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**ADB'S APPROACH TO WEAKLY-PERFORMING  
DEVELOPING MEMBER COUNTRIES**

**A DISCUSSION PAPER**

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## ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CPR	–	Country Performance Rating
DMC	–	developing member country
ETSW	–	economic, thematic and sector analytic work

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## **I. CHALLENGES OF WEAKLY-PERFORMING DEVELOPING MEMBER COUNTRIES IN THE ASIAN-PACIFIC REGION**

1. The economic and social transformation of the Asian-Pacific region over the last several decades is nothing short of dramatic. Not only have many people in the region become richer, healthier, better fed, and more educated, but they have become so in a short period of time. Similarly, where living conditions continue to be difficult, the adoption of good policies in recent years provides grounds for optimism that a positive transformation is also underway here. There are, however, some countries where not only progress but also the scope for progress remains limited. Under current trends such countries are unlikely to achieve the Millennium Development Goals. This paper is concerned with weakly-performing developing member countries (DMCs) and outlines an approach for ADB to remain engaged with them to strengthen their development performance.

2. A key message of this paper is that the ADB must be engaged with the weakly-performing DMCs. Weak performance in these countries has meant severe hardships for large sections of their populations. In addition, weak performance in one country can have negative implications for other countries, especially neighboring ones. Thus addressing the issue of weak performance is likely to benefit not only the weakly-performing DMCs themselves, but the region as a whole. Disengaging is not a reasonable option.

3. Unfortunately standard forms of assistance to weakly-performing countries have often lacked in effectiveness. As noted in recent research, aid has not worked well in such countries because their governments often lack the capacity or inclination to use assistance effectively.<sup>1</sup> Moreover, conditionality is unlikely to be useful for making aid more effective. Since governments in weakly-performing countries either have weak capacities and/or are not committed to reform, key initial conditions under which aid conditionality can be effective are likely to be missing in the weakly-performing DMCs. A new approach to assistance for weakly-performing DMCs is therefore needed.

## **II. IDENTIFYING AND UNDERSTANDING WEAK PERFORMANCE**

4. Identifying weak performance and understanding the factors that underlie it must precede an attempt at formulating a new approach. This section begins by adopting specific criteria of weak performance. The criteria are not meant to be definitive. Rather they are used to help draw attention to factors underlying weak performance and point to the elements of a new approach. Operationalizing a new approach will require criteria that are the product of consultations with development partners.

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<sup>1</sup> See, in particular, the report of the World Bank Group, "Low-Income Countries Under Stress: A Task Force Report" (2002).

5. For analytic and illustrative purposes, therefore, this paper proceeds by combining three indicators, which together capture broad economic, social, and institutional factors that characterize strong or weak performance. These are: (i) per-capita incomes; (ii) growth rates of per-capita incomes; and (iii) quintile rankings of ADB's Country Performance Ratings (CPRs).<sup>2</sup> A country is defined to be weakly-performing if it has either (i) experienced low growth relative to its income level and has a weak CPR; or (ii) it has a CPR in the weakest category, even though its growth in per capita income exceeds a threshold rate. Applying this criteria to the DMCs yields a 'working' list of weakly-performing DMCs.

6. Based on ADB's operational experience in DMCs and a review of related literature, we identify three factors that underlie weak performance. The three factors relate to: (i) weak managing capacity; (ii) small isolated market conditions; and (iii) civil conflict among important social groups. While the first of these is found to characterize all the weakly-performing DMCs the latter two factors occur on a case-by-case basis. Where they occur, they reinforce the difficulties caused by weak managing capacity.

7. Weak managing capacity refers to the weakness in the ability to formulate a consistent set of good policies, implement them, and evaluate the results with a view to undertaking corrective actions if and as needed. This factor becomes all the more challenging from a developmental perspective when it is accompanied by, or is the result of, misgovernance, i.e., where there exists a high degree of corruption in the public sector and/or a leadership caters to a narrow interest group.

8. The second factor —small and isolated markets— is typically found either in small island economies or in landlocked nations with poor transport links to larger markets. Small size in and of itself is not necessarily an obstacle to good performance, as has been proven repeatedly in Asia as well as elsewhere. However, the small countries that have been able to develop quickly have tended to be ones with strong natural transportation links to larger markets. Isolated nations with small markets are frequently unable to exploit economies of scale and comparative advantage. They tend to rely on commodity exports but competitiveness is low due to inefficient small-scale production and high shipping/transport costs.

9. The third factor is the physical and social disruption found in countries marked by serious conflict either currently or in the recent past (post-conflict). The sharp social cleavages and weakened infrastructure that mark conflict and post-conflict nations create specific and difficult challenges for governments and for donors. Conflict has a number of adverse consequences including the stunting and/or weakening of the types of social institutions on whose basis the foundation of fair and sound governance is based.

