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Graduation from ADB regular assistance: a critical analysis and policy options

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Acronyms

AAAA	Addis Ababa Agenda for Action
ADB	Asian Development Bank
ADF	Asian Development Fund
AfDB	African Development Bank
AfDF	African Development Fund
AIIB	Asian Infrastructure Investment Bank
COBP	Country Operations Business Plans
CPS	Country Partnership Strategy
DMC	Developing member country
EBRD	European Bank for Reconstruction and Development
EME	Emerging Market Economy
GAVI	Global Alliance for Vaccines and Immunisation
GFATM	Global Fund to Fight AIDS, Tuberculosis and Malaria
GNI	Gross National Income
HMIC	Higher-middle-income country
HSS	Health Systems Strengthening
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
LAC	Latin American Country
LIC	Low-income country
LMIC	Lower-middle income country
MDB	Multilateral development bank
MIC	Middle-income country
MO	Multilateral organisations
MOL	Market-based OCR Lending
MOU	Memorandum of understanding
MTR	Midterm review
OCR	Ordinary Capital Resources
ODA	Official Development Assistance
ODI	Overseas Development Institution
OIC	Organisation of Islamic Cooperation
OM	Operations Manual
PPP	Purchasing power parity
PRC	People’s Republic of China
SBL	Single Borrowing Limit
SDG	Sustainable Development Goal
TA	Technical assistance
UMIC	Upper-middle-income country
WBG	World Bank Group

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The views expressed here as solely those of the authors and do not reflect the views of the Overseas Development Institute or of ADB.

Executive summary

Objectives of the paper. The Overseas Development Institute (ODI) was commissioned to write a research paper to (i) help the Asian Development Bank (ADB) review its current policy regarding DMC (Developing Member Country) graduation from regular assistance/non-concessional resources and (ii) identify and assess options for graduation from regular assistance as well as areas for reform of the ADB's current policy. This paper is based on a desk-based literature review and interviews with ADB management, current and former staff in other multilateral development banks (MDBs), and academics.

Why this paper and why now. The ADB is formulating a new corporate strategy (Strategy 2030) to help reposition the institution in the rapidly changing global environment and development landscape of Asia and the Pacific. DMCs' needs and expectations are also evolving. Not only will most of ADB's DMCs be classified as middle-income countries (MICs) by 2020, according to the midterm review of Strategy 2020, but in a growing number of DMCs, annual income per capita is already greater than $7,175 (in six DMCs) or will be by 2030 (in an additional six DMCs). Exceeding an income per capita of $7,175 triggers a discussion of whether the DMC will no longer access sovereign and non-sovereign lending from the Ordinary Capital Resources (OCR) window with harder terms and conditions or other facilities (such as guarantees), unless for emergency purposes. Such an outlook for several ADB DMCs calls for a fresh look into the policy on graduation from regular assistance.

Other motivations for a revision of the ADB policy on graduation from regular assistance. The development landscape has changed remarkably since the policy on graduation from regular assistance was introduced in 1998 and since its revision in 2008. This calls for reflection on whether its parameters are still fit for purpose. These changes include: universality and inclusiveness of the Sustainable Development Goals (SDGs), which apply to all countries irrespective of income levels; growing inequality (across income levels, subregions and groups); a strong role played by the regional economic integration agenda in the Asian region; higher vulnerability to climate change, especially but not only in the Pacific Islands; the scaling up of ADB's support following the Asian Development Fund (ADF)-OCR merger; and finally changes from the demand side of development finance, with countries now usually being able to access a larger set of financing options (including capital markets and new financial institutions in the region) and being more assertive about how they manage different sources of finance.

ADB graduation policy: key criteria and their interpretation. To graduate from ADB regular assistance, a DMC has to meet three criteria: (i) annual gross national income (GNI) per capita currently above $7,175 (and regularly updated and aligned to the International Bank for Reconstruction and Development (IBRD)), (ii) availability of commercial capital flows on reasonable terms and (iii) attainment of a certain level of development of key economic and social institutions. Crossing the GNI per capita threshold merely triggers a process that may lead to graduation (income per capita is not a perfect indicator, but there are advantages to using it compared to other measures of wealth). It is worth noting, however, that the criteria that initially determined the GNI per capita thresholds have never been published and there is no evidence base (at least none publicly available) to justify them (Alonso et al., 2014; Ravallion, 2013). A DMC will graduate from ADB regular assistance only if it fully meets the other two criteria, whose indicators are now assessed on a subjective basis only, for at least four successive years (which is indicated in the 1998 graduation policy but is not explicitly stated in the Operations Manual). A DMC that discontinues de facto borrowing from ADB is still eligible for ADB non-concessional resources and it is not defined as 'graduated'. There are a number of DMCs that crossed the GNI per capita threshold more than five years ago (notably Kazakhstan in 2010, Malaysia in 2007, and Palau in 1998 when it joined) but that, for different reasons, have not yet been assessed as having either the ability to access commercial capital markets or a certain level of socioeconomic development, or both.

Policy options. The paper assesses five policy options for graduation from regular assistance, as illustrated in Figure 1. It also analyses the viability of four different exceptions applicable under each of the five options (differentiated pricing for each DMC, the separation of graduation policies between sovereign and non-sovereign lending, concessional terms applied to small island economies independently from their per capita income – the so-called small island and small economy exception, and support to projects targeting the regional agenda).

Figure 1: Policy options for graduation from regular assistance

Graduation based on publicly available thresholds/indicators for all criteria	Status quo	Increased flexibility in exit	Voluntary graduation	No graduation policy
Each criterion is transparent and measured by quantitative indicators	Current ADB graduation policy with criteria (ii) and (iii) based on subjective assessments	No strict timetable/path for graduation with flexibility in managing exit	A DMC decides whether and when to apply for graduation from regular assistance	DMCs have an indefinite option to borrow from ADB resources

Recommendations. Based on our review of the literature and our comparative analysis with other MDBs and multilateral organisations, we recommend the following:

- **A policy on graduation from regular assistance should be in place.** A graduation policy provides a framework – to guide decision-making, thus reducing discretionary political decisions; to utilise limited resources in the most effective way; and to help in planning future resource disbursements. For instance, the European Bank for Reconstruction and Development (EBRD) introduced broad criteria for graduation in 1997 following a Board request, and the 2015 revised GAVI (Global Alliance for Vaccines and Immunisation) eligibility policy addressed the gap left by the 2009 approach to graduation, when countries did not know when they might graduate because the timing and nature of future updates had not been specified.
- **The graduation policy should be correctly interpreted, with all three criteria (GNI per capita above threshold, availability of commercial capital at reasonable costs, and attainment of a certain socioeconomic level) to be met.** When assessing these last two criteria, the particular challenges faced by DMCs should be considered. Moreover, the policy should be applied flexibly. Besides harmonising with the more flexible approach of the IBRD and of the EBRD, there are several other motivations to introduce flexibility in the application of ADB's graduation policy:
    - The international development agenda – the universality and inclusiveness of the SDGs and regional and economic cooperation in the Asian region – calls for a longer-term engagement with DMCs. The increasing interconnectedness of the region means that externalities and positive spillovers from ADB's engagement in an individual DMC can have impacts on other DMCs. In addition, even MICs continue to face critical development challenges for which they seek multilateral partners to bring in not just finance but also international best practice and knowledge solutions.
    - The graduation point is likely to become more difficult to define at the national and aggregate level. Disparities in the level of development and access to financing can be as great within countries as between countries, one of the main challenges of the upper-middle income countries (UMICs) in the region.

- Changes in the development landscape reflected above may warrant the introduction of additional criteria to reflect the different set of challenges that DMCs face. Additional dimensions, if not already covered under the assessment of criteria (ii) and (iii) (the details of which are bounded by confidentiality and not accessible for this review), could include: income and non-income measures, human development indicators (health and education-related indicators, e.g. the components of the UNDP Human Development Index), vulnerability to climate change, tax revenue mobilisation, and availability of alternative financing options, both for the public and the private sectors.
- Access to multilateral finance can be seen as an insurance strategy against volatility. For example, none of the countries that re-entered IBRD assistance have re-graduated, with exception of the Republic of Korea (the country officially graduated from IBRD assistance in July 2016, after the research for this report was finalised), despite having not renewed borrowing for over ten years.
- While it should not drive ADB's graduation policy, graduation of more creditworthy borrowers can have an impact on the quality of the portfolio as well as on income generation for ADB, which also cross-subsidises the concessional window.
- Lending remains an instrument for policy change and for promoting international goals and standards, and for DMCs to fully engage with these agenda with benefits for non-borrowing member states that are not costly for their taxpayers.

- **New approaches to lending and eligibility should be considered to reflect the new circumstances of DMCs and ADB capacity to mobilise resources.** There are some exceptions worth exploring when it comes to the engagement with UMICs and/or graduated DMCs.
  - **ADB could offer differentiated pricing for each DMC.** The higher the income per capita of the country, the higher the pricing, in the case of sovereign lending – reflecting the capacity of some UMICs to afford more expensive loans. It has clear disadvantages. Such a proposal undermines the cooperative nature of MDB lending by penalising success – in that commercial banks normally charge more creditworthy borrowers less rather than more. Some DMCs might also find ADB assistance less attractive, not to mention the greater complexity in setting up differentiated terms or the fact that products already have differentiated terms, at least applicable to each country grouping. However, there are a series of advantages in taking a differentiated approach to pricing instruments: several borrowing DMCs are in a position to afford more expensive loans (compared to the market options they can access) and they can help generate income to subsidise soft-window lending; such an approach would also smooth the transition to (fully) market-based lending.
  - **Non-sovereign lending operations should not cease after graduation from sovereign lending.** For example, the private sector arm of the World Bank Group (WBG) – the International Finance Corporation, IFC – has a separate eligibility policy for the private sector in DMCs that is based on project-level criteria. Lending to private companies also means the country will continue to engage with the ADB, including policy dialogue. This policy would also help support regional cooperation projects (see last point) and harmonise the ADB approach with the WBG. Finally, a government can be creditworthy but certain segments of the private sector might not. This would mean continued support to projects with a demonstration effect. At the same time, pricing at commercial terms also means that private sector operations are not subsidised and ADB's current target of 40% of private sector operations in frontier markets prevents the risk of resources crowded out to low- and lower-middle-income countries.
  - **There is scope to formalise a small-island/small-economy exception in the graduation policy.** Such an exception would apply across ADF and OCR windows and not only to the options of graduation from ADB regular assistance. Small islands/small economies would be granted ADF status independently of their income per capita level (i.e. even if it is above $7,175, as is currently the case with Cook Islands and Palau).

Formalising such an exception will be consistent with the ADB charter that calls for attention to the special needs of such economies. The World Bank provides a similar exception.

- **An exception can be granted to projects supporting the regional integration and cooperation agenda that have positive externalities and spillover effects, independently of eligibility for regular ADB lending**. This exception would allow continued engagement with graduated DMCs on regional projects and initiatives that are at the core of the ADB mandate and strategy. The country-based lending might not create the right incentives for a borrowing country to support regional projects. Such projects, which could benefit the various sub-regions of Asia and Pacific more widely, might remain underinvested.

1 Introduction

1. **Scope of this background paper**. The Overseas Development Institute (ODI) was commissioned to write a background paper whose main objectives are (i) help the Asian Development Bank (ADB) review its current policy regarding the graduation of Developing Member Countries (DMCs) from regular assistance/non-concessional resources, (ii) compare the (upper-end) graduation policy with the approaches adopted by other multilateral development banks (MDBs) and multilateral organisations (MOs) from either non-concessional windows or from the organisation itself, and (iii) identify and assess options for graduation from ADB regular assistance as well as areas for reform of the ADB's current policy.

2. **ADB's engagement with UMICs**. The ADB is formulating a new corporate strategy to help reposition the institution in the rapidly changing global environment and development landscape of Asia and the Pacific. Building on the strategic and institutional directions identified in the midterm review of Strategy 2020 (MTR) in 2014, the new corporate strategy will set ADB's long-term strategic framework and guide ADB's operations and the delivery of its development assistance until 2030. With only two of ADB's DMCs (Afghanistan and Nepal) expected to be classified as low-income countries (LICs) by 2020, the MTR identifies the engagement of ADB with middle-income countries (MICs) as a key strategic priority going forward. Among others, the MTR specifically recognises the development challenges faced by upper-middle-income countries (UMICs). Such a strategy for the engagement with UMICs has initially been framed in the ADB Board Information Paper circulated in February 2015, *Clients–Contributors–Collaborators: A New Partnership with Upper Middle-Income Countries*, currently under revision (*ADB's Approach to UMICs: A Refined Framework*).

3. **A review of the policy on graduation from ADB regular assistance in the context of the new corporate strategy.** Not only will most of ADB's DMCs will be classified as MICs by 2020, according to the midterm review of Strategy 2020, but in a growing number of DMCs, annual income per capita is already greater than $7,175 (in six DMCs) or it will be by 2030 (in an additional six DMCs) (see Box 1). Such an outlook calls for a fresh look into the policy on graduation from regular assistance because exceeding an income per capita of $7,175 triggers the discussion on whether the DMC will no longer access sovereign and non-sovereign lending from the Ordinary Capital Resources (OCR) window. Other elements of the evolving nature of the engagement with UMICs – regional cooperation and integration, climate change and the environment, and a larger emphasis on private sector operations – drives this review of the policy on graduation from regular assistance as part of the new ADB corporate strategy. Graduation from regular assistance means a DMC will no longer access sovereign and non-sovereign lending from the OCR window with harder terms and conditions or other facilities (such as guarantees), unless for emergency purposes.[1] A DMC that discontinues de facto borrowing from ADB is still eligible for ADB non-concessional resources and it is not defined as 'graduated'. Graduation from ADB regular assistance refers to a formal process of ceasing to be eligible for ADB non-concessional resources approved by the ADB Board of Directors. Furthermore, by 2014 Azerbaijan (crossed the income per capita threshold in 2013), the People's Republic of China (PRC) (2014), Kazakhstan (2010), Malaysia (2007) and Turkmenistan (2014) had exceeded the $7,175 per capita income

[1] See ADB (1998) and ADB (2008) – *A graduation policy for the bank's DMCs* and *Review of the 1998 Graduation Policy of the Asian Development Bank.*

threshold.[2] Crossing this threshold only prompts a discussion about graduation from non-concessional resources. Six other countries are estimated to cross the gross national income (GNI) per capita threshold by 2030 (see Section 3). For sovereign and non-sovereign operations to cease in a DMC, other criteria have to be satisfied: availability of commercial capital flows on reasonable terms, and attainment of a certain level of development of key economic and social institutions.

4. **Methodology applied for the analysis in this background paper.** The ODI team commissioned for this background paper applied a mixed-methods approach. First, a rapid non-systematic literature review of the operations manuals of selected MDBs reviewing the criteria and procedures currently applied for graduation from non-concessional resources. Second, the analysis of relevant academic and policy papers, reviewing policy on criteria for graduation from non-concessional windows. Third, a non-systematic literature review of options for graduation that have been suggested but not implemented so far, based on academic and policy papers (see also Section 8). Fourth, a quantitative analysis to identify which DMCs are projected to cross the income per capita threshold triggering a discussion that could lead to graduation from regular assistance (see Section 2) by the horizon of the new corporate strategy, 2030. Fifth, a series of interviews with former and current relevant staff in MDBs (European Bank for Reconstruction and Development (EBRD), International Bank for Reconstruction and Development (IBRD), Inter-American Development Bank (IADB), Global Fund to Fight AIDS, Tuberculosis and Malaria (GFATM)) and academia (Center for Global Development, Brookings), conducted in March 2016 and in late June 2016. Finally, a round of consultations with ADB senior management staff, which took place in late March and early April 2016.[3]

5. **Limitations to the literature review.** Most of the literature on graduation focuses on the transition from concessional to non-concessional windows, with very little to be found on graduation from non-concessional windows out of regular assistance. The latter is the scope of this paper, and we do not analyse the transition from concessional (for example Asian Development Fund (ADF)) to non-concessional resources (e.g. OCR). The latter was mostly discussed in the reports of special purpose commissions back in the early 2000s that explored the role of MDBs. Their key findings are illustrated in the subsequent sections (Gurría and Volcker report on *The Role of the Multilateral Development Banks in Emerging Market Economies* in 2001 and Meltzer's *The Report of the International Financial Institution Advisory Commission* in 2000). Except for Knack et al. (2012), no academic paper explicitly and exclusively analysed the issue of graduation from regular assistance, let alone a systematic comparison among MDBs.

