



**ASIAN DEVELOPMENT FUND (ADF)
ADF X DONORS' MEETING**
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ADF X (2009–2012) Role and Priorities

Asian Development Bank

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ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
DMC	–	developing member country
GNI	–	gross national income
IDA	–	International Development Association
LTSF	–	long term strategic framework
MDG	–	Millennium Development Goal
OCR	–	Ordinary capital resources
ODA	–	official development assistance
OED	–	Operations Evaluation Department
PBA	–	performance-based allocation
RCI	–	regional cooperation and integration
TA	–	technical assistance

NOTE

In this report, "\$" refers to US dollars.

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EXECUTIVE SUMMARY

Poverty reduction remains an unfinished agenda in the Asia and Pacific region. Many Asian countries, including several Asian Development Fund (ADF) recipients, have grown dramatically in recent years. This, in turn, has reduced poverty significantly. Nevertheless, poverty is still the main challenge in ADF countries. About 100 million people (about 15% of the population) in ADF countries still live in extreme poverty (less than \$1 a day). An additional 300 million people (almost 60% of the population) live on less than \$2 a day. This large-scale persistence of income poverty is accompanied by a high prevalence of non-income poverty. ADF countries are likely to fall short of many Millennium Development Goal targets by about 70%.

Of the 28 ADF countries, as many as 18 are growing at around 3% to 4% or less per year. These countries need to accelerate growth to increase the pace of poverty reduction. This, in turn, will require a higher rate of investment combined with wide-ranging policy and institutional reforms. Inequalities are also increasing in most ADF countries. This trend needs to be arrested through strengthened social development programs that make growth more inclusive, i.e., improved access to education, health, and productive employment opportunities for the disadvantaged. Otherwise, rising inequality could lead to social unrest and erode public support for market-based policies that have enabled rapid growth in many ADF countries. Furthermore, economic and demographic growth have taken a heavy toll on the environment in many of these countries. Therefore, a considerable strengthening of environmental protection programs is urgently needed to ensure that growth is sustainable. Clearly, for ADF countries to maintain high rates of inclusive and environmentally sustainable growth, a significant expansion in development programs will be required across a wide front, supported by appropriate policy and institutional reforms.

This expansion of the development effort must be underpinned by a commensurate increase in official development assistance (ODA), especially for the poorer ADF countries (Group A and Group B1). ODA remains an important component of development expenditure for these countries, which have little or no access to alternative commercial sources of external financing. However, ADF countries' share of total ODA has been falling. Furthermore, ADF's share of total ODA to these countries has been declining, now accounting for only about 5% of ODA. Operational departments point out that, if this trend continues, the Asian Development Bank (ADB) might lose the critical mass required to provide effective development assistance or exercise any policy leverage—a concern increasingly raised by ADF countries themselves. This is unfortunate because the ADF has been an effective vehicle for delivering external assistance. Independent assessments point out that ADB manages its resources efficiently, and that its success rate in delivering concessional assistance is high and rising.

For ADB to remain an effective development partner in these countries, it will have to maintain an adequate volume of ADF assistance. This will have to be combined with greater selectivity in operations, efficient allocation of assistance, and continuing internal reforms to further strengthen ADB's development effectiveness.

Guidance from donors is sought on the analysis presented in this paper and the proposed directions for ADF X.

I. INTRODUCTION

1. Dramatic economic growth in the Asia and Pacific region in recent years notwithstanding, poverty reduction is still the main challenge facing developing member countries (DMC) of the Asian Development Bank (ADB), especially the Asian Development Fund (ADF) countries.¹ As such, ADB's strategic priority remains assisting these countries in rapidly reducing income poverty through fast growth and eliminating significant Millennium Development Goal (MDG) deficits by 2015. Enabling as many ADF countries as possible to graduate as quickly as possible is a more specific goal of the ADF.

2. This paper examines the key strategic challenges that ADF countries face, and proposes specific roles and directions of ADF X based on inferences drawn from a review of major participants in the development process, the evolving aid architecture, and ADB's strengths.

II. ADF COUNTRIES AT A CROSSROAD

A. The Two Faces of Asia

3. Asia's phenomenal economic growth is unprecedented. Rapid growth in Japan through the 1960s and 1970s was followed by decades of fast growth in the "miracle" economies. More recently, sustained periods of double-digit or near-double-digit growth in the People's Republic of China and India have been accompanied by equally fast or faster growth in Viet Nam and several Central Asian republics that are endowed with large hydrocarbon resources. Therefore, the world has come to see the region as a center of global growth. The international development community understandably has shifted its attention to Africa, where people in large parts of that continent still suffer from abysmal levels of deprivation, disease, and conflict. However, poverty reduction remains an unfinished agenda in Asia and the Pacific.

4. Dazzling images of prosperity in some high-growth Asian countries have masked a different reality in other countries of the region. In 18 ADF countries, annual economic growth rates during 2002–2006 were at about 3% to 4% or less (Appendix 1). Weakly performing countries comprise a particularly important subset of these countries that requires special attention.² In the other 10 ADF countries, although growth has been robust, increasing inequality remains an important challenge.³ While the incidence of poverty has declined significantly in ADF countries, millions of people still suffer from intense deprivation and chronic hunger. About 100 million people in ADF countries (about 15% of the population) live in extreme poverty (on less than \$1 a day); an additional 300 million (almost 60% of the population) are surviving on less than \$2 a day.⁴ These poor people are living on the edge of extreme poverty and very vulnerable. The slightest shock—a crop failure, natural disaster, illness, or even the expenses of marriage—can push them over the edge. This large-scale persistence of income poverty is accompanied by a high prevalence of non-income poverty. The region is likely to fall

¹ The term "ADF countries" in this paper refers to those countries that have access to ADF.

