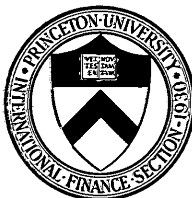
ESSAYS IN INTERNATIONAL FINANCE

No. 168, October 1987

CONDITIONALITY AS BARGAINING PROCESS: STRUCTURAL-ADJUSTMENT LENDING, 1980-86

PAUL MOSLEY



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS
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PRINCETON, NEW JERSEY

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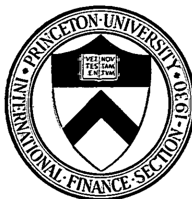

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CONTENTS

1 INTRODUCTION 1

2 CONDITIONAL DEVELOPMENT AID: OUTLINE HISTORY 4

3 POLICY DIALOGUE AS A NON–ZERO-SUM GAME 9
A Simple Two-Person, One-Stage Game 10
A Two-Person, Multistage Game with Nonbinding Threats 12
Behavior of Donor and Recipient: Hypotheses to Be Tested 18

4 INTERIM TESTS OF HYPOTHESES 19
Tightness and Compliance with Conditions 20
Effect of SALs on Ultimate Targets 26

5 POLICY IMPLICATIONS 29
Technical Appropriateness 29
Implementation 31
Additionality 32

REFERENCES 35

LIST OF TABLES

1 Three Types of Conditionality in Financial Transfers 3

2 Types of Policy Measure Requested in Return for SAL Finance, 1980–October 1986 5

3 Tightness of Conditions on Individual SALs, 1980-86 7

4 Output Changes Predicted by World Bank if Conditions Were Met 8

5 Status of World Bank Structural-Adjustment Operations for Eleven Developing Countries, December 1986 9

6 Simplest Case of Conditional Lending 10

7 Tightness of SAL Conditions and Possible Determinants 21

8 The World Bank's Price-Distortion Index and the Tightness Index 22

9 Slippage on SAL Conditions and Possible Determinants 24

10 Tightness of SAL Conditions in Relation to Slippage in Previous Periods 25

11 Economic Performance of SAL Countries Compared with Other Non–Oil Producing Countries, 1976-85 27

12 Conditional Aid as a One-Sided Prisoner's Dilemma 32

13 Number and Value of SALs and Sector-Adjustment Credits Awarded by the World Bank, 1979-87 33

LIST OF FIGURES

1 Conditional Aid: Bargaining Positions at Outset, with Associated Utilities 13

2 The "Tree" of the Conditionality "Game" 17

CONDITIONALITY AS BARGAINING PROCESS: STRUCTURAL-ADJUSTMENT LENDING, 1980-86

1 Introduction

International financial institutions dealing with third-world countries have devoted enormous attention recently to increasing the effectiveness, or productivity, of the capital resources they supply. One of the main policy instruments used for this purpose is the practice variously known as "conditionality," "leverage," or "policy dialogue": negotiation with the recipient government of a set of changes in economic policy that the recipient must implement in return for a loan or grant.

Conditionality is nothing new in itself. It is a standard feature of loans by banks to individuals or domestic companies. This first type of conditionality normally consists of a legally binding undertaking by the borrower to hand over a negotiable capital asset to the lender if he cannot otherwise pay back the loan.

When financial institutions lend to overseas governments, the conditions often become more complex, because the borrower is a sovereign body on whose assets the lender has no legal claim. The International Monetary Fund, for example, normally asks the governments to which it lends to adhere to specified targets for the growth of bank credit and government expenditure, and it may require changes in other variables such as the exchange rate (see Killick and associates, 1984, especially Chap. 6). This second type of conditionality is still an instrument intended to maximize the probability that the loan will be repaid, as in the case of an ordinary commercial loan, but for two reasons its application becomes more controversial: the link between the instrument and the ultimate target is less certain, and the application of the instrument may hurt influential interest groups and thus be politically destabilizing.[1]