6. **Road map.** The paper is structured as follows. Section 2 outlines the current criteria and process of the ADB graduation policy introduced in 1998 and revised in 2008 (from regular assistance, as defined in the policy) as well as its application so far. Section 3 reflects on changes in the development landscape since the graduation policy was introduced in 1998, and whether and how these changes call for its revision. Section 4 delves into the rationale for having a graduation policy. Section 5 analyses and compares the approaches on graduation applied by MDBs and MOs, drawing lessons for the discussion of the ADB current approach and its revision. Section 6 builds on these last two sections and critically assesses five policy options and directions for the reform of the graduation policy as well as the rationale for exceptions (differentiated pricing for each DMC, exception for small island economies, projects promoting regional cooperation and integration and separate policy for non-sovereign operations). Section 7 draws conclusions and outlines recommendations for the revision of the ADB's current policy on graduation from regular assistance.

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[2] The GNI of Palau has also risen above $7,175 since it joined ADB.
[3] ADB management was consulted for this review. Board members will be engaged in the next interaction.

2 ADB graduation policy from regular assistance: a brief overview

7. **Key references and policies.** This section aims to outline key elements only of the current policy as set in ADB's Operations Manual (OM – Section A1/BP, B) on graduation from regular/non-concessional assistance; the following sections will refer back to them. This section does not aim at a systematic review of the ADB graduation criteria and process and does not replace other ongoing analyses.

8. There are two major policies defining the criteria to be applied and the process to be followed in order for a DMC to graduate from what is referred to as ADB regular assistance: the 1998 Graduation Policy (ADB, 1998) and its review in 2008 (ADB, 2008). Graduation from regular assistance means a DMC will no longer access sovereign and non-sovereign lending from the OCR window with harder terms and conditions or other facilities (such as guarantees), unless for emergency purposes. A DMC that stops de facto borrowing from ADB is still eligible for ADB non-concessional resources and it is not defined as 'graduated'. Graduation from ADB regular assistance refers to a formal process of ceasing to be eligible for ADB non-concessional resources approved by the ADB Board of Directors. Graduation from ADB regular assistance was introduced only in 1998.

9. **Principles.** The policy setting the parameters for graduation from ADB regular assistance is governed by two key principles*:*

1. A country may graduate once it has reduced its dependence on official assistance and has reliable access to commercial capital.
2. Graduation is not linked to the DMC status of the country, nor does it signify termination of a regional member's relationship with ADB (OM Section A1/BP F 12).

10. The first point reflects one of the operating principles articulated in the ADB Charter (art. 14 v), the *ability of the borrower to obtain financing or facilities elsewhere on terms and conditions that the Bank considers reasonable for the recipient*.[4] However, in the Charter there is no explicit reference for ADB to have a graduation policy in place.

11. The graduation policy translates the second principle by taking into account potential effects of economic reversals (for example, a DMC graduating from either ADF or OCR resources may be eligible for these resources again if its economic conditions deteriorate, as in the case of the Republic of Korea in 1997) and by specifying different ways for the ADB and the graduated DMC (such as the Republic of Korea, Singapore, Hong Kong, China, Taipei,China) to collaborate (reimbursable technical assistance (RTA), contribution to the development of capital markets, transfer of technology, co-financing opportunities, subregional cooperation, and promotion of private-to-private flows). According to the ADB Charter (art. 28), the DMC status is determined by

[4] Taking into account all pertinent factors.

the Board of Governors, taking into account *appropriate economic considerations.*[5] De-linking the formal graduation process (and the engagement) from the DMC status also offers greater flexibility in the policy implementation.

12. **Criteria.** In OM Section A1/BP, para. 7 and the 1998 graduation policy, three criteria have been identified to operationalise these two principles:

(i) GNI per capita.
(ii) Availability of commercial capital flows on reasonable terms.
(iii) Attainment of a certain level of development of key economic and social institutions.

13. Criterion (i). GNI per capita only triggers the process that may lead to graduation, by exceeding a threshold that is annually updated ($7,175 in 2014). This indicator and threshold are intentionally aligned to the one applied by the World Bank Group (WBG). This is the approach adopted not only by the World Bank and the ADB, but also by the African Development Bank (AfDB), for country graduation and reclassification. In the early 1980s, the IBRD put forward its analytical country classification in relation to its operational lending categories. According to the World Bank,[6] the process of setting per capita income thresholds started with finding a stable relationship between a summary measure of well-being (such as poverty incidence or infant mortality), on the one hand, and economic variables (including per capita GNI estimates based on the World Bank's Atlas method), on the other.[7] Based on such a relationship and the annual availability of World Bank resources, the original per capita income thresholds were established. However, while the process of setting the original per capita income thresholds for defining categories of countries was related to the World Bank's previous lending activities, the specific criteria used for determining the thresholds have never been published and there is no evidence base (at least none publicly available) to justify the initial thresholds that were set (Alonso et al., 2014; Ravallion, 2013).[8] Furthermore, at least for the lower threshold (triggering International Development Association (IDA) graduation), the sudden change in the late 1980s (formalised since FY94) to an 'operational cut-off' more than a third lower than the traditional IDA analysis suggested was once again driven by pragmatic and political, not analytical, considerations (Mustapha et al., 2015). In contrast, the thresholds remain constant in real terms over time, and the criteria applied for their updating are transparent.[9]

14. In our consultations with ADB stakeholders, it often emerged how this first quantitative criterion overshadows the other two more subjective and long-term criteria, which are for internal assessment. In other words, while the OM clearly states that crossing the income per capita threshold only triggers the graduation process, the interpretation of the policy on graduation from regular assistance often relies on this indicator only. We would recommend that the OM stresses that exceeding the GNI per capita threshold triggers only the graduation process, and that graduation from ADB regular assistance requires all three criteria to be met simultaneously. Several DMCs have crossed the income per capita threshold (Azerbaijan, PRC, Kazakhstan, Malaysia, Palau and Turkmenistan), but in the round of consultations with senior ADB staff it emerged that discussion of whether the DMCs should graduate has so far been limited, although graduation is mentioned in the Country Partnership Strategy (CPS) of PRC (Transforming Partnership: People's Republic of China and Asian Development Bank, 2016–2020, 2016, footnote 1), Kazakhstan (Kazakhstan 2012–2016 Country Partnership Strategy, 2012, paragraph 1) and

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[5] Approval is by two thirds of the total number of Governors, representing not less than three fourths of the total voting power of the members. The Board of Governors from time to time determines which countries or members of the Bank are to be regarded as developed or developing countries or members, taking into account appropriate economic considerations.

[6] http://go.worldbank.org/U9BK7IA1J0

[7] http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20487070~menuPK:641 33156~pagePK:64133150~piPK:64133175~theSitePK:239419~isCURL:Y,00.html

[8] In a meeting in June 2016 with World Bank staff, no information was available to justify the original set-up of the income per capita thresholds for both the analytical income and operational classifications.

[9] Since then, the original thresholds have been updated to incorporate the effects of international inflation (measured by the average inflation of Japan, the United Kingdom, the United States and the Eurozone).

Azerbaijan (Azerbaijan Country Partnership Strategy 2014–2018, 2014, paragraph 34). The OM stresses how the graduation process *also involves close consultation with the borrower*.

15. Income per capita is far from being a perfect indicator for comparing wealth between countries: by definition it does not capture income inequality, regional disparities or purchasing power. However, there are no obvious alternatives, and using GNI per capita to trigger a discussion that could lead to graduation has several advantages compared with using other measures of wealth. GNI per capita is a synthetic measure that is easily understood; it is one of the easiest indicators to collect and to compare across countries; it is widely available (which might not be the case for measures of income inequality, such as the Gini index); it is usually released with a one-year lag, collected every year; and it is not affected by fluctuations associated with the choice of a base year or a reference basket (such as in the case of GDP/GNI calculated on the basis of purchasing power parity (PPP)). Mustapha et al. (2015) reviewed the use of alternative measures to GNI per capita for triggering the IDA graduation process. While in principle these other measures are also relevant to the discussion on graduation from regular assistance, they are not necessarily better proxies than GNI per capita. These include the median household income (Birdsall and Meyer, 2014), a measure of fiscal capacity (Kharas et al., 2014; Morris and Gleave, 2015) and indices of economic vulnerability (see Bourne, 2015).[10]

16. **Criteria (ii) and (iii).** These criteria – regarding the availability of commercial capital flows on reasonable terms and the attainment of a certain level of development of key economic and social institutions – are guided by the broad indicators set out in the 1998 graduation policy. The criteria are considered to assess one of the key principles of graduation from regular ADB assistance, i.e. reduced dependence on official assistance and reliable access to commercial capital. The weight of these two criteria therefore should be greater than that of the first criterion, GNI per capita. The 1998 policy states (p. 25) that key considerations for the assessment of creditworthiness (criterion ii) include *macroeconomic stability, exchange rate policy, trade and investment liberalisation, privatisation, tax reform, financial sector liberalisation and corporate governance.* With regard to criterion iii, dimensions taken into account to measure the level of development of key economic and social institutions include *the quality of processes for macroeconomic management, the regulatory and supervisory framework in the financial sectors, the efficiency and flexibility of labour markets,* and *the legal system.*

17. **2008 review of the graduation policy.** Two main changes introduced with the 2008 review are worth mentioning here, being relevant to a background analysis on graduation policy. First, the debt repayment capacity criterion (i.e. ability to gain access to commercial loans) was replaced with the concept of creditworthiness/availability of commercial capital flows on reasonable terms to align it to the practice of the World Bank Group (WBG). Second, debt repayment capacity was initially assessed both qualitatively[11] and quantitatively,[12] the latter measured by a composite index of four indicators (debt sustainability ratio, gross domestic saving rate, private capital inflow, and the size of the economy) applying a principal component analysis (see ADB 1998 for details on the methodology). The quantitative approach was removed following

[10] First, Birdsall and Meyer (2014) argue that survey-based median household consumption expenditure (or income) per capita is a better simple measure of "typical" well-being within a country than GNI per capita. While data availability has improved, this measure relies heavily on available household surveys for data on consumption (or income), in PPP terms, which will have to be updated, if not annually then at least every few years, and which might not be available for all countries. Second, a good way to measure a country's capacity to mobilise its own resources for poverty reduction is to compare the poverty gap – the total level of public transfers potentially needed to pull all those below the $1.25 a day (PPP) poverty line up to it – with tax revenues. However, this calculation requires good income distribution data, which is not systematically and annually available. Furthermore, it could potentially be miscommunicated as discouraging progressive rates of taxation, when the opposite is needed. Finally, an economic vulnerability index can be used to make adjustments to standard indicators to reflect the qualitative differences between countries in terms of their achievements and their ability to safeguard them. However, such indices tend to be criticised on the grounds of subjectivity: variables selected to construct the index must be based on plausible assumptions about what renders an economy vulnerable to forces outside its control, and they must be measured in a suitable manner – measurement errors are generally found in indices which attempt to assign numerical values for variables that are essentially qualitative.

[11] Criteria were: categorisation as a Heavily Indebted Poor Country, vulnerability to fluctuations in export growth, main external financing source, degree of access to IDA resources, and whether rated by Moody's and Standard and Poor's for sovereign borrowing.

[12] Including assessment of the debt sustainability ratio, share of private capital inflows in the total capital inflows, gross domestic savings rate, size of the economy.

the revision in 2008, and the indicators are now all qualitatively assessed. In the round of consultations, ADB staff justified this shift firstly by the limited data availability and quality for several indicators and secondly by the need for a more flexible approach to better capture the political economy dimensions of such analysis.

18. **Assessment of the indicators and implications of the new development agenda.** As mentioned above, all indicators are now assessed on a subjective basis only. The assessment of these indicators is informed at the time of the CPS (every five years) and of the annual Country Operations Business Plans (COBP), as part of the country's macroeconomic analysis. Detailed indicators and the methodology for the assessment are not publicly available. Some ADB interviewees requested the assessments of criteria (ii) and (iii) to be more rigorous, comparable and systematic. In Section 3 we review some key changes in the development landscape. Going forward, criterion (iii) on the development of economic and social institutions should also assess the capability of these institutions to address the new and more ambitious development agenda; that is, the universal set of Sustainable Development Goals (SDGs) and increased vulnerability to climate change. These would warrant the introduction of additional criteria to reflect the different set of challenges DMCs face. Additional dimensions, if not already covered under the assessment of criteria (ii) and (iii) (the details of which are bounded by confidentiality and not accessible for this review), include: income and non-inequality measures, human development indicators (health- and education-related indicators, e.g. components of the UNDP Human Development Index), vulnerability to climate change, tax revenue mobilisation, and availability of alternative financing options, both for the public and the private sectors. As mentioned above, the use of quantitative criteria would be limited by the availability of data and the need to capture the country context, and a satisfactory assessment using such criteria should only be given if a sustained positive trajectory has been maintained for at least five consecutive years. This approach would, however, address some of the limitations of using the GNI per capita indicator to trigger the graduation process, as GNI per capital cannot capture the complexity of improvements in well-being and access to finance.

19. **Graduation process and application of the policy.** The OM states that *graduation from OCR lending normally occurs within five years after a country crosses the graduation benchmark with variations according to country-specific conditions.* However, there is no precedent on the application of this policy to identify the average length of the cycle from crossing the GNI per capita threshold to graduation from ADB regular assistance. Four DMCs graduated from ADB regular assistance right after the 1998 policy was introduced: Hong Kong, China, the Republic of Korea, Singapore, and Taipei,China. These were all countries that had not borrowed from ADB for a long time (with the exception of the Republic of Korea on emergency lending in 1997). Brunei Darussalam has a special status: the country is not classified. Its status as a graduated DMC is pending since the memorandum of understanding (MOU) defining the strategic relationship between ADB and the government of Brunei Darussalam is not yet signed by both parties (at the time of visit in Manila, April 2016). There are a number of DMCs that crossed the GNI per capita threshold (criterion (i)) more than five years ago (notably Kazakhstan in 2010, Malaysia in 2007, and Palau in 1998 when it joined) but that, for different reasons, have not yet been assessed as having either the ability to access commercial capital markets or a certain level of socioeconomic development, or both. The time horizon for graduation stated in the OM and reference to variations according to country-specific conditions justify why a few DMCs are still eligible for ADB regular assistance despite having crossed the GNI per capita threshold more than a decade ago (see also Box 1). In some cases (Malaysia on both sovereign and non-sovereign operations and Thailand on sovereign operations; and, earlier, Hong Kong, China and Singapore in 1980; and Taipei,China, in 1971), senior ADB staff referred to a *voluntary graduation* since no borrowing arrangements have been in place for several years.

20. We would recommend two refinements of the current text of the OM to align the application of the graduation policy to its guiding principles (both stated in the Charter) and policies (1998, revised in 2008).

1. The reference to the five-year horizon (*graduation from OCR lending normally occurs within five years with variations depending on country-specific conditions)* should be removed because of lack of evidence based on previous experiences. In the round of interviews it often emerged that the current policy is perceived as rigid when compared to the approach taken by IBRD (see Section 4). However, both the reference in the OM (*ADB will take a flexible approach to determining the pace of graduation* – OM Section A1/BP, para. 7) and the practice would suggest a flexible approach to graduation from regular assistance.
2. Rather than setting a tentative time horizon for graduation, the OM should once again apply the approach that was put forward in the 1998 graduation policy (p. 33), i.e. *graduation from regular Bank assistance will take place after the required criteria are met for four successive years.* This approach has two main advantages. First, it clearly spells out that all three criteria for graduation must be met – not only the GNI per capita. Second, it stresses that the path towards graduation is a medium- to long-term process.

21. **Graduation policy for non-sovereign operations.** To conclude this section it is worth stressing how the policy clearly mentions (OM Section A1/BP, para. 7) that both sovereign and non-sovereign operations stop when a country graduates from ADB regular assistance (direct private sector investment by ADB in graduated DMCs would cease). Unlike ADB, the WBG has two separate arms – on sovereign operations (IBRD) on non-concessional terms and non-sovereign operations (International Finance Corporation (IFC)) – and the criteria for graduation and eligibility applied in the two institutions differ. The ADB policy is based on very similar principles and criteria to those applied by IBRD (Section 4 elaborates on the case of IBRD). IFC does not have a graduation policy but takes a more flexible approach defining an eligibility policy instead. The borrower must be in the private sector and located in a developing country that is a member of IFC, and the project must meet certain requirements, mostly linked with profitability and environmental and social safeguards.[13] We will elaborate on this point in Section 6.

[13] More precisely, the project needs to be technically sound, have good prospects of being profitable, benefit the local economy and be environmentally and socially sound, satisfying IFC environmental and social standards as well as those of the host country.

3 A new global and regional context and a different ADB compared to the landscape of the 1998 graduation policy

22. The main features of the global and regional macroeconomic context bear little resemblance to those prevailing when the graduation policy from ADB regular assistance was first introduced in 1998 and then reviewed in 2008. This section deliberately and primarily focuses only on the changes and evolutions affecting the rationale for the graduation policy, its criteria and its process at the global and regional level – looking from both the supply side (providers of development finance including the ADB itself and the architecture of MDBs) and the demand side (borrowing countries) of the development finance landscape. Our question is whether and how these changes can affect a review of the ADB policy on graduation from regular assistance.

