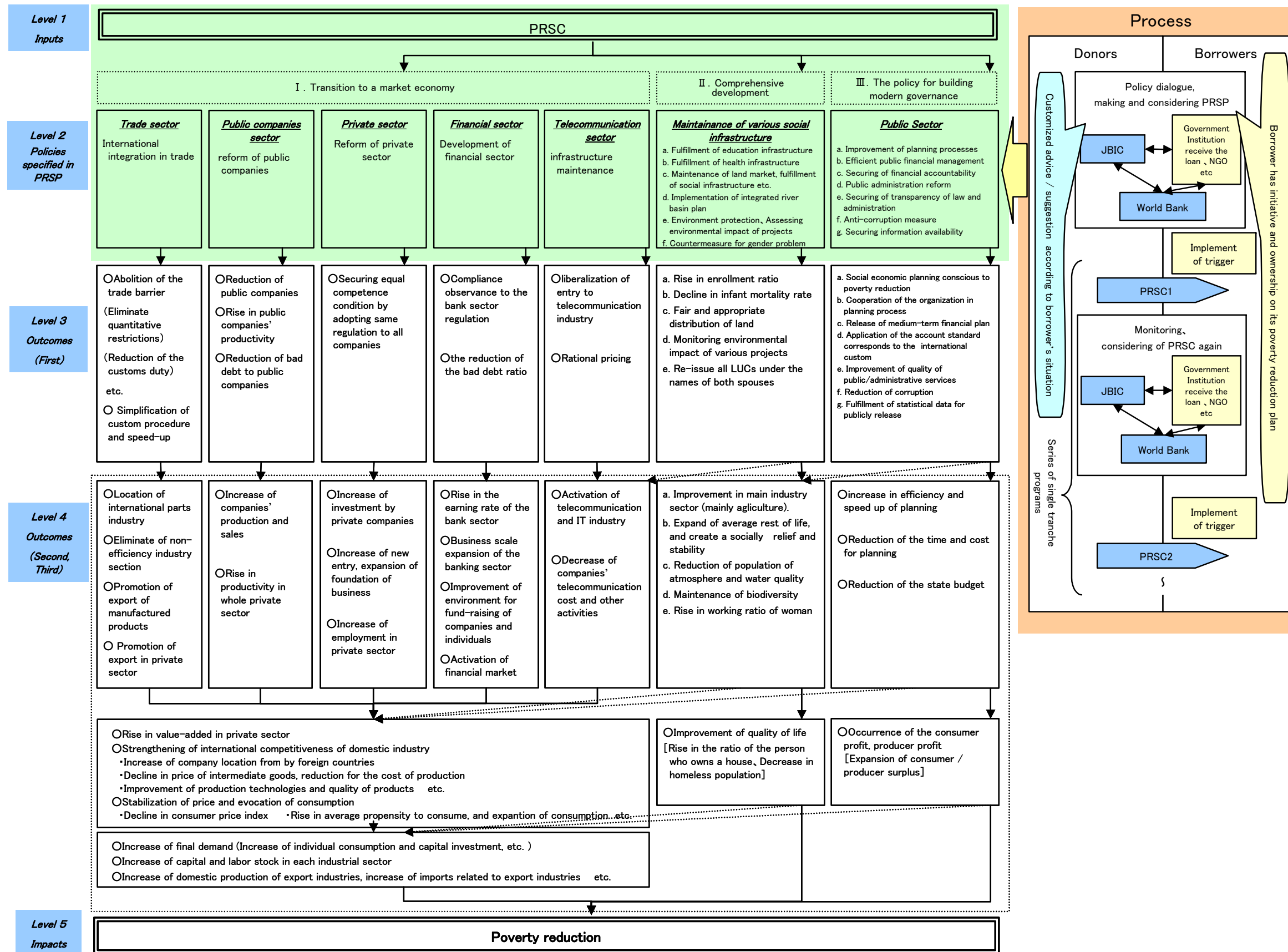
## **3. Concept of this analysis**

This quantitative analysis traced the path of effects of PRSCs in four levels shown in its logic model in figure 12.

