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**IMPACT OF RECENT EVENTS ON LOW- AND
MIDDLE-INCOME COUNTRIES:
RESPONSE OF THE WORLD BANK GROUP**

Attached for the 64th Meeting of the Development Committee, to be held in Ottawa, Canada, on November 18, 2001, is a paper prepared by the staff of the World Bank entitled "Impact of Recent Events on Low- and Middle-Income Countries: Response of the World Bank Group". This subject will be considered under item I.A of the Second Revised Provisional Agenda.

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ACRONYMS

AML	Anti-Money-Laundering
AsDB	Asian Development Bank
CIS	Commonwealth of Independent States
CAS	Country Assistance Strategy
ECA	Europe and Central Asia (Region)
ERL/C	Emergency Recovery Loan/Credit
FY	Fiscal Year
GDP	Gross Domestic Product
GEF	Global Environment Facility
HIPC	Heavily Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
LCR	Latin America and the Caribbean Region
MIGA	Multilateral Investment Guarantee Agency
OECD	Organization for Economic Co-operation and Development
OED	Operations Evaluation Department
OP/BP	Operational Policy/Bank Procedures Statement
RDB	Regional Development Bank
ROSC	Report on the Observance of Standards and Codes
SSAL	Special Structural Adjustment Loan
SDR	Special Drawing Rights
UNDP	United Nations Development Programme

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IMPACT OF RECENT EVENTS ON LOW- AND MIDDLE-INCOME COUNTRIES: RESPONSE OF THE WORLD BANK GROUP

EXECUTIVE SUMMARY

1. This paper assesses the impact of September 11 and its aftermath on developing countries and summarizes the Bank Group's emerging response. As the situation is still evolving amid much uncertainty, the paper focuses on the instruments of Bank Group assistance and the availability of financial resources, as a basis for gauging the Bank Group's underlying capacity to respond. The paper also highlights two issues that are receiving increased attention in the wake of September 11—international efforts to combat money-laundering and the financing of terrorist activities, and the need for effective approaches to helping poor-performing countries build the policy and institutional capacity to improve the lives of their people.

2. ***Direct and Indirect Effects.*** The events of September 11 and their aftermath have delayed the recovery from the ongoing global economic slowdown and worsened growth prospects for developed and developing countries, with adverse implications for poverty reduction worldwide. For the middle-income countries, the global slowdown means a longer period of reduced export earnings and, because of increased risk aversion, reduced capital inflows. For the low-income countries, it means reduced export earnings in the face of declining commodity prices and volumes. Beyond these general impacts, recent events also have generated pronounced specific effects for some countries. For countries close to areas of conflict, movements of refugees within countries and across borders are straining public services and resources, with major social and human consequences. Meanwhile, for countries that are important tourist destinations, heightened concerns about air travel security are seriously affecting foreign exchange earnings, with adverse consequences for ongoing development programs.

3. ***Focus on Countries.*** The Bank Group has taken a number of steps to help countries address the additional challenges they are facing as a result of these effects. Staff have been in dialogue with clients to assure them of the continued commitment to deliver on previously agreed programs, and to offer help in minimizing and mitigating the adverse impacts they are facing—whether from the prolonged global slowdown or the more country-specific effects. This dialogue is continuing on a country-by-country basis to ensure that Bank Group assistance remains appropriately prioritized. Particular attention is being paid to Africa, given the extreme poverty and vulnerability to declining commodity prices of so many countries there. Other parts of the world—especially the countries directly affected by an increased influx of refugees, as in Central and South Asia, or a downturn in tourist receipts, as in the Caribbean and elsewhere—also are receiving special attention.

4. ***Concerted International Response.*** In reviewing its country programs, the Bank Group has been working closely with the IMF, the regional development banks (RDBs), United Nations agencies, and other partners. Bank staff have been working particularly closely with IMF staff to assess the needs of the low-income countries, especially those that have been maintaining strong macroeconomic and social and structural policy performance, supported by IDA and IMF lending programs. They also have been working closely with United Nations Development

Programme and Asian Development Bank staff on preparing for the future reconstruction of Afghanistan, and with the RDBs more generally in region-specific contexts.

5. ***Instruments of Delivery.*** The Bank Group has assessed the readiness of its existing instruments for helping countries meet their post-September 11 challenges, and has generally concluded that it has sufficient flexibility to respond as needed. For the Bank, emergency recovery operations may be warranted to assist the countries that are experiencing the specific dislocations set out above. For these countries—as well as for others—new or supplemental investment operations and/or portfolio restructurings designed to target assistance to emerging priorities and to protect pro-poor programs may also be appropriate. New or supplemental adjustment lending will be an option for strong performers facing increased external financing gaps. For countries participating in the Heavily Indebted Poor Countries Initiative, Bank and Fund staff will be using the recently approved operational procedures to guide case-by-case assessments of whether there is adequate justification for additional assistance at completion points. IFC and MIGA will be utilizing the flexibility within existing instruments in tailoring their responses.

6. ***Financial Capacity.*** The country-by-country assessments that staff have carried out suggest that the magnitude of likely incremental demands on the Bank Group will be manageable from a financial capacity perspective. But a close watch will continue to be needed, with follow-up in key areas. For IDA, September 11 and its aftermath put a premium on the successful completion of the IDA13 replenishment process; it will be essential if IDA is to be able to continue supporting the policy and institutional reforms that low-income countries need to implement in order to grow sustainably and reduce poverty effectively. For IBRD and IFC, the strong correlation between demand for new credit by sovereign and corporate borrowers and deterioration in existing credit portfolios could constrain the institutions' future capacity to respond. For MIGA, the successful conclusion of the general capital increase remains an urgent priority.

7. ***Anti-Money-Laundering and Combating the Financing of Terrorism.*** Since the September 11 events, global attention has focused on abuses of the financial system, including support to criminal and terrorist activities, and on the urgent need for a more systematic approach to fighting this phenomenon. Central to this effort is the Financial Sector Assessment Program, which is being expanded to include a standard anti-money-laundering methodology. Follow-up will include technical assistance and training programs, particularly for those countries with the greatest need to upgrade their legal, judicial, and financial supervisory standards. It also includes work internally and with borrowers to strengthen due diligence on country procurement and financial management systems, to ensure that development funds, including those from operations financed by the Bank Group, do not inadvertently find their way to terrorist organizations.

8. ***Poor-Performing Low-Income Countries.*** Recent events also highlight the importance of giving greater attention to poor-performing low-income countries. But the Bank Group lacks an effective operational framework for working with such countries. Hence the creation of the Task Force on World Bank Group Assistance to Poor-Performing Low-Income Countries, focused on developing innovative approaches to strengthen Bank Group assistance to these countries—and help them develop the capacity to improve the lives of their people. At the same

time, the Bank will maintain the close links between IDA lending allocations and country policies and institutions, building on the annual Country Policy and Institutional Assessment exercise.

9. ***Issues for Discussion.*** Among the issues on which Ministers might wish to comment are the following: Do Ministers agree with the assessment of the post-September 11 situation provided in this paper? Do they agree that the Bank Group's existing menu of instruments—offered in concert with other international institutions—is sufficiently broad and flexible to meet the needs of developing countries in the wake of September 11? Do they agree that additional Bank support in responding to recent developments should be predicated on sound country policies? Do Ministers agree on the importance of Bank Group efforts, complementing those of the IMF and other agencies, to help countries combat financial abuse, including through the Financial Sector Assessment Program and strengthened due diligence on procurement and financial management? Do they agree that the Bank Group should increase its attention to poor-performing low-income countries, while retaining close links between country performance and IDA lending allocations and partnering with agencies that have a mandate and experience in this area?

IMPACT OF RECENT EVENTS ON LOW-AND MIDDLE-INCOME COUNTRIES: RESPONSE OF THE WORLD BANK GROUP

I. INTRODUCTION

1. The tragic events of September 11 and their aftermath are having adverse economic and social implications for developing countries, both direct impacts in some countries and broader indirect effects resulting from the delayed recovery of the global economy. To provide timely assistance as needed, the World Bank Group has been assessing the possible effects of these combined factors—recognizing, however, that any such assessment is subject to a high degree of uncertainty, both about unfolding events and about possible responses to them. Looking beyond the immediate impacts, it is still too early to predict exactly how the events will shape country assistance programs in the medium and longer term. Two effects are already being felt: greater emphasis on efforts to combat money-laundering and terrorist financing and a new understanding of the need to work with all low-income countries, even those with poor performance records. But above all, it is clear that the Bank Group’s poverty reduction mission and mandate have never been more important.