23. **A more ambitious development agenda at the global level.** The adoption of the Sustainable Development Goals (SDGs) Agenda and the Addis Ababa Agenda for Action (AAAA) in 2015 (henceforth 'Agenda 2030') as well as of the Conference of the Parties (COP) 21 might not have visibly changed the directions and operations of ADB (at least not yet) given the breadth of the sectors covered and the ambitiousness of the agenda – let alone the comparative advantage of ADB in large-scale infrastructure projects. However, there are different implications for ADB engagement with UMICs and countries on the path towards graduation from regular assistance.

24. First, the nature of the SDG agenda is universal – and therefore applicable to all countries, developed and developing alike – compared to the focus of the Millennium Development Goals (MDBs) on developing countries only. It is also an inclusive agenda, aiming to eradicate poverty for all people everywhere, *leaving no one behind.* While, for instance, PRC has often been cited as the main contributor towards the achievement of the MDG 1 of halving poverty globally (Chinese Ministry of Foreign Affairs (MoFA) and UN System in China, 2013), in 2010 more than 13% of the world's extreme poor still lived in PRC (World Bank, 2014). The Agenda 2030 also aims for gains to be achieved by 2030 and passed on to future generations. All these objectives would call for an extended engagement with DMCs to support the implementation of Agenda 2030 at the national level far beyond the approach taken with the MDGs (that were also global rather than national goals).

25. Second, such a broad development agenda under the SDGs and the ambitiousness of the tasks ahead would question the role of traditional Official Development Assistance (ODA), mainly grant financing, which could become even less relevant than it was in the MDG area. An MDB like ADB with a large spectrum of sophisticated financing instruments (grants, concessional and non-concessional loans, equity, partial-risk guarantees and technical assistance (TA)) is well positioned to support the implementation of Agenda 2030 in all DMCs, including UMICs.

26. **Remarkable macroeconomic performance of most DMCs in the region over the last decade.** Overall, the Asian region has grown remarkably quickly over the last decade (IMF, 2016a), mainly driven by sustained performances of the Chinese and Indian economy and of resource-rich economies in Central Asia, at least before the fall in commodity prices started in 2014 (World Bank, 2015a). With the exception of 1998, Asia has been the fastest growing region of the world for several decades (ADB, 2006). The growth rate of emerging and developing Asian countries was more than double the average for the global economy in 2015 (6.6% against 3.1% based on IMF 2016b) and well above the average for emerging and developing economies (4%). Many countries have rightly strengthened macroeconomic management, financial regulation, and corporate governance, learning the lessons from the mid-1990s financial crises (ADB, 2013).

27. **Sustained macroeconomic performance first translated into a strong record in poverty eradication that is not restricted to China.** According to the World Bank (2015b), all five top contributors to poverty eradication from 2008 to 2011 are in Asia (India, PRC, Indonesia, Pakistan, Viet Nam). In addition, the number of countries classified as low-income countries has been shrinking. ADB (2015) estimates that by 2020 only two DMCs (Afghanistan and Nepal) will be classified as LICs. While being a low-income country is neither a necessary nor sufficient condition for eligibility to concessional finance,[14] this outlook will certainly change the future client base of ADB and the terms and conditions borrowing DMCs will be able to access. In Box 1 we conducted a simplified projection exercise to depict which DMCs are expected to cross the GNI per capita threshold triggering the graduation process (from regular assistance) by 2030. As we outlined in the previous section, crossing the threshold is only one of the criteria to assess whether a DMC is in a position to graduate from ADB regular assistance, but this exercise shows the set of countries for which such a discussion might start.

Box 1: Which DMCs will cross the high-income GNI per capita threshold?

Crossing the GNI per capita threshold only triggers the graduation process, but it is the only criterion for graduation that can easily and consistently be measured across countries. From the review of Section 2, assessments of the other criteria (ii) and (iii) are both subjective and internal to ADB process. This exercise identifies which DMCs are projected to cross the GNI per capita threshold triggering the graduation process by the horizon of the new corporate strategy, 2030. To address this question, we construct a graduation model based on the GNI threshold.

- First, we project IBRD thresholds up to 2030 adjusting the World Bank's IBRD threshold upon which ADB's graduation policy is based. We do this by using the three-year average of the Special Drawing Right (SDR) deflator (0.7%) between 2012 and 2014.
- Second, we forecast each country's GNI per capita for the period 2015-2030.[15] Using the GNI Atlas Method figures in 2014 from the World Development Indicators (WDI) for each country, we project GNI forward for the period 2015-2030, but use a different methodology based on 2015-2020 vs. 2021-2030. For each year in the period 2015-2020, we multiply the corresponding GNI estimate by the average growth rate for the previous three years. These projections should be treated as optimistic, as they do not fully capture the future effects of the slowdown of the growth rate of the Chinese economy. For each year in the period 2021-2030, we multiply by a constant growth rate, which is the average of the growth rates between 2018 and 2020. We then divide GNI by the yearly UN Population Division projections to get projected GNI per capita from 2015 to 2030.

Based on these figures and assumptions, we mark the year the country is projected to pass (or to have passed) the income per capita threshold (which is the IBRD-set GNI per capita threshold projected above) (see Table 1). Also including those countries whose annual income per capita is already above $7,175, most countries whose GNI per capita is projected to be above the

[14] The cut-off value of the operational classification is higher than the analytical classification and also the country should be *creditworthy*.
[15] Data refers to calendar years 2015-2030 but correspond to the World Bank's Fiscal year 2016-2032.

threshold by 2030 are in the Central and West Asia region (Azerbaijan, Georgia, Kazakhstan and Turkmenistan) and East Asia (PRC and Mongolia) with only one country set to exceed the GNI per capita threshold in South Asia (Sri Lanka in 2028).

Table 1: Graduated DMCs, DMCs that passed the GNI per capita threshold before 2015 but have yet to graduate, DMCs whose GNI per capita is expected to exceed the threshold by 2030

Countries that have graduated to date	Countries that passed the GNI per capital threshold before 2015 but have yet to graduate	Countries projected to cross the GNI per capita threshold by 2030
Brunei Darussalam[16]; Hong Kong, China; Republic of Korea; Singapore; Taipei,China	Azerbaijan (2013) People's Republic of China (2014) Kazakhstan (2010) Malaysia (2007) Palau (1998 or earlier) Turkmenistan (2014)	Fiji (2029) Georgia (2028) Maldives (2018) Mongolia (2026) Sri Lanka (2028) Thailand (2024)

If the IBRD threshold were not updated for inflation, three more countries would pass the $7,175 threshold between 2021 and 2030 notably Bhutan (2030), Indonesia (2029) and Philippines (2029).

28. **An Age of Choice for development finance and evolving demand.** Over the last decade, borrowing DMCs in Asia have expanded their financing options to support their national strategies and plans, in what an ODI report (Prizzon et al., 2016) defined as 'Age of Choice' for development finance. These providers include emerging donors, philanthropic organisations, and international capital markets (notably with the issuances of international sovereign bonds), not to mention recently established multilateral institutions such as the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB), which have begun operating. For instance the AIIB has elaborated a short list of criteria for eligibility to borrowing.[17] While some countries in the region might see their financing options shrinking because of ODA flows either stabilising or falling as their income per capita rises and they graduate as middle-income countries (notably the case of Viet Nam), the presence of more financing options has strengthened the negotiation position of several borrowing countries vis-à-vis traditional donors, increasing their assertiveness and awareness on financing instruments and sources. In the same vein, the financial and economic crisis in 2008 (and the forecasted fall in external assistance) revamped and gave new emphasis to the role domestic resource mobilisation can play in financing development. However, it is no novelty that domestic resources – notably taxation – have been the largest source of financing development in most cases, both in LICs and MICs (see Greenhill and Prizzon, 2012). Furthermore it is worth stressing that public resources overall fall continuously until a country is well into middle-income status, as international assistance falls faster than tax revenues rise – what Kharas et al. (2014) describe as the 'missing middle' of development finance. MDB non-concessional resources have been flat for decades except during global crises, yet they could be in a strong

[16] Brunei Darussalam is not classified. Its status as a graduated DMC is pending since the MOU defining the strategic relationship between ADB and the government of Brunei Darussalam is not yet signed by both parties (at the time of writing).

[17] In its Articles of Agreement, eligibility to borrowing is open to any agency, instrumentality or political subdivision thereof, or any entity or enterprise operating in the territory of a member, as well as to international or regional agencies or entities concerned with economic development of the region. In special circumstances, the AIIB can provide assistance to a recipient not listed, but this will require the Board of Governors' approval and must support the AIIB's mandate.

position to fill this gap. Some MDBs (the ADB and, under discussion, the World Bank) have demonstrated concrete approaches to leverage their concessional window receivables (see paragraph 28 below). Finally, in the round of interviews at ADB, it emerged that the demand from DMCs has also evolved, being in a position now to accept less concessional loans to fund higher education programmes (borrowing for education outside of concessional resources used to be a red line for most borrowing countries) also as a result of cuts in aid budgets by bilateral donors.

29. **Renewed emphasis on regional integration and cooperation and regional public goods.** Several ADB publications (including ADB, 2006) have stressed how intraregional trade has significantly increased in Asia with proliferating free trade agreements, how physical connectivity has improved, and how vertically integrated production networks have brought Asian economies ever closer, in addition to the greater monetary and financial integration in East Asia exemplified by the Chiang Mai Initiative (CMI) and the Asian Bond Markets Initiative (ABMI). Some DMCs are themselves drivers of regional integration programmes (PRC in the case of AIIB for instance). A more interconnected continent also means more development projects targeting this agenda, with a growing number of countries involved and greater cross-country spillover effects. This strategic direction calls for an engagement, also from a financial point of view, with DMCs independently from their eligibility for regular ADB lending and country-based graduation. At the same time, the climate change agenda has become far more prominent than it was in the early 2000s when the MDGs were set. The agreement at the Conference of the Parties (COP) 21 in Paris in December 2015 called for greater resources to be provided to developing countries. Several DMCs, notably Pacific Islands, are highly vulnerable to climate change because of their high levels of exposure to sea level rise and extreme events, their susceptibility to damage from those events, and their limited adaptive capacity (ADB, 2015). An assessment of vulnerability to climate change shocks should be factored into the assessment of socioeconomic development under the graduation policy. In the parameters identified to evaluate whether a country is in a position to cease ADB regular assistance, there is no explicit mention of vulnerability to climate change.

30. **Despite progress, there are still challenges in the region and in several DMCs.** Beyond growing vulnerability to climate change, especially in (but not limited to) the Pacific islands, the Asian region has been experiencing several challenges. First of all, the spillover effects associated with the slowdown of the Chinese economy (several stakeholders in our consultation, somewhat stretching the concept, mentioned Chinese growth and stability being a global public good). Second, the boom and bust in the commodity markets heavily affected several economies in the Central Asia region that are highly dependent on oil and gas exports (notably Kazakhstan – in 2015 ADB approved a $1 billion countercyclical loan; Azerbaijan may seek similar countercyclical support), with their favourable economic prospects being revised downwards. Such abrupt reversals in macroeconomic conditions and high vulnerability to economic shocks would call for a more conservative approach to graduation – partially already embedded in the assessment of criteria (ii) and (iii). Third, inequality is on the rise in the region. According to Zhuang et al. (2014) the Gini coefficient of per capita expenditure worsened in 12 economies, including the PRC, India, and Indonesia. Fourth, some MICs, such as Philippines, Indonesia and Thailand, also face subnational situations of fragility (or conflict). Finally, notwithstanding that several populous Asian countries strongly contributed to the reduction in the number of poor people worldwide, these are still the homes of the largest share of poor people, especially Asian MICs – notably India (30% of poor people in 2011), followed by PRC (8%) (World Bank, 2014). [18]

31. **More resources to be mobilised by ADB following the ADF and OCR merger and a stronger ADB role in private sector development.** Last but far from least, this reflection on the ADB policy on graduation from regular assistance takes place at a watershed moment for ADB in two different directions.

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[18] However, by 2030 sub-Saharan Africa will be the region where the majority of extreme poverty resides (Kharas and Rogerson, 2012; Chandy et al., 2013).

32. The first and most obvious direction has to do with expanded lending capacity that will follow the implementation of the ADF-OCR merger. As of 1 January 2017, OCR equity will almost triple to about $53 billion from about $18 billion by combining ADF equity (together with lending operations) with the OCR balance sheet, raising the capacity for annual financing commitments (loans, guarantees, equity investments and grants) by up to 40%, from the current level of $13 billion to $15 billion-$18 billion, according to baseline scenarios. In other words, the review of the graduation policy is taking place at a time when ADB's financial ability to make annual commitments is expected to sharply rise, reducing the risk of ADB resources crowded out from LICs to MICs. At the same time, while the investment funding gap for the region's infrastructure alone, in the decade to 2020, is estimated at a total of $8 trillion – and the increase is still small when compared to the financial needs – one of the challenges emerging in the round of consultations was the identification of bankable projects and project pipelines.

33. Second, and also associated with the likely scale-up of ADB lending that will follow the merger, ADB has started identifying additional projects and building project pipelines with the creation of an Office of Public-Private Partnerships together with reforms of private sector operations. ADB's midterm review of Strategy 2020 has a target to scale up private sector development and private sector operations in all operational areas, increasing the share of private sector operations in OCR approvals from 15% during 2010-2012 to 25% by 2020. Over the last five years, most private sector operations that ADB has in place have targeted MICs.

4 Rationale for graduation from hard windows of MDBs: a critical assessment

34. Before reviewing whether other MDBs and MOs have policies in place on graduation from regular assistance and, if so, their main features, this section provides a brief non-systematic literature review[19] on the rationales for having a graduation policy and those against having graduation of borrowing countries, and the arguments in favour of a more flexible approach to graduation. Table 2 summarises each viewpoint.

Table 2: Summary: rationales for graduation from regular assistance from MDBs and MOs: a review

In favour of a graduation policy	Against a graduation policy	Arguments justifying a more flexible approach
Development as a process of 'graduation'	*Development as a non-linear process*	*A changing context: universality of the SDG agenda and regional integration and cooperation*
National and international prestige and signalling effect	*Lending is a vehicle for policy change and for promoting international goals and standards*	*Lending to emerging economies does not crowd out but rather indirectly could crowd-in lending to poorer countries*
Utilise limited resources in a more effective way and not crowd out resources to the poorest countries	*Several high-income countries that have graduated from MDBs could continue to benefit from MDBs resources, selectively and flexibly applied*	*For non-borrowing member countries, benefits of MDB lending to emerging economies are substantial (stake in policy choices and institutional resilience) and are not costly to taxpayers*
Planning of future MDB resource disbursements and borrowers		*A cut-off point for graduation is becoming more difficult to identify*
		Delayed response in dealing with crisis

[19] Methodology: the following combinations of words were searched on ScienceDirect, Wiley, and Google Scholar: 1. Multilateral Development Banks/ International financial institutions /Regional Development Banks graduation policy; 2. MDBs/IFIs reform; 3. role of MDBs ; 4. MDBs price differentiation; 5. MDBs and MICs; 6. MDBs and emerging markets; 7. emerging market access to multilateral lending; and 8. MIC access to multilateral lending.

35. **Why a graduation policy?** There are four main arguments justifying why a country should graduate from regular assistance when it has completed its development and/or transition process.

1. *Development as a process of 'graduation' both from the demand and supply sides.* Given the role of MDBs in fostering development or transition, graduation reflects a successful path to a well-functioning and sustainable market economy (EBRD, 2015; Government of US, 2010; Shihata, 2000). Although the development process, especially for the least-developed countries, may well take decades rather than years, the process of economic development and, more importantly, the transition process should be time limited. Thus, the MDBs should have an institutional culture appropriate to a public agency with a finite time span (Buiter and Fries, 2002).
2. *National and international prestige and signalling effect.* Graduating from borrowing to receive a higher status in its relationship with a development bank can influence international and domestic perceptions of a state's development. For example, when Japan graduated from the IBRD in 1964, *The New York Times* (1964) reported that Japan celebrated its 'graduation from the ranks of the developing countries'. Today, Japan continues to highlight the importance of its graduation; for instance, in a recent speech, Japan's Minister of Finance cited World Bank graduation as a crucial step in the country's prosperity (Jojima, 2012). (See Aronow, 2013, for more country examples). Once graduation is understood in the markets to be a rigorous and objective standard, countries that meet the criteria would be rewarded with improved risk ratings and better access to global capital markets (Government of US, 2010). In the context of IBRD, upon crossing the threshold of graduation eligibility, the Slovakian ministry stated, 'If Slovakia's graduation is completed, Slovakia will be acknowledged as a developed country, which will provide a good signal for foreign investors and the global financial market' (*The Slovak Spectator*, 2008). Similarly, the Czech Republic expected its graduation to allow the country to 'receive a better label on international markets' so that the country would 'receive more foreign direct investment in future years' (Velinger, 2006).
3. *Utilising limited resources in a more effective way.* Continuing to engage with countries following a successful completion of the development and transition processes will not be an effective use of shareholder resources (Buiter and Fries, 2002). In other words, a graduation policy is one of the options for making more funding available to the remaining needier borrowers. The Meltzer report, however, recommends TA to be offered to graduate countries, but these countries should borrow in the market and be subject to market discipline (Meltzer, 2000).
4. *Planning of future resource requirements*. In the absence of a formal graduation policy, there may be uncertainty over when eligibility to funding might be updated and what graduation would entail. Uncertainty on country eligibility to resource allocation would make planning difficult, if not impossible (GAVI, 2009), with implications for decisions on resource allocation. This was the motivation that led to the review of the Global Alliance for Vaccines and Immunisation's (GAVI) eligibility/graduation policy in 2009.

