

## Joaquim Vieira F. Levy's Presentation

### **Brazil Experience**

I will try to give the practitioner's perspective and will raise some issues on conditionality regarding both the IMF and the World Bank that are important for countries in the stage of Brazil. I will also discuss some of the challenges to make our relationship with the World Bank consistently meaningful in the future.

Paul Collier mentioned in his presentation that in some countries an external shock due to, e.g., falling commodity prices, could ruin several years of reform efforts. In the case of countries like Brazil, similar problems can be caused by capital flows. Brazil is strongly committed to free capital flows but they can generate very large tides and can create turbulences and disturbances that can be mixed with the direct effects of policies. As a result, the outcome may become very hard to judge by both experts and voters on the street. Thus, because, when judging performance of countries, it is always important to consider also external factors in addition to domestic policies, multilaterals should strive to devise instruments to reduce the risks that external shocks can impose on developing countries that have otherwise adjusted economies and policies.

One of the key issues for Brazil is how to have conditionality and facilities that could respond to the potential problems resulting from big changes in capital flows due mainly to external reasons. When we experienced a sharp contraction in flows in 2002, we developed an effective arrangement with the IMF, but that was an ad-hoc construction. Looking forward, it is critical to design structured facilities, especially for Middle-Income Countries (MICs), with conditionality that ensures quick and effective financial support.

### **IMF Program Conditionality**

Brazil certainly supports the streamlining of IMF conditionality. We have had, especially in the last three years, a quite successful relationship with IMF. This relationship has been based on IMF streamlined programs focused on the basics, i.e., on safeguarding IMF resources. In addition, the IMF did not try to use structural conditionality to impose a predetermined reform agenda.

Mr. Lula's government is strongly committed to reforms and has move forward in many key areas. Some of the elements of reforms, mainly the ones related to core areas of the IMF, gradually became part of the IMF program. Other elements were left outside of the program because, despite their importance, they were not related to core areas and we strongly believe that we should never try to hide behind the Fund to advance our reforms. We have to do what we believe is important. Although the dynamics of operating in a non-crisis situation can be sometimes different from operating in a crisis situation, the principle can find broad application.

In the context of discussions about outcomes, Brazil has been quite adamant never to promise things that do not depend only on the executive branch. In a democratic system, in order to ensure the right functioning of programs, the government should not commit on behalf of other branches, even when it has a majority in congress.

By well functioning program I mean the kind of results Brazil had in the last few years. Brazil had no need for waivers or other artifices to accommodate under-performance and try to make the program look well. In the contrary, Brazil over-performed in many cases, especially in the key areas. One of the key areas is fiscal, and when the new government came into power in 2003, it went to the general public and later to the Fund, and said that, based on its calculations, the primary target should be somewhat raised. Of course that meant additional efforts, especially in a year of low economic activity in the wake of a 5% of GDP adjustment of the external sector. However, it paid off, and fiscal discipline with a view to reduce the debt burden is at the core of other economic policies now.

Looking further back, it is noteworthy that, starting back in 1999 with inflation targeting, trust on the part of the Fund has served well both parties. Dropping quantitative monetary targets and stick to inflation targeting was an important innovation in the context of a program. It paid handsomely to Brazil, which has been able to keep inflation under control and overcome the huge external shock of 2002 without disorganizing its economy. It also proved effective to the Fund, as I am sure the Fund has learned from this experience and has considered applying it elsewhere. This has also helped change the perception of the Fund by the society and opened the way to the discussion—on a structured fashion—of issues such as how to protect and promote high-return investments in the face of strong budget constraints.

Looking ahead, it is important to assess whether the 2000 Conditionality Guidelines toward streamlining conditionality have been really implemented, before evaluating if they have achieved their goal and proposing any change in course. Our substantive recommendations for IMF conditionality are: program design should be adjusted to avoid the serious issue of blackout periods; the use of prior actions, as a modality of conditionality, should be limited to a minimum; there should be no conditionality in areas that diminish the odds of program implementation; there should be no conditionality associated to policy initiatives or structural measures that unnecessarily corner country authorities, e.g., stiff targets for variables that depend essentially on market demand; under certain preconditions, financing for public investment in infrastructure should be accommodated under program fiscal targets; and further discussions on the greater use of outcomes-based conditionality should be carried out before enshrined.