2. *Structure of the Paper.* Section II of the paper summarizes the direct and indirect effects of the September 11 events and the potential implications for growth and poverty reduction in developing countries. Section III discusses how the Bank Group is responding, in partnership with other international financial institutions and agencies. Section IV explores the financial implications for the Bank Group of the immediate response. Section V looks forward to the medium term, discussing new emphases in the Bank Group’s work program prompted by the recent events. Annexes elaborate on several points: Annex A summarizes the global economic prospects; Annex B summarizes the Regional dimension; and Annex C provides greater detail on the Bank’s instruments—policy content, past experience, and procedures for preparation and Board approval.

II. IMPACT OF RECENT EVENTS ON DEVELOPING COUNTRIES

3. Despite the September 11 events, the overall medium-term economic outlook remains favorable—at least in part because an aggressive global policy response to the 2001 economic slowdown was already under way to stimulate demand and business confidence. In addition, in many countries, the policy reforms of recent years had reduced vulnerability to external shocks. But it is clear that short-term prospects have been adversely affected, largely because the 2001 downturn of the major high-income economies has been prolonged and their expected recovery delayed into the second half of 2002.¹ The strength of this temporary indirect impact is likely to vary significantly among different low- and middle-income countries in view of their different linkages with industrialized countries through trade, financial markets, and commodity markets. More direct effects of the crisis—which also vary by country—include increased refugee flows, declines in tourism due to air travel security concerns, capital investors’ “flight to quality,” steep increases in the costs of trade (including shipping and insurance), lost and reduced trade opportunities because of lower growth and trade diversion, and loss of remittances.

¹ See *A Reassessment of Prospects for Developing Countries* (SecM2001-0057/1), October 5, 2001.

A. Outlook for Growth and Poverty Reduction

4. The Bank has revised its Global Economic Prospects² projections in the aftermath of September 11 (see Annex A). There are large uncertainties in the figures, but in general they underscore the importance of policies, backed by appropriate assistance, to support a rapid recovery from the downturn so as to avoid prolonged adverse effects, especially for poor people. On current projections, the pace of poverty reduction would slow, and reductions in infant and child mortality would be delayed.³ The short-term effects of the associated lower growth would prevent millions of people from climbing out of poverty in 2002; indeed, in economies that stall or fall into recession because of declining global demand, the number of people living on less than \$1 per day would actually increase. Because the prices for agricultural commodities—particularly cotton, coffee, and sugar—have fallen steeply, farmers, rural laborers, and others tied to agriculture—especially those in Africa and parts of Latin America—are likely to bear a major portion of the burden. Of the 600 million people in Sub-Saharan Africa, the overwhelming majority are poor and many of them are particularly vulnerable to such impacts because they depend on commodity exports and have limited capacity to manage household risks.

B. Direct and Indirect Effects

5. Developing countries are experiencing direct impacts from the crisis and are also suffering from the indirect effects of the developed countries' delayed recovery from the global economic slowdown. Some impacts—refugee movements and falling agricultural commodity prices—affect low-income countries more than middle-income countries. Reduced access to financial markets is a problem for emerging market countries, and the other impacts described in this section may affect both low- and middle-income countries.⁴

6. ***Refugees and Internal Displacements.*** After years of civil war and chronic drought in Afghanistan, 3.5 million of its citizens are already living as refugees in Pakistan and Iran; this figure will now swell with the arrival of more Afghans in Pakistan, Iran, and possibly Turkmenistan and Tajikistan. The influx will strain public services and may generate major health threats in the receiving countries; it may also put significant pressures on their budget and food security situations.

7. ***Tourism.*** Receipts from tourism are being hit exceptionally hard as increased security concerns related to air travel have exacerbated the adverse effects of the economic slowdown in the United States and other high-income countries on spending for tourism. Many winter tourism destinations, often small states, are likely to suffer sharp declines during the coming season, including those in the Caribbean; in eastern and southern Africa; and in South Asia, including Maldives, Nepal, and Sri Lanka. Perceptions of risk could also have a significant effect on tourism receipts in Egypt, Jordan, Morocco, and Tunisia.

² See *Global Economic Prospects and the Developing Countries, 2002* (Washington, D.C.: World Bank, 2001), online at www.worldbank.org/prospects/gep/2002/.

³ See *A Reassessment of Prospects for Developing Countries*, op. cit.

⁴ Annex B provides a Region-by-Region discussion of likely impacts.

8. **Financial Markets.** Reduced access to financial markets is likely to constrain development in a number of countries with high external financing requirements in the near term, even if a few low-risk borrowers may gain from the reduction in short-term U.S. and Euro area interest rates after September 11. Capital market commitments to emerging market economies in September fell 35 percent from their August level, bringing the third-quarter total to US\$33 billion, the lowest since the financial crisis of late 1998. In particular, bond financing dropped 60 percent and equity placements dried up. Uncertainty has also been reflected in the increased volatility of spreads on emerging market bonds. Financial market conditions at this point are more than usually difficult to foresee: if current conditions are sustained, only the more creditworthy borrowers will likely be able to access the markets for new lending, in contrast to the experience of the early 1990s, when a sharp reduction in U.S. interest rates triggered capital flows to developing countries; on the other hand, the same market selectivity could lead to a quick rebound of capital flows to countries with low debt levels and prudent policies, while increasing the risk of financial crises in other countries.⁵ Foreign direct investment, which is closely correlated with the business cycle in developed countries, is likely to decline; and perceived risks, particularly in the context of the expected decrease in global reinsurance capacity, may reduce foreign direct investment flows to developing countries. Reduced flows of foreign investment may also slow the pace of privatizations.

9. **Commodity Markets.** A delayed global recovery means that most commodity prices—which have fallen for the fourth year in a row—are not likely to recover next year. As of October 24, oil prices are lower by US\$4.50, and oil futures by US\$2.20, than just before September 11, reflecting the expected slowdown in global demand and the absence of immediate threats to oil supplies. While the change should benefit oil-importing countries, it may create foreign exchange problems for several oil exporters in South America, Africa, and Central Asia. Prices of non-oil commodities have also declined since September 11, between 6 and 8 percent for most agricultural commodities and 4 percent for metals (excluding gold and silver). Particularly steep declines in both cash prices and nearby futures were registered for corn, soybeans, sugar, cotton, and coffee. The forecast of further declines in commodity prices relative to manufactures implies different terms-of-trade changes for different countries. For economies that—like some African countries—have remained highly dependent on agricultural commodity exports while importing only modest amounts of oil, it would imply a terms-of-trade loss in addition to the impact of slower growth in GDP. A more widespread effect would come from a relative decline in agricultural commodity prices on income distribution and poverty, in many countries affecting farmers and other poor people tied to agriculture—for example, cotton producers in Central Asia and coffee producers in Africa and Latin America.

10. **Trade.** Developing countries' trade will likely be affected not only by a decline in tourism and falling commodity prices, but also by reduced export demand for their manufactures and by increased trading costs. Since export demand for manufactures, particularly high-tech goods, is very sensitive to changes in developed countries' income, the delay in the recovery is likely to continue to stifle growth in developing countries that depend on the export of

⁵ In view of the risk that the cut-off of emerging markets from capital flows may be more protracted than currently envisaged, the Bank is carefully monitoring the situation in concert with other international financial institutions.

manufactured goods, including those in East Asia and Latin America.⁶ Increased costs of shipping and insurance in response to higher perceived risks increase import costs and erode export margins, particularly affecting countries with open economies that are located far from their markets. On the larger issue of trade, recognizing that improving the access of poor countries to world export markets is an essential part of the poverty reduction agenda, the Bank will participate in the upcoming World Trade Organization Ministerial in Doha. This meeting is expected to make a decisive start on the launching of a new trade round, giving special weight to the needs and concerns of developing countries.

