How can the Multilateral Development Banks best adopt to the changing Development landscape?

A Policy Paper

For

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Background

Developing countries are facing a rapidly changing world with rapidly evolving opportunities and challenges. Old challenges such as poverty remain and are compounded by new ones such as financial instability, climate change and increasing inequality. Increasing private capital flows, higher commodity prices and increasing integration with the global economy present new opportunities.

The development community needs to help support the developing world meet emerging challenges and exploit opportunities so as to help eliminate poverty and maximise development potential. Multilateral Development Banks (MDBs) sit right at the heart of the development architecture and provide strong links with the financial system at the same time. Given the rapid growth in private financial flows which have characterized this phase of globalization, these institutions will need to play an instrumental role if developing countries are to succeed. However, in order to maximise impact, the MDBs will themselves need to have appropriate responses to the changing environment.

This discussion paper, which highlights some of the key trends, challenges and possible MDB responses, is a starting point in launching a comprehensive and informed debate on this complex issue.

While every attempt has been made to make the paper comprehensive and comprehensible, limits on time and capacity have put constraints on the full realization of these goals.

The discussion of key policy issues is divided between the sections on the MDBs themselves and special sections which are dedicated to addressing the most important issues.

The paper starts with a brief introduction of the MDBs, the challenges they face, their initial responses to those challenges and a brief policy discussion. The next section provides a detailed analysis of key policy issues and is supported by a couple of small appendices.

This draft is being circulated for initial comments which will be incorporated into a final version along with key recommendations.

Executive Summary

Multilateral Development Banks are entities which finance development expenditure by directing finance from private capital markets and rich country donors to development projects in poor and middle income countries.

The non-concessional arms, which borrow from international capital markets and lend to developing countries at lower rates than they would themselves get from the capital markets, have been facing a decline in demand for their flagship product sovereign loans. It has been suggested that these institutions have become irrelevant as an unprecedented number of countries now have access to international capital markets and as private capital inflows into developing countries hit record levels. Critics have also suggested that this declining demand for loans is likely to be fatal to their profitability.

However, suggestions that these institutions are irrelevant and unsustainable are exaggerated.

- While the demand for their loans has indeed been on the decline, part of the decline is cyclical. There already are signs of a resurgence of demand which is likely to pick up pace as the global economy slows down
- Contrary to common perceptions, the income for the MDBs is only weakly correlated to the level of lending. Most income, in fact, is earned from the lending or investment of zero cost equity so is not under serious threat as the volume of lending declines
- At the same time as demand for their flagship products has declined, demand for other financial products has increased. Some of these products are
    - private sector equity and loans
    - sub sovereign and supranational lending
    - guarantees
- Demand for knowledge and co-ordination services are still robust with new challenges and opportunities presented by
    - the emergence of the international public good agenda
    - the focus on increased regional/international integration
    - the increasing demand for sharing development learning experiences
    - the increasing demand for financial products such as
        - contingency products such as insurance
        - financial risk management products such as commodity derivatives
        - local currency denominated international bonds
        - domestic and regional bonds
        - currency reserve management

Meanwhile many of the client states of the non-concessional windows, which are typically middle income and (or) investment grade countries continue to both face traditional development challenges as well as emerging ones. Some of these challenges are

- how to tackle continuing pockets of extreme and absolute poverty
- how to tackle an unprecedented rise in inequality
- how to address the unpredictability of private capital flows and a possibility of sudden stop
- how to tackle possibilities of financial crisis and associated social and economic problems
- how to address large infrastructure bottlenecks
- how to reverse environmental degradation and water shortages

Some key recommendations to tackle these challenges are for the MDBs to

- have a strong policy focus on reducing inequality and increasing redistribution especially through an increased focus on reversing capital flight, increasing tax co-operation and helping introduce robust and progressive tax regimes
- focus on the provision of infrastructure needs with a special focus on

    - pro poor infrastructure such as rural roads
    - regional infrastructure such as power grids and inter-connectors
    - infrastructure that fulfils regional public good needs such as responsible watershed management
- explore using their excess equity more effectively by allocating larger ring-fenced amounts to
    - private sector operations (for the RDBs)
    - the provision of risk management products especially to low income countries
    - sub sovereign and supranational lending
    - finance international public good provision with co-financing from rich countries or through the sale of IMF gold
- play a more important co-ordination role by promoting
    - common standards across the region (or internationally)
    - international public good provision
    - common policy positions which the institutions then present as developing country perspectives in international fora and policy discussions
    - the pooling and management of currency reserves
    - intermediating intra-regional financial flows and promoting regional financial markets
- play a better role as knowledge banks by
    - promoting and financing more developing country based research
    - better evaluation and policy experimentation methodology so as to generate evidence based learning about successful development policies
- not ignore agriculture by
    - providing increased co-financing for International Fund for Agricultural Development led initiatives
    - ensuring that agricultural priorities for an integral part of country strategies
    - reinvesting in agricultural research
- explore leveraging more resources for development including through
    - innovative sources of financing
    - increased capital contributions from their regional member countries
    - a climate compensation fund

The concessional finance arms (funds) deliver money, in the form of concessional loans and grants, to low income (and) non creditworthy countries which do not typically have access to the capital markets. They operate on the basis of periodic (typically three yearly) replenishments.

These funds lie at the heart of the international aid architecture and are responsible for delivering between 20% and 30% of all aid that is disbursed. However, their role in the aid architecture far exceeds their financial contribution as they

- lead on key development policy issues
- are able to leverage significant amounts of additional finance behind their allocations
- play a crucial role in the planning and co-ordination of aid activities

Many of their client states continue to face serious development challenges some of which are

- widespread extreme poverty
- low human development indicators
- slow and volatile growth
- excessive dependence on commodities
- lack of infrastructure
- poor governance
- low domestic resource mobilization and excessive aid dependence
- high level of aid fragmentation
- a high degree of fragility including a high likelihood of conflict
- an increasing threat from climate change and other international public bads

Some key recommendations which might help meet these challenges are

- The MDBs need to play complementary roles with the World Bank focussing on

    - country level strategy and co-ordination
    - providing and mobilizing funding for social sectors
    - playing the role of a systems (residual) donor
    - funding and provision of global public goods
    - being the developing country voice in international fora
    - being the voice for the reform of the global financial architecture
    - overall development policy issues
    - cross-regional and global level development research and learning
    - providing the full range of services

- The RDBs should in turn concentrate on

    - regional and sub regional strategy and co-ordination
    - providing and mobilizing funding for the infrastructure sector
    - mobilizing co-financing from the public and private sector for their interventions
    - funding and provision of regional public goods
    - being the regional voice in international fora including discussions on the reform of the financial architecture
    - regional integration especially in helping develop regional financial markets
    - fulfilling other region specific needs
    - governance issues and natural resource management given their higher legitimacy in their respective region of operations

- The MDBs, especially IDA need to play a much more central part in the co-ordination/channelling of aid at the country level to help reduce aid fragmentation. This can be done by

    - Donors increasing MDB aid allocations
    - Rationalization of trust fund portfolios
    - Increased use of pooling, co-financing and country level co-ordination mechanisms
    - Increasing regional member contributions and encouraging emerging regional donors to channel all their allocations through the RDBs

- Conditionality needs to be minimised and a skeletal structure of principles listed below should be progressively adopted

    - Transparency
    - Do no harm
    - Result orientation

- There is an urgent need for a shift in aid allocation methodology away from the indicator based allocation to a need based allocation
- As poverty concentrates in fragile states, there is an urgent need to prioritize MDB operation in such states and make them more effective. This can be achieved by

    - Allocating more resources to fragile states partly by adopting a needs based allocation criteria
    - Reducing the conditionality load which imposes severe burdens on already strained state capacity
    - Increasing fragile state administration and research budgets and staffing levels
    - Better co-ordination behind the UN especially when the MDBs have no presence on the ground

    - Adoption of more flexible disbursement mechanisms such as UN led trust funds where channels of disbursement (government, local government, UN, NGOs etc) can be varied

- Avoid rushing too fast into the international public good provision agenda. In particular

    - Led the UN lead on the provision of public goods where it has a legitimacy and strengths but explore supporting it with the provision of funding
    - Focus on maximising grants not loans for public good provision
    - Try maximise additional sources of funding such as from a climate mitigation fund to finance the provision of two kinds of public goods in particular

        - Those where developed countries are mostly responsible for the public bads
        - Those where developed countries stand to benefit significantly from the public goods financed

- Seriously change the current knowledge bank model which is not working well by

    - Shifting gradually from in house research to funding research especially in case of the World Bank
    - Sharply increase independent evaluations and consider setting up an external body to carry out evaluation exercises for all MDBs
    - Encourage the setting up, development and funding of research capacity in the developing world especially in LDCs
    - Encourage bread and butter context specific development research over fancy theoretical macro modelling
    - Increase incentives for policy experimentation, random trails, rigorous evaluations, learning policy lessons and evidence based decision making

Introduction

Multilateral Development Banks (MDBs) are autonomous international financial entities that finance economic and social development projects and provide technical assistance in developing countries. While there are more than twenty five MDBs operating at the global, regional and sub regional levels. This paper focuses on four groups of MDBs in this paper which are

- The World Bank Group consisting of
    - The International Bank for Reconstruction and Development
    - The International Development Association
    - The International Finance Corporation
    - The Multilateral Investment Guarantee Agency
- The Asian Development Bank Group consisting of
    - Ordinary Capital Resources
    - Asian Development Fund
- The African Development Bank Group
    - African Development Bank
    - African Development Fund
- The Inter American Development Bank Group
    - Ordinary Capital
    - Fund for Special Operations
    - Inter American Investment Corporation

Of these, the first organization in each of the groups are the non-concessional windows which use pooled capital contributions from members to borrow from international private capital markets and on-lend to eligible developing country members on a cost plus basis.

The second organization in each of the groups are concessional funds which are replenished periodically (every three years) by donors. These typically give concessional (below market rate) loans as well as grants to poorer developing countries to meet their development needs.

Other organizations such as the IFC, MIGA and IIC operate primarily to help leverage private sector investment to developing countries.

The paper also briefly addresses the International Fund for Agricultural Development (IFAD).

The services provided by MDBs fall into three main categories: finance, knowledge, and co-ordination.

- **Financial services**: These include grants, concessional credits, loans, equity and related investments, financial enhancements (guarantees), the management of trust funds, sovereign asset and liability management services and risk management services.
- **Knowledge and other specialized services:** The knowledge component includes country-level analytic work, technical assistance, and capacity-building; cross-country development and benchmarking data; international studies and research; and detailed understanding of how to implement development projects successfully in different contexts.
- **Coordinating, convening, and catalytic services**: Directed at overcoming institutional coordination failures, these services include mobilizing and managing aid from other donors, providing vehicles for co-financing, chairing consultative group meetings and international public goods.

The MDBs are uniquely placed as more than all other organizations they interact with all entities that straddle the worlds of development and of international finance. They act both as co-ordination fora for key development issues as well as conduits between development and international finance.

Despite problems, shortcomings and criticisms these agencies have a reputation for relative competence and effectiveness and a reasonable track record. More important, there are no other institutions that provide a comparable range of products and services to member countries.

However, the field of development, developing countries themselves and the international landscape are all changing at a breathtaking pace. The multilateral development banks (MDBs) were set up decades ago and have changed little since. While they have played a central role in both the evolving policy discussions on development issues as well as the provision of funding for development, this role is at risk.

While many of the old challenges remain, new development challenges have emerged. Moreover, as the following table shows, the IFIs no longer have a near monopoly but instead are being jostled for space by an ever increasing number of diverse actors.

Role	Category	Providers
Lending	Finance	IFIs, RDBs, Other multilatreals, Banks & Capital Markets, Bilatreals including emerging ones
Grant Making	Finance	Bilaterals, RDBs, IFIs, Vertical Funds, UN Agencies, Foundations, Migrant Remittances
Guarantees	Finance	IFIs, RDBs, ECAs, Private Insurance Companies
Surveillance/Signalling	Knowledge/Co-ordination	Rating Agencies, IFIs, RDBs, Private Information Firms such as the EIU
Global Policy Analysis and Promotion	Knowledge	IFIs, RDBs, UNDP, UN DESA, Think Tanks, Academia, NGOs
Donor Co-ordination	Co-ordination	OECD DAC, UNDP, EC, IFIs, RDBs, Other UN agencies
Global Public Goods Provision	Finance/Knowledge/Co-ordination	Specialist UN organizations (WHO, UNEP etc), Private Foundations, RDBs, IFIs

That is why, if they are to continue to hold on to their pre-eminent role and retain relevance, the MDBs need not only to keep up with the changing world but also anticipate major trends and change accordingly.

They need to change their focus, funding, operation and structure to best suit current and forthcoming challenges so they are better placed to serve the evolving development needs of countries as well as plug some of the gaps in the provision of international public goods.

Key Trends and Challenges for the MDBs

There are several developments and trends crucial to understanding the policy choices facing all development actors - International financial institutions, donor countries and developing countries themselves. Some of these are

1) Most developing countries have been through a period of high growth relative to historic levels and relative to other richer economies.

   There are disturbing signs however that the benign global economic conditions which helped feed this growth may be giving way to a tougher economic regime. This raises questions about the evolving financing needs of developing economies and the role of MDBs in fulfilling those needs. Dealing with recurring financial crisis and volatility continues to be another critical challenge.

2) Despite progress made in a number of developing countries including some low income countries such as India, many others-collectively known as fragile states (concentrated in SSA and SA) remain mired in deep rooted development problems which present unique challenges.

   Addressing the problems of fragile states by providing sufficient funding thorough appropriate channels and with the right mix of policies is widely considered to be a core priority for the MDBs and the international development community.

3) Private capital flows now far exceed official flows for a number of developing countries most of which are either 1) fast growing economies such as India and China 2) middle income countries such as Brazil 3) Resource rich countries such as Angola. For others, especially most of the fragile states, official financial flows continue to be the main source of external financing.

   This necessitates a re-examination of the of the MDBs which have seen a drastic change in demand for their services.

   Despite large cross-border flows of international finance, developing countries as a group continue to be net exporters of capital. Reversing this is another key challenge faced by the MDBs.

4) The official financing landscape is no longer dominated by the MDBs but has become increasingly fragmented into a number of players which includes 1) vertical funds 2) an increasing number of bilateral donors 3) other multilateral agencies and initiatives 4) trust funds 5) NGOs and 6) Private foundations etc.

   The fragmentation far exceeds the increase in aid volume so each packet of aid is smaller than ever before while still imposing significant administrative costs on recipient country systems. The Aid Effectiveness Agenda which focuses on the best way to make international aid architecture more effective seeks to address these issues. The MDBs, themselves products of donor co-ordination need to play a central role in making aid more effective.

5) While fast growth in countries such as India and China has succeeded in reducing absolute poverty significantly, it has increased inequality sharply and presents a new set of policy and development challenges. Inequality also continues to be a central problem in Latin American economies. Poverty, while lower, continues to be persistent in pockets especially in rural and backward regions. The MDBs need also to be able to respond to other development issues of special relevance to Middle Income Countries.

   Tacking growing inequality is likely to be a big challenge for MDBs which have traditionally advocated growth oriented strategies and depended on the now discredited 'trickle down effects' for the benefits to accrue to those at the bottom of the society. This needs to happen at the same time as persistent pockets of poverty are tackled.

6) There is an increasing consensus on the urgent need to increase the production and supply of global public goods such as vaccines and tackle the pernicious impact of global public bads

such as pollution and global warming. While global public goods by definition will benefit all countries developing or developed, there is a significant overlap between the GPG agenda and the development landscape. This is due to three main reasons 1) GPGs such as vaccines benefit developing countries more than proportionately 2) As the weight of emerging economies such as China and India in the global economy grows, their contribution to global public bads such as pollution, climate change and environmental degradation is also on the rise, especially at the margin 3) Regional public goods such as an African road/rail network can provide a strong stimulus for development

The global / regional public goods agenda is thus growing in importance and profile and the MDBs are naturally placed to play a role in providing these goods. However the nature and scope of this role needs to be clearly defined.

7) Development is a complicated business, but for a number of years the MDBs amongst other actors were promoting a set of policies collectively known as the 'Washington Consensus' which were over hyped as the solutions to development problems. The certainty associated with such policies has been shattered by academic work and poor outcomes. However, there is no alternative set of cohesive policies to replace them. Instead, it is being increasingly recognized that development can only be brought about by a complex combination of situation specific and evidence based mix of locally owned policies which also involve a fair degree of experimentation and hit and miss. Development is not a guaranteed outcome as evidenced by a large number of development failures though the success of countries such as China and India give reason for hope.

   This highlights the need for another role for the MDBs, that of knowledge banks. As institutions with a global/international reach they are well placed to cross fertilize development policies and map successes and failures. They also have massive in-house research capacity as well as a broad sectoral and policy overview which can be invaluable for developing countries. Given their less than successful track record, should these institutions continue to play this role? How can this role be made more effective?

These trends and challenges are briefly summed up in the following table.

Some questions for the Multilateral Development Banks
How to keep providing appropriate financial suuport to fulfil the needs of developing countries?
How to tackle the persistent problems of Fragile States?
How to respond (through change in focus, structure and funding) to the expansion of private capital flows?
How to make the international aid architecture more effective in the face of proliferaion and fragmentation?
How to respond to the emerging needs of middle income and fast growing countries to stay relevant?
What role to play in the provison of global and regional public goods?
How to play the role of knowledge banks?

The agenda for the MDBs

What the MDBs should do depends on a number of factors of which the main ones are:

- The evolving development needs of their client base
- Relevant trends at national, regional and international level
- The capacity and characteristics of the institution
- What other institutions and development players are doing

This next part looks briefly at each of the four MDBs in turn. For analysis, it focuses on pulling together

- some key facts and figures about each institution
- the environment they operate in and their resource base
- suggestions that have been made for improving their effectiveness
- areas they need to focus on and actions they need to undertake

The Regional Development Banks

The three regional development banks – the African Development Bank (AfDB), the Asian Development Bank (AsDB) and the Inter-American Development Bank (IDB) are all the premier multilateral financial institutions in their respective regions. All three identity with strong regional member representation and over 60% of the staff from within the respective regions. In all three cases, there is strong sense of regional identity and ownership especially in comparison to the World Bank.

However the institutions and the client countries they cater to are quite different. The AfDB mainly has low income countries as its clients so the concessional window is bigger than the non concessional window and the operations focus on the problems of low income countries. The IDB on the other hand operates in a region where most of its clients are middle income so its non concessional window is more than ten times bigger than its concessional window and it focuses on the needs of its middle income clients. The AsDB sits somewhere in between with a mix of low income and middle income clients. In terms of size too, the IDB is the biggest with the AsDB in between that and the AfDB which is the smallest.

The three institutions have unique histories and different client bases. They face distinct challenges and have different opportunities and operate with dissimilar levels of resources. Yet at the same time some of the tasks they need to undertake to be more effective and some of their important areas of focus are closely related. In the next section we discuss the similarities and differences between these institutions and critically examine their responses to evolving challenges.

It is instructive to look at some of the characteristics of the MDBs in relation to each other and the following tables and figures summarize comparisons on some key parameters.

Financial ($ millions)

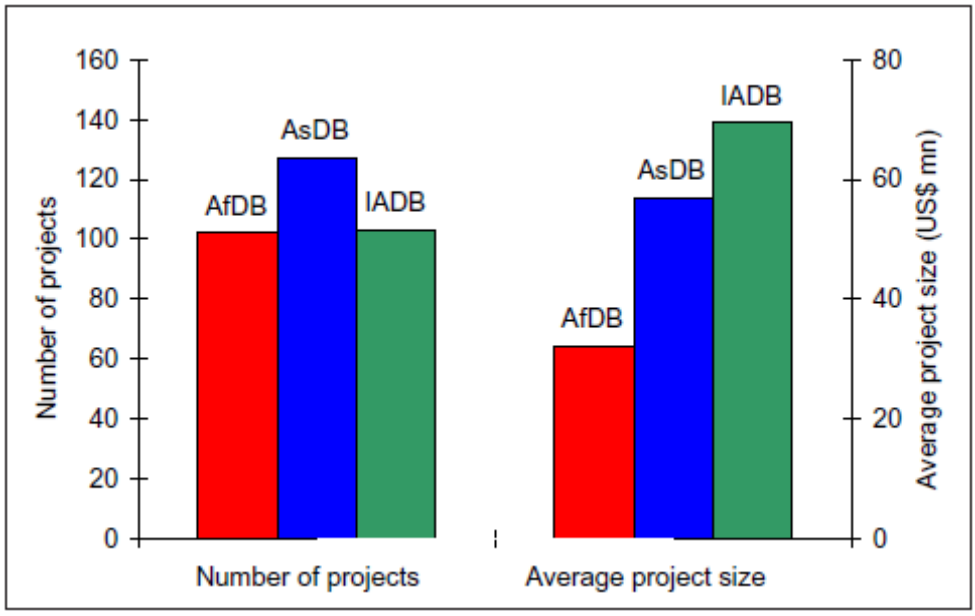
	IBRD + IDA	AfDB Group	IDB	AsDB
Subscribed Capital (callable + paid-in)	189,718	**30,924**	100,953	50,163
Approvals	22,307	**3,278**	7,148	7,233
of which from concessional window	8,696	**2,032**	410	2,527
Disbursements	18,672	**1,843**	5,323	4,745[1]
of which from concessional window	8,950	**988**	424	1,247[1]

Operations/Human Resources

	IBRD + IDA	AfDB Group	IDB	AsDB
Number of Projects Approved	278	**102**	103	127
Total Staff	8,700	**1,020**	1,852	2,456
Number of Regional/Country Offices	109	**9**	29	26
Countries eligible for borrowing	145	**53**	26	43
GDP of Eligible Countries ($ billion)[2]	8,862	**791**	2,006	4,519
average GDP ($ billion)	61	**15**	77	105
Population of Eligible Countries (millions)[2]	5,302	**877**	534	3,393
average (millions)	37	**17**	21	79

Administrative Comparison

	IBRD + IDA	AfDB Group	IDB	AsDB
Projects per Eligible Borrowing Country	1.92	**1.92**	3.96	2.95
Average Project Size ($ millions)	80	**32**	69	57
Approvals per Eligible Country ($ millions)	154	**62**	275	168
Staff per project approval	31	**10**	18	19
Staff members per eligible borrowing country	60	**19**	71	57



The World Bank is bigger than all the regional development banks put together on many parameters such as

- Capital and Equity for the non concessional window

- Size of the concessional window
- Staffing levels etc.

Because the Bank is the premier development institution, many of the same issues that are relevant in the discussion of the Bank's role would also be relevant to the discussion of the roles of the Regional Development Banks. That is why, the Bank and its role is analysed first followed by a less detailed discussion of its sister Regional Development Banks.

AfDB

RATINGS:
AAA/Stable/A-1+
Initial rating (1984).....AA

BASIC DATA (END-DEC. 2006):
Total assets .....SDR12,332 mil.
.....(US$18,552 mil.)
Development-related exposure.....SDR5,417 mil.
Adjusted paid-in capital.....SDR2,064 mil.
Adjusted shareholders' equity.....SDR4,370 mil.
Paid-in capital receivable.....SDR20 mil.
Callable capital from 'AAA' shareholders.....SDR5,490 mil.
Date last general capital increase approved.....1998
Amount of increase.....SDR5.7 bil.
Amount to be paid in.....SDR340 mil.
Date last scheduled payment due.....2008
Total shareholders.....77
Countries where development-related exposure.....34

PURPOSE:
To promote sustainable economic growth and reduce poverty in Africa. The bank pursues these goals primarily by making medium- and long-term loans for public sector projects. It also lends to the private sector and makes equity investments, and provides a variety of financial and technical advisory services.

AsDB

RATINGS:
AAA/Stable/A-1+
Initial rating (1971)..... 'AAA'

BASIC DATA (END-DEC. 2006):
Total assets .....US$56,850 mil.
Development-related assets .....US$28,099 mil.
Adjusted paid-in capital.....US$3,243 mil.
Adjusted shareholders' equity.....US$12,733 mil.
Callable capital from 'AAA' shareholders.....US$19,797 mil.
Date last general capital increase approved.....1994
Amount of increase...US$25.8 bil.
Amount to be paid in.....US$0.0 bil.
Date last scheduled payment due.....1996
Total shareholders.....66
Countries of borrowers 36

PURPOSE:
To provide loans, technical assistance, guarantees, grants, and equity investments that promote the economic and social advancement of its members and to encourage public and private sector investment for development purposes. ASDB's mission is to help its developing member countries reduce poverty and improve their quality of life. Special consideration is given to smaller and less-developed countries and projects that foster regional economic growth.

IaDB

RATINGS:
AAA/Stable/A-1+
Initial rating (1962) .....AAA

BASIC DATA (END-DEC. 2006):
Total assets .....US$66,475 mil.
Development-related exposure .....US$46,311 mil.
Adjusted paid-in capital.....US$3,780 mil.
Adjusted shareholders' equity.....US$19,248 mil.
Paid-in capital receivable .....US$418 mil.
Callable capital from 'AAA' shareholders.....US$41,026 mil.
Date last general capital increase approved.....1995
Amount of increase....US$40 bil.
Amount to be paid in ...US$1 bil.
Date last scheduled payment due.....2000
Total shareholders.....47
Countries where development-related exposure 25

PURPOSE:
To accelerate economic and social development in Latin American and Caribbean countries, with an emphasis on poverty reduction and social equity, modernization and sector reform, economic integration, and the environment. In support of these objectives, the bank provides long-term financing at favorable interest rates to governments, other public sector entities, and a limited number of private sector borrowers. It also provides technical and advisory services.

IBRD

RATINGS:
AAA/Stable/A-1+
Initial rating (1959) .....AAA

BASIC DATA (END-JUNE 2007):
Total assets .....US$208,030 mil.
Development-related exposure .....US$98,743 mil.
Adjusted paid-in capital.....US$9,126 mil.
Adjusted shareholders' equity.....US$37,458 mil.
Callable capital from 'AAA' shareholders.....US$79,281 mil.
Date last general capital increase approved.....1988
Amount of increase.US$79.1 bil.
Amount paid in.....US$2.4 bil.
Date last scheduled payment due.....1997
Total shareholders.....185
Countries where development-related exposure 78

PURPOSE:
To reduce poverty by promoting sustainable economic development via loans, guarantees, and related assistance for projects and programs in its developing member countries. IBRD is the largest constituent of the World Bank Group, which also includes the International Development Association, the Multilateral Investment Guarantee Agency, and the International Finance Corporation.

The World Bank

The World Bank was set up in 1944 as the International Bank for Reconstruction (IBRD) and Development which works like a development co-operative for its 185 member countries working to reduce poverty and increase development in member countries.

The International Development Association, set up in 1960, gives interest free credits and grants to the poorest 80 countries in the world as defined by per capita income. It mobilizes funds from its donors and through excess income transfers from the IBRD with the replenishment working on a three year cycle.

It, along with the European Commission and the United Nations is one of the largest multilateral development organizations in the world having averaged about $10 billion in annual IDA credits and grants for a number of years now. For example for low income countries between 2001 and 2005, the World Bank alone provided

- over 20% of aid in 17 countries
- 10%-20% in 34 countries and
- 5%-10% for a further 12 countries

However, the Bank's influence in poor countries goes far beyond its financial contribution alone. It plays a central role in decision making around joint assistance strategies and country performance assessment frameworks as well as budget support groups and similar donor formations. This means that the Bank also exerts a strong influence on the aid spending of other donors. Its country performance and rating system, data and analysis are widely used by other actors.

In an environment where there are more than 1000 (and counting) development funding mechanisms, the Bank stands as a giant amongst them and easily is the most influential and powerful aid organization. At the same time as being involved in most of the major financing and policy issues in developing countries, the Bank is already being given new mandates and funding streams, for example on climate change. It is at the heart of the debates in aid quantity, aid quality, global public goods, developing country debt, development research, global regulation and the financial architecture.

The core mandates of the World Bank – eliminating poverty and ushering development – are far from being realized, so the Bank continues to have a critical role.

Operating Environment

While the absolute number of people in poverty are falling, and most developing countries have registered strong growth in the current decade, on current trend more than 700 million people would still continue to subsist on less than $1 a day in extreme poverty in 2015. They will be increasingly concentrated in sub Saharan Africa and in fragile states that IDA works in.

