ASIAN DEVELOPMENT BANK

A GRADUATION POLICY FOR THE BANK'S DMCs

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ABBREVIATIONS

ADF	-	Asian Development Fund
ADTA	-	advisory technical assistance
AfDB	-	African Development Bank
CVI	-	composite vulnerability index
DMC	-	developing member country
EBRD	-	European Bank for Reconstruction and Development
FIRR	-	financial internal rate of return
FDI	-	foreign direct investment
FSO	-	fund for special operation
FY	-	fiscal year
GDP	-	gross domestic product
GNP	-	gross national product
HIPC	-	heavily indebted poor country
IADB	-	Inter-American Development Bank
IBRD	-	International Bank for Reconstruction and Development
IDA	-	International Development Association
IFC	-	International Finance Corporation
IFF	-	intermediate financing facility
IMF	-	International Monetary Fund
LLDC	-	least developed country
MDB	-	multilateral development bank
OC	-	ordinary capital
OCR	-	ordinary capital resources
PITA	-	project implementation technical assistance
PDMC	-	Pacific island developing member country
PCA	-	principal components analysis
PPP	-	purchasing power parity
PPTA	-	project/program preparatory technical assistance
PRC	-	People's Republic of China
TA	-	technical assistance
TASF	-	technical assistance special fund
UN	-	United Nations
US	-	United States
USAID	-	United States Agency for International Development

EXECUTIVE SUMMARY

Since 1977, the Bank has had a three-tier classification system that forms the basis for determining the eligibility of its developing member countries (DMCs) to borrow from the Asian Development Fund (ADF) and for applicable limits on Bank financing of project costs. DMCs are classified into three groups based on two criteria: (i) per capita gross national product (GNP); and (ii) debt repayment capacity. Group A DMCs are fully eligible for ADF, Group B DMCs ("blend" economies) are eligible for limited amounts of ADF in particular circumstances, and Group C DMCs are not eligible for ADF financing. While per capita GNP has been identified as a criterion, Bank policy is that cutoff points for the various groups should not be rigid. Also, the debt repayment capacity criterion is assessed in a qualitative way. Classification is determined at the time of entry. No borrowing country has been formally graduated from one group to the next to date. Further, no DMC has been formally graduated from Bank assistance, because the current policy does not envisage a stage beyond Group C.

As part of its policy review commitments made during the ADF VII negotiations, the Bank is required to submit proposals to the Board of Directors on a graduation policy for DMCs within one year of the effectivity of ADF VII.[1] Donors suggested that the proposed approach should preferably be comprehensive, extending graduation from ADF-only through "blend" status to ordinary capital resources (OCR)-only status, and finally to graduation from regular Bank assistance.

Since the inception of the classification system, per capita income and debt repayment capacity have been distinct classification criteria. Also, recognizing the importance of both criteria, Bank policy statements have been careful not to state that the per capita GNP criterion has primacy over the debt repayment capacity criterion. In practice, however, it has been assumed that low income goes with low debt repayment capacity, middle income with intermediate debt repayment capacity, and high income with high debt repayment capacity, i.e., there is an implicit assumption that per capita income and debt repayment capacity can be used interchangeably. Also, while there is a per capita GNP cutoff for ADF eligibility, there is no corresponding cutoff for OCR eligibility. As a result, high-income countries continue to be classified along with other regular OCR borrowers as Group C DMCs.

Over the years, fundamental changes have occurred in the interrelationships between the levels of per capita GNP and debt repayment capacity within and across country groupings. A growing number of low-income DMCs have improved debt repayment capacities and access to international capital markets, indicating a need to reengineer the classification system. Further, the current economic crisis in the region underscores the need to build flexibility into the proposed policy to reflect changes in the economic conditions of DMCs.

To this end, the Paper proposes a systematic approach to applying the two country criteria, viz., per capita GNP and debt repayment capacity, for determining ADF eligibility. The approach is captured in a decision matrix that is arrived at through a two-stage process: (i) in the first stage, the per capita GNP operational cutoff is applied to divide borrowing DMCs into two categories, i.e., those below and those above the cutoff; (ii) in the second stage, within each income category (i.e., below and above the per capita GNP cutoff) countries are further differentiated on the basis of debt repayment capacity.

[1] ADF VII became effective on 24 September 1997.

Unlike the income criterion, the debt repayment capacity of DMCs cannot be captured in a single indicator. To address this problem, a multidimensional evaluation procedure, combining quantitative and qualitative assessments, has been developed. The quantitative assessment of debt repayment capacity is based on the following indicators: (i) debt sustainability ratio, (ii) private capital inflow as a share of total capital inflow, (iii) gross domestic saving rate, and (iv) country size. The qualitative assessment of debt repayment capacity is based on the following categorical variables: (i) categorization as a heavily indebted poor country (HIPC) by the World Bank and the International Monetary Fund (IMF), (ii) volatility of export growth, (iii) main external financing source, (iv) degree of access to funds of the International Development Association (IDA), and (v) whether sovereign borrowing by the country is rated by Moody's and Standard and Poor's.

The assessment of debt repayment capacity comprises two types of determinants. The first type consists of quantitative indicators on a continuous scale that capture trends over the medium term. The second type depends on factors that change over the longer term. Both types of indicators must be used in order to strike a balance.

The joint application of the two criteria (i.e., per capita GNP and debt repayment capacity) yields the following system of DMC eligibility for ADF and OCR resources: (i) ADF-only (Group A); (ii) ADF with limited amounts of OCR (Group B1); (iii) OCR with limited amounts of ADF (Group B2); and (iv) OCR-only (Group C). Under the revised framework, the current ADF-OCR blend is proposed to be split into two groups: ADF with limited OCR (B1) and OCR with limited ADF (B2). As DMCs move out of Group A and progress towards Group C, they will have increasing access to OCR.

Bank lending on OCR terms and Bank guarantees with counter-guarantees from a government or its agencies could be considered on exceptional basis for Group A DMCs for projects that are foreign exchange earning and are able to fully service their foreign debt from their net foreign exchange earnings. Resources for the Group B1 DMCs would be predominantly ADF with limited OCR financing for revenue-earning projects, determined on a case-by-case basis. This is consistent with the recommendation of donors that while country criteria would be the primary consideration for ADF access, project considerations could be applied as a secondary criterion.

Graduation from one level of ADF access to the next would be triggered under the following conditions:

(i) for both Least Developed Countries (LLDCs) and non-LLDCs (others), when debt repayment capacity improves from weak to limited, or from limited to adequate;

(ii) for LLDCs, when they graduate from the LLDC classification and are also above the per capita GNP cutoff; and

(iii) for non-LLDCs (other) below the per capita GNP cutoff, when they cross the per capita GNP threshold.

In the event of a combination of (i) and (ii), or (i) and (iii), the graduation would take place over two levels (for example, from A to B2 or B1 to C). Movement through the decision matrix can be bi-directional, i.e., graduation would not be irreversible. To avoid frequent movements back

and forth between groups, a time lag, say four years, should be provided between the achievement of the criteria and formal graduation. Eligibility for, or graduation from, ADF will normally be coterminous with the ADF replenishment exercise.

In implementing the proposed framework, the current IDA operational cutoff of $925 at 1997 prices has been adopted for determining ADF eligibility. Joint application of the per capita income and debt repayment capacity criteria yields the following changes in the degree of ADF eligibility of DMCs:

(i) **Graduation from ADF-only to ADF with limited OCR**:
Bangladesh, Cook Islands,[2] the Federated States of Micronesia (Micronesia), Pakistan[3], the Republic of Marshall Islands (Marshall Islands), Sri Lanka, Tonga, and Viet Nam, would graduate from ADF-only (Group A) to ADF with limited OCR (Group B1).

(ii) **Eligible for OCR with limited ADF**:
People's Republic of China (PRC) and India would be eligible for OCR with limited amounts of ADF (Group B2).[4]

(iii) **Watchlist for graduation from ADF**:
Indonesia, to be re-classified as Group B2, would be on a watchlist for graduation out of ADF.

(iv) **Graduation from ADF**:
Kazakhstan, Papua New Guinea, Philippines, and Uzbekistan would graduate from ADF-OCR blend to OCR-only. The proposed graduation from ADF for Papua New Guinea would take effect in a phased manner spread over two years. In the case of Kazakhstan, Philippines, and Uzbekistan, the phasing out of concessional assistance at the operational level has been completed. The above four countries together with Thailand (a DMC that ceased to have access to ADF in 1983 but has remained in Group B) will be graduated to Group C.

The proposed policy would also be extended downstream to allow graduation from regular Bank assistance. The criteria applied here would be (i) per capita GNP, (ii) extent of reliance on commercial sources of external financing, and (iii) stage of development of economic and social institutions. In regard to the per capita GNP threshold, the International Bank for Reconstruction and Development (IBRD) operational cutoff of $5,445 at 1997 prices is proposed to be adopted. On this basis, four DMCs, Hong Kong, China; the Republic of Korea[5]; Singapore; and Taipei,China would be formally graduated from regular Bank assistance. They would, however, be eligible for emergency assistance from the Bank. The broad features of the post-graduation relationship of DMCs with the Bank are outlined in this Paper.

There would be changes in the project cost-sharing limits for the following graduating DMCs: (i) for Bangladesh, Cook Islands, Marshall Islands, Micronesia, Pakistan, Sri Lanka,

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[2] Limited OCR eligibility will take effect only after the external debt position improves.
[3] Although currently a Group A country, Pakistan has been receiving OCR in addition to ADF.
[4] As mandated by the donors, PRC and India would not have access to ADF during the ADF VII period.
[5] The Republic of Korea has been provided emergency assistance by the Bank in the wake of the regional crisis.

Tonga, and Viet Nam, the limit will fall from 80 percent to 70 percent; (ii) for PRC and India, the limit will fall from 80 percent to 60 percent; (iii) for Papua New Guinea, Philippines, Thailand, and Uzbekistan, the limit will fall from 60 percent to 40 percent; and (iv) for Kazakhstan from 80 percent to 40 percent. It is proposed that the lower cost-sharing ceilings for the affected countries would be introduced in a phased manner, with a 5 percentage points reduction per year. Further, the provisions in the existing policy on project cost-sharing ceilings that, under exceptional circumstances and where justified on country and project grounds, Bank financing may exceed the country cost-sharing limit, will continue to apply.

Cost-sharing norms are being proposed for technical assistance (TA). It is proposed that government contribution to TAs should be at least 15 percent of the total TA costs for Group A, 20 percent for Groups B1 and B2, and 30 percent for Group C. However, such contribution will be subject to the limit of total TA costs minus foreign exchange costs and costs of domestic consultants.

Pending review of the policy for domestic preference in procurement of goods and civil works, the status quo will be maintained with regard to the current eligibility of individual DMCs under the domestic preference scheme.

I. THE CONTEXT

1. Since 1977, the Bank has had a three-tier classification system for determining the eligibility of its developing member countries (DMCs) for Asian Development Fund (ADF) funding and for applicable limits on Bank financing of project costs. Classification is determined at the time of entry. No borrowing country has been formally reclassified or graduated from one group to the next. Also, no DMC has formally graduated from Bank assistance, because the current policy does not envisage a stage beyond Group C. As part of the policy review commitments made during the ADF VII negotiations, the Bank is to submit proposals to the Board of Directors on a graduation policy for DMCs within one year of the effectivity of ADF VII.[1] Donors suggested that the proposed approach should preferably be comprehensive, extending graduation downstream, i.e., from ADF-only through "blend" status to ordinary capital resources (OCR)-only status and finally to graduation from regular Bank assistance. This Paper examines the issues relating to graduation and proposes an approach that would be consistent with the Bank's role as a broad-based development finance institution.

2. The term "graduation policy" relates to the changes in the terms, the level, and the type of development assistance provided by multilateral development banks (MDBs) to a member country as it moves up the development ladder. In the early stages of a country's development, when its debt repayment capacity is weak and its per capita income is low, external assistance is provided on concessional[2] or "subsidized" terms. When the country reaches more advanced stages of development, MDBs do not need to maintain such a high degree of concessionality. Indeed, to do so would be counter-productive as it would constrict the freeing up and redirection of concessional resources towards countries that have a greater need for such resources (within the limits of their absorptive capacity). Lowering the level of concessionality of assistance at more advanced stages of development could be preceded by a gradual scaling back of the level of concessional assistance provided and a shift towards nonconcessional assistance. Changes in the terms and scale of development assistance are also typically accompanied by increasing resort to the use of indirect instruments such as guarantees, and by a shift from public to private sector lending. Eventually, the country is graduated from development assistance.

3. MDBs, including the Bank, do not merely supply official assistance but also facilitate the transition of member countries to greater reliance on private flows. Member countries are grouped according to their levels of development to allow for differentiation in operational guidelines across country groups. Graduating member countries from one group to the next as their development advances, moves them through configurations of terms, scale, and type of assistance consistent with higher stages of development.[3] In this way, MDBs assist DMCs to progress from dependence on concessional assistance towards reliance on commercial capital resources, both external and domestic.

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[1] ADF VII became effective on 24 September 1997.

[2] Concessionality is measured in terms of the grant element of loans. This is the difference between the discounted present value of disbursements and the discounted present value of the future streams of interest payments and principal repayments, expressed as a percentage of the discounted present value of disbursements. The discount rate typically used is 10 percent. The grant element is larger, the lower the rate of interest, the longer the grace period, and the longer the maturity period. According to the Development Assistance Committee definition, loans with a grant element of 25 percent or more are concessional.

[3] MDBs also encourage private investment flows to developing countries through the provision of policy advice, the financing of physical and social infrastructure, direct operations that deal with the private sector or catalyze private flows, technical assistance, and the dissemination of information.

4. This Paper focuses on the process by which the Bank's DMCs can graduate from one group in the classification system to the next. Two related topics are dealt with in separate papers: the issue of ADF loan terms[4] and the allocation of ADF resources among countries with access to concessional resources.[5] While these topics involve a complex set of issues and merit separate treatment, it is important to recognize the connecting facets: graduating DMCs across country groupings in step with their improved economic circumstances (i) moves them from terms that are highly concessional to terms that gradually approach commercial rates, and (ii) scales back the volume, first of concessional, then of nonconcessional, resources, culminating in graduation from regular Bank assistance.

5. This policy Paper on graduation is being discussed at a time when several Southeast and East Asian countries have, after decades of exemplary economic performance, suffered an unexpected reversal in their economic circumstances. An important lesson for the Bank's graduation policy is the need to build into the policy framework adequate flexibility to accommodate changes in the DMCs' economic circumstances, both positive and negative.

6. The rest of the Paper is organized as follows: Section II discusses the existing Bank policies and practices on graduation. Section III examines the graduation policies of other MDBs. Section IV proposes a framework for rationalizing the Bank's graduation system. Section V discusses other operational implications of the proposed changes in the Bank's classification system. Section VI includes conclusions and Section VII the recommendation.

II. PRESENT BANK POLICIES AND PRACTICES

A. Policies

7. The Bank's Charter states that:

(i) in financing development of its DMCs, the Bank should have special regard for the needs of smaller and less developed countries;

(ii) due account should be taken of the borrower's capacity to service Bank loans; and

(iii) Bank funding should not preempt resources that would otherwise have been made available to the borrower on reasonable terms.

These guiding principles form the basis for using country criteria to determine the eligibility of DMCs for Bank assistance. The first principle requires indicators that capture the dimensions of country size and development. The second principle requires indicators that capture a country's debt-repayment capacity. The third principle requires that indicators be taken into account of alternative sources of financing, including (i) a country's access to international

[4] Donors have requested the Bank to review the terms of ADF lending and prepare a policy paper on the subject for Board consideration within one year of ADF VII becoming effective.

[5] Donors have urged the Bank to examine the possibility of introducing a more formal allocation system, strengthening its link to more rigorous performance evaluation based on measurable indicators.

capital markets and domestic resources, and (ii) the capacity of a sector/project within a country to attract capital on reasonable terms on a sustained basis.