11. **Remittances.** Projected slower global growth in the wake of September 11 would affect remittance flows, but the impact is likely to be significant for only a limited number of countries—for example, the Philippines, where remittances from the Middle East are potentially at risk; Jordan, Morocco, and Tunisia, which receive remittances from the Gulf States and western Europe; Cape Verde, Eritrea, Ethiopia, and some of the poorest Sahelian countries; and Caribbean countries—particularly Dominican Republic, Guyana, and Jamaica—which benefit from remittances from the United States.

III. INTERNATIONAL AND BANK GROUP RESPONSE

12. The Bank Group has taken a number of actions to help borrowing member countries address the additional challenges they are facing as a result of the effects described above. Immediately after September 11, managers and staff were in contact with high-level officials in all client countries to assure them of the Bank's continued commitment to deliver on previously agreed programs, and to offer help in minimizing and mitigating adverse impacts from the heightened uncertainty, risk, and volatility in the current global economic environment. Mindful of the need for partnership, the Bank Group has been working closely with development partners in developing a concerted response. This section discusses the coordination efforts that have already been launched, and then describes the instruments through which the Bank Group expects to respond within the overall approach of international partnership.

A. International Response

13. The need for a concerted international response to help the most affected developing countries has been highlighted in a number of fora—most recently at the October 22-24 meeting of the IDA Deputies in Paris,⁷ and at the G-20 Deputies October 28-30 meeting in Toronto. And many cooperative initiatives have already begun. In line with the broader efforts of the Bank and Fund to improve their coordination, the staff of the two institutions are working together on program design in a number of countries. They also are working to develop updated estimates of the incremental impact of recent events on low-income countries' external financing needs. In addition, the Bank Group is engaging in dialogue with the regional development banks (RDBs)⁸

⁶ In June-August 2001, dollar exports from East Asia (including China) declined by nearly 15 percent from the level of the previous year, and Latin American exports fell 2.6 percent.

⁷ See *IDA13 Replenishment Meeting—October 22-24, 2001, Chairman's Summary* (IDA/SecM2001-0633), October 20, 2001.

⁸ These include the African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, and Inter-American Development Bank.

to share information and analysis and discuss the implications for activities in the borrowing countries most affected by the events.

14. ***International Financial Institutions.*** The Bank Group's President, the Fund's Managing Director,⁹ and the RDBs' Presidents have begun a series of videoconferences at which they take stock of unfolding events and discuss coordination. In a joint statement distributed to the Boards of the institutions, they outlined the guiding principles of their joint approach:¹⁰

- ***Importance of Policies.*** While the balance of lending and nonlending assistance offered will vary according to countries' specific needs, sound policies will need to be a common element for all.
- ***Coordinated Response.*** The international financial institutions are strengthening the mechanisms through which they share information and analysis, so that their assessments of country needs will be based on consistent parameters and their operational responses fully coordinated.
- ***Operational Facilities and Instruments.*** The international financial institutions believe their operational facilities and instruments are flexible and comprehensive enough to address their members' immediate needs, but they intend to keep them under review and to reassess them as necessary.
- ***Support for Low-Income Countries.*** The concessional lending windows of some of the international financial institutions have the headroom to allow for a significant short-term expansion of multilateral flows to low-income countries, although for other facilities this would have implications for the volume and timing of donor contributions. For the heavily indebted poor countries, debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative and additional bilateral debt forgiveness remain an important window of continued support.
- ***Support for Middle-Income Countries.*** There is greater uncertainty about the financing requirements for this group of members, especially regarding the potential needs of some large emerging market countries. While the prospective demand for Fund resources is sensitive to the size of the downturn and assumptions about market access for emerging market countries, the Fund has the capacity to respond to the evolving situation in its member countries in the period ahead. The multilateral development banks also are committed to supporting middle-income countries in ways that reflect their individual circumstances. In the event of a more prolonged

⁹ The Managing Director of the Fund has stated that the Fund is prepared to play its role in providing advice and additional financial support, where necessary, to members that have (or adopt) suitable policies, as part of a joint international effort to strengthen confidence in the global economy. See *Statement of the Managing Director on the Situation of the World Economy and the Fund Response*, IMF News Brief No. 01/98, October 5, 2001.

¹⁰ See Letter to Members of the International Monetary and Financial Committee and Members of Development Committee from heads of the four RDBs, Managing Director of IMF, and President of World Bank, October 5, 2001, circulated to Executive Directors in Office Memorandum, *Attached Letter to Governors on the Current Situation* (OM 2001-0082), October 5, 2001.

global slowdown than is currently expected, the multilateral development banks may be called upon to take a more proactive approach.

15. ***Collaboration on Country Programs.*** In addition, collaboration is proceeding in a number of countries. For example, the World Bank, the IMF, the Inter-American Development Bank, and the Caribbean Development Bank are working in tandem on support for affected countries in the Caribbean. For the poor and heavily indebted countries of Central Asia and the Southern Caucasus and Moldova, the Bank has joined with the IMF, the European Bank for Reconstruction and Development, and the Asian Development Bank (AsDB) to explore the medium- and long-term development perspectives and assess short-term financial needs. For Afghanistan, the Bank is in close touch with key assistance partners, including the United Nations Development Programme (UNDP) and other United Nations agencies, the IMF and AsDB, bilateral donors, and a number of nongovernmental organizations that have the experience and capacity to deliver services in the country. Jointly with UNDP and AsDB, the Bank is organizing a brainstorming meeting with these partners at the end of November to achieve consensus on a reconstruction strategy.¹¹

B. Bank Group Assistance

16. Existing Bank Group instruments and policies translate into a wide variety of options for assisting clients—options that can be used flexibly, in close collaboration with other international financial institutions and donors, to best meet each country’s specific needs.

1. IBRD and IDA

17. For most countries, the impacts are being assessed and the Bank’s response is being prepared and implemented in the context of an existing CAS, on the basis of updated country-specific analysis.¹² For countries with supportive policies and institutions, available instruments include both new lending commitments and an increase or acceleration in disbursements under existing loans, as well as, in some cases, guarantees.¹³

18. ***New Lending.*** Additional financial assistance can take the form of either investment or adjustment lending. On the investment side, emergency recovery operations may be appropriate in countries where the September 11 events have led to serious short-term economic dislocations, such as those caused by a sharp increase in the number of refugees. Where the impacts have led to cost overruns beyond the borrower’s control, the Bank may also advance the preparation or increase the scale of selected new investment projects, such as social funds. Adjustment lending solutions may be an option for affected countries with sound macroeconomic policies and reform

¹¹ See *Afghanistan: World Bank Strategy Brief* (SecM2001-0627), October 26, 2001.

¹² If the impact of changes in the external and internal environment is profound enough to require a substantial revision, a new CAS (or CAS Progress Report) would be prepared. If that is not feasible, a discussion of the changes in country circumstances and the Bank’s revised assistance program would be included in the Board documentation of any new operation(s) or in a short accompanying note, indicating the timing of the next CAS. If a substantial revision of the CAS is not required, the Bank may use the flexibility within the CAS envelope or, under exceptional circumstances, provide assistance at a level that falls outside the CAS envelope. IBRD adjustment lending assistance outside the CAS envelope is on special terms; see the discussion of special structural adjustment loans in Annex C.

¹³ Annex C includes a more detailed description of the available instruments.

programs, where factors such as falling export demand, commodity price shifts, declining remittances, or deteriorating access to capital markets have led to increased external financing gaps. Where such gaps jeopardize the implementation of an ongoing program that is otherwise proceeding on track, supplemental adjustment credits may be provided. For other strong performers, the Bank can expedite the preparation of new adjustment operations.¹⁴ Under exceptional circumstances, IBRD borrowers may be eligible for financing above the CAS envelope through special structural adjustment loans, as part of an international support package that includes an IMF program, and at higher charges than regular adjustment loans.¹⁵

19. **Portfolio Management.** In addition to providing new loans or credits, the Bank may work with the borrower to restructure the portfolio, that is, modify existing individual operations as needed—for example, to reallocate loan proceeds among project components to channel resources to activities that most effectively mitigate the social impact of the crisis. The Bank also has the flexibility, within existing policies, to increase or accelerate resource transfers through temporarily increased country cost-sharing limits or project disbursement percentages for investment lending. In this way, the Bank could increase or accelerate disbursements to a country affected by the crisis if its resource situation has recently become fundamentally more constrained or its external situation has deteriorated sharply.