### **World Bank Conditionality**

Some of the issues and recommendations above are relevant also for the World Bank. In particular, minimizing the use of prior actions and other coercive mechanisms is fundamental to ensure the development of a trust-based relationship. Conditions and conditionality have to be adapted to the situation – sensitivity is very important for the success of programs in any country.

Of course, there are good news. Apparently, there is growing recognition that the Bank's new policy for policy-based lending should ensure a unified policy framework, although leaving room for customization in the context of the Country Assistance Strategy (CAS). Programs' analytical underpinnings are being strengthened, as they should be. Also, our

experience shows that it is very important that the expected total volume for a borrower should be determined in the CAS. This is beneficial for the borrowers because it enables better planning of financial and personnel resources for the administration of programs. The central role of the CAS is quite compatible with a need to have a good policy dialogue with the government, and we certainly support the strengthening of this understanding.

The following examples from the last two or three years illustrate the possibility of success in some of the issues discussed on conditionality. The first example is a programmatic loan for the electricity sector agreed with the previous government. Electricity is an extremely complex sector, and the beauty of the relationship with the Bank in this area was the fact that, although there was an important contribution from World Bank staff, there was also, from the beginning, a clear understanding that these were complex issues and nobody had a complete answer. The loan conditionality emerged from rigorous analytical work, but it was geared towards providing clear support to changes already achieved in a difficult environment. The trust of the Bank on the appropriateness of the policy choices was expressed by a big disbursement in addition to technical assistance. The results included not only high performance, but also the success in avoiding a rupture by the new government. This is for me one of the good experiences of real partnership with the Bank yielding results many years after the program is signed.

The second example is the more recent SWAPs in social areas. In this case, the understanding of the hard fiscal constraints of the government and trust in the improved design and control mechanisms of new social programs were critical. In many cases, if the World Bank just comes with a new project involving a lot of new spending, it is not supporting our policy and reform—given the serious budget constraints all levels of government face in Brazil. In this case, we had to develop a mechanism that would allow a meaningful participation of the World Bank, so that it could bring all the best it has, without going against the core aspects of the general policy. The new mechanism relies on national fiduciary and safeguard systems that take advantage of existing mechanisms in World Bank programs (e.g., reimbursements), but conform to general policies in Brazil. It provided means for the Bank to participate in an innovative program of high visibility, granting the way for the Bank to contribute to the improvement of the design of government initiatives, while learning the complexities of a large-scale transfer-cum-requirement program, and reinforcing the macroeconomic framework of the federal government.

The third example is sub-national loans. The key here is the understanding of fiscal constraints of sub-national governments, which are typically cash hungry and often debt burdened. So, it is clear that programs can happen only where sub-national governments can afford additional debt. On the other hand, where the existing debt dynamics allows, programs should support investments or social reform with minimum financial requirements from the counterpart—thus providing an effective source of cash for states that have little other access to liquidity.

