

CHAPTER

I

INTRODUCTION

The current approach of the Asian Development Bank (ADB) to program lending¹ was introduced in 1987. The approach adopted signified a shift from the financing of imported inputs aimed at increasing capacity utilization to an emphasis on sector policy reforms to facilitate growth and development. Over the period 1987–2002, ADB supported 136 programs loans, accounting for 21% of the cumulative total of all loan approvals. Throughout, ADB carried out periodic reviews of program lending performance.² The reviews show that policy-based lending complements project financing and is a necessary development instrument. However, analyses in support of ADB policy-based operations indicate scope for further improvement in their relevance and effectiveness.

In 2001, ADB's Operations Evaluation Department (OED) completed [a special evaluation study of program lending](#), identifying several key aspects of program design and implementation needed to achieve successful outcomes (ADB 2001). These include: first, the need for sufficient

sector diagnosis to understand the contextual concerns of policy changes; second, improved ex-ante assessment of likely impacts of policy reforms and related analysis of the adjustment and related costs; and third, the requirement for institutional capacity building, before, during, and after the implementation phase of policy reform.

Policy changes relate to market and institutional reforms and address the economy- or sector-wide causes of structural constraints and under-performance. This has two key implications. First, since these reforms alter the underlying framework that governs the behavior of different stakeholders, stakeholders' responses to policy changes must be taken into account in policy analysis. Second, once a policy-related constraint is removed, another limitation becomes the next "binding constraint." In this sense, policy reform involves a process of removing sequential binding constraints. So, the various features of policy reform present a challenge and demand careful and comprehensive analysis.

Understanding of the nature and dynamics of policy change and institutional reform has evolved over time. The literature indicates the different stages in this evolving process in terms of the "generations" of reforms (Brinkerhoff and Crosby 2002). Broadly, first generation reforms include macroeconomic stabilization and parametric policy changes such as price liberalization. Structural policy and underlying market and institutional changes are the second generation. The approach to policy-based lending is also changing. Issues such as civil

¹ Program lending incorporates ADB's present lending modalities of program loans, sector development program loans, and cluster program loans. The term "program lending" refers to ADB's support for developing member countries to carry out a program of policy reforms and institutional changes. However, program lending modalities have evolved to include projects with policy and knowledge product components that often address policy issues. This volume uses the term "policy operations" and "policy-based operations" for policy-related lending and nonlending activities.

² ADB. WP 2-90: A Review of the Bank's Program Lending Policy, March 1990; R143-96: Review of the Bank's Program Lending Policies, July 1996; and R210-99: Review of ADB's Program Lending Policies, November 1999.

participation and country ownership are becoming essential elements of policy-based operations. This evolving understanding reinforces the need for more systematic policy and institutional analysis.

Recognition that policy reforms often involve a dynamic process indicates the need for a flexible built-in mechanism in design and implementation, with involvement of affected stakeholders. It also highlights the fact that the principles and good practices of sustainable policy reform are still evolving and have a strong learning content. So, from the policy analysis standpoint, the ex-ante analysis needs supplementing with effective monitoring and evaluation during and after the policy changes.

The present study provides a systematic exposition of key aspects of the economic analysis of policy operations for practitioners. It continues the operations-related research of ADB's Economics and Research Department (ERD) to address the above policy analysis concerns as they relate to operations (see Bolt and Fujimura 2002, Abonyi 2002). The study emphasizes the *relevance* and *feasibility* of policy changes (Abonyi 2002). *Relevance*, in this context, refers to the responsiveness of policy changes to specific characteristics of development issues in a country or sector setting. *Feasibility* refers to designing a policy change to be consistent with the specific context and prevailing circumstances, including its likelihood of contributing to improved country performance. It draws on policy operation practices within ADB and elsewhere,³ and contains case studies that help illustrate ways to conduct policy analysis. The focus is on issues common

to all sectors, rather than on individual sectors.

Chapter 2 begins by providing a macro-meso-micro perspective and emphasizes the importance of understanding the macroeconomic context for policy-based operations. This is to ensure the consistency of sector policy changes within the overall macroeconomic policy framework. Chapter 3 addresses the sector diagnosis that underpins policy operations and stresses the comprehensive sector diagnosis on issues relating to policy, institutions, and investment as the basis for preparing program lending. The linkage between reform and development is discussed. Key aspects of market and institutional reforms are elaborated upon. Issues of timing and sequencing of policy changes and the political economy of reforms are discussed.

Chapter 4 outlines analytical approaches and tools for assessing policy reform and highlights how they can be appropriately applied with regard to issues such as feedback effects, data availability, and human resource capacity. Chapter 5 focuses on the poverty impact and distribution implications of policy changes, and discusses current refinements in ADB

³ The background analysis to the paper draws on a variety of materials: (i) an in-depth examination of 10 program loan reports or reports and recommendations of the President (RRPs) (see Appendix 1); (ii) examination of the approaches to adjustment cost estimation from 30 other RRP; (iii) the special evaluation report by OED (ADB 2001); and (iv) ADB policy reviews on program lending. It also draws on discussions with ADB staff and consultants. In addition, reference is made to the relevant work from other international agencies, especially the International Monetary Fund (IMF) and the World Bank.

practice. Chapter 6 brings intertemporal and distribution aspects together to help understand the costs of reform and political economy considerations.

Chapter 7 addresses the implications of analytical dimensions for program loan design, including the need to build internal coherence between ex-ante impact analyses, the program logical framework, and the program policy matrix; the importance of monitoring and evaluation; and issues in loan release conditions.

The study emphasizes practical and systematic ex-ante analysis of policy reform in terms of context, process, and outcomes, rather than the implementation of policy operations. It also recognizes the existence of methodological and data limitations for such ex-ante analysis. This recognition stems from the uncertainty prevailing in the policy reform process. The range of analyses presented should be carried out not just in the context of program loan processing, but also as part of ADB's regular country and sector policy and institution studies, country strategies, country economic reports, and other economic and sector work.