36. **Why not a graduation policy?** There are, however, at least three arguments against a graduation policy.

1. *Development as a non-linear process.* It may be inappropriate to visualise development as a process of graduation from lower to higher steps on a development escalator (Eyben and Lister, 2004). Changes at the national and international level may occur in sudden and unexpected ways and may not necessarily lead to improvements in people's well-being. Improvement is neither inevitable nor systematic, and there are no universally applicable recipes for its sustained achievement.

2. *Lending is a vehicle for policy change and for promoting international goals and standards.* In the Gurría and Volcker report, officials from countries such as Brazil, Mexico, Turkey, Hungary, Thailand and the Republic of Korea repeatedly cite the technical and advisory services that are 'bundled' with MDB financing as a key reason for seeking MDB loans (Gurría and Volcker, 2001). They value the detailed, project, and sectoral and economic analysis of MDB staff and the dialogue on tough internal policy and budget choices that the lending process catalyses. Again according to the Gurría and Volcker report, 'The provision of some non-lending services can be separated from lending, and some governments have paid directly for advice from the MDBs without borrowing. However as a practical matter, the advice is taken more seriously, and is more likely to be effectively enforced if backed by and tied to a loan.' In the same vein, Rodrik (1996) also argues that in the absence of lending, MDBs have little incentive to ensure that their advice is being followed or to exercise their information function as effectively as possible.

3. *Several high-income countries that have graduated from MDBs could continue to benefit from MDBs' resources, if selectively and flexibly applied* (Kharas, 2015: 4). The European Investment Bank, for example, has built a successful business in providing long-term financing to support small and medium-sized enterprises, infrastructure and innovation, climate action, and other programmes in high-income countries; ADB and other MDBs could emulate this. In addition, there have been several cases of clients graduating only to again require support in the face of a crisis, such as the Republic of Korea, Hungary and Latvia. Kharas (2015) therefore states that IBRD could usefully abolish the upper limit threshold at which it graduates countries. Also graduation can undermine relevance of MDBs to graduated shareholders if it prevents them from accessing non-lending products. MDBs may still be relevant to high-income countries that want to access MDB dialogue and advice, which they should pay for (Birdsall, 2001).

37. **Why a more flexible approach to graduation?** Finally, there are at least five reasons why a graduation policy should be in place, but it should be more inclusive and flexible.

1. *A changing context: universality of the SDG agenda and regional integration and cooperation*. As already outlined in Section 2, unlike the MDGs – which were implemented at the global level and meant to monitor progress in developing countries only – the SDGs are intended to be tracked at the country level and are universal, i.e. applied to all countries independently of their level of development. An extended engagement with a DMC would also mean continued support under this agenda, requiring a more inclusive approach to eligibility for borrowing. At the same time, as we saw in Section 2, the level of interconnectivity between countries is much higher than ever before and so the role played by regional integration and cooperation is much greater, including any spillover effects and externalities. In the round of interviews with ADB staff, it emerged how the borrowing relationship with a DMC represented a clear incentive for the DMC to actively engage on this agenda. This point was often mentioned as one of the reasons why a DMC should continue to engage with ADB, despite the ability to access capital markets at very competitive terms compared with ADB's direct and opportunity costs.
2. *Lending to emerging economies does not crowd out but rather indirectly supports lending to poorer countries*. The MDBs mostly have a sufficient capital base and thus more than adequate 'headroom' to finance operations in both the emerging market economies (EMEs) and poorer countries, or, where they arguably do not (IBRD is a case in point), they could use available financial engineering tools responsibly – such as using reflows on their concessional loans as collateral – to increase that headroom substantially. Loans to EMEs should not in any event be considered one-for-one substitutes. Diversification reduces overall portfolio risk. EMEs usually have higher credit risk ratings, enabling MDBs to retain their AAA credit rating, which in turn provides larger scope for MDBs to subsidise loans to poorer countries. From a financial perspective, the opportunity cost of

lending to creditworthy UMICs with limited exposure is low, because a more concentrated portfolio on the poorest countries would be riskier and therefore would require more risk adjusted capital per unit of lending (World Bank, 2001). It has also been argued by the World Bank and others that ending loans to MICs would harm the poorest countries by reducing the Bank's income. However, according to Meltzer (2000: 11), this claim has no merit. The World Bank lends at a rate very little above its own cost of funds; it adds a fractional fee to cover administrative expense. The only 'profit' on the loan comes from the allocation of a portion of the Bank's costless equity capital. The same capital would be available to support grants. There would be no diminution of resources. To limit concentration on the most creditworthy and largest economies (population and economic size), IBRD has a Single Borrowing Limit (SBL) in place.[20] A surcharge of 50 basis points a year was introduced on loans and other exposures for the incremental exposure above the SBL. The surcharge reflects the impact of greater portfolio concentration.

3. *For the non-borrowing member countries of the MDBs, the benefits of MDB lending to EMEs are substantial and are not costly to taxpayers* (Gurría and Volcker, 2001). In an increasingly interdependent global economy, non-borrowing members of the MDBs have a substantial stake in the policy choices and institutional resilience of the EMEs. Their financial stability contributes to global financial stability. Their social and economic decisions affect the health and well-being of their own people, undermining or advancing such global goals as poverty reduction. And their decisions – on energy use, food safety, efforts to reduce drug trafficking and corruption and so on – increasingly affect the once-insulated residents of rich countries.
4. *A cut-off point for graduation is becoming more difficult to identify*. The graduation point is likely to become more difficult to define, as disparities in the level of development and access to financing can be as great within countries as between countries (Lindbaek et al., 1998).[21] At the same time, World Bank (2001) notes that IBRD-eligible countries vary widely with regard to income, poverty incidence, capital market access and the progress they have made in policy reforms and institution building. Thus, graduation decisions will need to become more nuanced to reflect finer distinctions than simply whether a country should be eligible to borrow, and on what terms.
5. *Delayed response in dealing with crisis.* The issue of graduation is a recurring one for MDBs during crises, delaying World Bank support for the Republic of Korea at the time of the East Asia crisis and for Hungary and Latvia during the recent crisis (IEG, 2012). The EBRD's handling of the issue was swifter, as it acted quickly to postpone Hungary's and Latvia's (and other countries') scheduled graduation and to announce that the World Bank's management planned to propose a post-graduation policy for them. In the WBG, the situation was different as Hungary and Latvia had already graduated when the crisis struck, presenting a greater policy and operational challenge. In principle, the IBRD Articles of Agreement permit lending to any member (including graduates) should other financing become unavailable, but in practice the lack of a clear policy or precedent led to a counterproductive delay, notably for Hungary.

38. Based on this brief literature review on the rationale for graduation from regular assistance, the overall argument would recommend a more flexible and inclusive approach to graduation. Given the universality of the SDG agenda and regional integration and cooperation, the development agenda has become more inclusive and, as a result, the cut-off point for graduation has become more difficult to define. A more flexible approach to graduation is also justified by making the use of lending as a way to manage crises and shocks more effective.

[20] The SBL was $20 billion for India and $19 billion for the other four SBL borrowing countries (Brazil, China, Indonesia and Mexico) in FY15, and will remain unchanged for FY16.
[21] http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.195.4112&rep=rep1&type=pdf

5 A comparative analysis of graduation policies of multilateral development banks and multilateral organisations

39. This section reviews the cases of the EBRD, IBRD, IADB, AfDB, GAVI and GFATM[22] in terms of their policies on graduation from regular assistance/non-concessional resources. Table A1 in the Annex provides a synthetic comparison. Each section attempts to cover five main areas depending on publicly available information and the approach to graduation from regular assistance: (i) main elements of the graduation policy and its evolution, (ii) graduated countries, reversals and exceptions, (iii) projections of future graduating borrowing member countries, (iv) nature of the engagement with graduated countries, and finally (v) strategy and engagement with UMICs.

40. Most of the analysis is based on review of policy documents and interviews with current and former staff in these institutions, when possible. The review is intentionally light-touch as these analyses were not meant as in-depth reviews of the graduation policy of each institution but descriptive analyses to identify key features of graduation policies and engagement with graduated countries and with UMICs. The case of the Islamic Development Bank has not been covered because eligibility for borrowing countries is associated with membership in the Organisation of the Islamic Cooperation (OIC). This section does not cover the European Investment Bank because of its small share of operations to developing countries (see Faure et al., 2015).

5.1 EBRD

5.1.1 Graduation policy and evolution

41. Established in 1991, the EBRD introduced its graduation policy only in 1997 at the time of the second capital resource review. A graduation policy was not introduced from the outset because the institution was meant to support the transition process to market economy only to be completed in the medium term. Also, EBRD expanded its membership to North Africa subsequently (first investments in Egypt, Jordan, Tunisia and Morocco were given the go-ahead in September 2012) and PRC more recently in 2015, making the transition-country model only partially relevant. The principle of graduation, as defined in its Graduation Policy, as well as the Post-Graduation Operational Approach, has been reaffirmed in 2015 (EBRD, 2015).

[22] While not being MDBs, GAVI and GFATM were also considered because these institutions have graduation/eligibility policies in place that have evolved over time, offering additional insights on the rationale and criteria for a graduation.

42. By ‘graduation’, EBRD refers to successful transition to a well-functioning and sustainable market economy, and it is based on three principles:

1. *transition impact*, defined as the effect of a project on the economy or society;
2. *additionality*, defined as the effect of the EBRD’s catalysing additional resources; and
3. *sound banking*, that is, assurance that the bank’s investment is secure.[23]

43. These principles are used to define a phased graduation approach 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 and secure access to international capital markets and other private sources of financing. Each criterion is intentionally based on subjective assessment. There is no reference to income per capita thresholds triggering the graduation process.

44. The main instrument for decision-making on graduation is the respective country strategies, jointly agreed by the EBRD and country authorities (EBRD, 2015). In this light, shareholders expect that country strategies for the EU7[24] will continue to set the path and indicate a plausible pace of graduation for these countries within the medium term, while recognising that countries face specific circumstances and that the economic and political context for transition can be volatile.

5.1.2 Past graduation, reversals and exceptions

45. So far, only the Czech Republic graduated from EBRD in 2007, and the graduation process was largely driven by the country itself. Apparently there is no formal graduation process – the graduation process has been ad hoc for the Czech Republic, and future graduations will most likely be based on this experience.

46. Had it not been for the financial and economic crisis in 2008, seven other EU countries of Central Europe and the Baltics would have been graduated by 2010, as it emerged in the discussion with ERBD staff. The EBRD Board decided to postpone graduation for the remaining seven countries. At the time of writing there is no discussion of graduation of these countries.

47. In the World Bank, Hungary and Latvia had already graduated in 2007. Although EBRD acted quickly to put on hold the graduation process for Hungary and Latvia, the World Bank took a year to decide to resume crisis lending to them. Though the two situations are not identical, quick decision-making by the EBRD was clearly less painful for both the countries involved and the institution (IEG, 2012), calling for a more flexible approach to graduation.

5.1.3 Engagement with graduated countries

48. At EBRD the engagement with graduated countries has three main pillars:

- *Supporting companies from the EU-8 countries investing in EBRD countries of operations and cross-border trade and investment*.[25] For example, since the graduation of the Czech Republic, EBRD’s business development activities have been focusing on cross-border investments with the aim of identifying and supporting Czech companies expanding to other EBRD countries of operations (EBRD, n.d.).

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[23] See also Sagasti and Prada (2006).
[24] Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.
[25] http://www.congrex.ch/fileadmin/files/2013/fidic2013/Presentations/FIDIC_CapacityBuildingAndFIDICTraining_DilekMacit.pdf

- *Assisting companies to enhance their participation and success in the EBRD procurement tenders through consultancy and procurement seminars, targeted outreach events and business development missions*. Again in the case of the Czech Republic, the EBRD's only borrowing country to graduate so far, procurement seminars and consultancy outreach events have been organised regularly to enhance awareness of local companies concerning business opportunities generated by the EBRD (EBRD, n.d.).
- *Enhancing know-how transfer through broader involvement of management experts*. These include EBRD advisory assignments for the Enterprise Growth Programme to transfer know-how and experience from more advanced to less advanced transition countries and provide contracting opportunities for experts in graduated countries.

49. To support these activities, a Post-Graduation Special Fund was established in March 2014 to assist the EBRD achieve its mandate of implementing a strategic and comprehensive approach to post-graduation. The resources of the Fund may be used to finance activities and costs to provide expertise to clients in countries where there is a clear perspective on graduation or to support post-graduation business development. However, based on the interviews with staff, we understand the drawdown has been negligible so far.

5.2 IBRD

5.2.1 Graduation policy and evolution

50. IBRD's stated criteria for eligibility stem from its Articles of Agreement. These outline two broad requirements for lending and investment eligibility. First, that given prevailing market conditions, a borrower would otherwise be unable to obtain the loan under reasonable conditions,[26] and second that private capital is not available on reasonable terms.[27]

51. The graduation process has evolved over time. In 1982 a review of graduation criteria recommended the additional consideration of 'a country's level of development and overall economic situation,' and 'a country's capacity to sustain long-term development without further recourse to the bank's financial resources'. Two substantive criteria were introduced to assess and quantify these conditions:

1. a country's ability to access external capital markets on reasonable terms, and
2. a country's progress in establishing key institutions for economic and social development.

All of these constitute fairly subjective measures dependent on internal analysis that do not enable much external predictive ability. While an income threshold was introduced in 1973, and is currently set at $7,175 per capita, this is again only a partial indicator of eligibility. As with the International Development Association (IDA), and perhaps even more so, a country's crossing of this threshold triggers only a start of discussions about graduation, and is not a sufficient condition in itself.

52. The current policy on graduation is highly flexible, in part because it is widely recognised that the income threshold is an imperfect proxy for the two criteria of access to capital markets and adequate institutions. A flexible policy does not necessarily imply an inconsistent or non-transparent policy, however (Knack et al., 2012). It should be possible to identify a limited set of indicators of institutional development that – together with per capita income – can explain past decisions on graduation and on pre-graduation IBRD borrowing. In fact, Knack et al. (2012) find that observed correlates of Bank graduation status are generally consistent with the stated policy.

[26] Article III, Section 4 (ii)
[27] Article 1 (ii)

Countries that are wealthier, more creditworthy, more institutionally developed, and less vulnerable to trade, financial, and other shocks are more likely to be graduates. Predicted probabilities generated by the model conform closely to the actual graduation and de-graduation experiences of Trinidad and Tobago, and the Republic of Korea, among other countries, and suggest that Hungary and Latvia may have graduated prematurely – a prediction subsequently borne out by the large loans that they later received from the IBRD in the wake of the global financial crisis.

53. In principle, the IBRD Articles of Agreement permit lending to any member (including graduates) should other financing become unavailable, but in practice the lack of a clear policy or precedent led to a counterproductive delay during the global economic crisis and notably for Hungary (IEG, 2012) as highlighted in Section 5.1 as well.

Box 2: Small states – access to IDA resources

The decision to introduce the small island exception was based on several considerations. First, small island economies share many of the problems of low-income developing countries including export concentration, small domestic markets, high infrastructure costs, limited skill base, and weak institutions. Second, research (Easterly and Kraay, 2000; Winters and Martins, 2004) has determined that these economies suffered from certain circumstances particular to their size and geography such as isolation, lack of natural resources, and unavailability of commercial credit. Third, many of these economies are highly vulnerable to natural disasters. Thus the IDA 2012 review concluded that the rationale for differential treatment of the small island countries remains valid.

Decisions on whether to grant a country continued eligibility to IDA under the small island exception is evaluated on a case by case basis, but since the inception of the policy all small island economies, whether classified as IDA-only or blend, have been accorded access to the exception when their GNI per capita surpassed the IDA eligibility threshold.