20. **Grant Support.** IDA is authorized to use grant financing to support emergency recovery and reconstruction operations in post-conflict IDA-eligible countries with large and protracted arrears. The conditions for access to IDA's existing post-conflict grant facility include the following: (a) the recipient is taking convincing steps toward social and economic recovery; (b) arrears to IBRD and/or IDA are large and protracted; (c) a concerted international assistance effort is under way; (d) all creditors have agreed not to make net withdrawals of financial resources from the country; and (e) alternative sources of financing for post-conflict recovery are inadequate or are available only on inappropriate terms.¹⁶ Depending on the course of events, such post-conflict grants could become applicable to Afghanistan.

21. **Debt Relief.** The primary purpose of the HIPC Initiative is to bring the debt burdens of heavily indebted poor countries to sustainable levels. As currently structured, the initiative provides significant flexibility to respond to adverse impacts on HIPC countries. First, interim debt relief under the enhanced initiative provides significant cash flow relief, beginning immediately at the decision point. For countries reaching the decision point, deteriorating terms of trade and losses in export earnings would be reflected in a higher level of debt relief in line with the modalities for determining HIPC assistance. Moreover, the level of interim relief can be adjusted in view of particular needs and circumstances at the discretion of creditors. Second, the enhanced framework provides for the consideration of additional “topping up” assistance at the

¹⁴ Beginning on May 1, 2002, the Bank will offer IBRD borrowers a deferred drawdown option (DDO) to be used in conjunction with a single-tranche adjustment loan. With a DDO, a borrowing country with satisfactory macroeconomic policies and program implementation would have support readily available to protect core structural reform programs during times of reduced market access—a situation illustrated by the events following September 11. See *Proposal to Introduce a Deferred Drawdown Option (DDO) for Use with IBRD Adjustment Loans* (R2001-0174), September 26, 2001.

¹⁵ As a general rule, disbursements from special structural adjustment loans do not precede, but proceed in parallel with or follow, IMF disbursements.

¹⁶ See Operational Policy 8.45, *Grants*. See also *Additions to IDA Resources: Twelfth Replenishment—A Partnership for Poverty Reduction* (IDA/R98-105), December 23, 1998.

completion point in exceptional cases where exogenous developments have adversely affected long-term debt sustainability.¹⁷ To the extent that recent events turn out to have fundamentally affected a HIPC country's economic circumstances, the impact would be assessed in the context of the debt sustainability analysis to be prepared as the country reaches its completion point.¹⁸

2. IFC Support

22. IFC has begun to assess the need for additional support to help sustain private investment flows to countries affected by the September 11 events and their aftermath. First indications are that the main impact on private investment will come from reduced access of corporate entities to financial markets. If sustained, their reduced access could have serious repercussions for developing countries, including bankruptcies, unemployment, and further decline in economic activities. IFC is therefore exploring options to support projects sponsored by such corporate entities by mobilizing funding from the markets.

3. MIGA Guarantees

23. In MIGA's assessment, a scale-back of foreign direct investment in the aftermath of September 11 is likely to temporarily reduce demand for some guarantee products, even though demand for projects already committed may not be affected. But this would be partly offset by a rise in demand for other products. In particular, demand for war-related risk coverage is likely to increase as private insurance markets seek to reduce their exposure.

IV. BANK GROUP FINANCIAL CAPACITY

24. The Bank Group has reviewed its financial resources to assess their adequacy in light of emerging needs. Ongoing country-by-country assessments suggest that the magnitude of likely incremental demands on the Bank Group will be manageable from a financial capacity perspective. But a close watch will clearly be needed, with follow-up in key areas. For IDA, the successful completion of the IDA13 replenishment process will be essential if IDA is to be able to continue to support the policy and institutional reforms that low-income countries need to implement in order to grow sustainably and reduce poverty effectively. For IBRD and IFC, the strong correlation between demand for new credit by sovereign and corporate borrowers and deterioration in existing credit portfolios could constrain the institutions' future capacity to respond. For MIGA, the successful conclusion of the general capital increase remains an urgent priority.

A. IDA

25. In the Bank's effort to respond, IDA may face some specific challenges. It will be important to maintain the special focus on Africa, and in particular to maintain the volume and

¹⁷ The relevant operational procedures have recently been approved by the Executive Boards of the Bank and the Fund. See *Enhanced HIPC Initiative—Completion Point Considerations* (IDA/SecM2001-0539/1), August 21, 2001.

¹⁸ Three countries—Ethiopia, Ghana, and Sierra Leone—are expected to reach their decision points in the coming months. Six countries—Benin, Burkina Faso, Guyana, Mali, Senegal, and Tanzania—are expected to reach their completion points in the near future. See *HIPC Debt Initiative: Multilateral Development Banks' Meeting, Chairman's Summary* (IDA/SecM2001-0614), October 18, 2001.

timing of aid flows envisaged by donors prior to September 11. At the same time, for states that may be seriously affected by the proximity of conflict, IDA may temporarily need to provide support beyond current IDA allocations. IDA may also be called on to provide additional support for countries whose creditworthiness for IBRD lending has been temporarily eroded. Afghanistan is a special case that may eventually require IDA assistance, and additional support may also be needed for Pakistan. Debt sustainability could be affected by declining commodity prices, falling export demand, and increased import costs, which could lead to increased costs to IDA under the HIPC framework.

26. ***Impact on IDA Finances.*** Projected IDA lending for FY02 is up to US\$7.8 billion, up from US\$7 billion before the September 11 events. Beyond the current fiscal year, the initial estimate of lending during the IDA13 period (FY03-05) was US\$23 billion (SDR 18 billion). Estimates completed after September 11 suggest that the crisis and ongoing economic downturn, especially if prolonged, could result in significant incremental demand during IDA13, particularly from countries in Africa and Asia. Meeting the needs of low-income countries, and especially of those that are now facing even greater challenges, places a premium on successfully concluding the IDA13 replenishment negotiations during the next meeting of IDA Deputies on December 6-7, 2001.

B. IBRD

27. Middle-income countries have been affected by September 11 and its aftermath largely through declining export demand, falling travel and tourism receipts, and deteriorating access to financial markets. Reflecting these developments, the Bank's revised FY02 corporate lending projections completed after September 11 point to a likely increase in fast-disbursing IBRD lending through additional adjustment lending to countries with sound policies and reform programs. At the same time, some planned investment projects are likely to be delayed because of the scarcity of local counterpart funds. As a result, while total IBRD commitments for FY02 are projected to remain in the range of US\$9-12 billion, with a modest upside over the FY01 level of US\$10.5 billion, the projected share of adjustment lending is approaching 60 percent—close to the level reached in FY99—after having contracted in FY00 and FY01 to the 40 percent range.

28. ***Impact on IBRD Risk-Bearing Capacity.*** IBRD commitments of around US\$12 billion in this fiscal year would be consistent with current plans for managing risk-bearing capacity. However, previous expectations that the Bank could begin to build additional capacity in FY02 are less likely to materialize, as transitory income gains from lower interest rates would not be sufficient to overcome the expected effects of a deteriorating credit portfolio. The greater risk is that, following the events of September 11, higher demand for fast-disbursing IBRD lending will be accompanied by an increase in credit risk on existing exposures. Responding to such developments could require measures to strengthen the Bank's financial capacity, in order to protect IBRD's ability to meet borrower needs and to meet its other high-priority development objectives, including support for IDA.

C. IFC

29. Before September 11, IFC was projecting US\$3.0-3.4 billion in FY02 commitments. IFC has adequate capacity to meet some additional needs, but expects the on-balance-sheet part of its business to stay within or close to the originally planned range. The relative mix of business is likely to change, however, with greater emphasis on restructurings and working capital facilities. Only in the event of a prolonged and serious global downturn would the IFC portfolio face a significant deterioration and a resulting erosion in capacity for future growth. The developments following September 11 will hit most heavily corporates that have some degree of financial market access under normal conditions. While such corporates no longer form part of IFC's core client base, they are critical to economic growth in some of its larger member countries. But their financing needs may be more medium-term than long-term, and their needs in aggregate are probably well beyond IFC's financial capacity. Therefore, IFC is seeking to support these corporate entities by mobilizing funding from the markets, using as much as possible structured finance techniques and, when needed, IFC's umbrella.