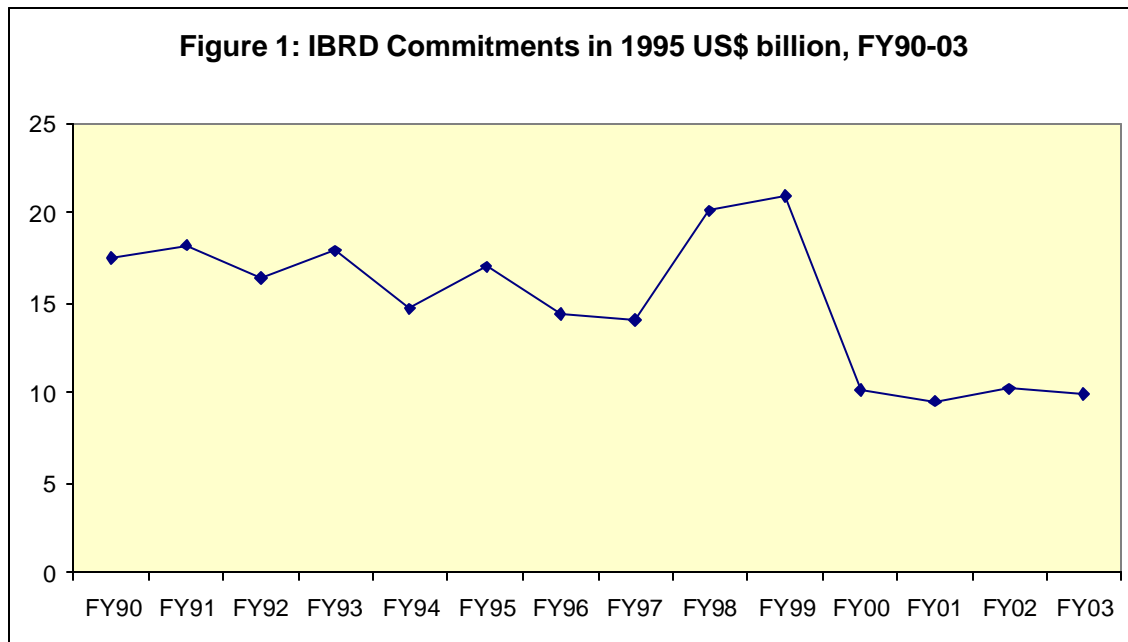
The fourth example is from the sensitive area of the Environment. It again shows the importance of trust. This is an example how conditionality has worked in Brazil. A recent programmatic loan has a significant disbursement based on the mutual agreement that what has been already achieved is meaningful and in the right direction, and that it is

the result of a policy effort of the government. Then, of course, we laid out the expected path for the future. However, this is not conditionality in the standard sense – it is a common view. The resulting policy matrix supports the achievements and priorities of the present administration—recognizing existing constraints and letting the government to chose its actions according to the circumstances. In the future, we are going to come together and assess what has happened and see if both sides are happy. If this is the case, we may repeat the process, having a new loan based on what may have been achieved so far. This is mainly a process of building confidence and exchanging experiences, and, if one can call this conditionality, I would say it shows a constructive approach to conditionality.

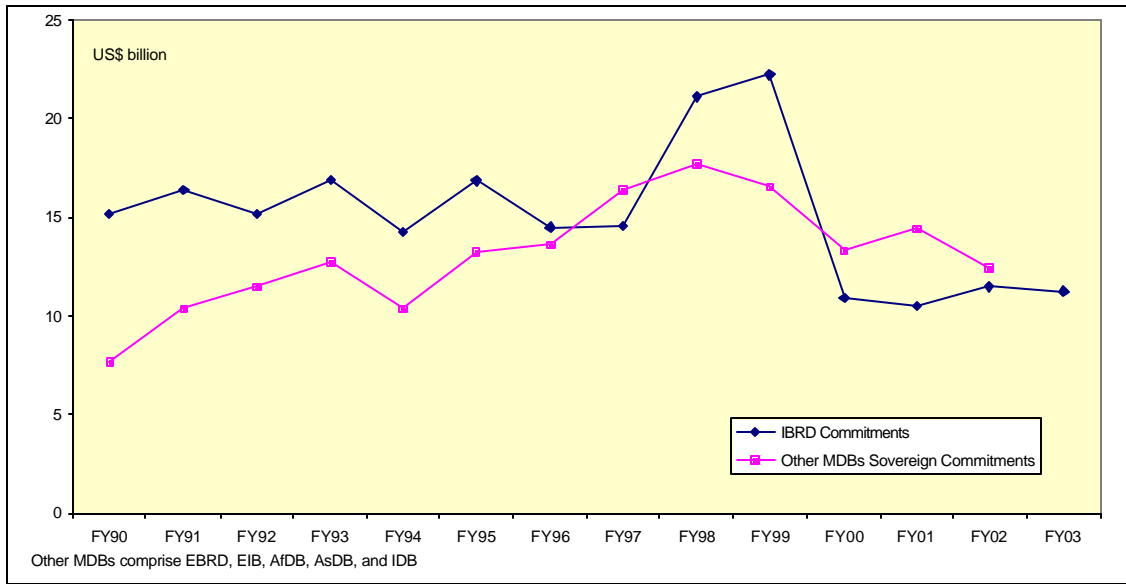
Of course, although the experience of Brazil is more applicable to middle-income countries, some aspects may be applicable to lower income countries as well. In particular, the boundaries between incentives and coercion may in some cases be blurred, especially if a country administration is very weak (e.g., on technical terms) vis-à-vis multilateral institutions and donors in general. In this case, special care has to be taken to avoid risks those imposing conditionality be trapped on narrow or self-righteous views, as it could do more harm than good, especially if attitudes and operational approaches fail to acknowledge the numerous factors and conflicting incentives often faced by authorities in small and poor countries. These factors, all too often, transcend domestic boundaries and reflect powerful economic forces elsewhere.