A third type of conditionality has now evolved. Whereas the IMF provides

[1] Both of these points can be illustrated by reference to devaluation, a common IMF condition (or precondition). An influential literature argues that in developing economies the elasticity of supply of exports and elasticity of demand for imports are too low to satisfy the Marshall-Lerner condition, in which event devaluation may worsen rather than improve the balance of payments (see, e.g., Taylor, 1983). Moreover, devaluation is notoriously unpopular politically, witness the finding of Cooper (1971) that devaluation trebled the risk that the finance minister responsible would lose his job within the year and doubled the risk that the entire government would fall within that time.

short-term finance that is generally keyed to policy measures designed to reduce demand, the World Bank and certain bilateral development agencies have, since the late 1970s, made money available for long-term development that is keyed to policy measures designed to augment supply, such as raising food and energy prices and lowering protective trade barriers. It is the contention of this essay that this development raises new analytical issues. The link between instrument and target may be as loose as in the IMF case and the application of the instrument may arouse equal political opposition, but there are important differences.

First, the objective of conditionality is no longer simply to maximize the probability of repayment. Much bilateral development aid is given on grant or near-grant terms, the World Bank's credits from the International Development Association (IDA) are virtually interest-free,[2] and even "hard" development aid lent on market terms is expected to fulfill purposes other than the mere generation of a healthy cash flow, such as the development of export potential, the growth of gross domestic product (GDP), and the reduction of poverty.

Second, it often takes a long time for the donor of supply-augmenting finance to see whether the recipient government is acting in accordance with the spirit of the policy conditions to which it agreed.[3] Because of the time required to commission, complete, and implement the necessary studies, it takes longer for the World Bank to find out, say, whether a recipient is genuinely rationalizing the structure of protection than for the IMF to find out whether a recipient has kept domestic credit expansion within agreed limits.[4] This delay offers the recipient an opportunity to exploit a donor when the recipient needs short-term help but is reluctant to offend the domestic interest groups that would be hurt by the application of conditionality. I shall argue that these two characteristics weaken the bargaining power of the donor of aid conditioned on the supply side, compared with the bargaining power of a commercial banker or even the IMF. A summary of the differ-

[2] Most bilateral aid by the countries of the Organization for Economic Cooperation and Development (OECD) consists of grants. For example, U.S. aid in 1983 had a grant element of 94 percent, and U.K. aid a grant element of 98 percent (OECD, 1984, Table VI-4). The World Bank's IDA credits are free of interest, carry a service charge of three-fourths of 1 percent, and are repaid over very long periods. They therefore contain a very significant element of concessionality in relation to loans at the standard market rate.

[3] For convenience I shall use the term "donor" for the provider of conditional finance, even though much of that finance is in fact provided on nonconcessional terms.

[4] Some World Bank conditions relating to the alteration of policy instruments can be quite quickly monitored; it generally takes longer to monitor compliance with conditions related to policy *instruments* (such as fertilizer subsidies) than with conditions related to intermediate policy *targets* (such as the budget deficit). For further discussion see section 3 below and the essay by Nelson in Feinberg (1986), pp. 71-73.

ences among the three types of conditional financial transfer is provided in Table 1.

The essay is organized as follows. In section 2, I briefly outline the history of supply-side conditionality, with particular reference to the major example to date, the World Bank's Structural Adjustment Loans. In section 3, I represent the application of conditionality by a development agency as a two-person, non–zero-sum game and generate certain hypotheses concerning the circumstances in which it is likely to be successful. These hypotheses are tested in section 4, which considers the effectiveness of conditionality in inducing policy change and achieving the ultimate targets at which this policy change is aimed. The essay concludes with section 5, in which the implications for donor policies are explored.

TABLE 1

THREE TYPES OF CONDITIONALITY IN FINANCIAL TRANSFERS

	Type of Loan		
	1. By Bank to Individual	2. By IMF to Sovereign Government	3. By World Bank or Bilateral-Aid Donor to Sovereign Government
Instrument (condition)	Collateral must be transferred to bank in event of loan default	Various, usually including ceilings on central-bank credit and public spending	Various, usually including increases in agricultural and energy prices and reductions in protection
Target (purpose of condition)	Maximize probability of repayment	Maximize probability of repayment; reduce aggregate demand	Increase aggregate supply by improving economic efficiency
Link between instrument and target	Very tight	Fairly tight	Rather loose
Can compliance with condition be monitored?	Instantly	Yes, after short delays involved in publication of statistics (usually 1-3 months)	Often not for a number of years
Is condition legally enforceable?	Yes	No	No