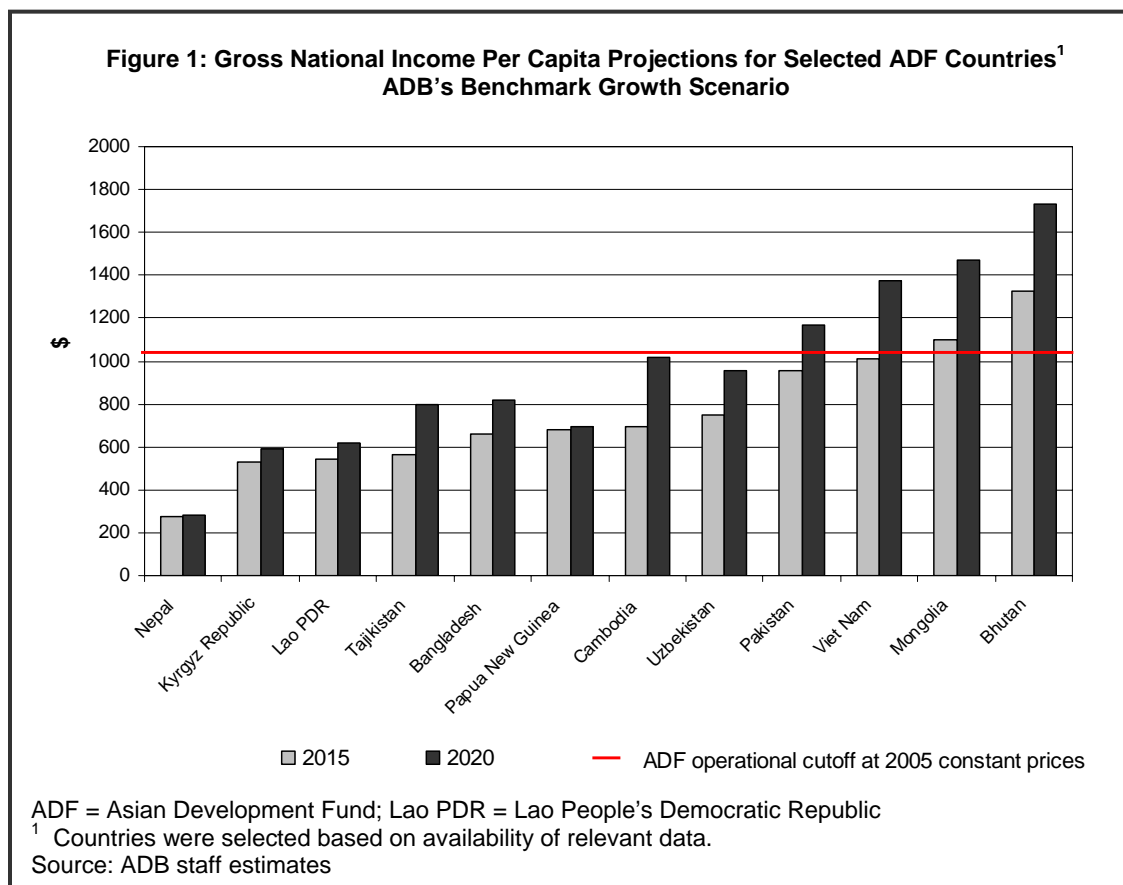
² Typically, these weakly performing countries have very low or even negative growth rates, and suffer from weak governance. Some of them are facing conflicts or civil unrest.

³ ADB. 2007. *Key Indicators 2007: Inequality in Asia*. Manila.

⁴ Both \$1-a-day and \$2-a-day poverty thresholds are estimated at 1993 purchasing power parity prices. Note that the poverty incidence data in para. 4 refer to ADF countries only. The number of persons in all Asia living on less than \$1 a day is estimated at well over 0.5 billion, while an estimated 1.5 billion are surviving on less than \$2 a day.

about 57% short on 24 MDG targets.⁵ In ADF countries, the shortfall increases to about 70%. The MDG deficits are concentrated in education, health, and access to water. In ADF countries, key targets on gender disparity are also likely to be missed.

5. The future outlook is also quite sobering. If current growth trajectories are maintained,⁶ all ADF countries—except Bhutan and Mongolia—that are below the ADF per capita income eligibility threshold today would still remain below the threshold in 2015,⁷ and many would be well below. Under this scenario, Viet Nam would cross the threshold in 2016, followed by Pakistan in 2017. All the other countries would remain below the threshold even in 2020 (Figure 1).



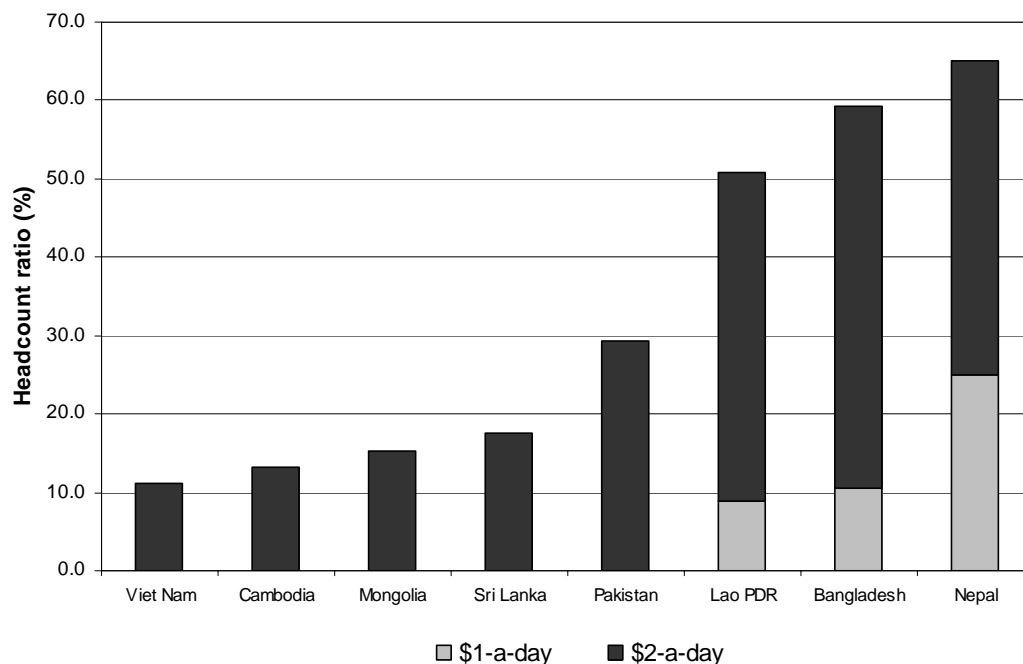
6. Assuming the income distribution does not change, about 30 million people would be living in extreme poverty, and about 220 million would be surviving on less than \$2 a day (Figure 2 and Table 1). Further, many MDG targets would not have been achieved even 5 years after the deadline, especially targets relating to hunger, education, health, gender disparity, and access to water.

⁵ For a more detailed discussion, see the discussion paper entitled "Effectiveness of ADF Operations", circulated for this meeting.

⁶ Benchmark growth projections from Economics and Research Department, ADB.

⁷ This excludes a number of countries, including small island economies, which are classified as ADF eligible because of their limited credit worthiness despite their per capita incomes exceeding the ADF eligibility threshold. These include Indonesia which is likely to graduate by the end of ADF IX period, and Armenia and Azerbaijan which are likely to graduate by the end of ADF X period.

Figure 2: \$1-a-Day and \$2-a-Day Poverty Incidence Projections of Selected ADF Countries in 2020 (Assuming Benchmark Growth and Neutral Distribution)¹



ADF = Asian Development Fund; Lao PDR = Lao People's Democratic Republic

¹ Countries were selected based on availability of relevant data.

