

Session 4

Problem Diagnosis in Support of Policy Based Lending

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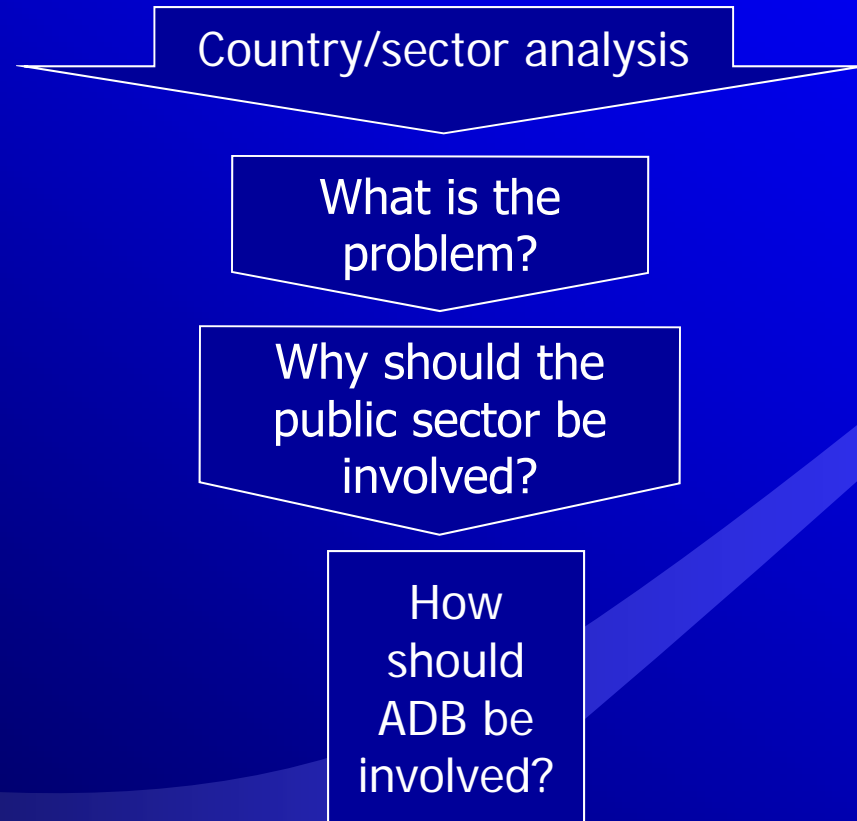
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Outline

- Why problem diagnosis is important
- Country diagnosis
- Sector diagnosis

Why is problem diagnosis Important?



These questions identify basic problems, binding constraints, solutions, and appropriate role of the government

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Country and Sector diagnosis

	Country diagnosis	Sector diagnosis	
Focus	Growth, sources of growth, binding constraints to growth, macroeconomic stability (monetary stability, fiscal sustainability, external vulnerability), growth outlook, poverty and inequality	Infrastructure, incentives, institutions, governance, policy	
Constraints	Bad infrastructure, low human capital, poor macroeconomic management, weak governance and institutions, bad finance	Lack of funding, weak legal/regulatory environment, weak planning capacity, bad policy (tax/subsidy), weak governance	
Solutions	Infrastructure investment, investment in human capital, policy and institutional reforms, etc.	Investment in physical and institutional capacity, policy and institutional reform, etc.	