2 Conditional Development Aid: Outline History

The main development agencies that have shown interest in conditionality as a means of enhancing the effectiveness of aid are, among bilateral agencies, the Canadian International Development Agency (CIDA), the U.K. Overseas Development Administration (ODA), and the U.S. Agency for International Development (AID), and, among multilateral agencies, preeminently the World Bank. After a period of early and transient enthusiasm in the 1960s (Hirschman and Bird, 1968), each of these agencies again increased its ratio of program to project aid disbursement during the late 1970s (OECD, 1984, p. 221). In part, this behavior was reactive—a response to the sudden deterioration in recipient countries' balance-of-payments situations caused by the oil shocks of 1974 and 1979 and to perceived limits on their absorptive capacity for projects. But, in addition, it reflected a growing perception that the failure of individual projects is frequently due to an unfavorable policy environment. An agricultural project that is well planned and executed may nonetheless fail because the price paid to producers for the crop is too low to give them an incentive to market it (see World Bank, 1978, 1981). Program aid has therefore been made conditional on improvements to the policy environment.

There is considerable consensus among the four agencies mentioned on the kinds of improvements that are necessary. Prices paid to agricultural producers, especially exporters, must be raised to give them an incentive to produce for the market; the financial performance of public enterprises must be improved by redirecting resources from the creation of new capacity to the maintenance of existing capital or by outright privatization; and trade policy must become more outward looking by the removal of trade and exchange controls that have been used to defend overvalued currencies and by the reduction of effective protection against imports (World Bank, 1981, pp. 3 and 24; AID, 1982). The common thread running through this package is that the degree of state control over the economy must be reduced. The theoretical and empirical rationale for the package will not be considered here. I will take it as given that these are the reforms desired by aid donors who wish to achieve policy change through conditionality and go on to examine the ways in which the donors have tried to persuade third-world governments to adopt them.

I shall concentrate on the most important exercise to date in this kind of persuasion, the World Bank's Structural Adjustment Loans (henceforth SALs). These were first introduced in the early 1980s, and 38 of them had been made to 21 countries by the end of 1986. Their objective has been defined by a World Bank official:

> To provide quick disbursing finance to support measures designed to strengthen

recipient countries' balance of payments within five to ten years without severely constraining demand in a manner that unnecessarily sets back economic and social development. (Landell-Mills, 1981, p. 17)

Disbursement of SALs is always conditional on "the elaboration of an appropriate set of specific actions that the government will take either to increase or save foreign exchange earnings" (*ibid.*).

Table 2 provides a broad indication of the areas in which recipient countries have promised such actions. Like the IMF, the World Bank is at pains to stress that there is no question of imposing a standard package of policy reforms on all recipients (Landell-Mills, 1981); each country's path toward structural adjustment must be tailored to its specific circumstances. Nonetheless, reforms in the system of export incentives, in the financial perform-

TABLE 2

TYPES OF POLICY MEASURE REQUESTED IN RETURN FOR SAL FINANCE, 1980–OCTOBER 1986

Measure	Percentage of SALs Subject to Conditions in This Area
Trade policy:	
Remove import quotas	57
Cut tariffs	24
Improve export incentives and institutional support	76
Resource mobilization:	
Reform budget or taxes	70
Reform interest-rate policy	49
Strengthen management of external borrowing	49
Improve financial performance by public enterprise	73
Efficient use of resources:	
Revise priorities of public investment program	59
Revise agricultural prices	73
Dissolve or reduce powers of state marketing boards	14
Reduce or eliminate some agricultural input subsidies	27
Revise energy prices	49
Introduce energy-conservation measures	35
Develop indigenous energy sources	24
Revise industry incentive system	68
Institutional reforms:	
Strengthen capacity to formulate and implement public investment program	86
Increase efficiency of public enterprises	57
Improve support for agriculture (marketing, etc.)	57
Improve support for industry and subsectors (including price controls)	49