## **4. Result of a Sensitivity Analysis**

A sensitivity analysis assesses the effects on the outcome (GDP related) indicators and the social development indicators (demonstrated in MDGs). As a result, it was found that the sectors effective to social development are not necessarily the same as those to the GDP growth. This result shows that financing PRSCs would not automatically result in the poverty reduction through the GDP growth brought by social capital accumulation including infrastructure and the human capital such as teachers or doctors. It is suggested that the support for the social infrastructure and financial sectors are needed to contribute to the poverty reduction apart from the economic sector.

Figure 12. Logic model of PRSCs



Source: Ministry of Foreign Affairs, the World Bank



## IV. Issues in SALs and SECALs

### 1. Three Issues

Several issues concerning adjustment lending have been raised since the 1980s. These issues can be roughly classified into following 3 categories<sup>11</sup>:

- (1) Criticisms on theories: the basic conditions implicated in neoclassical economics do not fit with realities in developing countries.
- (2) Criticisms on the social aspects: structural adjustment has negative impacts on the social aspect in recipient countries, especially on vulnerable people.
- (3) Criticisms on the operational issues: the approach and attitude of donor countries and institutions are coercive.

### 2. Response to issues in SALs and SECALs

Based on the analysis, the conditionality related to social development increased especially in 1988–94 though it was attached before 1988. Despite of the limitation that this review does not examine the operational aspects, result, effect and impact of conditionalities, it was observed SALs and SECALs has been putting greater emphasis on the social sector year by year. In this sense, criticism on the social sectors was taken into considerations.

### 3. Response through a new policy support instrument: Development Policy Lending

The World Bank renamed SALs, SECALs, and other adjustment lending instruments to Development Policy Lending in August 2004. One of the main instruments of Development Policy Lending is PRSCs (Poverty Reduction Support Credits), which were introduced by the World Bank in May 2001 to support recipient countries' implementation of PRSP (Poverty Reduction Strategy Paper). Major differences between PRSCs and adjustment lending are shown in table 1. PRSCs are expected to respond to the criticisms on the social aspect and operational issues.

However, there remains a question about the operational issues. It is pointed out that PRSCs might have so called moral hazard issue. Even though the attached conditionality in one tranche is not fully implemented, the resources in the next tranche are sometimes disbursed. It is hardly to say that PRSCs can mitigate the problem if it is provided repeatedly to the recipient country.

<sup>11</sup> This grouping method is based on Shimomura, Yasutami et al., *ODA Taiko no Seiji-Keizaigaku (The Political Economy on Japan's ODA Guideline)*, 1999, pp.22–25.

Table 1. Major differences between SALs/SECALs and PRSCs

	Traditional Adjustment lending	PRSCs
Initiative/ Ownership	The World Bank, the IMF and other development partners mainly lead the policy formation	Focus on borrowers' initiative / ownership based on PRSP. Harmonized support by partner countries
Policy framework of the World Bank	Standard policy advices are given based on the Washington Consensus	Customized recommendations in accordance with borrower's circumstances
Focus point	Emphasis on the short-run macro economy. The main policy goals are stabilization, liberalization of market and trade, privatization, and promotion of the private sector.	Emphasis on structure, society, and institution in Medium-term: distribution of social services, framework of regulations, public sector management, governance, and capacity building.
Loan formation	<ul style="list-style-type: none"> <li>• Multi tranche, single execution.</li> <li>• Ex ante, and not flexible conditionality</li> <li>• Monitor implementation of conditionality</li> <li>• Not coordinated with the domestic budget cycle</li> </ul>	<ul style="list-style-type: none"> <li>• Consecutive execution of single tranche programs, based on the medium-term policy framework.</li> <li>• Ex post, and flexible conditionality as triggers</li> <li>• Emphasis on the result, monitors the outcome</li> <li>• Tries to coordinate with domestic budget cycle</li> </ul>
Participation of stakeholders	Dialogue between the World Bank and the recipient government	Not only government but also other stakeholders: NGOs etc. takes part in the dialogue

Source: JBIC

#### 4. Issues in the Future

##### (1) Operational Issues from the Review of SALs and SECALs

###### a. Making clear policies on PRSCs

In this study, review team tried to feature the political decision made by the Japanese government as well as international events in the background of the trends of Japan's SALs and SECALs. However, information of government policy was hard to access in many cases. In addition, Japan's share of the total amount of co-financed programme could not be estimated. The review team could not reach the information of criteria by which the portions of the amount between donors are decided.