D. MIGA

30. Prior to the crisis, MIGA was expecting to issue US\$2.1-2.5 billion in guarantees in FY02. A possible general decline for MIGA guarantees due to scaled-back foreign direct investment is likely to be partially offset by a rise in demand for particular MIGA products, especially for war-related risk coverage. Contraction of the private insurance market could increase the demand for MIGA coverage of such risks, which MIGA should be able to better address once the general capital increase has been successfully completed.

V. GOING FORWARD

31. The events of September 11 and its aftermath have unsettled the global environment, adding to the economic downturn that was already under way, generating a number of more specific impacts on particular groups of countries, and increasing poverty. The previous sections described the principal instruments by which the Bank Group can transfer resources to assist countries in meeting the new challenges of the post-September 11 world. Looking to the medium term, recent events have other important implications for the Bank Group's work—specifically, they have prompted efforts to combat money laundering and the financing of terrorism, and an initiative to develop better ways for the Bank Group to assist low-income countries with poor performance records.

A. Anti-Money-Laundering and Combating the Financing of Terrorism

32. Since the events of September 11, global attention has focused on abuses of the financial system, including support to criminal and terrorist activities, and on the urgent need for a more systematic approach to fighting this phenomenon. The Bank has been providing technical assistance to a dozen member countries on anti-money-laundering (AML) issues. This number is expected to increase significantly as the Bank steps up its involvement with a specific focus on diagnostics, capacity-building, and training, building on work launched earlier this year with the IMF, which leads the AML efforts of the international financial institutions. Bank and Fund staff are examining how the issue of the financing of terrorism could be reflected in the recently

developed AML methodology that is being tested in several countries and will become a standard feature in the Financial Sector Assessment Program (FSAP). Follow-up to FSAPs will include technical assistance, capacity-building and training programs, particularly in the context of action plans for those countries that most need to upgrade their legal, judicial, and financial supervisory standards. The Bank is also developing a program to disseminate AML training materials to governments, central banks, other financial institutions, and nongovernmental organizations.¹⁹ It is expanding its staff working in this area, and approaching shareholders to help identify suitable candidates.

33. ***Analytic and Advisory Services.*** The analytic and diagnostic work carried out by the Bank, other IFIs, and donors provides the underpinnings for the AML efforts. Several elements of Bank economic and sector work are likely to be especially important in this respect. Country economic analysis, strengthened by FSAP diagnostics, will provide focus to follow-up work. Furthermore, under the Bank-Fund Reports on the Observance of Standards and Codes (ROSC) initiative, staff are collaborating with the Financial Action Task Force on Money Laundering of the Organization for Economic Co-operation and Development to develop an AML module that will complement other governance-related ROSC modules in the areas of accounting and auditing and corporate governance. In addition, the Bank is working internally and with borrowers to strengthen due diligence on country procurement and financial management systems, to help ensure that development funds, including those from operations financed by the Bank Group, do not inadvertently find their way to terrorist organizations. With this objective in mind, Bank staff are trying to advance the scheduling of country financial accountability assessments and country procurement assessments to the extent possible.

B. Poor-Performing Low-Income Countries

34. The September 11 events have highlighted the importance of attention to poor-performing countries—a group of countries that does not fit neatly into the Bank Group’s present operational framework. In response, the Bank has created the Task Force on World Bank Group Assistance to Poor-Performing Low-Income Countries²⁰ to take stock of research findings and of the lessons learned from past donor efforts to help such countries, as a basis for setting out pragmatic approaches through which the Bank can strengthen its assistance to these countries. The Task Force’s work will take place in the context of two important considerations—maintaining the close links between IDA lending allocations and country performance, grounded in the Country Policy and Institutional Assessment process and partnering with United Nations agencies and others with a mandate and experience in these areas. The Task Force’s report is expected early in 2002.

¹⁹ The Bank Group’s AML agenda and activities are described in *Enhancing Contributions to Combating Money Laundering, Policy Paper* (SecM2001-0228) April 5, 2001; *Enhancing Contributions to Combating Money Laundering—Summing Up of the Discussion of the Board of Directors of the World Bank and of the International Monetary Fund* (DC2001-0016), April 27, 2001; *Anti-Money Laundering (AML) Progress Report* (SecM2001-532), August 31, 2001; and *Update on the World Bank Group Anti-Money Laundering (AML) Activities in the Wake of September 11 Events* (SecM2001-0631), October 30, 2001.

²⁰ See World Bank Intranet Kiosk Announcement “Task Force on World Bank Group Assistance to Poor-Performing Low-Income Countries,” posted October 31, 2001.

C. The Bottom Line—Poverty Reduction

35. All of the efforts described in this paper share a common purpose. The work to respond to countries' needs at this time is precisely because the effects of September 11 and its aftermath have been to slow the pace of poverty reduction and even endanger some of the gains that have been made. By responding quickly to help countries protect priority social programs and reforms, the Bank Group is helping to minimize and mitigate the adverse impacts from the heightened uncertainty, risk, and volatility in the current global economic environment. By doing more to promote good governance and to combat money laundering, the Bank Group will be helping to ensure that development funds are not diverted from their intended applications. By developing ways to work with poorly performing low-income countries, the Bank Group will be helping such countries build the policy and institutional capacity needed to improve the lives of their people. And by keeping the objective of poverty reduction at the center of its operational and research work, the Bank Group will be leveraging the entire institution in the pursuit of its core mission and mandate—poverty reduction in developing countries.

GLOBAL ECONOMIC PROSPECTS

1. In preparing *Global Economic Prospects 2002*, the Bank assessed the possible impact of the events of September 11.¹ The forecasts are subject to an unusually high degree of uncertainty because of the difficulties of anticipating business and consumer responses to unprecedented events, together with unpredictable political ramifications. The forecast has assumed relatively normal responses, no further political disruptions, and continued support for economic activity by the monetary authorities in the Organization for Economic Co-operation and Development (OECD) area. Under these conditions, the developing world will be affected by the high-income economies' delayed recovery from the current slowdown; but the outlook for 2003 and beyond remains favorable, because many developing countries have made sustained structural improvements in their policies that would allow them to take advantage of the projected recovery in high-income countries. The key downside risks for developing countries are that a temporarily deeper OECD downswing would affect export earnings, particularly in East Asia and Africa, and that heightened financial instability would affect emerging market economies, especially those with high external financing requirements in the near term.

2. ***Global Slowdown in 2001.*** Before September 11, the world's three major economies had already entered into a simultaneous slowdown. Japan had slipped back into recession, U.S. growth had dropped to near zero, and Europe's growth was slowing sharply. World trade growth, at 13 percent last year, was anticipated to be under 2 percent this year; non-oil commodity prices were expected to decline 7 percent; capital market flows to developing countries were projected to decline from US\$240 billion last year to US\$160 billion this year; foreign direct investment had stopped growing; and severe financial shocks were apparent not only in Japan, but also in Argentina and Turkey. Businesses everywhere had fewer buffers to absorb new shocks. The events of September 11 therefore hit the global economy at a vulnerable moment.

3. ***Outlook for High-Income Countries.*** Before the crisis, the Bank had estimated that the economies of the OECD would grow by 1.1 percent in 2001 and recover to 2.2 percent in 2002. Assuming responses to the crisis are not destabilizing, the rate of GDP growth in the OECD could be lower by 1.1 percentage points in 2002 (see Table A1), and rebound more strongly in 2003 than forecast prior to September 11. The policy response in financial capitals has been swift: nearly all major central banks moved at once to ease monetary conditions. Growth in world trade volumes is predicted to drop below 1 percent in 2001, rise to 4 percent in 2002, and rebound to 10 percent in 2003.

