

# Emerging Practices in Policy-Based Lending

- Policy-based lending, known as **program lending** in ADB, was introduced to help **developing member countries** address **balance of payments** difficulties. Over the last thirty years, its use has widened to help improve incentives, enabling environments, and institutions, and more recently **public resource management**.
- At end-2006, program lending had absorbed 24% of ADB's total public sector lending. Does experience bring good practices to light? Can ADB's program lending policy be improved?

## Background

Program lending entails tranching, fast-disbursing funds and ex ante **conditionality**. The Asian Development Bank (ADB) introduced this lending modality in 1978 to address deficits in the balance of payments. In the 1980s and into the 1990s, it was used to strengthen institutional and policy environments. Later, the **1997 Asian financial crisis** invited a focus on the causes of the meltdown. Commencing 2001, it has dealt ever more with public resource management.

As of end-2006, a total of 184 program loans in 31 countries had been approved for an aggregate \$23.9 billion from **ordinary capital resources** and the **Asian Development Fund**, or \$19.2 billion and \$4.7 billion, respectively. Forty three percent of the total amount supported operations in the finance sector. Programs in the law, economic management, and public policy, and agriculture and natural resources sectors made up 19% and 12%, respectively, of lending.

From 1987 to 1995, program lending totaled \$3.4 billion. Major clients included **Bangladesh, India, Indonesia, Pakistan, and the Philippines**. In the wake of the Asian financial crisis, large loans were provided to the **Republic of Korea** (which borrowed \$4 billion for the **Financial Sector Program**), **Indonesia, and Thailand**. Program lending to Pakistan, Philippines, and **Sri Lanka** also increased. From 2001 to 2006, program lending to Pakistan rose more than fourfold compared to the period 1996 to 2000, almost tripled in the case of India, and doubled in that of the Philippines,

to which a new **Development Policy Support Program** is being extended.

In 2007, the Operations Evaluation Department of ADB conducted a **Special Evaluation Study on Policy-Based Lending: Emerging Practices in Supporting Reforms in Developing Member Countries**.<sup>1</sup> The study built on the **Special Evaluation Study on Program Lending** produced in 2001 and was planned as an input to the review of ADB's program lending policy by ADB's **Strategy and Policy Department**. (ADB regularly updates its **policy and strategy papers**. The policy was reviewed in 1983, 1987, **1996**, and **1999**.)

The study adopted a meta-evaluation approach that drew from program performance evaluation reports; further analyzed recent evaluation reports using **Good Practices for the Evaluation of Policy-Based Lending by Multilateral Development Banks**; updated program lending success rate statistics; and reviewed external evaluations of policy-based lending and general budget support. The study was informed by the **2003 Annual Review of Development Effectiveness** of the **Independent Evaluation Group** of the **World Bank**, which focused on support for policy reform. It also leaned on **Toward a Political Economy Approach to Policy-based Lending** and **Economic Analysis of Policy Based Lending: Key Dimensions**, two works of ADB's **Economics and Research Department**.

## Summary of Findings

Program completion reports and program performance evaluation reports have been prepared for 101 program loans up to 2006. Of these, 51% were rated

"successful", 46% "partly successful", and 3% "unsuccessful". Performance has improved since the disappointing results achieved by program loans approved in the 1980s and early 1990s. Of those approved after 1996, 69% were rated "successful". Finance sector program loans had a success rate of 74%. Law, economic management, and public policy program loans had a 61% success rate. Success rates in the agriculture sector were lowest (28% successful or above and 72% partly successful). There is a need and demand for institutional and policy reforms in the agriculture sector, although issues are often challenging.

Factors within ADB's influence that contributed to desired results included (i) consistency of reform outcomes with government reform agendas and priorities, (ii) sufficient analysis and dialogue, (iii) well-targeted reforms and policy change consensus among decision makers and stakeholders, (iv) coherence of program design and policy matrixes, and (v) focused and manageable conditions that were acted upon before program start-up. Factors within ADB's influence that detracted from results were (i) insufficient consideration of macroeconomic and wider sector policies, (ii) lack of counterfactual analysis and poorly understood outcomes and policy alternatives, (iii) complex designs with many tranche release conditions, (iv) weak implementing agency capacity, and (v) failure to identify or manage key direct and indirect costs.

Factors outside ADB's influence, but providing an opportunity for favorable results, were (i) stable country economic, social, and political contexts; and (ii) complementary macroeconomic and institutional reforms beyond the boundaries of programs. Factors that threatened reform programs were (i) negative changes in the broader market and policy environment; (ii) complementary macroeconomic and institutional reforms that did not occur; (iii) changes of government, policy swings, and conflicting interests that stalled reforms; and (iv) wavering government commitment.

The **Adjustment Lending Retrospective** carried out by the World Bank in 2001 prompted a shift from adjustment lending to a development policy approach that supports structural, social, and institutional reforms over the medium term linked to country assistance strategies. The World Bank is using fewer and more process-type conditions with a results focus, especially in **International Development Association** countries. The World Bank does not limit the proportion of its total annual lending used for development policy lending.

A 2006 **Evaluation of General Budget Support** by the **Organisation for Economic Co-operation and Development** cautions that aid agencies are actors in political systems, not just an external influence. A sensible role would include stepwise changes involving dialogue, conditions that are consistent with poverty reduction support programs, use of a longer term approach, and consistency with country capacity. The evaluation noted that general budget support has been effective in strengthening public finance management, planning and budgeting, and budget transparency and accountability, and in bringing aid agency funds on-budget.

## Recommendations

A range of good practices and policy and procedural considerations are recommended to improve ADB's program lending performance:

- Make sure the link between the intended outcome of a program loan and the use of associated funds is clear.
- Clarify operational guidance on program lending to encourage country ownership and alignment with partners' strategies in line with the Paris Declaration on Aid Effectiveness.
- Clarify the use of conditions ensuring judicious use that helps reformers to manage the process, not control it.
- Continue to strengthen understanding of the results chain in program lending.
- Review and consider relaxing the 3-year 20% (22.5% for loans from the Asian Development Fund) moving average ceiling for program lending value to bring it in line with developing member country needs and demands for program lending.

## Feedback

When these *Learning Curves* were prepared, **ADB Management's Response** and the **Chair's Summary of the Development Effectiveness Committee Discussions** were not available for disclosure to the public. The study was completed in August 2007.

<sup>1</sup> ADB. 2007. *Special Evaluation Study on Policy-Based Lending: Emerging Practices in Supporting Reforms in Developing Member Countries*. Manila. Available: <http://www.adb.org/Documents/SES/reg/policy-based-lending/EVU-OTH-2007-18.pdf>