Deep poverty, where people subsist on less than $2 a day, is likely to stay widespread with as many as 2 billion people living at that level in 2015. Importantly, more than two thirds of them will be in non IDA countries highlighting the continuing relevance of the work of the IBRD in developing countries with relatively higher incomes. In short, the Bank will continue to face serious challenges in fulfilling its mission in both client groups.

While many of the Bank's client countries can already be classified as middle income developing countries, poverty and especially growing inequality continue to be a serious problems that haunts them. More disturbingly, success growth stories such as India and China are exhibiting an increase in inequality of unprecedented proportions with the benefits of increasing prosperity accruing only to a part of the population. This emerging and growing challenge is one the Bank must respond successfully to in order to fulfil its mandate.

While many of the Bank's client countries have growing access to private sector funding with as much as $650 billion in private capital flows to developing countries in 2007, many others are de facto locked

out of the international financial system with the Bank being one of the very few sources of funding they have access to. Moreover, private capital flows can easily dry up as indeed they have in previous economic cycles and the danger that the benign economic environment of recent years may not last is only too real. Even for countries with access to private capital markets, the Bank remains an important source of development funding at least for the public sector.

Along with the need to continue to provide funding, these developments bring new challenges for the Bank in terms of a need for action to increase financial stability, reduce risk and volatility and promote continuing private capital flows.

At the other end of the spectrum, almost half of the Bank's poorest (IDA eligible clients) are now classified as fragile states which present difficult operating environments with high risks and dire development needs. While the focus on selectivity of funds and performance based allocation seems sensible enough, the Bank risks being in a situation of providing funds to countries which have access to other sources and withholding funds from fragile states where the need is most acute and few other alternatives are available.

Instead of focusing on delivering funds to 'successful countries' the Bank needs to continue and expand the delivery of development funds to fragile conflict prone states where money can make the most difference at the margin. Instead of varying the amount of funds allocated, it should perhaps allocate funds purely on need but experiment with different mechanisms for disbursement depending on the situation on the ground.

Too many donors and funds are jostling for space trying to do their own thing so the aid environment has become too complex and unmanageable. In such an environment, the World Bank's co-ordination role needs to be strengthened to help use the limited amounts of aid that is available (through an increasing number of sources) in a more effective and efficient way. Else we might end up in a situation where increasing fragmentation costs could mean that more aid could make the situation worse not better in developing countries.

The rising recognition and importance of global public goods such as tackling climate change and their large potential development impact means that this would be another challenge where the World Bank would need to step in with a considered policy response. This could, in this instance, include mobilizing and channelling additional funds for the provision of public goods, internalizing the discussion in national level development plans, analyzing and projecting their development impact and playing a co-ordinating role between developing and developed member states.

While it is clear from the preceding discussion that the Bank faces many challenges, it also does have relatively deep pockets, at least compared to other development institutions. For example, the Bank has almost $40 billion in equity with significant additional amounts of callable capital which gives it the financial capacity to have close to $200 billion in outstanding loans. Moreover, with its private sector arms – the IFC and MIGA, the Bank can exploit synergies in delivering a financial punch of even greater magnitude for example through catalysing private financial flows and developing risk management products for economies.

For the poorest countries, the Bank now has an additional $25 billion (total capacity $40 billion) commitment of funds from donors for the latest three year IDA 15 cycle. The commitment from donors is also supported by record pledges of $3.5 billion from excess IBRD and IFC income.

Added to these resources (and those of the IFC and MIGA), the Bank manages donor driven trust funds for a number of development, technical assistance and public good provision roles which now disburse more than $5 billion annually. While this money does not belong to the Bank, it does have significant leverage in directing these resources.

World Bank Trust Fund Details

Fiscal year	2002	2003	2004	2005	2006	Average annual growth (percent)
Contributions (millions of U.S. dollars)	2,732	3,899	4,940	4,750	5,214	18
Disbursements (millions of U.S. dollars)	1,931	2,561	3,277	4,128	4,374	22
Funds held in trust (millions of U.S. dollars)	5,342	6,887	8,587	9,308	10,293	18
Number of funds	921	933	903	840	929	0.2

Proposed focus areas for the World Bank

In its recent Long Term Strategic Framework in which the Bank projects how it expects the world and its own work to evolve over the next 15-30 years. It seeks to consolidate its status as a full service premier development institution while focussing on four main priority areas of work

- A geographic focus on Sub Saharan Africa
- A special focus on its Fragile State clients
- A thematic focus on promoting inclusiveness in its middle income clients
- A new focus on the area of Global Public Goods

It proposes that it would be best placed to fulfil its mandate and focus on these priority areas through a number of action points which follow

Financing

- Leveraging IDA's funds and capacities
    - In infrastructure
    - In the social sectors
    - In fragile states
- Renewing and expanding services in middle income countries
    - Unbundling finance and knowledge services
    - Easing access to the IBRD
    - Increase sub sovereign lending
    - Provide contingent financing and insurance

Co-ordination

- Reinforce the centrality of the Bank's country based approach
    - Aligning aid with country strategies using performance based allocation
    - Follow suggested good practices on conditionality
    - Use increasing amounts of pooling and co-financing to leverage own funds
    - Rationalize its trust fund portfolio
- Moving toward a global public good bank
    - Advocate developing country interests in global frameworks
    - Work on sustaining the environment
    - Work on combating communicable diseases

Knowledge

- Mining development experience for knowledge – Global Learning
- Expanding the knowledge frontier while reinforcing core expertise
    - Do more work on context specificity
    - More work on governance and institutions
    - More work on the inter-relationships between development and public goods
- Increase work on collection and dissemination of data & strengthen collection systems

A discussion of priorities and strategy

The overall four focus areas for the Bank are broadly appropriate though there is a significant amount of overlap between the sub Saharan African region and the fragile state grouping with about half of fragile states in SSA and also nearly half of SSA states being classified as fragile. It is in these two groups of countries that development needs are most acute though both extreme and deep poverty continue to be very serious problems in other developing countries such as India which do not belong to either of these groups.

A thematic focus on promoting inclusiveness in middle income countries is urgent though the Bank has been less than successful in spelling out how exactly it plans to do this without for example any significant capacity in taxation. It seems to be again focussing excessively on growth as a means of delivering inclusiveness in slow growing MICs despite the past failure of trickle down effects.

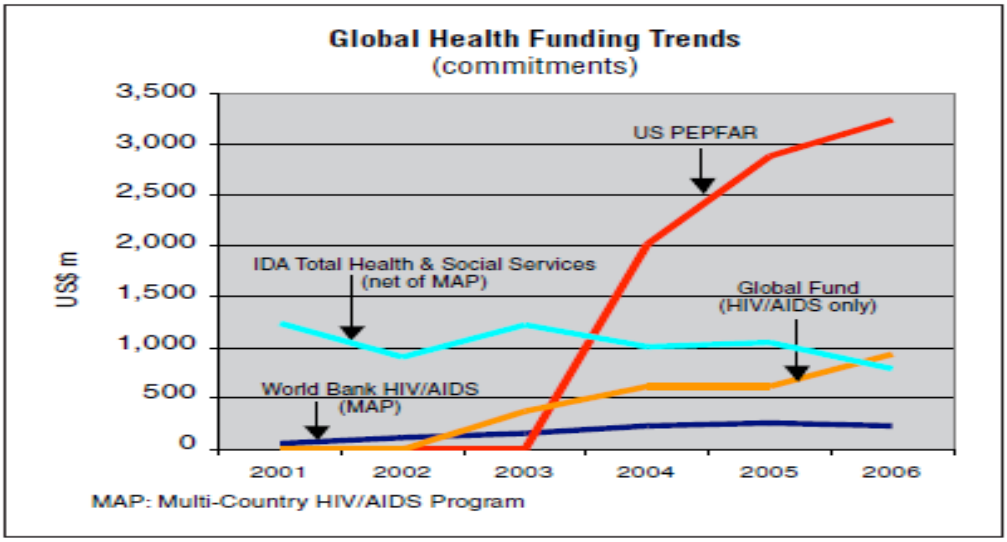
Perhaps in a quest to regain legitimacy and influence in a time of declining influence the World Bank seems to have over-egged the role its role in the area of global public goods which has the attention of the global community nowadays. While it is true that UN institutions have serious funding constraints and are seen as less effective than the MDBs, they do and should continue to lead the multilateral work on global public goods. The Bank's role is at best secondary and supportive in terms of its ability to leverage funds and legitimately represent the interests of developing countries in policy discussions of global public goods.

Development itself is a global public good and should continue to remain the dominant sphere of work for the Bank. While it is appropriate for the Bank to try to rationalize its current de facto role in the provision of global public goods for example through its trust fund portfolio and to track and influence the development impact of climate change, it seems to be stretching beyond these core needs.

Given that absolute poverty has doubled in sub Saharan Africa which has been a focus area for the Bank's work, it is difficult not to have the sense that the Bank is taking its eyes off the ball and overstretching itself without having successfully addressed its core mandate. In the case of relative success stories such as India and China, the majority of commentators agree that the Bank did not play a central role in their success so it is not time to rest on its laurels and move on to the next challenge.

Sector allocation, co-ordination and aid effectiveness

IDA delivers 3-4 times the amount of concessional funds and grants as all the RDBs put together so it continues to be the largest or one of the largest sources of development funding in most of the countries it operates in. However as evident from the graph below, IDA's share as a percentage of total aid to its client counties is in decline as the total share of multilateral ODA stagnates at about 30% and as new vertical funds such as the Global Fund, philanthropic organization such as the Gates foundation and NGOs become increasingly important in the aid landscape.



Another point that jumps out from the graph above is that the proportion of untied ODA available for building up health systems and flexible forms of country specific expenditure are declining (at least in the health sector) compared to single purpose or earmarked funds such as those available from the Global Fund and PEPFAR etc. This can lead to absurd situations such as when the money available to fund HIV/AIDS exceeds money available to fund the rest of the health service put together. Bottlenecks in the health system might prevent the money being spent effectively and country priorities such as treatment of malaria to be put on the back burner.

That is where IDA's role as a residual (or perhaps more accurately a system donor) becomes especially critical where it finances bread and butter critical systems expenditure on social service infrastructure and recurring costs which are not 'sexy' with other donors and for which money would not be readily available from other sources. Thus IDA helps finance platforms which other donors including multilateral funds can then piggyback on to make their work more effective. This is the role IDA must consciously choose to play more and more as vertical funds and other sources of funds multiply (partly in order to be able to mobilize higher overall amounts of ODA).

IDA is one of the only donors which have a good overall comprehensive snapshot of what is going on a country level in its client developing countries. So, working together with the recipient government it can help formulate plans and direct ODA flows from various sources to where they are most effective and plug the gaps in essential development expenditure through its own resources. There are four ways that it can successfully leverage its critical role at country levels.

- Increase the share of resources flowing through IDA – this is unlikely in the long term though donors, judging from the successful IDA 15 round, seem committed to maintaining the share of IDA close to current levels
- Playing a larger role in country based co-ordination of donors under the aid effectiveness agenda by encouraging and leading Sector Wide approaches, pooling of funds and better donor harmonization at the downstream levels
- Using its prominent role in the delivery of vertical funds and trust fund resources to use them as co-financing vehicles in a strategic manner
- Advocating for donors to push vertical funds to have higher general and support budgets which for example can then be used for system and social infrastructure financing which is pre-requisite, for example, for the successful delivery of HIV/AIDS treatments

With the focus on MDGs the share of social sector allocation global ODA increased drastically especially in sub Saharan Africa to as much as 60%. At the same time, the share of infrastructure has declined to about 20%. Development is both about ensuring that poverty is eliminated (which is what social sector spending can help accomplish directly) as well as that the country is set up on a self sustaining self financing path to prosperity and economic well-being. For that to happen, infrastructure investment is vital as without that the benefits form social spending would only be partially translated into economic growth. Also, the delivery of social services is severely hampered by the lack of infrastructure such as rural roads.

So IDA has argued for a bigger role in the financing of infrastructure. However, this does not seem to be an area that IDA should prioritize heavily

- Because infrastructure projects such as power plants, tool roads etc are more likely to be able to generate financial returns than social sectors, more sources of funds, such as domestic resources, natural resource rents, domestic and private investment, regional development banks, private credit and China etc are available to finance them. So the marginal difference that IDA can make is low
- In many of the poorest countries, the interests of the minorities, the poor, the disenfranchised and the indigenous communities are not properly represented so expenditure that disproportionately benefits them, such as the free provision of health and education etc, is not prioritized enough by developing country governments. Here donors such as IDA are needed to fill a critical gap

- Many big infrastructure projects such as airports etc are aimed primarily at the needs of the industry and the elite so their direct contribution to poverty reduction and development is suspect though second order effects such as through the acceleration of economic growth are also important. Moreover, many such projects have serious environmental and social costs (such as the Three Gorges dam) and may not generate proportionate benefits for the country (such as copper mining in Zambia where Zambia was getting only 2% of the profits) or be well-integrated with the domestic economy (such as the aluminium industry in Mozambique). In these cases, the case for the increased participation of IDA in infrastructure is suspect.
- Where it does decide to pursue such projects it should do so only after a thorough PSIA

IDA should instead focus on the delivery of social infrastructure as discussed above in the case of health systems. This would perhaps make the most difference to the development of a country at the margin because such investment would make other ODA flows more effective and direct benefits to the poor. On this issue, it can work closely with the regional development banks. For example, the co-financing of the construction of a rural road network in Africa by the World Bank and the African Development Bank has been discussed for some time now.

Another area where IDA could make a substantial difference is agriculture which has been ignored in recent years. Despite increased urbanization, agriculture continues to be the mainstay of most people in poor countries. With soil depletion, increasing scarcity of water, global warming and subdivision of land holdings agriculture is becoming more marginal in many of the poorest countries threatening the livelihoods and food security of hundreds of millions. As the green revolution showed, even small investments in agricultural research and technology can make big differences in poverty and productivity.

With a young demographic profile, already high unemployment, poor urban infrastructure and primarily agrarian economies, most low income clients of the World Bank stand to benefit tremendously from even incremental investments in agriculture. As mentioned elsewhere in the report, agriculture led growth generates more poverty reduction than industrial growth and produces more equitable benefits.

Fragile States

There is little doubt that fragile states present serious development challenges. Just under half of IDA clients are now fragile so success in these states is critical to the success of IDA and its mission of development. At the same time IDA is a very major channel for ODA delivery to fragile environments. It is right that given this and the fact that fragile states have the most acute development needs that IDA increase its involvement in these states. However, the seriousness of IDA's efforts and the depth of its knowledge and understanding of the challenges of development in fragile environments is cast into doubt given that it only has staff on the ground in about half of these sates.

The UN on the other hand, has a much greater presence in these states. Also, the UN presence stretches across a larger number of relevant spheres such as development (UNDP), peacekeeping (UN Peacekeepers) and refugee management (UNHCR) etc. so the UN may be better able to understand and provide for the development needs of citizens in such situations.

IDA can be more effective in these environments through

- Increasing its presence on the ground in fragile states
- Ceding the leading and co-ordinating role to the UNDP in some of these nations and play a fiduciary, strategic and funding role while preparing for an increased future role
- Using donor financed trust funds to leverage its own involvement
- Advocating for an increased used of the TRUIMF mechanism (discussed later in this paper) which helps allocate needed funds in a more flexible way through non governmental actors and which allows fund from multiple sources to accumulate

Allocation, selectivity and conditionality

The criteria used to make decisions on

- Loan vs. grants
- Country IDA allocation

Are far from perfect and need to be changed. The loan vs. grants decision is made purely on the basis of the debt sustainability. It ignores the fact almost no country with a GDP per capita of less than $500 has been able to carry even relatively small amounts of debt without needing substantial cancellation. Nor have many countries at this level of income have registered sustained economic growth in recent years. Even low levels of current loans might just be storing up problems for the future so such countries should get mainly grants.

At the other end of the spectrum, many commodity rich low income countries and some others such as Ghana have recently floated commercial bonds including those that are linked to oil. Moreover, new players such as China which is seeking access to resources are readily providing these same countries with loans. It is more difficult to justify providing grants in such instances.

One possible way of providing the right incentives for countries would be to provide countries with GDP per capita only grants until they borrow at near commercial terms from other sources (unless it is under a crisis situation or other special circumstances) at which point the grant facility should be partially or fully withdrawn (perhaps even with retrospective effect) to help reinforce responsible fiscal management.

Country IDA quotas are currently allocated on the basis of country size and poverty levels (which are appropriate) as well as on the basis of a complex Bank constructed indicator called the country policy and institutional assessment. This indicator, which was not made public until recently, is based on a set of subjective staff estimates of policy and institutional conditions in a country and has been widely criticized especially for the significant weight it puts on the liberalization of trade for instance – a policy measure which has been shown to have no empirical link with development progress or poverty reduction.

While this rather ad-hoc allocation is problematic in itself, it gets amplified as Bank CPIA measures are widely used by other donors including for example the African Development Fund to make their allocations. Moreover donors including the Bank use progression along the CPIA scale as a chart of progress in the country which is rewarded. The theoretical underpinning of this approach as well as its empirical justification is highly suspect and it is less than clear to countries what they could do to make progress. It also means that rather than focusing on development outcomes and experimenting with various policy mixes to find out which one works, recipients may target maximising CPIA ratings which may not deliver as much development benefits as other approaches.

IDA should allocate aid primarily on the basis of country need and vary the channel of delivery to suit country specific governance situations. The TRIUMF approach could be used to flexibly exploit this option while generating positives incentives for pro development policies and outcomes. The TRIUMF approach is flexible and especially well adapted to being used in fragile states.

Increasing the predictability of IDA allocations over a longer term horizon (say ten years) would help increase the quality of IDA contributions. This would, however, require donors to introduce greater predictability in the replenishment process which could be done by splitting contributions into base contributions (say 60% of current levels) to be committed three cycles in advance and voluntary top ups which can be renegotiated every cycle.

The traditional World Bank policy of conditionality such as the structural adjustment phase has not had a good record of success. Talking about country ownership and imposing significant policy conditionality including in sensitive areas such as privatization and trade liberalization is not mutually compatible. Even when country strategies are jointly designed such as the PRS papers it is instructive to find out where the original policy suggestion originated. When a country itself has suggested a policy it is still difficult to tell whether it is truly owned or whether the country merely put it there cause it knows what is expected (and rewarded if it looks at the inputs into the CPIA ratings for example).

The progress that the World Bank claims it has made on reducing and rationalizing conditionality is also strongly contested. So neither selectivity nor conditionality are fool proof approaches to making efficient and effective aid allocations and can be significantly improved.

What could work better would be a three tier minimalist approach which focuses on only three main principles – transparency (to reduce corruption), do no harm (to address human right violation concerns) and outcomes (see appendix on TRIUMF).

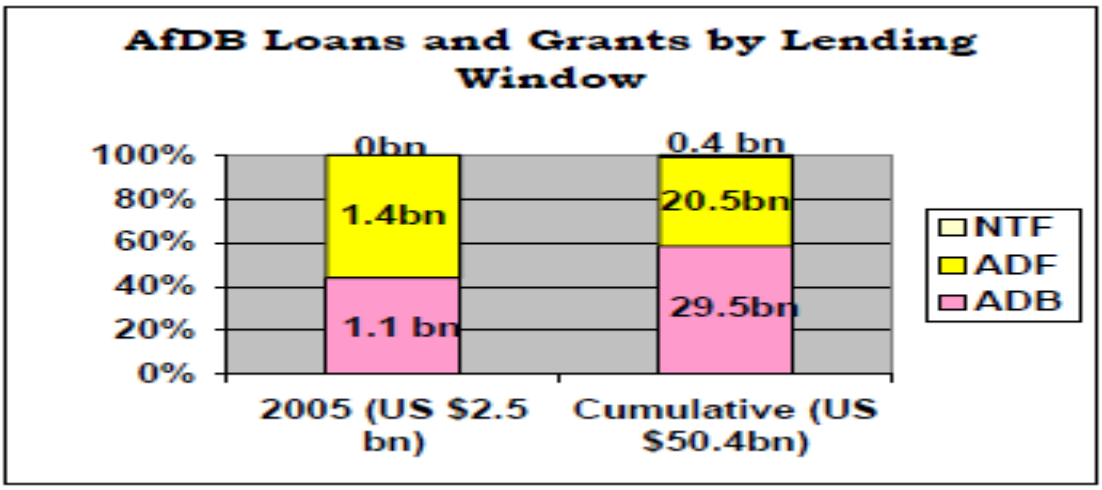
How the IBRD could improve its offerings, inclusive growth in middle income countries and the role of MDBs in Knowledge delivery and development research are all discussed in subsequent sections.

The African Development Bank

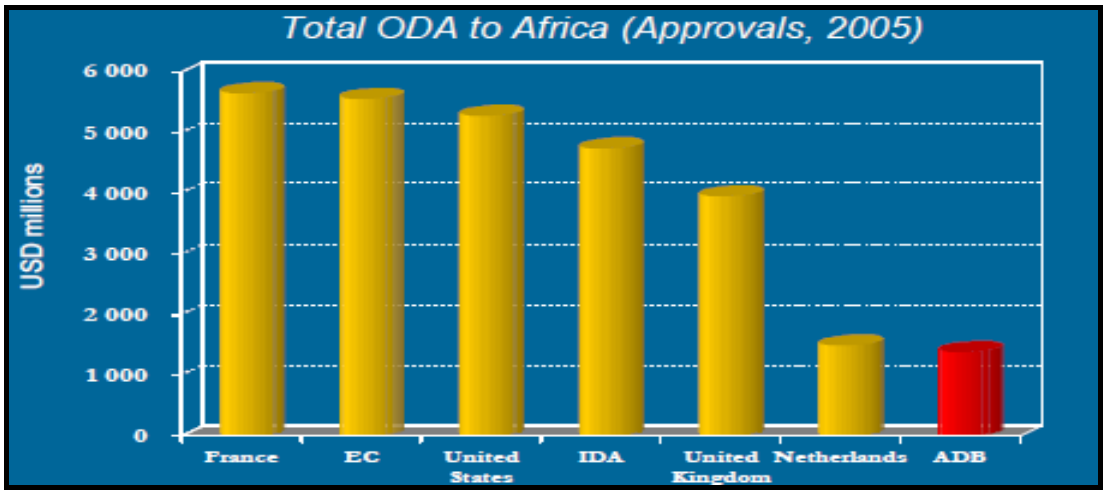
The African Development Bank was set up as a purely African institution in 1964. As African economies were suffering in the aftermath of the oil crisis in the 1970s, non African members were brought on board in 1982 to shore up the financial resources of the Bank. The Bank suffered a crisis of confidence in the mid 1990s when bad lending practices and a series of scandals tainted its reputation and it became the first RDB to lose its AAA rating in 1995. However, it recovered by cutting costs, closing down all field offices and focussing – it has since regained the AAA rating and has re-established its reputation.

The African Development Bank is officially headquartered in Abidjan but relocated temporarily to Tunisia in 2003 due to conflict in Cote d'Ivoire. It continues to operate from Tunisia today. The AfDB maintains regional offices in Senegal, Gabon, and Mozambique, and is in the midst of opening 25 offices throughout Africa. The AfDB has 53 "regional" and 24 "non-regional" member states.

Like the other MDBs, the AfDB has both a concessional window (the African Development Fund – AFD) and a non concessional one with 40 and 14 client states respectively. The AfDB is the smallest of the RDBs and is only the seventh largest donor in the region with close to a twentieth of the share of total ODA flowing to Africa.



Through its International Development Association (IDA), the World Bank annually approves about four times more in low-interest loans and grants to Africa than the AfDB does. The AfDB lacks the financial resources, the staff capacity and the range of staff skills and experience of the World Bank. For example, at the World Bank there are more than four times the number of staff working on any given project than at the AfDB.



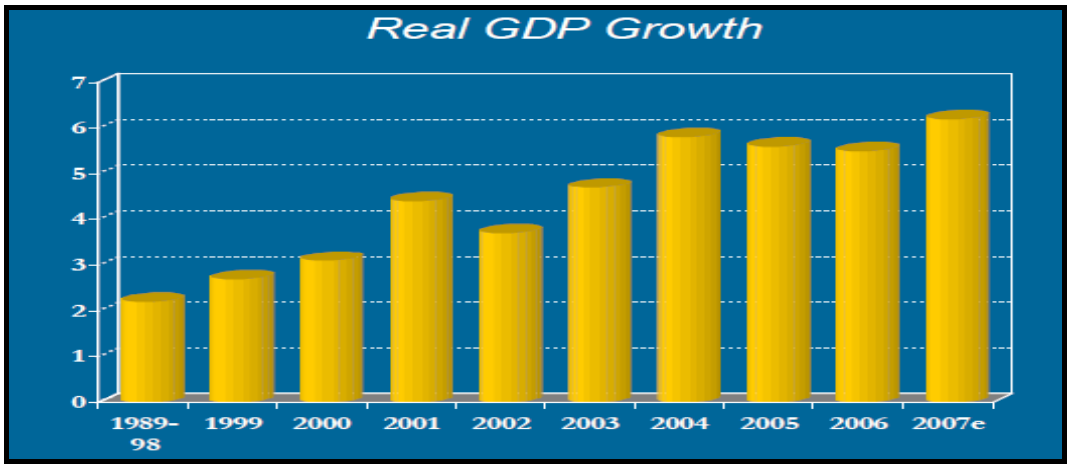
While the AfDB's lending had not expanded significantly in recent years, recent figures indicate that things may be changing. Between 2005 and 2006, for example, the AfDB's lending activities increased by more than 30 percent to US$3.4 billion.

Operating environment

The AfDB operates in a very challenging environment characterized by

- Widespread extreme poverty
- Low human development indicators
- Large number of small economies with low levels of integration
- High levels of conflict
- High levels of endemic diseases and related mortality
- Poor infrastructure and high corruption
- Crowded field of donors
- Weak and volatile historical growth

As indicated by the bullet points above the environment for the AfDB is no doubt very difficult with as many as half of its client states classified as fragile. However, things are improving in most countries across the continent with most of the region having registered significant and stable growth in recent years partly because of the global commodity price boom.



Also both overall flows of ODA to Africa as well as the contribution of the AfDB are growing. Private capital flows of all kinds, including FDI and portfolio investment, coming into Africa are also growing as are the volume of interregional and intraregional trade. However, Africa's share of these flows is going down indicating that the continent may be being left behind by the faster growth and integration of Asia into the international economy.

So while the operating environment of the AfDB remains tough, things seem to be getting better and resources available to bring about much needed development seem to be increasing. The AfDB's challenge is to carve out a pan African niche for itself to make a significant development contribution to the region.

Proposed focus areas for the African Development Bank

While the money that the AfDB delivers is no doubt significant, its relatively small size means that this cannot alone be a justification for its continuing existence or growth. The uniqueness of the institution comes from it pan African nature and it is that that the AfDB must exploit in its bid to strategically have a bigger development impact. It must also be more selective on the sectors it focuses on given its comparatively limited human resource and financial capacity.

A number of the AfDB's projects, especially its policy loans, are financed jointly with the World Bank and other donors. The AfDB also relies extensively on World Bank research and analysis. As a larger institution and often the lead financier on joint projects, the World Bank attracts more attention than the AfDB. However, at least on issues of critical pan African nature, the AfDB needs to enhance its work and its reputation to become a point of reference for such issues.