1. Country Criteria for Bank Assistance

8. Consistent with the principle that Bank assistance should be based primarily on country criteria, the Bank has at present a three-tier country classification system, viz., Groups A, B, and C.[6] This three-tier classification allows for a differentiation among groups in regard to ADF eligibility. Group A DMCs are "fully eligible," Group B DMCs are eligible for "limited amounts in particular circumstances," and Group C DMCs are ineligible for ADF resources. The policy implies the progression (although no country has been formally reclassified or graduated since the adoption of the policy in 1977) of a DMC from Group A through Group B to Group C. The policy does not envisage a stage beyond Group C when a DMC would cease to be eligible for Bank assistance.

9. The basic rationale for providing concessional assistance to Groups A and B is their economic situation as reflected in two main criteria: per capita gross national product (GNP) and debt repayment capacity. The ADF Regulations state that the goal of ADF is "to enable the Bank more effectively to carry out its purpose and functions by providing resources on concessional terms for the economic and social development of the developing member countries of the Bank, having due regard to the economic situation of such countries and to the needs of the less developed members." The benefits of concessionality are meant to accrue to a member government[7] and, through its policies, to the economy as a whole. In fact, in its ADF operations, the Bank provides loans only to DMC governments.

10. The existing policy does not explicitly prohibit Group A DMC governments from borrowing from OCR beyond the amount available from ADF. At the same time, however, the policy does suggest that the possible adverse effects on capital markets of the Bank's lending from OCR to countries of low creditworthiness should be carefully considered. For this reason, and to minimize strain on their debt repayment capacities, OCR lending to Group A countries that have been identified as having low creditworthiness has normally[8] not been encouraged. They have therefore come to be characterized as "ADF-only" countries. Group B countries with ADF access[9] are characterized as "ADF-OCR blend" countries, while Group C countries are "OCR-only" countries.

11. In addition to ADF eligibility, the existing classification system has been used to differentiate between groups with regard to (i) loan terms,[10] (ii) scale of concessional assistance, (iii) sector coverage, and (iv) applicable limits for Bank financing of project costs. In regard to new loans, the most concessional terms are for the "ADF-only" countries. Assistance

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6 R67-78 25. *A Review of Arrangements for Lending from the Asian Development Fund (1978-1982),* 25 July 1978. The classification system also provides applicable cost-sharing limits for Bank financing and eligibility for the domestic preference scheme.

7 *Operations Manual*: Operational Procedures. Section 4.

8 The exception is Pakistan. People's Republic of China and India do not have access to ADF.

9 Thailand ceased to have ADF access in 1983 but remained classified as a Group B DMC.

10 For Groups A and B, standardized terms apply for ADF loans, with relatively harder terms for Group B DMCs compared with Group A. For Group B and Group C DMCs borrowing from OCR, a uniform interest rate is applied, but the maturity and grace periods are project-specific.

to ADF-OCR blend countries is less concessional than that for "ADF-only" countries due to (i) blending of concessional and nonconcessional assistance, and (ii) the “harder” ADF loan terms for blend DMCs. Assistance to the OCR-only countries is the least concessional.[11]

12. The classification system also signifies a scaling back in the volume of concessional assistance: compared with Group A, Group B DMCs have limited access to ADF and Group C DMCs no access at all. After a country's per capita GNP and debt repayment capacity improve sufficiently to warrant graduation from ADF-only to ADF-OCR blend, OCR resources are expected to increasingly replace concessional ADF funding. Eventually, the country would graduate from concessional funding altogether and become an OCR-only DMC.

13. Also associated with the classification system is a differentiation between Group A and Group B DMCs in terms of sector coverage. For Group A DMCs, there are no sector restrictions for ADF funding. For four Group B DMCs (Indonesia, Kazakhstan, Philippines, and Uzbekistan) during the ADF VI period, ADF funding has been restricted to a few specified sectors.[12]

14. The classification system has to strike a balance between (i) avoiding frequent movements of DMCs back and forth between categories, and (ii) having country groupings that are reasonably homogenous internally in terms of the main criteria (otherwise the purpose of the classification system would be defeated). Whether a balance is struck between these considerations depends on how the guidelines for applying the country criteria are framed.

2. Guidelines for Applying Country Criteria

15. Under the existing system, the two country criteria (per capita GNP and debt repayment capacity) are to be applied such that Group A includes countries with low per capita GNP and limited debt repayment capacity; Group B includes lower-middle income countries at intermediate levels of economic development and with increasing capacity to service their debt; and Group C includes upper-middle income and high-income countries with relatively high debt repayment capacity.

16. The present Bank policy allows considerable latitude in the application of the country criteria. In regard to the per capita GNP criterion, the approach is that rigid cutoff points should

[11] In regard to past ADF loans on which debt service is still due, Bank policy is that the terms of loans committed from ADF resources may be adjusted to reflect substantial changes in individual countries’ economic circumstances. Repayments of principal on an outstanding ADF loan to a particular country will be increased 100 percent of the originally scheduled amount if (i) the per capita GNP of the country has remained above the ADF eligibility benchmark for five consecutive years, and (ii) the country has achieved the capacity to repay debt on OCR terms.

[12] For Indonesia and the Philippines, ADF funding has been restricted to projects directed at poverty reduction, the primary social sector, and protection of the environment (R83-92. *Arrangements for Lending from ADF and TASF Operations Funded by ADF Contributions*, 28 May 1992). For Kazakhstan, limited ADF support on a blend basis has been allowed, particularly for projects with social orientation (R162-94. *Classification of New Members: Tuvalu, Kazakhstan, and the Kyrgyz Republic,* 14 September 1994.) For Uzbekistan, ADF funding has been provided for social sector projects (R180-96. *The Country Classification of Uzbekistan,* 29 August 1996).

not be used for classifying countries. This has allowed country groups to be characterized[13] in terms of certain per capita GNP limits that do not form a continuous scale (see Appendix 1). There is also an operational cutoff for ADF access, originally set at $300 (1972 prices) which when updated using the United States (US) gross domestic product (GDP) deflator[14] is $1,017 in 1997 prices.

17. For the debt repayment capacity criterion, Bank policy[15] is that this capacity is to be judged by the overall strength of an economy, indicated by factors such as its development performance and prospects, levels of saving and investment, ability to generate export earnings, levels of international reserves, outstanding external debt, and debt-servicing burden. The criterion has been applied in a qualitative way.

B. Practices

18. The structure and composition of the Bank's classification system is meant to reflect the relative levels of development of its DMCs and the dynamics of development in the region over time. In a sense, the country classification system is an evolving taxonomy of DMCs, reflecting changing development realities in the region.

19. The composition of DMCs under the various categories when the three-tier classification system was first set up in 1977[16] compared to the current situation shows that the system has remained essentially static, i.e., countries have remained in the groups to which they were originally assigned. The only change is that, from time to time, new members have been added to the list.

20. At the time it was originally conceived, the classification system reflected the differing levels of development in the region. For Group A and to a lesser extent Group B countries, most of the external financing came from official sources, both bilateral and multilateral. Foreign direct investment other than for the exploitation of natural resources was low. Commercial bank lending and portfolio investment were also low. Inward orientation and modest rates of export growth limited the capacity of these DMCs to generate foreign exchange earnings. Due to these and other factors, low levels of per capita GNP went hand-in-hand with low debt repayment capacity.[17] Since then, however, the region has seen fundamental economic changes. These changes are reflected in a shift in the interrelationship between per capita GNP and debt repayment capacities within and across country groupings.

21. A growing number of low- and lower-middle income DMCs no longer conform to the expected pattern of development finance.[18] Asian economies have heterogeneous economic

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13 R83-92. *Arrangements for Lending from ADF and TASF Operations Funded by ADF Contribution*, 28 May 1992.

14 From 1974 to 1993, the US GNP implicit deflator was used to update the operational cutoff. In 1994 (see R162-94. *Classification of New Members: Tuvalu, Kazakhstan, Kyrgyz Republic,* 14 September 1994) a switch was made to the US GDP deflator.

15 *Operations Manual:* Policies and Procedures. Section 1.

16 R83-77. *A Review of Criteria for Lending from Asian Development Fund,* 14 September 1977.

17 The only recognized exception to this pattern was Indonesia, which was characterized as having a low per capita income but with intermediate debt repayment capacity on account of its oil revenues.

18 See also *Development Cooperation: Efforts and Policies of the Members of the Development Assistance Committee (1996)*. This report discusses changing country profiles for development finance. It notes that "the

management records and growth performances. Yet the region as a whole shows changing trends in DMCs' creditworthiness, access to international capital markets, and sources of external financing. There are also changing trends in the capacity of DMCs to generate foreign exchange earnings and high rates of growth. The larger countries (People's Republic of China [PRC], India, Indonesia, Philippines, and Thailand) in the region have built up the capacity to service debt on non-concessional terms, including OCR terms. They have gained access to international capital markets[19] and have demonstrable capacity to attract foreign direct investment.

22. The current financial crisis in Southeast and East Asian economies has led some observers to take a pessimistic view of the region's prospects. In this vein, doubt has also been cast on the usefulness of a proposed policy that assumes that countries will make development progress over the medium term. In this connection, it is worth noting that the crisis has not engulfed the entire Asian region, but only some economies. Even for these economies, recent events cannot erase their past achievements in accumulating savings, promoting investment, and developing human capital. Moreover, in historical perspective, growth in the region has never been a linear progression. Rather, it has been characterized by episodic recessions and recovery. The historical record also suggests that financial crises by themselves do not irretrievably destroy the potential for long-term growth. Economies have recovered from contraction in output to regain their previous course over time. The crisis-affected Southeast and East Asian economies should, given the requisite commitment to financial sector reform and improved public and corporate governance, not only recover but emerge from the crisis stronger than before.

23. Returning to the longer term, Asia-wide perspective, the changing trends in the region make a strong case for redesigning the classification system to better meet the changing realities. The system should provide a formal framework in which countries graduate through a sequence of stages in Bank financing, culminating in graduation from regular Bank assistance. This would ensure that the classification system reflects the development progress of borrowing DMCs. Before discussing the proposed approach, the graduation policies of other MDBs will be outlined.

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relationships between domestic and external, and private and official, flows of development finance have begun to resolve themselves in very new ways among the range of developing countries.... Thus, it is time to move away from simple lists of "market financed" and "aid dependent" developing countries and work through the more diverse and dynamic combinations that are now taking shape."

19 Private capital inflows for some large DMCs, however, may still account for a modest share of their total investment needs, and they may continue to require nonconcessional development assistance to meet resource gaps for some time after they cease to depend on concessional assistance.

III. GRADUATION POLICIES OF OTHER MULTILATERAL DEVELOPMENT BANKS

A. World Bank Group

1. International Development Association (IDA)

24. IDA's policy is that concessional assistance, both in the form of resource transfer as well as technical assistance (TA), is designed to aid countries make the transition to International Bank for Reconstruction and Development (IBRD) lending and eventually to creditworthiness in international capital markets.

25. Graduation from IDA is based on per capita GNP and creditworthiness considerations. Until 1984, the per capita GNP benchmark for IDA eligibility was $250 at 1964 prices, adjusted annually for inflation. In 1984, a second informal benchmark was introduced in view of the increasing number of eligible borrowers and the limited resources available. The first explicit operational cutoff was $580 at 1987 prices, which when updated is $925 at 1997 prices. The original benchmark ($1,505 at 1997 prices) has been retained as a "historical" ceiling. The reason for not discarding the original benchmark is that the United Nations (UN) and other agencies use it to determine eligibility for other concessional assistance. Also, IBRD borrowers that are below the cutoff have access to loans on 20-year maturity terms.

26. Creditworthiness considerations have always guided IDA lending policies. IDA Articles of Agreement limit it from providing assistance if financing (i) is available from private sources on terms that are reasonable for the recipient, or (ii) could be provided by a loan of the type made by the IBRD. In some cases, countries with per capita incomes below the operational cutoff have not received IDA credits as they were creditworthy and were able to obtain substantial loans on nonconcessional terms, including loans from IBRD. The Philippines and Thailand obtained their last IDA credits in fiscal year (FY) 1979, and Indonesia[20] in FY 1980, despite having per capita incomes below the formal eligibility guidelines at that time.

27. Conversely, some countries that are above the operational cutoff have not been graduated from concessional funding. IDA recognizes two specific exceptions to the application of the operational cutoff, both based on the principle that a member of the World Bank group should not be left without access to either IDA or IBRD, provided its performance is adequate. The first is that under exceptional circumstances, temporary access to IDA may be extended to countries whose per capita income is above the operational cutoff, but whose creditworthiness for IBRD lending is limited. Such countries would be expected to be undertaking major adjustment efforts, designed at least in part to restore creditworthiness within a reasonable period of time. The second exception relates to the small island economies and is based on three considerations. First, these island economies share most of the problems of low income countries (export concentration, high cost of infrastructure, and limited skills and institutions). Second, they are vulnerable to natural disasters, are isolated, lack natural resources, and do not have access to commercial credit. Third, their average level of per capita income is often heavily skewed by large numbers of foreign residents with incomes that are considerably higher than the average. Eligibility for the small island exception is

[20] Recently, the World Bank has decided to make Indonesia again eligible for IDA. See IDA/SecM98-580, 6 November 1998.

decided by the IDA Board of Governors at the beginning of each IDA replenishment, based on the recommendations of management. Some of the small island economies are also classified as least developed countries by the United Nations. IDA charges LLDCs the same terms for IDA credits as other IDA-only countries.[21]

28. Graduation from IDA is usually not a sudden process. Transition to IBRD lending usually takes place well before countries reach the IDA eligibility limit through a blending of IBRD and IDA resources.

2. International Bank for Reconstruction and Development (IBRD)

29. According to IBRD policy, graduation reflects the achievements of a country in reaching a certain level of development, management capacity, and access to capital markets. The policy also states that graduation from IBRD borrowing does not imply that the development process is complete. Rather, it implies that the special financial and technical support that IBRD provides to a graduating country is no longer justified in view of the demand from other members on limited IBRD financial and staff resources. Further, because graduation is the culmination of a process extending over many years, it is neither abrupt nor unpredictable. IBRD countries progress through a sequence of increasingly harder terms (i.e., shorter maturity and grace periods) before they finally graduate from IBRD assistance. The per capita GNP limits are $1,505 or less for 20-year IBRD terms; $1,506-$3,125 for 17-year IBRD terms, and $3,126 or more for 15-year IBRD terms.

30. When a country reaches a GNP per capita benchmark ($5,445 at 1997 prices), IBRD analyzes its readiness for graduation. The analysis focuses on (i) determining whether the country has access to external capital markets on reasonable terms, and (ii) the progress the country has made in establishing economic and social institutions. Recognizing that countries reaching the graduation threshold may differ in the extent of their progress towards developing key institutions for economic and social development, IBRD takes a flexible approach to determining the pace of graduation. Graduation from new IBRD lending normally occurs within five years after a country crosses the graduation benchmark, with variations according to country-specific conditions.

31. In regard to the procedure for graduating countries, until 1984, if a country had reached the GNP per capita benchmark, the World Bank management sent a graduation paper to its board for formal approval. Since 1984, the board is simply informed of the graduation when the last loan is extended to the country. Over the past ten years, five countries[22] have graduated from IBRD. Following graduation, IBRD is prepared to provide TA on a reimbursable basis. Graduates from IBRD continue to be eligible for International Finance Corporation (IFC) operations for several years.

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[21] World Bank Operational Manual. 3.10.

[22] World Bank policy does not prohibit the resumption of lending to a country whose economic conditions have retrogressed. The Republic of Korea graduated out of IBRD in 1995. However, in the wake of the recent financial crisis the World Bank has provided conditional support to the country. Other graduated IBRD borrowers that have become re-eligible for IBRD financing are Gabon and Venezuela.

