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STRENGTHENING THE WORLD BANK GROUP'S SUPPORT FOR MIDDLE-INCOME COUNTRIES

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CONTENTS

ACRONYMS

CAS	Country Assistance Strategy
CDF	Comprehensive Development Framework
ESW	Economic and Sector Work
HIPC	Heavily Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
MDB	Multilateral Development Bank
MIGA	Multilateral Investment Guarantee Agency

STRENGTHENING THE WORLD BANK GROUP'S SUPPORT FOR MIDDLE-INCOME COUNTRIES

I. INTRODUCTION

1. At its September 25, 2000, meeting in Prague, the Development Committee held an initial review of the World Bank Group's role and instruments in supporting country development.[1] Ministers welcomed the Bank's overall approach and the specific proposals for low-income (IDA-eligible) countries. They also reaffirmed the important continuing role of the World Bank Group in helping to reduce poverty in middle-income countries, and looked forward to the Bank's articulating its strategy for this diverse group of countries (defined as all those eligible for IBRD lending) on the basis of proposals from a task force created to consider how the Bank Group can best respond to their needs. This paper reports on the results of the task force's work and subsequent discussion by Management and Executive Directors, highlighting the particular issues likely to be of interest to Ministers.

A. Supporting Country Development: The Changing Paradigm

2. The paper for the Prague meeting—*Supporting Country Development: World Bank Role and Instruments in Low- and Middle-Income Countries*—described the changing paradigm for development assistance and outlined the way the Bank Group, along with other development partners, is adapting its approach to better reflect the lessons of experience and respond to new needs for development services.

3. ***Poverty Reduction.*** Poverty reduction is now universally acknowledged as the central objective of development assistance.[2] Good country policies and institutions are recognized as the most important determinants of success in reducing poverty and in making external financial assistance effective. *Supporting Country Development* described how the Bank Group's approach and instruments are being aligned with the poverty reduction objective; the evolving needs of middle-income countries, including managing the effects of external financial volatility on poverty; and the lessons of experience. It noted the increasing focus of development thinking on policies and institutions, the role of the private sector, and country ownership and partnership as articulated in the Comprehensive Development Framework (CDF). Paralleling this evolution, the Bank Group has progressively adopted a program approach to its operations—with the Country Assistance Strategy (CAS) based on the country's agenda, institutions, and policies and the CDF principles.

4. ***Country Model.*** At the Prague meeting of the Development Committee, Ministers welcomed the way this approach is being put into practice in low-income countries. They stressed the need for the Bank to strengthen its diagnostic and other economic and sector work

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[1] See *Supporting Country Development: World Bank Role and Instruments in Low- and Middle-Income Countries* (DC/2000-19), September 8, 2000.

[2] See *2000, A Better World for All: Progress towards the International Development Goals,* jointly issued by the IMF, Organization for Economic Co-operation and Development, the United Nations, and the World Bank Group (Washington, D.C.: International Monetary Fund, 2000), available at http://www.paris21.org/.

(ESW) in all developing countries to ensure that its country programs are well grounded—particularly given the increasing use of programmatic lending in support of countries' social, structural, and sectoral reforms, and the vision of Bank and Fund roles articulated in the Joint Statement by the President and the Managing Director in September 2000.[3] They emphasized the need for the Bank to be more selective, working closely and systematically with development partners, concentrating on areas in which the Bank has comparative advantage. They welcomed the creation of the Task Force on the World Bank Group and the Middle-Income Countries.

B. Middle-Income Task Force

5. In the course of its work, the task force held extensive discussions with clients and with other shareholders. In addition to a number of bilateral discussions, the task force held informal discussions with representatives of about 25 middle-income countries and with a group of European shareholders. Its report was discussed in draft by Executive Directors, as was an earlier draft of this paper. A consistent message from the consultations with Executive Directors and with clients was the need for the Bank Group to remain engaged in helping middle-income countries address their development challenges. An equally consistent message from nonborrowing shareholders was that since such a large proportion of the world's poor people live in middle-income countries, helping these countries meet their development challenges is central to the Bank Group's overarching mission of tackling global poverty and to progress toward the international development goals.