Countries that benefit from the small island exception account for only a very small share of IDA lending, and consequently the impact on overall availability of IDA resources to the poorest countries is relatively small.. However, it does give rise to issues of equitable treatment across IDA-eligible countries, and in particular other small states, defined by the World Bank as those with a population of 1.5 million or less. While it is recognised that small islands are particularly vulnerable to natural disasters, the challenges associated with small populations and economies (diseconomies of scale, capacity and institutional constraints, open economies unable to easily diversify, remoteness and high transport costs) are common to other non-island small states.

Source: IDA (2012).

54. When it comes to small island states in 1985, the World Bank introduced the Small States – Exceptional Access to IDA Resources. It is worth stressing that these exceptions mean small states have IDA access independently from the level of per capita income. Under this policy in 1985, six small island countries (Dominica, Grenada, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Tonga) obtained access to IDA resources even though their per capita incomes were above the IDA eligibility criterion. Since that time, the number of countries eligible for IDA under this 'small island exception' has risen to thirteen. Eight other small island countries saw their per capita income increase above the operational cut-off (Cape Verde, Kiribati, Maldives, Marshall Islands, Micronesia, Samoa, Vanuatu, and Tuvalu) while one of those originally eligible graduated from IDA (St. Kitts and Nevis). Box 2 elaborates on this exception.

5.2.2 Past graduation, reversals, exceptions

55. Five countries were forced to re-enter IBRD (Gabon, Iraq, the Republic of Korea, Trinidad and Tobago, and Venezuela). Reasons for de-graduation include falling petroleum output and prices in Gabon,[28] Trinidad and Tobago[29] and Venezuela[30] and the subsequent economic and financial crisis, severe conflict in Iraq, and regional financial crisis in the Republic of Korea. Table 3 lists member states that graduated since 1970 from IBRD, and the year of the last loan approval.

56. None of these countries have re-graduated (the high-income Republic of Korea graduated from IBRD officially on July 2016 after the research for this report was completed), despite having not renewed borrowing for over ten years, indicating a hesitancy to close off a source of financing should economic crisis strike again.

57. Beyond those countries such as Hungary and Latvia that received emergency assistance in 2008 in the aftermath of the financial and economic crisis, there is one exception among graduated countries: Barbados. The rationale for including Barbados in a regional programme for the control of a communicable disease (such as HIV/AIDS) was the strong public goods and externalities rationale and Barbados' leadership role in these activities in the Eastern Caribbean (See Annex 13.1 of project document for further details).[31]

5.2.3 Projections of prospective graduates

58. Using the IBRD threshold of $7,115 per capita GNI[32] and applying a three year average lag, Morris and Gleave (2015) estimated that 36 countries will be eligible for graduation from IBRD by 2019, and five more by 2025. The vast majority of these countries (33) are already above the GNI threshold, although some may not cross it for up to seven years.

59. Given the less concessional nature of IBRD lending and the increased flexibility in choosing to borrow, regardless of status, Morris and Gleave (2015) argue there is less pressure on IBRD countries to graduate than in IDA. Again, Morris and Gleave (2015) see membership as an insurance strategy against volatility, and despite a pause in lending (as 18 of the potential graduates chose) both the bank and its borrowers have an interest in keeping the option open.

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[28] http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1988/03/21/000009265_3960926172900/Rendered/PDF/multi0page.pdf

[29] http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1989/11/21/000009265_3960928044343/Rendered/PDF/multi0page.pdf

[30] http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1989/05/22/000009265_3960927222202/Rendered/PDF/multi0page.pdf

[31] http://www-wds.worldbank.org/servlet/WDSContentServer/IW3P/IB/2001/07/11/000094946_01061204004344/Rendered/PDF/multi0page.pdf and https://www.imf.org/external/pubs/ft/scr/2014/cr1452.pdf

[32] The threshold has not adjusted and updated for inflation over time. It refers to the threshold at the time of writing the article.

Table 3: IBRD graduates, 1970-2014

Country	Cross GNI per capita threshold	Graduation	De-graduation	Last loan approval
New Zealand	1980	1972		1972
Iraq	2018	1973	2003	2010
Iceland	1975	1974		1973
Venezuela	2007	1974	1989	2001
Finland	1978	1975		1975
Israel	1987	1975		1975
Singapore	1986	1975		1975
Ireland	1987	1976		1975
Gabon	2008	1977	1988	2012
Spain	1988	1977		1977
Greece	1988	1979		1979
Trinidad and Tobago	2003	1984	1990	2003
Oman	2000	1987		1987
Bahamas	1979	1989		1988
Portugal	1991	1989		1989
Cyprus	1988	1992		1991
Barbados	1991	1994		2008
Korea, Rep.*	1992	1995	1998	1998
Slovenia	1994	2004		2000
Czech Republic	2003	2005		1993
Estonia	2004	2006		2000
Lithuania	2005	2006		2002
Hungary	2004	2007		1999
Latvia	2006	2007		2011
Slovak Republic	2004	2008		2006

Source: Morris and Gleave (2015) (see methodology on page 60)
** Not classified as IBRD country since July 2016.*

Table 4: Projected graduation from IBRD

By 2019		By 2025
Argentina	Gabon	Azerbaijan
Korea, Rep.*	Brazil	Iraq
Seychelles	Romania	Thailand
Uruguay	Lebanon	Dominican Republic
St. Kitts and Nevis	Mauritius	Namibia
Antigua and Barbuda	Kazakhstan	
Palau	Panama	
Trinidad and Tobago	Suriname	
Mexico	Costa Rica	
Croatia	Montenegro	
Poland	Botswana	
Chile	South Africa	
Turkey	Colombia	
Libya	Bulgaria	
Venezuela	Belarus	
Russia	Turkmenistan	
Equatorial Guinea	Peru	
Malaysia	PRC	

Source: Morris and Gleave (2015)
** Not classified as IBRD country since July 2016.*

5.2.4 Engagement with graduated countries

60. IBRD has two main instruments for its engagement with graduated countries: the Special Development Policy Loan (in the case of Hungary and Latvia) and reimbursable technical assistance.

1. The new *Special Development Policy Loan* policy of 2009 eliminated the linkage between loans and the Country Assistance Strategy lending envelope and reintroduced standardised pricing, albeit at lower rates.[33] The Special Development Policy Loan was used only for graduated countries and not for all IBRD-eligible countries that met the criteria of internationally coordinated rescues and severe crisis effects. This approach apparently posed

[33] Special Development Policy Loans had a grace period of 3-5 years with a final maturity of 5-10 years; a minimum fixed spread over LIBOR of 200 basis points; and a front-end fee of 100 basis points, broadly aligned with the IMF's higher paid tranches.

a particular problem due to the absence of guidelines for lending terms for IBRD graduates. These experiences underscore the value of formulating an explicit policy toward IBRD graduates that can be in place before the next crisis (IEG, 2012).

2. *Reimbursable technical assistance* (RTA).[34] RTAs were originally designed for Gulf Cooperation Council countries and have been operating for at least two decades. For example, no longer eligible to receive financial resources or IBRD-financed technical assistance, the Hungarian authorities proposed an arrangement to use the IBRD technical expertise whereby the government reimbursed the World Bank from EU funds available to the country and own resources for any advice and support provided. The fees charged by the Bank covered only the costs of the staff and resources provided and did not include a profit element. This approach allowed IBRD to provide ongoing advice to its graduate clients while also maintaining its technical assistance services to its poorer borrowing countries. In addition, some 40 countries to date have reimbursed (in part or in full) the World Bank for knowledge and advisory services in a range of sectors and covering a broad spectrum of issues.

5.2.5 Engagement with MICs, including UMICs

61. According to the World Bank Strategy 2013, the WBG will continue to help middle- and upper-middle-income countries sustain progress toward the two goals of ending extreme poverty and promoting shared prosperity in a sustainable manner, small and island states with their particular needs, and higher-income countries, notably during times of distress (p.4 of WBG strategy).[35,36]

62. The WBG strategy for MICs lies on four main pillars:

1. *Partnering with MICs as global actors.* The WBG is working with MICs in their roles as global actors and development partners, supporting MICs in their leadership roles in international fora such as the G20; as development partners; and as key shareholders of the World Bank. Inclusive and sustainable growth and development in MICs provides positive spillovers to the rest of the world in terms of poverty reduction, international financial stability, and cross-border global issues, such as climate change, energy, food and water security, and international trade.
2. *Working with MICs to meet second-generation development challenges*. The WBG will continue to help middle- and upper-middle-income countries address issues that are critical to sustaining their development progress, including escaping the 'MIC trap' – that is, stagnation caused by rapid growth unaccompanied by structural changes to address such issues as social inclusion and rapid urbanisation (p.19).[37] This support will include a fresh look at the political economy of second-generation structural reforms in the context of building shared prosperity. These challenges typically include lifestyle diseases, aging populations, pension reform, tertiary education, social inequality, competitiveness, trade and tax policy, financial literacy, green growth, and urbanisation.[38]
3. *Strengthening the knowledge partnership and facilitating cross-country learning*. The WBG produces just-in-time notes, pieces of analysis, and flagship reports – such as China 2030 and Golden Growth, in partnership with and in response to MICs' requests.

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[34] http://www.worldbank.org/en/news/press-release/2012/11/27/world-bank-and-hungary-agree-to-technical-cooperation-on-structural-reform-program

[35] https://openknowledge.worldbank.org/bitstream/handle/10986/16093/32813_ebook.pdf?sequence=5

[36] This also stems from Evaluation of WB's support to MICs (IEG, 2007)[36] which concluded that WBGs support to MICs overall was moderately satisfactory but suggests that the institution can do better. It recommends that the WBG remain engaged with MICs but take steps to increase development effectiveness through these channels: draw more on MIC capacity; demonstrate best practice in its MIC support; and be more agile in providing support, including making the most of Bank Group cooperation.

[37] https://openknowledge.worldbank.org/bitstream/handle/10986/16095/32824_ebook.pdf

[38] http://www.worldbank.org/en/country/mic/overview#2

4. *Providing a range of financial services.* The WBG is bringing together its public and private sector arms (IBRD, IFC, and MIGA) to partner with MICs in responding to their development and reform challenges, meeting those needs by drawing on an array of financial products. IBRD's financial products are evolving to increasingly support MICs in areas such as financial risk, exposure to natural disasters, and asset management, as well as at the sub-national level.

5.3 IADB

5.3.1 Graduation policy

63. IADB has no formal graduation policy from regular assistance (Tussie, 1995: 46). In the round of consultations, however, we understood that a discussion about introducing a graduation policy took place in the aftermath of the debt crisis in Latin America in the mid-1980s but never materialised in an agreed policy. However, no discussion on a graduation policy has taken place since then. In 1999, the IADB started using a country grouping for the purpose of monitoring the distribution of its lending, but not to inform a graduation policy.

64. There are examples of voluntary temporary graduation, however. For instance, Venezuela withdrew from active borrowing during the 1970s oil bonanza (Tussie, 1995: 9).[39]

5.3.2 Engagement with UMICs

65. By 2020, most of the countries in the Latin American region will be considered high middle-income economies.[40] None of them have so far graduated from IBRD, but seven member countries are expected to surpass the threshold of $20,000 by 2020, which means they can reach developed status by the end of this decade (see also Table 4 for the case of IBRD). [41] Against this backdrop, the Update to the Institutional Strategy 2016-2019, approved by the Governors in March 2015, identified the need to refine the IADB approach to client heterogeneity (IADB, 2015): 'The IADB will need to continue acknowledging the different types of client segments in which it works as the starting point to specialise and improve the delivery of its services, for example, introducing instruments such as fee-based services, or more knowledge products for high-middle-income countries.'[42] [43]

66. IADB (2013) undertook an evaluation of how the IADB is serving higher-middle-income countries (HMICs). The evaluation found that IADB remains a valued and trusted development partner in the vast majority of the HMIC case study countries. It is still financially competitive, even in countries with investment-grade sovereign risk ratings, and is particularly so during times of international turbulence. IADB's counterparts particularly valued: the discipline IADB helps impart to project design and execution, along with capacity building related to project management; the opportunity that IADB provides to learn from other experiences in the region; the seal of approval that IADB's project financing can help provide through its social, environmental, and fiduciary safeguards; and IADB's ability to facilitate medium- to long-term project continuity across political cycles.

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[39] https://books.google.co.uk/books?id=pa8Z8ss60KEC&pg=PA46&lpg=PA46&dq=inter+american+development+bank+graduation+policy&source=bl&ots=hgQS3NV-Wg&sig=LtOR4S4eQDpHMWQ2dN4s4JtLqvg&hl=en&sa=X&ved=0ahUKEwiblN70hPzKAhVI7xQKHUdXAIoQ6AEIOTAE#v=onepage&q=graduation&f=false

[40] Page 3 of http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=39556684

[41] In terms of annual GDP per capita, 11 additional countries could surpass the threshold of $10,000 over the same period, and even the poorest country may reach middle-income status by reaching the $5,000 benchmark. All Dollar amounts are in terms of purchasing power parity (PPP).

[42] Page 17 of http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=39556684

[43] IADB does not have a framework for fee-based services (IADB, 2013, p.33).

5.4 AfDB

5.4.1 Graduation

67. The AfDB does not have a graduation policy from regular assistance. The AfDB Credit Policy[44] determines each country's eligibility for AfDF resources only (Category A), ADB resources only (Category C), or a blend of resources from the two windows (Category B, blend countries) on the basis of two criteria: per capita income and creditworthiness to sustain non-concessional financing. Graduation for AfDB refers to the process by which an AfDF-only country transitions to blend or to AfDB-only status or a blend country to AfDB-only status, not from regular assistance.

68. Based on the Credit Policy of the Bank, and as set out in para 1.1.1 of AfDB (2011) and revised in 2014, MICs comprise the Category C countries, which are eligible for financing from the non-concessional ADB lending window only, as well as Category B countries, which are eligible for a blend of resources from the ADF concessional lending window and the AfDB non-concessional lending window.

5.4.2 Engagement with MICs

69. A 'Strategic Framework for Enhancing Bank Group Support to Middle Income Countries' was developed and discussed by the Board in April 2008 (ADF/BD/WP/2008/41, 25 April 2008). The Strategic Framework advocated for (i) clear guiding principles, (ii) sharpened sector and thematic priorities, (iii) enhanced financial products and pricing, (iv) strengthened business processes (to improve delivery), (v) stronger partnerships, and (vi) better dissemination of information. The Strategic Framework was complemented, in June 2008, by a 'Report of the Presidential Working Group on Enhancing Bank Support to MICs', which provides operational recommendations in each of these areas and sets out a concrete action plan to ensure follow-through and implementation.

70. The MIC Technical Assistance Fund set up in 2001 provides grant resources for capacity building, economic and sector work and project preparation in MICs. It has five priority areas: (i) project preparation work, (ii) technical assistance, advisory services and project cycle activities, (iii) the training of government officials and capacity building work, (iv) support for activities promoting the development of the private sector and the importance of building country knowledge through intensification of economic and sector work and other country analytical work, and (v) activities promoting regional integration.

5.5 GAVI

5.5.1 Graduation policy and evolution

71. The 2015 policy outlines two key principles about GAVI's support:

- It focuses on lower-income countries.
- It is time-limited and directly linked to governments' ability to pay for vaccines, as measured by GNI per capita (Atlas method) based on World Bank data (eligibility threshold set at $1,500[45] in 2011 and updated annually to account for inflation).

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[44] Adopted in 1995 and reaffirmed in 1998, and is aligned to the IBRD's Credit Policy.

[45] Adjusted for inflation, $1,500 was roughly equivalent to $1,000 in 2000 (the year the eligibility policy and the $1,000 threshold were first applied).

This 2015 policy replaced the 2009 GAVI eligibility and graduation policy. Under the 2009 eligibility policy, countries did not know when they might graduate, as the timing and nature of future updates had not been specified.

72. Two reasons justify the choice of income per capita as the only indicator of eligibility for GAVI assistance: first because it is correlated, to some extent, with the performance of the immunisation services and other health measures, and second because it poses the fewest challenges in terms of data quality issues, frequency of reporting (GAVI, 2013: 17). While documentation to explain the motivations for the policy design is sparse, the eligibility threshold was based at least in part on the resources available to GAVI at the time of its formation (Steve Landry: Personal communication; 2009) as well as a desire by GAVI's architects to create an 'IDA-like' list of countries (GAVI, 2015: 14).

73. GAVI has a structured and time-bounded transition process, which aimed to address the uncertainty of the process under the previous policy. See Box 3 on the criteria for the country groupings (Phase 1, 2, and 3). For instance, for current and future Phase 1 countries, GAVI initiates transition assessments as early as feasible during Phase 1 (approximately 2-3 years before the projected date of entering Phase 2). GAVI support is phased out over a five-year period. At the end of this process, countries are fully self-financing vaccines.[46]

Box 3: GAVI country classification

- **'Phase 1 Country':** A GAVI-eligible country whose GNI per capita is above the LIC threshold and whose average GNI per capita of the previous three years is equal to or below the eligibility threshold.
- **'Phase 2 Country':** A country whose three-year average GNI per capita is above the eligibility threshold, and for whom GAVI support is decreasing in accordance with section 7 of the 2015 policy.
- **'Phase 3 Country':** A country that is no longer receiving GAVI support and is fully self-financing GAVI vaccines, and that has access to UNICEF tenders for vaccines issued on behalf of GAVI countries, for a time-limited period.