B. Inter-American Development Bank (IaDB)

32. IaDB has a four-tier (Groups A, B, C, and D) country classification system to determine eligibility of its members for assistance from its three sources: The Fund for Special Operations (FSO); the Intermediate Financing Facility (IFF); and Ordinary Capital (OC). Resources from FSO, IaDB's soft loan window, are distributed among the poorest, least developed borrowing countries. These are classified as Group D countries and are typically the IDA-only countries of the region. A country that uses FSO may also be eligible for OC resources. IaDB management makes decisions regarding country creditworthiness and the prudence of extending OC lending to FSO-eligible countries on a case-by-case basis. Further, countries in Groups C and D are eligible to borrow from IFF, IaDB's "Third Window." In allocating IFF resources, priority is given to countries that are not eligible for FSO. Groups A and B are eligible only for OC borrowing. While IaDB has an informal process of assessing the needs of its member countries for assistance, it does not have a formal graduation policy.

C. African Development Bank (AfDB)

33. AfDB has a three-tier classification system[23] to determine the eligibility of its member countries to borrow from the African Development Fund, its concessional window. The classification is based on the World Bank's classification system. Thus, AfDB's 39 Category A countries are those deemed lacking creditworthiness for nonconcessional financing by the World Bank (i.e., IDA-only countries); the 3 Category B countries are deemed creditworthy for blend financing by the World Bank; and the 11 Category C countries are IBRD-only countries. In Category B, AfDB reserves concessional resources for activities targeted at poverty reduction.

D. European Bank for Reconstruction and Development (EBRD)

34. EBRD provides loans on nonconcessional terms only. The EBRD board has recently approved a policy on graduation of its countries of operation. This policy is based on EBRD's charter mandate of advancing transition towards market-oriented economies. The EBRD concept of graduation rests on three principles: (i) transition impact, (ii) additionality, and (iii) sound banking. Transition impact is defined as the effect of a project on the economy or society, in particular on the transition process itself. Additionality is defined as the effect of EBRD on the project. The sound banking principle requires assurance that EBRD's investment is secure. These principles are used toward phased graduation across market segments within a country. As a country advances, it will have fewer and fewer segments in which the principles of transition and additionality are met. Eventually, the country will graduate from EBRD operations entirely. None of EBRD's countries of operation are expected to graduate in this sense within the next few years.

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[23] *Draft Report on the Consultative Meetings on the Seventh General Replenishment of the Resources of the African Development Fund,* May 1996.

IV. RATIONALIZING THE BANK'S CLASSIFICATION AND GRADUATION SYSTEM

35. The discussions in Sections II and III provide the background against which an approach can be developed for rationalizing the system for determining eligibility for and graduation from concessional and nonconcessional regular Bank assistance. The proposed approach is not to attempt to create an entirely new structure but rather to redesign the existing policy framework to provide a platform for the graduation process. The document *ADF VII: Report of Donors*[24] envisages graduation from (i) ADF-only to ADF-OCR blend, (ii) ADF-OCR blend to OCR-only, and finally (iii) OCR-only to cessation of regular assistance from the Bank. This approach encompasses the entire graduation spectrum rather than narrowly focusing on graduation either from ADF or OCR. The approach proposed in this Paper is dealt within two parts: Part A relates to the process of graduation from ADF and Part B relates to the process of graduation from regular Bank assistance.

A. Graduation From ADF

1. Criteria

36. The issue of graduation from ADF is closely tied to eligibility for ADF. When a country grouped under a given degree of ADF eligibility based on certain criteria develops to the point where it achieves and retains for an adequate length of time the criteria for the next level, it graduates to that level.

37. The criteria that determine the eligibility for and graduation from ADF should be based on the rationale for concessional financing. Many developing countries lack capital, both physical and human. Critical bottlenecks to solving this problem are low domestic saving and investment rates. The poor state of infrastructure, low absorptive capacity, and low creditworthiness typical of these countries has resulted in their being denied access to international capital markets. The resulting low growth rates and stagnant incomes complete a vicious cycle of low savings and low growth. Concessional finance helps such countries break out of this cycle by augmenting resources for investment available to them without straining their debt repayment capacities. Also, such funding helps finance the infrastructure and human resource and institutional development that will increase absorptive capacity and attract commercial funding in later stages of development. From the donors' side, budgetary and other domestic considerations have constrained their contribution to concessional funds and this in turn has meant these funds have had to be carefully targeted to realize the greatest benefits. Concessional assistance is most needed and effective in countries that have weak debt repayment capacity, low domestic saving, and low income, and becomes progressively less needed as debt repayment capacity improves and incomes increase.

38. The foregoing arguments provide the context for formulating criteria that determine eligibility for and graduation from ADF while reinforcing the original rationale for concessional funding, i.e., a country's general economic situation. In developing eligibility and graduation

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[24] R15-97. *Sixth Replenishment of the Asian Development Fund*, 18 February 1997.

criteria, a useful starting point is the following recommendation in the *Report of Donors:* "the first and foremost criteria determining ADF access shall be country criteria, i.e., small- and medium-sized countries with low per capita income but without access to external resources and lacking the capacity to repay loans." At the same time, the *Report of Donors* states that project criteria could be a secondary consideration, supplementing country criteria in determining access to ADF. The identified criteria and their interlinkages are examined below.

a. Current Country Criteria: Income and Debt Repayment Capacity

39. The *Report of Donors* reiterated the importance of the two current criteria for ADF eligibility: income as measured by per capita GNP and debt repayment capacity. Donors direct their aid to low income countries on equity considerations. There is also an economic rationale for the income criterion. Development assistance could be viewed as an attempt to maximize the utility of world income by redistributing it from richer to poorer countries. The utility gain accruing to the poor from an additional unit of income is much greater in value than the utility loss suffered by the rich from forgoing it. The impact of income transfer will be greater, the poorer the recipient country and the more concessional the terms of the transfer.

40. A country's overall debt repayment capacity remains an important consideration for determining the extent of its need for concesssional funding. The basic rationale for providing concessional assistance is the economic situation of DMCs and the needs of less developed members. Per capita GNP by itself is insufficient to assess the economic situation of DMCs. It has to be used in conjunction with another measure that reflects those aspects of the economic situation of a country not captured by per capita GNP, including access to international capital markets, saving rate, etc. Debt repayment capacity defined[25] in the broad sense is such a measure.

b. Additional Country Criteria: Country Size and Access to External Resources

41. In addition to the current country criteria, donors have suggested country size and access to external resources, both of which have a bearing on a country's debt repayment capacity and can be subsumed under it. Country size[26] and location (isolated/landlocked) are relevant considerations for ADF eligibility to the extent that these factors affect the general economic circumstances of a country and hence its debt repayment capacity. Broadly speaking, the larger the country, the wider its economic base and consequently the more robust its long-term debt repayment capacity; conversely, the smaller and more isolated the country, the more adverse are its economic circumstances, including vulnerability to shocks, high costs of infrastructure, etc. The small island Pacific DMCs (PDMCs) fit this description.

42. Access to international capital markets serves as an indicator of debt repayment capacity for OCR loans. A DMC rated as "Investment Grade" by commercial rating agencies may have alternative sources for sovereign borrowing. The economic fundamentals that are taken into account in commercial creditors' assessments of country creditworthiness are the same considerations for determining capacity to service debt on OCR terms. In fact, the

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[25] *Operations Manual.* Section 1. Bank Policies.
[26] Country size could be measured along several dimensions: level of GDP, land area, population, etc.

commercial creditors impose tighter constraints than the Bank, as the Bank's preferred creditor status allows it to lend into environments considered risky by private creditors.

c. Project Criteria

43. The basic premise of the country classification system and the notion of graduation of DMCs is that country criteria rather than project criteria are the primary consideration for determining the source of funding. Some of the reasons why this principle makes economic sense and safeguards the interests of the DMCs and the Bank are discussed below. At the same time, when the supply of concessional resources is constrained, the Bank's poorer and less developed DMCs could be denied needed access to funding if the Bank adhered strictly to the country criteria principle. Thus, the possibility of allowing exceptions that are consistent with the Bank's developmental objective of boosting the overall debt repayment capacities of such countries will be examined.

i. Implications of Using Project Criteria as the Primary Consideration

44. If project considerations rather than country considerations were used as the primary criterion, then all DMCs would have to borrow on OCR terms for certain types of projects. As a result, over time, the outstanding nonconcessional loan balances of countries with weak debt repayment capacities would accumulate and they could experience repayment difficulties. Also, OCR exposure to DMCs with weak debt repayment capacity could have implications for the Bank's OCR portfolio risk. Further, if project considerations are accorded primacy in determining ADF access, then high income DMCs with strong debt repayment capacities would have the same degree of entitlement to ADF resources (provided they meet the specified project criteria for ADF access) as poorer countries with weaker debt repayment capacities. This does not appear justified on equity and effectiveness considerations. Thus, to avoid strain on the balance of payments of DMCs with weak debt repayment capacities, to avoid impairment of the Bank's OCR portfolio, and to reflect equity and effectiveness concerns, project criteria should not be the primary consideration for ADF access.

ii. Project Criteria as a Secondary Consideration

45. The next issue is how project criteria can be used as a secondary consideration for ADF access. For DMCs categorized as blend countries, project criteria can be used as a secondary consideration for determining the appropriate funding source. This is essentially what the *Report of Donors* had envisaged when suggesting that the revenue-generating capacity of a project be used as a criterion for phasing out certain activities from ADF funding ahead of others. The following considerations are relevant in this regard. First, is the issue of criteria for distinguishing between revenue- and nonrevenue-generating projects. Any project that has at least some cost recovery could be considered as revenue generating. Adopting this definition would, however, mean that very few projects (other than projects involving pure public goods) would qualify for concessional funding. If a minimum level of financial internal rate of return (FIRR) is required for a project to qualify as revenue generating, then there would be the problem of choosing an appropriate FIRR, and for this there is no clear-cut answer.[27]

[27] The Bank no longer has a cutoff point for FIRR. The conventional proposal of using the weighted average cost

Second, unlike foreign exchange-earning projects, projects that generate revenue in domestic currency are not necessarily self servicing, at least not in regard to servicing foreign-currency denominated debt. Third, sector heterogeneity makes it difficult to characterize entire sectors/market segments as revenue-generating and others as not. Even in the social infrastructure and environmental improvement sectors, there could be some projects where cost recovery is warranted. Fourth, given that money is fungible, a debt can be discharged with any money, not merely money generated by a particular project, provided a country has the requisite overall debt repayment capacity. Fifth, making funding decisions on the basis of the revenue-generating potential of a project could have an adverse impact on incentives for cost recovery, i.e., if low cost recovery is the basis for providing concessional funding, there is a built-in incentive to go in for suboptimal levels of cost recovery. Sixth, depending on the project pipeline to a country, a situation could arise that in a particular year or for several consecutive years, there could be no projects that qualify for concessional assistance using the revenue-generation criteria. In such cases, even though the country is eligible for ADF, it is not able to benefit from it. For these reasons, using the criteria of revenue generation to determine which projects in blend countries are to be funded out of ADF and which out of OCR is not problem-free.

46. Notwithstanding the foregoing concerns, some benefit could result if, in blend DMCs, on a case-by-case basis, projects clearly identifiable as revenue-earning could be funded out of OCR. This would provide a simple decision rule for applying OCR in blend DMCs with increasing access to OCR. However, the determination of the revenue-earning potential of projects should not be based merely on sectoral classification but on a confirmation of the revenue generation capacity of the projects through the Bank's due diligence process.

iii. Foreign Exchange Earning Projects in DMCs with Weak Debt Repayment Capacities

47. It has been suggested that, when a project has the capacity to generate high levels of foreign exchange and is profitable, then it should be funded out of OCR, even in countries considered to have weak debt repayment capacity. The merit of this argument is that such projects not only generate foreign exchange for servicing foreign debt but also earn foreign exchange over and above the debt service requirement, thereby contributing to strengthening a country's debt repayment capacity. Accordingly, exceptions will be allowed to the ADF-only norm for Group A countries to allow OCR lending on a case-by-case basis for revenue-earning projects that generate net foreign exchange over and above the foreign debt service requirement and also meet other lending criteria of the Bank. This exceptional access will also apply to the Bank's guarantee facility when used in conjunction with government counterguarantee. Even in such exceptional cases, prudence will need to be exercised in the amount of OCR lending, as the DMCs involved are those having weak debt repayment capacities overall.

iv. Financing Subregional Projects in Countries with Weak Debt Repayment Capacity

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of capital is project-specific, and even then requires choices about inputing returns to financial capital contributions by the government.

48. In considering the financing options for subregional projects, it has been suggested that for subregional infrastructure projects, OCR terms could be charged even for countries considered to have weak debt repayment capacity. In this connection, it is noted that in principle, it should make no difference whether a project is national or subregional in determining the source of funding: both types of projects should be financed out of concessional resources for countries with weak debt repayment capacity. However, subregional projects that fall under the exception made in the preceding subsection, i.e., profitable projects that generate adequate foreign exchange, could be considered for OCR funding in countries with weak debt repayment capacity.

2. Guidelines for Applying the Criteria

49. The foregoing discussion shows that the criteria relating to country size and access to international capital markets can be subsumed under the debt repayment criterion. Project considerations could apply on an exceptional basis for ADF-only countries with weak debt repayment capacity and as a secondary criterion for blend countries. This leaves two main country criteria for ADF eligibility: (i) per capita GNP, and (ii) debt repayment capacity. The proposed guidelines for applying these two criteria are discussed below.

a. Per Capita GNP

50. Current guidelines on per capita GNP thresholds (para. 16) could be rationalized. The following considerations merit consideration in revising the guidelines.

(i) During the ADF VII negotiations, donors raised the issue of harmonizing ADF eligibility criteria with those of IDA. The IDA per capita GNP operational cutoff is updated each year using the international inflation rate as measured by the Special Drawing Rights (SDR) deflator in US dollar terms. To obtain per capita GNP estimates for individual countries, a three-year moving average of the official exchange rate is used, adjusting for differences in relative inflation between the country and the international inflation rate.[28] Against the background of the recent currency crisis, there have been suggestions that the use of per capita GNP estimates based on official exchange rates are unstable and, therefore, national income figures based on purchasing power parity (PPP) should be used. The PPP methodology is, however, not problem-free. The most important of its problems relates to consistency over time of PPP data and dependency of PPP-based rankings on methodological choices, including the choice of the base year and the process of aggregation. Further, PPP data are based on price surveys that use 1993 as the reference year. Annual updating of

[28] *Per Capita Income*. SecM94-661. International Bank for Reconstruction and Development, June 28, 1994.

estimates would be difficult unless extrapolation is used. Finally, PPP-based estimates are not available for all the countries.[29]

(ii) There have also been suggestions that per capita GDP rather than per capita GNP is a better measure of a country's income-generation capability. The difference between GDP and GNP is the net factor income from abroad. In this connection, net factor incomes truly constitute resources available to residents of the countries under consideration, or resources taken away from them. As such, operational decisions should continue to be based on per capita GNP rather than per capita GDP.

For the above reasons, the World Bank's IDA operational cutoff and its per capita GNP estimates for DMCs based on the *Atlas* method are the most practical indicators available. The Bank's existing operational cutoff of $1,017 at 1997 prices would cease to apply and would be replaced by the IDA operational cutoff (currently $925 at 1997 prices). The operational cutoff would be updated annually when IDA updates its per capita GNP operational cutoff.[30]

b. Debt Repayment Capacity

51. In establishing guidelines for applying the debt repayment capacity criterion, it is necessary to distinguish between debt repayment capacity for OCR loans and creditworthiness for commercial loans. For graduation from ADF, debt repayment capacity for OCR loans is of primary relevance; for graduation from regular Bank assistance, creditworthiness for commercial borrowing is the key consideration.

52. Unlike the income criterion, debt repayment capacity cannot be captured in a single indicator such as the debt service ratio. Historically, situations involving debt-service ratios that were quite high have been successfully managed, and many countries have been in severe servicing difficulties with low ratios.[31] To overcome these and other problems inherent in a single debt indicator, multidimensional evaluation procedures must be developed, combining

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[29] The World Bank *Atlas* reports PPP-based per capita GNP estimates for selected countries that are based on calculations from earlier PPPs and extrapolated to the reported year or are based on regression estimates. The *Atlas* does not report PPP-based per capita GNP for the following countries: Afghanistan, Cambodia, Cook Islands, Kiribati, Lao People's Democratic Republic, Marshall Islands, Micronesia, Mongolia, Myanmar, Nauru, Tonga, Tuvalu, and Viet Nam. For Samoa, Solomon Islands, and Vanuatu, the reported figures are based on regression estimates.

