

6 Linkage to Policy- Based Lending

It is worth noting that project ideas emerge from sector-level work and the proposed project should address some type of constraint identified in a sector-level analysis, which cannot be addressed if left to private sector activities. Logical framework requires that projects be identified to improve sector economic performance for the benefit of the entire economy. When in some cases project identification is based on inadequate sector-level analysis or project formulation is based on unclear economic justification, the process of project economic analysis can proactively raise policy issues. For example, the extent of difference between financial and economic prices (and therefore the consequences for estimates of FIRR and EIRR) usually implies something fundamental about the nature of the policy environment

within which the project is being prepared (ADB June 1999). If such difference can be traced to either sector-level and economy-wide policy or institutional anomalies (that hinder efficient workings of the economy), there may be room to address the former within the project design (e.g., removal of state monopoly in a particular project input or output market) before the full investments take place. Or alternatively, in consultation with the counterpart government, consideration can be given to resorting to sector development program modality with a policy loan component. The project analyst should examine whether the project's envisaged benefits could be jeopardized by the current policy and institutional environment and whether this should be addressed through policy-based interventions including high-level policy dialogue. The early findings from a separate EDRC study (Bolt and Fujimura 2001) point to the importance of political economy process in assessing links between policy-based lending and poverty reduction.