Table A1. GDP Growth Forecasts, 2001-2003

(Annual percentage change)

	<i>Actual</i>	<i>Before September 11</i>			<i>After September 11</i>		
	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>
High-income countries	3.4	1.1	2.2	2.8	0.9	1.1	3.5
Developing countries	5.5	2.9	4.3	4.9	2.9	3.7	5.2

Source: Development Economics Prospects Group.

¹ See *Global Economic Prospects and the Developing Countries, 2002* (Washington D.C.: World Bank, 2001), online at www.worldbank.org/prospects/gep/2002/.

4. **Outlook for Developing Countries.** Although the slowdown in global economic activity is being led by the industrial countries, aggregate growth for developing countries is being adversely affected and is expected to weaken from 5.5 percent in 2000 to 2.9 percent in 2001. Delayed recovery in the OECD area is likely to restrain developing country growth in 2002 to 3.7 percent, about 0.6 percentage points lower than projected prior to September 11. But the projected subsequent recovery in high-income countries should ignite a strong rebound to 5.2 percent growth in developing countries in 2003. While the global slowdown is the main underlying cause for the poor 2001-2002 outlook, higher risk perceptions are also at work, reflecting both investors' flight to quality and financial tensions in large emerging markets.

5. **Outlook by Bank Region.** Overall, growth in developing countries is projected to follow the prolonged cyclical downswing in the OECD area and rebound in 2003, though with marked differences among the Regions.

- Growth in the countries of the *Africa and Middle East and North Africa* Regions has fallen modestly from already low 2000 levels (3.0 percent and 3.9 percent, respectively), but is projected to deteriorate further in 2002 (to 2.7 percent and 2.9 percent, respectively) as commodity prices fall relative to the cost of manufacturing imports, and tourism recovers only slowly. This implies that Sub-Saharan Africa's gradual recovery from the late 1990s economic slump is likely to be at least temporarily derailed, with per capita income stagnant in 2001-2002 and growth resuming only in 2003.
- Countries in the *Europe and Central Asia* (ECA) and *Latin America and the Caribbean* (LCR) Regions have been hit particularly hard by the deteriorating global environment, with growth in ECA declining from 6.3 percent last year to a projected 2.1 percent this year, and in LCR from 3.8 percent to 0.9 percent. LCR countries will also face a challenging external environment in 2002, with weak export demand, falling commodity prices, declining international tourism, and heightened capital-market risk aversion.
- The *East Asia and the Pacific* Region, which is experiencing a decline in growth from 7.5 percent in 2000 to a projected 4.6 percent in 2001, is anticipated to be the first among developing regions to achieve an export-driven recovery, reflecting strong policy responses that are already under way. In China, however, strong domestic demand is expected to support continued growth.
- The *South Asia* Region is expected to experience a less pronounced growth cycle (with 4.9 percent last year, 4.5 percent this year, and 5.3 percent in 2002), as the Region is relatively less integrated with the global economy.

RESPONSE TO COUNTRY-SPECIFIC IMPACTS

1. The September 11 events and their aftermath will affect different groups of countries in different ways. External assistance must take into account each country's particular circumstances and shocks it experiences. This annex provides a general overview by Region and indicates the Bank's early thinking about possible responses.

A. Africa

2. Africa remains heavily dependent on exports of primary commodities. As a result of the global economic slowdown, countries in the Africa Region may suffer significant terms-of-trade shocks, with adverse effects on living standards, investment and growth, debt sustainability, and macroeconomic stability. Millions of poor people in Sub-Saharan Africa are vulnerable to such shocks, often exacerbated by the events of September 11. In addition, many countries in east and southern Africa are expected to suffer from declines in travel and tourism as a direct result of the crisis.

3. **Response.** The Bank is exploring ways to assist countries with the appropriate policy environments to deal with terms-of-trade shocks. The options could include planned adjustment operations (developed in close cooperation with the IMF) and supplemental operations, provided the country's policy framework is satisfactory, as well as investment operations designed to mitigate the adverse social impacts of September 11 and the economic slowdown—for example, social fund operations. Several countries also would benefit from enhanced debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. In response to increased needs, it will be particularly important to maintain high levels of Bank and other donor support to IDA-eligible countries in Africa that have sound policies.

B. East Asia and the Pacific

4. A delayed recovery, or further deceleration in global trade growth, especially in the United States and Japan, would adversely affect developing countries in East Asia and the Pacific. Several countries are approaching recessionary activity levels; a decline in intraregional trade would amplify the downturn, and falling equity markets and reduced access to capital markets could worsen prospects for business investment and consumers. Despite recent economic and financial progress, Indonesia remains vulnerable to shifts in external demand and would be affected if oil prices decline by more than is currently forecast. The Philippines is vulnerable to a possible loss of remittances from the Middle East.

5. **Response.** Before September 11, the Bank was planning possible adjustment operations for the Philippines, conditioned on enhanced reform progress. For Indonesia, a move to the high-case scenario of the Bank's assistance strategy and access to adjustment lending would be predicated on a set of upfront reform actions plus continued progress in key reform areas. The Bank participated with other donors in the 11th Meeting of the Consultative Group for Indonesia, being held on November 7-8 in Jakarta, to support the government's efforts to restore momentum to the reform agenda. For both the Philippines and Indonesia, any such adjustment operations would focus on deepening reforms of public sector management and governance, and on decentralization.

C. Europe and Central Asia

6. Although the impact of the September 11 events on refugee movements has so far not been as large as initially expected, several countries of Central Asia could be exposed to refugee movements in the future. Further political tensions and increases in internally displaced populations could also cause a serious concern in the southern Caucasus. Both groups of countries are vulnerable to a loss of foreign direct investment, trade disruptions, and tightening fiscal constraints. It is important to note, however, that Russia's strong economic performance has provided a lift to these economies in 2001. Countries in central and southeastern Europe are exposed to the economic downturn in western Europe—a downturn that could deepen with loss of consumer and business confidence. Turkey is particularly vulnerable to additional strain because of rising global risk premia. Major exporters of oil, gas, and cotton could also be affected.

7. **Response.** For the potentially highly affected Central Asian countries, the Bank continues to liaise with the United Nations system and relief agencies responsible for emergency assistance, to be prepared for further support that may be needed in the future. Options are being explored for modifying the Bank's portfolio to meet emerging needs while continuing to meet project development objectives. External financing needs are being assessed in close cooperation with IMF staff. Country policy performance will continue to be the driving factor in the ability to mobilize sustained higher levels of financial assistance. Generally, the debt profile of the poorer Commonwealth of Independent States (CIS) countries argues for highly concessional terms of external assistance. Moldova and countries in the Southern Caucasus may require enhanced IDA assistance in the form of adjustment credits accompanied by capacity-building operations. A joint initiative of several international financial institutions is being launched for CIS countries with IDA eligibility. The initiative centers on the countries' medium-term development agendas and aims to improve their financing mix; enhance donor coordination; and strengthen the focus of, and implementation support for, the countries' reform programs. With respect to Turkey, the Bank continues to closely monitor progress of the economic reform program, together with the IMF.

D. Latin America and the Caribbean

8. Adverse trade effects are expected to be especially significant for Mexico and Central America. The Caribbean is expected to experience a devastating loss of tourism revenues. Argentina and Brazil would be most affected by a protracted disturbance in capital markets and private flows. Some oil-exporting countries—Colombia, Ecuador, and Venezuela—may face balance of payments problems.

9. **Response.** Depending on individual country circumstances, the Bank is considering reallocations under existing loans and credits and temporary increases in the share of Bank disbursements in project costs, including in the Caribbean, where the Bank is also considering the use of emergency recovery loans/credits. New fast-disbursing operations are being considered for some especially hard-pressed countries in the Region. Additionally, a significant economic slowdown in the Region could mean the deferral at the borrower's request of some investment operations now being processed, given the likely greater difficulty in mobilizing counterpart funding.

E. Middle East and North Africa

10. Countries in the Middle East and North Africa could be profoundly affected by the probable loss of tourism revenues resulting from heightened security concerns. Increased uncertainty in financial markets is likely also to depress foreign direct investment throughout the Region, and the costs of trade could escalate because of war-risk premia. Egypt, Jordan, Morocco, and Tunisia may experience a severe balance of payments impact from a drop in winter tourism revenues, foreign direct investment, and remittances. Increasing political tensions may also affect economic activity in the Region.