### World Bank Support to Middle-Income Countries

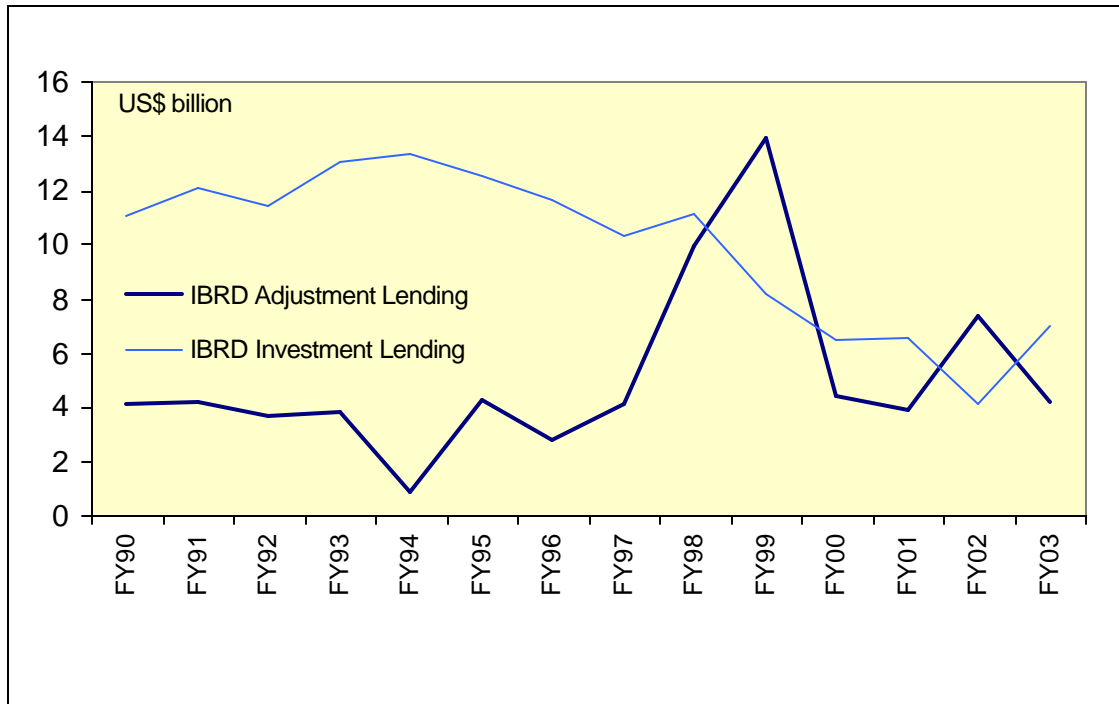
World Bank total lending to this group of countries has undergone a significant decline (26% in nominal terms) – from an average of \$15.7 billion per year in FY90-97 to an average of \$11.6 billion per year in FY00-03 (see Figures 1-3).