6. ***Task Force Proposals.*** The strategy the task force proposed for the Bank Group would translate the general approach set out for Prague and the views of clients and shareholders into a set of more specific proposals for strengthening the Bank Group's support for middle-income countries.[4] The main elements are summarized in Box 1. Management believes these proposals, appropriately operationalized, could ultimately provide a basis for strengthened collaboration and division of labor with other development partners, similar to that being pursued for low-income countries. However, more work is needed on the specific modalities and instruments if they are to provide a firm basis for the Bank Group's work in helping this diverse group of countries address their development challenges and build capacity. After further refinement, taking account of comments by the Development Committee, Management will submit specific proposals to the Bank's Executive Board for its consideration.

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3 See *The IMF and the World Bank Group: An Enhanced Partnership for Sustainable Growth and Poverty Reduction*, a joint statement by Horst Köhler, Managing Director, and James Wolfensohn, President, September 6, 2000, available at http://www.worldbank.org/developmentnews/, under Press Releases.

4 See *Task Force on the World Bank Group and the Middle-Income Countries—Final Report* (forthcoming).

Box 1. Summary of Main Task Force Proposals

Strengthen the Country Assistance Strategy as the key vehicle for agreeing on a focused program of World Bank Group lending and nonlending support, based on the country's development vision and priorities, a systematic and comprehensive diagnosis, and an informed view of support that is or can be provided by others.

Invite countries to present their vision of development as a basis for support from all development partners and the starting point for the Bank's CAS. Invite countries to set out this vision in the form of a Letter of Development Strategy.

Rebuild and systematize the Bank's economic and sector work. This is needed if the Bank is to be more effective in helping countries identify and implement development priorities and build capacity. The CAS should set out a program of ESW, including development policy reviews, fiduciary assessments, and other diagnostic ESW, carried out wherever possible with clients and other development partners.

Develop lending products that match the needs of middle-income countries. Investment lending can be a powerful vehicle for transferring knowledge, testing new approaches, and supporting in-depth programs when hands-on Bank expertise is needed. Programmatic adjustment lending can effectively support medium-term reform programs, particularly when synchronized with national budget and policy cycles, and its use is likely to expand where there is sufficiently strong country performance and fiduciary and public expenditure management capacity. A new deferred drawdown option is proposed for use with policy-based loans. This would meet the needs of countries that are currently able to borrow from the market, but are concerned both to remain continuously engaged with the Bank and to enhance their debt management flexibility. It would also help countries that wish to remain engaged with the Bank but for the time being do not need to borrow from the Bank, although they are at a stage of development when experience suggests they may need support again in the future.

Use these enhancements and improved processes to reduce the cost of doing business with the Bank and as a basis for greater country and institutional selectivity. The improved and more systematic policy dialogue will help countries focus on key policy priorities, and, combined with a streamlining of Bank internal processes, will help reduce the cost of doing business with the Bank. It will also allow the Bank to cooperate more effectively with other multilateral development banks (MDBs) and other development partners (and better exploit synergies within the Bank Group), exercising greater selectivity at the country level about which of the priorities for each country the Bank itself should support. Other areas for enhanced institutional cooperation with other MDBs should also be explored, starting with fiduciary assessments, where there are shared institutional needs.

Strengthen collaboration with the IMF. The improved processes and strengthened analytic and diagnostic work will help the Bank to better advise countries on social, structural, and sectoral policies and institutions, paralleling and complementing the work of the IMF on macroeconomic policies and related institutions. They should foster more structured and streamlined Bank-Fund cooperation in the policy dialogue with and support for middle-income countries, along the lines of the enhanced framework being developed for low-income countries.

II. WHY THE BANK GROUP SHOULD REMAIN ENGAGED

7. Nearly 80 percent of the world's poor people (as measured by those living on less than US$2 per day) live in IBRD-eligible countries. Even if we do not count China's poor people or those living in India and the other countries eligible for both IDA and IBRD lending, 40 percent of the remainder of the world's poor live in IBRD-eligible countries. So combating poverty in IBRD borrowers is essential if global objectives for poverty reduction are to be met. Developments in middle-income countries are also important for poverty reduction elsewhere. The economic well-being of the middle-income countries translates into trade opportunities for low-income countries; and financial instability, environmental degradation, and communicable diseases in middle-income countries can all have adverse effects far outside their own borders.