ance and investment priorities of public enterprises, and in agricultural pricing policy had been requested in over 70 percent of cases by the end of 1986. Furthermore, Table 3 makes clear that this form of finance was confined to faster-growing and more outward-looking developing countries. The average rate of growth of GDP during the 1970s was 5.5 percent among countries awarded SALs, compared with 4.6 percent for all low- and middle-income countries, and Yugoslavia is the only socialist country to have received a SAL. In principle, "any country facing a serious medium-term foreign exchange constraint and proposing a viable adjustment programme is eligible" (Landell-Mills, 1981, p. 17), but those third-world countries with the most deep-rooted economic difficulties appear to have been excluded from the scheme. Some very poor countries have initiated negotiations with the World Bank for SAL finance, but these have been broken off because agreement on the required package of policy reforms could not be reached; I return to this point later.

Let us examine the logic behind the reform packages listed in Table 2. In nearly all cases, their implementation involves the removal from some interest group of a shield against market forces that the government had granted to win the group's political support. Food and energy subsidies provide a shield for urban consumers; tariffs and import quotas provide one for industrialists supplying the home market; extravagant projects in rural areas assist those who benefit from the services they provide. The additional real incomes that these beneficiaries obtain are, as Krueger (1974) argues, rents to the suppliers of particular factors of production that have been made artificially scarce by government policy. Countries that receive SALs have been told explicitly by the World Bank that production and exports will increase, sometimes dramatically, if the burden of these rents is lifted; some of its forecasts are shown in Table 4. This prospect of faster economic growth, along with the SAL finance itself, is the economic benefit that the Bank offers to potential recipients of SALs in order to embolden them to incur the political cost of taking away rents from those who receive them. It is a bribe to third-world governments to buy out some of the restrictive practices by which they currently hold the state together.

On the limited evidence available, the bribes usually succeed in eliciting the policy changes requested, but not always. Table 5 shows the degree of compliance with World Bank conditions on the part of eleven recipients of SALs and the number of SALs that those countries had received by the end of 1986. Jamaica, Pakistan, South Korea, and Turkey had met nearly all the conditions; Turkey was into its fifth SAL, while Jamaica was into its third. Bolivia, Guyana, and Kenya were particularly remiss in complying with the conditions; Bolivia and Guyana had received only one SAL, while Kenya had received two. An intermediate group, comprising the Ivory Coast, Malawi, the Philippines, and Thailand, had met most but not all of the conditions,

TABLE 3

TIGHTNESS OF CONDITIONS ON INDIVIDUAL SALS, 1980-86

SAL or Credit[a]		Date	Value (millions of $)	Tightness Score[b]	
Bolivia		May 1980	50	6	
Burundi		May 1986	15	12	
Chile		Oct. 1985	250	5	
Costa Rica		April 1985	80	8	
Guinea		Feb. 1986	25	14	
Guyana[c]		March 1981	22	13	
Ivory Coast	I	Nov. 1981	150	9	
	II	July 1983	250	11	10
	III	June 1986	250	10	
Jamaica	I	March 1982	76	11	
	II	June 1983	60	11	10
	III	Nov. 1984	55	7	
Kenya	I	March 1980	55	10	12
	II	July 1983	70	14	
Malawi	I	June 1981	45	12	
	II	Dec. 1983	55	11	11
	III	Dec. 1985	30	9	
Mauritius	I	June 1981	15	6	9
	II	Dec. 1983	40	12	
Niger		Feb. 1986	60	4	
Pakistan		June 1982	140	12	
Panama		Nov. 1983	60	8	
Philippines	I	Sept. 1980	200	5	6
	II	April 1983	302	7	
Senegal[d]		Feb. 1986	131[e]	11	
South Korea	I	Dec. 1981	250	12	11
	II	Nov. 1983	300	10	
Thailand	I	Mar. 1982	150	10	11
	II	Mar. 1983	175	13	
Togo	I	May 1983	40	8	
	II	May 1985	28	9	
Turkey	I	Mar. 1980	275	11	
	II	May 1981	300	15	
	III	May 1982	304	14	13
	IV	June 1983	300	14	
	V	June 1984	376	9	
Yugoslavia		June 1983	275	11	

SOURCE: Stern (1983), supplemented by data from World Bank Country Policy Department.

[a] IDA credits in italics.