Some of the focal aspects for the AfDB's work that have been suggested going forward are

- Infrastructure
- Leading on regional issues
- Fragile States
- Private Sector
- Governance

Infrastructure

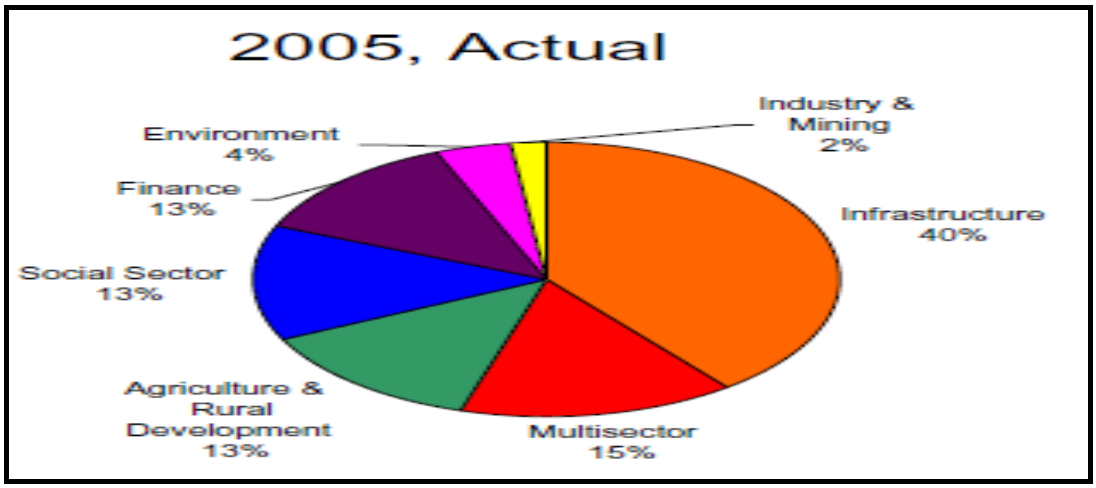
Most commentators both inside and outside the Bank agree that infrastructure must be a core focal point for the Bank's work at least in the short term. This makes sense as the AfDB has

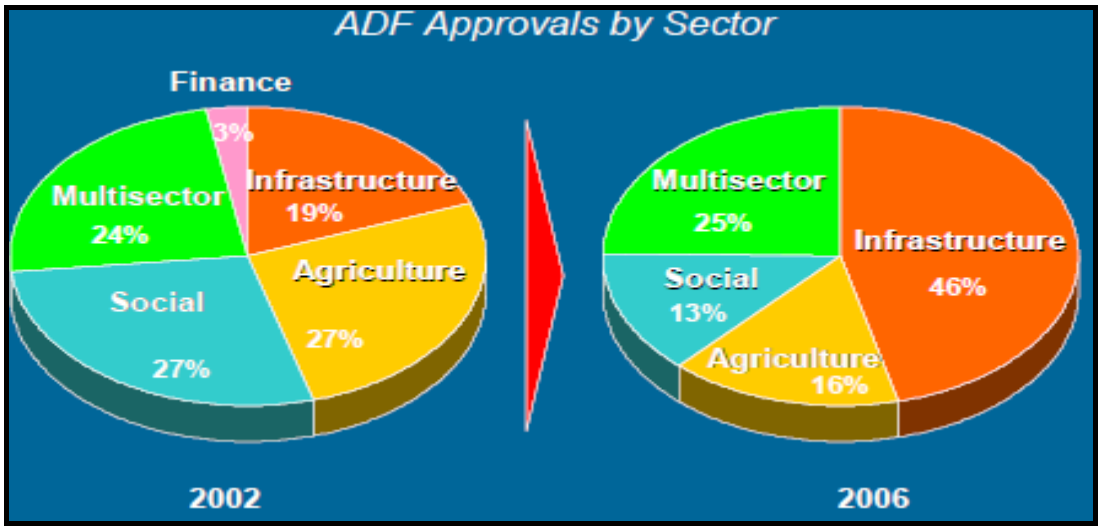
- Substantial experience and a good reputation in this sector
- Poor infrastructure is a major constraint for private sector investment and growth
- A special mandate from NEPAD and the Infrastructure Consortium of Africa which it hosts
- And this area is relevant to borrowers from both the windows of the bank

Within infrastructure, it has been proposed that the Bank focus especially on

- Transportation with a special emphasis on regional transport corridors, rural roads, integrated projects (that incorporate various means of transport), rehabilitation and maintenance programs;
- Electricity with a special emphasis on on power pools and interconnections; production, transmission and distribution grid projects, cleaner/lower carbon energy sources, including renewable energy;
- Water and sanitation with a special emphasis on rural water supply and sanitation and the promotion of integrated management of water resources, secondary focus on urban and peri-urban water supply and sanitation as well as small and medium towns;
- ICT with a focus on priority initiatives reducing the digital divide between countries and regions, and between towns and rural areas

As the following figures show, infrastructure has been a growth area for both the concessional and the non concesisonal windows of the AfDB. This growth has come about partly as a result of client demand and partly as other donors have significantly increased their funding of the social sectors. The social sectors now receive a considerable majority of ODA, while the proportion of these resources directed to infrastructure has declined sharply. Special purpose organizations such as the Global Fund have moved strongly into sectors such as health. Meanwhile, support for regional integration and multinational infrastructure projects, in particular, has traditionally been very limited, even as the demand for such investments has grown dramatically.





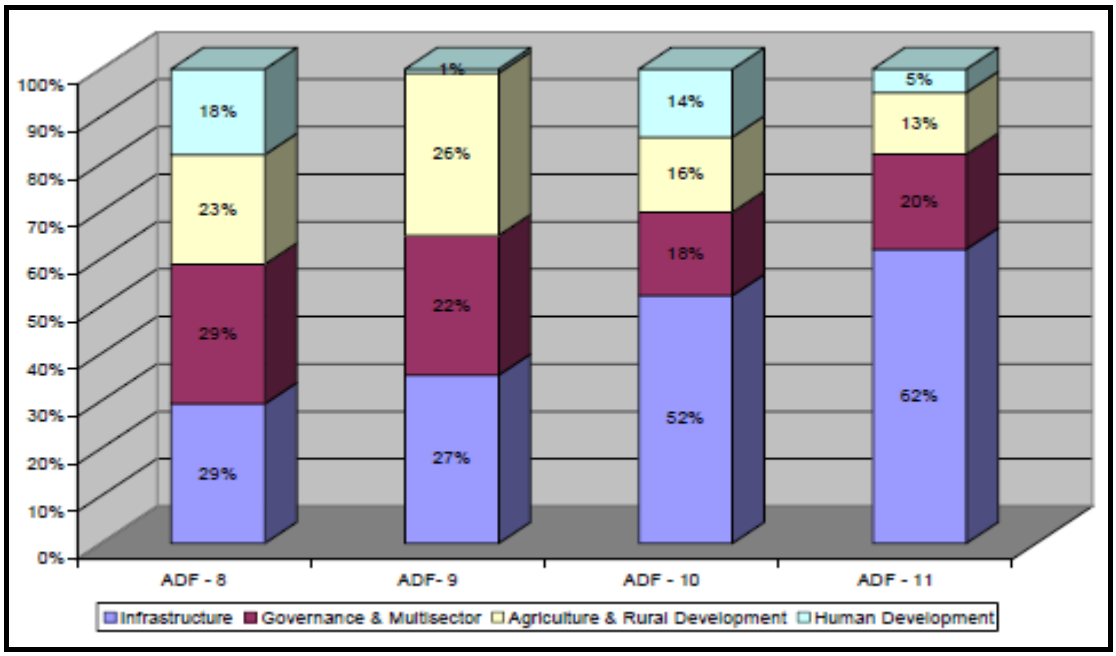
The AfDB has been given a special mandate by NEPAD to lead on infrastructure and also hosts the Infrastructure Consortium of Africa which was established by G8 countries to coordinate and encourage infrastructure development in Africa, focusing on regional infrastructure development in particular. The AfDB also has a special facility to prepare projects so they may obtain financing from others sources through an initiative called the Infrastructure Project Preparation Facility (IPPF).

The right factors – need, demand, mandate, skill, reputation and finance all seem to be in place for infrastructure to become the flagship area of the AfDB's operations in the near future. This is appropriate; but contrary to what some researchers have indicated infrastructure is not the only thing the AfDB needs to do. Its role in some of the other areas for future work is very critical both from the perspective of serving client needs as well as for the purpose of making itself relevant in the crowded development field.

Another caveat is that while infrastructure development is critical for poverty reduction, not all infrastructure benefits the poor. It is important to understand what type of infrastructure project is being proposed and for whose benefit. Is the power plant going to export most of its production in a country where 90 percent of the people lack access to electricity? Will transmission lines lead from the hydropower station to large mining projects but bypass the communities living beneath them? Does the road go from the capital city to the port but not connect with feeder or rural roads that would enable local people to get goods to market? Have other options been thoroughly assessed, including decentralized, small-scale and renewable alternatives? Is the infrastructure project designed to provide water and energy services to people in that country or purely to generate revenue for the government by exporting those services?

A thorough Poverty and Social Impact Analysis of infrastructure projects is vital and only when projects are expected to generate substantial development benefits should they be financed. Projects where private sector financing is involved, especially where the AfDB is supporting private sector involvement through its balance sheet, need to be scrutinized with even greater rigour.

In addition to its mandates from African Institutions, the Bank has also been mandated by RMCs and donors to manage several major initiatives in the fields of infrastructure, water and sanitation, private sector development agriculture, capacity building and project cycle activities. This emphasis is clear from the trends in the allocation of the African Development Fund.



Leading on regional issues

Such issues come in various shapes and sizes but the four (overlapping) categories that are most relevant to present day Africa are

- Regional integration
- Regional infrastructure provision
- Provision of regional public goods
- The Development of a pan African development voice

The AfDB regularly collaborates with the AU and the UNECA on all major development issues for the Continent. In addition, it has been given lead mandates by the NEPAD in Banking and Financial Regulations as well as Corporate Governance, for the implementation of the African Peer Review Mechanism (APRM), and in infrastructure. The Bank also has the mandate to promote regional integration, and is an active contributor to the on-going AU initiative to rationalize Regional Economic Communities.

Over the past decade, regional integration has been recognized by African organizations and the international donor community as essential to increase competitiveness and productivity, expand trade, pool resources for investment, enlarge local markets, and industrialize efficiently by taking advantage of the scale of production that large markets provide.

The Bank is well-positioned to lead in regional integration. It is a key means for the Bank to support the NEPAD initiative and complements its focus in infrastructure. A combination of the promotion of regional standardization and polices on banking, trade and business practices as well as regional infrastructure would help small African states to work together to achieve a critical size. This would help overcome

Africa's high level of dependence on the outside world for trade and finance and help foster better intra regional economic and political ties.

The ADF deputies decision to put a special emphasis on optimising synergies between regional infrastructure programmes and development in the agriculture, health and education sectors would help ensure that such projects deliver maximum pro poor benefits.

The right investments in global public goods, such as Africa-oriented agricultural or medical research, could improve the lives of millions of Africans. The creation of an anti-malarial vaccine or new drought-resistant crops would produce immediate gains for the continent. Although the AfDB does not have many of its own resources to such projects, it could nonetheless work to promote initiatives that would impact Africa and bring a credible regional perspective to some of the debates about investing in and deploying such technologies. Funding for such efforts could be mobilized through donor financed trust funds, working closer together with IFAD and the Global Fund, the World Bank or through private foundations.

As a pan-African development institution engaged across the continent, the Bank Group has a unique role to play as the voice of Africa vis-à-vis the donor community. It has built strong connections and relationships of trust through partnerships and special mandates but needs to do much more work to built up trust and credibility amongst its members as well as external actors.

The emphasis of the African Development Bank on regional issues as a priority area is a critical one and a significant amount of the administrative budget should be allocated to fulfilling the bank's role as the premier African public financial institution. On the project side, a special emphasis on pro poor regional infrastructure projects of the kind listed out in the last section can fulfil multiple goals such as

- Increasing pro poor expenditure
- Promoting regional integration
- Help remove barriers to private sector growth
- Deliver regional public goods

So these projects in particular should be a top priority for the African Development Bank and it should explore co-financing with the World Bank and other donors if its own resources prove insufficient to meet demands and needs of client states.

The AfDB should also explore the possibility of China (and other emerging donors) contributing to a promotion of such regional infrastructure projects.

The AfDB should focus on developing effective partnership with African and regional institutions particularly with the AU and related initiatives (NEPAD, APRM) as well as with sub-regional development banks (i.e., BOAD, EADB, DBSA).

Bank needs a restructured partnership with the World Bank, as an institution which best represents Africa that will provide a clearer division of labour, leaving the AfDB with space to grow. The AfDB must also play a leading role in structuring Africa's partnerships with emerging donors such as China and can also partner with foundations and vertical funds to avoid duplication of efforts.

It must also more vocally and confidently represent African voice at various multilateral forums working on development, financial architecture, commodities, trade and other issues relevant to African economic and development interests.

Fragile States

Almost half of the AfDF's clients are fragile states so its emphasis on these is understood. However, it is not very cleat how this focus would be operationalized. Various planning documents refer mostly providing some supplementary funding, additional targeted support for knowledge management and capacity building and arrears clearance. All of these are important steps in their own right

- Fragile states let far fewer resources than they need and can absorb so the supplementary funding would be helpful. However, the AfDB follows IDA's allocation formula quite closely so it is unclear if a few additional resources from the AfDB would make a very substantial difference given IDA's much greater size
- Targeted support for knowledge management and capacity building is exactly the right kind of expenditure in fragile states which helps build up local networks, realistic on the ground development needs assessments and generate learning on how to best deal with challenging situations. So this additional allocation is welcome but it would only really make a significant contribution if it were to be partly used to fund additional permanent staff presence on the ground. As the discussion of fragile states in a later section will show, all MDBs suffer from a lock of manpower in fragile states so the AfDB could make a big marginal difference by allocating more such manpower. Being a pan African organization it could do so more easily and effectively especially by working closely with the AU. Such actions could also put in a position of taking the lead in certain fragile states with IDA and other donors pooling resources behind the AfDB effort

The Bank's plan to adapt its business practices and procedures and strengthen its internal capacity, including through staff secondment or presence in selected fragile states, to deliver assistance and measure results in fragile states, while enhancing strategic partnership frameworks with other MDBs, partner agencies and institutions working in fragile states, including the UN does sound promising and could make a significant impact provided it does deliver results. Developing a closer relationship with AU missions on the ground in fragile states should also be explored seriously.

Furthermore, the AfDB needs to stop following IDA allocation methodology for allocating its funds and develop its own needs based assessment and allocation. It also needs to increase the proportion of grants in the ADF portfolio and increase its own independent research activities perhaps partly funded by the World Bank (see knowledge bank).

Private Sector

The private sector is critical to future growth, job creation and economic insertion for Africa. The Bank's focus needs to primarily an enabling environment with direct support to private sector operators taking a secondary role. The Bank's work on infrastructure as well as regional integration would help remove many of the bottlenecks that constraint private sector growth.

As an RDB, the bank is not restricted to lending to sovereigns and can (and does) lend to the private sector directly. Perhaps at a time when its equity is underutilized, the Bank can allocate as much as 15%-20% of its capital towards facilitating development through the involvement of the private sector including through public private partnerships. The Bank should fully utilize a broad spectrum of instruments including loans, guarantees, equity investments (including in emerging equity funds targeting Africa) and lines of credit.

It has been suggested that the Bank increase its work on small- and medium-sized enterprises (SMEs) which represent an important vector for growth and job creation but are difficult for the Bank to serve directly for reasons of scale and capacity. The Bank should develop a network of intermediaries (local banks, funds, rural credit cooperatives) to ensure that SMEs have access to finance for growth. Here lessons from the experiences of the IFC (not very successful in this field in terms of development impact) and the IDB could serve as useful inputs and combined with support for microfinance and leveraging migrant remittances for development. These are promising areas that the AfDB should explore before making decisions on how to best allocate its excess equity.

Another promising area for expanding its work in the private sector is to help facilitate the development of risk management products which are discussed in detail in a subsequent section. Here it

would do well to partner with the World Bank which has been leading the international work. The AfDB's private sector operations are also highly relevant in ADF countries.

Rather than directly supporting the extractive sector as a priority area, the AFDB could maximise its development contribution through helping member countries to make the most of their natural resources by negotiating fair concessions and using revenues wisely by aiding in the design and running of commodity funds and by promoting diversification strategies.

Governance

As the continent with the most serious governance and corruption problems Africa needs for the AfDB to work on governance issues as a cross-cutting priority area. Here the prospects are promising at a number of levels where the AfDB can contribute.

For example at the Regional level, the AfDB should encourage and supporting regional initiatives and organizations, promoting regional charters, international best practice standards and codes of good financial governance and play a leading role in the promotion of the African Peer Review Mechanism.

At the Country level it can assist in the transparent management of public resources including natural resources and help build robust budget and financial control systems, as well as institutions to provide oversight and accountability. It could make a significant impact through total transparency in its projects and by disclosing all financial transfers and disseminating them widely. It needs to significantly increase the involvement of civil society in its operations as its current record in promoting civil society record is disappointing.

At the Sector level the AfDB should promote transparency and good governance especially in the infrastructure and extractive sectors. This is particularly relevant in fragile states

At an international level, the AfDB could lead the call for an identification and repatriation of fled capital and a removal of bank secrecy as a route to tackling the supply side of corruption and decreasing rewards for corrupt behaviour.

Knowledge Bank

The Bank Group should continue to strengthen its knowledge, research and dissemination capacity to provide intellectual leadership on development issues in Africa and to ensure a stronger African voice in international debates on African development.

Enhancing the Bank's research, analytical and policy-dialogue capacity can be accomplished in large part through partnerships. By linking with strong knowledge institutions in Africa or elsewhere (ECA, AERC, African and non-African universities or think tanks), the Bank can scale up its knowledge activities faster and more effectively than building exclusively in house. By
leveraging African institutions and researchers, the Bank can ensure that a distinctly African voice is heard.

To be a premier player, the Bank must have greater analytical/policy capacity. The Bank's knowledge work must be directly relevant to the Bank's operational focus, serving as an interface between knowledge and development application. The Bank can add value by being a voice for Africa in international fora on development issues highlighting African views and concerns.

To be relevant to all of its clients and leverage its African character, the Bank must have better knowledge of its RMCs. This can be accomplished in part through greater decentralization, staffing field offices with substantive staff for dialogue. The primary focus should be on building capacity and networks in Africa that will provide material. The Bank's primary role would be to synthesize and distill this material and ensure sharing of lessons learned and practical application to the Bank's operations.

It has also been suggested that the World Bank should allocate part of its research budget to the RDBs who should have a significant input into research and analytical work in their regions.

The Inter-American Development Bank

The IDB is the oldest and largest regional development bank in the World and was founded in 1959. It has 47 member countries: 26 borrowing member countries in Latin America and the Caribbean (all of Latin America's recognized countries, except Cuba), and 21 lending member countries, including the United States, Canada, Japan, South Korea, 16 European countries (Austria, Belgium, Croatia, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Portugal, Slovenia, Spain, Sweden, Switzerland and the United Kingdom), and Israel.

Compared with other multilateral institutions, the IDB has a more transparent and inclusive procedure for selecting its president, giving it far better governance credentials, contributing to a strong sense of regional ownership, and reinforcing its credibility with its membership.

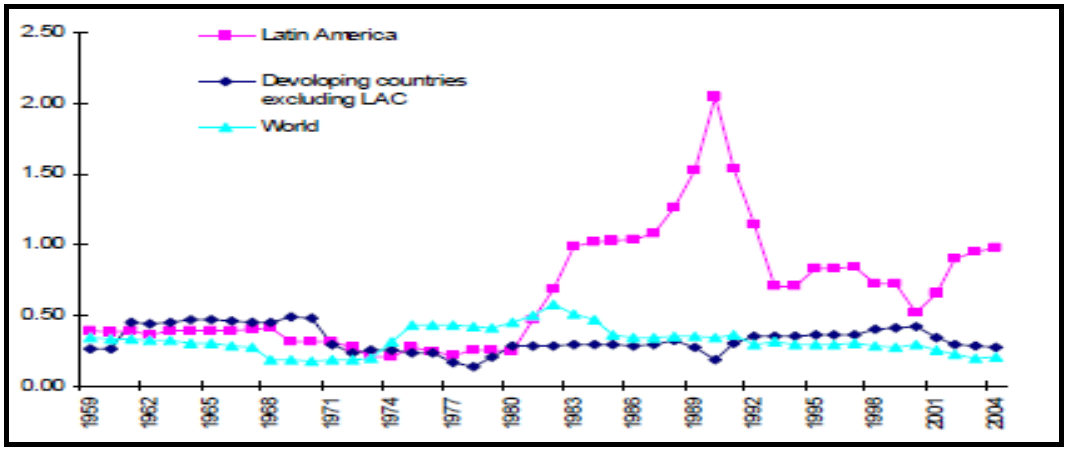
The IDB is also financially very strong being the largest source of development funding in the region. As would make sense for an institution in a middle income continent, the non-concessional window disburses more than ten times the amount disbursed from the concessional window which is small. The IDB has a strong capital base which allows it to have over $100 billion in lending capacity of which only about half is being currently used.

Environment

Annual growth rates

	Developed Economies	Developing Countries	Latin America (19)
1980-1990	3.1	3.3	1.1
1990-2005	2.4	4.7	2.8
1980-2005	2.6	4.2	2.5*

Volatility of growth rates



- In 2007 Latin America and the Caribbean reached the lowest levels of poverty and indigence in 17 years (35.1% and 12.7%, respectively)
- While Brazil, Chile and Mexico have reached the Millennium Development Goal of halving the extreme poverty rates of 1990, several other countries are still far from reaching their targets.
- Latin American and Caribbean countries have yet to recover from decades of underinvestment in infrastructure, in contrast with Asian countries that have faster-growing economies, such as China and South Korea
- The outlook for Latin America and the Caribbean for 2008 is favourable, despite the instability in international financial markets. Consensus forecasts for regional growth range between 4% and 4.5%, down from 5% in 2007
- In the last decade and a half, growth performance in Latin American economies has been disappointing. In 1980-2005, growth rates were quite modest, with an average of 2.2%, while

for the same period other developing countries grew, on average, by more than 4.0%. (see table).

- Growth rates were not only low but also highly volatile. Real volatility in the region has increased significantly since the 1980s, becoming, on average, four times as large as in the rest of the developing world (see graph).
- Latin America is primarily middle income but has the highest prevalent rates of inequality in the world
- The regional financial markets are poorly integrated and are short term oriented with little depth or long term instruments
- The most important obstacles to growth in the region are market failures, lack of know-how, and inadequate policies rather than lack of capital.
- Regional integration in Latin America and the Caribbean, particularly of energy and transportation systems, is extremely poor and undermines the region's competitiveness in the global economy

Summing up the Latin American economic situation, it is characterized by

- Middle income countries with high levels of inequality
- Low and volatile growth
- Poor financial development
- Low investment
- Poor regional integration

Areas of focus

The stated areas of focus for the IDB include

- promoting poverty reduction and reduction in inequality by promoting growth and supporting sustainable development
- fostering social cohesion by creating opportunities for the majority
- supporting private sector development and job creation
- supporting regional integration
- improving financial architecture
- increasing knowledge

These broadly make sense given its unique set of circumstances and problems. While growth is slow and volatile in many of the Latin American economies, it has been so for a while. Efforts to address the issue have not yet succeded so it is unclear exactly what the IDB can do to ensure that things are different this time round.

Tackling inequality

As the section in this report on tackling inequality will show, one probable cause of growth ills is the high current level of inequality which hampers growth. High levels of existing inequality also mean that growth is less effective in reducing poverty. Instead the kind of growth that Latin America has seen (especially in the recent high commodity price period) has not been broad based in terms of either sectors of economy or the sections of the population. This has led to even higher levels of inequality. Data in a later section would show that tax systems are particularly ineffective in redistributing wealth in this part of the world so making them more progressive and actions to repatriate fled capital can help make a significant dent in inequality. This would be helpful on many fronts

- it could help reduce the social unrest which is endemic in many Latin American countries
- the higher social and political stability could help reduce growth volatility
- it could help trigger in a structurally higher period of growth which is higher at lower levels of inequality

- by making growth and prosperity more broad based it could help reduce the volatility of growth
- it could help tackle persistent poverty and social exclusion
- it could help the IDB fend off the challenge from emerging institutions such as the Banco del Sur
- lower levels of economic inequality also translate into increased opportunities for education and jobs for those who have been excluded
- lower inequality combined with support for microfinance and micro-enterprises can usher in an upward spiral of higher consumer purchasing power and a development of micro and small and medium level enterprises which Latin America sorely lacks

That is why tackling economic inequality has to be the single most important priority for the IDB. It needs to spell out more clearly how it plans to go about doing that. It needs to act on all three policy families which are discussed in a later section on inequality – leveraging both its policy advice as well as its balance sheet.

Increasing regional integration, infrastructure and private sector financing

The region suffers from poor integration with relatively low levels of intra regional trade and even lower levels of intra regional financial flows. The IDB is right to recognize that this needs to change. That is why making progress on these fronts, at the same time as promoting investment in regional infrastructure is a priority area. The region lags behind Asia in terms of infrastructure and investment which partly helps explain its lower growth rates.

The IDB needs to prioritize policy, standardization and harmonization measures aimed at increasing cross-border trade and investment flow.

Given that the IDB has no restrictions on lending to the private sector and sub-sovereign entities, such as municipalities, it is time to expand and modernize its private sector lending and to more aggressively explore the potential for direct lending to sub-sovereigns as well as supra regional entities especially for regional infrastructure projects.

The IDB is already starting to lend to state governments, cities and local development banks -- even when the central government doesn't guarantee repayment. The bank also should increase the percentage of loans to private-sector borrowers to as much as 10% of its outstanding loans from the 3% current size. Given the current underutilization of its equity and the high financial strength of its balance sheet the IDB can easily devote as much as 20%-25% of its equity to non sovereign lending of the kind discussed above.

The IDB also need to increase its co-financing of public and private sector projects including private-public partnerships. Its largest partners in multilateral co-financing arrangements are the World Bank, the International Finance Corporation and the Andean Development Corporation. Co-financing helps complete financing plans for large projects and mobilize international support and concessional funding for high-priority projects and programs.

The IDB should explore new loan and guarantee products for multi-country investments by borrowers. These new instruments could take a number of forms. The IDB could offer political insurance to potential investors in multi-country projects, while using its leverage to strengthen international cooperation among governments in order to reduce the cost of the guarantees. Both would add to the potential for regional integration.

The IDB could, in conjunction with the World Bank promote the development of regional financial markets.

International Finance Architecture

International capital flows have become central to the international environment faced by Latin American and Caribbean economies—and most of them have already suffered volatility in external

financing at one time or another. Even those countries carrying out prudent policies have been severely affected by capital flow volatility through contagion.

Since the 1997 Asian crisis, there has been a growing demand for regional financial cooperation to establish mechanisms to prevent the recurrence of financial crises. These demands focus on emergency lending, on the one hand, and on the development of more liquid and deeper financial markets, on the other. Recent examples are the Chiang Mai Initiative, launched in 2000, which involved the creation of a short-term liquidity facility via a network of bilateral currency swaps; and the 2003 Asian bond market initiative aimed at developing a full-fledged regional bond market. The IDB could take a cue from these initiatives and adapt them to local conditions.

To protect against the risk of capital flows reversal, the majority of Latin American countries have used stabilization funds and international reserves as self-insurance mechanisms. Holding international reserves as an insurance mechanism, has proven to be costly and inefficient since reserves bear lower returns than less liquid assets. Also, given the deficits in infrastructure and social needs, the opportunity cost of holding reserves can be quite high. The IDB could promote reserve pooling beyond what for example has been agreed to in Asia and perhaps stimulate the investment of part of pooled reserve funds in local infrastructure projects.

There are very good reasons for the IDB to take the lead in promoting regional financial integration and financial stability. First, the contagion effects surrounding financial crises have important regional dimensions. Second, intraregional trade and investment flows have deepened because of regional agreements. Third, macroeconomic linkages have deepened, and domestic macroeconomic policies' externalities for neighbouring countries have increased

The IDB should obtain a mandate from the shareholders for active participation in all international forums where various aspects of the financial system are discussed. This would include the Bank for International Settlements, the Basel Committee, the Financial Stability Forum and the G-8 and G-20 discussions of the international financial architecture.

With the support of the board, the president and staff should provide an independent view that reflects the interests of Latin American and Caribbean countries and is directed at modifying the international financial architecture so as to mitigate the risks of contagion and attain a more stable financial environment.

The IDB take leadership in ensuring collaboration with the International Monetary Fund and the World Bank in designing proposals to reduce financial contagion.

The IDB should also explore

- Issuing in the international capital markets, long-term AAA bonds in local currencies or indexed to domestic price indices—and for different maturities.

- Together with members, the benefits of developing markets for bonds indexed to a variety of variables including, for instance, commodity prices or U.S. economic growth.

- The provision of public sector credit guarantees denominated in the region's local currencies. This would help sovereign issuers in one country gain access to capital markets of other countries within the region and help promote regional financial integration.

Knowledge management

The IDB should establish, in partnership with borrowers, (for example, with combined IDB, World Bank and borrower financing) specialized regional institutes or centres to generate and preserve technical knowledge where members need continued assistance. Examples of such specialized knowledge include health, education, environment, debt management, trade negotiations, tax systems and administration, and auditing and procurement, among others.

These centers of regional expertise could help to shape IDB projects and programs. They should be ready to work with all levels of national and subnational governments. Specialized regional centers would strengthen the IDB's authority in regional policy debates and contribute to building stronger links and exchange of experiences among member country governments and the private sector, as well as with other multilateral institutions.