A. The Bank Group's Role

8. The prevalence of poverty in middle-income countries—and the middle-income countries' important role in poverty reduction elsewhere—is the primary reason for continued development assistance to these countries. But to answer specifically how the World Bank Group should remain engaged, it is necessary to consider what special contribution the Bank Group can make in these countries. This section describes the benefits of Bank Group support for middle-income countries and their poverty reduction efforts.

9. ***Country Issues.*** The most powerful reason for the Bank to remain engaged in the middle-income countries is the nature of the challenges many of them face.

- ***Policies and Institutions.*** Experience shows that the main drivers of growth and poverty reduction are good policies, and good institutions to implement them. Development assistance is effective in the presence of such policies and institutions, less so in their absence. Increasingly, middle-income countries that have been implementing sound macroeconomic policies find that the main obstacle to faster growth and poverty reduction lies in weak social, structural, and sectoral policies and institutions. But these are the areas where the Bank has a mandate and expertise and is able to offer assistance—both financial assistance and, equally important, advice and knowledge transfer. With its global reach, broad sectoral knowledge, and specific engagement with the private sector through IFC and MIGA, the Bank Group has a particular comparative advantage in advising on overall priorities in these areas, and on actions needed to improve the investment climate.

- ***Limits on Access to Market Finance.*** Even developing countries that have access to financial markets can appreciate and benefit from Bank support. The reason is that these countries' market access is too often for limited amounts and for short-term maturities (rather than the long-term finance appropriate for long-term development), and it tends to be volatile. The social, structural, and sectoral policies the Bank supports help countries create an investment climate that catalyzes stable private flows, at the same time that IFC seeks investments that push the frontiers of what market participants are willing to finance. In these ways Bank Group financial support crowds in private financial flows. The objective is to help countries attain sustainable access to market finance so that they no longer need the Bank's financial support. But experience shows that before countries reach that stage they can be vulnerable to market volatility, and that reversals of private flows can lead to severe setbacks in the process of poverty reduction. A key aspect of the Bank's support for some middle-income countries, therefore, is to help them reduce risks of volatility and handle reversals better when they happen. This is very much part of the Bank's poverty reduction mission.

10. ***Cross-Country and Global Issues.*** A further reason for the Bank to be engaged in middle-income countries is that developments in these countries are important for global public goods—poverty reduction itself, as well as such issues as trade integration, environmental protection, communicable diseases, and the international financial architecture—in which the

Bank has been asked to act as agent of the international community.[5] Knowledge is another global public good, and one of the particular benefits of the Bank's engagement with middle-income countries is that it creates valuable experience to pass on to countries that are at an earlier stage of development. Against this background, the Bank's disclosure policy takes on heightened importance; enhanced disclosure with a view to promoting transparency, facilitating external dialogue, and increasing accountability will also contribute to better sharing of information and lessons learned across countries.[6]

11. ***The Bank Group's Catalytic Role.*** In each of these areas the Bank Group's role must be strategic, leveraging its small share of the overall funding requirement into poverty reduction. In particular, the Bank's effectiveness depends on its acting as a catalyst for policy and institutional change, for stable and sustainable private flows, and for policy and financial support from other development partners. The program approach is central to this role. CASs link Bank Group support to priority policy and institutional developments and capacity building, which in turn help catalyze private financial flows. And country-led development strategies and the related Bank diagnostic work and policy dialogue that underlie CASs provide a basis for cooperation and division of labor at the country level with development partners. Strong participation by citizens in the formulation and implementation of national strategies crucially strengthens country ownership and also helps ensure good governance. So the Bank encourages governments and citizens to design their country's development agenda through an interactive process of consultation and participation.

B. Country Diversity

12. Middle-income countries are a diverse group. The group encompasses upper middle-income countries, such as Argentina and Poland, with annual per capita incomes above US$2,995; lower-middle-income countries, such as Peru, the Philippines, and Romania, with annual per capita incomes ranging between US$756 and US$2,995; and several low-income countries, such as India, Indonesia, and Ukraine, with annual per capita incomes below US$756.[7] It includes many transition, as well as developing, countries. It includes large federal states like Russia and Brazil, and small island states like Micronesia and St. Lucia. And it includes countries with still limited domestic institutional capacity, like Papua New Guinea, where the first priority is to build that capacity; countries with stronger capacity and well-defined reform programs that are embarking on more complex reforms, like Tunisia; countries with good track records of reform that continue to seek Bank financial support for ongoing structural and social investment programs, like Mexico; and countries that normally rely on good market access but wish to be able to turn to the Bank to finance ongoing social and structural investments in the event of reduced market access. As the various groups are cross-cutting and overlapping, the critical bottom-line conclusion is that each country is unique. What is important is that the Bank