Source: ADB staff estimates

B. Alternative Paths to the Future

7. The benchmark scenario described in paras. 5–6, based on projections of current trends and unchanged income distribution, is only one of many possible paths to the future. Actual trends of growth and poverty reduction could turn out to be better or worse, depending on the choices made today. Two risks that need to be mitigated in this context are shocks and increasing inequality. ADF countries are by definition relatively poor, and their ability to absorb shocks is limited. Any major adverse development could shift them to a slower growth path. Ten years after the Asian financial crisis, most affected countries—which are much stronger economies than ADF countries—have not fully returned to their precrisis growth path.

8. Furthermore, rising inequality is a particularly disturbing trend that has emerged in the region in recent years. Income inequality increased between 1990 and 2005 in most ADF countries (Table 2).⁸ Inequalities in access to social services (such as health and education) are also widening. If this trend persists, it could lead to social unrest and erode public support for market-based policies that have enabled rapid growth in many ADF countries. If these risks are not mitigated, economic growth and poverty reduction could slow in ADF countries. On the other

⁸ See Ali, Ifzal and J. Zhuang. 2007. *Inclusive Growth toward a Prosperous Asia: Policy Implications*. ERD Working Paper, Series No. 97. Manila: ADB. Also see ADB. 2007. *Key Indicators 2007: Inequality in Asia*. Manila.

hand, successful management of these risks could accelerate growth as well as poverty reduction. Two alternative scenarios are described below.

Table 1: \$1-a-Day and \$2-a-Day Poverty Incidence Projections of Selected Countries

DMC	Headcount Ratio (%) in 2020					
	\$1-a-Day ^a			\$2-a-Day ^a		
	Benchmark Growth with Neutral Distribution	Low Growth with Pro-Rich Distribution	High Growth with Pro-Poor Distribution	Benchmark Growth with Neutral Distribution	Low Growth with Pro-Rich Distribution	High Growth with Pro-Poor Distribution
Viet Nam	0	1	0	11	25	6
Cambodia	0	2	0	13	32	7
Mongolia	0	5	0	15	28	11
Sri Lanka	0	0	0	17	25	6
Pakistan	0	4	0	29	44	22
Lao People's Dem Rep	9	19	6	51	58	46
Bangladesh	10	26	5	59	70	54
Nepal	25	34	22	65	64	65
Selected ADF DMCs	5	13	3	38	50	31
No. of Persons (millions)	30	74	18	221	293	185

ADF = Asian Development Fund, DMC = developing member country.

^a In 1993 purchasing power parity terms.

Source: ADB staff estimates

Table 2: Recent Trend in Income/Expenditure Inequality Gini Coefficients (%) in Selected ADF Countries¹

DMCs	Gini Coefficients			
	Initial Year		Latest Available Year	
Bangladesh	28.3	1991	34.1	2005
Cambodia	31.8	1993	40.7	2004
Indonesia	34.4	1993	34.3	2002
Lao PDR	30.4	1992	34.7	2002
Mongolia	33.2	1995	32.8	2002
Nepal	37.7	1995	47.3	2003
Pakistan	30.3	1992	31.2	2004
Sri Lanka	34.4	1995	40.2	2002
Viet Nam	34.9	1993	37.1	2004

ADF = Asian Development Fund; DMC = developing member country;

Lao PDR = Lao People's Democratic Republic

¹ Countries were selected based on the availability of relevant data.

Source: Economics and Research Department, ADB

9. A worst-case scenario based on lower growth, combined with higher inequality,⁹ indicates that none of the current ADF countries except Bhutan would cross the ADF income threshold by 2015. Of those remaining, only Mongolia would cross that threshold by 2020. Per capita incomes in all other ADF countries currently below the income threshold, including Pakistan and Viet Nam, would remain below the threshold.¹⁰ About 74 million people still would be living in extreme poverty in 2020 under this scenario, and about 300 million would be living on less than \$2 a day (Table 1).

10. On the other hand, appropriate interventions undertaken today could produce a much more optimistic scenario of faster growth that is also more inclusive. Improved distribution and accelerated social development can significantly increase the pace of income growth and poverty reduction. Under this scenario,¹¹ Bhutan, Mongolia, and Viet Nam would cross the ADF per capita income threshold by 2015; and Cambodia, Pakistan, and Uzbekistan would follow by 2020. The number of poor people living on less than \$2 a day would decline to about 185 million by 2020 under this scenario, with only about 18 million living in extreme poverty (Table 1).

11. Clearly, the decade ahead is a critical period of transition for ADF countries. Key interventions that governments and other stakeholders make today will determine which scenario is realized over the next 10–12 years. Country-specific variations apart, these key interventions would in general include the following:

- (i) An increase in investment rates in a majority of ADF countries that are growing at about 3% to 4% or less to enable these countries to accelerate growth. This, in turn, would require a significant improvement in the investment climate through policy and institutional reforms, deepening of financial markets, infrastructure improvements, and adequate provision of a skilled workforce. These measures are also necessary for the fast-growing ADF countries to maintain or accelerate their growth.
- (ii) Interventions to ensure improved access to education and health services, as well as productive employment and opportunities for the disadvantaged, to make growth more inclusive.
- (iii) Measures to ensure that the environmental risks of accelerated growth are mitigated adequately.

12. The key intervention required at the regional level is to further consolidate ongoing regional cooperation and integration (RCI) initiatives. This will enable slower-growing ADF countries to accelerate their growth through strengthened backward and forward linkages with faster-growing countries. This will also facilitate the provision of regional public goods that are urgently required on a much larger scale than currently available.¹²

⁹ Benchmark growth projections less 40% and pro-rich change in income distribution.

¹⁰ See footnote 7.

¹¹ Benchmark growth projections plus 20% and pro-poor change in income distribution.

¹² A regional public good is a benefit shared by two or more countries in a region, such as clean air, environmental protection, control of communicable diseases, management of natural disasters, availability of knowledge products, and shared standards.

III. MAJOR DEVELOPMENT PLAYERS, AID ARCHITECTURE, AND THE ADF

13. Who are the major players to deliver these key interventions? In charting their own course, ADB and other international development partners need to consider their role vis-à-vis the other major development players, as well as some key features in the evolving aid architecture.

A. Major Development Players

14. Four main players can be identified:

- (i) **Private sector.** The private sector is the leading player which drives growth and poverty reduction by creating jobs, improving productivity, and raising incomes. It is important to emphasize that the private sector in ADF countries is not the organized corporate sector of advanced economies. It is made up largely of small producers in rural and urban areas—the so-called informal sector—which provide the bulk of output and employment in these countries. In addition to developing the informal sector, ADF countries need to boost the rate of private investment, which accounts for more than 70% of total investment in the region,¹³ to accelerate growth. This would involve not only the small producers but also a nascent corporate sector, including potential foreign investors. However, the perceived high investment risks in ADF countries severely constrain the expansion of private investment.¹⁴ Government action to improve the investment climate is a necessary precondition for the acceleration of private investment. In addition, the private sector is turning increasingly to institutions with risk-mitigating capabilities, such as ADB, to share and mitigate special risks involved in ADF countries.
- (ii) **Governments.** Governments have the key role in improving the investment climate. They can provide predictable and undistorted policy regimes, develop capable institutions, and build modern physical infrastructure. They can also provide basic social services, including health and education, which are not only important ends in themselves but also instrumental in developing a skilled workforce. To effectively perform their role, governments in many ADF countries, particularly those in the poorest and weakly performing groups, often look to external development partners for financial assistance as well as transfer of technology and best practices.
- (iii) **Civil society.** In defining the development agenda, civil society plays an important role. Its demand for improved governance, and more sustainable and equitable development, has had a major impact on the way governments, development institutions, and the private sector operate. Civil society institutions are also increasingly collaborating with governments and international development partners on a range of development initiatives.