Summing up

In order to maximise its development impact and fulfil the needs of its client countries, the IDB should

- have reducing inequality as its main policy focus
- work in partnership with domestic and international partners on a serious reform of the domestic and international financial systems
- leverage its balance sheet to offer financial risk management products
- focus on infrastructure as a priority sector
- work extensively on promoting regional integration

These recommendations are supplementary to those made elsewhere in the discussion paper

Asian Development Bank

The AsDB was established in 1966 and is headquartered in Manila. It is owned and financed by 67 member countries of which 48 are from the region and 19 are from other parts of the globe. The Asian Development Fund (ADF) was set up in 1973 to provide concessional resources for the poorer members of the AsDB.

The bank contributes low interest loans, guarantees, grants, private sector investments, and knowledge and advice to help build infrastructure and improve essential services such as health and education and to boost quality of life, particularly for the nearly 1.9 billion people in the region still living on $2 or less a day.

AsDB also has 26 field offices, including resident and regional missions, a country office, a liaison office, and representative offices. The field offices give vital support to the operations and outreach work of the Manila Headquarters. The Bank has a strong regional identity with over 60% of staff as well as share capital from Asia and the presence of strong regional member countries. :

The bank adopted poverty elimination as its overarching goal in 1999 and its charter calls on ADB to pay special attention to small, vulnerable economies and to encourage regional and sub-regional cooperation. These are both distinguishing features of ADB.

While the bank is financially very strong, the fact that many of its clients are relatively large economies means that its overall share of their total development financing is rather low. Especially for the Asian Development Fund countries, its share of their total aid budgets is on the decline as seen in the table below.

Declining share of ADF countries in ODA.

2001	2002	2003	2004	2005
8.1	8.2	7.1	6.2	5.5

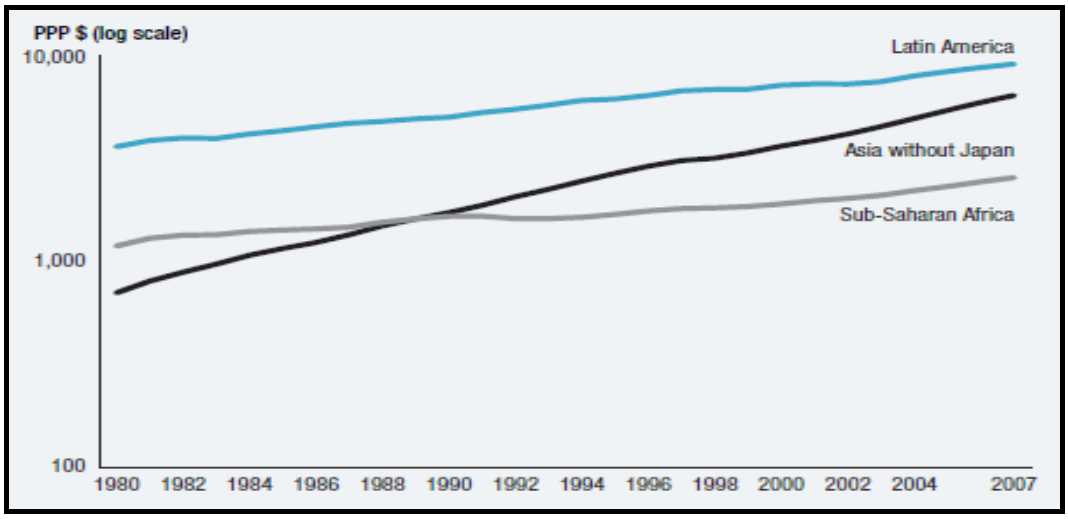
Given its limited size and lack of critical mass in many of its clients, it is essential for the ADF to concentrate on a few things it does well and where it can complement the work of other donors especially IDA. For the AsDB, the challenge is to stay relevant to the emerging needs of its client countries while continuing to focus on its core mission of poverty elimination.

Operating Environment

Of all the MDBs, the AsDB operates in most dynamic and fastest growing environment. However many challenges remain as the region and its development is riddled with paradoxes and contrasts. Some of the important features of the AsDB's economic environment are

- The Asia and Pacific region has experienced high and sustained growth rates, with an average growth rate of about 6% per annum in recent years. Extreme poverty rates in the region have declined at an unprecedented level. For example in the Asia pacific sub-region from 29% in 1990 to 8% in 2004.
- However, despite rapid decline in poverty rates, recent ADB estimates suggest that around 600 million people in the region are surviving on less than $1 a day. Almost 1.9 billion are living in absolute poverty under $2 a day.

Growth rates between 1980 and 2007



- The growth of the Asian Development Fund (ADF borrower countries) has been on average significantly slower at 3%-4% or slower which is not enough to be able to seriously tackle poverty.

- Progress on the non-income millennium development goals (MDGs) in the Asia and Pacific region has been mixed: 504 million people remain undernourished, 58 children per 1,000 live births die before reaching 5 years old, 260 million adults are illiterate, 7% of primary school children drop out of school, gender disparity persists in education and work opportunities, 596 million people do not have access to safe drinking water, and 1.8 billion people do not have access to sanitation facilities.

- The Bank's members have more than three trillion dollars in foreign exchange reserves that could be invested and the region is a very large net lender to developed countries, yet its unmet investment needs— particularly in infrastructure—are immense.
- Its excess savings are intermediated in the financial centres of Europe and North America because it is more efficient to do so there than in Asia's own financial centres. That is why there is an urgent need to develop effective domestic capital markets to channel untapped domestic savings to investments, and to minimize countries' vulnerability to fluctuations in global markets.

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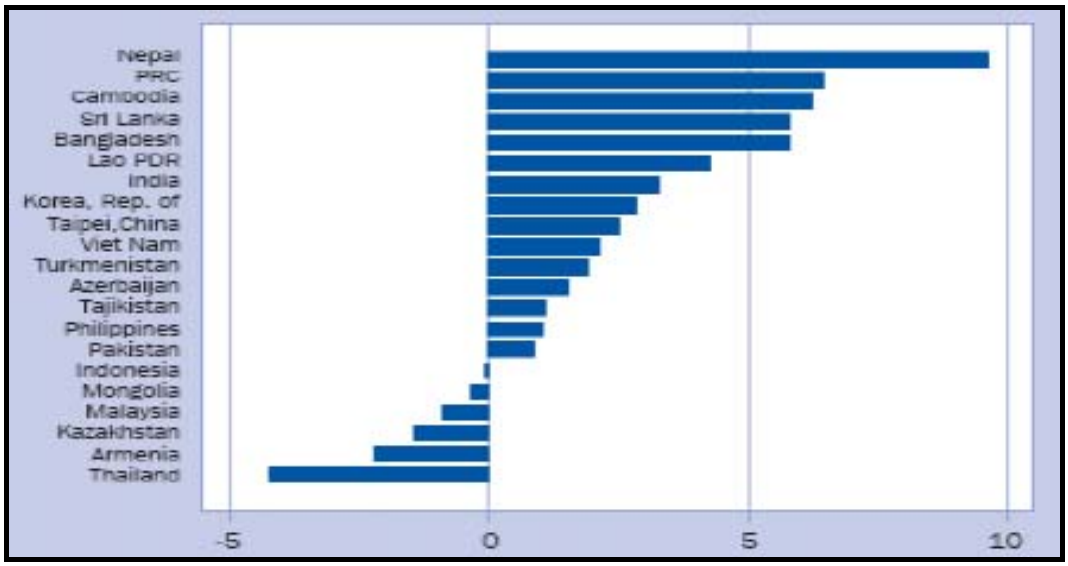
- Accompanying the growth in the region has been a sharp rise in inequality which now exceeds that in several Latin American countries. This issue threatens to undermine growth, poverty reduction and social stability unless it is tackled immediately

Changes in inequality between the 1990s and 2000s
(% point change in the Gini coefficient)



- The environmental record of Asian countries nowhere near matches their economic performance over the past 30 years. For many years, the environmental impact of development was ignored in most of the region and a price is now being paid for this neglect. This needs to be addressed urgently.
- Intraregional trade accounts for 55% of the total investment in East Asia and intraregional FDI for about 40% of the total so the region has a relatively high degree of regional integration but has tremendous scope for expansion especially in terms of financial integration and regional investment of regional savings.

Areas of focus

Traditionally, agriculture and rural development - the mainstay of many Asian economies - have received most African Development Fund support. In recent years, however, the Social Infrastructure Sector - including health, education, and water supply has increased in importance as agriculture's share has fallen drastically since the 1980s.

The focus on social sector in Asia has mirrored global trends where its ODA share grew from 29% in 1990–1994 to 52% in 2000–2004 at a global level. On the other hand, the share of the infrastructure and production sectors dropped from 59% to 38% during the same period. Infrastructure allocations in the ADF are now on the rise again.

For the non-concessional lending window – the OCR (ordinary capital resources), over half of recent loan approvals have concentrated on just on two sectors (energy and transport), except during the crisis years when lending to the industry, finance and law sector increased. Since 2000, energy and transport have accounted for about 60% of total new OCR approvals. In contrast, lending to the agriculture sector has decreased over time (from 19% of total approvals in the 980s to just 4% of total approvals since 2000). OCR lending to the social sectors (health and education) has always been modest (averaging about 6% of total approvals over the past 3 decades).

The private sector operations of the ASDB increased by almost six times from $138.8 million in 1990 to $821.5 million in 2005 and are focussed primarily on two key areas:

- finance and capital markets
- infrastructure (mostly in the energy sector

The eminent persons group (EPG) report of the AsDB looks at the long term (2020) vision of how it sees Asia and the AsDB changing. In order to respond to the changing environment, the EPG feels that the AsDB need to move from

- fighting extensive poverty *to* supporting faster and more inclusive growth

- economic growth *to* environmentally sustainable growth
- *from* a primarily national focus *to* a regional and ultimately global focus

The ADF replenishment discussions highlight the same responses but add good governance and capacity building as an additional area of work.

The EPG suggests that for the AsDB the work priorities should be

- *Infrastructure development* should be a primary instrument to promote higher and more inclusive growth. There is a suggestion for an increased focus on ICT, an increased use of public private partnerships and more regional and sub-regional work

- *Financial development* should bring together lenders and borrowers from within the region. In addition, it has been suggested that the AsDB should pilot projects for selling local currency bonds and currency reserve management

- *Energy and environment* activities should concentrate on global commons issues, such as climate change, where it has been suggested that the development of financial markets for carbon trading should be a priority area.

- *Regional integration* must become central to the Bank's operational activities and include physical connectivity, management of commons and money and exchange rate co-ordination

- *Technological development* and *knowledge management* activities should pool regional know how, with the Bank as a platform for knowledge-sharing rather than as the primary source of knowledge.

The ADF replenishment discussions have also come up with broadly similar priorities as can be seen from the following suggested sector allocations

- Infrastructure – 56%
- Education – 11%
- Agriculture – 10%
- Finance – 5%
- Health – 5%

Where the focus of infrastructure spending would be on

- Transport
- Power
- Environment (especially Water Resource management)
- Rural infrastructure
- Regional and sub-regional initiatives

Policy Discussion

The broad areas of focus for the AsDB and the ADF are more or less in the right frame given its expertise and resources and the dynamic economic environment in Asia.

However, the economic projections on which the long term strategy is anchored would not hold if there were to be a major slowdown of global growth or the recurrence of a financial crisis or incidence of political unrest in member countries. Moreover, even if the economic projections were indeed borne out, growth alone would be far from sufficient to tackle the widespread problems of absolute poverty and weed out pockets of extreme inequality. This is because the kind of growth we have seen in the recent past has come with record rising inequality which means that the poor get ever smaller proportions of the fruits of growth (see section on inequality). That is why redistribution and policies that can help bring

it about will need to be an integral part of any future AsDB strategy. Else there is a danger that Asia will get stuck in the high inequality – low growth trap where much of Latin America finds itself.

The major focus on infrastructure is right given the massive growth of demand for it, an increasing incidence of infrastructure bottlenecks and the possible contribution it can make to both increasing growth and reducing poverty. Also, very importantly, infrastructure is a particular strong point of the Asian Development Bank along with Education.

However, within this sector there needs to be a strict Poverty and Social Impact Analysis before any major investments are made as the AsDB's USP (unique selling proposition) has to be infrastructure which helps tackle poverty and accelerate development. On these criteria, a special focus needs to be on

- water and sanitation (which also helps tackle environmental degradation (another focus area),
- clean energy (small scale investments in biogas plants and wind turbines etc can contribute both to fighting climate change and delivering pro poor growth)
- rural infrastructure such as a road network, internet and telephone connectivity and electrification
- regional and sub regional projects which simultaneously enhance regional integration and play on the AsDB's uniqueness as an Asian financial institution.

It is true that Asian financial markets are not well developed and lag well behind regional trade linkages. The wasteful holding of excessive foreign exchange reserves of up to $3 trillion has a large cost to the local economies. This self insurance mechanism costs economies as much as 1.5% - 2% of GDP every year and a pooling of reserves could help significantly reduce the need for holding them as well as facilitate the development of better reserve investment mechanisms. A percentage could easily be invested in a regional infrastructure fund which would help fulfil some investment needs at the same time as increasing the returns on the reserves.

Encouraging intra-regional but cross border bond issues can help ensure that the excessive savings in the region go to fulfil the large infrastructure investment needs of the region. Some initiatives around the development of local bond markets have already been taken and these need to be consolidated.

The need for macro and micro risk management financial products (See section on financial products) is also acute and country volatility and country risk can be sharply reduced by the development of currency hedging, interest rate hedging, commodity price hedging products and GDP and inflation linked bonds etc. Making weather risk management insurance to poor farmers can help mitigate many economic and social risks and the development of other micro level financial products such as micro-savings and micro-insurance etc can help bring the benefits of financial markets to the poor.

There are there things essential for making progress on this front

- capital – some of which could come from the excessive equity of the AsDB or through additional capital subscriptions from fast growing economies or through a small fraction of the reserve pool in Asia
- capacity – the AsDB currently lacks deep capacity in financial products if it hopes to fulfil the needs of its client countries and foster a more stable and dynamic financial environment it needs to recruit capacity. In the interim, it could build on the work already done by the World Bank and the Inter American Development Bank and co-operate with them
- co-operation – the AsDB strongly needs to foster increased regional trust and co-operation especially on financial and monetary matters perhaps by arranging regular confidence building and policy strategy sessions between relevant regional officials. Another aspect would be to get regional policymakers and regulators should harmonize accounting, reporting, and regulatory standards, simplify tax and registration procedures, remove regulatory hurdles and develop a regional "financial plumbing or infrastructure," with regional clearing systems

The energy and environment activities should address the growing share of Asia in global GHG emissions and the growing problem of associated pollution and impact of global warming. For this, it should try mobilize additional funds from rich countries (a climate adaptation or a climate mitigation

fund) as well as from its DMCs to work on global public commons closely along with the World Bank and UN agencies. However, tacking Global warming should not be a core mandate of the AsDB.

Instead it should focus on helping countries upgrade to and invest in clean energy technologies and focus on regional public bads such as water pollution and haze and acid rain which fall much more directly in its mandate as a pan Asian institution.

In its spending on social sectors, it should work closely with other donors such as IDA and the UK as well as the recipient countries to ensure that it is aligned with recipient priorities and complementary to the spending of other much larger donors.

As the only pan-Asian multilateral institution in the region, ADB should try to become the premier platform for sharing knowledge and exchanging lessons on the key economic, social development, and financial issues. Like the OECD, ADB could convene meetings of policymakers and experts from within and outside the region to enhance knowledge sharing and exchanges of ideas.

It should become the voice of Asia in relevant international fora and focus on developing local research capacity in its developing country clients. A strong focus on evaluation and learning is essential to developing a database of what works which is an essential ingredient in what the AsDB can uniquely contribute both to its OCR and ADF clients.

International Fund for Agricultural Development

IFAD is a specialized agency of the United Nations. Established in 1977, and headquartered in Rome, it is the only international financial institution mandated to contribute exclusively to developing agriculture, reducing poverty and food insecurity in the rural areas of developing countries. Till date, the IFAD has allocated almost $9 billion towards achieving these goals and has been able to leverage another $16 billion in co-financing from other donors. Over the period of the Seventh Replenishment (2007-2009), IFAD plans to commit around US$2 billion for its development activities.

IFAD's comparative advantage is rooted in its experience and its record. When other development agencies swung their attention away from agriculture and rural poverty reduction in the 1990s, IFAD kept its focus on the rural areas, on agriculture and on sustainable improvement in rural livelihoods; and indeed, unlike almost all other agencies, it actually increased its support to the sector during that decade. Another distinguishing characteristic of IFAD is that relative to the funding of other international financial institutions developing countries share a substantial burden in supporting IFAD financially. This increases the incentives for them to be more closely involved in its operations, have a higher sense of ownership and stronger incentives to help IFAD succeed in its projects.

IFAD is singularly focused on initiatives that reach poor grassroots communities in rural areas. IFAD accomplishes its mission by working in partnership with governments, donors, and NGOs. It provides highly concessional loans for agricultural and rural development projects within low-income countries and grants to NGOs and agricultural research institutions experimenting with innovative approaches to rural poverty alleviation.

Extreme poverty remains a daily reality for more the more than 1 billion people who subsist on less than a $1 a day. 75% of the world's poor live in rural areas. Most of them make their living as farmers or farm workers. If we want our resources to reach the world's poorest people, then those resources must target the rural areas where three-fourths of them live and work. However other agencies have a much greater focus on urban areas which they believe will lead growth and deliver productivity gains in the country.

Aid resources should target the things that the poor do to earn money. The rural poor are often small-scale farmers, farm workers, herders, or fishers. Even rural entrepreneurs rely on customers whose income hinges on agriculture. In short, the majority of the men, women and children who comprise the rural poor depend -- directly or indirectly -- on agriculture for their livelihoods. Again other agencies typically focus on the industrial and service sector of the economy especially since the 1990s so agriculture is ignored.

Agriculture and rural development are the keys to the economic growth needed to sustain poverty reduction. For developing countries without substantial mineral or oil wealth, agriculture is often the basis of the economy. The World Trade Organization reports that agriculture accounts for one-third of the export earnings of nearly 50 developing countries. Further, WTO reports that almost 40 of them depended on agriculture for over half of export earnings between 1998 and 2000. Moreover agriculture led-growth is pro poor and helps reduce inequality. This need to reduce inequality is at the core of the challenges that face MDBs.

Productivity increases in agriculture can generate results. The World Bank estimates that a mere 10% increase in crop yields would reduce the proportion of people living on less than a dollar a day by between 6 to 12%. For African countries, a 10% increase in yields could reduce the percentage of the extreme poor by nearly 10%.

At their July 2003 African Union Summit in Maputo, African heads of state endorsed the Comprehensive African Agriculture Development Program (CAADP) developed by the New Partnership for Africa's Development (NEPAD). They also pledged to allocate 10% of their national budgetary resources to agriculture based on their conclusion that "agriculture must be the engine for overall economic growth in Africa."

Yet, despite the global and regional commitment to poverty reduction, the capacity to address the real issues faced by poor rural people and the agriculture sector are seriously lagging behind. For example, none of the other MDBs discussed in this paper have made agriculture a priority area and in most cases the share of allocations to agriculture has gone down substantially in the last couple of decades.

So agriculture and the rural sector are critical for poverty reduction, employment generation and reducing inequality. At the same time the funding allocations for the sector are going down.

Policy Recommendation

That is why it is imperative that all the MDBs unite behind IFAD initiatives and planning and significantly increase their allocations to IFAD co-financing. At the same time, $2 billion of donor allocations to IFAD is simply not enough and there is an urgent need for scaling up replenishments. The dual combination of scaling up IFAD replenishments and IFAD co-financing can mean that average IFAD annual allocations can go up to as much as $3 billion - $5 billion (with co-financing) about the level which is needed at minimum to be able to seriously tackle the development challenges in the rural and agricultural sectors.

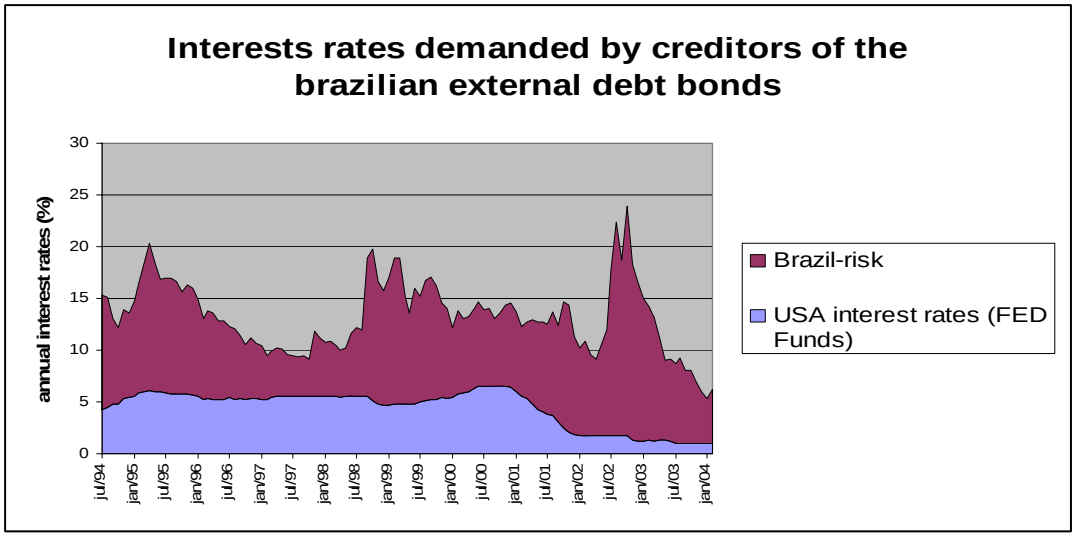
At the same time, IFAD capacity would need to go up which could perhaps be achieved in the short term by secondment of staff from other MDBs especially the World Bank. IFAD would, however need to seriously re-examine its project only model and start funding programs to be able to

- Use this scaled up financing more effectively
- Reduce fragmentation costs for recipients
- Integrate better with the overall development strategies of recipient countries

Expanding the offer of Risk Management Products

While all economies are subject to uncertain economic and natural environments and exhibit volatility to some extent, the volatility and risks faced by developing economies are especially acute. Developing countries also typically have fewer resources and mechanisms available to help cope with this volatility and risks. Given this combination of higher risks and fewer coping mechanisms, developing countries- especially their poor citizens are highly vulnerable to any form of financial volatility or natural risks and disasters

Change in Country Risk - Spread over US Treasury Bonds in basis points			
Country	**Jan 2003**	**Dec 2003**	**Change in the year**
1 Brasil	1438	463	-67,8%
2 Nigéria	2215	733	-66,9%
3 Egypt	383	138	-64,0%
4 Ukraine	668	258	-61,4%
5 Poland	178	69	-61,2%
6 Morocco	390	160	-59,0%
7 Maláysia	166	71	-57,2%
8 Equador	1796	799	-55,5%
9 Turkey	687	309	-55,0%
10 Peru	606	312	-48,5%
11 Venezuela	1119	593	-47,0%
12 Rússia	472	257	-45,6%
13 EMBI +	759	418	-44,9%
14 South Africa	233	142	-39,1%



As the table and graph above show, the interest rates payable when countries borrow in international financial markets can change very substantially in a very short time. What comes out especially clearly from the table above is that these changes normally have little do with developing country policy or with country specific incidents but much more to do with what is happening in developed countries such as the United States. Currency risk, commodity price risk and weather risk are all similar in the sense that volatility and economic risk arise primarily due to factors outside the control of developing countries yet all have the potential to cause substantial damage to developing country economies.

It has been estimated, for example, that in the past decades, financial crisis alone have cost developing countries as much as $150 billion in annual lost output.

That is why, from the perspective of development in general and poverty reduction in particular, there is an acute need for providing services and products which can help mitigate financial volatility as well as reduce the financial and economic impact of natural risks and disasters.

The importance of providing these products has increased in recent years because of two main factors

- A rapid increase in the private capital flows in and out of developing countries – these are vulnerable to high volatility and sudden stops

- An increase in unpredictable weather events, environmental and natural disasters and higher vulnerability as population pressures drive the poorest into ever more marginal and vulnerable geographic zones

The UN Department of Economic and Social Affairs (DESA) has for years called on the Bank to help "develop counter-cyclical instruments, both public and market-based, that would help smooth private capital flows so they can better support - and not undermine - development".

Robert Zoellick, the incoming World Bank president recently made comments about the Bank learning from Wall Street "concepts and tools" The two areas that Zoellick is likely to push on are the promotion of risk management instruments, and the development of local currency bond markets.

Developing countries face a number of financial risks most of which arise from

- Borrowing from external sources of finance in a foreign currency (Currency Risk)
- Borrowing at a floating exchange rate or having to roll over debt (Interest Rate Risk)
- Changes in the price of primary commodity exports (Commodity Price Risk)
- Unfavourable weather events and their impact on Agriculture (Weather Risk)
- The risks of severe weather events which can trigger natural disasters (Disaster Risk)

The World Bank, especially in the aftermath of the SE Asian crisis, now offers some products which can help mitigate these risks.

Some of these products are

- Currency Swaps
- Interest Rate Swaps
- Commodity Swaps
- Weather Derivatives
- Pooled Insurance and Indexed Insurance Products

In addition to these, there have been discussions of the World Bank helping in the development of markets in

- GDP Linked Bonds
- Local Currency Bonds through initiatives such as the recently launched $5bn Gemloc facility

Pros

- The World Bank has a highly sophisticated treasury department which uses many of the products listed above for an active risk management of its own portfolio. It can easily extend these services to it client countries especially those that are small and have low capacity. The Bank (IBRD) has in fact been offering such products since the late 1990s but they have had a modest uptake with more than $11 billion worth of transactions having been concluded.
- The chief advantages for developing countries in going to the World Bank rather than private banks are access and cost. The Bank uses its top-notch credit rating to access larger volumes, longer maturities, and lower costs than countries could get on their own

- The IFC has a good record in helping launch emerging market equity as a major asset class. It could help do the same for emerging market bonds.
- Since 2001, the IFC (in partnership with the private sector) has been offering weather risk management products to developing countries. Such products can be especially useful in helping mitigate the effect of crop failures or yield loss on the poorest citizens of developing countries (see appendix on monsoon bonds)
- The IFC has also pioneered a program of pooled index insurance against disasters for Caribbean countries which has the potential of being replicated widely

Cons

- The currency risk and interest rate risk management products have been used primarily to hedge exposure to the Bank, which now constitutes only a small part of the financial exposure for most developing countries. So far only five countries have used these products for their whole debt portfolio.
- It is not clear exactly what the value added of the Bank is when it acts as an arranger for such transactions. When it acts as an intermediary, it could be putting capital at risk.
- There is a danger that the IFC could use GEMLOC to pressure countries into liberalizing their capital accounts prematurely. The initiative might also crowd out existing domestic bond markets.
- Any transaction which involves factoring out risk to the private capital markets would incorporate a healthy profit margin for the private sector players. For example, when the World Bank was partnering with the private sector on weather derivatives for developing countries, an average margin of 25%-30% was incorporated by the private sector partners on most transactions
- Most weather and disaster index insurance transactions involve a basis risk which means that the payout is based on an index and not how much damage has actually occurred to the crops/country because of weather phenomenon. There is hence a risk that any damage caused would only be partly compensated and that volatility would be reduced less than in standard insurance contracts.
- There is a real danger that many of these products are 'band-aid' products which merely help mitigate symptoms of deep rooted problems in the international financial system. Such band-aid treatment could help stall long-overdue action on tackling systemic problems.

Discussion

Financial volatility is a very serious problem for most developing countries both developing and developed. There is an urgent need for systemic reform of the financial system but it is unlikely that much progress will be achieved in the short term. That is why it is important for progress to be made in helping deal with the consequences of an imperfect financial system. The higher volatility of weather phenomenon and greater frequency of severe weather events adds to the need for action.

Private financial markets have more or less failed to address these serious problems faced by developing countries. That is why it has been necessary for public financial institutions such as the World Bank to step in to complete the market.

Insurance and risk management industries are based on the benefits accruing from the reduction in volatility and risk exceeding the extra (above the expected value of the outcome) costs incurred in buying the protection. So the profit accruing to the private sector, as long as it is within reasonable limits, should not be a problem. In fact, once these markets take off and there is higher volume and more competition, there is little doubt that the costs of risk mitigation will come down substantially.