[30] The Bank has a provision in its ADF loan agreements that it may, by notice to the borrower, accelerate repayments on past ADF loans to DMCs that have remained above the ADF eligibility cutoff mark for five consecutive years and that have achieved the capacity to repay debt on OCR terms (para. 11). The per capita GNP figure to be cited in future loan agreements should be made consistent with the applicable ADF eligibility cutoff.

[31] Donogh C. McDonald. 1982. *Debt Capacity and Developing Country Borrowing: A Survey of the Literature.* Staff Papers, Vol. 28, No. 4, International Monetary Fund.

quantitative and qualitative assessments.[32] It is emphasized that it is the debt repayment capacity over the medium-term that is sought to be captured in such assessments.

i. Quantitative Component

53. For the quantitative component of debt repayment capacity, the following indicators will be used:

(i) debt sustainability ratio,
(ii) share of private capital inflows in total capital inflows,
(iii) gross domestic savings rate, and
(iv) size of economy.

See Appendix 2 for a technical description of the methodology.

ii. Qualitative Component

54. The quantitative assessment may fail to capture a number of qualitative considerations that are relevant for assessing debt repayment capacity. Also, comparable quantitative data may not be available on each indicator for all the countries. Therefore, a supplementary assessment is needed that takes into account the following categorical variables (for details see Appendix 2):

(i) categorization as a heavily indebted poor country (HIPC),
(ii) vulnerability to fluctuations in export growth,
(iii) main external financing source,[33]
(iv) degree of access to IDA[34] resources, and
(v) whether rated by Moody's or Standard & Poor's for sovereign borrowing.

Overall assessment of debt repayment capacity will be made taking into account both quantitative scores and qualitative assessments.

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[32] It is important to distinguish between assessment of debt repayment capacity for determining ADF access, on the one hand, and country risk assessment on the other. The former covers all borrowing countries including those that borrow on concessional terms. Assessment of debt repayment capacity is also based on historical data, because the use of projections is subject to prediction error. Country risk assessment on the other hand is restricted to nonconcessional borrowers as its focus is the credit risk to the Bank. Moreover, country risk assessment is based on macroeconomic projections and the associated downside risks over the medium/long term.

[33] *World Economic Outlook May 1998.*

[34] If a country is considered creditworthy enough to be an IBRD borrower, this is one indication that it also has debt repayment capacity for loans on OCR terms.

c. Decision Matrix

55. A weakness in the existing system has been the procedure by which the per capita GNP criterion and the debt repayment capacity criterion should jointly determine access to concessional assistance. The basic premise of the existing system has been that a DMC with low per capita GNP would also have low debt repayment capacity. As a country's income reaches the range for middle income countries, so too would its debt repayment capacity. However, the system needs to have a mechanism for dealing with departures from this symmetry. Such departures occur when a DMC with a low level of per capita GNP has the capacity to service debt on nonconcessional terms, including OCR terms. Conversely, a country with a relatively high level of per capita GNP could have a low debt servicing capacity for OCR loans. As noted in para. 21, country profiles for development finance are changing, particularly in the Bank's region. A systematic approach to country criteria is, therefore, necessary to deal with emerging patterns. The proposed approach is to apply the country criteria in a two-stage process.

(i) In the first stage, the operational cutoff for per capita GNP would be applied to divide DMCs into two categories: those below and those above the latest available IDA per capita GNP cutoff.

(ii) In the second stage, within each income category (i.e., below and above cutoff), DMCs would be further differentiated on the basis of debt repayment capacity. Three levels of differentiation among DMCs' debt repayment capacities for OCR loans are proposed: (a) weak, (b) limited, and (c) adequate.

56. The categories that would result from the application of the criteria as proposed above and their eligibility for/access to ADF are shown in the decision matrix in Table 1.

Table 1: Proposed Decision Matrix for ADF Eligibility

Debt Repayment Capacity	Proposed Per Capita GNP Cutoff			
	Below Per Capita GNP Cutoff		Above Per Capita GNP Cutoff	
	LLDC	Other	LLDC	Other
Weak	ADF-only (A)	ADF-only (A)	ADF-only (A)	ADF with limited OCR (B1)
Limited	ADF with limited OCR (B1)	ADF with limited OCR (B1)	ADF with limited OCR (B1)	OCR with limited ADF (B2)
Adequate	OCR with limited ADF (B2)	OCR with limited ADF (B2)	OCR with limited ADF (B2)	OCR-only (C)

57. The matrix provides a framework for determining a DMC's degree and priority of access to ADF based on the joint application of the two country criteria.

(i) DMCs below the per capita GNP cutoff would be eligible for ADF (whether or not classified as LLDCs). However, their degree of ADF eligibility would be circumscribed by their debt repayment capacity. (a) DMCs with weak debt repayment capacity would be eligible for ADF-only. However, in the exceptional circumstances described in para. 47, OCR funding could be considered. (b) DMCs with limited debt repayment capacity would be eligible for ADF with limited amounts of OCR. Non-concessional lending for this group would preferably be for financing revenue-generating projects but the criterion should be applied on a case-by-case basis (para. 46). (c) DMCs with adequate debt repayment capacity would be eligible for OCR with limited amounts of ADF. For this category of countries, the primary consideration for limited ADF eligibility is relative poverty. The *Report of Donors* recognizes the strong case for concessional assistance to low-income Asian countries on grounds of equity (because of the magnitude and intensity of poverty) as well as efficiency. Concentrating aid on low-income countries does not guarantee that the funds will be used to reduce poverty but it does make such a focus more likely as noted in a World Bank document.[35] To the extent, however, that a few of these low-income countries have the capacity for servicing OCR loans, their access to ADF should be limited. OCR funding would be provided for revenue-earning projects.

(ii) DMCs that are above the per capita GNP cutoff but are classified as LLDCs would also be eligible for ADF but as with DMCs in (i), their degree of eligibility will fall successively from ADF-only through ADF with limited OCR to OCR with

[35] World Bank. *Global Development Finance 1998.*

limited ADF, corresponding to the progressive levels of debt repayment capacity.

(iii) DMCs that are above the cutoff and are not classified as LLDCs would be eligible for ADF with limited amounts of OCR if they have weak debt repayment capacity, OCR with limited ADF if they have limited debt repayment capacities, and OCR-only if they have adequate debt repayment capacities. On equity considerations, such DMCs should not have the same degree of ADF eligibility as DMCs below the per capita GNP cutoff or LLDCs.

58. Graduation from one level of ADF access to the next would be triggered under the following conditions:

(i) for both LLDCs and non-LLDCs (other), when debt repayment capacity improves from weak to limited, or from limited to adequate;

(ii) for LLDCs, when they graduate from the LLDC classification and are also above the per capita GNP cutoff; and

(iii) for non-LLDCs (other) below the per capita GNP cutoff, when they cross the per capita GNP threshold.

In the event of a combination of (i) and (ii), or (i) and (iii), the graduation would take place over two levels (for example, from Group A to Group B2 or Group B1 to Group C). Movement through the decision matrix can be bi-directional, i.e., graduation would not be irreversible. To avoid frequent movements back and forth between groups, a time lag, say four years, should be provided between the achievement of the criteria and formal graduation. Formal reclassification of a DMC to a lower category would generally require that the deterioration in its economic circumstances is not a transitory phenomenon; in the meantime, the Bank would have the operational flexibility to provide appropriate assistance to the DMC. Eligibility for, or graduation from, ADF will normally be coterminous with the ADF replenishment exercise.

59. To sum up, application of the proposed levels of differentiation in the per capita GNP and debt servicing criteria yield the following degrees of ADF access: (i) ADF-only (Group A); (ii) ADF with limited amounts of OCR (Group B1); (iii) OCR with limited amounts of ADF (Group B2); and (iv) OCR-only (Group C). Within the blend category, two levels of ADF access, viz., ADF with limited OCR and OCR with limited ADF, are proposed. The rationale is that the countries that are at the lower end of the per capita GNP and debt repayment capacity spectra will have access to predominantly ADF with limited amounts of OCR, with the amount of OCR lending circumscribed by considerations of the country's debt repayment capacity and the Bank's risk exposure. At more advanced stages of increased OCR access, the funding mix will be reversed, with limited amounts of ADF, based on resource availability, after the needs of DMCs with higher priority for ADF access have been met. This would ensure that the Bank's portfolio risk remains within acceptable limits.

60. The decision matrix (Table 1, para. 56) provides the foundation for the proposed Bank policy for classifying and graduating DMCs. The matrix is underpinned by the identification of a core set of indicators that can be used to place DMCs in the appropriate categories. The

values of these indicators for the DMCs and thresholds would have to be updated whenever a review is undertaken, and as a result the composition of DMCs in the various cells might change. However, the principles for reclassification and graduation captured in the structure of the decision matrix would continue to apply. This point is emphasized because the current crisis could understandably weigh so heavily on stakeholders' perceptions that the distinction could be blurred between (i) the criteria and the structure of the decision matrix; and (ii) the application of the criteria at different points in time to match changing economic circumstances of DMCs (and consequently their location in the decision matrix).

3. Application of Guidelines to Current Data on DMCs

61. Fitting the guidelines proposed above to current data implies the following:

(i) **Per Capita GNP**
In para. 50, it was recommended that the IDA operational cutoff (currently $925 at 1997 prices) and per capita GNP estimates based on the *Atlas* methodology be adopted as one of the country criteria for determining ADF access. Applying this cutoff, 17 DMCs fall below this cutoff, while the other 17 DMCs are above it.

(ii) **Debt Repayment Capacity**
The debt repayment capacity of borrowing DMCs assessed using the latest available data that is comparable across countries shows (a) 19 DMCs including nine PDMCs as having weak debt repayment capacity; (b) six DMCs as having limited debt repayment capacity; and (c) nine DMCs as having adequate debt repayment capacity.

On the basis of the proposed per capita GNP cutoff and the assessment of debt repayment capacities, DMCs may be reclassified as in Table 2.

Table 2: Proposed ADF Eligibility of DMCs as per Decision Matrix[a]

Debt Repayment Capacity	Proposed Per Capita GNP Cutoff ($925 in 1997 prices)			
	Below Per Capita GNP Cutoff		Above Per Capita GNP Cutoff	
	LLDC[b]	Other	LLDC	Other
Weak	ADF-only **(A)** Afghanistan, Bhutan, Cambodia, Kiribati, Lao PDR, Myanmar, Nepal, Solomon Islands	ADF-only **(A)** Kyrgyz Republic, Mongolia, Tajikistan	ADF-only **(A)** Maldives, Samoa, Tuvalu, Vanuatu	ADF with limited OCR **(B1)** Cook Islands,[c] Marshall Islands, Micronesia, Tonga
Limited	ADF with limited OCR **(B1)** Bangladesh	ADF with limited OCR **(B1)** Pakistan, Sri Lanka, Viet Nam	ADF with limited OCR **(B1)** **-**	OCR with limited ADF **(B2)** Nauru, Indonesia[d]
Adequate	OCR with limited ADF **(B2)** -	OCR with limited ADF **(B2)** India,[e] People's Republic of China[e]	OCR with limited ADF **(B2)** -	OCR-only **(C)** Fiji, Kazakhstan, Papua New Guinea, Philippines, Malaysia, Thailand, Uzbekistan

[a] Some of the cells in Table 2 are "empty" because current borrowing DMCs do not fit the specific characteristics of a particular cell. This could change as new members are classified and existing DMCs graduate to the next level.

[b] The following DMCs are classified as LLDCs: Afghanistan, Bangladesh, Bhutan, Cambodia, Kiribati, Lao PDR, Maldives, Myanmar, Nepal, Samoa, Solomon Islands, Tuvalu, and Vanuatu. *Least Developed Countries*. 1997 Report. United Nations Conference on Trade and Development.

[c] Limited OCR eligibility will take effect only after the country's external debt position has improved**.**

[d] Assessed as having adequate debt repayment capacity over the medium term but due to fragile social and political situation over the short term, placed on "watchlist" for graduation out of ADF.

[e] No ADF access during the ADF VII period as mandated by donors.

4. Implications for DMCs

62. The implications of the proposed system for graduation of DMCs from their current state of ADF eligibility may be summarized as follows:

(i) Bangladesh, Cook Islands, Marshall Islands, Micronesia, Sri Lanka, Tonga, and Viet Nam will move from the ADF-only group to the ADF with limited OCR group. Pakistan is currently a *de facto* blend country.

(a) Bangladesh is below the per capita GNP cutoff and, on the basis of the selected indicators, has limited debt repayment capacity. It is an IDA-only borrower of the World Bank. On balance, it is considered appropriate to give Bangladesh eligibility for ADF with limited amounts of OCR.

(b) Cook Islands is above the per capita GNP cutoff. It is not a member of the World Bank. Although Cook Islands has a weak debt repayment capacity, it is not an LLDC. It is therefore proposed to categorize Cook Islands' eligibility status as ADF with limited OCR. However, in view of its recent debt rescheduling, the limited OCR eligibility will be applied only after the debt position improves.

(c) Marshall Islands, Micronesia, and Tonga, are above the per capita GNP cutoff.[36] These countries have weak debt repayment capacities, but they are not LLDCs. Marshall Islands and Micronesia are IBRD-only borrowers of the World Bank while Tonga is an IDA-only borrower. It is proposed to categorize their eligibility as ADF with limited OCR.

(d) Pakistan is below the per capita GNP cutoff and has limited debt repayment capacity. As such, it will continue to have access to ADF with limited amounts of OCR. Pakistan will now be formally recognized as a blend country on account of its capacity to service a limited amount of OCR loans.[37] This is consistent with Pakistan's access to both IDA and IBRD resources of the World Bank Group.

(e) Sri Lanka is below the per capita GNP cutoff and has limited debt repayment capacity. The ongoing civil strife in the country has adverse implications for its debt repayment capacity and Sri Lanka is an IDA-only borrower of the World Bank. However, on the basis of quantitative and qualitative assessments of debt repayment capacity based on the

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[36] The relatively high per capita GNP levels of Marshall Islands and Micronesia reflect the sizeable inflow of Compact Funds. When this inflow ceases in the year 2000, there could be a sharp fall in the per capita GNP levels of these two DMCs. The position in this regard will be carefully monitored.

[37] The allocation of ADF and limited OCR to Pakistan is on the grounds that it has *limited* debt repayment capacity. The previous justification that it should have access to OCR because its ADF allocation is insufficient to meet its investment needs is replaced by the current criteria which give due consideration to the debt repayment capacity.

available information, it is considered appropriate to give Sri Lanka access to ADF with limited amounts of OCR.

(f) Viet Nam is below the per capita GNP cutoff and has limited debt repayment capacity. Viet Nam is an IDA-only borrower and has been classified as a severely indebted country by the World Bank. However, its debt burden has been assessed as sustainable over the long term. The regional crisis is likely to dampen Viet Nam's growth prospects. Nevertheless, the country is still expected to grow at around 5-6 percent over the next two years. As such, it will have access to ADF with limited amounts of OCR.

(ii) PRC and India are below the cutoff but have adequate debt repayment capacity. The proposed approach as per the decision matrix would have allowed these countries limited eligibility for ADF resources. However, the *Report of Donors* states that it would not be possible to make ADF resources available to PRC and India during the ADF VII period. Both PRC and India are IDA-IBRD blend borrowers.

(iii) Papua New Guinea and the Philippines (both blend DMCs under the existing system) will graduate from ADF.

(a) In terms of the relevant indicators, the Philippines has adequate debt repayment capacity to service loans on OCR terms. Its per capita GNP is above the IDA operational cutoff of $925 at 1997 prices. The Philippines crossed the applicable IDA operational cutoff in 1994 and has remained above the cutoffs updated in subsequent years. It graduated from IDA in 1993.