¹³ ADB. 2006. *Medium-Term Strategy II 2006-2008*. Manila.

¹⁴ World Bank. 2006. *Doing Business 2007: How to Reform*. Washington, D.C. Also see a discussion on business start up days and costs in ADF countries in "Effectiveness of ADF Operations," a discussion paper circulated for this meeting.

- (iv) **International development partners.** By intermediating the delivery of finance and knowledge, international development partners support the private sector, governments, and civil society. Responding to the persistence of global poverty, they have adopted MDG targets in partnership with developing countries, and have committed themselves to more effective development. Based on the common framework adopted in the Paris Declaration on Aid Effectiveness in 2005, each partner is expected to demonstrate progress toward deeper collaboration among development partners, harmonization of their assistance modes and processes, and alignment with national systems.

B. Aid Architecture

15. The key trends of the global aid architecture, which influences the role of development partners individually and collectively, are presented below:

- (i) **Growing complexity.**¹⁵ This is characterized by (a) rising number of bilateral and multilateral agencies providing assistance;¹⁶ (b) emergence of new private and public donors; (c) growing earmarking of aid resources for specific uses through global programs or “vertical” funds;¹⁷ and (d) aid fragmentation—increasing number of donor-funded activities, each with decreasing financial size. While these trends might reflect the growing vitality of the donor community, the proliferation of donors and modes could raise transaction costs, thereby undermining aid effectiveness.
- (ii) **Shift of focus from infrastructure and production sectors to social sectors.** The share of the social sectors in the total sector allocable official development assistance (ODA) to low-income countries has grown markedly since the early 1990s. The share grew from 29% in 1990–1994 to 52% in 2000–2004. On the other hand, the share of the infrastructure and production sectors dropped from 59% to 38% during the same period.¹⁸
- (iii) **Declining share of ADF countries in ODA.** As Table 3 shows, net ODA to all developing countries has more than doubled from about \$50 billion in 2000 to about \$107 billion in 2005 (at current prices).¹⁹ Net ODA to ADB’s DMCs and ADF countries also expanded during 2000–2005, although more slowly than overall ODA flows. As a consequence, the share of ADF countries in total ODA has been falling. The decline would have been sharper in 2005 in the absence of the special assistance provided for tsunami relief.

¹⁵ For a more detailed discussion, see World Bank. 2007. *Aid Architecture: An Overview of the Main Trends in ODA Flows*. Washington, D.C.

¹⁶ The number of agencies increased from 12 in the 1960s to about 33 in the 2001–2005. See the reference cited in footnote 15.

¹⁷ Global programs or “vertical funds” dedicate their support to specific themes or issues that cut across more than one country or region of the world. This compares with a more “horizontal” country-based approach to development aid typically taken by multilateral development banks. For more discussion on this subject, see footnote 15.

¹⁸ Production sectors include agriculture, forestry and fishery, industry and mining, and tourism. See the reference cited in footnote 15.

¹⁹ Net ODA disbursements refer to net ODA and official aid (e.g. grant, loan, technical cooperation) on a disbursement basis (i.e. actual expenditures) from all bilateral and multilateral donors.

Table 3: Net ODA by Destinations, 2000–2005

Destination	2000	2001	2002	2003	2004	2005
All developing countries (\$ million)	49,759	51,595	60,230	70,361	78,953	107,255
ADB developing member countries						
Amount (\$ million)	13,769	14,448	15,200	14,538	15,020	19,793
Share of the total ODA (%)	28	28	25	21	19	18
Countries with ADF access						
Amount (\$ million)	8,693	9,681	10,620	11,678	11,018	15,081
Share of the total ODA (%)	17	19	18	17	14	14

ADF=Asian Development Fund, ODA=official development assistance.

Source: Organization for Economic Cooperation and Development (OECD), OECD Stat database, downloaded 20 July 2007 and ADB staff estimates.

- (iv) **Share of ODA in ADF country development spending.** On average, net ODA accounts for about 10% of development spending in ADF countries (Table 4). However, for the poorest ADF countries (Group A: ADF-only countries), ODA accounts for as much as 41% of development spending. For countries mainly receiving ADF (Group B1), the share is about 25%. Thus, despite ADF countries' declining share of global ODA, ODA remains an important component of development expenditures in these countries. Clearly, trends in the volume and effectiveness of ODA will have a major impact on development outcomes in these countries.

Table 4: Share of Net ODA in Development Spending in ADF Countries (%)

Country Groups	2003	2004	2005
Group A ^a	44	42	41
Group B1	27	25	25
Group B2	3	1	4
Average ADF Countries	11	8	10

ADF = Asian Development Fund.

^a Excludes post-conflict countries (Afghanistan and Timor-Leste).

Source: ADB staff estimates.

16. Important as it is, it is useful to note that in absolute volume the flow of ODA to ADF countries is very small. In per capita terms, it amounts to only about \$20 per head per year.²⁰ Given the importance of ODA for ADF countries, its limited volume in absolute terms, and the multiple channels and modes of aid flow, it is essential that international development partners carefully harmonize their operations and align them with country priorities in line with the Paris Declaration. Since each development partner has limited resources, it is equally important for ADB and other agencies to be selective, assess their own comparative strengths, and focus their assistance accordingly. Even for the largest agencies, doing everything everywhere is neither desirable nor possible.

²⁰ ADB staff estimate based the total ODA flow to ADF countries in 2005 (Table 3) and the total 2005 mid-year population of ADF countries. Source: ADB. 2006. *Key Indicators*. Manila.