11. **Response.** For Jordan and Tunisia, the Bank is exploring the possibility of enhancing operations already in the FY02 program and developing new economic recovery operations. For Egypt, the Bank is working with the government to assess the impact of the crisis. The Consultative Group meeting, postponed from October 2001 to February 2002 to allow for an impact assessment, will provide the framework for a coordinated response by the Bank and the international community. There may also be a need to assist Iran to address the social dislocations and heightened impact on poverty arising from likely refugee flows from, and disruptions of trade with, Afghanistan.

F. South Asia

12. South Asia could suffer from protracted conflict in the aftermath of September 11. Afghanistan is the country most directly affected. There have also been exceptional adverse effects on Pakistan, where a strong but underfunded reform program has now become much more difficult to implement. Under the current circumstances, GDP and export growth are projected to be lower, as are foreign direct investment and remittances, and prospects for privatization are reduced. Tax revenues are likely to decline, and at the same time the number of refugees is likely to rise, further complicating the fiscal position. Exceptional financing needs for FY02 are projected to increase by as much as US\$1.3 billion compared to that anticipated before September 11. Bangladesh, Maldives, Nepal, and Sri Lanka, are also likely to be affected.

13. **Response.** The Bank is following developments in Afghanistan closely in preparation for the country's future reconstruction. Since 1996, and in line with the Bank's post-conflict reconstruction strategy, IDA has maintained a "watching brief" for Afghanistan to enhance knowledge, support training programs (for instance for Afghan teachers and for Pakistan-based Afghan nongovernmental organizations), and provide analytic and strategic support through studies, conferences, and interagency work to the existing assistance program for Afghanistan. As a first step toward development of a reconstruction strategy and plan, a Strategy Brief was prepared and submitted to the Board on October 26. In collaboration with the Asian Development Bank and the United Nations Development Programme, the Bank will co-host a conference on "Preparing for Afghanistan's Reconstruction," scheduled for November 27-29. Subsequently, the Bank will explore how to assess Afghanistan's most immediately pressing reconstruction needs in the post-crisis period. In Pakistan, preparation of the Interim Poverty Reduction Strategy Paper (I-PRSP) is in its final stages. The authorities and the IMF are about to complete negotiations on a Poverty Reduction Growth Facility. On the basis of the government's resolve to enhance the speed, quality, and scope of its reform program, IDA is moving ahead

with preparations for possible parallel adjustment support for the country's program to implement its poverty reduction strategy and further governance reforms. The Bank also is prepared to respond quickly and flexibly as needed to assist Bangladesh and Sri Lanka to address the adverse economic impact of the recent events.

WORLD BANK ASSISTANCE INSTRUMENTS

1. There are a number of ways in which the Bank may provide additional financial assistance to countries affected by the events of September 11. In many cases, new lending—particularly through supplemental and emergency recovery loans—may be appropriate; in other cases, restructuring or increased or accelerated disbursements under the existing portfolio may be an important part of the Bank’s response. This annex reviews the operational policy framework governing the various instruments.

A. New Lending

2. **Supplemental Financing.** Supplemental financing can be a quick and effective way to increase the flow of funds to some affected countries.

- **Operational Policy Context.** Operational Policy (OP) 13.20, *Supplemental Financing*, provides that supplemental loans or credits can be used to cover cost overruns in investment operations that are due to exceptional circumstances beyond the borrower’s control, such as natural catastrophe, war, or civil strife. Supplements also may be provided in exceptional circumstances for adjustment operations for which an unanticipated gap in financing jeopardizes a reform program that is otherwise proceeding on schedule and in compliance with the agreed policy agenda.¹
- **Application in Current Situation.** The operational policy criteria for supplemental financing may be met in some operations in the countries affected by the crisis. For example, the September 11 events have generated new security measures and have led to significant increases in trading and transport costs, which may, in turn, lead to cost overruns in some projects with large import components. Similarly, additional financing gaps may emerge in the reform programs of countries that now have reduced access to capital markets, are negatively affected by the increased volatility of commodity prices, or receive declining remittances. Such unexpected cost overruns in investment projects and financing gaps in adjustment operations may meet the criteria for supplemental financing. The specific conditions under which supplemental loans or credits may be made would need to be demonstrated on a case-by-case basis.
- **Recent Experience with Supplemental Loans.** Between FY90 and FY02 the Bank approved more than 200 supplemental operations worth more than US\$3 billion, of which the large majority was for IDA countries. The majority of supplements have been associated with adjustment operations. The Africa Region accounted for about

¹ There are additional criteria for supplemental investment loans and supplemental adjustment loans. Supplemental investment projects also require that (a) the borrower is in compliance with loan covenants; (b) a reduction of project scope would endanger its economic viability or the achievement of project objectives; (c) the borrower is unable to finance the additional costs or obtain such financing from other lenders on reasonable terms in reasonable time; (d) there is not enough time to process a new loan; (e) the borrower is committed to the project and has demonstrated adequate implementation capacity; and (f) the project is economically justified. Supplemental adjustment loans must be reviewed by the Operations Committee. Supplemental loans are subject to Board approval in the same manner as the original loan.

60 percent of all supplements, both as a share of the number of operations and as a share of commitments. Recent examples of supplemental financing in response to an economic shock include seven supplemental adjustment credits to selected countries in Sub-Saharan Africa for a total of US\$155 million, approved by the Board in December 2000.² These supplemental credits served to sustain the countries' ongoing reform and poverty reduction efforts in a period when they experienced severe adverse terms of trade because of a sharp and unexpected increase in the world oil price in 2000. Recipient countries were selected on the basis of four criteria: satisfactory performance, severity of the shock, lack of other financing, and absence of new adjustment operations in the immediate pipeline. The seven supplemental credits were prepared and approved in two months or less, illustrating the speed of response possible through supplemental operations.

3. ***Emergency Recovery Loans/Credits.*** Emergency recovery loans/credits (ERLs/Cs) are another vehicle for delivering new Bank assistance quickly in certain crisis situations.

- ***Operational Policy Context.*** OP 8.50, *Emergency Recovery Lending*, provides that an ERL/C may be provided when a country “is struck by an emergency that seriously dislocates the country’s economy and calls for a quick response from the government and the Bank.” An emergency is “an extraordinary event of limited duration, such as war, civil disturbance, or natural disaster”; however, “serious economic dislocation caused by external economic shocks or other situations justifying adjustment lending is not considered an emergency.” ERLs may include quick-disbursing components. However, they are designed to finance only a positive list of imports identified as necessary to a well-defined recovery program. OP 8.50 also provides that, when designing quick-disbursing components, the Bank should coordinate with the IMF regarding the country’s plans to use the Fund’s Compensatory Financing Facility for recovery activities.
- ***Relevance for Current Situation.*** Following the events of September 11, the criteria of OP 8.50 are likely to be met for projects in countries experiencing a sharp increase in the number of refugees that involve related basic housing, health, and other resettlement activities. For countries that depend on a productive tourist industry, where security concerns associated with the September 11 events have led to a severe decline in tourism activity and serious dislocation of the countries’ economies, emergency recovery assistance under OP 8.50 may be possible to help finance well-

² The seven countries were Madagascar, Mali, Mauritania, Niger, Rwanda, Uganda, and Zambia. See *President’s Report—The Impact of Oil Prices—Supplemental Credits to Madagascar: Second Structural Adjustment Credit; Mali: Economic Management Credit; Mauritania: Fiscal Reform Support Operation; Niger: Public Finance Recovery Adjustment Credit; Rwanda: Economic Recovery Credit; Zambia: Fiscal Sustainability Credit; Uganda: Third Structural Adjustment* (IDA/R2000-0226, ITF/R2000-0003), November 30, 2000.