The IFIs also have an important role to play in the development and standardization of the legal and accounting aspects of these contracts.

While it is true that making risk management tools available might create some degree of moral hazard in policy options the fact that risk is merely mitigated not eliminated means that the danger is limited.

Recommendation

The Bank and the IFC should team up to develop a comprehensive portfolio of risk management products which can be tailored according to the particular requirements of each country. Risk pooling and regional initiative such as the Asian Bond Fund launched by the Executives Meeting of East Asia Pacific Central Banks (EMEAP) in 2003 should be encouraged but co-ordinated under a global umbrella so benefits of scale and diversification can be reaped. There needs to be a clear cut definition and delineation of mandate vis a vis the IMF.

A pool of capital should be allocated from both the IBRD and IDA for helping subsidize access for, as well as credit enhance the products of the weaker developing countries. This pool need not be very big and could be a good utilization of IBRD money especially when uptake of IBRD loans is low.

Risk management as a discipline as well as the risk management products offered by the Bank should be given a higher profile. As critical mass is attained in the offering of these products, their costs will go down as profit margins for private sector participants are brought down by economies of scale and higher competition.

The AsDB has pioneered local bond market development and should accelerate the initiative in conjunction with the Bank and with EMEAP which can help increase regional financial integration and help recycle the excess savings in the Asian region more productively within Asia itself. Especially if the AsDB also takes on an active or advisory role in the management of regional reserves, there is a strong potential for cross border financial integration in Asia.

The IaDB should learn from the experience in Asia and try foster similar developments in Latin America.

Africa as a whole is still deficient in savings but there is space for a bigger role for the AfDB in the area of weather derivatives and disaster insurance. Because the increase in the threat from natural phenomenon is linked to global warming, donors should earmark extra funds in the next round of ADF negotiations funded by additional contributions which could be linked to a climate mitigation fund.

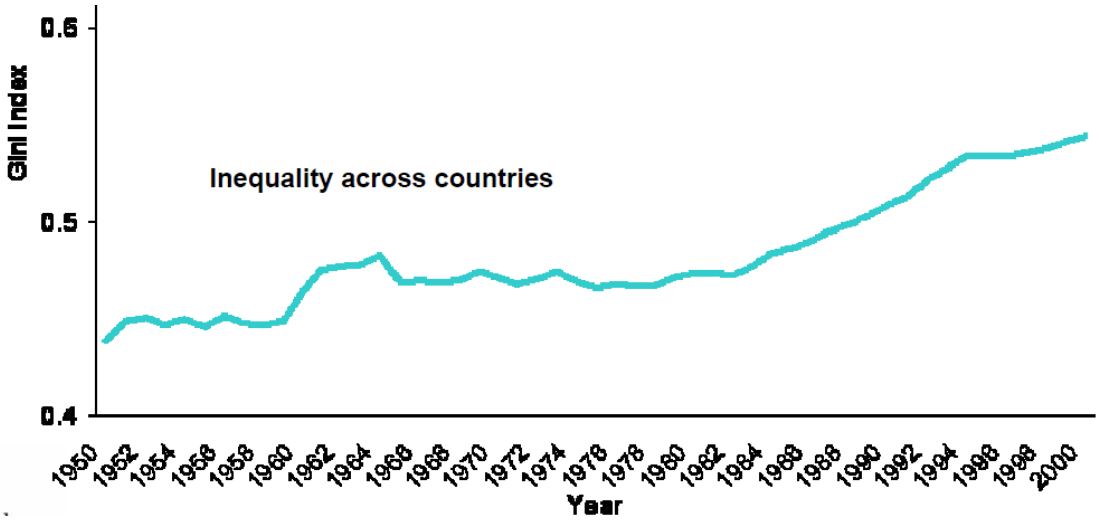
The Bank, with its greater manpower, financial leverage and international experience should take a lead role in the area of developing risk management products but work closely with the RDBs in their special product niches and to address the region specific requirements of their clients. These services should be offered on a cost recovery plus fee basis for middle income countries but might need to be subsidized for low income countries.

Tackling rising inequality and pockets of persistent poverty

One of the most characteristics of this current phase of global expansion has been the rapid rise in both within country and cross country inequality throughout the world. Within country inequality has risen most especially in fast growing developing economies such as India and China.

A report by the AsDB states that economic inequality in Asia, a region long characterized by low inequality, now nears the levels of Latin America which has been plagued by persistent high inequality. This rise in inequality has been observed both in India and China, as well as the 'Asian tigers' such as Korea, Thailand and Malaysia etc.

In particular, China, which two decades back was one of the most equal countries in the world, is now among the most unequal countries. Its Gini coefficient – a standard measure of inequality, with zero indicating no inequality and one extreme inequality – for income inequality has now surpassed that of the US. If current trends continue, China may soon match that of high-inequality countries such as Brazil, Mexico and Chile.



Meanwhile high inequality continues to persist in middle income developing countries in Latin America.

These levels of inequality are at least partly the result of the policies fostered by the International Financial Institutions which have long advocated the high growth – trickle down route to poverty reduction which has now been empirically discredited. Many developing countries were persuaded, through a combination of ideology and conditionality, to pursue policies such as

- Large scale privatization
- Liberalization of trade in good and services
- Liberalization of current and capital accounts
- Independent central banks and inflation targeting
- Removal of subsidies for fuel and food
- Introduction of user fees for public services
- Attracting foreign direct investment etc

Debating the merit of these policies is outside the scope of this discussion paper but many of these policies were aimed at increasing growth and little if any note was taken of their short term impact on poverty and inequality. In the long term it was assumed that the rising tide of growth would carry all (poor and rich) along upwards. The empirical evidence is quite clear that it did not.

The renewed focus on reducing inequality and focusing on inclusive growth that comes across in the various documents of the IFIs are late efforts to address these policy errors. Even now however, it is not

made clear what the inclusive growth that the Asian Development Bank talks about really means. So we define it here

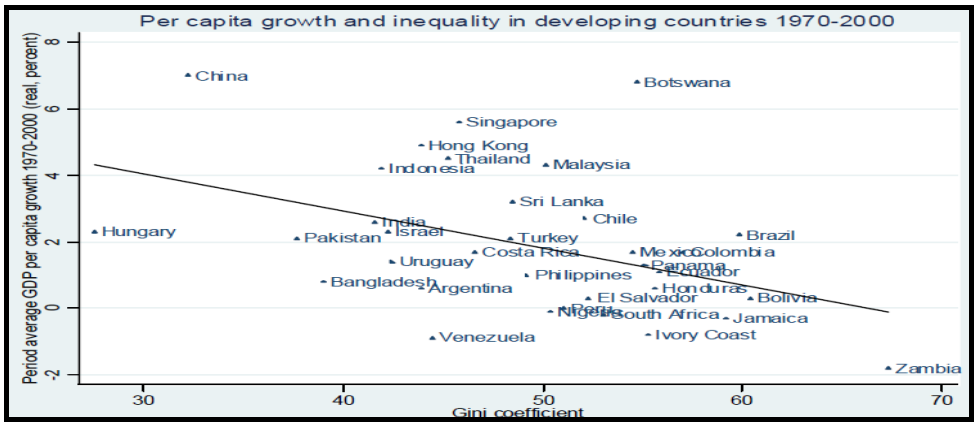
Each economy is characterized by a certain current level of economic inequality which is captured by a gini coefficient (zero no inequality, one extreme inequality). Let us say that a country A has a certain gini coefficient which implies that the bottom 20% of the population earns 3% of the income. Let us further assume that the country A grows by 10% in a year. This growth can then be characterized as

- **Inequality increasing growth** if the share of the bottom 20% in the growth is less than their current share of the national income of 3% - it would increase levels of inequality
- **Inequality neutral growth** if the share of the bottom 20% in the growth is the same as their current share of the national income – it would maintain current levels of inequality
- **Inequality decreasing growth** of the share of the bottom 20% in the growth is larger than their current share of income – it would reduce current levels of inequality and reduce levels of poverty significantly. This is the true definition of **inclusive growth or pro poor growth** which means that the poor reap the benefits of growth.

The threat of rising inequality

Tackling this rising level of inequality is a critical public policy challenge because

- Rising inequality is likely to create increasing social unrest as we are already seeing in China as well as India
- Developing countries with high levels of inequality grow more slowly than those with lower levels of inequality over the long term
- Higher levels of inequality mean that each percent of growth reduces poverty by ever decreasing amounts
- High levels of economic inequality translate sharply into inequality of opportunity and inequality in access to health and education which sharply reduce welfare and development progress
- High levels of economic inequality translate into inequality of power and political representation which means that the interests of the poorest segment of the community are ignored having negative development and welfare impacts.
- Where the poor and disenfranchised have a voice, high levels of inequality may also lead to a complete backlash against globalization. This might lead to an excessive amount of protectionism and price control which also hamper growth



Inequality Trap

There is a danger that countries can get stuck in inequality traps which can come about as follows

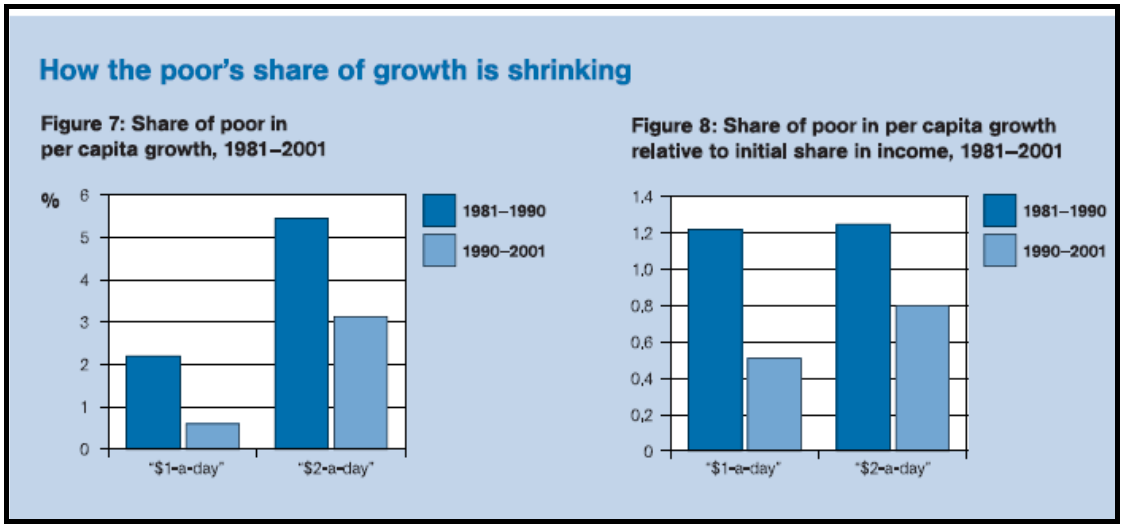
- Poor countries are encouraged by IFIs (Washington Consensus) to pursue growth strategies ignoring impact on poverty and inequality in the short term

- The growth that came about in many of the countries has been Inequality increasing growth as the poor get ever shrinking portions of a growing national pie
- Meanwhile a reduction in tax revenues and subsidies etc and introduction of user fees for public services further reduce the real income and hence the welfare of the poor with negative consequences for poverty and development
- The higher level of inequality that is progressively prevalent every year means that the share of the poor keeps shrinking
- Once levels of inequality reach high enough levels, they start depressing overall growth in the economy and which further reduces the well-being of the poor
- High levels of economic inequality translate into high levels of education and health inequality (as they do in central America and India in particular) which traps the poor in their current circumstances and polarizes society
- Meanwhile political and economic power concentrates in the hands of a shrinking number of elite who then enact policies to retain their stranglehold often at the cost of overall economic growth and poverty reduction.

These are the traps that many Latin American countries now find themselves in. In Guatemala, for example, the bottom quintile of 15-24 year olds in 2003 only had 2 years of schooling on average compared to 8.9 years for the top quintile. In Peru in the 1990s for example, more than 45% of the children under 3 had stunted growth in the bottom quintile while less than 5% were stunted in the top quintile.

The efficiency of redistributive policies

The pattern of inclusion in growth observed in the developing world has gone from being mildly pro-poor in the 1980s to being inequality enhancing in the 1990s as is clearly seen from the following graph. Anecdotal evidence points to a further sharpening of the ant-poor bias since then.



At current high levels of inequality and an increasing anti-poor bias to growth in developing countries, less and less of the fruits of growth are accruing to the poor in the world.

Growth of the kind that seems of be happening across most of the developing world seems to provide an extremely inefficient tool for poverty reduction. Even the IMF has recognized this policy quandary faced by developing country governments. In a widely circulated recent working paper it finds "that the welfare costs of inequality outweigh the benefits of growth in most cases. These calculations support the case for a research agenda that treats not only growth but also inequality as a priority". Furthermore "the results suggest that cross-country inequality is the major determinant of worldwide welfare and that for an individual country's welfare, within country inequality is as important a determinant as growth."

It concludes saying "that societies could benefit greatly from reducing inequality". It also explains "why societies may not always find it best to adopt growth enhancing institutions particularly when inequality is large and those institutions may foster further inequality."

At current inequality levels prevalent in developing countries, it would require a inequality-neutral growth rate of between 8%-25% per annum (which is unachievable for any sustained length of time) to achieve the same levels of poverty reduction in the bottom quintile as just a 1% redistribution of income from the richest to the poorest quintile. It is clear that redistribution is a far more efficient tool for poverty reduction in developing economies than inequality-increasing or even inequality-neutral growth that has been observed. As an aside, such inefficient growth (from the perspective of poverty reduction and increasing welfare) would come under increasing stress from a limited environmental envelope. So, inclusive growth is more sustainable than non inclusive growth.

In fact, strong redistributive policies in an economy can work together with inclusive (pro-poor growth) as the most efficient tools of poverty reduction, development progress and welfare increase for a developing country.

Redistributive policies can take three shapes

- Those that help skew the pre-tax incomes towards the poor such as
    a. the development of agriculture
    b. the development of rural infrastructure
    c. the introduction of a minimum wage
    d. or provision of guaranteed employment schemes etc
- Those that help skew post-tax incomes towards the poor such as
    a. a relatively high zero tax slab for income
    b. a progressive structure of income tax
    c. a rate for capital gains tax that fits within the income tax structure
    d. provision of tax credits for women, the poor, the vulnerable and the aged
    e. tackling tax evasion by rich individuals and corporations
    f. a relatively low level of value added taxes with exemptions for essentials
    g. a progressive financial transaction tax regime such as the CMPF
    h. a fair and robust natural resource royalty and tax scheme etc
- Those that help skew expenditure towards the poor such as
    a. prioritizing the free provision of education and healthcare
    b. providing free school meals for poor children
    c. using conditional cash transfer programs of the kind used in Mexico
    d. targeting backward areas for infrastructure provision etc
    e. provision of public pensions or citizens income

Countries, both developing and developed, use policies of all three kinds on a regular basis. These pro-poor policies are driven by fiscal policy and especially in the case of aid dependent poor developing countries are also heavily supported by donor policy.

The IFIs and redistributive policies

Of all these policies, the IFIs have focussed most on the third kind which redirect expenditure towards the poorer segments in society. While a moderate degree of efforts have been made on investment in agriculture and rural infrastructure (first kind), these clearly have not been the priority areas for IFIs.

Even under current strategic plans, none of the IFIs plan to focus on any of the areas which can help play a redistributive role in pre tax earnings in poor countries. The IFIs have in fact actively shied away from policies such as the introduction of a minimum wage etc.

However, it is in the second category of policies which focus on a progressive tax system that are amongst the most important development policies for all developing country governments. A good progressive tax system helps

- Raise substantial amount of domestic revenue
- Redistribute income to reduce poverty and inequality
- Re-price activities to ensure that all social costs (such as from pollution) and benefits are priced

Domestic resource mobilization lies at the heart of sustainable development. Aid and donor flows can at best supplement domestic finance for a short time and help address glaring development gaps. They can never be a substitute for domestic resources.

Projected aid flows, for example, are unlikely to meet even the modest MDG commitments leave alone fulfil the long term sustainable development needs of developing countries.

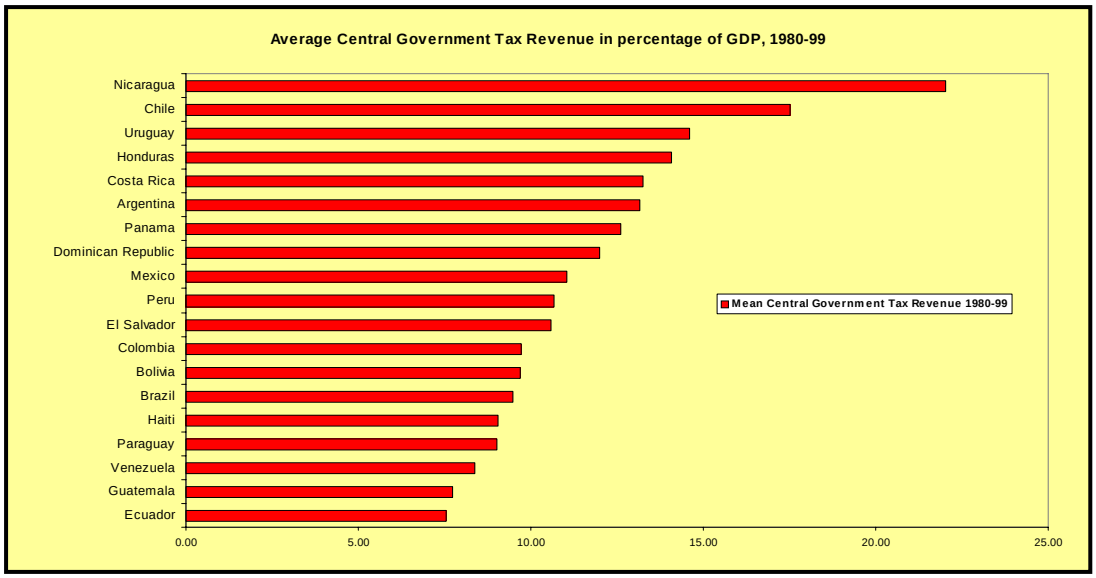
A progressive and robust tax system can help raise substantial amounts of tax revenue in a way that reduces inequality at the same time. Most important, once the revenue has been raised, the government and the people have the option of directing expenditure to the third kind of listed policies – expenditure and investment policies that disproportionately benefit the poor and help stimulate development progress and increase overall welfare.

Without sufficient revenue, it is well nigh impossible for developing country governments to make sufficient finance available for development, MDG and poverty reduction expenditure as donor finance is simply not sufficient and excessive dependence on external aid comes with several serious governance problems.

As a percentage of the GNI of (recipient) all developing countries 'real ODA' has only averaged at about 0.4% – 0.5% of GNI. At an aggregate level, it is clear that ODA flows are not a major source of funding for developing countries. Domestic tax revenue, on the other hand, ranges between 12% - 18% of GNI for most developing countries and provides a much more significant source of finance. This is borne out by the table below which presents the average revenue and aid statistics as a percentage of the GNI for a typical group of developing countries.

However, developing countries have a long way to go as tax systems are on average much less progressive (hence less redistributive) than in rich countries. Moreover, they only mobilize about half as much revenue (as a percentage of GDP) as typical OECD countries do.

Country	Rev (% GNI)	Aid (% GNI)	Rev/Aid (%)
Bhutan	18.5	9.2%	202%
Burundi	17.4	7.0%	247%
Congo, Dem. Rep.	5.5	1.9%	295%
Cote d'Ivoire	17.4	3.7%	471%
India	11.6	0.1%	10268%
Kenya	21.0	1.5%	1415%
Kyrgyz Republic	16.7	3.6%	469%
Nepal	10.3	2.7%	385%
Nicaragua	18.2	9.8%	185%
Pakistan	16.0	0.3%	5331%
Papua New Guinea	22.4	4.4%	507%
Senegal	17.0	6.8%	252%
Tajikistan	9.7	4.9%	199%
Uganda	11.1	5.9%	190%
Zambia	18.7	10.1%	185%



It is clear that a 1% increase in the volume of domestic revenue for most countries will generate more resources for development than an extra 1% increase in aid would. Domestic resource mobilization is also a focal point for the Monterrey Consensus.

Given the importance of tax systems, it is quite shocking to realize that the MDBs taken together have little or no tax system expertise to speak of having gotten rid of most of their tax departments in the late 80s and early 90s. Moreover, many of the policies pushed by the MDBs (such as reduction in import tariffs, the privatization of customs, the liberalization of finance and introduction of incentives for FDI, the introduction of relatively high rates of VAT) have actually made the tax system more regressive (increasing inequality) and reduced the volume of resources mobilized.

Redistributive Impact of Taxes in some countries of the World			
	Gini Coefficient		
Country	Before-Tax	After-Tax	Difference
Brazil	56.2	55.3	-0.9
Czech Republic	28.3	22.1	-6.1
Ecuador	51.5	43	-8.5
Estonia	36.2	37.6	1.4
Hungary	26.9	22.4	-4.5
India	40.5	30.9	-9.6
Indonesia	42.7	36.6	-6.1
Mauritius	45.7	39.6	-6.1
Mexico	52.5	51	-1.5
Pakistan	33.5	31.2	-2.3
Peru	49.3	42.8	-6.6
Russia	29.8	45.5	15.7
Singapore	38.7	34	-4.7

As the table above shows, tax policy can vary substantially in the degree of redistribution it provides from a high degree (in Scandinavia for example) to a moderate degree (in India) to almost none (Brazil) to a negative redistribution (Russia).

If MDBs can provide policy and technical advice in redesigning tax systems in developing countries they could help tackle several public policy goals simultaneously. These are

- Tackling rising inequality
- Significantly increasing the availability of development finance
- Increasing welfare

- Reducing poverty
- Helping tackle public bads such as through the introduction of environmental taxes

Pros

- Tackling rising inequality has become a clear priority goal for authorities in China and India and countries in Latin America continue to try to fight rampant inequality. MDB action on this front would help increase their relevance and role in middle income countries and fast growing emerging economies
- Even modest progress on the implementation of a progressive and robust tax policy will help increase domestic resource mobilization, redistribute income and tackle negative externalities such as pollution – all fundamental to MDB mandates
- Building progressive tax systems, especially through tackling tax competition as well as cross border tax evasion etc requires international co-operation and co-ordination which fits in very well with the mandate of MDBs as international development finance institutions
- There are several aspects to tax policy and countries around the world have experimented with different piecemeal efforts with varying degrees of success. This makes the area ideal for cross-border learning and sharing of success stories and lessons – which fits in well with MDB role as knowledge banks
- The MDBs do have expertise in some aspects of tax policy for example with respect to the management of natural resource wealth. Moreover, tax expertise from the IMF could be transferred to the Bank to help build up expertise quickly
- Efforts at the international level, especially to repatriate stolen assets, are already afoot and the MDBs seem well placed to play an important role in such efforts

Cons

- Till date, apart from helping fund pro-poor spending and modest efforts on rural infrastructure and agriculture, MDBs have expended little effort on inequality reducing policy. Despite rhetoric around the urgent need to reduce inequality etc, indications are the staff and managers continue to believe in focusing on growth and count on the now discredited trickle down effect as the main tool for poverty reduction. Hence any expansion of mandate to tackle inequality needs to be handled with caution if it is to have more than a cosmetic effect.
- The MDBs have little expertise on tax policy and building up such expertise takes time. Earnest efforts to build up this expertise need to be paced over time so as to have maximal effect
- IFI tax policies which have focussed on sharp reductions in tariffs, low taxes for corporations, the offering of tax incentives for foreign investments, and high value added taxes etc need to substantially change direction. There is a danger of inertia and a loss of credibility in any such action
- There seems to be a backlash against the increases in pro poor health and education spending and big infrastructure projects (many of which are inequality enhancing in their short term impact) seem to be coming back in fashion. In the face of this trend, MDBs might find it difficult to maintain, leave alone increase levels of pro-poor spending.
- There are possibilities of conflicts of interest between the private sector arms (such as IFC) of the MDBs and the public sector and concessional finance arms in terms of their stance on tax policy. These will need to be managed carefully.
- At an international level, any efforts to enhance tax-cooperation and co-ordination will be strongly resisted and it is possible that the MDBs might be pressured by their bigger shareholders such as the US to abandon this work

Recommendations

- It is strongly recommended that the World Bank, the Asian Development Bank and the Inter American Development Bank in particular be pushed to adopt tackling inequality as a central focus area for their work

- The discussion of growth vs. inequality needs to be brought out in the open and given a high profile with the latest work on the relation between high inequality and low growth, growth and environmental sustainability, high inequality and low welfare and the efficiency of redistribution vs. growth as a tool for poverty reduction etc being given priority
- Under this mandate, these institutions need to take actions on all three policy families discussed above (skewing pre tax incomes, skewing post tax income and skewing expenditure) to help tackle inequality by increasing redistribution and pro-poor growth.
- Pro-poor policies need to be clearly defined in the terms they have been in the discussion above and mere lip service to them should no longer be acceptable
- It is recommended that the tax department from the Fund be transferred at least in part to the Bank and that the Bank be explicitly asked to build up expertise on tax policy
- Donors need to ensure that there is a renewed focus on pro poor investment and spending such as on agriculture and social spending and that the renewed focus of the Bank, the AsDB, the AfDB and the IaDB on infrastructure does not cannibalize pro poor spending too much
- Amongst the institutions, the World Bank needs to build up all round tax expertise including against tax evasion, the AsDB and IaDB need to focus on innovative tax tools such as financial transaction taxes and carbon taxes etc while working with the Bank against evasion and the AfDB and IaDB need to work with the Bank on asset repatriation and better natural resource management

Tackling aid proliferation and aid fragmentation to increase effectiveness

The sheer scale and variety of development challenges faced mean that there is a need for a portfolio of aid instruments such as projects, budget support, sector wide programs etc. many of which are complementary and work best in specific circumstances. The multiplicity of the tasks that lie ahead and the acute shortage of funds also imply that all donors – small or large, bilateral or multilateral, public or private have complementary roles to play.

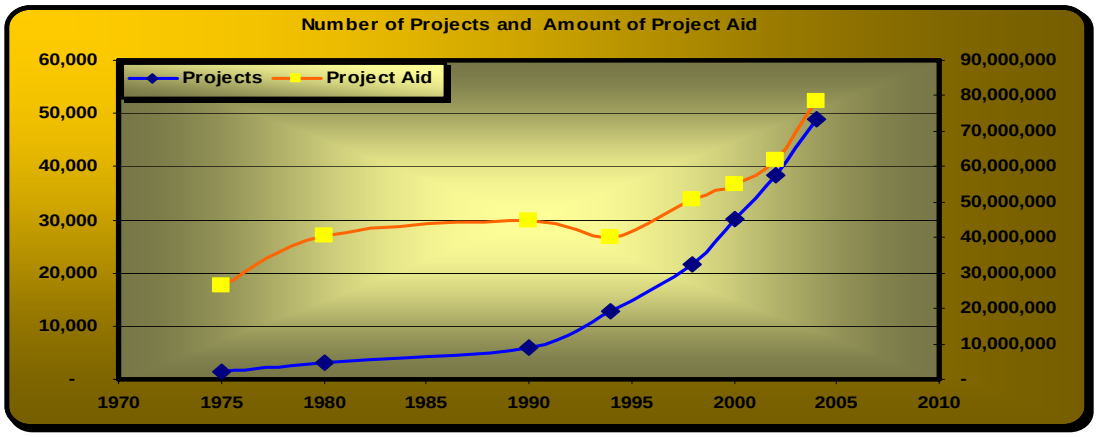
However, each donor-recipient interaction imposes additional administrative burden on the recipient and increases the danger of the overall aid effort becoming increasingly incoherent. The fear is that positive effects of increasing aid quantities would be undermined by the negative impacts of a deteriorating aid quality to such an extent that increasing aid could actually make the situation on the ground worse in poor countries.