5.5.2 Past graduation, reversals, exceptions

74. Over the period 2007-2010 country eligibility was maintained at the initial level of approximately $1,000. The updated GNI data meant four countries (Albania, PRC, Bosnia & Herzegovina, and Turkmenistan) surpassed the threshold while another (Kiribati) dropped below it and became eligible.

75. Since January 2011, the threshold has been adjusted for inflation on an annual basis. No new countries have become eligible; however, a growing list of 16-20 countries has entered the graduation process, restricting access to newer vaccines/antigens to a subset of the countries that were eligible at the outset of Phase 3. In 2015, 19 countries were in the accelerated transition phase. In 2016, 2 countries will enter the accelerated transition phase (Nicaragua and Papua New Guinea) and 5 countries (Bhutan, Honduras, Mongolia, Sri Lanka and Ukraine) will have reached the end of GAVI support and will be fully self-financing vaccines.

[46] Transition process: http://www.gavi.org/support/apply/graduating-countries/

76. Countries that surpass the eligibility threshold and enter the graduation process have one year to apply for new health systems strengthening (HSS) (i.e. for a country that has not received any HSS support from GAVI yet) and vaccine support, from January 1 of the year after surpassing the eligibility threshold (a grace year).[47]

5.5.3 Engagement with graduated countries

77. Support for a previously eligible country does not end abruptly as existing multi-year commitments for vaccines and/or cash-based programmes from GAVI will continue to be honoured. In November 2013 the GAVI Board approved a strengthened approach to graduation, according to which countries entering graduation now have an additional year to apply for GAVI new vaccine support and are entitled to apply for HSS support for the duration of their graduation period.[48]

5.6 GFATM (Global Fund)

5.6.1 Graduation policy and evolution

78. Eligibility for Global Fund support is rather more complex compared to GAVI. All LICs and MICs (as determined by the World Bank) are eligible for Global Fund support. UMICs are only eligible for funding for diseases where the burden is rated high, severe or extreme. UMICs with severe or extreme (but not high) disease burdens can apply for HSS funding. All the grants to UMICs must be allocated to special groups and/or interventions. Lower-middle income countries (LMICs) are eligible for all types of grants, irrespective of disease burden (except where malaria has been declared eliminated), but 50% of funds must be allocated to special groups and/or interventions. At the time of writing, a new eligibility policy is being approved. However, this section focuses only on the current policy in place.

5.6.2 Past graduation, reversals and exceptions

79. There are several examples of country graduation in past Global Fund rounds (GFATM, 2011). More specifically, country graduation can be either automatic or voluntary.

- *Automatic graduation* occurs when a country is classified as high income and thus no longer eligible to apply for Global Fund financing. As of 2011 only three countries that have received grants have automatically graduated: Estonia in Round 7 (2007) and Croatia and Equatorial Guinea in Round 9 (2009). Equatorial Guinea was an exceptional case, as it moved very quickly from LIC in 2002 to High Income Countries (HIC) by 2007.
- *Voluntary graduation* occurs when eligible countries have chosen to self-finance their disease programmes, e.g., Russia, which agreed to reimburse Global Fund grants. The Counterpart Financing requirement for UMICs is used to prepare countries for financial sustainability once Global Fund grants end.

80. The Global Fund applies an exception for UMICs designated as ‘small island economies’ similar to the case of the World Bank. These countries are eligible to apply for funding from the Global Fund, regardless of national disease burden. This exception is justified on the grounds that these economies face real economic vulnerabilities which limit their ability to spend in health care resources, thereby affecting their ability to combat these three diseases (AIDS, tuberculosis and malaria) (GFATM, 2006a and 2006b). Also the high level of tourist traffic through these islands creates a particular risk for global expansion of disease epidemics if insufficient resources are available to vulnerable populations and those living with disease. Therefore, considering the small

[47] However, new HSS support is restricted to those countries with Penta3 coverage below 90%.
[48] Provided their DTP3 coverage is below 90%.

population size of these island economies (on average 110,000 people), the relative investment is a highly cost-effective measure for the prevention of a larger spread of disease and to ensure access to health care for those suffering with the three diseases (GFATM, 2006b).

5.6.3 Engagement with UMICs

81. Building on the sections above, the eligibility and counterpart financing policy identifies a series of criteria and areas for engagement with UMICs.

- *UMICs will be evaluated for eligibility based upon their respective disease burden*.
- *Co-financing requirements increase with income*. At least 5% of the overall national effort is to be domestically funded for LICs. The figure increases to 20% for lower LMICs, 40% for upper LMICs, and 60% for UMICs. UMICs are encouraged to increase their counterpart financing contribution to above 90% for the duration of grant implementation to facilitate graduation out of Global Fund financing.
- *UMICs designated under the 'small island economy' exception to the IDA lending requirements* are eligible to apply for funding from the Global Fund, regardless of national disease burden as mentioned above.
- *UMICs that are members of the Group of 20 (G-20) countries are not eligible for new or renewal of existing funding unless they have an 'extreme' disease burden*.[49]

5.7 Lessons for ADB graduation policy

82. This review of approaches, by selected MDBs and MOs, to graduation from regular assistance and eligibility span from a rigid approach based on a single indicator such as income per capita (Global Fund), to a more flexible approach triggered by crossing a certain income per capita threshold (IBRD), to a series of subjective criteria to be progressively met (EBRD), or the total absence of a graduation policy (IADB and AfDB). In this latter case, such an approach is motivated by the composition of the borrowing members: voting majority with borrowing developing countries, mostly UMIC, in the case of IADB, and most borrowing countries still classified as LMICs when it comes to the AfDB. There are important lessons emerging from this review.

83. **A graduation policy in place provides a framework for the future engagement with countries.**

- The 2015 revised GAVI eligibility policy addressed the gap left by the 2009 approach to graduation, when countries did not know when they might graduate, as the timing and nature of future updates had not been specified.

84. **Graduation from regular assistance can be premature**.

- First, in the World Bank, Hungary and Latvia had already graduated in 2007. While EBRD acted quickly to put on hold the graduation process for Hungary and Latvia (also because these countries were still eligible for EBRD assistance), the World Bank took a year to decide to resume crisis lending to them. Though the two situations are not identical, quick decision-making by the EBRD was clearly less painful for both the countries involved and the institution (IEG, 2012).
- Second, to look at this point from another perspective, in principle the IBRD Articles of Agreement permit lending to any member (including graduates), should other financing become unavailable, but in practice the lack of a clear policy or precedent

[49] However, countries excluded from applying for funding under this provision may be eligible to apply for HIV/AIDS funding if they meet the criteria described in Paragraph 12 of this Policy (i.e., the NGO Rule).

led to a counterproductive delay during the global economic crisis and notably for Hungary (IEG, 2012).

- Third, this argument is supported by quantitative evidence. According to Knack et al. (2012), predicted probabilities generated by the model conform closely to the actual graduation and de-graduation experiences of Trinidad and Tobago, and the Republic of Korea, at the IBRD, among other countries. This would suggest that Hungary and Latvia may have graduated prematurely – a prediction subsequently borne out by the large loans that they later received from the IBRD in the wake of the global financial crisis.
- Finally, none of the countries that re-entered IBRD assistance have re-graduated, with a recent exception of the Republic of Korea (effective as of July 2016, after the research for this report was finalised), despite having not renewed borrowing for over ten years. This approach denotes a hesitancy to close off a source of financing in case economic crisis strikes again.

85. **In line with the point above, the graduation policy from regular assistance should be flexible and it should allow for an explicit exception for small economies.**

- First, the current IBRD policy on graduation is highly flexible, in part because it is widely recognised that the income threshold is an imperfect proxy for the two criteria of access to capital markets and adequate institutions. A flexible policy does not necessarily imply an inconsistent or non-transparent policy, however.
- Second, at least in the case of IBRD, membership can be seen as an insurance strategy against volatility, and despite a pause in lending (as 18 of the potential graduates currently have chosen) both the bank and its borrowers have an interest in keeping the option open.
- A graduation policy should allow space for voluntary or strongly country-driven graduation (as in the case of Russia for GFATM or the Czech Republic for the EBRD). The criteria applied by EBRD (transition impact, additionality and sound banking) are such that 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 and secure access to international capital markets and other private sources of financing. Each criterion is however based on subjective assessment and it applies to non-sovereign lending only (the main mandate of EBRD).

86. An exception for small island economies to be granted access to the soft window only independently from the level of income per capita is justified first by these economies sharing the problems of low-income developing countries, including export concentration, small domestic markets, high infrastructure costs, limited skill base, and weak institutions. Second, these economies suffered from certain circumstances particular to their size and geography, such as isolation, lack of natural resources, and unavailability of commercial credit. Third, many of these economies are highly vulnerable to natural disasters.

87. **An income per capita threshold triggering the graduation process is far from being the best measure to assess the ability to access international capital markets (MDBs) or health interventions (GAVI and Global Fund)** but it is the measure posing the fewest challenges in terms of data quality issues or frequency of reporting.

88. **The financing relationship with UMICs can also evolve on the basis of their ability to mobilise resources.**

- As in the case of the Global Fund, co-financing requirements increase with income. At least 5% of the overall national effort is to be domestically funded for LICs. The figure increases to 20% for lower LMICs, 40% for upper LMICs, and 60% for UMICs. UMICs are encouraged to increase their counterpart financing contribution to above 90 % for the duration of grant implementation to facilitate graduation out of Global Fund financing.

- This review also shows that AfDB, IADB and IBRD all have in place well-defined strategies for the engagement with MICs (and UMICs in the case of IADB).

89. Together with the review on the rationale for a graduation policy, these lessons from the experience of other MDBs and MOs will inform the analysis on policy options elaborated and compared in the next section. Table A1 in the Annex compares the country operational classification for DMCs eligible for ADB assistance with other relevant MDBs (notably WBG and EBRD).

6 Review of ADB graduation policy from regular assistance: assessment of policy options

90. Building on the review of the literature and the analyses of approaches adopted by MDBs and MOs, this section reviews five policy options on graduation from regular assistance/non-concessional finance (including a status quo which is the current policy in place) as illustrated in Figure 2. Albeit with some degree of subjectivity, these options are ranked from the most transparent and certain but also more rigid approach (graduation based on publicly available thresholds/indicators for all criteria) up to the most extreme scenario of no graduation policy,[50] more flexible but more arbitrary and uncertain, at least when it comes to programming and resource allocation.

Figure 2: Policy options for graduation from regular assistance

More transparent/certain but rigid ⟷ **More flexible but arbitrary/uncertain**

Graduation based on publicly available thresholds/indicators for all criteria	Status quo	Increased flexibility in exit	Voluntary graduation	No graduation policy
Each criterion is transparent and measured by quantitative indicators	Current ADB graduation policy with criteria (ii) and (iii) based on subjective assessments	No strict timetable/path for graduation with flexibility in managing exit.	A DMC decides whether and when to apply for graduation from regular assistance	DMCs have an indefinite option to borrow from ADB resources

91. We will also explore four possible exceptions that are in principle applicable under each option: (i) differentiated pricing/cost sharing based on country circumstances, (ii) a small island/economy exception as in the case of the WBG and GFATM, (iii) an exception for projects supporting regional economic integration and development (see Section 2) and (iv) a separate graduation policy for non-sovereign operations as applied by IFC. These are exceptions worth exploring when it comes to the engagement with UMICs and/or graduated DMCs. This report analyses the pros and cons of each approach for illustrative purposes, but it does not make any

[50] Its rationale has also been discussed in depth in Section 4.

specific or explicit recommendation as the details of each exception require further elaboration on the basis of the direction of Strategy 2030.

92. We will judge the merits of alternative options on the basis of five main criteria, selected to help navigate and compare the different proposals.

1. Simplicity (of design and communication)
2. Data availability and transparency
3. Resource implications
4. Stability (few or no likely reversals)
5. Robustness/soundness of methodology.

93. These criteria derive from a companion analysis (Mustapha et al., 2015) reflecting on some of the advantages that were attributed to the World Bank lending categories and income classifications (such as of the simplicity of the indicator, in terms of both calculation and presentation to a technical and informed audience) or disadvantages (lack of transparency and reversals of World Bank lending categories). Criteria were also chosen to gauge the technical feasibility of each option (based on data availability and robustness of the methodology) as well as the financial viability of its implementation (i.e. whether the proposal can have a positive or negative impact on the ADB balance sheet) when possible.

6.1 Graduation based on publicly available thresholds/indicators for all criteria

6.1.1 Description

94. Under this option, the graduation process will still be assessed based on three criteria ((i) GNI per capita, (ii) availability of commercial capital flows on reasonable terms, and (iii) attainment of a certain level of development by key economic and social institutions) but with two intrinsic differences from the status quo.

- First, each criterion will be assessed by an indicator (or a combination of indicators), under criteria (ii) and (iii). The graduation process will still be triggered by criterion (i), but full graduation from regular assistance will be completed only when all three indicators (or combination of) are met.
- Second, there will be no room for discretionary decisions in the graduation policy as the criteria will be mechanically assessed.

6.1.2 Criteria assessment

Criteria	Assessment
Simplicity (of design and communication)	Depending on the number of indicators identified to measure the two criteria other than per capita income (i.e. (ii) availability of commercial capital flows on reasonable terms, and (iii) attainment of a certain level of development by key economic and social institutions), selecting appropriate indicators and weighting them might be challenging.
Data availability and transparency	The information on income per capita Atlas method is already easily available. The challenge is to identify criteria that are quantitatively robust (low degree of subjectivity) for a consistent assessment across countries and over time for the other two criteria.

Resource implications	No major difference with the *status quo* option.
Stability (few or no likely reversals)	High risk of reversals (as the *status quo* option) (see Section 5 on IBRD).
Robustness/soundness of methodology	Limitations of evaluation based on per capita income only to trigger the graduation process. As above, challenges in identifying transparent indicators to measure the other two criteria.

6.1.3 Other pros and cons for this proposal

Pros	**Cons**
Scarce official financial resources should be concentrated on poor countries, with richer countries having access to alternative funds (i.e. private capital markets) (*rationale for a graduation policy)*. Graduation would release resources to 'poorer' countries. However, the ADF-OCR merger will expand funding available to DMCs, attenuating resource constraints.	Inflexibility and/or delayed response in case of crisis. This current approach does not take into account exceptions for small island economies/small economies (ADF terms independently from the income per capita level) or support to regional economic integration projects.

6.2 Status quo

6.2.1 Description

95. By 'status quo' we mean the current application of ADB policy on graduation from regular assistance as defined in the OM. To graduate from ADB regular assistance, a DMC has to meet three criteria (see Section 2). Crossing the GNI per capita threshold merely triggers a process that may lead to graduation (income per capita is not a perfect indicator, but there are advantages to using it compared with other measures of wealth). A DMC will graduate from ADB regular assistance only if it fully meets the other two criteria, whose indicators are now assessed on a subjective basis only (Option 6.1 is based on a quantitative and transparent assessment of these indicators), for at least four successive years. This section summarises the key advantages and disadvantages of this option, partly reviewed in Section 2. Again, as we saw in Section 2, the assessment is based on three criteria: (i) GNI per capita, (ii) availability of commercial capital flows on reasonable terms, and (iii) attainment of a certain level of development by key economic and social institutions. The analysis here shared most of its features with option 1 (graduation based on publicly available thresholds/indicators for all criteria).

6.2.2 Criteria assessment

Criteria	**Assessment**
Simplicity (of design and communication)	Yes, the concept of income per capita Atlas method but not necessarily the other two criteria (see Section 2).
Data availability and transparency	Yes, the information on income per capita Atlas method is already easily available. Evaluation of criteria (ii) and (iii) is largely subjective.

Resource implications	No difference, by definition, with the baseline.
Stability (few or no likely reversals)	High risk of reversals (see Section 5 on IBRD).
Robustness/soundness of methodology	Limitations of evaluation based on per capita income only to trigger the graduation process.

6.2.3 Other pros and cons for the status quo options

Pros	**Cons**
Scarce official financial resources should be concentrated on poor countries, with richer countries having access to alternative funds (i.e. private capital markets) (*rationale for a graduation policy)*. Graduation would release resources to 'poorer' countries. However, the ADF-OCR merger will expand funding available to DMCs, attenuating resource constraints.	Inflexibility and/or delayed response in case of crisis. There is no better alternative than GNI per capita to measure wealth – other statistics are not easily available and/or comparable. Therefore income per capita should be interpreted as only triggering the process that may lead to graduation and graduation from ADB regular assistance is assessed when a country meets all the three criteria. This current approach does not take into account exceptions for small island economies/small economies (ADF terms independently from the income per capita level) or support to regional economic integration projects.