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5 See *Global Public Goods—Progress Report* (forthcoming), and *Leveraging Trade for Development: The World Bank's Role* (DC/2001-0004), April 4, 2001, papers for the April 30, 2001, meeting of the Development Committee; *Poverty Reduction and Global Public Goods: Issues for the World Bank in Supporting Global Collective Action* (DC/2000-16), September 6, 2000; and *International Financial Architecture: An Update on World Bank Group Activities* (DC/2000-20), September 13, 2000.

6 See *World Bank Policy on Information Disclosure: Discussion Draft,* September 20, 2000; available at http://www.worldbank.org/html/pic/disclosure/index.htm.

7 These are 1999 GNP per capita figures. See Operational Policy 3.10, Annex D, *IBRD/IDA Countries: Per Capita Incomes, Lending Eligibility, and Repayment Terms,* available at http://wbln0018.worldbank.org/institutional/manuals/opmanual.nsf/.

Group has the right overall approach to supporting country development and helping build capacity, and the appropriate menu of instruments from which to choose in giving this support.

III. STRENGTHENING AND FOCUSING BANK GROUP SUPPORT FOR MIDDLE-INCOME COUNTRIES

13. This diversity in middle-income countries highlights the need to use the CAS process to customize a program of Bank Group support for each country. As *Supporting Country Development* described, the CAS should set out each country's own development *vision* (a country-led and country-owned policy framework); a Bank *diagnosis* (the assessment of a country's policies and institutions, which informs the Bank's country dialogue and also helps countries refine their vision); the proposed *program* of Bank Group lending and nonlending support; and proposals for monitoring and evaluating *results.*[8] This section sets out Management's proposals to strengthen the different stages of this process. It also includes proposals for improving synergies within the World Bank Group—among IBRD, IFC, and MIGA.

A. Country Development Strategies

14. CASs are and should remain the key vehicle for developing the Bank Group country program. But they need to be more sharply focused and businesslike, clearly setting out the lending and nonlending program and the understandings reached about the performance, deliverables, and accountabilities of both the country and the Bank. The program should fully integrate the Bank Group's analytical support and assistance for capacity building.

15. ***Ownership and Partnership.*** If the CAS process is to be able to pinpoint the interventions with which the Bank Group can have the greatest development impact, it must build on (a) the country's development vision and agenda, (b) a systematic and comprehensive diagnosis, and (c) an informed view of what others—including the private sector—are doing. Experience shows that a country-owned and country-led comprehensive vision of development—a framework for country policies and priorities—is an essential starting point for successful development assistance. In middle-income as in low-income countries, therefore, the Bank should encourage countries to articulate a development framework setting out their targets as clearly as possible. Many middle-income countries already have such a framework, and have set it out in existing documents; they should be invited to reflect their vision in a *Letter of Development Strategy* that could underpin the CAS and help to increase country ownership of the CAS process.

16. ***Monitoring and Evaluation.*** As a business document, the CAS also should assess Bank Group performance systematically, incorporating feedback from client surveys, as a basis for determining the direction of future support. Monitoring progress and results achieved is an ongoing challenge. While the outcome of *individual* lending operations is routinely assessed and reported on, the methodology for assessing the cumulative *country* impact of, for example, a

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8 See *Supporting Country Development: World Bank Group Role and Instruments in Low- and Middle-Income Countries,* op. cit.

series of programmatic adjustment operations and other lending and nonlending support is still at an early stage of development. This is a priority for future collaboration between Bank evaluation, research, and operational staff on the one hand and clients and partners on the other—focusing clearly on the overall impact judged in terms of poverty reduction.

B. Economic and Sector Work

17. With policies and institutions the key to successful development, the Bank Group's capacity to provide sound diagnostic analysis and advice is essential to its continued relevance. This points to the importance of a strong economic and sector work (ESW) program. It does not mean the Bank must do all the underlying analysis itself. On the contrary, it is important for the Bank wherever possible to build on analysis done by others to avoid duplication and to promote efficiency. It is especially important to draw on—and encourage—country-based analysis, which has important capacity-building dimensions. In addition, the Bank's research, evaluation, and outreach activities should include the evolving development agenda in middle-income countries.