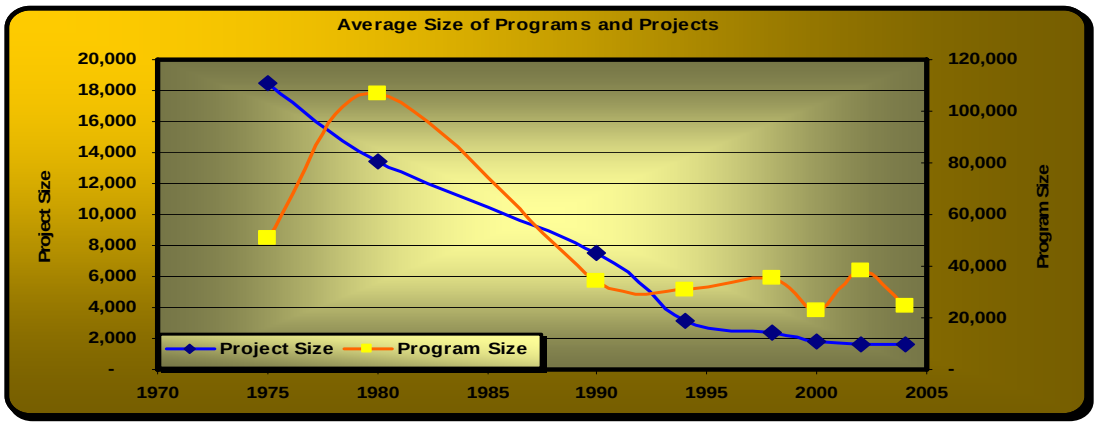
There is increasing evidence that the number of donors, projects and donor-recipient interactions has already far exceeded what is reasonable and manageable and that the proliferating aid architecture now seriously undermines the effectiveness of the aid it delivers.

The number of official donors has risen from 15 in 1960 to more than 53 in 2004 - 92 if one accounts for the multiple agencies that many donors channel their aid through. Simultaneously, the channels of aid delivery in the form of various programs and projects have also exhibited an exponential growth to the point where there were more than 40,000 distinct aid 'commitments' in 2004. Meanwhile, aid volumes have grown much more slowly implying that each 'packet' of aid is now smaller than it used to be. More than 80% of recipients, for example, receive less than 1% of French aid.

Proliferation in the form of sources and channels of aid by donors result in a fragmented aid environment at the recipient end where donors behaving in uncoordinated ways pursuing their own agendas impose serious costs on recipients and reduce the effectiveness of aid.

Fragmented aid may actually leave recipient countries in a worse shape than they would be if they received no aid at all. This counterintuitive result can arise because of 1) the deterioration of overloaded domestic institutions 2) the weakening of domestic accountability systems and 3) the undermining of domestic resource mobilization and its proper utilization.





The negative impacts of a fragmented aid landscape

A fragmented aid landscape can have grave consequences for recipient countries especially those that are low income, fragile, aid dependent and have low capacity. Some of these impacts are listed below

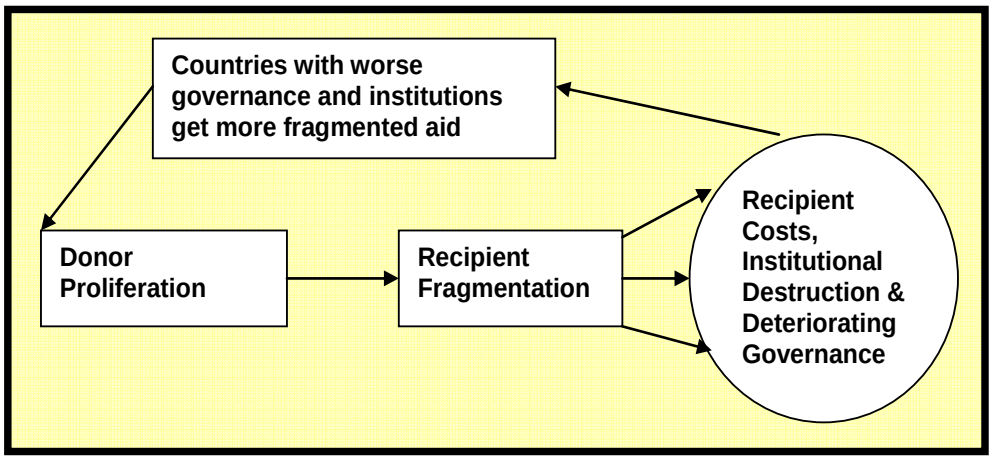
1) Aid wastage which arises from donors pursuing their own priorities, poor project design, conflicting policies, an inefficient use of resources and other forms of myopic behaviour

2) Institutional deterioration which arises because of the large transaction costs imposed by donors putting excessive demands on the time of senior officials and overburdening them, poaching of the best staff by donors and NGOs and circumvention of official systems

3) Weakened accountability which means that in the presence of multiple donors with their own agendas and processes the accountability of recipients and their incentive to change behaviour gets weakened and the lack of proper information and stringent demands by donors for upward accountability to them weakens accountability to domestic institutions such as parliaments and civil society

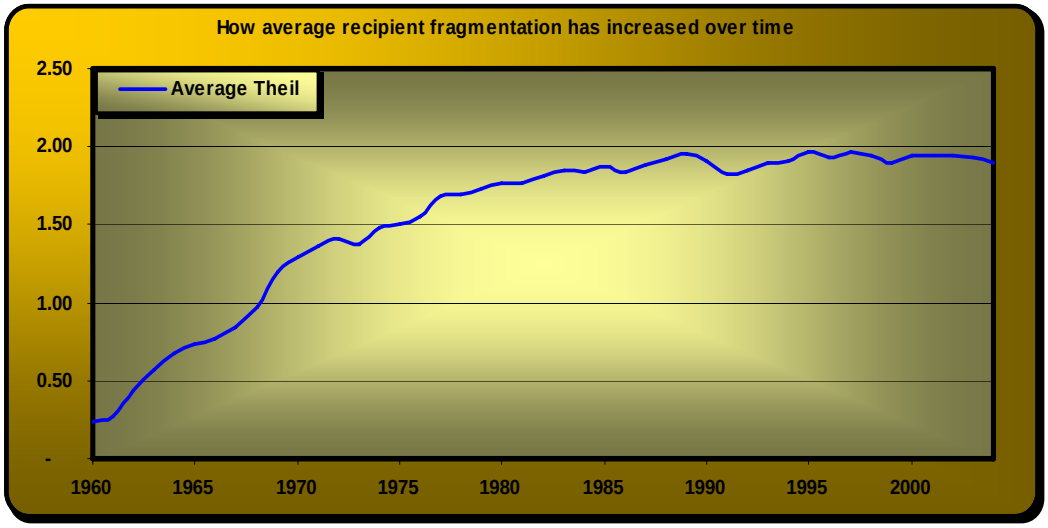
4) The tragedy of commons which arises as each donor treats recipient budgets and resources as a common pool resource and tries to capture as large a share for its own pet projects and priorities as possible. Schools and clinics are built by donors but they need to be maintained and staffed by recipients – so short term capital spending by donors imposes long term recurrent costs on recipients since these costs are seldom financed by donors

Many countries are stuck in a **low-governance high-fragmentation corner** where the existence of poor governance drives donor behaviour which increases fragmentation and through the various costs inherent in a fragmented aid landscape worsen the already poor governance.



A typology of the costs of aid fragmentation	
Aid wastage effect	
	Lack of Ownership
	Poor Design
	Donor Myopia
	Conflicting or Incompatible Policies
	Inefficient use of resources
Institutional Deterioration effect	
	Overburdening
	Poaching
	Circumvention
Weakened Accountability effect	
	Weakened accountability to donors
	Weakened domestic accountability
The Tragedy of Commons effect	

While fragmentation costs rise with each new interaction, some such as the entry of a new donor impose more costs than others such as the entry of a new agency or the start up of a new project. Costs also rise less than proportionately with the per dollar fragmentation costs being smaller for larger interactions such as programs than smaller ones such as projects. Importantly, the costs of each donor-recipient interaction will depend on the specific qualitative nature of that interaction so can only be partially captured by any standardized qualitative measure.



An ideal new donor will disburse aid through budget support for country owned priorities with minimal transaction costs – such ideal donors do not exist – so a new donor is likely to bring their own priorities, is unlikely to use budget support and hence is highly likely to waste money through projects based on it's own priorities. Depending on the channels the donor uses, the actual additional fragmentation costs will of course vary from donor to donor.

The costs of each such interaction are also likely to depend on the particular donor under consideration. For instance World Bank aid has a high conditionality content which is likely to impose high direct 'deterioration' costs but it also gives aid in larger chunks than most other donors so aid costs per dollar are likely to be lower. Some donors are known for their 'interventionist' and 'mission intensive' behaviour whilst others have a more hands off approach.

What can be done to increase donor co-ordination and reduce fragmentation costs?

Aid fragmentation costs can be reduced and aid effectiveness can be improved both through better donor-donor co-ordination and donor-recipient co-ordination. Current efforts at donor-donor co-ordination range from perfect co-ordination when aid is delivered through multilateral channels and zero co-ordination such as when donors compete to implement pet projects in a recipient country. At the donor-recipient level co-ordination varies from near perfect when donors pool resources behind

recipient priorities through general budget support and near zero when donors implement projects independently without any consideration to recipient priorities or systems.

- The most coordinated international mechanism for delivering aid which minimises proliferation is delegation to a multilateral agency such as IDA or the African Development Fund. However, despite ample evidence of their effectiveness, donors make limited use of multilateral agencies - less than a third of aid was delivered via multilaterals in 2004, and this proportion has remained more or less constant for 30 years.

- At an international level, even when donors may not wish to delegate aid to a multilateral agency, they can still use other international coordination mechanisms. These include formal donor forums such as the OECD DAC which provide opportunities for consultation and information sharing and for donors to agree coordinated policies, procedures and practices.

- Less formal groups of donors such as the Utstein Group, which comprises Norway, Sweden, Germany, The Netherlands, Canada and the United Kingdom, also offer opportunities for donor co-ordination. Such groups can help reduce proliferation by allowing like minded donors to make decisions on priority countries or priority sectors to support.

- International conferences and discussions such as those that happened under the UN summit that produced the Millennium Development Goals (MDGs) also help co-ordinate donor efforts if only around the same priorities. There is no doubt that the meetings in Rome and Paris which produced the Rome harmonization agenda and the Paris declaration are already playing a big part in improving aid co-ordination.

- Even if donors do not co-ordinate at the international levels discussed above, they can still reduce fragmentation costs by co-ordinating at recipient country level. This can be done through delegating aid to other donors and being silent partners – something donors have found exceedingly difficult to implement in practice. There are, however successful example of donors pooling their money into recipient budgets through instruments such as the poverty reduction budget support (PRBS) etc.

- Donors have also come together and co-ordinated their efforts behind sector wide programs and approaches (SWAps) in some recipient countries. Again, efforts on this front are progressing much slower than had been hoped. Some efforts made to co-ordinate through country level like-minded donor groups or the more inclusive but more diffuse consultative groups have yielded fruit but once again progress seems to have been much slower than is needed to significantly reduce fragmentation costs for recipients.

At the same time as aid has been accused of being too un-coordinated, some commentators have expressed concerns about aid becoming too co-ordinated. The lessons from the 1980s and 1990s when much aid was co-ordinated (in policy terms) behind the now severely criticized Structural Adjustment Programs mean that countries such as Vietnam prefer to have higher transaction costs over a situation when donors may again unite behind a strong policy conditionality program. It has also been said that aid that is too co-ordinated may become even more volatile. Some others have expressed that excessive levels of co-ordination could mean increased selectivity which could freeze out some recipient countries.

Donors such as the UK and Norway are expressing concerns about the high conditionality load in MDB aid disbursements but there are some encouraging signs that the World Bank (and to some extent the IMF) are being less dogmatic about policy conditionality so recipient and donor country concerns should be assuaged.

Recipient countries are cautious about increased co-ordination primarily because of fears of increased policy conditionality. Another reason, especially for countries which have high domestic capacity and low aid dependence could be that having multiple donors allows them much more flexibility in being able to pick and choose who to work with. However, on the whole they are warm to the idea of

increased co-ordination and the significant reduction in transaction costs and aid wastage that can bring about.

What role can the MDBs play in reducing aid fragmentation?

It is clear that increased multilateral aid is at least part of the answer to the need to reduce aid proliferation and fragmentation in a quick and efficient way. The MDBs and the UN for example, already play an important role in development research and hence in formulating policy positions on key development issues. The policies agreed for aid delivered by the MDBs such as the World Bank have already gained the support of a large number of donors (11 of the 24 seats on the board are held by OECD DAC countries), which already represents some form of a demi-consensus.

The amount of aid given by the MDBs – IDA in particular makes them a significant player especially in the aid dependent poor countries where fragmentation costs are most important. Even without an explicit mandate to reduce fragmentation costs IDA has already been taking the lead (such as in Zambia) in putting together efforts to increase donor-donor and donor-recipient co-ordination.

Donors making decisions not to proliferate upstream through rationalising their portfolio can reduce fragmentation costs significantly. Instead of trying to deliver aid to each and every country, they can perhaps start by diverting aid flows to countries where they do not account for more than 1% of the aid through IDA and the RDB concessional funds which typically have a much bigger presence in the country. Decisions to disburse more aid multilaterally would help reduce many of the fragmentation costs that currently plague the international aid architecture.

Which multilaterals can help reduce aid proliferation and fragmentation most effectively?

Amongst the multilaterals the UN agencies have the most proliferating operation. This is largely because on average they are relatively small and are mandated by their charter to operate in more or less all developing nations. This is more by design than desire. New bilateral donors such as Korea rank right at the top both because of their relatively very small ODA programs and the very large number of countries (more than 100 on average) that they disburse aid to.

Donor Ranking by aid and recipient rank differential in decreasing order of proliferation
UNDP
UNFPA
GEF
IFAD
Norway
EC
IDB Sp Fund
AfDF
AsDF
IDA

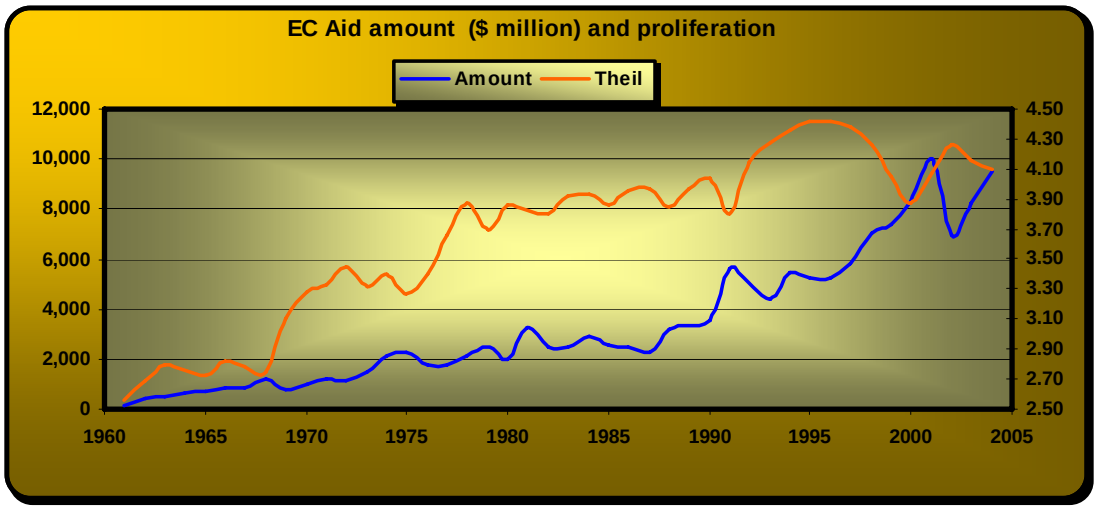
Donor Ranking by Proliferation Index in decreasing order of proliferation
UNFPA
UNDP
IFAD
Norway
EC
IDA
GEF
AfDF
AsDF
IDB Sp Fund

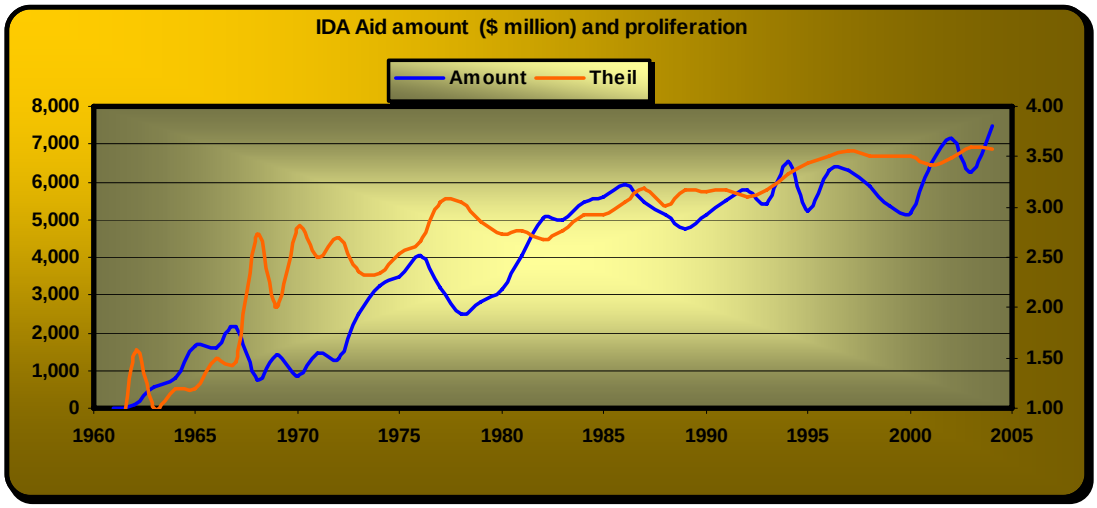
It can be clearly seen that the concessional fund arms of the MDBs are on average less proliferating than other donors both bilateral and multilateral. Hence channelling more aid on the margin through these entities would help reduce the overall level of aid fragmentation. Especially if donors with weak presence in countries or sectors were to decide to divert aid from that country/sector through these multilateral funds, fragmentation costs would no doubt come down significantly.

It might be useful to compare IDA and EC both of which disburse roughly similar amounts of aid. This is especially relevant given that many European countries have committed themselves to increasing their aid flows and that this increased aid could either be channelled through the EC or IDA (and other multilateral concessional funds) at the margin.

These countries have to take decisions at the level of 1) how much bilateral aid vs. multilateral aid and 2) which channels to channel multilateral aid through so the choice between allocating additional funding either to the EC or to IDA (and other smaller multilateral aid agencies such as the UNDP and the AfDB etc.) arises often.

The following graphs trace the evolution of EC and IDA aid and their (DAC Theil) proliferation measures. These show that on average the EC has a stronger tendency to proliferate than IDA.





The number of projects (aid activities) being funded by the EC are also much greater than the number of projects funded by IDA with the consequence that EC projects are on average smaller with the average size (for 2000, 2002 and 2004) being $6,455 compared to the equivalent IDA figure of $43,157.

The next table shows how IDA performs better than the EC on all measures of donor proliferation including the number of recipients, the number of aid activities, the number of recipients getting less than 1% of aid, the CRS Theil and the DAC Theil.

	Aid Activities	CRS Theil	DAC Theil	CRS Theil Rank	DAC Theil Rank	Recipients	% getting < 1% of aid
EC	892	5.36	4.1	9	3	145	81
IDA	318	4.98	3.58	16	12	70	64

The EC also clearly falls behind the World Bank, in its capacity for analysis. Because IDA aid represents a larger constituency of donors (with all OECD DAC members) and recipients, it is also true that getting donors (and recipients) to co-ordinate behind country level IDA aid co-ordination programmes would be easier than getting a consensus behind EC aid policy and may help improve co-ordination better.

There have been other proposals for channelling aid in more effective ways with a recent proposal for a new independent UN agency specifically to replace IDA being most prominent. While such a proposal has some merit and no doubt deserves serious consideration, given that the UN itself has been a big proliferator (23 agencies involved in water alone) and that donors seem to view the UN as less effective than IDA, it is unlikely to provide a serious alternative to IDA anytime soon. Donors are worried about the potential conflict between the UN and the World Bank for management of multilateral funds and this is a complex discussion involving issues such as conditionality, legitimacy, governance, country ownership etc.

Purely from the perspective of reducing aid fragmentation, donors are best advised to deliver increasing amounts of aid through IDA and through the concessional finance channels of regional development banks all of which have superior proliferation profiles compared to most bilateral agencies and other multilaterals such as the UN and the EC.

Pros

- Multilateral funds such as the MDBs and the concessional funds of the RDBs already represent a degree of consensus and co-ordination in international development so aid flows channelled through them have lower proliferation
- These funds all operate only in low income countries where poverty is concentrated meaning that aid delivered through them is likely to reach areas where it is most needed
- These funds have country level expertise and use country based systems which can also help increase country level co-ordination between donors
- Being significant in size and having mandates that cover the whole gamut (overview) of development needs and development policy, it is more likely that the aid would be use to meet the development requirements of the country rather than be diverted towards pet projects of each donor
- Channelling more amounts of aid through the multilateral funds can help substantially reduce overall aid fragmentation costs and ensure that aid is delivered more effectively

Cons

- Too much co-ordination behind multilateral funds can mean that there is a danger that a healthy diversity of opinion can be quashed and that donors could sometimes behind co-ordinate behind flawed policies as evidenced by the experience with structural adjustment in the 1980s.
- While co-ordination behind concessional multilateral funds can significantly reduce some kinds of fragmentation costs, if it comes with a high level of conditionality it can impose other types of fragmentation costs which might outweigh any benefits to countries
- Having too high a proportion of aid delivered through multilateral channels can reduce the policy options and policy space available to recipients and make aid flows more volatile and subject to poorly understood selectivity criteria

- As a significant amount of concessional multilateral aid is still delivered in the form of loans not grants (despite a recent move to the latter), diverting too much aid through these channels might change the loan/grant ODA mix to sub optimal levels
- While the concessional financing multilateral arms are better at keeping fragmentation down, they are inferior to UN agencies such as the UNDP in terms of local presence and ownership of policies etc so appropriate trade-offs need to be made for increasing the effectiveness of aid
- The multilaterals may not have enough staff on the ground, country level ownership and political representation of recipient countries to be able to truly deliver country level co-ordination behind recipient country policy

Recommendations

- It is strongly recommended that efforts to tackle aid proliferation and fragmentation need to be redoubled and that as part of this, increasing amounts of aid at the margin should be directed through the concessional funding arms of the World Bank and the RDBs
- There is also a strong need to re-examine the bilateral aid portfolio and make efforts to rationalize it by redirecting aid to countries where Norwegian aid is small through multilateral channels
- The MDBs should be pushed to increase program aid especially budget support and reduce project aid.
- Donors need to reduce starting ad hoc trust funds especially those that are single donor and single purpose. Trust fund proliferation, for example at the World Bank has gone too far with over 1000 trust funds having disbursed half as much money as IDA in the last financial year. Many of these are also non-transparent and some operate on tied-aid principles
- Donors need to check the tendency to start a vertical fund for every pet initiative and instead use existing multilateral mechanisms such as the MDBs to deliver aid for the same purposes
- There is a good case for the MDBs to be given formal aid-co-ordination roles at the recipient country level but only once country presence has been beefed up sufficiently by relocating more staff from headquarters to the recipient country permanently
- Efforts at trying to ensure reduced fragmentation costs need to be accompanied by serious efforts to reduce conditionality, increase recipient country ownership and policy space and ensure that selectivity formulae do not freeze any developing country out
- There is need to seriously examine the case for strengthening UN agencies such as the UNDP which have a high level of country presence and are usually seen as having more legitimacy and lower conditionality loads
- Emerging donors in Asia and Latin America should be encouraged to channel their aid allocations through the concessional arms of their regional development banks which can be encouraged by giving them a larger say in the running of such funds.

The changing role of the non-concessional arms of the MDBs

The world has been witnessing a sustained run of benign economic conditions with low interest rates, high liquidity, high commodity prices and few financial jitters over the past few years. While the current sub-prime meltdown seems likely to change that, it is clear that these benign conditions have had a big impact on the operations MDBs such as the IBRD and Regional Development Banks.

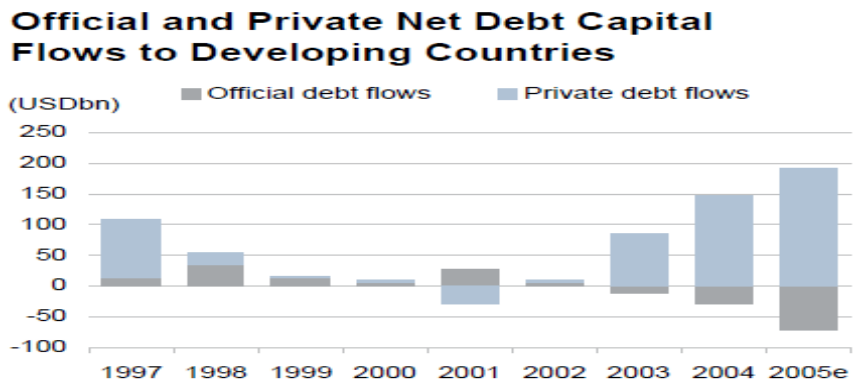
Emerging market borrowing spreads have fallen to a record low (before trending upward again recently) and economic conditions and public finances in many of the emerging economies (the biggest clients of the non-concessional windows of the MDBs) have been robust reducing the need for sovereign borrowing. Many of these countries have used low interest rate refinancing and accumulated reserves to pay down some of their outstanding sovereign debt including that to the MDBs.

In aggregate borrowing from the IBRD as well as the RDBs has fallen in this current economic cycle as the following table demonstrates.

Gross Disbursed Loans, Equity Investments and Guarantees				
(mill US$)	**IBRD**	**IaDB**	**AsDB**	**AfDB**
2002	117,494	48,293	30,547	8,365
2006	98,743	46,311	28,099	8,151
% decrease	16%	4%	8%	3%

Some commentators have highlighted much sharper falls in the MDB lending portfolio but they have used the years 1997-99 as base years. IBRD disbursements, for example, have fallen by more than 30% in real terms from their peak in the late 1990s. These years were atypical as the aftermath of the SE Asian crisis meant that many emerging economies borrowed to the maximum allowable limit from the MDBs to compensate for the drying up of private capital flows. In fact, net disbursements from the MDBs have turned negative partly as these loans taken up in times of trouble are repaid in more the more benign economic conditions that prevail now. Another reason for net payments has been that MDB lending focus shifted away from large infrastructure projects which attracted a significant proportion of the large loans in previous decades.

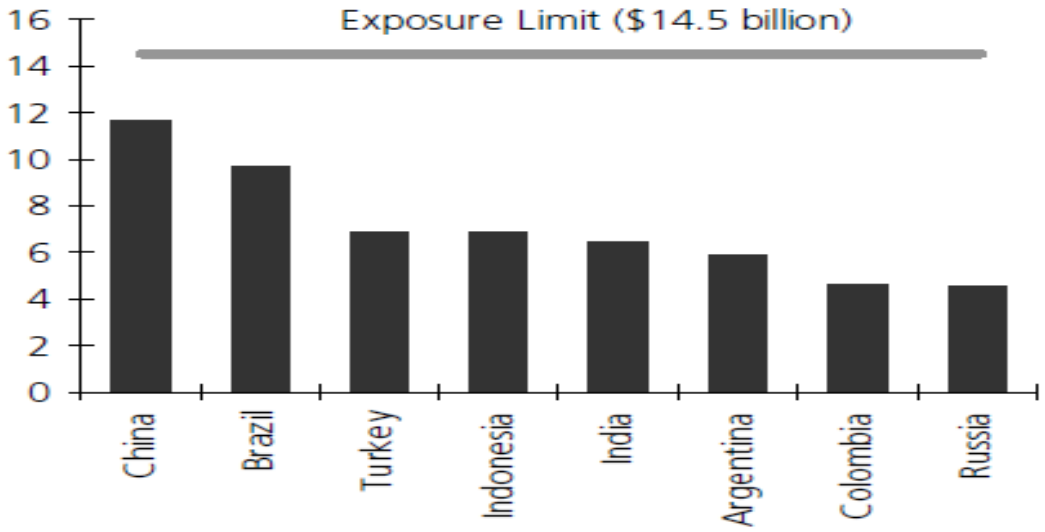
At the same time as sovereign borrowing has gone down private sector flows have boomed as can be seen in the graph below.



Borrowing from MDBs has shrunk primarily for three reasons

- Loans that were taken up in the late 1990s in times of economic turmoil are being repaid
- Prevailing low interest rates means that some loans taken at higher interest rates are being refinanced
- Record low interest rate spreads mean that the implicit subsidy in MDB lending has reduced sharply impacting the relative attractiveness of MDB loans vis a vis those from other sources

Much of the shrinking in borrowing from the MDBs is cyclical. Borrowing already seems to be on the upturn. There are however some structural elements to the shrinkage with an increased number of emerging economies now having got access to private capital markets and accumulated vast amounts of foreign exchange reserves which are invested at lower rates than the interest payable on MDB loans.