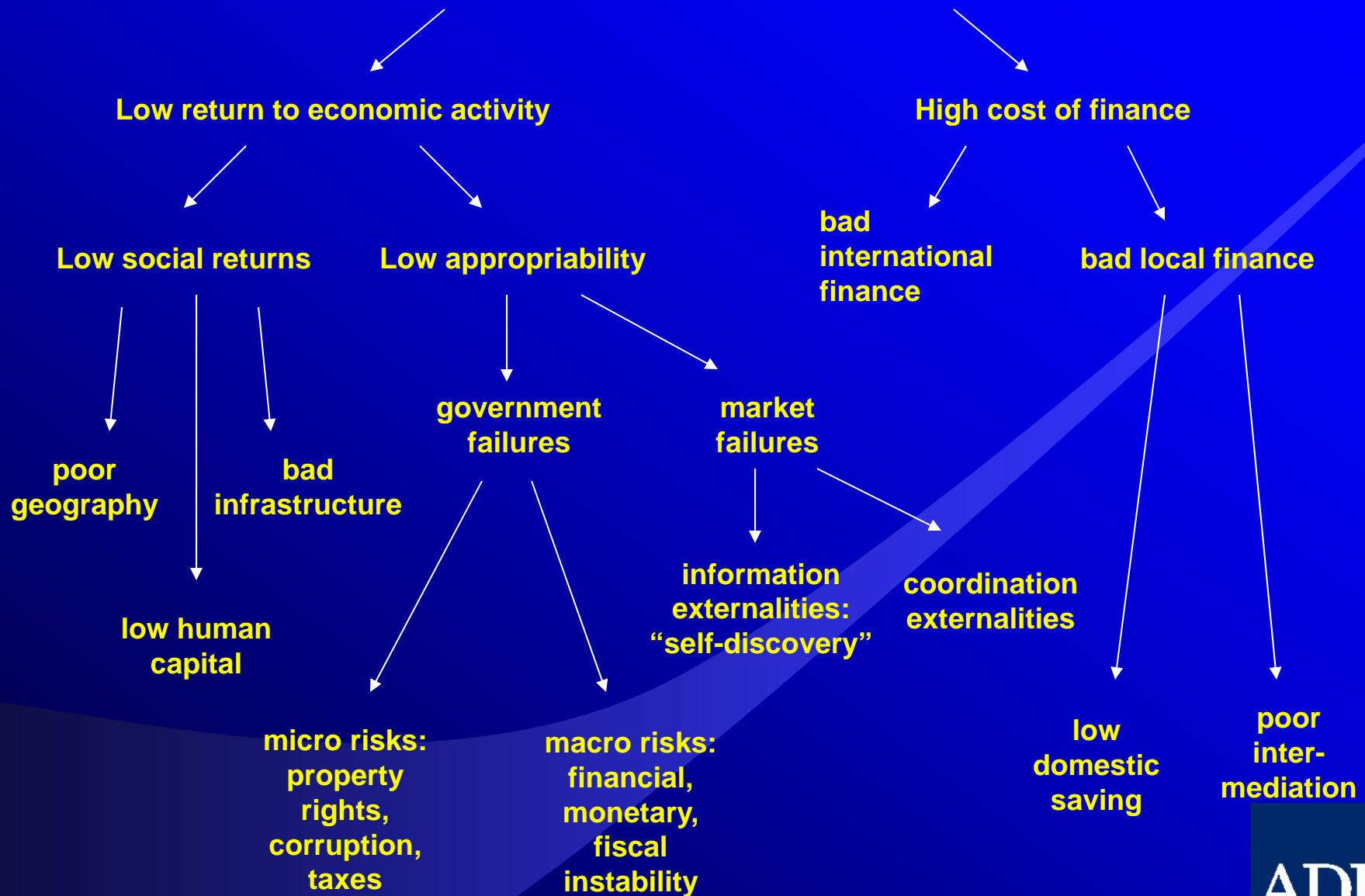
Country Diagnosis

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I. Focusing on binding constraints

- An underperforming country faces many distortions constraining its economy from growing faster.
- Distortions are often caused by market failures (externalities, information asymmetry) or government failures (excessive tax, poor economic management, weak institutions).
- At a particular time, some constraints are binding and some may not. Among the binding constraints, some have higher shadow prices and their relaxation lead to greater development impact.
- A key challenge for the government and aid agencies in devising development or country assistance strategies is to identify the most binding constraints and to target efforts at relaxing the binding development constraints.

Low levels of private investment and entrepreneurship



II. From theory to practice

- Explicit search for “diagnostic signals”:
 - “If story A is correct, signals x, y, and z should present”.
- Searching for price signals, such as return to education, interest rates, cost of transport:
 - If low education is a serious problem, returns to skill/education should be high and unemployed skilled people should be low.
 - If investment is constrained by savings, interest rates should be high and growth respond to changes in available savings (e.g., inflow of foreign capital).
 - If poor transport links is a constraint, there should be bottlenecks and high private cost of transport.