(b) Papua New Guinea has adequate debt repayment capacity for servicing loans on OCR terms, is also above the per capita GNP operational cutoff, and graduated from IDA in 1982.

(iv) Due to its current economic circumstances, Indonesia will be classified under OCR with limited ADF but will be placed on a "watchlist" for subsequent graduation from ADF.

(v) Two Central Asian DMCs, Kazakhstan and Uzbekistan, are above the proposed per capita GNP operational cutoff. They also have adequate capacity over the medium term to service debt on OCR terms. These DMCs will be graduated to OCR-only.

63. As per the above classification, four countries will move from blend status to OCR-only status. The phase out of ADF has been operationally completed for three of the four DMCs, namely Kazakhstan, Philippines, and Uzbekistan. The fourth DMC, namely Papua New Guinea, is programmed as of date for ADF lending up to 2001. Following the reclassification, it is proposed that the phaseout of ADF for Papua New Guinea be advanced to the year 2000, i.e., over the next two years. These countries together with Thailand (a DMC that ceased to have access to OCR in 1983 but has remained in Group B) will be reclassified from Group B to

Group C.

B. Graduation from Bank Assistance

64. Part A of this section dealt with the graduation of DMCs from ADF-only through ADF with limited OCR to OCR with limited ADF, to OCR-only. Part B discusses the graduation process further downstream, i.e., from OCR-only to graduation out of regular Bank assistance.

65. As in the case of the Bank's concessional lending operations, the classification system needs to reflect the progress DMCs have made in reducing their dependence on non-concessional official assistance. Besides, one of the major recommendations of the *Report of the Task Force on Multilateral Development Banks*[38] is that, in countries having reliable access to private capital, MDBs should initiate the process of financial disengagement and establish graduation policies for this purpose.

66. The present system does not formally follow the transition process to its logical conclusion, i.e., to graduation from regular Bank assistance. In the absence of a formal policy on graduation out of Bank assistance, the arrangements for cooperation among graduated DMCs, the Bank, and borrowing DMCs are *ad hoc*. To address these concerns, policies should be formulated that

(i) extend the graduation policy to graduation from regular Bank assistance;

(ii) specify the process by which DMCs will be graduated from regular Bank assistance; and

(iii) provide a framework for the relationship among graduated DMCs, borrowing DMCs, and the Bank.

The first step is to develop the criteria for graduation from Bank assistance.

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[38] Development Committee. March 1996. Report of the Task Force on Multilateral Development Banks. *Serving a Changing World*.

1. The Criteria

67. The criteria for graduation from regular Bank assistance will be

(i) per capita GNP;

(ii) availability of commercial capital flows on reasonable terms; and

(iii) for key economic and social institutions, attainment of a certain level of development.

a. Per Capita GNP

68. A per capita GNP benchmark is needed to trigger graduation procedures. For this purpose, the IBRD benchmark of $5,445 (at 1997 prices) is adopted.

b. Creditworthiness

69. Access to international capital markets for medium- and long-term capital is a key criterion for graduation from regular Bank assistance. Particular attention will be paid to the adequacy and sustainability of private capital flows. Determining the sustainability of private capital flows is not easy because the prospects for sustainability vary widely by country, and considerably by type of capital flow. A proper assessment of the sustainability of capital flows requires a country-specific evaluation of whether the prevailing policy, incentive structures, and institutions encourage the use of capital to support investment and whether the growth of exports will provide the basis for sustained creditworthiness. Key considerations in this regard include macroeconomic stability, exchange rate policy, the extent of trade and investment liberalization, privatization, tax reform, financial sector liberalization, and corporate governance. Both the record of past access and future prospects will be taken into account in assessing a DMC's readiness for complete reliance on commercial capital flows.

c. Economic and Social Institutions

70. Institutional capacity building is one of the Bank's strategic operating objectives. In determining a country's readiness for graduation, the degree to which economic and social institutions have taken hold, and their capacity for fostering sound development management will be taken into account. Development management is contingent upon context and opportunity. As such, assessment of the level of institutional development would necessarily be country-specific. Broadly speaking, the following considerations will, *inter alia*, be taken into account in assessing the level of development of key economic and social institutions: (i) the quality of processes for macroeconomic management, (ii) the regulatory and supervisory framework in the financial sector, (iii) the efficiency and flexibility of labor markets, and (iv) the legal system.

71. Once a country crosses the per capita GNP threshold for graduation from regular Bank assistance, its readiness for graduation would be reviewed annually. Graduation from regular Bank lending would be expected to occur within four years of meeting all three graduation

criteria, i.e., per capita GNP, creditworthiness, and advanced level of development of economic and social institutions. At that time, Board approval may be obtained on a "no-objection" basis. The Bank may also decide to cease or reduce regular lending to a country whose per capita GNP remains below the level of the graduation trigger, provided its creditworthiness and performance warrant such an action.

72. In planning the graduation process for a country, the Bank would seek an understanding with that country about the length of the phase-out period, the number and type of projects to be included, and the total amount of lending. Sectors that have been receiving commercial financing, both external and domestic, on a sustained basis can be graduated from OCR lending ahead of other sectors (para. 7). The volume of lending will taper off gradually. A logical sequencing would be to first phase out direct lending, to be followed by TA and direct private sector involvement.

73. Graduation from private sector operations requires further elaboration. Under the World Bank system, IBRD graduates continue to be eligible for IFC operations for a number of years. However, unlike the World Bank, the Bank's private sector operations are located within the institution and the source of funding for private sector borrowing is OCR. Private enterprises in the graduated DMCs are expected to be able to tap into domestic financial systems that are well developed, supplemented by resort to international capital markets. To the extent that the Bank's resources are invested in these countries, the availability of funds for less developed, regular borrowers of the Bank would be diminished. For these reasons, continuation of direct private sector involvement in graduated DMCs would not be justified.

74. While graduation will not involve a change in the development status of the concerned country, it will formally differentiate high-income nonborrowing DMCs from other DMCs. Graduation from regular Bank assistance need not and should not be linked with the development status of a country, which is typically determined at the time of its admission as a member of the Bank and can be reviewed by the Board of Governors. Graduation from regular Bank assistance means that the country concerned has reached a stage where it can carry forward the development process without regular Bank assistance.

2. Application of Criteria

75. Some Bank members already meet the graduation criteria set forth above:

(i) Singapore, which has a per capita GNP of $26,470 at 1997 prices, ceased to borrow from the Bank in 1980;

(ii) Hong Kong, China, which has a per capita GDP[39] of $26,360 received its last Bank loan in 1980;

(iii) Taipei,China, which has a per capita GNP of $13,200 has not borrowed from the Bank since 1971; and

(iv) The Republic of Korea which has a per capita GNP of $10,550, received its last

[39] Per capita GNP estimates are not available for Hong Kong, China.

regular public sector project loan in 1988. However, the Republic of Korea is currently receiving emergency assistance from the Bank.

76. The per capita GNP levels of Hong Kong, China; Republic of Korea; Singapore; and Taipei,China are well above the trigger of $5,445. Starting with the May 1997 *World Economic Outlook*, the IMF began classifying these four as "advanced economies" along with the group of countries traditionally known as industrial countries. IMF justified its reclassification on the grounds that the four economies have well-developed financial markets and high degrees of financial intermediation, as well as diversified economic structures with relatively large and rapidly growing service sectors.[40] The Republic of Korea was admitted to the Organisation for Economic Co-operation and Development (OECD) in 1996.

77. The four economies (Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China) meet the identified criteria and may be graduated from Bank assistance immediately. They have access to international capital markets for medium- and long-term capital. Economic and social institutions are well developed in these economies, and human development indicators are exceptionally good. *The Human Development Report 1998* lists Hong Kong, China (ranked 25), the Republic of Korea (ranked 30), and Singapore (ranked 28) among the economies[41] that have achieved a high level of human development.

3. Postgraduation Relationship

78. Graduation from Bank assistance would not signify termination of a DMC's relationship. Rather, it is seen as the transition to a new phase in that relationship. Some of the ways in which graduated DMCs and the Bank will cooperate in this phase are indicated below.

a. Emergency Assistance

79. The recent crises overtaking several East and Southeast Asian economies show that even relatively more advanced DMCs are not immune to temporary economic reversals. Such crises are symptoms of the globalization of economic and financial activities, where domestic and/or external events can have rapid impact on confidence of markets in members' economies and on their creditworthiness. It is therefore proposed that emergency assistance should be available to DMCs that have graduated from regular Bank assistance.

b. Provision of Expert Services and Technical Assistance

80. Staff resources permitting, the Bank could provide expert services and TA on a reimbursable basis to graduated DMCs, should they so desire. These services could be provided for

(i) reviews of sector plans and policies,

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[40] Two of the economies (Singapore and Taipei,China) reclassified by IMF as advanced economies have objected to the reclassification. This could possibly be due to the perception that such reclassification could mean a loss of preferential trading rights.

[41] Taipei,China was not covered in the *Human Development Report*.

(ii) institution building, and

(iii) training of staff from graduated DMCs.

However, active borrowers would always have priority on staff resources.

c. Bond Issues

81. The Bank has always been mindful of contributing to the development of capital markets of its nonborrowing DMCs through its borrowing activities. In addition to its developmental impact on the region's capital markets, bond issues stimulate participation by the region's investment banking community in international capital market activities. The Bank has provided support to newly industrialized economies' capital market development by listing some of its borrowings on their stock exchanges. The Bank could consider returning to these markets with benchmark issues in the future. In addition, the Bank could tap other bond markets in the region, provided that such an initiative is in line with the governments' plans and would further the development of such markets.

d. Transfer of Technology

82. The transfer of technology between graduated DMCs and other DMCs could be expanded in fields where the former have established a comparative advantage. Such cooperation could be undertaken on a case-by-case basis or under formal arrangements with one or more of the graduated DMCs.

e. Cofinancing

83. Graduated DMCs and the Bank could enter into cofinancing arrangements for projects in borrowing DMCs. The Bank could provide its expertise in project appraisal and administration services for a fee as it does for certain developed member countries.

f. Promotion of Private-to-Private Flows

84. The Bank would seek the participation of private enterprises and financial intermediaries from the high-income graduated DMCs in private enterprises of the low- and middle-income DMCs. In this way, it would be promoting private-to-private flows among DMCs within the region.

g. Subregional Cooperation

85. The Bank has several initiatives in subregional cooperation, notably in the Greater Mekong Subregion. The involvement of graduated DMCs in such initiatives could impart greater momentum to activities in subregional cooperation. Such involvement could take forms such as provision of counterguarantees for subregional projects funded out of OCR, cofinancing, etc.

V. OTHER OPERATIONAL IMPLICATIONS

86. The existing classification system has operational implications in regard to the eligibility for Bank assistance and to applicable cost-sharing limits for loans and domestic preference for civil works. While not part of the current policy, cost-sharing in TA operations could also be brought within the ambit of the classification system. The adjustments required in regard to these other operational implications are examined below.

A. Cost-Sharing Limits for Project Cost Financing and TA Cost Financing

1. Project Cost Financing

87. According to existing Bank policy,[42] the maximum proportion of project costs that the Bank may normally finance is determined by a DMC's country grouping.[43] These limits are not to be applied mechanically, but are to be based on a DMC's performance in domestic resource mobilization, the balance-of-payments situation, and any special circumstances that may prevail. These criteria relate to the economic strength of a DMC, the same principle on which assessment of debt repayment capacity is based. It is therefore proposed that, in general, the eligibility for Bank assistance should be used when applying cost-sharing limits. It is proposed that the existing cost-sharing ceilings (80 percent for Group A, 60 percent for Group B, and 40 percent for Group C) be retained with the modification that a ceiling of 70 percent be applied to Group B1, i.e., if a country graduates from Group A to Group B1, it will also graduate from an 80 percent cost-sharing limit to a 70 percent limit. The 60 percent cost-sharing limit will apply to Group B2. The lower ceilings for countries that are proposed to be reclassified will be effected in phased manner, with a 5 percentage points reduction per year. As per current policy, under exceptional circumstances and where justified on country and project grounds, Bank financing may also exceed the country cost-sharing limit.[44]

2. TA Cost Financing

88. Some Board members expressed concern about the lack of "ownership" and commitment on the part of recipients of Bank TA. This perceived lack of ownership has been attributed to the low levels of financial contribution to total costs that recipients are currently required to make. A higher level of contribution by recipients, it is argued, would ensure that they properly assess whether a proposed TA is indeed one of their priorities and one for which

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[42] *Operations Manual*: Bank Policies. Section 11.

[43] The actual level of cost-sharing will, in addition to country considerations, take into account project considerations.

[44] *Operations Manual*: Bank Policies. Section 11.

they are prepared to take ownership. A change in existing Bank policy on TA cost-sharing has been considered necessary to bring about the desired attitude change. The issues involved in sharing of TA costs are discussed in detail in Appendix 3, while the salient points are outlined below.

89. According to the cost-sharing principle applied by most multilateral and bilateral development agencies, the recipient is expected to meet most of the local currency costs of a project, while the external donor meets the foreign exchange costs. Bank policy on TA financing is broadly based on this principle: it stipulates that the share of local cost financing (excluding the cost of domestic consultants) in the amount financed by the Bank cannot exceed 25 percent.

90. The key question is whether minimum levels should be prescribed for government contribution to total TA costs. Such an approach would mark a significant departure from the existing policy, wherein the composition of TA costs is taken into account in determining the type and extent of government contribution. An analysis of Bank TAs during 1994–1997 shows that foreign exchange costs and local costs of domestic consultants (Appendix 3) account for over four fifths of the total TA costs. Strict adherence to minimum levels of government contribution to total TA costs without regard for the composition of such costs could result in DMCs having to contribute to foreign exchange costs and local costs of domestic consultants to meet the prescribed minimum levels of contribution expected of them. The foreign exchange costs of TAs are largely accounted for by the costs of international consultants. Requiring DMCs to contribute towards such costs would not only go against well-established Bank principles but could also mean that TAs would be delayed in bargaining over issues such as the costs of international consultants. In regard to financing the local costs of domestic consultants, the Bank has found it administratively convenient to bear such costs.

91. It is proposed that the government contribution to TAs should be at least 15 percent of the total TA costs for Group A, 20 percent for Group B1 and B2, and 30 percent for Group C. However, such contribution will be subject to the limit of total TA costs minus foreign exchange costs and costs of domestic consultants.

92. The ADF eligibility matrix (Table 2), the proposed policy for graduation from regular Bank assistance, and the cost-sharing ceilings for projects and TAs are linked to the classification of DMCs as shown in Table 3.

Table 3: Operational Implications of Proposed Country Classification

Classification	ADF/OCR Eligibility	Cost-Sharing Limit for Project Financing[a]	Minimum Government Contribution to Total Costs of TAs[b]
Group A Afghanistan, Bhutan, Cambodia, Kiribati, Kyrgyz Republic, Lao PDR, Maldives, Mongolia, Myanmar Nepal, Samoa, Solomon Islands, Tajikistan, Tuvalu, Vanuatu	ADF-only	80%	15%
Group B1 Bangladesh, Cook Islands,[c] Marshall Islands, Micronesia, Pakistan, Sri Lanka, Tonga, Viet Nam	ADF with limited amounts of OCR	70%	20%
Group B2 People's Republic of China,[d] India,[d] Indonesia,[e] Nauru	OCR with limited amounts of ADF	60%	20%
Group C Fiji, Kazakhstan, Malaysia, Papua New Guinea,[f] Philippines, Thailand, Uzbekistan	OCR-only	40%	30%
Graduate Korea;[g] Hong Kong, China; Singapore; Taipei,China	Graduated from regular Bank assistance	NA	NA

[a] Phased reduction in ceilings for affected countries at the rate of 5 percent per year.
[b] Subject to the limit of total TA costs *minus* foreign exchange costs and cost of domestic consultants.
[c] Limited OCR eligibility will be applied only after the external debt position improves.
[d] No ADF access during the ADF VII period as mandated by donors.
[e] On watchlist for graduation from ADF.
[f] Graduation from ADF to be phased over two years.
[g] Graduate but under emergency assistance until normalcy is restored.