As seen from the graph above the IBRD and RDBs depend heavily on large emerging economies for a majority of their loan portfolio. 40% to 60% of the total portfolio of various MDBs consists of loans to their five largest borrowers so their loan portfolios are quite vulnerable to a reduction in borrowing levels by these large clients.

However, contrary to what a number of commentators have implied, the income viability of the MDBs is not under serous threat. Let us use the IBRD as an example. Running the IBRD costs about $1 billion annually in operating expenses and it has about $40 billion in equity and reserves which have a zero funding cost. Let us assume that it has no outstanding loans whatsoever in a particular year. The equity would then need to be invested in highly rated government securities which yield 3.5% - 5% in most years. This would imply an annual income of about $1.2 - $1.8 billion which is well in excess of its expenses.

Other MDBs are in a similar position and the primary source of income for MDBs is the earnings on the part of investments and loans funded by zero cost equity.

Irrespective of the income situation, it is quite clear that in the current environment of low loan uptake all the MDBs have excess equity. The equity of the MDBs is a global public good where countries have gotten together and pooled resources to achieve an outcome (development) which has the potential to benefit the whole world.

While an upturn in loans is projected over the short term it is unlikely, on the basis of past trends and recent structural developments discussed above, that the MDBs will be reaching their lending capacity anytime in the near future. Combined with this is the fact, that the weights of emerging market economies such as India, Argentina and South Africa, are not fully reflected in their current share of capital in the MDBs (especially the regional development banks from their regions). This means that most of the MDBs have ready sources of recapitalization to turn to although voting shares would need to be readjusted to reflect the new capital share.

It would be safe for all the MDBs to earmark at least as much as 25% of their equity and reserves for financial operations other than their core lending operations. This has the potential to generate as much as $15 billion of capital which can then be put to a variety of uses in the service of global development initiatives. The partial sale of IMF gold which could provide say another $15 billion which could increase the value of the MDB corpus to $30 billion, a substantial amount of money. IMF gold sales at current price can generate as much as $70 billion of capital.

While the leading emerging market borrowers are likely to continue to keep having access to private capital markets most other developing countries remain unable to regularly access private debt markets at reasonable costs. Many are vulnerable to the continuing risks of financial crisis and sudden stops of inflows of private capital.

But these figures hide wide disparities and segmented markets. Most developing countries remain unable to regularly access private debt markets at low cost. Many are vulnerable to the continuing risks of financial crisis, marked by rising spreads and abrupt financing cutoffs. Similarly, many second-tier private firms, and those in frontier regions, have limited access to global finance, even in low-risk countries. So, many developing countries, particularly the poorest, will remain heavily dependent on development assistance.

Given the less than optimal use of MDB equity several suggestion have been made which could help put this scarce public resource to better use.

Making non concessional resources more easily accessible

This proposal entails easing eligibility criteria for countries to be able to borrow from the non concessional windows of MDBs. As low income countries have also shown substantial growth in recent years and as the MDRI and HIPC initiatives have reduced debt burdens, it has certainly become less risky to let low income less credit worthy countries access non concessional funds. The Bank has, for example, suggested that "risk parameters could be modified to permit more exposure to lower middle-income and slow-growing countries, as well as to IDA graduates—to offset lower demand from more creditworthy IBRD clients. To illustrate this point, a halving of lending to the countries with the easiest access to international capital markets (Brazil, Russia, India, China, and Mexico) could be offset by an increase in exposure to other lower income countries of around 30 percent."

Another suggestion is that ring fenced investment projects such as toll roads and hydropower plants etc which are likely to generate financial returns etc could be part financed by non concessional MDB finance even in countries which are normally not eligible to borrow from the non concessional MDB windows.

These proposals, however, are not without risks. Previous experience does not give cause for optimism as many of the poorer countries have been unable to repay even concessional lending and have often found themselves in debt traps.

Making loans available to sub national and supra national entities

Another way of increasing demand for MDB loans would be to relax requirements for sovereign guarantees in making loans to sub national entities such as states. The RDB charter already allows that and the AsDB, for example, has significant sub national operations in China. This could also help the MDBs direct finance to backward areas in fast growth low income countries and in middle income countries which are characterized by pockets of poverty. This could help reduce inequality and help finance poverty reduction.

Allowing MDBs to lend to supranational entities and ad hoc groups of countries to help finance regional public goods, regional integration and regional infrastructure could also help both stimulate loan demand and fulfil an important public policy function. This again would require a relaxation in current lending guidelines and in the short term can perhaps be accomplished by requiring nations to 'jointly and severally' guarantee such borrowings.

Expanding contingent financing and financial risk management programs

Traditional sources of volatility such as interest rate fluctuations, sudden currency changes and commodity price crashes continue to pose a serious threat to developing economies and the frequency of financial crisis is still on a long term increasing trend despite a recent quiet phase. Incidents of financial instability not only reduce growth in developing economies but have also been shown to redistribute wealth negatively.

In parallel, risks from unfavourable weather such as on crop yields and from extreme weather events such as hurricanes etc have increased in recent years. Again, the economic impacts of such events affect the poor and the vulnerable more than the richer percentiles of population.

Financial Instruments need to be developed to provide contingent finance against a range of shocks and there is also a need for more for post-crisis assistance. Work need to be done on multilateral disaster guarantee facility, perhaps jointly by the MDBs. Weather-contingent crop insurance programs and other financial risk products discussed in another section can all serve valuable public policy needs.

Dedicating a chunk of MDB excess capital to the development, expansion and subsidizing of such products could also help put MDB capital to more efficient use.

Changing the terms of loans to make them more attractive

There have been suggestions from reducing the interest and commitment charge on loans, to reducing the hassle factor of contracting MDB loans to increasing the length of time that loans are given out for as ways to increase the attractiveness of MDB loans for borrowers.

The commitment charge and interest rate margin charged by the MDBs is already so low that it barely covers the cost to the institutions for contracting loans so scope for any further attraction is very limited.

The hassle factor can be divided into three parts

- The loan contract process
- Due diligence, safeguards and standards for projects financed by loans
- Conditionality that is associated with MDB loans and assistance

Of these, progress can be made on simplifying and speeding up the loan contract process and significantly reducing the policy conditionality load. Reducing due diligence and safeguards is much less straightforward. On the one hand it is true that it is problematic for single issue groups to be allowed to highjack important projects and stall them indefinitely but on the other there are serious problems with

letting public money fund projects that have serious social and environmental costs. One possible solution is to use the due diligence and safeguards processes more flexibly letting governments with a good track use their national benchmarks, safeguards and standards and being tougher with governments with dubious records of respecting rights. The World Bank has already reduced its commitment and loan charges and simplified them a few months back. Its impact on lending volume is not known yet.

Making more money available to the private sector

Private capital flows to developing countries have shot up in recent years and now exceed $600 billion. The increase has been registered across all categories – loans, portfolio equity and foreign direct investment.

In keeping with these developments, the private sector operations of the MDBs have been increasing sharply. For the World Bank group, for example, International Finance Corporation (IFC) disbursements have increased 75 percent and Multilateral Investment Guarantee Agency (MIGA) guarantee contracts 45 percent in real U.S. dollar terms since 1995. Almost half of the World Bank group business in investment grade countries is now directed through the IFC and MIGA.

Unlike the World Bank group where the IFC and MIGA are run independent of the IBRD, the regional development banks do not have separate arms fro private sector financing but instead use the non-concessional window for providing such financing. The share of exposure to the private sector is shown below.

The main problem with increasing private sector business is not volume growth (there is a lot of demand) but ensuring that public resources are used in the best possible way to promote development outcomes.

However at a time when MDB equity is clearly being underutilized, increasing the share of exposure to the private sector in terms of loans, equity, guarantees and partial risk guarantees etc to say 10% for the RDBs (which is still low when we look at the relative size of IBRD and IFC operations) can surely have a positive development impact at the margin especially in areas such as infrastructure where projects could involve public-private partnerships etc.

MDBs' Exposure to the Private Sector

Private Loans and Equity Stakes to Total Loans and Equity Stakes

(%)	2005	2004
AfDB	7.8	7.3
AsDB	4.5	3.3
IADB	2.4	2.5
IBRD	0.0	0.0
Global & regional MDBs	**3.7**	**3.3**

The problems of fragile states

A number of developing countries in which poverty is concentrated and needs are the most acute are 'fragile' and cannot be relied upon to deliver core state functions for the majority of their people. Such states are home to just 16% of the world's population, but 35% of the world's poor, 44% of maternal deaths, 46% of children out of school, and 51% of children dying before the age of five. Even by 2015 and beyond, more than half their people will still live on less than $1 a day. In fact, it is likely that, outside the large countries in South Asia, world poverty will concentrate in fragile states.

More than three quarters of these states have either been through conflict or are still in the midst of it. The links between poverty and conflict are now well-established with causality running in both directions. That is why it is imperative to tackle the development failures and acute poverty in these states in order to both help alleviate suffering and prevent renewed conflict or the prolonging of ongoing conflict.

However, though the development financing needs of such countries are widely recognized, too little money flows to them because these are deemed high risk environments. For example, such 'fragile' states receive almost no debt cancellation and less than half the aid allocation that the World Bank recommends based on its measure of governance which has already been adjusted downwards to reflect poor governance. Countries such as Burundi and Sierra Leone for example have the highest level of aid fragmentation. They appear to be stuck in the low-governance high fragmentation corner. In a situation of limited administrative capacity, such fragmented aid landscapes represent serious failures of donor co-ordination.

Despite their greater need for aid and donor support, fragile states are faced with low aid quantity and poor aid quality. Both of these issues need to be addressed urgently.

Fragile states are characterized by very weak policies, institutions, and governance. Traditional aid does not work well in these environments because governments lack the capacity or inclination to use finance effectively for poverty reduction. Yet neglect of such countries perpetuates poverty and may contribute to the collapse of the state, with adverse regional and even global consequences. While the risks of operating in fragile environments are very clear, they also present opportunities for accomplishing development goals as the development indicators start from a very low base and successful aid programs can make a significant difference at the margin. This can be seen in individual country examples: Timor-Leste achieved the highest rate of decrease in under-five mortality of all developing countries between 1990 and 2005, with an annual percentage decrease of 7.1 percent. Guinea and Burundi significantly improved primary education completion rates from 2000 to 2005: from 33.3 to 54.5 percent and from 25.1 to 35.7 percent, respectively.

The engagement of the development community in fragile states is critical because

- These countries often exhibit the most extreme poverty and the worst development indicators so the needs of the citizens are acute
- The costs of non engagement are high as it can lead to renewed conflict, a prolonging of conflict, the collapse of the state and negative economic spill-overs to neighbouring countries where it can depress GDP growth significantly. Aiding fragile states is a regional and global public good
- The fact that development indicators are so depressed in these economies can mean that successful aid programs can make a very big positive difference at the margin

Increasing the likelihood of development success in fragile states involves progress on three dimensions

- Increasing the quantity of aid – which can help finance critical development needs and serve as 'peace dividend' in conflict situations. This can be used both as a reward and reduce the likelihood of renewed conflict as well as serve as a carrot to accelerate the end of ongoing conflicts
- Increase the quality of aid – which can help reduce fragmentation costs significantly. It can also help make optimal use of limited 'capacity on the ground' through increased co-ordination. The

pooling of financial resources can also help strengthen the bargaining position of the international community and facilitate the development of a comprehensive development strategy

- Innovate in the delivery of aid – it has been shown that there is substantial absorptive capacity in fragile states so keeping aid effective under changing situations is best achieved through changing channels of delivery rather than tinkering with the amount of aid. Predictability of aid is even more important in fragile states so donors would need to innovate in situations where the delivery of aid thorough government channels is no longer possible.

The difficulty of delivering aid effectively in fragile states is compounded by their lower than average performance on measures of corruption and respect for human rights. It has been observed, for example, that bilateral donors are highly sensitive to the Transparency International 'Corruption Perception Indicators' (CPI) measures for their aid allocation decisions.

There seems to be a significant negative relationship between the Transparency International Corruption Perceptions Index and all the fragmentation measures. This implies that developing countries that are perceived to be more corrupt are more likely to have a more fragmented aid landscape.

Correlation between the TI CPI Index 2005 and Fragmentation				
Norm H (1) (KR)	H (1) (IDS)	Theil (w/g)	T(w/g) norm	CRS Theil
-0.53	-0.48	-0.58	-0.48	-0.47

This correlation which is already significant gets substantially amplified when one looks at a smaller list of countries with low GNI per capita.

Correlation of TI 2004 with Fragmentation for countries which are both IDA and have TI scores						
CRS Theil	Projs	Donors (DAC)	DAC Theil	DAC Theil (norm)	Norm H (1) (KR)	H (1) (IDS)
-0.73	-0.49	-0.68	-0.74	-0.68	-0.75	-0.62

While TI clearly asserts that the CPI…cannot be used as a measure of national performance in the fight against corruption, it is often (mis) interpreted by newspapers, and sometimes (mis) used by donors, as precisely such a measure. In its own words, TI "does not encourage the CPI to be used for decisions on aid allocation."

However, bilateral donors are still letting popular perceptions of corruption (as captured by the TI CPI index) drive decisions on aid. Despite the fact that Transparency International itself warns against such use, it would seem that donors are being heavily influenced by the media attention surrounding the release of the CPI and the increasing coverage being given to high profile cases of corruption.

"In the 1980s, the amount of aid a country received was not correlated with institutional quality" – whereas "in the 1990s the picture changed: countries with better institutions received significantly more aid." It would seem that aid quantity decisions are being made on the basis of the CPI as a proxy for institutional quality.

Of course any single donor's decision to give less aid to a country with a low CPI rating by itself does not cause fragmentation at the recipients end. It is when a number of donors make such decisions that two effects happen.

- Countries with low CPI ratings get less aid than other countries with similar needs and characteristics. Other donor countries seeing the obvious need for aid chip in with small amounts. The fact that there is a strong -0.68 correlation with the number of donors means that this is likely to be at least part of the explanation.

- As a consequence of most donors giving less money and a lower amount of overall money, the recipient aid landscape gets fragmented – with any single dollar of aid now having come from more sources.

No doubt this behaviour of donors adds to the fragmentation costs in weak fragile states and at least in some cases leads to a deterioration of the situation on the graund.

The role of MDBs in fragile states

It is important to look at the role of MDBs in fragile states especially the quantity and quality of aid they deliver. MDBs such as IDA base their allocation decisions on a composite index called the country policy and institutional assessment (CPIA) where higher rated countries are supposed to have better policies and institutions than lower rated ones. This is done in the belief that given a limited overall aid envelope, aid is best allocated to better performers who, it is believed, will be able to make better use of inflows.

On this measure, fragile states are those which score below 3.2 on the CPIA scale. This means that these states get less funding than other states with similar levels of per capita income. However, IDA, for example allocates extra funding for post conflict countries. In IDA 14 almost two thirds of funding was allocated by the means of the formula and ten percent was set aside as extra for post conflict countries so fragile states received about 20% of total funds disbursed. While this is still less than what they would qualify for on a per capita basis alone, this is more than the share of bilateral donor funds they attract. Of more than 80 IDA eligible states, nearly half are now classified as fragile so success in these states is critical to the overall success of the World Bank.

Because many of these states are in arrears and/or have high debt burdens and weak government capacity, a greater share of funds allocated to them are allocated in the form of grants 57% in IDA 14 as compared to just 8% for non fragile states. In addition to the main IDA funds, the World Bank group also runs several trust funds which allocate more resources to fragile states.

The Low Income Country Under Stress (LICUS) trust fund which has approved grants worth about $40 million and the Post Conflict Fund (PCF) which has approved about $80 million are small but important initiatives which have started delivering resources in difficult fragile environments for capacity building and service delivery through a wide variety of partners including governments, the UN, NGOs, faith based organizations and other civil society organizations.

However, it is other donor financed World Bank-managed trust funds which channel the bulk of resources (outside IDA) to certain fragile states. Trust funds are a very flexible tool and are particularly useful in certain situations. These could be

- IDA cannot operate in countries which are in arrears to the Bank so resources are primarily channelled through trust funds
- Trust funds give grants as opposed to a mix of grants and loans in the case of IDA so they can be a more appropriate source of funding in fragile states which have little financial and administrative capacity to take and repay loans.
- Trust funds are often used to finance recurrent costs so they provide a good complement to IDA resources which are primarily allocated towards financing investments
- Trust funds can be recipient executed - Recipient Executed Trust Funds (RETFs) such as in Afghanistan where the World Bank has fiduciary control but recipient governments can control how the funds are allocated.
- Trust funds can be linked to IDA programs in countries where IDA has a substantial operation or be free standing in other more fragile states where they are used to allocate donor pooled resources to the UN, NGOs and other institutions
- An increasing number of trust funds are now multi-donor funds where donors pool resources so reduce fragmentation costs for weak recipient states.
- Through trust funds, donors have a cost-effective tool for supporting countries they otherwise may not have been able to support, or could support only at a much greater cost.
- Trust funds also allow donors to take advantage of the World Bank's expertise in terms of country dialogue, policy advice and project preparation. The risks to donor resources are also reduced through the World Bank's high fiduciary standards and experience in project management.

While the CPIA indicators and MDB allocation methodology is far from perfect, empirical tests reveal that unlike bilateral donors, MDBs are not swayed by the transparency international corruption perception index and that MDB allocations are independent of the perception. So MDBs are less likely that bilateral governments to push fragile states into the low governance – high fragmentation corner. Because the MDBs and their concessional windows such as IDA, are already the product of donor co-ordination, and because most aid outside these windows is delivered through multi-donor trust funds, MDB funding of fragile states places lower fragmentation costs and hence is more effective than bilateral donor assistance in many cases. (Of course both IDA and trust funds are eventually financed by bilateral donors)

A couple of important points emerge from the above discussion.

- On average, a larger proportion of MDB (for example IDA) aid is allocated to fragile states than is bilateral aid – so if more aid is channelled through MDBs especially with earmarking for fragile states the quantity of aid being delivered to them is likely to be higher
- On average, MDB aid to fragile states, where the aid landscape is especially fragmented and administrative capacity is especially low, is less fragmented and more co-ordinated than bilateral aid and hence more likely to be effective. Donors, especially those with a small presence in fragile states, should withdraw and instead allocated aid through multi donor trust funds.

The limitations to MDB involvement in fragile states and scope for improvement

One big limitation to MDB involvement in fragile states is the fact that MDB typically do not have operational presence in many of these high risk states. The World Bank, for example, only has people on the ground in about half of the fragile states that it operates in. The UN, on the other hand (including the UNDP) has staff on the ground in more or less all of these states. Especially in states where information is hard to come by and the situation is fast changing and volatile, the lack of in-country presence is a very serious handicap. There are two potential ways around this

- The MDBs increase their presence on the ground
- The MDBs take the backseat by focussing on fiduciary management and let agencies such as the UNDP take the lead in countries where they have a better presence

The MDBs are making some progress on both but more could be done. Another problem with staffing for fragile states is that because they are more complex and high risk situations, top staff may shy away from them as a lack of success could provide a career setback. Changing staff incentives, increasing in-country presence perhaps by placing MDB staff in UN offices, compulsory fragile state staffing rotations and dedicating greater administrative and research budgets might all be ways of addressing some of the shortcomings. This will also help the generation and sharing of lessons in successful interventions and best practices across various fragile states.

Especially in situations where the UN is engaged in peacekeeping, refugee management, emergency funding etc, it might make more sense to give UN agencies such the UNDP a much more prominent role by channelling most MDB resources through them and leaving only fiduciary operations, project management and overall economic strategy with the MDBs. Then, once the situation normalizes, the MDBs can gradually increase their role in the development process of the country. It is also relevant that the UN is seen as a more trusted and neutral body than MDBs in many conflict situations.

A **Trust** (independent UN mandated) **Fund** (**TRIUMF**) mechanism has been suggested as an alternative to delivering effective development assistance in difficult fragile environments. The mechanism builds on the most useful features of current mechanisms such as multi donor trust funds and adds some features such as an improvement in the governance mechanism, a provision for debt relief, a lower conditionality and selectivity load, higher legitimacy, and provision for the accumulation of funds so a credible peace dividend signal can be send to provide incentives for ending conflicts.

Moreover, issues such as co-ordination, arrears clearance and the lengthening of the period of post conflict assistance are already incorporated in this proposal which should be considered by the international community.

Public Goods

Public goods (bads) and services are those for which the benefits/costs spill across borders (externalities) and that these are not fully reflected in the calculations of individual actors. For example, air pollution belched out by a polluting factory harms people irrespective of the borders of the province/country that the factory operates in while the benefits of the productive activity of the factory accrue only to direct stakeholders such as its shareholders, customers and employees.

That is why, individual actors, left to themselves, will always under-invest in public goods such as keeping air quality clean and engage in an over production of public bads such as pollution because they get all the benefits from associated activities without having to bear all the costs. Hence it is critical to have co-ordination among actors to ensure that society as a whole accounts for all relevant costs and benefits of their activities including externalities.

Some examples of public goods which are especially relevant for development are

- Maintaining a clean air quality
- Controlling communicable diseases
- Creating and sharing development knowledge
- Maintaining bio-diversity and forests
- Reducing emissions of greenhouse gases
- Keeping watersheds pollution free
- Developing vaccines and treatments for diseases that afflict the poor

While it is true that public goods spill over boundaries, they can be usefully analysed by how far these spillovers go.

For example, the emission of sulphur dioxide by a coal generation plant is likely to produce the most profound negative impact in its immediate neighbourhood in the form of acid rain and respiratory damage. However, once the pollutant has been released into the atmosphere, it does not respect national boundaries and is likely to blow into neighbouring countries where it can causes further damage. While most of the sulphur dioxide is washed down by rain, some of it stays in the atmosphere for good and increases the pollutant levels in air over a much larger geographical area. But the damage decreases sharply as the distance from the point of origin increases.

Such public goods where the negative (positive) externalities are mostly borne regionally with relatively small global effects are called regional public goods (RPGs). So reducing the emission of sulphur dioxide is primarily a regional public good.

Greenhouse gases such as carbon dioxide, on the other hand, cumulate in the atmosphere and contribute to global warming which depends on the percentage of these gases in the atmosphere. So the warming experienced close to the source of carbon dioxide emission is not any more or less than that experienced 5000 kilometres away or is global in nature.

Public goods where the externalities spread globally and are not just concentrated regionally are called global public goods (bads). So controlling greenhouse gas emission to prevent global warming is a global public good.

It is obvious from this discussion that regional and global level co-ordination are the best ways to work on regional and global public goods respectively.

The role of MDB in public good provision

The multilateral development banks (MDBs), which are products of co-ordination of donor and recipient countries can themselves be regarded as public goods as their existence generates public externalities and benefits such as better aid co-ordination, cross-border development learning and improved access

to financial resources. On this basis, the World Bank would be a global public good and the regional development banks (RDBs) regional public goods.

Hence it would be sensible to consider that the MDBs have a role to play in the delivery of public goods, especially those such as the prevention of communicable diseases and tackling climate change etc which have a strong development dimension and require both developing and developed countries to work together.

However, there are several other international institutions, especially various United Nation bodies such as the World Health Organization (WHO) and the United Nations Environmental Program (UNEP) etc which have been mandated with the provision of some public goods already. So the involvement of the MDBs would only make sense if they were able to leverage additional benefits. These benefits could come about in the form of

- Leveraging additional finance for financing public good creation
- Analysing the development dimension to the public good discussion/delivery
- Higher levels of co-ordination and incorporation of public good support into national and regional plans

In some ways the MDBs are uniquely positioned for greater strategic involvement in the production and financing of global public goods. It is so because of their potential to finance production of such goods (including by others), and because of their combination of a global and regional "macro" perspective on the costs and benefits of such goods with specific technical expertise in relevant sectors, such as agriculture, health and environment.

The MDBs, especially the World Bank, have already been active in the public goods arena for some time now. The Bank has, for example, used part of its profits to support the development of agricultural technologies through institutions like the CGIAR system.

The existence of UN agencies and other bodies working on a specific public good mandate does not necessarily exclude a role for MDBs as organizational partnerships are a natural way of operating in this arena. An encouraging recent example has been the collective action taken to cope with the threat of an avian influenza pandemic. Concerted efforts by affected countries, UN agencies, the animal health organization OIE, and the Bank, strongly supported by a global political consensus, have enabled a quick response to the crisis with the Bank providing country based assistance on both animal and human health.

The important criteria for making decisions on the involvement of MDB in public good generation are

- There is an institutional or financing gap that the MDBs could help fill
- The MDBs should have the requisite capabilities and resources to be effective.
- MDB engagement should be consistent with a development mandate and strengths.
- Action by the Bank should support or catalyze other resources
- MDBs should be successfully able to incorporate public good provision in their work on national systems

Judged by these criteria, several possibilities of MDB involvement in areas of public good delivery arise. Some of these are

- Environmental commons
    - Climate change
    - Water
    - Forests
    - Biodiversity, ozone depletion and land degradation
    - Promoting agricultural research
- Communicable diseases
    - HIV/AIDS, tuberculosis, malaria and childhood communicable diseases

    - Vaccines and drug development for major communicable diseases in developing countries
- Information and Knowledge
    - Redressing the Digital Divide and equipping countries with the capacity to access knowledge
    - Understanding development and poverty reduction
- International Financial Architecture
    - Development of international standards Financial stability (incl. sound public debt management)
    - International accounting and legal framework
    - International Financial Stability and crisis prevention
    - Tackling Capital Flight
    - Increasing Tax Co-operation
- Infrastructure provision
    - Transport networks
    - ICT networks
    - Energy
    - Water

The unique role of MDBs in the provision of international public goods

As is obvious from the above list, MDBs have already been fairly active in the provision of international public goods for example in the provision of regional infrastructure, the financing of HIV/AIDS and communicable disease treatment and in promoting agricultural research. However, till date, the interventions and their financing has been ad hoc and uncertain rather than strategic and predictable. The growing recognition of the need to provide public goods means that this needs to change.

Discussions need to centre around the following policy issues

- What is the role of MDBs?
- What is the relative role of the World Bank and the Regional Development Banks?
- What areas, if any, should the MDBs prioritize and why?
- How can financing for the provision of such goods be mobilized?
- What are the caveats?

What is the role of MDBs?

The role that MDBs can and should play has already been addressed in the previous section. To summarize MDBs can act as catalysts of collective action. They are playing an increasingly important role in the provision of public goods through their ability to convene, generate and transfer knowledge, assist negotiations, and transfer funding. Already, for example, the regional development banks are providing a third of the total multilateral funding available for financing the provision of international public goods in the respective areas of operation.

What is the relative role of the World Bank and the Regional Development Banks?

A number of public goods were listed in the previous section. Some of these goods such as fighting climate change and developing vaccines are best tackled at a global level whereas others such as coordination of transport and energy infrastructure among neighbouring countries and financial regulation to limit cross-border contagion are better dealt with at a regional level. The global public goods best fall under the World Bank mandate and the regional public goods under the mandate of the regional development banks.

However, at the same time there are several such as preservation of biodiversity, fighting endemic communicable diseases, reforming the international financial architecture and building development

knowledge and research etc which can naturally fit into both the regional or the global development portfolio (and those of other organizations). Partnerships, focus, prioritization and co-ordination remain the best way to develop synergies in these areas.

What areas, if any, should the MDBs prioritize and why?

Though the discussion of public goods is in a state of flux, some clear ideas do emerge. The Regional Development Banks should focus on public goods such as

- Building regional infrastructure
- Increasing regional integration and co-ordination in trade and finance
- Region specific development research
- Watershed management

The economic case for the coordination of transport infrastructure among neighbouring countries is compelling when remote regions and landlocked countries can thereby be connected to urban centres and ports. Similarly, there is often considerable scope for efficiency gains by integrating the supply and distribution of energy across borders.

Policy measures promoting financial and trade integration and development are especially relevant in regions/sub-regions which comprise of small countries which by themselves do not represent critical market size for goods and for the development of deep financial markets. Steps include harmonizing payments procedures, commercial and financial law, reducing barriers to regional trade, developing accounting standards, and increasing prudential supervision. The possibility of cross-border financial contagion and, again, the desirability of bringing about economies of scale, are among the considerations in favour of regional approaches to regulating and stabilizing financial markets and deepening them to circulate regional savings to regional investments.