C. ADB's Strengths

1. Inherent Assets

17. Some consistent messages about ADB's strengths can be gleaned from feedback that is received from DMC clients during programming missions, project missions, client surveys, and other consultations. These include the following:

- (i) **Regional specialization and expertise.** One important value that ADB brings to its clients is its specialization in countries of the region over a long period. ADB has implemented sustained assistance programs in different sectors in most countries over several decades. This has yielded an institutional stock of expertise and depth of domain knowledge in each of these sectors in each country.
- (ii) **Long-standing strategic partnerships with DMCs.** ADB interventions are driven by a shared strategic vision, as reflected in country partnership strategies and operational business plans that are aligned with countries' own development priorities. The shared strategic visions arise from a long standing development relationship in each country, sustained policy dialogue, and the active role of DMC government representatives and other professionals in ADB's governance structure and staff. This "relationship asset" has been reinforced by ADB's sensitivity and quick response to the devastating disasters that have struck many of its DMCs in recent years. This relationship asset also enables ADB to engage in sensitive policy dialogue.
- (iii) **Ability to offer integrated solutions.** ADB is one of the few international development partners with the capability to package finance and knowledge into integrated development solutions—supported by technical assistance (TA), grants, loans, equity, and guarantee operations. Furthermore, with its mandate to serve public and private clients, ADB can combine services to both sectors under one roof. This unique integration of services enables ADB to adopt a holistic approach in supporting development in DMCs.
- (iv) **Institutional commitment to regional cooperation.** ADB actively promotes regional cooperation in Asia and the Pacific. It has demonstrated its commitment to supporting subregional initiatives, such as Greater Mekong Subregion Economic Cooperation; South Asia Subregional Economic Cooperation; the Central Asia Regional Economic Cooperation; Brunei Darussalam, Indonesia, Malaysia, the Philippines-East ASEAN Growth Area; and Indonesia-Malaysia-Thailand Growth Triangle. These initiatives are the platforms for ADB's cross-border projects, which constitute the first of the four pillars of its RCI strategy.²¹ The other pillars are delivery of regional public goods, trade facilitation, and support for monetary and financial cooperation.
- (v) **Unique role in the Pacific subregion.** As mandated by its charter, ADB allocates dedicated resources to engage with smaller and more vulnerable countries. This is especially relevant for the island economies in the Pacific. ADB is the leading multilateral development partner—and in some cases, the only

²¹ See ADB. 2006. *Regional Cooperation and Integration Strategy*. Manila.

multilateral partner—with the largest physical presence in these countries. ADB applies more innovative and flexible approaches in providing assistance to these countries to meet their specific requirements.

2. Operational Performance Track Record

18. The paper entitled “*Effectiveness of ADF Operations*,” circulated for this meeting, presents a comprehensive discussion of ADB’s performance—successes and failures—in implementing ADB’s poverty reduction strategy and institutional reforms. The discussion here focuses only on identifying ADB’s comparative strengths, as revealed in its operations.

19. **Project Success Rates Are High and Rising.** Independent evaluation by the Operations Evaluation Department (OED) indicates that the success rate for loan projects, which was declining until the mid-1980s, has continued to improve since then.²² Even more encouraging, the success rate of ADF projects, which had been much lower than for ordinary capital resources (OCR) projects, has caught up with the OCR success rate (Figure 3). OED has observed that two thirds of the TA projects evaluated succeeded in delivering expected outcomes. However, managing this product with regard to strategic focus, DMC ownership, and quality at entry still has much room for improvement.²³ A TA reform initiative is being introduced later in 2007 to address these issues.

20. **ADF Program Loans Are Performing Better.** Another independent OED evaluation on program (or policy-based) lending indicates that, while the performance of earlier program lending in ADF countries was mixed, it has been improving since the mid-1990s.²⁴ The study also shows that demand for policy-based lending remains strong in ADF countries. In 2001–2006, the ADF funded 51 program loans to 15 countries, totaling about \$1.7 billion across all sectors. These were designed to improve the quality of governance and reduce corruption through policy and institutional reforms.

21. **Portfolio Performance Is Improving.** As the discussion paper on development effectiveness points out, weaknesses in implementation capacity and fiduciary control remain an issue. However, portfolio ratings of ongoing projects, including ADF projects, have shown a distinct trend improvement. The proportion of projects rated satisfactory has increased from less than 80% about 5 years ago to more than 90% now. In addition, this rating is now about the same for ADF projects as for OCR projects. Similarly the proportion of projects classified as being “at risk” has shown a declining trend over the same period, and this proportion has tended to be lower for ADF projects than for OCR projects.²⁵

22. **ADB Is Strengthening Partnerships.** The involvement of civil society organizations in ADB projects (loans and TA) has increased steadily. Currently, these organizations are participating in 69% of ADB projects. Their participation is especially evident in the ADF countries. ADB has also increased its participation in program-based approaches over the years, strengthening partnerships with bilateral and multilateral agencies. This is in line with partnership commitments under the Paris Declaration.²⁶ In addition to the nine program-based

²² ADB. 2006. *2006 Annual Evaluation Review*. Manila.

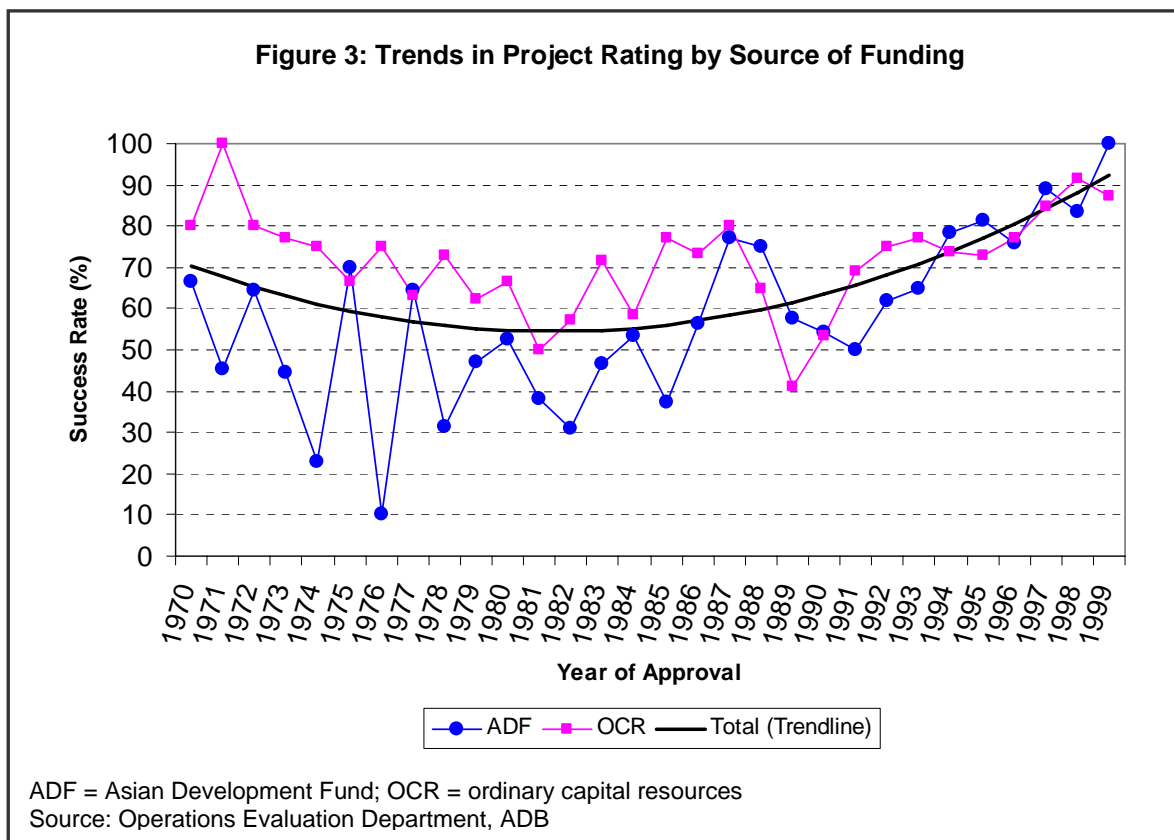
²³ ADB. 2007. *Special Evaluation Study: Performance of Technical Assistance*. Manila.