**Figure 2: IBRD and Other MDBs Commitments, FY90-03**

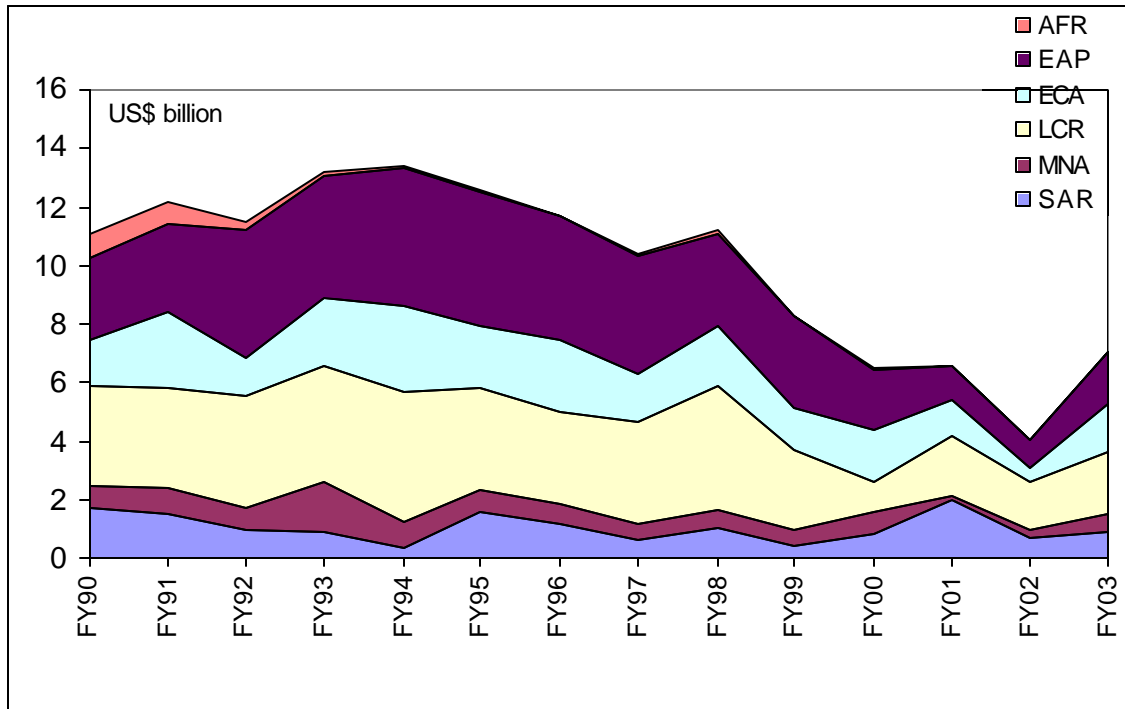


**Figure 3: IBRD Adjustment and Investment Lending, FY90-93**

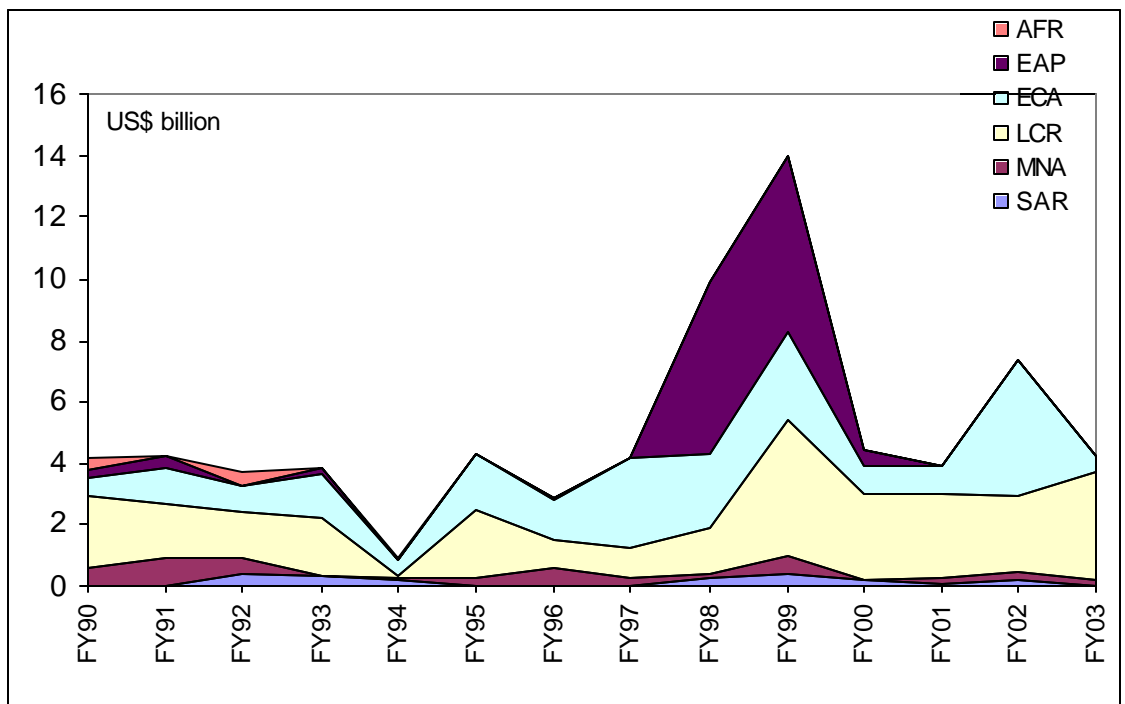


Since the mid-1990s, investment lending declined in all regions except