Each region is characterized by its environmental and cultural context and presents unique development challenges which might be significantly different from those faced by other regions. Success and failure of development policies could hold a valuable lesson for neighbouring countries in the region. Research, for example on crops and endemic diseases indigenous to the region may be particularly relevant areas which need to be financed by the region.

Watershed management is particularly relevant in this context. On shared river systems, the use of water resources in one country can profoundly affect the quantity and quality of water available in downstream riparian countries. Diminishing water availability and water quality constrain economic development and can generate tensions, if not outright conflict. International law in the area of shared waters provides some guidance, but no universally accepted standards are available for the utilization and management of shared waters

The World Bank should focus on

- Tackling Climate Change
- Fighting communicable diseases and global pandemics especially through the development of vaccines
- Reforming the Global Financial Architecture to increase financial stability
- Tackling capital flight and promoting international tax co-operation
- Development of standards and codes of practice
- Cross regional and international development research and learning

On the first, the World Bank has hosted the Global Environment Facility since its inception. It has recently been playing a leading role in the development and disbursement of carbon funds, is involved with technical analysis of the intersection of development and climate change and has been working on policy solution such as the expansion of emissions taxes along with the IMF. However, it would need to keep its role subordinate to the UN which is the body mandated to lead on the issue. It should play a

supplemental development related role on tackling climate change by being a channel of transfer of funds from rich developed countries to poorer developing ones and by encouraging the adaptation of clean technologies and right economic policy solutions. It should also lend voice to the concerns of both middle income and low income developing countries in the international arena.

The Bank has already been active in several global/international initiatives to tackle diseases. Its challenge is to help co-ordinate the financing provided by single purpose vertical funds such as the Global Fund with its own and other donor's health system expenditure so the development community as a whole is able to have the biggest impact. Here again, the Bank should play a subordinate and supporting role to the WHO and other UN bodies such as UNAIDS and help channel and deliver financing. The Bank should explore sponsoring tournaments to help stimulate research on public health issues such as vaccines. The Bank's central role in launching the Advanced Market Commitments and the IFF is also a step in the right direction.

The Bank needs to help stimulate and influence discussions on the reform of international financial architecture speaking on behalf of the interests of developing countries for example on the need for a comprehensive sovereign bankruptcy mechanism, the cancellation of odious debt, the use of financial transaction taxes and other mechanisms which help promote financial stability for developing countries. The Bank has already been working on promoting the development of local currency bond markets, GDP linked bond markets and the availability of country level insurance against natural disasters – work it should continue in co-operation with the regional development banks.

The Bank needs to urgently address the issue of stemming and reversing capital flight from developing countries which can help raise developing country resource base and revenue by significant amounts and hence release substantial additional resources for development. Here its work should co-ordinate closely with the UN, the IMF and the Norwegian led Task force against illicit financial flows. It needs to seriously expand its initial foray in this area – the STAR initiative. The Bank needs to ramp up its tax capacity (see section on tackling inequality) and champion the cause of international tax co-operation.

The Bank needs to continue to develop its work on international standards and codes and practices working closely on the issue with the UN, the IMF and the RDBs.

The Bank needs to focus its research effort on issue of relevance to diverse regional and income groups of developing countries and play a leading role in the creation and dissemination of country/region specific development policy lessons which have special relevance to other countries/regions.

How can financing for the provision of such goods be mobilized?

The potential financing role of MDBs is one of the primary reasons and justification for involving them in public good delivery. This section explores how this financing role can be best exploited.

The MDBs currently contribute to the financing of public goods by means of allocations from their administrative budgets, limited transfers of net income, the expenditure of donor- funded trust funds administered by them and through their concessional finance windows. The first three of these modalities involve purely grant-based funding and the last two are primarily loan based.

It is interesting to explore the relative role of grants and loans in the provision of public goods. Goods which are more international in nature – i.e. where the primary benefits of provision would fall outside of the borders of a country, such as the reduction of green house gases, should primarily be financed by grants. Others such as the Consultative Group on International Agricultural Research, a global program where the benefits accrue world wide are also best funded by grants.

Public goods, where the financial benefits to countries are uncertain or where the provision does not generate financial benefits which can be ring-fenced (and hence used to repay loans) should also primarily be grant funded. (such as research on vaccines and bio-diversity preservation etc)

Public goods where most of the benefits can be captured locally and where such benefits can generate financial returns that can be partially ring fenced (such as in the construction of regional toll roads etc) can also be financed by loans.

In addition to providing financing for public goods through their regular concessional and non concessional windows, the MDBs also have access to significant additional resources in the form of donor financed trust funds. The World Bank alone, for example, manages almost a thousand distinct trust funds with the RDBs collectively hosting a few hundred more. While not all funds are linked to the provision of public goods, many such as the Global Environment Facility and the endowment funding the recently established Regional Fund for Agricultural Technology in Latin America and the Caribbean are. Importantly, these funds provide grants which are the right way to finance most public goods provision in developing countries.

While these trust funds provide money, they add to transaction and fragmentation costs for recipients and undermine comprehensive development strategies by diverting scarce funding to donor priorities and earmarking development funds for such priorities. Much can be achieved by some simple reforms

- Consolidating trust funds (especially those that finance public good provision) into 4-5 broad categories (perhaps those proposed in the previous section)
- Making all funds multi-donor funds with a core endowment/periodic contribution to make resourcing more predictable.
- Allowing the MDBs and recipient countries much greater flexibility in the use of these funds within the specified global public good category

More ambitious proposals for reform include the creation of a single separate grant disbursing window under the concessional finance windows of the MDBs or of piggybacking such a facility on the next replenishments rounds in the form of additional funds earmarked for public good provision.

Another proposal, made in a separate part of this paper, involves the transfer of excess equity (as much as $15 billion is available from the MDBs) from the MDBs and/or the partial proceeds of IMF gold sales to create a new source of public good financing of $30 billion or more which could either use its principle or work like an endowment by contributing investment income only.

Financial mechanisms such as sponsoring research tournaments, advanced market commitments, internationally co-ordinated taxes on public bads and confiscated capital flight where the source country can no longer be clearly identified are other areas of mobilizing funding for the provision of public goods which need to be explored more seriously.

Additional mechanisms for financing specific public good provision such as CDM (for reducing carbon emissions) and the recent Ecuadorian suggestion for mobilizing funds not to drill for oil in an ecologically sensitive zone etc should also be explored seriously.

Caveats

Several caveats are in order on this discussion of the role of MDBs in public good provision. It is important to remember that the UN itself is the most important international (global) public good agency with the core of public good provision built into many of its agencies and functions (such as the WHO, UNEP etc). It must remain the main agency for taking the lead on the discussion and policy making on international public good provision.
The MDBs do have important roles in especially in the translation of public goods policy into national and regional policy, in the provision of finance when the UN is always short of funds and most important in addressing the intersection of public good and development policy.

Many public goods such as tackling climate change primarily deliver benefits (at least in financial terms in the short term) to rich developed countries. In these cases, it is not appropriate the financing for such goods comes out of the already stretched and scarce development budgets.

This is doubly so the public bads being addressed, such as climate change, have come about primarily as a result of the actions of richest countries.

Funding for public goods, such as the development of a rural road network in Africa where developing countries are the primary beneficiaries should of course come out of the development budget.

For most public goods it should be able to identify (at least within a range) what proportion of benefits accrue to developing countries and mobilize only that component under the ODA budget with additional funds for the rest.

Knowledge Bank

The World Bank stands shoulders above any other institution in terms of its influence on the field of development. While it dominates funding streams and is able to leverage its own funding allocation, its true dominance in the field comes from it being a powerhouse of research employing more PhD's than perhaps any other institution in the world. Its research budget alone dwarfs the country budgets of some of its smaller members. The idea of a 'knowledge bank' has always been central to the Bank's identity. It has been said that if the Bank were simply a financial intermediary, it would barely need a tenth of its staff.

The Bank produces more research than all other MDBs combined. In fact most of the other institutions, especially the African Development Bank, for example, follow the Bank's lead on most policy issues and depend on the Bank for research.

The Bank's roles in this area are significantly reinforced by bilateral donors who provide additional funding to the Bank to encourage it to take an interest in policy issues they see as important.

A knowledge bank should serve a number of functions which are

- Statistical work such as the collection, analysis and dissemination of important statistics
- Policy Work such as Economic Updates at a country, regional and global level
- Theoretical academic research work relevant to the field
- Applied research work which is relevant to the field
- Operation expertise such as various aspects of project management, budgetary planning and legal systems
- Learning - Evaluating field operations, learning from them, assimilating and analysing the results and disseminating them in a way that countries can learn from the successes and failures of others

Having a single institution that is so big can prove to be advantageous in many ways such as

- It provides a critical mass of research expertise and knowledge
- There is a vast potential for cross-fertilization across disciplines, academic schools of thought, geographies etc
- There is the potential of a cross fertilization of operations with research and of researchers learning from operational successes and failures in the field
- It allows the Bank to put together cross-disciplinary teams who can work on complex project and policy issues
- It can stimulate a healthy competition between researchers
- It sharply increases the awareness of staff of the latest work in their fields and allows them to build on such work

At the same time, however, having a single institution dominating the research and knowledge landscape in the field of development can create several problems

- It might lead to the establishment, perpetuation and dominance of a single paradigm of thinking
- It may encourage incremental progress at the cost of stifling radical and experimental thought which can lead to sudden progress
- It may marginalize those outside the institution, especially those the institution has chosen to eschew
- It may lead the institution to become too self referential
- It may lead to the creation of powerful intellectual cliques

While these problems are generic in nature there is a specific set of issues that pertain to the World Bank. Some of these are

- Development is a complex field where progress depends on a successful interaction of economic, social, political and cultural factors. However the Bank's staff mix, while getting better, is still hugely dominated by economists – so the potential for cross fertilization of ideas and the development of a more complete understanding of the field is not realized
- The field of economics itself has been dominated by a single school of thought especially in the leading universities in the US where the Bank mostly recruits from. As staff recruit others they are more likely to bring only those who share their world view on board so a single strand of thought has begun to dominate at the Bank
- The formal and informal incentive system at the Bank is flawed where research conforming to the dominant paradigm which can justify past and current policy thinking and operational practices rewarded and dissenting research punished
- While there exists a potential for a high degree of learning from field experience, most staff spend little actual time in the field
- In a field where different policies have produced different payoffs and where there is no single successful route to a positive development outcome (as demonstrated by the success of the Nordic development model) the Bank's policies are still too dogmatic and do not offer alternatives which reflect successful development practice
- The housing of research and funding in the same institution has to some extent distorted incentives and compromised the independence of the research
- The Bank's management and external affairs department has been accused by several credible academics of continuing to promote certain researchers such as Dollar whose work resonates with the dominant view at the Bank even when its validity has been seriously challenged by independent researchers

Many other criticisms have also been levied against the role of the Bank as a 'knowledge bank'. Some of the important ones are -

- The Banks own operation evaluation department noted that the majority its clients said the Bank presents 'ready-made' solutions that are not adapted to individual country circumstances. They argue that the Bank is reluctant to consider alternative models and solutions". A government representative from Brazil stated: "these 'best practices' come to us as norms; they become guidelines. "For a majority of respondents, this insistence that the Bank's way is the only way underlies most [Bank] reports, strategic models, and policy analyses".
- The staff association questioned whether the Bank's "public image matters more than germane research findings", pointing out that staff guidelines on getting press articles approved before publishing "come perilously close to saying that staff members must not publicly suggest changes in the institution's practice". Senior Bank researcher David Ellerman complained of "bureaucratic conformity", with public relations staff acting as "thought police to the black sheep in the organization who are not 'on message'".
- Other senior researcher such as Nancy Birdsall have urged an end to "the analytic near-monopoly of the World Bank on the details of pension reform, privatisation, the ideal bank deposit insurance system, and so many of the other issues of economic and social reform."
- Ravi Kanbur, formerly the Chief Economist of the Bank's Africa region and now a professor at Cornell University, points out that "the Bank as a whole cannot possibly be viewed as an independent arbiter of social science research. It is owned by the rich countries, and it has operational policies that need to be defended". He therefore urged that "more of the research at the Bank should be farmed out to universities and transparently independent institutions".
- Bank researchers creates strong incentives to give pride of place to *propositional* knowledge—the search for "universal" laws of development from the frontiers of academia—and using that to generate *prescriptive* knowledge. LDC-based researchers are seldom, if ever, represented in the former. there are typically participants from developing countries in conferences focusing on propositional knowledge research involvement with the World Bank has substantial payoffs, from research funding to access to data and visibility. incentives place a large positive premium in academic papers on the novelty of ideas, methodological innovation, generalizability and parsimonious explanations.

- Detailed country and sector knowledge, an acknowledgement that the ideas may be sensible but not especially novel, that uncertainty and complexity rather than parsimony are perhaps the ground reality, are all poor country-cousins of research that purports to find universal truths.
- The very fact that the vast majority of the Bank's work on poverty is in English, a language understood by almost none of world's poor, is also a big criticism of the knowledge bank role being played by the Bank
- In the 1980s, debt and corruption were a no-mans land, in recent years intellectual property rights, capital account liberalization and genetically modified crops are examples of issue areas that the Bank has had to tiptoe around. If the value of the Bank's research as a global public good is undermined by its perceived lack of independence – then there is serious problem with the continuation of its pre-eminent research role
- Other researchers such as Levine and Savedoff worry that "the Bank rarely creates new knowledge about what works."

Policy Discussion

Clearly there are a lot of problems with

- The concept of having such a dominant knowledge institution in general
- With the way the knowledge function of the World Bank is run in particular

However, not all parts of the list of 'knowledge functions' of the Bank are equally controversial. For example, it is widely recognized that the Bank (together with the Fund) plays a very important role in the compilation of statistics. This role needs to expand as more statistics and data needs to be collected and disseminated to bring about more fine tuned analysis of public policy. The Bank's data is used by researchers all over the world.

But even on this aspect, there are many improvements that can be made. What is not measured, will not be analysed and hence will not be changed seems to be the operating philosophy of some of the Bank's work. On this, the Bank has fallen short on two aspects.

- By having paid less attention to the collection of statistics on say inequality, which was not an important parameter under the Bank's paradigm, it has sent a signal to its client countries that such numbers do not matter
- By refusing to do more work on say capital flight where data is hard to come by saying that it cannot really analyse what it cannot measure so it does not know I fit is important enough to try to measure in the first place
- Another complaint against the Bank which it can easily address is that if it is indeed being a knowledge bank then its data should all be available in the public domain for free as it is financed by tax payers as a global public good – however much of Bank (and Fund) data is not easily available without substantial expense

The second relatively uncontroversial aspect of the Bank's role in developing operational expertise – this role is widely understood and is vital in the performance of its duties as the premier development finance institution with cross sector in house expertise.

It's the Bank's role in research and its poor record on evaluation and learning that has been most criticized. Some important but difficult questions to ask while debating the future of this role would include

- If the Bank's overall budget was cut by a third and the resulting savings (more than half billion annually) were put into research in those diseases, crops and energy technologies that are sui generis to poor countries, would the global welfare of the poor improve or decline

- If the Bank were to cut its "Analytical and Advisory Activities" (AAA) expenditures (from its estimated $600 million in 2005), shifting its focus from the social sciences to funding research in the health sciences, would the global welfare of the poor increase or decline?

- If the Bank's research activities were more akin to a National Science Foundation (NSF) type funding activity, rather than in-house research, would LDCs gain or lose?

- If the Bank were to reallocate part of its large transfers from net income (about $600 million annually over the past few years) to create endowments for centers of learning in LDCs, would those countries be better off?

These are good hard questions and can be asked of any big major institution and will always generate difficult and controversial answers which are beyond the scope of this paper. There are however a couple of points which are clear from the discussion above and the ongoing debate about the 'knowledge bank'. One that the Bank should give more emphasis to financing research and two that the Bank (and other development actors) need to significantly improve their evaluation and learning practices to generate invaluable and transplantable lessons on what works.

That the Bank should give greater emphasis to financing rather than producing research, in particular, financing developing country research institutions. Despite the modest quality of the latter, such a shift is likely to be more effective in changing national policies and in nurturing implementation. It will also contribute to long-run institution building (at a minimum, by not reinforcing the brain drain).

It is problematic that half century into "development," developing countries still seem incapable of thinking for themselves on issues (to put it crudely) critical to their own welfare, at least as measured by the lack of meaningful contributions that would find a place at the high seats of social science research. The Bank has done little in the last half-century to build institutions in developing countries that could help them think for themselves.

The Bank's domination of development research has substantial opportunity costs. It should be emphasized that in-house knowledge-related activities at the Bank are expensive, even when compared to U.S. universities, let alone LDCs. Second, there are important strategic benefits of publicly funded research for developing countries, particularly the creation of capabilities, through the vital links between research and the supply of skilled graduates.

Moreover, diversity may matter in and of itself on the grounds that there should be at least a minimum degree of participation by those likely to be affected by the actions resulting from ideas emanating from these institutions. Diversity may also be important for its instrumentality—it diversifies risk, a not unimportant criterion, given limited knowledge and the consequences of misplaced advice.

The development community should ensure that some of the research functions and research resources shift out of the Bank and into the field. Governments and private foundations that support World Bank research and publicity would do far better to support independent research institutions that are stimulating a more diverse development debate.

Some of the money should be redirected towards

- Regional development banks to increase their output of research relevant to the region and for them to be able to become the points of reference for development issues within the region and represent the region's interest in international for a
- LDC and other developing country universities where money could go much further and is likely to generate more relevant research closer to the field. It will also have the additional benefit of reducing brain drain
- Independent research institutions and think tanks around the world with a special emphasis on institutions in the developing world

- Non governmental organizations and advocacy organizations which would then develop increased capacity to present policy alternatives and hold their governments to account
- The production of country specific knowledge

Bilateral Donors the Bank and the RDBs all need to encourage and support much more impact evaluation, including of the programs and projects they finances, and to join in a collective response to ensure "supply of knowledge, a global public good in the truest sense." An institutional effort is needed to strengthen the cycle of lending, learning, and knowledge.

Initiatives such as the Development Impact Evaluation (DIME) initiative will set incentives to rigorously evaluate development impacts and thus strengthen accountability and produce a global public good—development knowledge.

Policy experimentation and randomized trails need to be strongly encouraged as means of generating knowledge and learning on successful policy outcomes and developing an empirically sound database of sets of policies.

Appendix I

Using financial risk management products to aid development – An example

Agriculture constitutes a significant proportion of the GDP of several 'third world' countries. Farmers in these countries typically lack proper access to irrigation and are heavily dependent on rainfall for cultivation. As a consequence of this dependence, the economies of these countries face considerable weather-related risk. The economic volatility induced by this risk, hampers development at both a macroeconomic and microeconomic level.

The monsoon risk faced by India is used an as an example to illustrate the nature of the problem and how it might be tackled.

Agriculture, from which 60 % of India's population directly derives its livelihood, accounts for more than a 25 % of the GDP. More than 60 % of cultivated land is not irrigated hence solely dependent on rainfall, 80 % of which is in the form of monsoon between June and September.

A poor monsoon adversely impacts both staple food crops such as rice and wheat as well as commercial crops such as sugarcane and cotton (and downstream industries). A good or a bad monsoon can impact countrywide crop production by more than 20%. Also, as a consequence of a bad monsoon, the quality of farm credit deteriorates sharply.

As a sizeable proportion of the consumer demand in the economy comes from the rural (primarily agrarian) economy, a poor monsoon has a detrimental effect on industries in the Fast Moving Consumer Goods (FMCG), consumer durables and agro-related sectors.

In the event of a poor monsoon, the government needs to increase agricultural subsidies, step up the Public Distribution System (as subsidized food and fuel delivery system that forms the backbone of India's welfare support) and sometimes import food grains. Especially under conditions of drought, the government needs to spend a substantial amount towards aid and relief efforts. These additional expenses, along with lower tax revenues from both industrial and agricultural sources, can make a serious dent in the public finances.

Economic variables such as GDP, stock indices, export/import ratios, fiscal deficits, NPAs, exchange rate, forex reserves etc. are all affected by the monsoon. A former Finance Minister of India said that his budget was "largely a gamble on monsoon". In summary, the adverse economic impact of the monsoon is worth several billion dollars.

The micro influence of these macroeconomic effects is amplified especially as a significant proportion of farmers in India are subsistence farmers whose solvency is incapable of withstanding even one monsoon shock. Cases of suicides by affected farmers are not unknown.

Most of the issues highlighted above could be suitably tackled if appropriate insurance could be found to protect against weather risk. However, such a market does not exist. Additionally, the sheer size of the problem would make it infeasible for conventional insurance companies to offer such a product.

Another way of tackling the problem is the issuance of monsoon related bonds. Conceptually, these bonds are similar to catastrophe-linked securities, except that the payout, instead of being linked to the occurrence of catastrophic events, is indexed to a standard measurement of the monsoon rainfall. Such an index has been in existence since 1871.

Operationally, a bankruptcy remote Special Purpose Vehicle will set up to issue the monsoon bonds. The federal government, state governments, corporate bodies, farm co-operatives, disaster relief authorities, aid agencies and financial institutions can all buy into this SPV through the contribution of a premium. In return, they will receive financial compensation in the event of poor monsoon rainfall. This can then be used directly or disbursed to affected parties (such as subsistence farmers), to help mitigate the adverse effect of a poor monsoon.

Typically, the issue will consist of an investment grade principal-protected coupon-at-risk tranche and a junk rated principal-at-risk component. The SPV will invest the proceeds from the issue in high quality fixed income securities. Together with the premium paid into the SPV, the interest from this will be used to pay the coupon for the monsoon bonds.

There is a high latent demand for such securities especially under the present market environment wherein both stock market and fixed income returns are at historically low levels. An uncorrelated investment such as the monsoon bond will stochastically dominate conventional fixed income securities, have a high alpha and zero beta (under the market model) and a high Sharpe ratio. It would improve the risk return profile of most security portfolios held by institutional investors. Typically, pension funds and mutual funds will be interested in the first tranche and hedge funds and proprietary investment vehicles in the second.

The most important components of fixed income security modelling are default probability and expected value. The nature of the monsoon and the availability of a long data history mean that the modelled values for monsoon bonds are more accurate than those for other securities such as corporate bonds. This reduced 'model risk' and high portfolio benefits will allow the SPV to issue the monsoon bonds at relatively low coupons thus making them cheaper and more attractive than possible insurance alternatives.

This and other similar concepts for hedging weather risk can be used to reduce development inhibiting economic volatility at both micro and macroeconomic levels across a number of 'third world' countries.

Technical and financial support from the World Bank or Regional development banks would be the ideal route for issuing an popularizing such risk management problems which have the potential to have a substantial positive impact at both the micro and the macro level in several developing countries.

Appendix II

The TRIUMF

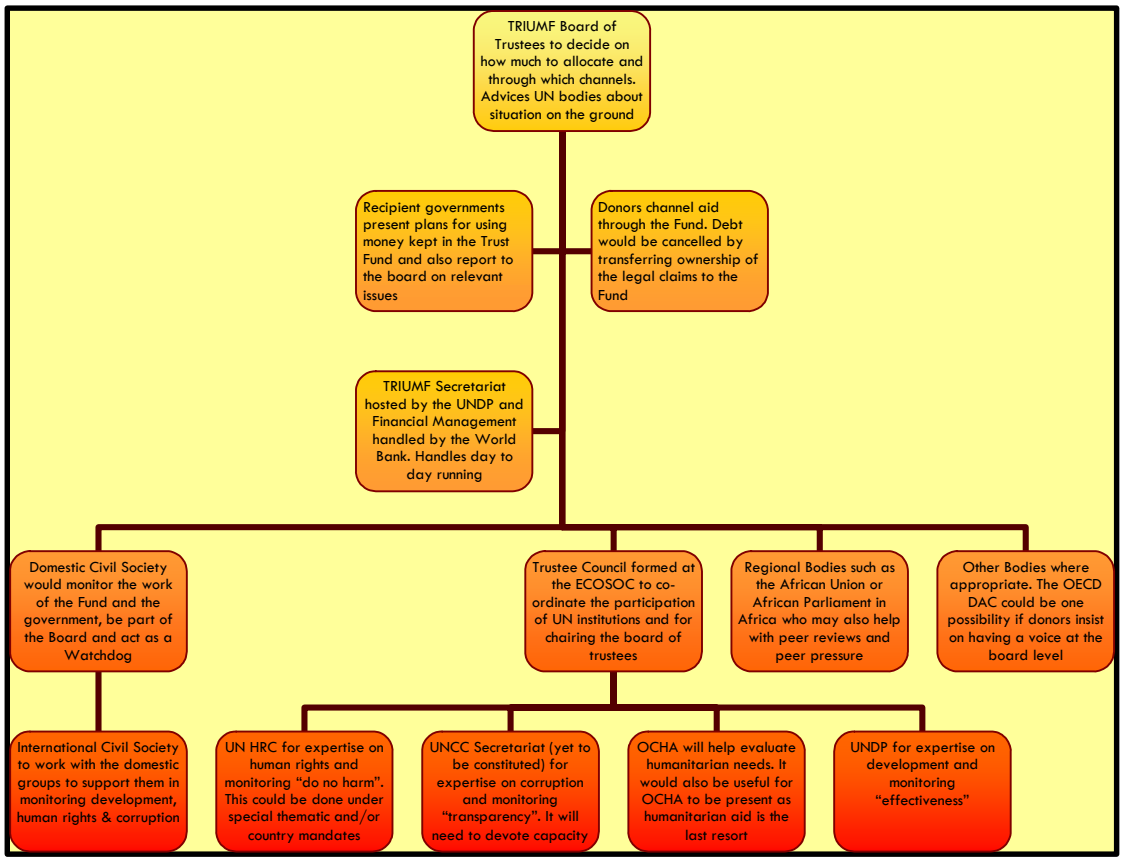
The TRIUMF would work as a country level fund which holds money accruing from 1) aid inflows and 2) debt repayment (on debt for which relief is being granted) and in the longer term possibly 3) natural resource rents in an escrow account in trust on behalf of developing countries with serious governance problems. The board of trustees would be composed of 1) the United Nations 2) Civil Society 3) Regional Bodies 4) Other Bodies as might be appropriate.

The TRIUMF would, to the extent possible, carry day to day operations in country where a secretariat operating under the aegis of the local UNDP office would sit permanently[i]. It is envisioned that the management of the financial operations of the Fund would be handled by the World Bank[ii] which has excellent in-house financial management expertise though all major decisions will be taken by the secretariat and approved by the board of trustees.

The TRIUMF is expected to fulfil a development role by ensuring that funds are made available for fulfilling all development needs. It will disburse funds in accordance with the three principles of 'transparency', 'do no harm' and 'effectiveness' detailed earlier in the paper. It is expected to approve and monitor plans, budgets and reports presented by the recipient government for the use of funds to finance development needs.

To help with decision making and monitoring, expertise would need to be provided by various UN bodies such as the Human Rights Council[iii] (on the 'do no harm' principle), the United Nations Convention on Corruption[iv] (on transparency), the Office of the Commissioner on Humanitarian Assistance (on humanitarian needs and the United Nations Development Program (on development needs and the 'effectiveness' guideline). It is recommended that the UN role be co-ordinated by a new 'Trustee Council' which would need to be established under the aegis of the UN ECOSOC. Such a Council would be different from the now suspended Trusteeship Council which was meant to help with the transition of territories from former colonies to independent states.

A working structure for TRIUMF



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[i] UNDP has country offices in 134 countries which make it the development agency with most local expertise and on the ground knowledge. This and the fact that it is a UN body make it a suitable entity to host such a secretariat

[ii] The World Bank has more experience of managing financial accounts and cross border development flows than any other development organization. It would thus be appropriate to draw on this vast experience to ask the Bank to handle the financial affairs of the Trust Fund

[iii] Note: The Human Rights Council has thematic and country mandates which allow it to fulfil its role. Current mandates include poorly governed countries such as DRC, Somalia, Sudan and Myanmar and critical issues such as torture, freedom of expression, disappearances and extrajudicial executions. One pre condition for putting a TRIUMF in place could be that a country would need to agree to 'open invitation' which means that the HRC will then have the right to monitor it continuously.

[iv] Note: the UNCC is yet to come into force. When it does, the fulfilment of its suggested role would mean that it would need to have dedicated staff, both international experts and in country staff to help it fulfil its mandate to fight and reduce corruption (and increase transparency). We also suggest that these staff members could help with identifying and tackling capital flight and helping repatriate stolen assets. These monies too, could then be channelled though the Trust Fund.