²⁴ ADB. *Policy Based Lending in ADB: Recent Trends and Good Practices from Evaluation*. 2007. Manila.

²⁵ Note however that OED is now reviewing the portfolio performance classification system.

²⁶ For a detailed discussion on ADB’s implementation progress of the Paris Declaration, see a background paper entitled “*Implementation of the Paris Declaration in ADF Countries*,” circulated for this meeting.

approaches approved during 2001–2005, four were approved in 2006. All but one of these program-based approaches were in ADF countries.



23. **ADB Is Managing its Internal Resources Efficiently.** ADB's administrative cost per \$1 million approved is less than \$41,000. The administrative cost per \$1 million disbursed is less than \$50,000. These financial performance ratios indicate that ADB's administrative resource management is efficient and compares well with available benchmarks, as is evident from a recent report of the Department for International Development (DFID).²⁷

24. **Infrastructure and Education Are ADB's Major Strengths.** A comprehensive assessment by OED of projects undertaken in different sectors indicates that, among the projects approved in the 1990s, ADB has been most successful in implementing ADF projects in transport and communications (91%) and energy (87%), followed by education (77%) (Table 5). Projects have been much less successful in agriculture and natural resources (49%); industry and trade (57%); and health, nutrition, and social protection (58%). The 2006 ADB perceptions survey also identified infrastructure development as the perceived key strength of ADB.²⁸

²⁷ See DFID. London. *Draft Asian Development Bank Effectiveness Summary*. June 2007.

²⁸ The survey report is at <http://www.adb.org/Documents/Reports/ADB-Perceptions-Survey/2006/default.asp>

Table 5: Project Performance by Sector and Source of Financing
(% of Projects Rated Successful)

Sector	ADF			OCR		
	1970s	1980s	1990s	1970s	1980s	1990s
Transport and Communications	79	74	91	86	76	88
Energy	68	83	87	89	77	84
Education	78	31	77	75	88	93
Multisector	40	62	71	55	82	62
Water Supply Sanitation and Waste Management	14	43	67	74	36	80
Finance	0	25	62	67	57	56
Health, Nutrition, and Social Protection		29	58	100	50	67
Industry and Trade	56	40	57	71	100	50
Agriculture and Natural Resources	34	48	49	37	36	43
Law, Economic Management, and Public Policy ^a			0			0
Total	46	54	70	72	63	75

ADF=Asian Development Fund, OCR = ordinary capital resources.

^a Only two projects have been evaluated (one each for ADF and OCR). The ADF-funded project was rated partly successful and the OCR-funded unsuccessful.

Source: Operations Evaluation Department, ADB

D. Implications

25. This discussion of key development players, an increasingly complex aid architecture, and ADB's strengths leads to some distinct conclusions. National players, including governments, the private sector, and civil society, will continue to be the primary leaders of development initiatives. However, international development partners have an important role to play, particularly in Group A ADF countries (where they account for more than 40% of development expenditure) and Group B1 ADF countries (where they account for more than 25%). Since each external agency has limited resources, it is essential that they be selective and focus their operations on identified areas of comparative strength to maximize impact.

26. Some of ADB's strengths that DMC clients recognize have been identified. ADB's resource management in the delivery of assistance to DMCs is efficient and compares well with available benchmarks. Independent OED evaluations also show ADB's overall project delivery performance is high and improving. However, its performance across sectors is mixed. ADB has been most successful in delivering projects in transport and communication, energy, and education. The track record is weaker in agriculture and natural resources; industry and trade; and health, nutrition, and social protection. In a few subsectors, ADB's performance has been poor, prompting the decision in its *Medium-Term Strategy II (2006–2008)* to exit those fields.²⁹

²⁹ ADB. 2006. *Medium-Term Strategy II 2006–2008*. Manila

IV. DIRECTIONS FOR ADF X (2009–2012)³⁰

A. Responding to Needs

27. The main objectives of ADB are to help its DMCs rapidly reduce income poverty through high growth, as well as to reduce the large deficits in some MDGs for 2015. Furthermore, a specific goal for the ADF is to help ADF countries graduate as quickly as possible. ADF countries are at a crossroad today. Strategic decisions about how these countries position themselves now will determine whether many of them (i) continue along the path of moderate or slow growth and increasing inequality; or (ii) accelerate poverty reduction and graduate sooner through faster, more inclusive, and environmentally sustainable growth. Most ADF countries would need to increase their rate of investment to achieve faster and more inclusive growth. For instance, even a modest target of raising the economic growth rates of 3%–4% currently observed in most ADF countries to 4%–5% would require an increase in investment rates by about 25% to 30% on average, assuming unchanged efficiency of capital use.

28. ADF countries would have difficulty achieving this large increase in investment without a commensurate increase in ODA. This is especially true for Group A and B1 ADF countries relying wholly or mainly on concessional assistance, because they have limited access to commercial financing. In these countries, ODA forms a large share of their total development expenditure. Thus, ADB, like other donors, needs to scale up its concessional assistance to support the required increase in investment in these countries. One area of concern in this context is that the ADF's share of total ODA to ADF countries has been declining and today accounts for only about 5% (Table 6).

Table 6: Share of Net ADF Disbursements in Net ODA
(%)

2001	2002	2003	2004	2005
8.1	8.2	7.1	6.2	5.5

ADF = Asian Development Fund; ODA = Official Development Assistance

Sources: Controller's Department, ADB.

OECD, OECD Stat database, data downloaded as of 20 July 2007.

29. ADB has coped with the severe constraint of ADF allocations in various ways, including dropping projects from the pipeline, postponing project processing to later years, downsizing individual loans, and chopping a project into several time slices to fit into annual allocation limits. ADB's operational departments point out that if this trend continues, ADB will lose the critical mass required to provide effective development assistance and have policy leverage in many of its DMCs. DMCs are increasingly voicing this concern themselves.