II. From theory to practice

- Searching for non-price signals:
 - The camels and the hippopotamus.
 - When a constraint binds, it results in activities designed to get around it:
 - High tax → high informality.
 - Poor legal institutions → high demand for informal mechanisms of conflict resolution and contract enforcement.
 - Poor financial intermediation → internalization of finance through business groups, etc.

II. From theory to practice

- Searching for historical growth episodes:
 - High growth episodes of the past cause one to ask what has changed.
- Finding out what the business community says:
 - Conducting business climate surveys.
- Bench-marking with other countries and other periods:
 - To figure out thresholds.

II. From theory to practice

- For fast-growing economies, focusing on constraints to sustaining growth.
- Relying on in-depth local knowledge and conducting in-depth country-specific studies.

III. A case study: El Salvador

- A star reformer, but not a star performer: low growth and low investment.
- Binding constraint: low domestic savings?
 - Symptoms: High return to capital and excessive level of foreign capital inflows.
 - Diagnosis: No such symptoms. External debt 30% of GDP; the credit rating investment grade; current account deficit averaged at 2% of GDP in 1994-2003; the interest rate among the lowest in the region.
 - Conclusion: Investment was low not because of difficulties in mobilizing the resources to invest, but because of a perceived low return on investment.

III. A case study: El Salvador

- Binding constraint: Low supply of other complements to physical capital – human capital?
 - Symptoms: High returns to schooling.
 - Diagnosis: While the years of schooling of the labor force were low, the returns were also low, significantly lower than countries such as Brazil, Chile, and Thailand. The educational efforts increased significantly through the past decade, growth remained slow.
 - Conclusion: Low human capital is not the binding constraint.

III. A case study: El Salvador

- Binding constraint: Low appropriability?
 - Symptoms: High taxes; macro imbalance; poor definition and enforcement of property rights; uncertainty.
 - Diagnosis: (i) The country has a moderate income tax and VAT; and low tariffs. (ii) It was ranked relatively high (30-35th in the world) in terms of macro environment and economic freedom, and always near the top in terms of World Bank's Country Policy and Institutional Assessment rating. (iii) The political uncertainty was not high until after the 2001 parliamentary election, whereas growth has been low since 1996.
 - Conclusion: These are not binding constraints.

III. A case study: El Salvador

- Binding constraints: Low investment demand due to low incentives for “self-discovery”.
 - Need to find new high return investment opportunities.
 - Solution: Industrial policy?
 - What will not work: Improving “institutional environment” will not be very effective when the constraint is low appropriability due to “cost discovery” and coordination externalities

Sector Diagnosis

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I. Basic framework for sector assessment

- Sector description
- Assessment of Institutions, policies and governance
- Analysis of markets, prices and incentives

I. Sector Description

- Sector role and features: contribution to economy, resource endowment, structure, growth
- Overall demand and supply of sector goods and services, input/output systems, projections
- Government policies, reform agenda, key institutions.
- Public or private goods and service provision

II. Institutional Diagnosis

Public Sector Focus

- Public goods/service provision capacity, efficiency, and distribution
- Fiscal and public expenditure incidence, impact and sustainability
- Involvement and effect of public enterprises
- Role and capacity of public institutions in enabling and regulating markets

III. Markets, prices & incentive structure

Private Sector Perspective

- Market structure, conduct and performance
- How are prices determined?
- Constraints facing private providers (enabling and regulatory environment, policy issues – how they affect transaction costs and profitability).
- Demand analysis: what factors affect demand (population, preferences, price, user charges, etc.)