6.3 Increased flexibility in exit

6.3.1 Description

96. While the assessment will still be based on the three main criteria, possibly also factoring in the universal SDG agenda in the third criterion, this option will not apply a strict timetable/path for graduation with flexibility in managing exit and it will state more explicitly that all three criteria for graduation will have to meet. Crossing the income per capita threshold will only trigger the discussion of graduation with the DMC – as it is currently stated in the graduation policy but somehow misinterpreted (see Section 2). This option also has the advantage of aligning ADB policy to that of IBRD.

6.3.2 Criteria assessment

Criteria	**Assessment**
Simplicity (of design and communication)	Yes, the concept of income per capita Atlas method is easily understood and clear, triggering the graduation process.
Data availability and transparency	Yes, the information on income per capita Atlas method is already easily available. Evaluation of criteria (ii) and (iii) is largely subjective. The policy may be applied inconsistently (this is one of the main criticisms of the IBRD graduation policy).

Resource implications	No opportunity costs associated with eligible countries that do not borrow (except for staff covering these countries).
Stability (few or no likely reversals)	Lower risk of reversal.
Robustness/soundness of methodology	Limitations of evaluation based on per capita income – but in this case, crossing the income per capita threshold will only trigger the graduation process rather than setting its path/process.

6.4 Voluntary graduation

6.4.1 Description

97. A DMC will decide whether and when to apply for graduation from regular assistance.

6.4.2 Criteria assessment

Criteria	Assessment
Simplicity (of design and communication)	Yes, decision made by the borrowing country.
Data availability and transparency	No data required but discretionary decision of ceasing borrowing with potential political pressure.
Resource implications	More difficult estimates of resource requirements (and so of cross-subsidy to soft window).
Stability (few or no likely reversals)	Low risk of reversal.
Robustness/soundness of methodology	Not required.

6.4.3 Other pros and cons of this option

Pros	Cons
A voluntary graduation policy, coupled with incentives, gives MDBs the flexibility to deal with individual countries' needs, and reflects the fact that countries tend to 'self-graduate' from the MDBs of their own accord.	This approach would increase uncertainty for resource estimation/borrowing requirements, being largely arbitrary or affected by political decisions rather than criteria-based (even though some of indicators might be highly subjective).

6.5 No graduation policy

6.5.1 Description

98. Under this option, no policy process or criteria have to be established. Countries are expected to remain DMCs with an indefinite option to borrow from ADB resources.

6.5.2 Criteria assessment

Criteria	Assessment
Simplicity (of design and communication)	Yes, no policy required.
Data availability and transparency	No data required as no policy/eligibility criteria exist.
Resource implications	No opportunity costs associated with eligible countries that do not borrow (only staff covering these countries).
Stability (few or no likely reversals)	No reversals (by definition).
Robustness/soundness of methodology	Not required.

6.5.3 Other pros and cons of this option

Pros	Cons
An arbitrary rule (such as income per capita threshold) can create perverse incentives and prevent lending to countries still in need of MDB financing. The graduation point is likely to become more difficult to define, as disparities in the level of development and access to financing can be as great within countries as between countries. Graduation may have a negative impact on the quality of MDBs' portfolios. In the case of the ADB, there is no reference to the need for a graduation policy in the Charter.	Non-borrowing members need to have a clear strategy to ensure the MDB has fulfilled its mandate. Lack of policy framework leading to uncertainty of graduation process, resource allocation and subjective decisions.

6.6 Exceptions

6.6.1 Differentiated terms and conditions by income per capita groups or cost sharing arrangements

Description

99. Instead of a graduation policy that applies to all DMCs, ADB could offer differentiated pricing and/or cost sharing at the country level;[51] either the higher the income per capita of the country, the higher the pricing, in the case of sovereign lending – reflecting the capacity of the country to afford more expensive loans; or cost sharing would be lower, the richer the country. An example of differentiated pricing is the Single Borrowing Limit applied by IBRD to larger borrowers to reduce concentration risks.

[51] This option differentiates by borrowing country rather than by instrument. ADB has differentiated instruments with different pricing which they apply to countries belonging to the same country grouping or sharing specific circumstances (such as the Countercyclical Credit Facility).

Criteria assessment

Criteria	Assessment
Simplicity (of design and communication)	Differentiated pricing /cost-sharing will be based on a case-by-case basis, making the application of the graduation policy more complex.
Data availability and transparency	Larger amount of information required to assess differentiated pricing (based on commercial/political risk). Sensitivity in sharing ratings and evaluations (for potential impact on market perception as for creditworthiness assessment) leading to lack of transparency in borrowing terms and conditions.
Resource implications	Depending on the price differentiation/costing share structure, higher terms and conditions for countries that are in a position to afford them can help generate income to subsidise soft window lending.
Stability (few or no likely reversals)	Low risk of reversal.
Robustness/soundness of methodology	Similar assessment on data availability, see above.

Other pros and cons of this option

Pros	Cons
Accommodates countries moving toward self-graduation, while supporting a continued policy role for MDBs that would be demand-driven. Accessing financing under less favourable conditions (or higher cost sharing) can smooth the transition to (fully) market-based lending. Charging higher-income countries more should not be seen as unfair. The difference between the conditions these economies can access in international financial markets and ADB is smaller than for countries 'less creditworthy'.	Undermines the cooperative nature of MDB lending. Charging higher-income countries higher rates has been criticised for seeming to penalise success, on the grounds that commercial banks normally charge more creditworthy borrowers less rather than more. Countries might consider borrowing from ADB less attractive given alternative funding sources.

6.6.2 Small island and small economies

Description

100. This special clause can be applied across all options outlined above, emphasising the special status small economies have in the ADB charter. Based on the WBG approach, such an exception would mean that the ADB would apply concessional terms and conditions to small (island) economies despite income per capita above the cut-off value that would normally trigger a discussion on graduation from regular assistance. It has been applied since 1985 to grant IDA eligibility to small island economies despite their GNI per capita surpassing the IDA eligibility threshold (and under certain cases even IBRD eligibility threshold), evaluated on a case-by-case basis. The GFATM has a similar rule. Eligibility criteria under this exception should be further elaborated.

Pros and cons of this option

Pros	Cons
Small island economies share many of the problems of low-income developing countries, including export concentration, small domestic markets, high infrastructure costs, limited skill base, and weak institutions. Small island economies suffer from certain circumstances particular to their size and geography, such as isolation, lack of natural resources, and unavailability of commercial credit. Many of these economies are highly vulnerable to natural disasters and disease transmission (via tourism). In the case of IDA lending, countries that benefit from the small island exception account for only a very small share of IDA lending, and consequently the impact on overall availability of IDA resources to the poorest countries is small. In the interviews with ADB staff, it was stated that Pacific countries were more prone to reversals and country reclassification due to the nature of these economies and their exposure to shocks.	This option raises the issue of equitable treatment across eligible countries to the soft window, and in particular other small states. While it is recognised that small islands are particularly vulnerable to natural disasters, challenges associated with small populations and economies (diseconomies of scale, capacity and institutional constraints, open economies unable to easily diversify, remoteness and high transport costs) are common to other non-island small states.

6.6.3 Support to projects targeting the regional agenda (climate change/regional integration/knowledge sharing)

Description

101. Exceptions to the graduation policy can be granted to projects that support the regional agenda, independently of eligibility for regular ADB lending. For instance, as we have seen in Section 5.2, IBRD applied an exception to the graduation policy in the case of Barbados for an HIV/AIDS project with strong public goods and externalities. Technical assistance to UMICs and graduated countries would also feature under this option, given its spillover effects. However, in the round of consultations, several challenges emerged about the provision of the TA by ADB. These include whether the ADB has a comparative advantage in the provision of such services in a competitive marketplace and whether DMCs in the region would accept paying for TA (reimbursable or fee for service TA). The concept used here for projects targeting the regional agenda is broad, and further development of this proposal will have to identify more clearly the set of regional projects promoting public goods that will be eligible for this exception.

Pros and cons of this option

Pros	Cons
Allows for exceptions related to core mandates/strategy of ADB, including regional public goods. Incentivises investment in regional integration and cooperation projects, correcting a market failure. These projects generate positive externalities and spillover	Challenges in identifying robust eligibility criteria for each project to avoid loopholes (i.e. ambiguous interpretation of whether a project is eligible or not) including estimates of spillover effects. In the same vein, challenges in identifying a list of regional

effects. The country-based lending model of MDBs can therefore lead to underinvestment in regional goods and can be become less relevant for the promotion of projects supporting RCI.	public goods to be supported. In the case of projects with large spillovers, country-based lending might not create the right incentives for a borrowing country to take up the loan, given the benefits that can also accrue to other/neighbouring countries.

6.6.4 Separate graduation policy for sovereign and non-sovereign operations

Description

102. The graduation policy will apply to sovereign lending only; non-sovereign lending operations will not cease after graduation of sovereign lending. Demand for non-sovereign operation is strong from UMICs. A notable example is Thailand, which has de facto ceased sovereign operations while its private sector continues to borrow from ADB.

Pros and cons of this option

Pros	**Cons**
Private companies can still apply for funding – as usual, non-sovereign lending priced based on commercial/political risk. Pricing at commercial terms also means that private sector operations are not subsidised. In the round of consultations, a strong demand for non-sovereign lending from UMICs was often mentioned. Income generated from non-sovereign lending and equity and other related investments to subsidise lending to low-income/poorer countries. Lending to private companies also means the country will continue to engage with the ADB, e.g. policy dialogue, country office. Continuing support to regional cooperation projects. Harmonising the approach with the WBG (with different policies for IBRD and IFC). A government can be creditworthy even while certain segments of the private sector are not. This would mean continued support to projects with a demonstration effect. In the round of consultations with ADB staff, it was stressed how private sector borrowers in MICs seek ADB's support because of ADB's expertise in international best practices, technology transfer and financial innovation.	A major expansion of non-sovereign lending operations in MICs might require a separate strategy and structure (as in the case of IFC). Increasing role as commercial bank rather than development bank, potentially clashing with the poverty reduction/growth mandate and cooperative approach of an MDB. In the same vein, an eligibility policy for non-sovereign lending operations should in any case be developed to assess minimum criteria (e.g. benefit the local economy, be technically sound, with good economic prospects, as in the case of IFC) and define a maximum limit for lending to high income (5% in the case of IFC) or upper MICs, so as not to jeopardise resources to the poorest countries. ADB already has a target of 40% of non-sovereign lending projects in frontier economies, however. Assessment of financial implications, risk profile, evolution of balance sheets as a result of changing allocation of sovereign/non-sovereign lending allocation, especially under funding constraints/limitations. Private enterprises in graduated DMCs should be able to tap into domestic and international financial markets – as it should have emerged in the creditworthiness assessment for sovereign lending.

7 Conclusions and recommendations

103. This report provided a first assessment of the criteria and process for a DMC to cease sovereign and non-sovereign borrowing from ADB, how it compares with the practice of other MDBs and MOs, and whether (and how) the current ADB approach to graduation from regular/non-concessional assistance needs revisiting. Seven DMCs are currently classified as UMICs among Asian countries[52] and eight among small island states,[53] and more are expected to join these ranks in the coming years.

104. The analysis was based on the review of the current ADB approach, stakeholders' interviews (ADB staff, other former and current MDB staff and academics) and a review of the relevant literature on graduation from non-concessional lending (both policy documents and academic papers). It is worth stressing, however, that there are a limited number of such sources reviewing graduation from non-concessional assistance of MDBs (or from assistance from multilateral organisations that do not distinguish between soft and hard lending windows). We identified six key recommendations emerging from this analysis.

1. An evolving development landscape – from both the supply side and the demand side – calls for a revision of the graduation policy

105. The development landscape has changed remarkably since the policy on graduation from regular assistance was introduced in 1998 and then revised in 2008 (see Section 3). This transformation challenges the assumptions under which the current policy was set up, calling for reflection on whether its parameters are still fit for purpose.

106. The new agenda includes: universality and inclusiveness of the SDGs, growing inequality (across income, subregions and groups); a strong role played by the regional economic integration agenda in the Asian region; sustained macroeconomic performance in most Asian countries with (partly as a result) a growing number of DMCs moving towards the upper end of the MIC spectrum; higher vulnerability to climate change, especially in Pacific Islands; potentially higher annual ADB commitments following the ADF-OCR merger; and finally changes from the demand side of development finance, with countries usually able to access a larger set of financing options (including capital markets and new financial institutions in the region) being more assertive about how they manage different sources of finance.

2. On balance, a graduation policy from regular assistance should be in place…

107. There are several arguments justifying the existence of a graduation policy. First of all, development is perceived as a process of 'graduation'. Although the development process,

[52] Azerbaijan, PRC, Kazakhstan, Malaysia, Mongolia, Thailand, and Turkmenistan.
[53] Cook Islands, Fiji, Maldives, Marshall Islands, Nauru, Palau, Tonga, and Tuvalu.

especially for the least-developed countries, may well take decades rather than years, the process of economic development and, more importantly, the transition process should still be time limited. Second, graduation can also bring a signalling effect to international financial markets, not to mention national and international prestige. Last but not least, a graduation policy provides a framework to guide decision-making, reducing discretionary political decisions; to utilise limited resources in the most effective way; and to help plan future resource disbursements (Section 4). For instance, EBRD introduced broad criteria for graduation in 1997 following a Board request, and the 2015 revised GAVI eligibility policy addressed the gap left by the 2009 approach to graduation, when countries did not know when they might graduate, as the timing and nature of future updates had not been specified.

3. …but it should flexible in nature

108. While a graduation policy should be in place, there are several motivations for applying and interpreting it in a flexible way:

- First, the international development agenda – the universality and inclusiveness of the SDGs and regional and economic cooperation in the Asian region – calls for a longer-term engagement with DMCs.
- Second, at least in the case of IBRD, membership can be seen as an insurance strategy against volatility, and despite a pause in lending (as 18 of the potential graduates currently have chosen) both the World Bank and its borrowers have an interest in keeping the option open. Even though graduation policy may allow for emergency support in exceptional situations, it is often time-consuming and resource-intensive to re-engage with a DMC after a prolonged period of disengagement. For example, none of the countries that re-entered IBRD assistance have re-graduated, with the exception of the Republic of Korea, which only recently graduated from IBRD (effective as of July 2016, after the research for this report was finalised), despite having not renewed borrowing for over ten years. This approach denotes a hesitancy to close off a source of financing in case economic crisis strikes again.
- Third, and associated with the point above, graduation might be too premature, and emergency lending can be less timely and therefore less effective. Hungary and Latvia had already graduated in 2007 from IBRD assistance. While EBRD acted quickly to put on hold the graduation process for Hungary and Latvia (also because these countries were still eligible for EBRD assistance), the World Bank took a year to decide to resume crisis lending to them. Though the two situations are not identical, quick decision-making by the EBRD was clearly less painful for both the countries involved and the institution (IEG, 2012).
- Fourth, while it should not drive the graduation of DMCs from regular assistance, graduation of more creditworthy borrowers can have an impact on the quality of the portfolio of an MDB as well as on its income generation, which also cross-subsidises the concessional window.
- Fifth, the graduation point is likely to become more difficult to define at the national and aggregate level. Disparities in the level of development and access to financing can be as great within countries as between countries, requiring an average income per capita criterion to be assessed together with more detailed measures of economic development and well-being. The current IBRD policy on graduation is deliberately highly flexible, in part because it is widely recognised that the income threshold is an imperfect proxy for the two criteria of access to capital markets and adequate institutions. A flexible policy does not necessarily imply an inconsistent or non-transparent policy, however.

- Finally, lending remains an instrument for policy change and for promoting international goals and standards and for DMCs to fully engage with these agenda with benefits for non-borrowing member states that are not costly for their taxpayers.

4. The current criteria for graduation from regular assistance are broadly correct…

109. The criteria currently applied to assess whether a DMC should graduate from ADB regular assistance are broadly correct. While far from being the first best measure – as it cannot capture purchasing power parity and inequality dimensions – GNI per capita remains the best alternative to assess a country's wealth. It is a synthetic measure easily understood, one of the easiest indicators to collect and to compare across countries, widely available (this might not be the case for measures of income inequality such as the Gini index), usually released with a one-year lag, collected every year, and finally it is not affected by fluctuations associated with the choice of the base year and reference basket (as is the case of GDP/GNI calculated based on PPP terms). However, we are not in a position to assess the methodology and assumptions that determined current GNI per capita threshold – aligned to the IBRD approach – triggering the discussion on graduation. The process of setting the original per capita income thresholds for defining categories for countries was related to the World Bank's previous lending activities. However, it is important to note that, while aligned with the approach adopted by the World Bank for operational purposes, the criteria that initially determined the GNI per capita thresholds have never been published and there is no evidence base (at least none publicly available) to justify them (Alonso et al., 2014; Ravallion, 2013).