South Asia, with the greatest decline in East Asia. It also dropped in all sectors, except education and health, with infrastructure being the most affected (see Figures 4-7).

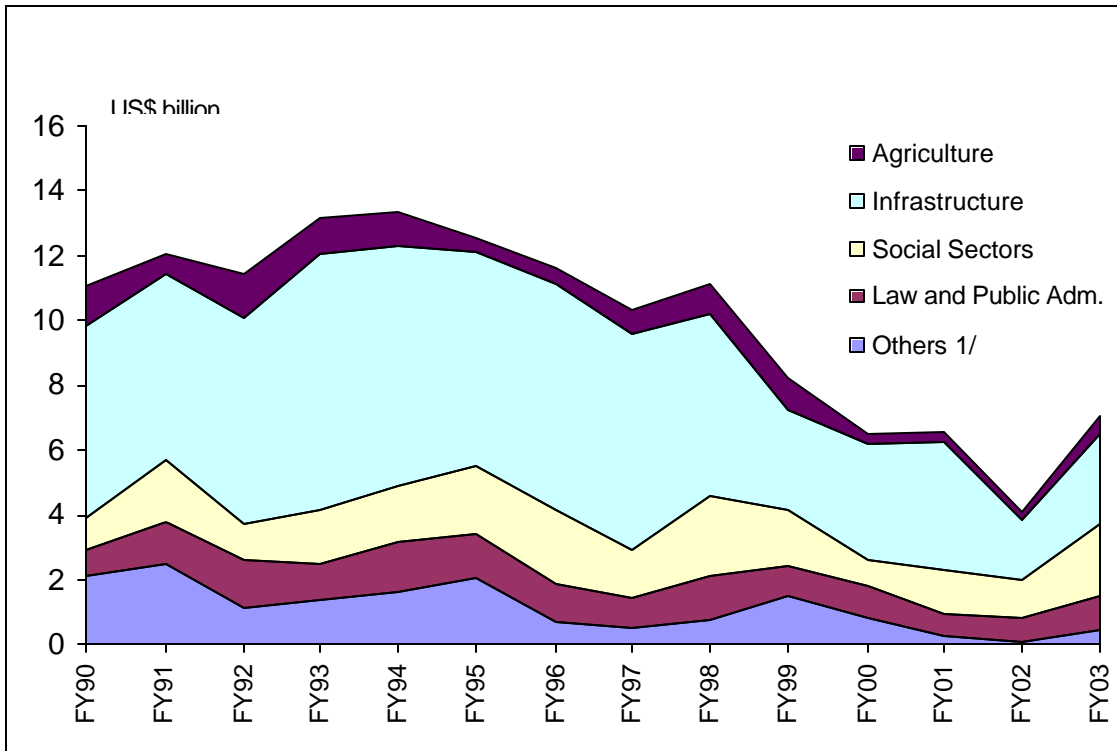
**Figure 4: IBRD Investment Lending by Region, FY90-03**