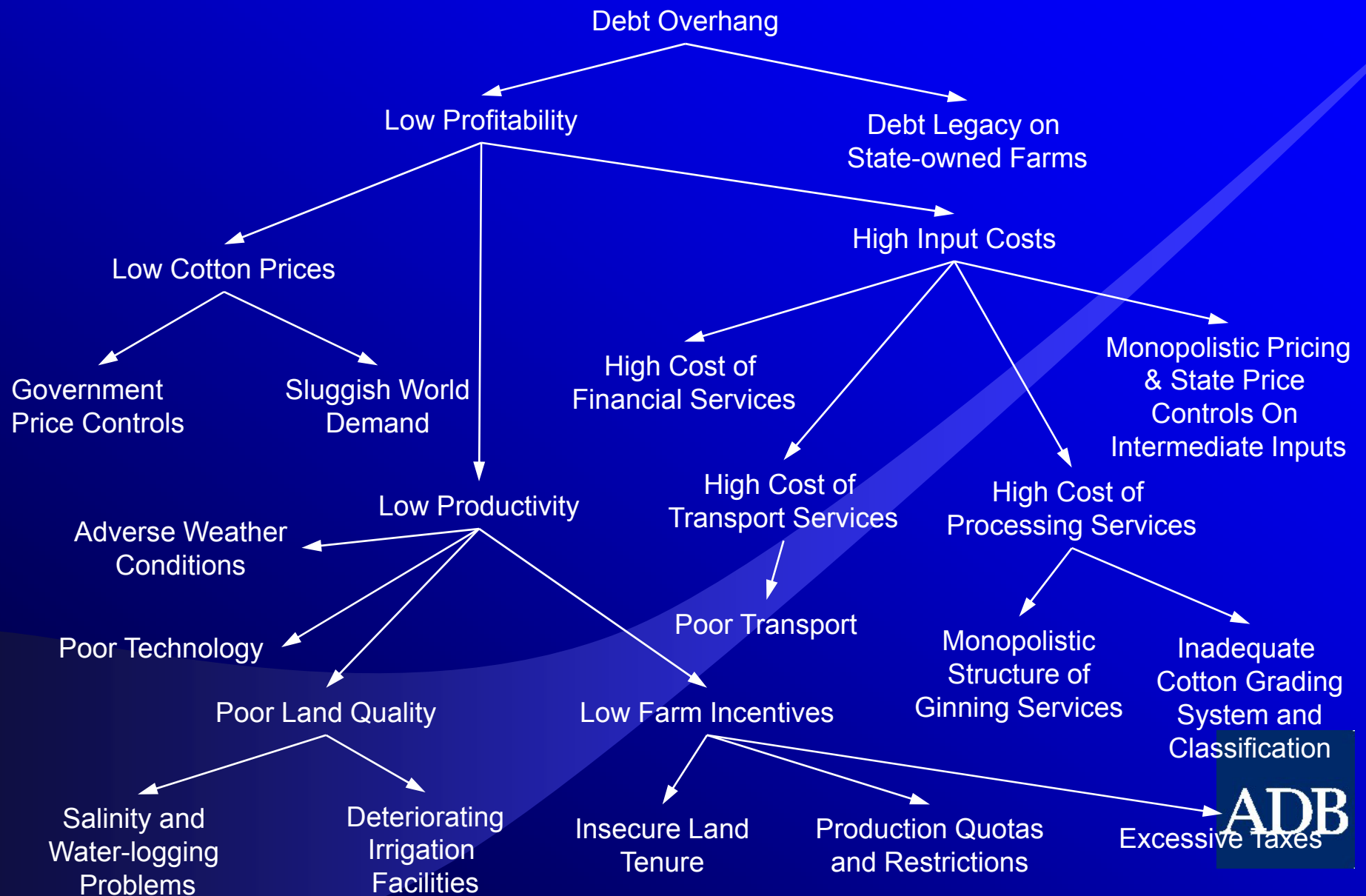
IV. Typical causes of market failures

- Failure of competition
- Externalities
- Public goods

V. Typical institutional failures

- Poorly defined and enforced property rights and contracts
- Excessive bureaucratic intervention & corruption
- Barriers to market entry and service delivery
- Poor implementation, operations and maintenance in delivering public goods
- Inequitable distribution of public expenditures

Case Study - Sector Diagnosis of an ADB Operation



Thank you.

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