[b] Number of policy conditions listed in Table 2 that were imposed on that loan.

[c] Blend of IBRD "hard" loan and IDA credit.

[d] Senegal has had two structural-adjustment transactions with the World Bank, the first of which, in 1980, was terminated shortly after the beginning of disbursement.

[e] Sum of the two structural-adjustment transactions.

TABLE 4

OUTPUT CHANGES PREDICTED BY WORLD BANK IF CONDITIONS WERE MET

Recipient Country	At Time of First SAL[a]		At Time of Second SAL[b]	
	With Structural Adjustment	Without Structural Adjustment	With Structural Adjustment	Without Structural Adjustment
Ivory Coast:				
Total output	6.8	4.9	6.5	4.5
Agriculture only	4.2	1.9	6.0	4.2
Exports only	7.6	5.5	5.1	2.5
Jamaica:				
Total output			4.0	−0.2
Exports only			6.8	5.5
Kenya:				
Total output			4.3	3.8
Agriculture only			3.9	2.7
Exports only			4.7	4.0
Malawi:				
Total output			3.4	2.5
Agriculture only			3.4	2.4
Exports only			5.5	4.0
Philippines:				
Total output	6.4	5.5	6.5	4.0
Agriculture only	5.0	4.7		
Exports only	10.7	9.3	8.5	6.5
Thailand:				
Total output	7.3	7.0	5.4	4.8
Agriculture only	4.2	3.1	4.0	3.1
Exports only	10.0	8.1	6.8	4.5

SOURCE: World Bank.

[a] Growth for 1980-5.

[b] Growth for the following periods: Ivory Coast—1985-90; Jamaica, Kenya—1981-86; Malawi—1983-87; Philippines—1986-89; Thailand—1982-90.

and the process of dialogue continued; the Ivory Coast and Malawi were into their third SALs.

Table 5 forces us to ask two questions: If the World Bank's arguments for policy reform have been equally cogent across countries, why have they been unevenly successful in persuading governments and overcoming the vested interests arrayed against reform? And why hasn't the Bank applied the principle of equal treatment of equals, instead of awarding two SALs to Kenya,

TABLE 5

STATUS OF WORLD BANK STRUCTURAL-ADJUSTMENT OPERATIONS FOR ELEVEN DEVELOPING COUNTRIES, DECEMBER 1986

Recipient Government	World Bank Has Granted 2 or More SALs	World Bank Has Granted Only 1 SAL
Has complied with all or nearly all Bank's conditions (compliance index of 90% or more)	Jamaica South Korea Turkey	Pakistan
Has complied with some but not all Bank's conditions (compliance index of 60-90%)	Ivory Coast Malawi Philippines Thailand	
Has complied with few of Bank's conditions (compliance index of 0-60%)	Kenya	Bolivia Guyana

NOTE: Compliance index is a measure of the percentage of conditions, expressed as a tightness score in Table 3, that had been complied with by December 1986.

SOURCE: Mosley (1985), Table 4 updated.

with a compliance index of 38 percent, but only one to Pakistan, with a compliance index of 90 percent?

We can begin our search for answers by referring back to two specific features of conditional development aid featured in Table 1. First, the conditions are likely to cause serious economic hurt to certain interest groups. Second, failure to comply with them may not be picked up by the donor for several years, because policy changes of the structural-adjustment type have a long gestation period. These two features may tempt a government to promise to comply with the conditions proposed by a donor and then to renege on its promise if it does not expect to need program finance beyond the point at which its failure to comply becomes known to the donor. In other words, it may treat aid negotiations as a game whose object is to obtain specific sums of money without complying with the associated conditions. In this sort of situation, the donor needs threat strategies to discourage such behavior without embittering relationships to the point where it loses all influence over the recipient.

3 Policy Dialogue as a Non–Zero-Sum Game

This section attempts to model the relations between the donor and recipient of conditional development aid as a two-person game. A formal solution to the game, which would require the assumption of perfect foresight on the

part of both parties, is not attempted. Instead, the model is used to generate hypotheses concerning the tightness of conditions set by the donor, the recipient's compliance with those conditions, and the donor's behavior in granting follow-on finance.