**Figure 5: IBRD Adjustment Lending by Region, FY90-03**



**Figure 6: IBRD Investment Lending by Key Sectors, FY90-03**



**Figure 7: IBRD Adjustment Lending by Key Sectors, FY90-03**

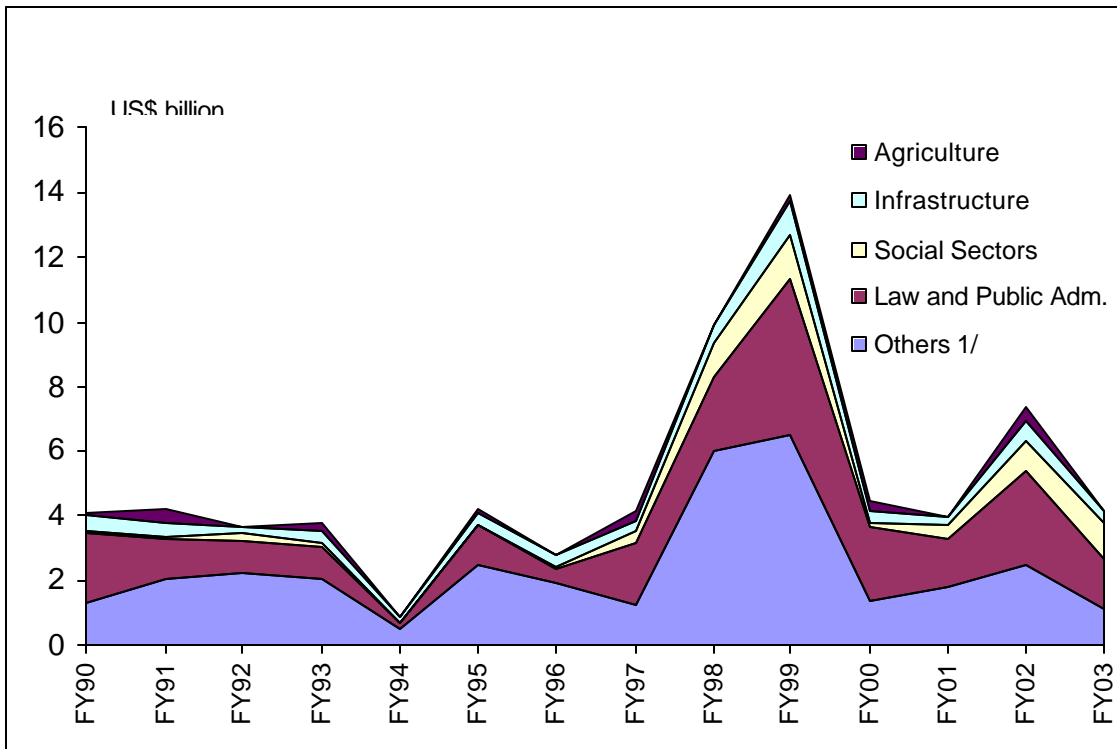
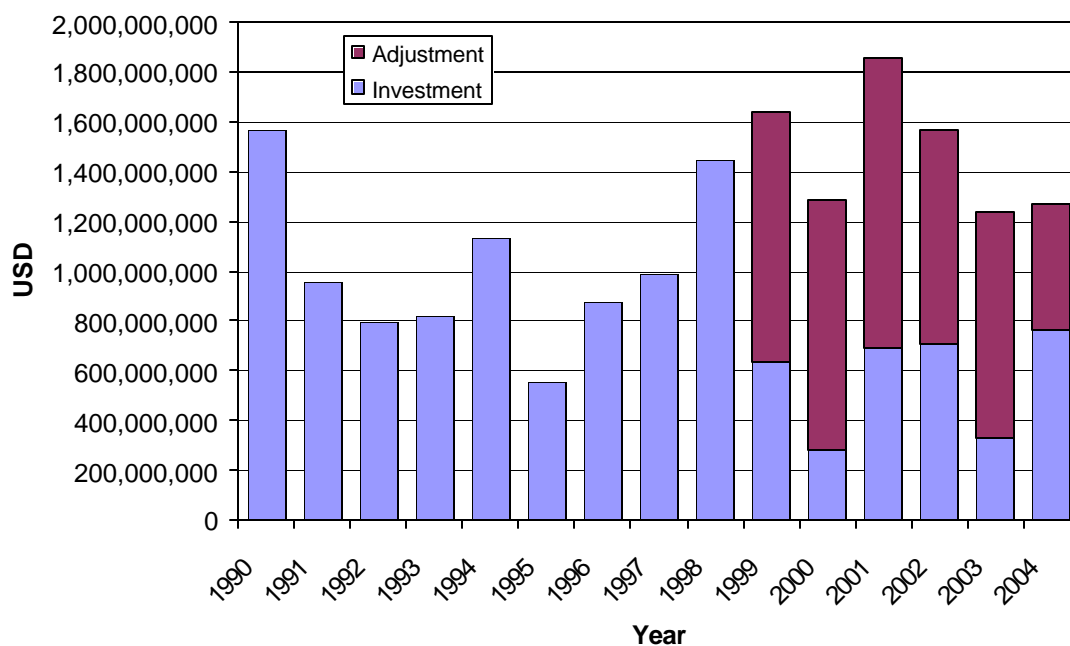