30. Clearly, if the ADF is to remain relevant as a major source of development assistance in these countries, a significant increase in the level of ADF assistance is imperative. This is particularly important for the poorest and weakest countries (Group A). Moreover, ADF X is the last replenishment during which projects relevant for MDG outcomes in 2015 can be implemented. Consequently, a substantially enlarged replenishment for ADF X is particularly

³⁰ Replenishment negotiations for ADF X are proceeding in parallel with the review of ADB's *Long-Term Strategic Framework* (LTSF), which will apply to ADB's OCR and ADF operations. The time horizon of the revised LTSF also will extend up to 2020, compared with the 4-year period of ADF X (2009–2012). Nevertheless, it will be ensured that the approach and priorities of ADF X outlined in this section are fully consistent with those of the LTSF.

urgent. As shown by the benchmark growth projections, most ADF countries would remain eligible for ADF until about 2020, by which time some major ADF recipients such as Pakistan and Viet Nam are likely to graduate.³¹ Accordingly, increased ADF assistance needs to be maintained for about another decade (i.e., through ADF X, XI, and XII) and then gradually tapered down as some of the major ADF countries graduate.

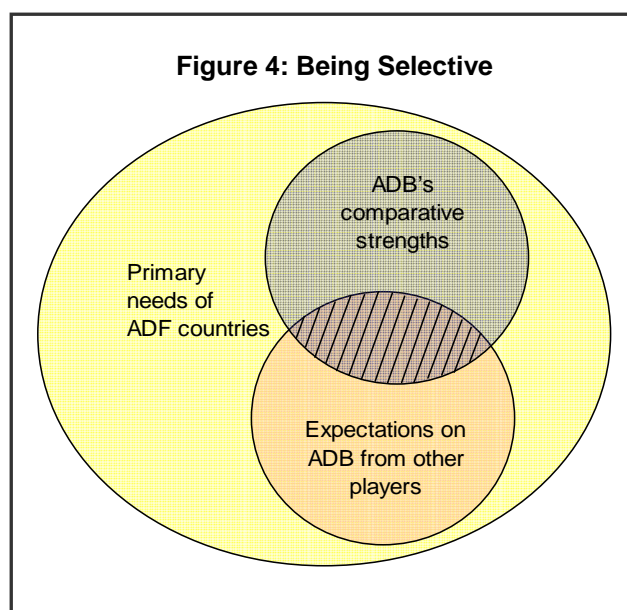
31. Proposed operational pipelines developed under the current programming cycle (2008–2010) indicate that country and regional programs would total about \$4.9 billion for the first 2 years of ADF X (Appendix 2). The actual size of full ADF X program would depend on the scale of replenishment on which donors finally agree.

B. Maximizing Impact

32. Whatever size of ADF X is finally agreed upon, ensuring that these resources are deployed for maximum development impact is important. Since resources are limited, ADB must be selective based on its comparative strengths, allocate its assistance efficiently based on country performance, and continue to improve organizational efficiency to provide better and faster assistance. These steps will have to be combined with ADB's continuing efforts to implement its harmonization and alignment agenda in line with the Paris Declaration.

1. Being Selective

33. To accelerate the pace of poverty reduction, ADF countries need to (i) achieve and maintain fast growth through higher investment rates supported by an improved investment climate; (ii) promote social development to improve access to health, education, and productive employment opportunities for the disadvantaged; and (iii) mitigate the environmental costs of rapid growth. The emerging aid architecture emphasizes that each development partner needs to be selective based on its comparative strengths. ADB, therefore, must focus its operations on areas where these priority needs of client countries and expectations from other development players intersect with ADB's institutional strengths and operational success (Figure 4).



34. Priorities that belong to this intersection include:

- (i) **Promoting inclusiveness and gender equality.** In addition to growth, inclusiveness is crucial for successful poverty reduction. ADB operations in ADF countries will have to focus on how best to support inclusiveness in line with its

³¹ Graduation is based on two criteria: per capita gross national income (GNI) and debt repayment capacity. The per capita GNI operational cutoff applied for ADF eligibility is the same as that of the International Development Association, i.e., \$1,065 in 2006, as estimated by the World Bank Atlas method. Debt repayment capacity is assessed based on multiple criteria. Countries are assumed likely to graduate within 4 years upon reaching the ADF GNI per capita cutoff.

comparative strengths. Projects that improve access to education for the disadvantaged are particularly relevant in this context, as are rural infrastructure projects that expand growth and employment opportunities in rural areas where the poor are concentrated. An aspect of inclusiveness that requires urgent attention is gender equality. This is particularly relevant for ADF countries, given their performance gaps in meeting gender-related MDG targets. ADB is developing a new action plan to implement its *Policy on Gender and Development* (1998).

- (ii) **Improving governance and preventing corruption.** Three key interventions are required in ADF countries, i.e., improving the investment climate, increasing access to social services, and mitigating the environmental costs of rapid growth. The effectiveness of all these interventions depends on the quality of governance. Consequently, assistance for improving governance has to be a major priority for ADB operations in ADF countries. However, to be tractable and effective, ADB's engagement in this field will be selective in line with its second governance and anticorruption action plan adopted in 2006. The plan prioritizes public financial management, including procurement and public expenditure management, as well as the legal and regulatory framework and capacity development in sectors where ADB is active.
- (iii) **Supporting private sector development.** ADF client countries urgently need to improve the investment climate and attract more private investment. The required interventions include infrastructure improvements, policy and institutional reforms, deepening of financial markets, and adequate provision of a skilled workforce. To reinforce its support in this area, ADB introduced a new strategic framework for private sector development in 2006. This, together with ADB's strong track record on infrastructure operations and policy-based lending, has positioned ADB to effectively expand its operations in this area. The financial sector is particularly important in this context. Past ADB operations in the sector that focused on providing directed credit through nodal domestic credit agencies were not very successful. However, recent policy loans for the sector have done well. These operations need to be intensified to help the development of robust financial markets in ADF countries.
- (iv) **Strengthening environmental protection.** Unless reversed, rapid deterioration of the environment in ADF countries will seriously threaten growth and social stability. The main environmental challenges include climate change (mitigation and adaptation), water scarcity, pollution, and loss of forest cover and biodiversity. ADB country operations will address these issues selectively based on ADB's comparative strengths within this field and the *Environmental Policy* (2002). Special environment initiatives will include energy efficiency, carbon markets, water for all, and clean air for Asian cities.
- (v) **Promoting regional cooperation and integration.** RCI is a powerful regional instrument to boost the pace of growth in the slow-growing and poorer ADF countries by strengthening backward and forward linkages to the fast-growing and larger economies of the region. RCI also facilitates the provision of urgently required regional public goods to reinforce inclusive and sustainable growth initiatives at the country level. ADF X operations will stress (a) development of cross-border infrastructure; (b) provision of regional public goods, such as

containment of communicable diseases, and protection from climate change or cross-border pollution; and (c) provision of other regional integration services. Demand for regional cooperation projects far exceeds the availability of ADF resource earmarked for this purpose.³² Considering ADB's mandate and performance in RCI, an increase in the resources earmarked for regional projects warrant consideration.³³

35. These priorities will have to be pursued through operations in sectors where ADB has a proven track record, especially infrastructure and education.³⁴ At the same time, ADB needs to maintain some flexibility and capacity to deliver limited assistance in other sectors where its performance is less impressive to respond to varying country needs and priorities. Particularly relevant in this context are sectors such as health, and agriculture and natural resources, which are important for both inclusiveness as well as sustainability of growth. In these other sectors, the impact of ADB's assistance could be leveraged considerably by expanding partnerships with bilateral and multilateral development partners, and civil society organizations that are specializing in these fields.