Japan has been asked to have more strategic ODA and to play an active role in PRSP. Japanese government needs to set clear conditions when utilize PRSCs as a tool of budget support so that necessary information for evaluation can be collected.

###### b. Stabilization on Macro Economy and Poverty Reduction

The purpose of PRSCs is designed to support development policy while pursuing stabilization of macro economy. Then, 2 questions arise here.

First question is about customization which accounts for the difference between PRSCs and adjustment lending. PRSCs could make the support policies for development appropriate to the country situations. However, it is not clear that PRSCs intend to formulate a policy in accordance with the levels of development or the political, social and cultural characteristics in the recipient country.

Second question is causal link between macro economics growth and poverty reduction. The logic model of PRSCs (figure 12) sets the final goal of poverty reduction

at level 5 and the precondition of economical and social stabilization at level 4. Is it true? This question is related to the criticism on theories of adjustment lending, which says the basic conditions implicated in neoclassical economics does not fit with reality in developing countries. The past experiences have shown that trickle down hypothesis<sup>12</sup> cannot explain how to benefit the poor people in the recipient country. Although PRSCs have various conditionalities aiming at reforms in policies, institutions and governances as well as support for vulnerable people, it is not clear whether these conditionalities can unite or synergize with macro economic policies.

## **(2) Issues for Future Research**

This research was conducted to review the results of the past adjustment lending and could be a base of detailed researches for evaluation and policy formulation in the future. The issues for future research are the effect and policy formulation of adjustment lending as well as management system of budget support.

### **a. Assessment of the effect of adjustment lending**

The original purpose of adjustment lending was to improve international balance of payment in a short term. Then, conditionality regarding structural reforms has been adopted to improve economic fundamentals so that sustainable balance of payment can be realized in the medium term.

Hence, it is useful to analyze whether the medium term goals of structural adjustment are achieved. The effectiveness of conditionality is worth to be assessed. It is also interesting to examine whether structural adjustment has negative or positive impact on poverty reduction. These research and analysis should be conducted in both qualitative and quantitative manners.

### **b. Investigation that Support Policies**

This review tried to grasp the overall trend of Japan's SALs and SECALs and provided basic information to design future policies. It is, however, difficult to say the information in this report is enough. The process of decision making and the trend of political will are not fully described. The information of those issues together with the effectiveness of these loans will make this review more useful in formulating assistance strategies and policies. Further research should focus on the decision making on the basis of the data collected in this study.

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<sup>12</sup> "Trickle down" is a hypothesis that if a developing country gets over shortage of capital stock and economic growth continues around the modern sector, its outcome would permeate to the whole economy in the country through market mechanisms without governmental intervention. After that, as even if economic growth had occurred, poverty problems weren't solved, so it has been criticized that economic growth itself wouldn't bring a profit to poverty people.

### **c. Research of management Issues of New Modality including PRSCs**

There are issues to be addressed in the new modality such as PRSCs. The greater emphasis is placed on consensus between donors and recipient country in the management of PRSCs. The increased number of conference causes to high transaction cost. It is also necessary to keep specialists since highly technical knowledge is demanded in the process of PRSCs. These issues in the initial and implementation phase need to be addressed.

PRSCs are based on the result based management in which donors and the partner country participate in monitoring and evaluation. The methods are being developed for more effective evaluation under the data constraints in the recipient country. It is necessary to clarify the effectiveness and improvement of these methods.

PRSCs put an emphasis on other issues of fiscal budget system and customization. Specialists and officials pointed out the needs to research and analyze the extent to which the conditionality reflects the recipient country's culture and society. The extent to which moral hazard is mitigated should be put into careful analysis.

### **5. Direction of the PRSCs from quantitative analysis**

From the quantitative analysis, it is observed that an investment in a specific sector which contributes to GDP growth is not automatically related to the poverty reduction. Social development indicators would be improved by the investment in other sectors such as agriculture, electric, gas and water, health and education et al. These results of the quantitative analysis implicate that economic growth is not directly related to the poverty reduction despite of the expectation in the logic model.

It is also clearly observed that concentrate funding in a specific sector has greater effects than equal funding towards several sectors. Hence, the investment should be directed prior to the sectors which have great influence on social development indicators including poverty reduction.