18. ***Core Integrative Assessments.*** Two integrative diagnostic analyses are key to the Bank Group's assistance to each country, whether it is a low- or a middle-income country. A *fiduciary assessment* is needed to analyze the country's public financial accountability arrangements, including its systems for public expenditure, procurement, and financial management, as a contribution to the CAS. Building on more in-depth analyses of these areas, it would diagnose the problems and identify the priorities for policy action and capacity building and possibilities for Bank support, particularly in the context of helping countries to prepare for programmatic adjustment lending. Given the shared interest in assessing and helping to strengthen public financial management, this is an important area for partnership with other development agencies, and more fundamentally with clients. It has also been recognized that an integrated analysis of the country's social, structural, and sectoral policies is important to underpin the Bank Group assistance strategy, the policy dialogue, and where appropriate programmatic lending. Indeed, given its global reach across countries and sectors, the Bank has a strong comparative advantage in assessing—and helping clients assess—the social, structural, and sectoral agenda in an integrated way. The task force proposed that the Bank systematize this kind of integrative analysis in a *development policy review*—a concise cross-cutting assessment of policy reform and institutional development priorities for growth and poverty reduction. While it is clear that such integrative policy analysis is essential to underpin the CAS, the specific modalities of how it should be carried out and presented are still being discussed, in light of the feedback received from Executive Directors, clients, and staff. In particular, care must be taken to avoid duplication by synthesizing the findings of existing in-depth diagnostic work, including poverty assessments, and by drawing on analyses produced outside the Bank by clients and partner institutions as well as the Bank's own work.

19. ***Other Diagnostic Economic and Sector Work.*** The need for additional analytic products for a particular country would depend on what upstream analyses of economywide and sector-specific issues are needed for the future policy dialogue and lending. This is especially important in view of the evidence that upstream ESW has a strong positive effect on the quality and development impact of lending. The work would also provide building blocks for the core integrative instruments described above and would aim to help countries build capacity. Which

of these products would be part of the Bank's ESW package would depend on the availability of work in the country and from other sources. But clearly, up-to-date analyses of poverty and environmental issues on the one hand and public expenditure, procurement, and financial management systems on the other would be essential. The CAS also would spell out which sector-specific studies would need to be produced by the Bank, as part of the upstream preparation for future lending. CAS programs also should set out the scope for customized ESW within the CAS envelope, providing for cost-sharing for specific items of analytic and advisory work that go beyond the base-case allocation.

C. Lending

20. During the task force's consultations, client representatives called for a larger rather than a smaller menu of lending instruments, mindful of the role of the CAS in identifying the right instruments for achieving results in a particular country context. Some clients stressed the importance of investment lending, while others highlighted the increasing use of adjustment lending instruments in a more developmental way. Yet others focused on the value of adjustment lending instruments to help them manage in the face of financial market volatility, noting its adverse implications for poverty. The priority is to set out the menus of options available for supporting country programs and clear rules of the game for their use, in the process clarifying that almost all Bank instruments are variations on the two basic instruments of investment lending and adjustment lending.

21. ***Investment Lending.*** Investment lending has a continuing and important role to play in all middle-income country programs, with the specifics tailored to the particular needs of clients as set out in the CAS. Indeed, it can be a powerful vehicle for transferring knowledge, testing and demonstrating new approaches, and supporting in-depth programs where hands-on attention is needed. But it is more effective in the presence of good policies and institutions, and must therefore be set in the context of a satisfactory program of policy and institutional development. The Bank's current focus on compliance with operational policies must continue, but it needs to be complemented by a capacity-building approach designed to help borrowers develop effective safeguard and fiduciary systems. Reducing unnecessary delays and other transaction costs of investment lending—by clarifying policies and procedures and streamlining internal processes—is essential.