36. ADB will continue to pay special attention to weakly performing countries during ADF X. ADB aims to increase its impact on these countries through differentiated modes of engagement based on specific country situations, new and more flexible modes and instruments, and more innovative and efficient business processes.³⁵

2. Allocating Assistance Efficiently

37. The main rationale for the revised performance-based allocation (PBA) policy is that the poverty-reducing impact of assistance is maximized when assistance is allocated to countries according to their performance. This policy has been implemented since 2005. Country allocations are now fully aligned with country performance, which is assessed through a rigorous and transparent process.³⁶ This allocation policy is also closely aligned with that of International Development Agency (IDA) and the African Development Fund. The grant framework embedded in this policy is being revised to exclusively link the loan and grant structure of the terms of assistance to a country's debt situation, as in the case of IDA and African Development Fund. These adjustments will maximize the efficiency of the allocation and terms of ADF assistance.

3. Strengthening Institutional Effectiveness

38. OED's independent evaluation reports indicate that ADB's operational performance is high and improving, and that it has been particularly successful in sectors such as infrastructure and education. ADB has also demonstrated its ability to use its internal resources efficiently. However, OED reports have also pointed out some continuing institutional weaknesses. These

³² For example, of the pipeline of 13 projects totaling \$567.5 million in 2007–2008, ADF IX's resources earmarked for regional projects will be able to finance only five projects (totaling \$165.7 million).

³³ Increasing the level of ADF resources earmarked for regional projects is discussed in the paper entitled "Refining Performance-Based Allocation," circulated for this meeting.

³⁴ As shown in Appendix 2, the proposed ADF operations for these sectors would account for a little over 60% of the total program for the first two years of ADF X period (2009–2010).

³⁵ A separate paper on weakly performing countries will be presented at the second ADF X negotiation meeting.

³⁶ Some issues relating to strengthening the PBA policy are being discussed in the paper entitled "Refining Performance-Based Allocation," circulated for this meeting.

are echoed in the discussion on ADB's institutional effectiveness presented in the paper entitled "*Effectiveness of ADF Operations*," circulated for this meeting. Clearly, institutional reforms will continue to be an important management agenda for strengthening ADB's overall development effectiveness. Since 2004, ADB has successfully introduced wide-ranging reforms to improve its organizational capabilities to deliver development results. To ensure that the results of such reforms are fully realized, ADB will shift its attention to their effective implementation, capitalizing on the progress made so far and responding to issues that have emerged during implementation.

V. ISSUES FOR DONOR GUIDANCE

39. This paper has discussed the poverty context in ADF countries, the outlook for the decade ahead, and the main strategic challenges facing these countries. It has also discussed the roles of key development players, the evolving aid architecture, and ADB's comparative strengths. Based on this analysis, the paper has proposed certain directions for ADF X, including scaled-up operations, better selectivity, efficient allocation of country assistance, and continuing institutional reforms. Donor guidance is requested on the analysis presented in this paper and the proposed directions for ADF X.

**BENCHMARK GROWTH RATES OF PER CAPITA GROSS DOMESTIC PRODUCT
(Average 2002–2006)**

ADF Recipient DMCs	ADB Benchmark Growth ^a (%)	ADF Group
1. Azerbaijan ^b	16.4	Group B1
2. Armenia ^b	13.2	Group B1
3. Afghanistan	8.3	Group A
4. Cambodia	7.8	Group A
5. Tajikistan	7.0	Group A
6. Viet Nam	6.3	Group B1
7. Maldives ^b	6.0	Group A
8. Mongolia	6.0	Group A
9. Bhutan	5.4	Group A
10. Uzbekistan	5.0	Group B2
11. Bangladesh	4.3	Group B1
12. Pakistan	4.1	Group B1
13. Indonesia ^b	3.8	Group B2
14. Sri Lanka	3.4	Group B1
15. Tuvalu ^b	3.2	Group A
16. Samoa ^b	2.7	Group A
17. Lao People's Democratic Republic	2.7	Group A
18. Kyrgyz Republic	2.3	Group A
19. Tonga ^b	2.1	Group B1
20. Solomon Islands	2.0	Group A
21. Cook Islands ^b	1.3	Group B1
22. Papua New Guinea	0.4	Group B2
23. Nepal	0.3	Group A
24. Kiribati ^b	0.2	Group A
25. Micronesia ^b	0.1	Group B1
26. Vanuatu ^b	0.0	Group A
27. Marshall Islands ^b	(0.2)	Group B1
28. Timor-Leste	(7.9)	Group A

() = negative, ADB = Asian Development Bank, ADF = Asian Development Fund,
DMC = developing member countries

^a Benchmark growth estimates from Economics and Research Department, ADB.

^b These countries are classified as ADF eligible because of their limited credit worthiness despite their per capita incomes exceeding the ADF operational cutoff level (\$1,065 in 2006).

Source: ADB staff estimates

**ASIAN DEVELOPMENT FUND LENDING AND GRANT OPERATIONS PIPELINES
(2009–2010 By Medium-Term Strategy Group And Sector)**

Classification	2009 Projects				2010 Projects			
	No.	%	\$ m	%	No.	%	\$ m	%
Group I	32	55	1,478	61	41	68	1,688	68
Education	5	9	338	14	3	5	110	4
Energy	1	2	20	1	8	13	295	12
Financial Sector	2	3	110	5	4	7	151	6
Road Transport	11	19	484	20	9	15	510	21
Rural Infrastructure	8	14	360	15	8	13	325	13
Urban Infrastructure	5	9	167	7	9	15	297	12
Group II	16	28	665	27	14	23	675	27
Agriculture and Natural	9	16	335	14	6	10	350	14
Health	4	7	210	9	5	8	100	4
Law and the Judiciary					1	2	100	4
Public Finance and	3	5	120	5	1	2	100	4
Railways					1	2	25	1
Trade (RCI related)								
Group III	5	9	146	6	2	3	75	3
Civil Aviation					1	2	25	1
Communications	1	2	40	2				
Development Finance								
Fishery								
General Government	1	2	30	1	1	2	50	2
Housing Construction								
Industry	2	3	66	3				
Livestock								
Water Transport	1	2	10	0				
Multisector	5	9	142	6	3	5	35	1
TOTAL	58	100	2,430	100	60	100	2,473	100