Comments on Policy-Based Lending at the Inter-American Development Bank, 2005–2019

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The Office of Evaluation and Oversight (OVE) at the Inter-American Development Bank (IDB) has produced a crisp, candid, and well-structured evaluation of IDB's policy-based lending (PBL). The report presents many carefully drawn out, relevant, and interesting results. The authors deserve congratulations.

The chapter, which largely reflects the findings of a review of PBL that OVE undertook in 2015, is divided into two sections. The first neatly summarizes facts regarding the evolution of PBL and its use by borrowing countries since its introduction at IDB in 1989. The second assesses PBL along several dimensions (based on well-focused findings), including the reasons why countries demand PBL; complementarities between PBL and other IDB operations; and issues in design and implementation of PBL operations. The chapter provides recommendations for possible amendments to IDB policy-based bending.

The analysis part of the chapter is strong when it comes to findings, but it falls short when interpreting the implications of such findings for IDB and borrowing countries. These comments will therefore elaborate on these and raise a few other questions and issues.

1. Main Comments

The chapter should from the outset have more frankly recognized that there are potential tensions between the reasons why countries demand PBL, on the one hand, and what multilateral development banks (MDBs) expect to obtain by offering PBL, on the other.

The chapter provides significant evidence that borrowing countries' use PBL mainly to fill their budget financing needs rather than to intensify high-impact reforms. MDBs do recognize that financing needs are at the heart of the demand for PBL but point to policies and reforms as the main rationale for offering PBL. Reforms are highlighted by MDB staff when justifying a PBL before their Boards of Directors. Efforts to align these two motivations drive PBL preparation and design. These efforts succeed at times, but not always.

It is not surprising that, using a creative analytical approach, the OVE evaluation found that most conditions in PBL were of low- to medium-depth, i.e., they tended to involve one-off and easily reversible policy measures, to be process-oriented, or to contain good policy intentions that are not operationalized for implementation. The OVE evaluation stressed that conditionality in PBL "was generally relevant to the programs' objectives" yet it clarified that such conditionality "was probably insufficient to attain the expected outcomes." Or, to put it differently, "most conditions … helped set in motion policy reforms but could not by themselves effect lasting institutional changes." These findings have important implications, which are discussed below.

Adjusting Multilateral Development Bank Expectations for Policy-Based Lending

The findings of the OVE report should lead MDBs to adjust expectations downward, toward more realistic levels. PBL operations do not simply "buy" reforms, as is often believed. At best, PBL provides needed budgetary financing while recognizing (and helping fine-tune and strengthen the technical aspects of) reforms that would have been attempted by the country *with or without the PBL*. At worst, PBL operations over-sell and exaggerate the importance and depth of the conditions (reforms) on which they are based.

Nevertheless, the rise in policy-based program loans (PBPs) can be interpreted as a major step towards greater realism and frankness in policy-based lending. PBPs have accounted for the lion's share of IDB-originated PBL since 2005 (see Figure 2.2 in the IDB OVE's chapter). Wisely, PBPs do not pretend to "buy reforms." Instead, they move away from "conditionality" in that each single-tranche loan in the program recognizes and gives credit to the country for policy actions and reforms that have already happened.[1] Future reforms appear only as indicative guides for future tranches under the multi-year program but do not condition the big upfront disbursement associated with the single-tranche in question.

As a result, PBPs address the tricky question of "ownership" (a key issue that is not discussed in the chapter but should have been) while avoiding the time inconsistency trap of traditional PBL operations, where countries under duress agree to conditions (reforms) that have a low probability of being met (because the incentives to stick to the conditions diminish after the PBL is approved and the first disbursement comes in). However, PBPs can lead to marginal or low-depth reforms, cooked up in a hurry by country authorities under the stress of large financing needs, and thus are quite vulnerable to being truncated after the first single-tranche loan has been disbursed. The OVE evaluation found that 38% of PBPs approved since 2005 had been interrupted, with a higher incidence of truncations where loans are approved during times of changes of government.

Related to the question of ownership is the crucial question of whether PBL or PBPs can realistically be expected to generate policy additionality. Given the difficulties in identifying a counterfactual, it is difficult to attribute policy reforms to PBL or, equivalently, to reject the hypothesis that those policy reforms would have taken place even in the absence of PBL. This calls for modesty on the part of MDBs, whose role is not so much to tell countries what to do, but to partner with countries in their quest for social and economic progress, which includes partnering in the process of reform design, implementation, and evaluation. In any case, the chapter should have discussed more fully whether, how, and to what extent PBL promotes country ownership of reforms. This is crucial to avoid situations where a country engages in reforms without conviction but only to get the loan. The chapter should have tried to tease out from the data the counterfactual of whether reforms would have been adopted in the absence of PBL.

In any case, to mitigate the mentioned downsides (low-depth reforms and truncation) of PBPs, a premium must be put on a continued and robust technical engagement and policy dialogue between the MDB and the client country. This is particularly important considering a number of important findings in the OVE evaluation, including that: (i) "IDB tends to support policy reforms in sectors in which it had previously worked (usually through technical cooperation grants and investment loans) and thus has some country-level expertise that allows it to sustain a policy dialogue and provide relevant technical advice;" and (ii) "there was a significant positive relationship between technical cooperation support and the likelihood of a PBP series being completed."