B. Domestic Preference Scheme for Goods and Civil Works

93. Under the existing procurement policy, all DMCs receiving Bank loans are eligible to participate in the domestic preference scheme for procurement of goods. The domestic preference scheme for procurement of civil works is, however, applied only to domestic contractors in Group A DMCs, typically the ADF-only countries. The policy was last revised in August 1991[45] and at the time, it was stipulated that the policy be reviewed again after five years. Pending such review, it is proposed that the *status quo* be maintained in regard to the current eligibility of individual DMCs under the domestic preference scheme.

VI. CONCLUSIONS

94. In view of the changing patterns in the debt repayment capacities of DMCs in the region, there is a strong case for reengineering the classification system (last reviewed in 1977) to better address present realities. The revised system will provide a formal framework in which countries graduate through a sequence of stages in Bank financing, culminating in graduation from regular Bank assistance.

A. Graduation from ADF

95. Based on the Bank's policy that country criteria should be the primary consideration for access to/graduation from ADF, the decision matrix (Table 1) shows the basis of the policy framework. This matrix has been designed for the joint application of two main country criteria, per capita GNP and debt repayment capacity. In the past, debt repayment capacity has been assessed on a qualitative basis. The qualitative basis has been refined and a quantitative dimension has been added to provide a more systematic assessment of debt repayment capacity. Based on this, the current blend group (Group B) is proposed to be split into two categories: (i) ADF with limited OCR (Group B1), and (ii) OCR with limited ADF (Group B2).

96. The criteria and the structure of the matrix have been developed to provide a stable policy platform over time for eligibility for and graduation from ADF. However, the application of the criteria at different points, and consequently their location in the decision matrix, would change in time to match changing economic circumstances of DMCs. Also, movement across the decision matrix would not be irreversible. It is proposed that the periodic review of eligibility for ADF would coincide with the ADF replenishment exercise.

97. Applying the methodology to current data yields the results in Table 2. The application of the decision matrix implies the following:

(i) Kazakhstan, Papua New Guinea, Philippines, and Uzbekistan, will graduate from ADF-OCR blend to OCR-only. Phase out of ADF has been completed for all these countries except Papua New Guinea which will be allowed two years for the phase out. All the above DMCs, together with Thailand (a DMC that ceased to have access to ADF in 1983 but has remained in Group B), will be graduated to Group C.

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[45] Doc. R108-91. *Review of Domestic Preference Scheme,* 8 August 1991.

(ii) Indonesia will be on watchlist for the effectivity of graduation out of ADF. It will be classified as Group B2 for the present.

(iii) People's Republic of China and India will graduate to Group B2 and be eligible for OCR with limited ADF but as mandated by donors, will not have access to ADF during the ADF VII period.

(iv) Pakistan will continue to receive a blend of ADF and OCR resources and will be graduated to Group B1. Bangladesh, Cook Islands, Marshall Islands, Micronesia, Sri Lanka, Tonga, and Viet Nam will graduate from ADF-only (Group A) to ADF with limited amounts of OCR (Group B1). However, limited OCR eligibility for Cook Islands will be applied only after the external debt position of the country improves.

Normally, OCR funding to Group A (ADF-only) countries that have weak debt repayment capacity will not be encouraged. However, an exception could be made in projects that generate foreign exchange earnings in excess of the foreign exchange debt repayment requirements. (para. 47).

B. Graduation from Regular Bank Assistance

98. A formal policy is proposed for graduating countries from Bank regular assistance (paras. 67-74). Typically, graduation from regular Bank assistance will take place after the required criteria are met for four successive years. The following nonborrowing economies, namely, Hong Kong, China; Republic of Korea; Singapore; and Taipei,China will be graduated on the effectivity of this policy since they have met this four-year requirement. Graduation will not be a termination of a DMC's relationship with the Bank. Rather, it will be a new phase in the relationship, with implications for regional cooperation.

C. Ceiling on Bank Financing of Project Costs

99. In step with graduation from a higher level of concessional funding to a lower level, the applicable cost-sharing limits for project and TA financing will normally be lowered. For project financing, however, the existing provision of flexibility to take into account country and project considerations will be retained. For Group B1 DMCs, the limit will fall from 80 percent to 70 percent. For Group B2, the applicable ceiling would be 60 percent. The lower ceilings for countries that have been reclassified would be effected in phased manner, with a 5 percentage point reduction per year.

D. Norms for TA Cost Sharing

100. New norms have been proposed for cost sharing in TAs (para. 91). Government contribution to TAs should be at least 15 percent of the total TA costs for Group A, 20 percent for Group B1 and B2, and 30 percent for Group C. However, such contribution will be subject to the limit of total TA costs minus foreign exchange costs and costs of domestic consultants.

E. Domestic Preference Scheme for Procurement of Goods and Civil Works

101. Pending review of the policy for domestic preference in procurement of goods and civil works, the *status quo* will be maintained in regard to the current eligibility of individual DMCs under the domestic preference scheme.

VII. RECOMMENDATION

102. The Board of Directors is requested to approve the general thrust of the proposed "Graduation Policy for the Bank's DMCs" and, the effectivity from 1 January 1999 of the proposals with regard to the graduation framework and the classification of DMCs (as presented in Section IV), and with regard to ceilings on Bank financing of project costs, norms for sharing of TA costs, and domestic preference scheme for procurement of goods and civil works (as presented in Section V).

APPENDIXES

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2	Technical Supplement on Assessment of Debt Repayment Capacity	37	16, 53 16, 54
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Appendix 1

CURRENT COUNTRY CLASSIFICATION AND ACCESS TO ADF RESOURCES

DMC	Per Capita GNP 1997 $[a]	Bank Classification	Least Developed Country (United Nations)	ADF Access
Afghanistan	NA	A	X	X[b]
Myanmar	NA	A	X	X
Nepal	210	A	X	X
Bangladesh	270	A	X	X
Cambodia	300	A	X	X
Viet Nam	320	A		X
Tajikistan	330	A		X
Mongolia	390	A		X
India	390	A		X[c]
Bhutan	400	A	X	X
Lao People's Democratic Republic	400	A	X	X
Kyrgyz Republic	440	A		X
Pakistan	490	A		X[d]
	729	Upper limit of Group A[e]		
Sri Lanka	800	A		X
China, People's Republic of	860	A		X[c]
Solomon Islands	900	A	X	X[si]
	909	Lower limit of Group B[e]		
Kiribati	910	A	X	X[si]
Papua New Guinea	940	B		X[d]
Uzbekistan	1,010	B		X[d]
	1,017	ADF operational cutoff [f]		
Indonesia	1,110	B		X[d]
Maldives	1,150	A	X	X[si]
Samoa	1,150	A	X	X[si]
Philippines	1,220	B		X[d]
Vanuatu	1,310	A	X	X[si]
Kazakhstan	1,340	B		X[d]
Tuvalu	1,430 [g]	A	X	X[si]
	1,697	Upper limit of Group B[e]		
Marshall Islands	1,770	A		X[si]
Tonga	1,830	A		X[si]
Micronesia, Federal States of	1,980	A		X[si]
	2,116	Lower limit of Group C[e]		
Fiji	2,470	C		
Thailand	2,800	B		
Nauru	4,470 [h]	B		X[si]
Cook Islands	4,630[i]	A		X[si]
Malaysia	4,680	C		
Korea, Rep. Of	10,550	C		
Taipei,China	13,200 [j]	C		
Hong Kong, China	26,360[i]	C		
Singapore	26,470[j]	C		

[a] Taken from World Bank Operational Manual unless otherwise indicated.
[b] Inactive borrower, nonaccrual status.
[c] Eligible but no access.
[d] Access to both ADF and OCR.
[e] Bank country classification limits based on R83-92 dated 28 May 1992 are as follows:

	1990 $	Updated to 1997 $
Group A	less than $610	less than $729
Group B	$760–$1,420	$909–$1,697
Group C	over $1,770	over $2,116

[f] Operational cutoff for ADF eligibility is $1,017 in 1997 prices.
[g] 1996 per capita GDP computed from national data.
[h] Estimated per capita GDP in FY 1995/1996 from the Bank's Country Assistance Plan.
[i] Per capita GNP computed from national data.
[j] Per capita GNP computed from national data.
x[si] ADF access under small island exception.
NA Not available.

(Reference in text: page 5, para. 16)

TECHNICAL SUPPLEMENT ON ASSESSMENT OF DEBT REPAYMENT CAPACITY

1. Weak debt repayment capacity for nonconcessional external borrowing has traditionally been recognized as a determinant of eligibility to the Asian Development Fund (ADF), but there has so far been no Bankwide systematic approach to its assessment. The procedures proposed to systematize assessment of debt repayment capacity use econometric techniques to construct indexes based on quantitative and qualitative variables. The principal objective is to group countries according to three levels of debt repayment capacity: (i) adequate, (ii) limited, and (iii) weak. ADF eligibility matrix (main text, Table 2, para. 61).

A. Assessment Based on Quantitative Variables

2. The quantitative assessment focuses on the construction of a composite index of debt repayment capacity based on indicators that have a significant bearing on a country's capacity to service nonconcessional loans. The three key steps in this process are: (i) selection of indicators, (ii) methodology for aggregating the selected indicators into a composite index, and (iii) grouping of countries based on the composite index. The procedures used in each of these steps are discussed below.

1. Selection of Quantitative Indicators

3. Criteria for selection of each indicator include:

(i) the economic logic of the indicator's relationship with the concept of debt repayment capacity, with particular attention paid to avoiding possible ambiguities in interpretation;

(ii) availability of data on the indicator for most of the developing member countries (DMCs);

(iii) comparability of data on the indicator across countries (preferably data on a given indicator should be available from a single reliable source);

(iv) ensuring simplicity of the overall model by restricting the number of indicators to a relatively few variables that measure different dimensions of debt repayment capacity;

(v) focus on medium-term trends rather than capturing only transitory features; and

(vi) the overall indices must produce plausible results, i.e., rank countries that obviously lack creditworthiness lower than countries that obviously have creditworthiness.

4. By applying these criteria, a large number of "candidate" indicators were eliminated from the indicator set. After careful consideration, the following four indicators were chosen:

(Reference in text: page 16, para. 53)

COST SHARING IN TECHNICAL ASSISTANCE

1. Some Board members have expressed concern about the lack of "ownership" and commitment on the part of recipients of Bank technical assistance (TA). This perceived lack of ownership has been attributed to the low levels of financial contribution that recipients are currently required to make. A higher level of financial contribution by recipients, it is argued, would ensure that they undertake a critical assessment that a proposed TA is one of their priorities. It is also argued that a higher level of financial contribution would ensure increased ownership by TA recipients and the eventual implementation of its recommendations. A requirement for TA cost sharing is therefore proposed in the paper on *A Graduation Policy for the Bank's DMCs*. This Appendix identifies the issues involved, the various options available, and their practical implications.

A. Rationale and Definition of Cost Sharing

2. Cost sharing is a standard operational principle of most multilateral and bilateral organizations. It is based on the notion that the donor and the recipient of development assistance are in partnership to achieve development goals. For the partnership to be successful, both parties need to have commitment to and ownership of the development activities to be implemented. Cost sharing is seen as a means of (i) ensuring commitment by the recipient, (ii) enhancing the sustainability of a development undertaking, and (iii) effective management of scarce resources by the donor.

3. While the principle of cost sharing is well recognized, there are differences in its definition/interpretation. One definition of cost sharing turns on the distinction between foreign exchange and local currency costs. According to this definition, the recipient is normally expected to meet the local currency costs of a project or TA, while the donor meets the foreign exchange costs. The World Bank, the Inter-American Development Bank (IaDB), and the Swedish International Development Cooperation Agency (SIDA), and other funding sources, subscribe to this interpretation of cost sharing. The other definition focuses on the share of the recipient in total costs. The United States Agency for International Development (USAID) falls under this category: it requires that the recipient contribute 25 percent of the cost of a project or TA.[1]

4. Bank policy on cost sharing in TAs and projects is closer to the first definition than to the second. For projects, limits have been set on the share of total costs that may be financed by the Bank. However, the entire foreign exchange costs of a project can be met by the Bank even if the cost-sharing limits are exceeded. The ceiling on LCF of TA operations is 25 percent of the total amount of the TA financed by the Bank, excluding the costs of domestic consultants.

5. The basis for defining cost sharing has a significant bearing on how to assess the adequacy of a government's contribution. When cost sharing is understood as the government's responsibility to bear the local costs of a TA (or for that matter a project), then the adequacy of government contribution is to be judged in terms of contribution to *local* costs, not to total costs. In TAs with large foreign exchange components relative to the local cost components, the developing member country (DMC) may bear the entire local currency cost and yet account for only a small proportion of total costs. This would be consistent with cost

[1] At the operational level, the contribution by the recipient may be considerably less because USAID permits the use of counterpart funds generated by past United States Government aid (such as those from Public Law 480, Titles, etc.) towards recipients' share of costs. USAID also accepts contributions in kind. Data on recipients' share of foreign currency costs, if any, and cash contributions in local currency are not available.

(Reference in text: page 30, para. 88)

sharing based on the foreign exchange and local currency distinction, but not with the definition based on contribution to total costs. Where local costs are a significant proportion of total costs, there is obviously less room for conflict between the two definitions of cost sharing.

B. Trends in Cost Sharing

6. The foregoing discussion on the principle and definitions of cost sharing provides the context for assessing the adequacy of actual levels of cost sharing in Bank TAs. Data were collected for a four-year period from 1994 to 1997 (see Table 1) with a more detailed, item-wise breakdown for 1997 (see Table 2). Stand-alone Project Preparatory (PP), Project Implementation (PI), and Advisory (AD) TAs[2] were included in the data set. Group A DMCs accounted for 542 of the 734 TAs in 1994-1997; Group B accounted for 172, while Group C accounted for 20. Government contribution averaged 12 percent (11 percent in Group A, 14 percent in Group B, and 22 percent in Group C). The proportion of foreign exchange cost and that of cost of domestic consultants in total costs was 71 percent and 9 percent, respectively. No significant difference was observed between ADTAs and PPTAs in regard to the share of government contribution to total costs. In drawing conclusions about the adequacy of government contributions, several issues need to be flagged.

[2] The specific TA instruments of the Bank comprise PPTA, PITA, ADTA, and regional TA. PPTA assists feasibility studies and detailed engineering of bankable projects. PITA supplies consulting services for project implementation and initial operation, including training of project personnel. ADTA supports institutional strengthening, sector and policy studies, and nonproject-related human resource development. Regional TA provides assistance to address issues of regional or subregional interest, or to assist a group of individual DMCs on specific issues.

Table 1: Trends in TA[a] Cost Sharing, 1994-1997
(in percent unless otherwise indicated)

Item	Group A	Group B	Group C	Overall
Number of TAs	542	172	20	734
Cost of TAs	71.9	22.4	5.7	100.0
Share of Foreign Currency Costs to Total Costs	73	66.5	70.3	71.2
Government				
Contribution to Total Costs	10.9	13.6	22.4	12.4
Contribution to Local Costs	40.1	40.4	76.1	42.6
of which				
Domestic Consultants	0.4	0.7	4.6	0.8
Contribution to Foreign Exchange Costs	0.1	0.2	0.0	0.1
Bank				
Contribution to Total Costs	82.9	84.1	77.6	82.6
Contribution to Local Costs	52.6	57.3	23.9	51.7
of which				
Domestic Consultants	26.2	32.9	11.5	26.7
Contribution to Foreign Exchange Costs	94.2	97.5	100.0	95.1
Other				
Contribution to Total Costs	6.2	2.3	0.0	5.0
Contribution to Local Costs	7.3	2.3	0.0	5.7
of which				
Domestic Consultants	3.8	1.5	0.0	2.9
Contribution to Foreign Exchange Costs	5.8	2.2	0.0	4.8

[a] Excludes small-scale, supplementary, and other TAs for which cost details are not available.