- defined recovery programs that will help bolster and restore economic and social activities.³
 - **Recent Experience with ERLs/Cs.** Between FY90 and FY02, the Bank has approved more than 70 ERLs/Cs to 50 countries for a total of US\$6.5 billion. The majority of ERLs/Cs served to provide assistance in cases of natural disasters (such as earthquakes, floods, or hurricanes). About 30 percent of ERL/C operations were to post-conflict countries to help finance the post-conflict recovery program. Average processing time for an ERL/C has been around five months from identification to approval, compared to roughly two years for an average specific investment loan.
4. **Special Structural Adjustment Loans.** Under exceptional circumstances, IBRD borrowers may be eligible for financing outside the Country Assistance Strategy envelope through special structural adjustment loans (SSALs).
- **Operational Policy Context.** According to the Guidelines for Special Structural Adjustment Loans, “the SSAL is part of an international support package, including multilaterals, bilateral donors, and private lenders and investors.” Moreover, “an IMF program is in place” and, “as a general rule, World Bank disbursements do not precede, but proceed in parallel with or follow IMF disbursements.”⁴ The financial terms of SSALs reflect their exceptional nature and high risks.
 - **Recent Experience with SSALs.** To date, the Bank has approved a total of seven SSALs: two to Argentina in FY99; four to Brazil, two each in FY99 and FY00; and one to Turkey in FY02.⁵
5. **Regular New Lending.** The Bank may also decide to accelerate the preparation of selected investment projects in the lending program, or enhance them by adding new project components or increasing the scope of existing components. Similarly, new adjustment lending could be a useful vehicle for fast-disbursing Bank assistance to support policy and institutional

³ According to OP 8.50, standard Bank operational policies on procurement, disbursements, and consultants apply. ERLs/Cs may include quick-disbursing components (in principle up to 100 percent of the loan/credit amount). However, in all cases (including for fast-disbursing components), ERLs/Cs finance only a positive list of imports identified as necessary for the creation of a well-defined recovery program. Up to 20 percent of loan proceeds can be used for retroactive financing of expenditures, for payments made after the emergency occurred and within four months before the expected date of loan signing (the Managing Director concerned may in exceptional circumstances approve exceptions to these limits according to OP 8.50 and OP 12.10, *Retroactive Financing*), and the justification is set out in the documents presented to the Board.

⁴ See *Programmatic Emergency Adjustment Lending: World Bank Guidelines* (R98-249), October 2, 1998; the *Operational Memorandum Guidelines for Special Structural Adjustment Loans*, April 19, 1999; and *Special Structural Adjustment Loans: Composition of International Support Packages* (SecM2001-308), May 8, 2001.

⁵ See *Argentina: President’s Report—Special Sector Adjustment Loan and Repurchase Facility Support Loan* (R98-0267), November 4, 1998; *Brazil: President’s Report—Proposed Social Security Special Sector Adjustment Loan* (R98-0298), December 10, 1998; *Brazil: President’s Report—Proposed Social Protection Special Sector Adjustment Loan* (R98-0302), December 16, 1998; *Brazil: President’s Report—Fiscal and Administrative Reform Special Sector Adjustment Loan* (R2000-0026), March 9, 2000; *Brazil: President’s Report—Second Social Security Special Sector Adjustment Loan* (R2000-0029), March 9, 2000; and *Turkey: President’s Report—Programmatic Financial and Public Sector Adjustment Loan* (R2000-0123), June 21, 2001.

reforms in IBRD or IDA countries affected by recent events, if they have strong reform programs and increased external financing gaps. The Bank could speed up the processing of these loans in a variety of ways: designing operations with simplicity and replicability in mind, relying on implementing agencies with Bank experience, expediting as a priority the consideration of operations in affected countries within the Bank, and advising counterparts to ensure rapid approvals on the government's side.

- **Investment Lending.** To address the social impacts of September 11, particularly attractive options may be project designs that replicate successful examples of delivering small-scale infrastructure and other basic services to the poor and that have disbursed rapidly in spite of difficult conditions. Examples are social funds that can effectively mobilize nongovernmental organization capacity and community resources at the local level. The amount of the Bank loan/credit for new investment projects in the affected countries would be calculated taking into account any temporarily increased cost-sharing limits.
- **Adjustment Lending.** Some countries facing increased external financing gaps may respond by strengthening their program of policy and institutional reforms. New adjustment lending can be a useful vehicle of support for countries with sound macroeconomic policies and reform programs.⁶ In times of crisis, the strength of the policy programs supported by Bank adjustment lending is particularly important for its effectiveness.

B. Portfolio Management

6. In addition to new lending, the Bank has several options with which it can increase or accelerate resource transfers through management of the loan and credit portfolio—including restructuring the existing portfolio and temporarily increasing project disbursement percentages or country cost-sharing limits.

7. **Portfolio Restructuring.** With respect to portfolio restructuring, a range of measures could be taken to address the emerging problems of the availability of counterpart funds and changing priorities:

- reallocating the loan among project components to channel resources to activities that most effectively mitigate the social impact of the crisis;
- adding project components to support urgent new needs such as employment-generating activities, and eliminating components that are no longer of high priority in light of increased scarcity of counterpart funds; and
- extending loan closing dates to accommodate delays in project implementation due to the reduced availability of counterpart funds.

⁶ See Operational Directive 8.60, *Adjustment Lending Policy*, and the Operational Memorandum *Clarification of Current Bank Policy on Adjustment Lending*, June 5, 2000.

As Bank Procedures (BP) 13.05, *Project Supervision*, provides, the Bank and the borrower must agree on the modifications to individual operations. When modifications include significant changes in project objectives, project design, or the basic project concept, a Memorandum of the President is prepared and, together with the proposed amendments to the Loan Agreement, submitted for Board approval on a no-objection basis.⁷ When modifications are minor, amendments to Loan Agreements are approved by the country director, after consultation with the lawyer.

8. **Temporary Increase in Project Disbursement Percentages.** The Bank can accelerate the resource transfer to countries affected by the crisis by “frontloading” disbursements for investment projects through temporarily increased disbursement percentages, with compensatory reductions in disbursement percentages in the outer years.⁸ Bank staff would undertake project-by-project reviews with borrowers to determine where temporary increases in disbursement percentages would be needed. When considering temporary increases in disbursement percentages for individual projects, staff need to assess the risk that as the Bank’s disbursement percentages are reduced in the outer years to maintain appraised cost-sharing percentages, the borrower may not have sufficient funds to make up the difference. For existing operations, the country director and the Loan Department approve the temporary increase in disbursement percentages. In all cases, increased disbursement percentages would be reflected in the financing plan for the operation and in the Loan Agreement—for existing operations, through appropriate amendments.

9. **Temporary Increase in Country Cost-Sharing Limits.** As described in BP 6.30, *Local Cost Financing and Cost Sharing*, the Regional vice president may approve a temporary increase in the cost-sharing limit for a country whose resource situation has become fundamentally more constrained in recent years or whose external situation has deteriorated sharply.⁹ The borrower is expected to demonstrate commitment to the project by making a 10 percent minimum contribution to project cost (net of taxes and duties).¹⁰ The affected countries would be expected to revert to the cost-sharing limits applicable to their per capita income group when their ability to mobilize domestic and foreign resources returns to pre-crisis levels.

⁷ For Global Environment Facility (GEF) grants, the GEF Regional Coordinator may consult with the GEF Secretariat, which will determine whether the restructured project should be submitted to the GEF Council.

⁸ Disbursement percentages can be increased temporarily up to 100 percent of all eligible expenditures, net of taxes and duties.

⁹ The cost-sharing limits are applicable not to individual projects but to the Bank’s overall investment lending program of existing and new projects for a country (excluding supplemental, financial intermediary, emergency recovery, and technical assistance loans/credits). The country cost-sharing limit is applied to a rolling three-year investment lending program, encompassing two prior years and the current year. The table below provides the present cost-sharing limits:

<i>Per capita income group</i>	<i>2000 per capita income (US\$)</i>	<i>Normal limit (%)</i>
I and II: IDA only	\$1,445 or less	90
I and II : IBRD	\$1,445 or less	75
III and IV	\$1,446 - \$5,225	60
V	Over \$5,225	50

¹⁰ When there is sufficient evidence that a borrower is committed to a project or investment program, the country director may make exceptions to the borrower’s minimum 10 percent cost sharing for individual projects and may permit cofinancing to substitute for the borrower’s contribution.