110. The other two criteria to assess whether a DMC should graduate from ADB regular assistance (the availability of commercial capital flows on reasonable terms and the attainment of a certain level of development of key economic and social institutions) are guided by the broad indicators set out in the 1998 graduation policy. These criteria are considered to assess one of the principles of the graduation from regular ADB assistance, i.e. reduced dependence on official assistance and reliable access to commercial capital. Key considerations for the assessment of creditworthiness (criterion (ii)) include macroeconomic stability, exchange rate policy, trade and investment liberalisation, privatisation, tax reform, financial sector liberalisation and corporate governance. When it comes to criterion (iii), dimensions taken into account to measure the level of development of key economic and social institutions include the quality of processes for macroeconomic management, the regulatory and supervisory framework in the financial sectors, the efficiency and flexibility of labour markets and the legal system. Criterion (iii) could potentially include an assessment of the extent to which economic and social institutions are capable of helping a DMC achieve the SDGs.

111. A number of ADB senior staff interviewed for this project also called for a more rigorous, comparable and systematic assessment of these criteria. However, the complexity embedded in the evaluation of the two criteria determines a subjective approach, as selecting appropriate indicators, let alone their weighting and thresholds, can be challenging with the limited evidence base supporting any decisions.

5. …however, the interpretation of the policy as well as its application has to change and should reflect the new development agenda and challenges…

112. With the parameters of the graduation policy from ADB regular assistance currently in place broadly correct (see above on the caveat), we would however recommend at least two refinements of the current text of the OM to align the application of the graduation policy to its guiding principles (both stated in the Charter) and policies (1998 revised in 2008).

- First, the reference to the five-year horizon for a country to graduate after crossing the GNI per capita threshold should be removed because of lack of evidence based on previous experiences. For instance among graduated countries, DMCs like Singapore, the Republic of Korea, Hong Kong, China and Taipei,China, graduated when the policy was introduced in 1998; Brunei is an exception case that does not set a precedent. In the round of interviews it often emerged that the current ADB graduation policy is perceived as rigid when compared to the approach taken by IBRD (see Section 4). However, both the reference in the OM (*ADB will take a flexible approach to determining the pace of graduation* – OM Section A1/BP, para. 7) and the practice would suggest a de facto very flexible approach to graduation.

- Second, rather than setting a tentative time horizon for graduation, the OM should once again apply the approach that was put forward in the 1998 graduation policy (p. 33), i.e. *graduation from regular Bank assistance will take place after the required criteria are met for four successive years.* This approach has two main advantages. It clearly spells out how all three criteria must be met for graduation – not just the GNI per capita that only potentially starts a discussion about future graduation but was often considered by ADB staff as the key criterion for graduation. Different language in the Operations Manual, as suggested above, stresses that the path towards graduation is a medium to long-term process.
- *Changes in the development landscape reflected above may warrant the introduction of additional criteria to reflect the different set of that challenges that DMCs now face.* Additional dimensions, if not already covered under the assessment of criteria (ii) and (iii) (the details of which are bounded by confidentiality and are not accessible for this review), include: income and non-inequality measures, human development indicators (health and education-related indicators, e.g. components of the UNDP Human Development Index), vulnerability to climate change, tax revenue mobilisation and availability of alternative financing options, for both the public and the private sectors.

6. …with consideration of new approaches to lending and eligibility, to reflect the new circumstances of DMCs and ADB capacity to mobilise resources

113. There are some exceptions worth exploring when it comes to the engagement with UMICs and/or graduated DMCs. This report analyses the pros and cons of each approach for illustrative purposes only. It does not make any specific or explicit recommendation as the details of each exception require further elaboration on the basis of the direction of Strategy 2030.

- First, ADB could offer *differentiated pricing for each DMC*: the higher the income per capita of the country, the higher the pricing, in the case of sovereign lending – reflecting the capacity of some UMICs to afford more expensive loans. The Gurría and Volcker commission recommended this option. It has clear disadvantages: such a proposal undermines the cooperative nature of MDB lending, it penalises success – in that commercial banks normally charge more creditworthy borrowers less rather than more – and some DMCs might find ADB assistance less attractive, not to mention the greater complexity in setting up differentiated terms or the fact that products already have differentiated terms, at least applicable to each country grouping. However, there are a series of advantages in taking a differentiated approach to pricing instruments: several borrowing DMCs are in a position to afford more expensive loans (compared to the market options they can access) and they can help generate income to subsidise soft-window lending; such an approach would smooth the transition to (fully) market-based lending. For instance, to limit concentration on the most creditworthy and largest economies (population and economic size), IBRD has a Single Borrowing Limit (SBL) in place.[54] A surcharge of 50 basis points a year was introduced on loans and other exposures for the incremental exposure above the previous SBL. The surcharge reflects the impact of greater portfolio concentration.

[54] The SBL was $20 billion for India and $19 billion for the other four SBL borrowing countries (Brazil, China, Indonesia, and Mexico) in FY15, and will remain unchanged for FY16.

- Second, *graduation from regular assistance should not necessarily cease both sovereign and non-sovereign lending*. There are several other arguments justifying a differentiated approach to graduation from sovereign and non-sovereign lending. First, lending to private companies also means the country will continue to engage with the ADB, including through policy dialogue. Second, such an approach would help support regional cooperation projects (see the final point) and harmonise the ADB approach with that of the WBG (with different policies for IBRD and IFC). Finally, a government can be creditworthy, but certain segments of the private sector might not. This would mean continued support to projects with a demonstration effect. However, such a distinction could require a separate strategy and structure (as in the case of IFC). ADB would play an increasing role as a commercial bank rather than a development bank, clashing with the poverty reduction/growth mandate and cooperative approach of an MDB mandate. Private enterprises in graduated DMCs should be able to tap into domestic and international financial markets – as it should have emerged in the creditworthiness assessment for sovereign lending. The ADB target of 40% of non-sovereign projects in frontier markets means that the risk of crowding out resources from poorer countries is less likely.
- Third, there is scope to *introduce a small-island/small-economy exception*. Such an exception would apply across ADF and OCR windows and not only to the options of graduation from ADB regular assistance. Small islands/small economies would be granted ADF status independently of their income per capita level (also above $7,175 as is currently the case of Cook Islands and Palau). This policy would align ADB to World Bank practice, with attention to the special needs of these economies, as stated in the ADB Charter.
- Finally, an exception can be granted to projects *supporting the regional integration and cooperation agenda*, independently of eligibility for regular ADB lending. For instance, IBRD applied an exception to the graduation policy in the case of Barbados for an HIV/AIDS project with strong public goods and externalities. This exception would allow support to projects that are at the core of the ADB mandate and strategy and would allow for continued engagement with graduated DMCs, including the provision of TA. Challenges to the implementation of this option are related to the identification of robust eligibility criteria and estimates of spillover effects, and country-based lending might not create the right incentives for a borrowing country to take up a loan because the benefits accrue to neighbouring countries and not just to the country responsible for repaying the loan.

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9 Annex

Table A1: Summary: a comparison between MDBs and MO

MDB/MOs	Graduation policy			Graduated countries			Engagement with graduated countries	Engagement with UMIC	Future graduates
	Policy in place	Criteria	Process	Countries (year)	Reversals	Exceptions			
EBRD	Yes, it was established in 1995 as the EBRD operations were expected to cease 10 years after its establishment	Not public or clearly defined[55] They apply the key principles of EBRD lending ((i) additionality; (ii) crowding-in; (iii) commercial sustainability)	Country-specific approach with country strategies, jointly agreed by the Bank & country authorities. Process is very much ad hoc based on the experience with Czech Republic	Czech Republic[56] (2007)	None, though expected graduation of EU7 countries by 2010 was delayed due to financial crisis. No public benchmarks were given to support this decision	None, though graduation postponed	Post-Graduation Operational Approach (BDS13-049 (Final)) (PGOA) and EBRD Post-Graduation Special Fund[57]	No info available	No info available *Note: It is expected that country strategies for the EU7 will continue to set the path and indicate a plausible pace of graduation for these countries within the medium term.*

[55] http://bankwatch.org/sites/default/files/EBRD-stuck-in-market.pdf and https://books.google.co.uk/books?id=8nBGZSyut6UC&pg=PA46&lpg=PA46&dq=ebrd+graduation+criteria&source=bl&ots=qw55kmfqJ2&sig=wjNNjyx0qN6t-OM1-q5fT38nZFU&hl=en&sa=X&ved=0ahUKEwjV7tvLgO3KAhXLbhQKHfwnD64Q6AEIITAA#v=onepage&q=ebrd%20graduation%20criteria&f=false

[56] http://www.ebrd.com/who-we-are/history-of-the-ebrd.html

[57] The Fund was approved in March 2014 to help the EBRD achieve its mandate of implementing a strategic and comprehensive approach to post-graduation. The resources of the Fund may be used to finance activities and costs to provide expertise to clients in countries where there is a clear perspective on graduation, or to support post-graduation business development. As the primary purpose of the Fund is to help the Bank to achieve its post-graduation mandate rather than to generate a return on its assets, financial risks, with the exception of credit risk, are not actively managed by the Fund.

MDB/MOs	Graduation policy			Graduated countries			Engagement with graduated countries	Engagement with UMIC	Future graduates
	Policy in place	Criteria	Process	Countries (year)	Reversals	Exceptions			
IBRD	Yes, Articles of Agreement and 1982 review	Income threshold and other subjective measures like institutional capacity and credit rating	Crossing income threshold triggers only a start of discussion about graduation, and is not a sufficient condition in itself[58]	20 graduates since 1970	Yes, 5 Iraq in 2003, Venezuela in 1989, Gabon in 1988, Trinidad and Tobago in 1990, the Republic of Korea in 1998 (for reasons of falling petroleum output and prices,[59] severe conflict, regional financial crisis).	Yes, 3 Barbados, Hungary and Latvia received additional loans after graduation, but not officially reinstated as IBRD	i. Special Development Policy Loan (Latvia and Hungary)[60] ii. Reimbursable technical cooperation[61]	No specific IBRD strategy; however, WBG strategy (2013) states that the WBG will continue to help MICs and UMICs address issues that are critical to sustaining their development progress. MIC strategy [62] includes: i. Partnering with MICs as Global Actors ii. Working with MICs to Meet Second-generation Development Challenges iii. Strengthening	Yes (by 2019 and 2025 (Morris and Gleave, 2015)

[58] http://www.ifad.org/events/ifi_trends/wb75.pdf
[59] http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1989/11/21/000009265_3960928044343/Rendered/PDF/multi0page.pdf
[60] IEG, 2012
[61] http://www.worldbank.org/en/news/press-release/2012/11/27/world-bank-and-hungary-agree-to-technical-cooperation-on-structural-reform-program
[62] http://www.worldbank.org/en/country/mic/overview#2

								the Knowledge Partnership and Facilitating Cross-Country Learning iv. Providing a Range of Financial Services	

MDB/MOs	**Graduation policy**			**Graduated countries**			**Engagement with graduated countries**	**Engagement with UMIC**	**Future graduates**
	Policy in place	**Criteria**	**Process**	**Countries (year)**	**Reversals**	**Exceptions**			
GAVI	Yes, 2015 Eligibility and Transition policy	GNI per capita	Transition assessment as early as feasible during Phase 1 (approx. 2-3 years before the projected date of entering Phase 2). When a country's reported average GNI p.c. over the past three years is above the eligibility threshold, GAVI	2000-06[63]: 75 countries eligible 2007-10: 72 countries eligible due to updated GNI data. Albania, PRC, Bosnia & Herzegovina, and Turkmenistan surpassed the threshold while Kiribati dropped below 2016[64]: 54 countries	No info available	None	Depending on the specific vaccine, countries have access to the lower GAVI price for a period of time after graduation. Countries that surpass the Eligibility Threshold have one year to apply for new HSS (i.e. for a country that has not received any HSS support from GAVI yet) and vaccine	No	Yes, i. 2011-2022, see *Equitable Access Initiative (2015)* ii. Short Term 2015 to 2020, Medium Term 2020 to 2030, Long Term 2030 to 2050. See Pearson and Mundy, 2015 iii. 2011-

[63] http://www.gavi.org/support/apply/countries-eligible-for-support/

			will inform the country that it will enter Phase 2 effective the next year. Graduation phase of 5 years	eligible. 5 countries (Bhutan, Honduras, Mongolia, Sri Lanka, Ukraine) will have reached the end of support in 2016.			support, from January 1 of the year after surpassing the Eligibility Threshold (a grace year). However, new HSS support is restricted to those countries with Penta3[65] coverage below 90%.		2020, See Khatib-Othman, 2013
GFATM (a new policy is under discussion to be approved in May 2016 – the analysis here refers to the current policy only)	Yes, Eligibility and Counterpart Financing Policy, 2013	Income level (as determined by the WB income classifications) & official disease burden[66]	Eligibility is reviewed annually. Countries receive an allocation of funding for a 3-year period for each of the 3 diseases eligible	As of 2011: i. Automatic graduation: Estonia (2007) and Croatia and Equatorial Guinea (2009). ii. Voluntary graduation: Russia	No info available	Yes, 'small island economy' exception (IDA) for UMICs	No info available	Yes, UMICs with severe or extreme disease burdens can apply for health systems strengthening (HSS) funding, to special groups and/or projects	i. Short Term 2015 to 2020, Medium Term 2020 to 2030, Long Term 2030 to 2050. See Pearson and Mundy, 2015

[64] http://www.gavi.org/support/apply/graduating-countries/
[65] Percentage of infants that received three doses of pentavalent vaccine.
[66] http://www.theglobalfund.org/en/fundingmodel/process/eligibility/

Table A2: Summary: operational classification of DMCs: ADB, World Bank and EBRD (based on April 2016 data and information)

DMC	GNI per capita, Atlas method (current US$) 2014	ADB classification	WB classification	EBRD classification	Discrepancies – Exceptions
Afghanistan	680	Grants-only	IDA		
Armenia	4020	MOL-only	IBRD	Eligible	
Azerbaijan	7590	MOL-only	IBRD	Eligible	*Crossed the GNI pc threshold for graduation from regular assistance*
Bangladesh	*1080*	OCR-blend	IDA		
Bhutan	2370	COL-only	IDA		
Cambodia	1020	COL-only	IDA		
PRC	7400	MOL-only	IBRD		*Crossed the GNI pc threshold for graduation from regular assistance*
Cook Islands		MOL-only	n/a		
Fiji	4870	MOL-only	IBRD		
Georgia	3720	MOL-only	IBRD	Eligible	
Hong Kong,China		Graduated	Graduated		
India	1570	MOL-only	IBRD		
Indonesia	3630	MOL-only	IBRD		
Kazakhstan	11850	MOL-only	IBRD	Eligible	*Crossed the GNI pc threshold for graduation from regular assistance*

Kiribati	2950	Grants-only	IDA		
Korea, Rep.*		Graduated			
Kyrgyz Republic	1250	ADF blend	IDA	Eligible	
Lao PDR	1660	COL-only	IDA		
Macao		Graduated	Graduated		
Malaysia	11120	MOL-only	IBRD		*Crossed the GNI pc threshold for graduation from regular assistance*
Maldives	6410	Grants-only	IDA		
Marshall Islands	4390	Grants-only	IDA		
Micronesia, Fed. Sts.	3200	OCR-blend	IDA		*OCR-blend – GNI pc below threshold – small islands exception for WB*
Mongolia	4280	OCR-blend	Blend	Eligible	
Myanmar	1270	COL-only	IDA		
Nauru		Grants-only	n/a		
Nepal	730	COL-only	IDA		
Pakistan	1400	OCR-blend	Blend		
Palau	11110	OCR-blend	IBRD		*OCR-blend for ADB, IBRD for WB*
Papua New Guinea	2240	OCR-blend	Blend		
Philippines	3500	MOL-only	IBRD		
Samoa	4060	Grants-only	IDA		

Singapore		Graduated	Graduated		
Solomon Islands	1830	ADF blend	IDA		
Sri Lanka	3460	OCR-blend	Blend		
Taipei,China		Graduated	n/a		
Tajikistan	1080	ADF blend	IDA	Eligible	
Thailand	5780	MOL-only	IBRD		
Timor-Leste	2680	OCR-blend	Blend		
Tonga	4260	ADF blend	IDA		
Turkmenistan	8020	MOL-only	IBRD	Eligible	*Crossed the GNI pc threshold for graduation from regular assistance*
Tuvalu	5720	Grants-only	IDA		
Uzbekistan	2090	OCR-blend	Blend	Eligible	
Vanuatu	3160	ADF blend	IDA		
Vietnam	1890	OCR-blend	Blend		

*Notes: Discrepancies among ADB and WB highlighted in bold. Source: World Bank development indicators, latest financial statements for IBRD and ADB, EBRD website. * Not classified as IBRD country since July 2016.*