Table 2: Composition of Costs, 1997[a]

Item	Percent of Total
Local Currency Costs	**32.5**
In-kind (counterpart staff, office space, other local support services)	11.0
Costs of Domestic Consultants	9.9
Equipment	1.7
Training, Workshops, Seminars	2.3
Studies and Surveys	1.7
Other	6.0
Foreign Exchange Costs	**67.5**
Costs of International Consultants	49.2
Equipment	5.2
Training, Fellowships	2.7
Studies and Surveys	0.2
Contingency and Miscellaneous	10.2

[a] Excludes small-scale, supplementary, and other TAs for which cost details are not available.

7. The first issue for consideration is the significance of the distribution of TAs across country groupings. Group A DMCs accounted for 74 percent of the TAs in 1994-1997. Group A DMCs typically have limited capacity to meet the foreign exchange costs of TAs and projects. In their case, the distinction between the capacity to pay and the willingness to pay assumes added significance. The low levels of government contribution to total costs by Group A DMCs are not necessarily indicative of a lack of ownership but of the limited capacity of these poorer DMCs to contribute to TA costs that have a substantial foreign exchange component.

8. The second issue that needs to be considered is how the costs are to be calculated and how the boundaries are to be drawn around a TA. The costs included in TA financing tables are those attributable to a narrow definition of the TA. Typically, however, the Bank's TA is only a small input into a larger government process of policy evolution, investment outlays, and institution building that could be spread over several years. The associated costs of this process are usually inseparable from the government budget and arguably are not incremental to the TA. In any case, it is impractical to use such a broad-based notion of costs in calculating the financing of TAs. Because it is not easy to draw boundaries around a TA, it is possible to underestimate government contributions to TA costs in the broad sense.

9. The third issue is the form in which government contributions are made. The Bank and other development institutions including the World Bank, IaDB, United Nations Development Programme (UNDP), and USAID allow a government to make contributions in kind or in cash. Although the breakup of local cost contribution in kind and in cash is not usually presented in TA reports, government contributions are typically in kind. In this connection, there is the issue of whether cost sharing should include part of the cash component of local expenditures. While there is some merit to adopting such an approach, administrative costs would render it impractical.

10. The fourth issue is the distinction between cost sharing and cost recovery in TAs (see Figure 1). Cost sharing relates to the up-front sharing of local and total costs, while cost recovery (pricing) relates to the terms of the Bank-financed portion of the TA, i.e., grant, grant-cum-loan, or loan. The Bank has so far applied its ceiling on local cost financing (LCF) to stand-alone ADTAs, PPTAs, and PITAs alike. In regard to pricing of TAs funded out of the Technical Assistance Special Fund (TASF), however, a distinction is made between ADTAs and PPTAs. ADTAs are generally grant financed. PPTAs are initially grant financed, but if a loan ensues, the TASF-financed portion of the PPTA above a certain level is recovered through the loan. On this basis, it has been argued that there is a higher level of cost-sharing in PPTAs than in ADTAs. This line of argument is open to question for two reasons. First, as already noted, cost sharing refers to the up-front contribution of DMCs to local costs, whereas cost recovery relates to the mode of funding the Bank-financed portion of TA costs. The principle of cost sharing wherein the recipient is expected to meet the local costs of TAs should apply to PPTAs and ADTAs alike. Second, the fact that the Bank-financed portions of PPTAs are recoverable through the ensuing loan does not mean that they are in fact so recovered. PPTAs financed out of the Japan Special Fund (JSF) are not subject to cost recovery. For these reasons, cost sharing is not necessarily higher in PPTAs than in ADTAs.

11. A related issue is the perception that lack of ownership is much more serious for ADTAs than for PPTAs. That ADTAs have a more mixed record of implementing recommendations than PPTAs should not come as a surprise. ADTAs involve policy reform and organizational change that can be highly sensitive. Whether reforms ensue or not, ADTAs do expose DMCs to new policy approaches that can have a high development impact. PPTAs, on the other hand, typically involve technical questions that DMCs may not find as difficult to implement. PPTAs are also linked to potential projects for Bank financing. From the perspective of Bank staff, PPTAs are critical because they lay the proper foundation for potential projects. Thus, the two types of TA are inherently different and therefore comparisons between ADTAs and PPTAs in regard to ownership may be inappropriate.

12. The fifth issue for consideration is the comparison among multilateral development banks (MDBs) in regard to government contribution to total costs. It has been argued that, although the World Bank and IaDB do not require minimum levels of government contribution to total costs, they are able to realize substantially higher levels than the Bank. Available data for IaDB indicate that the size of its TA loans is substantially larger than the typical size of the Bank's TAs. Large TAs are more likely to have a significant local cost component than smaller ones. Accordingly, there is more scope for recipient contribution by way of sharing local costs. Differences in the size of typical TAs suggest that caution needs to be exercised in drawing comparisons in regard to the adequacy of government contribution to the TAs of the Bank vis-à-vis those of other MDBs.

C. Rationalization of Cost Sharing in TAs

13. Against the background given above, it needs to be considered whether minimum levels should be prescribed for government contribution to *total* costs. This would mark a significant departure from the existing policy, wherein the composition of TA costs is taken into account in determining the type and extent of government contribution. A shift towards cost sharing based on total costs raises the crucial question of whether, in the pursuit of minimum levels of government contribution, DMCs could be required to contribute to foreign exchange costs. A related issue is the question of financing the local costs of domestic consultants. The average shares of foreign exchange costs to total costs in 1997 were 73 percent in Group A, 67 percent in Group B, and 70 percent in Group C (Table 1). The shares of domestic consultant's costs to total costs were 8 percent, 12 percent, and 7 percent, respectively. These cost figures are useful in assessing alternative cost-sharing options. It is assumed that the pattern of TA operations over the past three years will be continued in the future. As such, the effect of the four options considered below could be assessed by applying them to past data.

1. Minimum Level of Government Contribution with No Provisos

14. If the minimum share of government contribution is fixed at 20 percent, 25 percent, and 30 percent of total costs, respectively, for Groups A, B, and C, and these levels had been applied over 1994-1997, then (i) Group A's share (total 20 percent) would have come 19 percent from local costs other than the costs of domestic consultants, and the remaining 1 percent would have come from either foreign exchange costs or the costs of domestic consultants; (ii) Group B's share (total 25 percent) would have come 22 percent from local costs other than the costs of domestic consultants, and the remaining 3 percent would have come from either foreign exchange costs or the local costs of domestic consultants; and (iii) Group C's share (total 30 percent) would have come 23 percent from local costs other than the costs of domestic consultants, and the remaining 7 percent would have come from either foreign exchange costs or the local costs of domestic consultants. In each of these cases, strict adherence to prescribed levels of government contribution would have meant that the DMCs would end up bearing part of the foreign exchange costs and/or the local costs of domestic consultants.

15. The foreign exchange costs of TAs are largely accounted for by the costs of international consultants. Requiring DMCs to contribute to such costs would not only go against well-established Bank principles, but would make it likely that TA implementation would be rendered more difficult because of bargaining over issues such as the costs of international consultants, etc.

16. In regard to financing the local costs of domestic consultants, the Bank has found it administratively convenient to bear such costs: governments have to go through a time-consuming process of budget approval for hiring consultants. Synchronizing the implementation of the TA with the government budget process is likely to become a bottleneck. Equally important, Bank financing helps develop the domestic consulting industry.

2. Minimum Level of Government Contribution with Provisos for Foreign Currency and Domestic Consultants Costs

17. It is of course possible to specify minimum levels of government contribution to total costs as in para. 14, but to add the proviso that such levels would not preclude full Bank financing of the foreign exchange costs and the local costs of domestic consultants. Then, depending on the cost composition of TAs, the actual levels of government contribution would be different from the prescribed levels. For example, if (i) the minimum shares for Groups A, B, and C were set at 15 percent, 20 percent, and 30 percent, respectively, and (ii) foreign exchange and domestic consultants' costs were excluded from the cost-sharing formula, and the cost-sharing formula were applied to 1994-1997 data, then the "actual" group-wise contributions of governments to total costs would have been 15 percent, 20 percent, and 23 percent for Groups A, B, and C, respectively. Most TAs have foreign exchange and domestic consultant components that together exceed four fifths of the total costs. Moreover, available data show that Group C DMCs are highly selective in their requests for Bank TA: these are typically TAs that have a high percentage of foreign exchange costs that would require exceeding the ceiling for Bank financing of total costs.

3. Maintaining the Status Quo

18. The existing policy on LCF in TAs is also not entirely satisfactory, because the LCF ceiling is set in terms of the amount financed by the Bank and not in terms of the local costs. If the objective is to get a DMC to finance as much of the local costs as possible, then specification of the ceiling in terms of the amount of Bank financing is at best an indirect way of

achieving the objective. Moreover, when the proportion of foreign exchange costs relative to local costs (other than costs of domestic consultants) exceeds a critical level, the Bank could finance the entire local costs and still not violate the 25 percent LCF limit. This is inconsistent with the principle of cost sharing defined earlier.

3. Minimum Levels of Government Contribution to Local Costs Other than Domestic Consultants

19. A ceiling on LCF (other than the local costs of domestic consultants) by the Bank as a proportion of the local cost component of the TA would be more in line with the spirit of the cost-sharing principle. Some DMCs, particularly the less developed DMCs in Group A, could be hard-pressed to mobilize the necessary resources. The minimum level of government contribution to local costs (other than the costs of domestic consultants) could be set at 50 percent, 75 percent, and 100 percent for Groups A, B, and C, respectively. The proposed minimum levels will not apply to regional TAs or small-scale TAs. If this principle were applied to the 1994-1997 data set, then the group-wise contribution of DMCs to total costs would have been 10 percent, 17 percent, and 23 percent, respectively. These shares of government contribution to total costs could be considered inadequate, particularly in relation to the contributions in para. 17.

20. Each one of the options considered above has operational implications that need to be carefully considered. The most viable option appears to be specifying minimum levels of government contribution, but allowing for the possibility that the Bank can finance all of the foreign exchange costs and the local costs of domestic consultants.

21. Situations could arise when cofinancing is made available from other sources. In such cases, the Bank's contribution to TA costs should be adjusted downwards, and it must be ensured that the government contributes at least the minimum levels prescribed.

22. Summing up, it is recommended that government contribution to TAs should be at least 15 percent of the total TA costs for Group A, 20 percent for Group B1 and B2, and 30 percent for Group C. However, such contribution will be subject to the limit of total TA costs *minus* foreign exchange costs and costs of domestic consultants.

(i) debt sustainability ratio;
(ii) private capital inflow as a share of total capital inflow;
(iii) gross domestic saving as a share of gross domestic product; and
(iv) size of economy measured by GNP.

a. Debt Sustainability Ratio

5. Assessment of debt sustainability is based on work done by van Wijnbergen.[1] This approach looks at the time path of the debt output ratio based on its principal determinants, namely, the noninterest current account, the differential between the interest rate and the rate of growth of output, and the outstanding stock of debt. Debt sustainability requires that on average, the sum of the noninterest current account plus the debt outstanding times the difference between the real interest cost on foreign debt and the real output growth rate should be positive. In the present analysis, a modified version of the "van Wijnbergen equation" is used, i.e.,

$$SI = [CAB+INT+FDI]/GDP + (g - (r - usp)) * LDOD/GDP$$

where

SI is the debt sustainability index,
CAB is the current account balance,[2]
INT is the interest paid on external foreign debt,
FDI is the net foreign direct investment,
GDP is the gross domestic product,
g is the growth in real output,
r is the average interest rate on foreign debt,
usp is the US price index, and
LDOD is long-term external debt.

The debt sustainability index links the key elements bearing on a country's external debt sustainability: non-interest current account balance, the inflow of FDI, the stock of external debt, and the differential between the growth rate and the real interest rate.

6. For DMCs where the share of concessional debt is large in relation to total debt, the average interest rate on foreign debt is well below market/Ordinary Capital Resources (OCR) rates. For determining debt repayment capacity for OCR loans, actual interest rates may thus provide only a partial answer. "What if" analyses are required to obtain a clearer picture of debt repayment capacity for OCR loans. For example, what if a DMC had to service all its debt on nonconcessional OCR terms? This question is addressed by setting *r* at the OCR rate for each DMC and examining the effect on the debt sustainability index. For DMCs that are already servicing loans on conventional terms, this substitution should not have much impact on the debt sustainability ratio. For countries where most of the outstanding debt is on concessional terms, the impact on the debt sustainability ratio could turn out to be quite significant. Debt sustainability would hinge on whether or not the growth of output *g* is large enough to offset the effect of the higher (OCR) interest rate. If SI is sufficiently large, then this could be one

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[1] van Wijnbergen, Sweder. 1990. *External Debt, Inflation, and the Public Sector: Towards Fiscal Policy For Sustainable Growth*. World Bank Economic Review. Vol. 3 No. 3.

[2] For CAB, the line item taken from balance-of-payments accounts is balance after income but before transfers.

indication (to be corroborated by other indicators) that the country has the capacity to service debt on conventional terms, including OCR terms.

7. The debt data used in the debt sustainability index are based on the figures in the *Global Development Finance 1998* published by the World Bank, which is considered to be the best source of reliable debt data for cross-country comparisons. The balance-of-payments data are taken from International Monetary Fund (IMF) sources. The time series covered is 1989–1996. To address the problem of unusually large ratios for one or two years skewing the results, three-year moving averages are used.

b. Gross Domestic Saving Rate

8. The gross domestic saving rate is an important indicator of debt repayment capacity because it determines the investment rate and therefore future growth of an economy. The sources for the data include *Key Indicators 1998,* Country Economic Reviews, and Country Assistance Plans (CAPs). The times series covered is 1990-1997. A growing saving rate is a necessary but not sufficient condition for enhanced debt repayment capacity because growth is predicated on the channeling of saving into productive investment.

c. Private Capital Inflow

9. The ratio of private capital inflows to total capital inflows is a measure of a country's debt repayment capacity in three ways: (i) as a form of external saving, private capital flows augment domestic saving, enable higher investment, and thereby spur growth; (ii) private capital inflows reflect a country's commercial creditworthiness in terms of the capacity to attract private capital; and (iii) the share of private capital inflows is an indicator of the degree of dependence of a DMC on official sources of external financing. The key issues in using private capital inflows as an indicator of debt repayment capacity are sustainability, reversibility, and volatility of the elements that make up these flows. FDI is not readily reversible or volatile. Moreover, there are no contractual repayments associated with such flows. However, sharp drops in new flows of FDI cannot be ruled out. Foreign portfolio investment can, depending on the instrument and how it is used, be more volatile than FDI. The net impact depends on whether the seller uses the proceeds to undertake new investment. With these qualifications, it is proposed to include the share of private capital inflows in total capital inflows as an indicator of debt repayment capacity. Included in the measure are (i) non-debt flows, i.e., FDI and portfolio equity; and (ii) long-term debt flows, i.e., borrowing from private creditors including publicly guaranteed private debt and non-guaranteed private debt. The main source of the data is the *Global Development Finance 1998.* The time series covered is 1990–1996.

d. Size of Economy

10. Country size is an important determinant of a country's debt repayment capacity: the larger the country, the wider its economic base and consequently the stronger its debt repayment capacity. This is the underlying rationale of the Bank’s Charter mandate that special consideration be given to small countries in allocating resources. Country size can be defined in terms of, inter alia, land area, population, and size of economy measured by the GNP. The last factor, i.e., size of economy, has the strongest linkage with debt repayment capacity and has therefore been selected. It was found that the alternatives of GNP estimates using (i) the Atlas method based on official exchange rates, and (ii) PPP-based estimates generally produced similar results in terms of the composite debt repayment capacity index. The data source is the *World Bank Atlas 1998*.

2. Country Coverage

11. Of the Bank's 34 borrowers, 26 (including Tajikistan that has recently become a member of the Bank) have been covered in the quantitative assessment. The remaining eight DMCs (Afghanistan, Cook Islands, Kiribati, Marshall Islands, Micronesia, Myanmar, Nauru, and Tuvalu) could not be covered because of gaps in data for one or more of the indicators.