In other words, the reform impact and non-truncation of PBPs hinge directly on the quality of the policy dialogue that an MDB maintains with client countries and the quality of knowledge services the MDB provides. This is a point that is insufficiently highlighted in the chapter.

[1] **IDB can put some pressure on a country to achieve certain reform milestones as a prior condition for approval of the single-tranche disbursement.**

This point also argues in favor of not evaluating PBL (or any particular financial product offered by an MDB) in isolation, but in context, i.e., taking into account the entire portfolio of services the MDB offers to its client countries (including financial services, knowledge services, and convening services). The chapter could have been enhanced by relying on such a more contextualized or portfolio approach to the analysis of PBL. In the end, evaluating PBL in isolation may lead to biases in the assessment of MDB value added to development. It should be rather argued that the whole of an MDB engagement in a country (via a portfolio of financial services, technical assistance services, policy dialogue, and convening services) is likely to be larger than the sum of its parts.

PBL and Market-Based Finance

The findings in the chapter raise questions about the complementarity and substitutability of PBL and market-based finance. This is an issue that the chapter does not address but should have. One hypothesis is that, in countries with strong macro-financial policy frameworks, PBL is complementary to market-based finance—that is, these countries use PBL as part of their prudent management of the portfolio of public sector liabilities. In countries with weaker macro-financial policy frameworks, the hypothesis would imply that PBL is a substitute to market-based finance—that is, these countries resort to PBL because they do not have access to market-based finance. The chapter should have explored this hypothesis and elaborated on the implications of what it finds in this regard.

Limits to the Countercyclical Role of Policy-Based Lending

The findings in the chapter invite a richer discussion of the limits to the countercyclical and systemic liquidity functions of PBL. The chapter finds a mild countercyclical pattern: PBL has been negatively correlated with GDP growth. However, it quickly clarifies that "the instrument's ability to affect macroeconomic conditions in these countries was limited by the small size of the loans in relation to their overall economies." The leverage limits faced by MDBs (and the associated need for MDBs to retain their high ratings) lead to caps on lending to individual countries. Hence, the chapter should have more frankly recognized that MDBs are not set up to act as international lenders of last resort. That is a function left to the International Monetary Fund (IMF). This should dampen down the wrong, yet widely held, expectation that MDBs can be major players in countercyclical lending and emergency (systemic) liquidity assistance.

The limits to countercyclical lending by MBDs do not, of course, invalidate the prescription (which the evaluation should have highlighted) that MDBs must avoid unduly procyclical lending. In other words, MDBs need to avoid the tendency to join markets in lending copiously and euphorically in good times, which is necessary for MDBs to keep firepower available to provide considerable budget support (via PBL) in bad times. At the same time, the fact that bad times can facilitate a push to reform may play in favor of MDBs in times of crises, even if their countercyclical impact is limited.

2. Other Comments

The chapter notes the intriguing fact that, starting around 2005, IDB policy-based lending ceased to formally depend on the IMF's assessment of a country's macroeconomic viability and can now rely solely on the views of IDB's own Independent Macroeconomic Assessment Unit within the Research Department. This move is interesting considering that the World Bank tried a similar route but then abandoned it, after a bad experience in Argentina. Have there been specific situations of tension in IDB PBL operations, where the Research Department's assessment of macroeconomic viability was at odds with that of the IMF? If so, how were those tensions managed? In any case, strengthening an MDB's capacity to conduct systematic macroeconomic viability assessments—independently or in coordination with the IMF—is particularly relevant given the coronavirus disease (COVID)-induced surge in debt across the world.

Given the need for MDBs to cooperate with the IMF, especially in large, emergency financing packages, the chapter should also have examined the extent to which the policy reforms featured in PBL are incorporated as structural benchmarks in IMF-supported programs.

The chapter should have shown not only PBL disbursements (flows), but also PBL stocks. This would have helped shed light on the relevant question of whether much of the PBL activity is essentially refinancing (disbursements that compensate for amortizations falling due) rather than increases in exposure. In fact, one wonders why MDBs tend to focus so much on disbursement flows and to pay little attention to exposure (stocks). This question deserved at least a footnote in the chapter.

Do burden-sharing and bailing-in considerations play any role in PBL? I assume that IDB is not indifferent to situations where its loans are used by a country mainly to pay (or bail out) private or bilateral external creditors in times of sudden stops or reversals in capital flows. Are there any IDB policy guidelines in this respect? If not, shouldn't such guidelines be developed?

The fact that budget financing needs, rather than balance of payments needs, are the dominant driver of PBL demand deserves further assessment. This seems to invalidate the traditional view of MDB lending as a means to close a country's external financing gap. The chapter should have offered a well thought out discussion of why the external financing motive for MDB lending seems to have vanished, at least in normal times. A likely answer would point in the direction of the rising international financial integration of emerging economies.