A Simple Two-Person, One-Stage Game

In the simplest model of negotiations between a donor and recipient, both parties have all-or-nothing options, threats are binding, and compliance with conditions can be monitored instantly. The donor has two possible strategies, to give a loan or not to give it; the recipient also has two possible strategies, to comply with the conditions proposed by the donor or to renege on the commitment to comply; before disbursing the loan, the donor can ascertain whether the recipient has complied or reneged; and the donor is committed to disburse the loan if the recipient has complied and to carry out its threat not to disburse if the donor has reneged. This game between donor and recipient is portrayed in Table 6.

The table describes more or less precisely the first case of conditionality mentioned in section 1: the one-tranche loan by a bank to an individual, which is conditional on the transfer of collateral (or a legal claim to it) by the borrower to the lender. The off-diagonal outcomes in parentheses would involve exploitation of one party by the other, but they are excluded by the rules of the game. Outcome (2), in which the recipient gets its money but reneges on the commitment to comply with the conditions, is excluded by the donor's binding threat to refuse to disburse if the conditions are not met. Outcome (4) is excluded by the donor's binding promise to disburse if the recipient complies with the conditions. The only thing that is indeterminate is the recipient's subjective comparison of the expected short-term cost of complying and the expected long-term economic benefit from receiving the loan. If the cost is perceived to exceed the benefit, negotiations collapse, and we have outcome 3; if the benefit is perceived to exceed the cost, the deal is done, and we have outcome 1.

TABLE 6

SIMPLEST CASE OF CONDITIONAL LENDING

Donor's Strategies	Recipient's Strategies: Fulfill Commitment to Comply with Donor's Conditions	Recipient's Strategies: Renege on Commitment to Comply with Donor's Conditions
Disburse loan	1	(2)
Do not disburse loan	(4)	3

When the World Bank or a bilateral donor offers conditional program aid, the situation is different in a number of ways. First, it is open for both donor and recipient to follow mixed strategies. The recipient can comply with some but not all of the conditions set by the donor, and the donor can disburse some but not all of a planned loan, for example by giving it out in several tranches, each of which is contingent on satisfactory performance during the previous period.

Second, the donor cannot ascertain whether the recipient has complied with the conditions before disbursing the loan. All that can be negotiated before disbursement is a *promise* by the recipient to comply with the conditions.[5] Actual compliance will not be ascertainable for some time. In section 1, I argued that the complexity of the requisite policy changes may make the lag quite long for loans such as World Bank SALs, which are intended to boost the supply side of the economy, compared with the lags involved in monitoring loans such as IMF standbys, which are intended to stabilize the demand side. The lag is often as long as three or four years. Some conditions, such as "Remove quantitative import restrictions on 64 commodities within the next year" (Jamaica: SAL I), can be fairly quickly monitored, but others, such as "Raise the tax/GNP ratio to 22 percent over the next five years" (South Korea: SAL I), cannot, by definition. Still others, such as "Develop a concrete program to implement government policy to make state economic enterprises financially independent" (Thailand: SAL II), enable the recipient to buy much time by promising to study a problem in the abstract, which is painless politically, rather than confront the opposition of vested interests that is likely to follow from actually altering policy instruments.

The long delay between the donor's request for policy actions and the point at which the recipient's compliance can be effectively monitored allows a recipient to "exploit" a donor if the recipient needs finance only for a short period and discounts the long-term consequences of a deterioration in the relationship with the donor. Such a recipient can promise to comply with particular performance criteria, receive its money, and then fail to comply. This behavior corresponds to the off-diagonal outcome (2) in Table 6, which becomes attainable as soon as we relax the assumption that compliance with conditions can be instantly monitored. The donor can try to defend itself against exploitation by making a series of loans, rather than one large loan, and dividing each loan into tranches; this is what happens with World Bank SALs.

A third circumstance, however, may complicate the donor's problem. The donor may not wish to be bound by its initial threat to cut off program aid if it finds at the end of a loan (or tranche) that its conditions have not yet been met. It may prefer to give the recipient the benefit of the doubt and thus

[5] The donor can also ask for what World Bank staff members call a "down payment," the execution of certain policy reforms before SAL money is handed over.