22. ***Adjustment Lending.*** Research, evaluation findings, and operational experience suggest that policy-based adjustment lending can effectively support countries' efforts to reduce poverty, in the context of a favorable policy and institutional environment and strong government commitment. It provides a powerful direct link to countries' policy reform and budget priority setting processes. (Indeed, "adjustment" no longer correctly describes the purpose of such lending, and the task force recommended adoption of a more up-to-date name). A large part of the improvement in adjustment lending outcomes during the 1990s reflects the increased country selectivity of the Bank's adjustment lending decisions. Adjustment lending to countries with poor track records must be used with extreme caution, grounded in a careful assessment of risks and rewards that demonstrates the likelihood of a turnaround; for such countries, ESW-based advice and technical assistance for capacity building are better suited to nurturing support for reforms in their early stages. However, for strong performers with good track records and sound

and transparent fiduciary and policy frameworks, programmatic adjustment lending—using a series of single-tranche operations under a clearly defined and monitored medium-term framework—can be an effective vehicle for supporting poverty reduction. For other countries with sound reform programs but with more limited capacity and less strong track records, a series of multitranche operations may be more appropriate—with conditionality linked to prior actions wherever possible. Traditional multiyear, multitranche designs may be appropriate in some situations, especially for supporting in-depth sectoral and subnational reforms. In all cases a sound macroeconomic framework is essential. Debate continues about these issues and the minimum fiduciary and other standards required for different form of programmatic adjustment lending, which will be the subject of discussions with Executive Directors in preparing for the revision of the Bank's operational policy on adjustment lending.

23. ***Deferred Drawdown Option.*** The Bank also needs to ensure that its lending instruments match borrower needs. Loans with currency and interest flexibility and, more recently, local currency loans have already been introduced. For borrowers that currently have some access to financial markets but wish to remain engaged in a policy dialogue with the Bank and enhance their debt management flexibility, the task force proposed developing a *deferred drawdown option* for program loans. This would allow countries to obtain a loan in the usual way within the CAS envelope; it would support ongoing and defined social, structural, and sectoral reform programs; and it would provide financing in support of those programs if and when market borrowing becomes difficult and a financing need arises. Drawdown would be subject to a confirmation of progress on agreed reform programs and a satisfactory macroeconomic framework. The deferred drawdown option would not be designed as a new "window": it would simply introduce additional flexibility within the regular lending program to address the increasingly diverse needs of IBRD borrowers. It would also provide a basis for a continued strong policy dialogue with a group of countries that may not currently need to borrow from the Bank. The option would likely be of most interest to more advanced borrowers and potentially to some currently inactive borrowers with regular capital market access. Loan amounts with this option would not be large enough to provide major liquidity support in a crisis and, once disbursed, would represent a long-term obligation. The deferred drawdown option would not replace special structural adjustment loans, which would remain the vehicle for exceptional support, outside the CAS envelope, to countries needing Bank assistance with social, structural, and sectoral issues at times of major crisis. Nor would it compete, either in intent or in structure, with the IMF's Contingent Credit Line, which augments a country's reserves in emergency situations in case of capital market crisis due to contagion.

D. Bank Group Synergies

24. Valuable steps have been taken in recent years to capture synergies within the Bank Group in supporting private sector development. The Joint CAS program is one of the most important, providing a vehicle for Bank Group staff to work together with clients in a concrete way on the policy, institutional, and transactional issues affecting private sector development; 20 joint Bank Group CASs have been completed to date for IBRD borrowers, and the coverage is rising. Meanwhile, Bank Group-wide units have been created to cover private sector advisory services; small and medium enterprises; oil, gas, and chemicals; mining; and information and communications technologies. Initial work is being conducted on developing Bank Group

survey instruments to analyze national business environments. But more needs to be done, especially in coordinating strategic and diagnostic work (including ESW tools, client-focused analytic and advisory services, and survey instruments) and on coordinating specific operations. Future work will include strengthening Bank-IFC collaboration in designing regional and sector strategies and following up on opportunities identified in joint CASs for developing joint operations and for sequencing Bank-supported policy reforms with IFC-supported transactions. Attention also is being given to developing better mechanisms to promote synergies with MIGA.

IV. SELECTIVITY AND SUSTAINABILITY

25. Management believes that in addition to proposed changes in Bank Group lending and nonlending strategies, two other issues examined by the task force warrant consideration by Ministers. The first is how to strengthen the partnership with the IMF and the regional development banks so as to enhance the effectiveness of client support and sharpen institutional selectivity and specialization. The second issue is how to ensure the continued viability of the Bank as a financial institution. These issues are discussed below.