10. While each of these three factors may be present to varying degrees in other low-income countries, they present a special challenge to the weakly-performing DMCs given that virtually all of them are at a relatively early stage of economic transition. For some weakly-performing DMCs, the transition being initiated is one from a state-led planned economy to a

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<sup>2</sup> The rationale for including these indicators in assessing the weak performance is as follows. First, sustained economic growth is necessary for improving the welfare of a country's population, especially at low levels of income. Additionally, since it should be possible for low-income countries to grow relatively fast, an assessment of whether economic growth over the medium term (5-10 years) has been adequate or not should be made in relation to income levels. Second, a country's policy and institutional framework for dealing with economic and social issues is likely to have a strong bearing on overall performance. We therefore include the quintile rankings of ADB's CPRs as a determinant of performance. It may be noted that while the CPRs combine assessments of the policy and institutional framework with those of ADB portfolio quality, a much larger weight is given to the former as opposed to the latter (85% versus 15%).

market-based one. In others, the challenge is in strengthening the transition from traditional, subsistence activities to market-based ones.

### **III. ASSISTANCE FOR THE WEAKLY-PERFORMING DEVELOPING MEMBER COUNTRIES: ELEMENTS OF AN APPROACH**

11. In view of the special circumstances of the weakly-performing DMCs, there are two key building blocks on which more effective assistance can be built: in-depth, country-specific analytical work and strategic partnerships with other donors. The former is needed for both understanding the root causes of weak performance as well as designing country-specific approaches. While economic, thematic and sector analytic work (ETSW) will play a critically important role, the non-economic nature of some of the underlying factors holding weakly-performing DMCs back means that the required analysis will have to go well beyond the general scope of ETSW. In particular, given that problems of conflict and/or misgovernance may be key factors underlying weak performance, it will be necessary to get a better understanding of social and political processes in such weakly-performing DMCs.

12. Establishing strategic partnerships with other donors will also be critical. While the importance of partnerships is by now well recognized in development work, they have special relevance for assistance to the weakly-performing DMCs. First, donor coordination is vital to ensuring a focused approach that does not stretch already weak capacities to the limit. Second, where misgovernance and/or conflicts are serious obstacles to better performance, the nature of required assistance could be one that ADB cannot address without the appropriate partners. This is because the problems of misgovernance and conflict are often bound to political factors in which ADB has little or no direct role to play. Finally, given the negative spillovers that weak performance can have on neighboring countries, partnerships involving regional shareholders of ADB warrant serious consideration. These partnerships can be useful not only as a source of complementary technical, administrative, and financial resources, but also for expanding the effective market for weakly-performing DMCs.

13. The combined benefit of in-depth analysis and strategic partnerships is that the two together are likely to provide both a sound basis for determining the main areas where assistance could be most effective and how this assistance is to be provided. While the specifics on the types and forms of assistance would naturally have to await the analysis and partnerships being suggested here, current knowledge suggests a few issues for consideration.

14. First, it is likely that an in-depth analysis would confirm weak managing capacity as the key constraint to performance in the weakly-performing DMCs. Assistance designed for capacity-building is therefore likely to be the main component of operations. The unique circumstances of the weakly-performing DMCs will warrant special attention to the design and delivery of capacity building efforts, however. ADB's operational experience in DMCs has shown that while aid has already accorded a high priority to capacity building in these countries, it has often ended up with capacity "substitution" - as consultants are hired to fill staff positions owing to weak institutional and human capacities locally. Similarly, where misgovernance and or social cleavages are serious, capacity building efforts will need to incorporate and foster a participatory approach.

15. Second, capacity building is unlikely to work on its own. Where misgovernance is not a major issue, capacity building could be complemented and reinforced by projects vital for generating economic growth and providing basic social services to the poor using carefully

designed delivery and monitoring mechanisms to ensure project goals are met. Such a 'development dividend' is needed for key stakeholders within the weakly-performing DMCs to buy into the efforts of donors. It is analogous to the case of the post-conflict weakly-performing DMCs where there is likely to be a political imperative to deliver a visible 'peace dividend' within a relatively short timeframe in order to consolidate the peace.<sup>3</sup> For weakly-performing countries characterized by a high degree of misgovernance, a 'development dividend' could also be considered; but this would require firm and credible commitment by the government to improve governance.

16. Finally, the pervasiveness of weak capacity suggests that selectivity and focus will need to be a key principle guiding assistance efforts. Too many projects and programs could distract both donors and concerned governments from those which deserve highest priorities. Only in-depth, country-specific analysis of the type described above can inform the development community on what combination of capacity building and projects will be effective.

17. Summarizing the above, the first order of priority is to establish a well focused ETSW program which encompasses pertinent social and political analysis to determine the major constraints, including political economy ones, to better performance. Underpinned by a sound analytical and empirical assessment, ADB would be in a position of conducting dialogues with the concerned countries on a regular basis and implement capacity building initiatives. While analytical work and capacity building will be the primary forms of assistance, they will also serve to inform ADB on decisions regarding the financing and composition of projects. In all of the above, strong partnerships with bilateral and multilateral donors would be critical.