3. Construction of a Composite Index

12. The four indicator values can be aggregated into a composite index through (i) normalization of the different indicator values to a common scale and the subjective assignment of weights to construct a composite index or (ii) econometric procedures. The UNDP's Human Development Index is an example of the first type of composite index while the Commonwealth Secretariat's composite vulnerability index (CVI)[3] is an example of the second type. While the subjective assignment of weights can be justified by using economic reasoning, the results would depend on the weighting scheme(s) used. This appendix takes the second route but uses a different procedure for aggregation from the one used in the CVI.[4]

13. A clearly defined, unique, dependent variable that represents the debt repayment capacity construct may not exist. It is therefore necessary to use an econometric procedure for obtaining indices that does not require the *a priori* specification of a dependent variable. Principal components analysis (PCA) meets this requirement. PCA is essentially a data reduction method that produces linear combinations of the variables (principal components) that measure different dimensions of the data. The extraction of principal components amounts to a variance maximizing rotation of the original variable space to facilitate discrimination between similar, though not necessarily identical, profiles.[5] Because each consecutive principal component is defined to maximize the variability that is not captured in the preceding principal component, the consecutive principal components are orthogonal to each other. Since each consecutive component explains less and less variability, it makes sense to stop extracting components when there is very little variability left to explain.

14. The first principal component accounts for 75 percent of the total variance. The remaining 25 percent is associated with components whose eigenvalues are all less than 1. Interpreting such components is usually not recommended.[6] If the objective is to substitute just one combined measurement for the selected variables, the best choice is the first principal

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[3] A Composite Index of Vulnerability. Draft Report Prepared for the Commonwealth Secretariat. London. March 1998.

[4] The construction of the CVI depends on the choice of the dependent variable. Output growth volatility has been chosen as the dependent variable, and based thereon, a set of regression coefficients have been obtained. A different choice of the dependent variable (e.g., export growth volatility) with the same predictor variables would have yielded a different set of regression coefficients and indexes. While the regression procedure may be model-driven and may avoid the subjectivity inherent in the subjective assignment of weights, the choice of the dependent variable determines the weights assigned. Also, the output volatility indicator does not discriminate between (a) frequent changes in the direction of indicator values, and (b) rapid acceleration or deceleration of indicator values in the same direction. In effect, the indicator cannot discriminate between a stable but low level equilibrium and accelerating strength of performance. This could perhaps be the reason why Nepal exhibits a lower degree of vulnerability on the index than People's Republic of China, India, Indonesia, Malaysia, and Thailand. In fact, viewed from the perspective of the need for development assistance, some of the results of the CVI would appear to be counter-intuitive.

[5] See Marascuilo, Leonard A. and Joel R. Levin. 1983. *Multivariate Statistics in the Social Sciences—A Researcher's Guide*. Brooks/Cole Publishing Company.

[6] Originally proposed by H.F. Kaiser and known as Kaiser's rule.

component which is maximally correlated with them and explains more of their variance than any other composite measurement could. Based on the scores obtained from the first principal component, countries have been grouped into three categories of debt repayment capacities: adequate (Group 1), limited (Group 2), weak (Group 3). The grouping of countries obtained from PCA is:

(i) Group 1: People's Republic of China, India, Indonesia, Kazakhstan, Malaysia, Papua New Guinea, Philippines, Thailand, and Uzbekistan;

(ii) Group 2: Bangladesh, Fiji, Maldives, Pakistan, Sri Lanka, and Viet Nam; and

(iii) Group 3: Bhutan, Cambodia, Kyrgyz Republic, Lao PDR, Mongolia, Nepal, Samoa, Solomon Islands, Tajikistan, Tonga, and Vanuatu.

Group 1 corresponds to DMCs with adequate debt repayment capacity, Group 2 corresponds to DMCs with limited debt repayment capacity and Group 3 corresponds to DMCs with weak debt repayment capacity.

B. Assessment Based on Qualitative Variables

15. The results of the PCA are supplemented by an analysis of qualitative or categorical variables that have a bearing on debt repayment capacity. The procedure used for this purpose is correspondence analysis. The description of the categorical variables and the results of the analysis are discussed below.

1. Selection of Categorical Variables

a. Classification as Heavily Indebted Poor Country (HIPC)

16. A two-level categorization based on categorization as an HIPC is used. HIPCs comprise a group of countries considered by the IMF and the World Bank for their debt initative, known as the HIPC Initiative.[7] The HIPC classification is reported in the *World Economic Outlook 1998*.

b. Vulnerability to Fluctuations in Export Growth

17. A sustained capacity to repay foreign currency debt is dependent upon consistently strong export performance for the generation of foreign exchange receipts. Fluctuations in export growth indicate that foreign exchange receipts and in turn debt repayment capacity is vulnerable to external shocks. To measure such volatility, the coefficient of variation of export growth may be used to divide countries into two main groups: countries with volatility of export growth above and below the median, respectively. The level of exports must also be factored in because (i) small countries with low volatility but also low levels of exports could be in a low level equilibrium that indicates weak debt repayment capacity, and (ii) smaller countries are more dependent on export earnings than larger countries with sizeable domestic markets. Accordingly, the following levels of classification are proposed: (i) above median coefficient of

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[7] Boote, Anthony R. and Kamau, Thugge. *Debt Relief for Low-Income Countries: The HIPC Initiative*. Pamphlet Series, No. 51 (December 1997).

variation of export growth and below median level of exports (highly vulnerable), (ii) below median coefficient of variation of export growth and below median level of exports (moderately vulnerable), (iii) above median coefficient of variation of export growth and above median level of exports (less vulnerable), and (iv) below median coefficient of variation of export growth and above median level of exports (least vulnerable).

c. Main External Financing Source

18. A three-level categorization by main source of external financing source is used for the third categorical variable: (i) official financing, (ii) diversified financing, and (iii) private financing. The categorization is taken from the *World Economic Outlook 1998*. Other factors being the same, countries dependent on official financing are those that lack creditworthiness and access to international markets; countries relying on private financing are creditworthy and are able to tap international capital markets; and countries with diversified sources of external financing fall in between.

2. Rating for Sovereign Borrowing

19. DMCs that have access to and tap the international capital markets are rated by Moody's and Standard & Poor's, the leading commercial credit rating agencies. A two-level categorization is used for the fourth categorical variable: (i) rated, and (ii) not rated.

3. Degree of International Development Association (IDA) Access

20. IDA uses creditworthiness as one of two criteria (the other being per capita GNP) as the basis for determining access to IDA. The degree of IDA access could therefore be considered for inclusion among the categorical variables with a three-level categorization: (i) IDA-only, (ii) IDA-IBRD blend, and (iii) IBRD-only.

21. Correspondence analysis was used to analyze the selected categorical variables.[8] The PCA procedure was not employed because the extraction of principal components is based on a correlation matrix using Euclidean distance that is suitable for quantitative variables measured on a continuous scale. For categorical/qualitative variables, the "distance" between DMCs is in terms of similarities and differences between their profiles made up of the selected attributes. The data matrix that is suitable for such variables is the contingency table and the appropriate analytical procedure is correspondence analysis. Correspondence analysis displays categorical data points in high dimensional space in a lower-dimensional subspace that comes "closest" to all the data points. An examination of the relative positions of the points suggests similarities and differences among the cases (DMCs) based on the categorical variables.

22. The results obtained from the correspondence analysis are:

(i) Group 1: People's Republic of China, Fiji, India, Indonesia, Kazakhstan, Malaysia, Papua New Guinea, Philippines, Thailand, and Uzbekistan;

(ii) Group 2: Bangladesh, Kyrgyz Republic, Pakistan, Sri Lanka, and Viet Nam; and

[8] See Greenacre, Michael J. 1984. *Theory and Applications of Correspondence Analysis.* Academic Press.

(iii) Group 3: Bhutan, Cambodia, Kiribati, Lao PDR, Maldives, Mongolia, Myanmar, Nepal, Samoa, Solomon Islands, Tajikistan, Tonga, and Vanuatu.

DMCs in Group 1 share the following attributes: (i) their main external financing is not official (it is either private or diversified), (ii) most of them are rated by Moody's and Standard & Poor's, (iii) they comprise less and least vulnerable DMCs in terms of fluctuations in export growth, and (iv) most of the DMCs are IBRD-only borrowers of the World Bank. Group 3 DMCs share the following attributes: (i) their main external financing source is official, (ii) they are not rated by credit rating agencies, (iii) they comprise highly and moderately vulnerable DMCs, (iv) they are IDA-only borrowers of the World Bank, and (v) they include HIPCs. Group 2 has some attributes common with Group 1 and some with Group 3. Consequently, they fall between the two groups.

23. As with the results obtained from PCA, Group 1 corresponds to DMCs with adequate debt repayment capacity, Group 2 corresponds to DMCs with limited debt repayment capacity, and Group 3 corresponds to DMCs with weak debt repayment capacity.

24. An overall assessment of debt repayment capacity can be made by reconciling the results of the assessments based on quantitative and qualitative variables as shown in the Table below.

Table 1: Reconciliation of Results of Analysis of Quantitative and Qualitative Indicators of Debt Repayment Capacity

		QUALITATIVE VARIABLES		
		Weak	**Limited**	**Adequate**
QUANTITATIVE VARIABLES	**Weak**	Bhutan Cambodia Lao PDR Mongolia Nepal Samoa Solomon Island Tajikistan Tonga Vanuatu	Kyrgyz Republic	
	Limited	Maldives	Bangladesh Indonesia[a] Pakistan Sri Lanka Viet Nam	Fiji
	Adequate			PRC India Malaysia Papua New Guinea Philippines Thailand Uzbekistan

[a] Assessed as having adequate repayment capacity over the medium term but due to fragile social and political situation over the short term, shown as having limited debt repayment capacity here and in the main text.

Along the diagonal of the matrix, from top left to bottom right, the assessments based on quantitative and qualitative variables match. Reconciliation is required for the off-diagonal DMCs, i.e., Maldives, Kyrgyz Republic, and Fiji. As a rule of thumb, when the assessments on the quantitative and qualitative variables do not match, the current classification will be maintained.

a. Maldives

25. The assessment based on quantitative variables that Maldives has limited debt servicing capacity must be reconciled with the assessment based on qualitative variables that it has weak debt repayment capacity. The more favorable assessment on quantitative variables is because Maldives scores well on the debt sustainability ratio and the gross domestic saving rate. The less favorable assessment on qualitative variables reflects Maldives' position as (i) highly vulnerable to fluctuations in export growth, (ii) dependent on official financing, (iii) categorization as an IDA-only country, and (iv) not rated by Moody's or Standard & Poor's. Overall, it is proposed to go along with the qualitative assessment that Maldives has weak debt repayment capacity.

b. Kyrgyz Republic

26. The assessment on quantitative variables that the Kyrgyz Republic has weak debt repayment capacity has to be reconciled with the assessment on qualitative variables that it has limited debt repayment capacity. The less favorable assessment on quantitative variables is due to (i) the very small share of private capital inflow in total capital inflow, (ii) the high vulnerability to fluctuations in export growth, (iii) the low gross domestic saving rate, and (iv) the relatively small size of the economy. The more favorable assessment on qualitative variables is because the Kyrgyz Republic is (i) not an HIPC, (ii) categorized as an IDA-IBRD blend borrower by the World Bank. Overall, it is proposed to go along with the assessment on quantitative variables that the Kyrgyz Republic has weak debt repayment capacity.

c. Fiji

27. The assessment on quantitative variables that Fiji has limited debt repayment capacity has to be reconciled with the assessment on qualitative variables that it has adequate debt repayment capacity. The less favorable assessment on qualitative variables is due to (i) a low value for the gross domestic saving rate, and (ii) the relatively small size of the economy. The more favorable assessment on qualitative variables is due to (i) the main external financing source being private, and (ii) categorization as an IBRD-only borrower of the World Bank. Notwithstanding low investment rates leading to sluggish growth performance, the case for going along with the qualitative assessment and maintaining the status quo is supported by Fiji's historical record of macroeconomic stability and comfortable external debt service position. Overall, it is proposed to assess Fiji as having adequate debt repayment capacity.

C. DMCs Not Covered under Assessment on Quantitative Variables

28. Two countries, Kiribati and Myanmar, that were not covered under the assessment on quantitative variables, were assessed on qualitative variables as having weak debt repayment capacities.

29. Kiribati is dependent on official sources of external financing and is highly vulnerable to fluctuations in export growth. Additional considerations are (i) the limited scope for agricultural crops given the small land mass and poor quality of soil, (ii) the fragile environment, and (iii) the dependence on transfer payments from the trust fund from sales of phosphates (now depleted) in past years.

30. Myanmar has been assessed as having weak debt repayment capacity on the qualitative variables. It is classified as an HIPC. It is quite vulnerable to fluctuations in export growth. Additional considerations are the low rates of saving and investments and very limited availability of external finance.

31. Countries not covered either under the assessment on quantitative variables or qualitative variables due to paucity of data are discussed below.

32. Afghanistan is proposed to be categorized as having weak debt repayment capacity on account of (i) its categorization as a severely indebted country by the World Bank, and (ii) the collapse of the physical infrastructure following years of civil strife.

33. Cook Islands is proposed to be categorized as having weak debt repayment capacity. The country's inability to meet its debt repayment obligations recently led to rescheduling of the

country's debt. Prior to the debt write-off, a report[9] was prepared that underscored the country's precarious fiscal and debt situation. Following the debt rescheduling, the Government is committed to financing development expenditures from concessional or nondebt-creating sources.

34. Marshall Islands and Micronesia have been experiencing contraction in output over the past few years. These economies are almost entirely dependent on Compact Funds which are scheduled to cease in 2001. Marshall Islands has been issuing bonds to finance its capital expenditures and has used Compact Funds as collateral against the bonds. Excluding foreign grants, the fiscal and current account balances have been in deficit over the last 10 years. For these reasons, it is proposed to categorize Marshall Islands and Micronesia as having weak debt repayment capacity.

35. Nauru is proposed to be categorized as having limited debt repayment capacity. The country is in the midst of financial crisis caused by running unsustainable budget deficits and mismanagement of National Phosphate Royalty Trust (NPRT) funds. However, Nauru still owns several substantial assets that if managed judiciously could return the country to its previous levels of per capita income: (i) phosphate reserves that could last another five to six years, (ii) substantial unmortgaged offshore assets in NPRT, and (iii) considerable wealth and trust fund earnings accruing to landowners.[10]

36. Tuvalu is proposed to be categorized as having weak debt repayment capacity because of severe development constraints imposed on the country by its small size and fragmentation of land area, remoteness from markets, and limited resource endowments.[11]

D. Overall Assessment of Debt Repayment Capacity

37. Pulling together the quantitative and qualitative assessments of debt repayment capacity, DMCs are proposed to be categorized according to debt repayment capacity as in Table 2.

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[9] Asian Development Bank. The Cook Islands. Economic Situation, Prospects, and the Outlook on Debt. May 1998.
[10] Nauru. Country Assistance Plan. 1999–2001.
[11] Tuvalu. 1997 Economic Report. Pacific Studies Series. Asian Development Bank.

Table 2: Overall Assessment of Debt Repayment Capacity

Debt Repayment Capacity	Developing Member Country
Weak	Afghanistan, Bhutan, Cambodia, Cook Islands, Kiribati, Kyrgyz Republic, Lao PDR, Maldives, Federated States of Micronesia, Mongolia, Myanmar, Nepal, Marshall Islands, Samoa, Solomon Islands, Tajikistan, Tonga, Tuvalu, Vanuatu
Limited	Bangladesh, Indonesia,[a] Nauru, Pakistan, Sri Lanka, Viet Nam
Adequate	People's Republic of China, Fiji, India, Kazakhstan, Malaysia, Papua New Guinea, Philippines, Thailand, Uzbekistan

[a] Assessed as having adequate repayment capacity over the medium term but due to fragile social and political situation over the short term, shown as having limited debt repayment capacity here and in the main text.