A. Selectivity

26. Taken together, the task force proposals aim to allow the Bank to systematize and strengthen its support for middle-income countries and its partnerships with others in this effort. In each area the proposals stress the importance of the Bank's being more selective in what it does itself, working with others wherever possible and focusing on its areas of comparative advantage. Management is fully committed to this approach.

27. ***Complementarity with the IMF.*** The Bank and the Fund have long had in place a collaborative framework, recently enhanced for low-income countries under the Heavily Indebted Poor Country (HIPC) and Poverty Reduction Strategy Paper initiatives. These enhanced arrangements provide for each institution to take lead responsibility for distinct aspects of the policy dialogue with borrowers, and set a common framework in which the Bank and the Fund jointly and separately assess and monitor progress. The ESW and programmatic lending proposals set out above will position the Bank to deliver better advice in its lead areas, thereby setting the stage for better structured Bank-Fund cooperation and more streamlining of institutional responsibilities in middle-income countries.[9] Indeed, an important context for the proposals is the IMF's desire to focus more on its core macroeconomic and related structural areas of responsibility, looking to the Bank to take the lead in the dialogue on social, structural, and sectoral issues. The proposed strengthening of ESW, including core integrative fiduciary and policy assessments, will be particularly important in this context. The successful Bank-Fund collaboration on the Financial Sector Assessment Program and on the Reports on Observance of Standards and Codes provides a strong foundation for a broad-based partnership on a number of issues.

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[9] In turn, this will be essential for enhancing the cooperative framework with the IMF in line with the September 2000 Joint Statement by the President and Managing Director on an enhanced partnership between the two institutions. See *The IMF and the World Bank Group: An Enhanced Partnership for Sustainable Growth and Poverty Reduction,* op. cit.

28. ***Partnerships with Other MDBs and Donors.*** While the Bank and the Fund operate in virtually all developing countries, most development agencies do not. Partly because the other MDBs and development partners operate in a subset of countries, the main focus for collaboration is likely to remain at the country and regional level, where the task force found the sectoral overlap of lending support much less than commonly perceived. Management does see scope for enhanced institutional cooperation on analytic and diagnostic work—starting with fiduciary assessments, where there are shared institutional needs and approaches, and where joint work is already under way with the Inter-American Development Bank—but also exploring over time areas of possible institutional specialization in particular sectors, guided by the principles of comparative advantage and institutional mandates. In the meantime, continued work on the "harmonization" of operational policies and procedures remains a priority, with a view to reducing the transaction costs of development assistance for both clients and development institutions, and improving development impact.[10]

B. Financial Sustainability

29. Since middle-income countries are defined as the set of IBRD-eligible borrowers, it is critical to assess any significant strategic shift in terms of its impact on the Bank's financial sustainability and the efficient use of the Bank's financial and other resources. IBRD equity—its usable paid-in capital and accumulated reserves—supports a loan portfolio approximately five times its size. Income from the investment of capital and from loan charges (net of borrowing expenses and provisions) generates resources to provide development services (in addition to the loans themselves), maintain the risk-bearing capacity necessary to support new lending, and make grants to IDA, HIPC, and other shareholder priorities. Given current capital ratios and loan charges introduced in 1998, the Bank can absorb plausible risks, make adequate reserve allocations to underpin lending, and—in the absence of major credit events—continue to generate these development resources.

30. ***The Zone.*** The level of Bank lending to middle-income countries in recent years, while volatile, has remained within a band that is appropriate to IBRD's financial structure and that has sufficient borrower diversification to efficiently utilize the Bank's capital. Loan commitments above the US$18-21 billion range experienced in the late 1990s would translate into larger net disbursements, which, if sustained, would require the Bank to secure a capital increase, tolerate substantially higher risk, and/or again raise loan charges. At the other extreme, if the Bank's annual lending volume consistently fell below current levels of about US$9-12 billion in new commitments, and/or became more concentrated among less creditworthy borrowers, and if no new source of income were developed, it could become difficult to maintain current services, make transfers to IDA, HIPC, and other shareholder priorities, and retain the earnings necessary to support future lending. These bounds establish a "zone" of financially sustainable lending. At present the Bank is nearer the lower end of this zone than the higher end. In the future, lending is likely to fluctuate much more than in the past, as IBRD borrowers face volatility in market access. The best assessment, based on analysis of lending trends and discussions with middle-income clients on expected lending demand, is that the strategy for continued Bank engagement

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10 See *Harmonization of Operational Policies, Procedures, and Practices: Experience to Date* (forthcoming), paper for the April 30, 2001, meeting of the Development Committee.

in middle-income countries set out in this paper will be consistent with lending continuing to fluctuate broadly within this acceptable zone; but this will need to be kept under close review.