#### **IV. OPERATIONAL ISSUES AND IMPLICATIONS FOR ADB**

18. Operationalizing an assistance package for the weakly-performing DMCs along the lines just noted will entail a number of actions and considerations. A key initial step will be to adopt criteria for identifying weakly-performing DMCs which is the product of consultation with all relevant development partners. There will also be organizational and financial implications for ADB. In terms of the former, special attention will need to be paid to staff incentives and skills. Modest lending operations should not work as a negative factor in the evaluation of staff performance. Conversely, work in complex and problematic country circumstances should be recognized. The incentive structure must also encourage high-quality country-specific analysis that is required for designing an effective assistance package.

19. On the financial side, there are a number of issues involved. Enhanced ETSW and an emphasis on capacity building assistance is likely to lead to an expansion of the use of non-lending products in the weakly-performing DMCs. This will lead to an increase in the need for technical assistance resources.

20. Additional loan and grant resources may be required for funding projects which serve important growth and developmental goals, including that of providing a 'development dividend'.<sup>4</sup> To ensure sustainability of these projects significant efforts would be needed to

<sup>3</sup> As with the specifics on capacity building, the specifics on the types of projects will depend on the outcome of serious analytical work involving economic, social, and political analysis, carried out in the context of partnerships among donors. Thus, for example, for a small, isolated weakly-performing DMC, geography can present serious limits to what may be achievable with capacity building efforts alone. Investments in improving transportation infrastructure could alleviate geographical constraints, especially if accompanied by efforts at promoting regional cooperation with better placed neighbors.

<sup>4</sup> The projects that would provide the development dividend would conform to the principles outlined in paragraph 15.

enhance the capacities of executing agencies. Additional resources, and quick disbursements, are also required for emergency assistance. This is because while many weakly-performing DMCs are generally more prone to disasters due to special geographical circumstances, civil conflicts, or poor health systems, they also have the least capacity (in financial, technical, and managerial terms) to cope with disasters. Grant financing could therefore be used to deliver short-term emergency assistance.

21. With regard to the Asian Development Fund (ADF) financing of projects in weakly-performing DMCs, cognizance has to be taken of the possibility that some of them may be in non-accrual status.<sup>5</sup> Under current ADF policy, the existence of arrears would constrain the resumption of ADF operations.<sup>6</sup> In the context of weakly-performing DMCs in arrears, the possibility of grant financing under ADF IX suggests that it would be important to decide on whether the existing sanctions on ADF loans for countries in arrears should only be applicable to ADF loans but should not be applicable to the provision of ADF grants. This decision would need to be based on a careful consideration of two issues. First, the weakly-performing DMCs that are in arrears are likely to be in pressing need for ADF grant assistance. Second, since money is fungible, the grants provided from ADF could be used to clear the arrears from ADF or from other institutions thereby creating a moral hazard problem. Since grants did not exist under the ADF VIII when ADF's current policy on sanctions was approved by the Board in April 2001, a decision on the application of sanctions to the provision of ADF grants would play an important role in the design and recommendations of the policy paper on grant financing that would have to be approved by the Board of Directors.

22. An important source of additional resources would be partner countries. In view of partners' incentives in ensuring stability and growth in their own neighborhoods, it is likely that some donors will be willing and interested in cofinancing of ADB activities. ADB could facilitate this in two ways. With ADB becoming the source of development knowledge on weakly-performing DMCs, ADB's expertise and experience could be leveraged by partner countries to initiate or strengthen activities by them. Further, if grant financing by ADF were possible, the above would be augmented by cofinancing with bilateral and multilateral partners.

23. In some cases, alternative strategies such as the establishment of trust funds may be a realistic way forward.

## **V. REQUEST FOR DONOR GUIDANCE**

24. This paper has described the broad elements of an approach to weakly-performing DMCs. Its purpose is to provide a starting point for discussing a variety of developmental, financial, and organizational issues and to solicit donor guidance which will be reflected in either the concerned Country Strategy and Programs and their updates for Board review or the final Donors' report. In this context, donor guidance is requested on whether:

- (i) Per capita incomes, growth rates of per capita incomes, and quintile rankings of CPRs are appropriate indicators for identifying weakly-performing DMCs.

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<sup>5</sup> ADB has a clear policy on sanctions when a DMC goes into non-accrual status which is defined as the principal or interest payment being overdue by six months. Under the sanctions policy, ADB will propose no further loans if a country is in arrears for 60 days. Further, if a country is in arrears for 90 days, all disbursements would be suspended. Some weakly-performing DMCs might be under ADB sanctions due to loan arrears.

<sup>6</sup> R59-01 A Review of Loan Loss Provisioning Policy for ADF, 9 April 2001.

- (ii) The two key building blocks suggested above consisting of (a) in-depth country specific analytical work and (b) strategic partnerships with other donors are broadly correct.
- (iii) Ensuring a development dividend that may require investments is needed for key stakeholders within weakly-performing DMCs to buy into reform efforts of donors.
- (iv) Weakly-performing DMCs should have access to grant financing even if they have arrears to ADF.