Figure 8 shows the development of World Bank commitments to Brazil since FY90. Although there were more resources committed in loans in 2001-2002 than in most previous years, there was a sharp drop in 2003, which persists in 2004. Of course, the flow of investment loans to some areas envisaged in the heydays of the second half of the 1990s proved not sustainable, while the World Bank signaled limits to the scope of adjustment loans. Thus, although we have successfully discussed a CAS recently, there are many challenges ahead to ensure a meaningful role of the Bank in Brazil and to avoid a continued reduction of the Bank portfolio (Brazil was a net payer to the Bank in 2003 and for part of 2004).

**Figure 8: Investment and Adjustment Lending Commitments to Brazil, FY90-04**



Looking ahead, some things appear quite evident. In particular, the World Bank has an approach for low-income countries based on the Poverty Reduction Strategy Paper (PRSP) process and, similarly, for low-income countries under stress (LICUS). It is time to develop a structured approach also for the middle-income countries (MICs). I believe that efforts are already underway but I would like to stress the importance of building something together, since the contribution of countries in the stage of Brazil can be extremely positive for the Bank if it will be based on open dialogue.

More specifically, the World Bank should take the following actions towards MICs: reassess and integrate Country Exposure Limits, since several MICs do want to increase the role of the private sector in infra-structure, and the IFC has been unable to handle this demand in view of limits to credit exposure. This may result in idle resources in the World Bank (as governments cannot borrow more for fiscal reasons), and shortage of room in the IFC. One possibility to improve this area—in addition to swap risks between

the two branches of the WB Group (IBRD and IFC), would be to take a comprehensive view of risk along sectors or even corporate borrowers in given regions.

It would also be important to reduce the cost of doing business with the Bank by, e.g., finding ways to issue in local currency to fund infrastructure projects that generate revenues in local currencies (this could also be achieved by issuing derivatives, given the existing restrictions on the funding policies of the WB). Such a policy would facilitate public-private partnerships in many MICs. Another way to reduce costs is to rely more on national fiduciary and safeguard systems, e.g., by employing the country systems of budgetary control, where they are developed enough. In the area of conditionality, the World Bank's approach should be realistic and pragmatic in order to reduce the burden of sector policy conditions on individual projects. The Bank should also make continued efforts to simplify its procedures and harmonize its policies with other MDBs.

The Bank's new commitment to infrastructure loans is an opportunity to revitalize its relationship with MICs. It is important that in its dialog with the Fund, the Bank develop a real framework to make operational the insight that stifling investment to ensure debt service may be a sub-optimal choice. Among other issues, the framework has to show how to measure the additional resources that may become available to service the public debt in the wake of a relaxation of budget constraints, and how to make these resources effectively available. The Bank has advantages vis-à-vis simple investment banks in assessing macro sustainability of additional spending, and could use them in moving this dialogue forward.

## **Conclusions**

The meaning of conditionality has changed over time. The principle will remain important, as it will be important that facilities and programs from multilateral financial institutions continue to be backed by actual and meaningful resources. In some cases, these resources may need not to be withdrawn immediately, and they need not entail significant increases in fiscal spending by governments. But they ought to remain an integral part of programs. This is particularly important to MICs. Conditionality for these countries shall reflect, on the other hand, the stage of the administrative structures and the sophistication of policy making, implementation and monitoring in these countries and should never be used to attempt to impose pre-established policies from the outside. The recent experience of Brazil with both the IMF and MDB shows that these objectives can be approached and should be further pursued, as the building up of trust through streamlined and focused conditionality reduces the risks of moral hazard and reinforces good policies.