31. ***Loan Pricing.*** It is against this background that the task force considered whether its proposals would have any specific implications for loan pricing. The broad conclusion was that there were no implications for the general level of loan charges, which were reviewed in 1999 in the context of reviewing IBRD's long-term options for enhancing financial capacity. The underlying analysis is regularly updated as part of the annual net income allocation exercise; work is under way for this year's update, which will address a number of the issues raised by shareholders in this connection. Meanwhile, the task force did conclude that there was scope for price differentiation for specific products as they affect the Bank's finances. Thus for the deferred drawdown option, for example, the task force proposed a level of fees that reflects both the cost of the continuing client engagement and the reservation of Bank risk capital. The task force also reviewed the long-standing practice among MDBs to use means other than pricing to achieve appropriate selectivity among sector or country operations, and concluded that it was still appropriate. Especially in middle-income countries, where Bank finance often accounts for only a small proportion of total resource needs, to offer low-priced lending in, for example, education or health could encourage countries to take their borrowing from the Bank in these sectors, but without actually increasing overall public spending there. At the same time, such an approach could possibly reduce the effectiveness of the Bank-client partnership in other parts of the policy spectrum.

V. ISSUES FOR DISCUSSION

32. At the September 2000 meeting of the Development Committee, Ministers reaffirmed the important continuing role of the World Bank Group in helping to reduce poverty in middle-income countries. They also looked forward to further proposals about how the Bank Group can best respond to such countries' needs. Since that time, the Task Force on the World Bank Group Strategy and the Middle-Income Countries has completed its work, and its proposals have been subject to considerable discussion among Management, Executive Directors, and others. Some of the proposals have been broadly supported; on others there is continuing debate, reflecting the broad range of opinions held by different constituencies. In this context, Ministers may wish to focus on the issues highlighted below.

33. ***Country Assistance Strategies***. The paper stresses the centrality of the CAS to effective Bank Group support for country development. For ownership and impact, the CAS must reflect the country's own vision for development, take account of the roles of other development partners, be based on comprehensive diagnosis, and build in procedures for monitoring and evaluation. Starting from the importance of the private sector, it must make clear how the Bank Group catalyzes and complements private investment, adding value that private markets cannot. ***Do Ministers agree with the framework set out in the paper for systematizing and focusing the Bank Group's support for middle-income countries in the CAS? Do they support the proposals for strengthening the framework? Do they support the idea of inviting countries to set out their own development priorities in the form of a Letter of Development Strategy—which along with more systematic ESW—would underpin the CAS? What guidance do Ministers have for improving the CAS process and performance-based country selectivity in middle-income countries?***

34. ***Lending Instruments.*** The CAS sets out the broad modalities for lending and nonlending activities, based on an assessment of country performance and Bank comparative advantage. Investment lending appropriately positioned within a sound CAS framework can add value for almost all middle-income countries. Country selectivity is a more critical issue for adjustment lending, and especially programmatic adjustment lending, where country performance is particularly important for development effectiveness and poverty reduction. In countries with poor track records, adjustment lending must be used cautiously; and in many cases, ESW-based advice and capacity building may be more appropriate. ***Do Ministers agree on the more systematic and developmental role for adjustment lending set out in the paper, with country selectivity and loan design underpinned by cross-cutting analyses of countries' development policies and fiduciary systems? Do they support the development of a deferred drawdown option for adjustment lending to allow countries to remain engaged in a policy dialogue with the Bank, helping them to enhance debt management flexibility and maintain social, structural, and sectoral investment programs in the face of unexpected downturns?***

35. ***Selectivity and Partnerships***. The paper sets out an approach to selectivity that is based on building effective partnerships with other institutions and donors. In particular, the proposals for ESW and adjustment lending would provide a basis for progress toward more structured cooperation and streamlining of institutional responsibilities with the IMF. ***Do Ministers support the approach to selectivity set out in the paper? Do they support the proposals for strengthened ESW and, where appropriate, adjustment lending to provide a basis for progress toward more structured and streamlined Bank-Fund cooperation?***