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This report was commissioned by the Spanish Fundación para las Relaciones Exteriores y el Diálogo Exterior (FRIDE, www.fride.org) and carried out by a team of Development Finance Corporation (DFC, www.thedfcgroup.com) composed of:

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I.I. = Institutional Infrastructure
IMF = International Monetary Fund
INTAN = National Institute of Public Administration, Malaysia
L-T = Long-Term
LAC = Latin America and Caribbean
LDC = Less Developed Countries
LIBOR = London Interbank offered rate
MANPUI = Modernisation and Management Planning Unit, Malaysia
MDB = Multilateral Development Banks
MDGs = Millennium Development Goals
MENA = Middle East and North Africa
EXECUTIVE SUMMARY

Aid plays a crucial role in pursuing humanitarian, social and economic goals in the developing world. Yet the notion of solidarity among nations, and that rich countries should help poorer ones, is relatively recent – dating back to the post World War II reconstruction. In a remarkably short period of time, the aid landscape has evolved dramatically, and now exhibits many of the characteristics typically found in other major industries: Global operations, multinational institutions, increasingly diverse and specialised suppliers, tens of billions of dollars in “turnover”, hundreds of thousands of employees… An examination of the history, effectiveness and future outlook of this industry suggests a need for major reform.

Previous attempts at reforming the aid industry have typically focused on its “supply side” – the institutions and organisations that channel and manage aid. We take a different approach, and argue that successful reform will require addressing shortcomings on the “demand side” – thus ensuring that recipient countries become more mature and capable consumers of aid finance.

The concept of Institutional Infrastructure (I.I.) is at the heart of our approach. A country’s I.I. is defined as its policies, institutions, and managerial capacity in the spheres of government, law, finance, business, and trade. Accordingly, the study develops the concept in detail around a 15 component matrix which defines, and evaluates, each of the components and their interrelations.

A structural analysis of the development aid industry and a detailed review of development case histories in a sample of countries confirm the importance of adequate I.I. to achieve levels of development that are sustainable.

This report draws conclusions from a detailed analysis of the evolution and key characteristics of the global aid industry. It identifies lessons from an in-depth case study review of the development experience of 8 sample countries. It recommends a broad-based, yet concise, five-point action plan to strengthen the I.I. of Less Developed Countries (LDCs), and proposes a framework for implementation. Finally, it provides initial suggestions for complementary actions to ensure successful reform.

THE IMPERATIVE FOR REFORM

Aid must reform if it is to be effective. This belief rests on three observations. First, the industry has become increasingly complex, given the extent to which it has evolved in the past 60 years, the rapid expansion and diversification of key actors, and the proliferation of new instruments. Second, development aid has a mixed track record of impact to date – both in terms of meeting its objectives for economic and social development, and in terms of the operating performance of current delivery mechanisms. Finally, an analysis of the future drivers of aid suggests a bleak outlook, and the industry appears ill equipped to tackle the major challenges ahead.

Growing complexity:
The global aid industry has evolved considerably since its inception. Following World War II and up to the mid-60s, aid was provided overwhelmingly by bilateral channels – often motivated by strategic and security interests. The real starting point for development aid was the Pearson Report in 1969, which set the tone for the objectives and behaviour of the industry in the following two decades. These witnessed a significant increase in aid, particularly from publicly funded, multilateral donors. The trend continued through to the early 1990s, which witnessed a fall in Official Development Assistance (ODA) and the overtaking of public flows by private ones – by up to a factor of 6 in some years. Private flows have proven to be both volatile and highly concentrated in a small number of countries, sectors, and indeed, companies. Yet Foreign Direct Investment (FDI), the most important component of private flows, has continued to increase steadily, even in years when other private flows have turned negative. The focus of aid has shifted considerably, from funding large infrastructure projects in the early decades, to the alleviation of poverty and the creation of institutional capacity today. The distribution of aid flows by region has also varied considerably, largely depending on its origin: Sub-Saharan Africa has traditionally been the main beneficiary of public funds, while East Asia and Latin America have received the bulk of private funds.

The landscape of aid institutions has grown even more complex, and now includes a diverse set of players, such as international policy setters, multilateral institutions, bilateral donors, private investors and Non-Governmental Organisations (NGOs). While offering the benefit of more choice and flexibility for recipients, this expansion brings the added complexity of multiple points of contact, different – and sometimes conflicting – requirements, and more co-ordination.

The menu of aid instruments has also expanded considerably and now encompasses a broad range of products, such as instruments for dialogue and co-ordination, debt financing, debt restructuring, procurement, and research & policy development. While the expansion of products represents a – largely positive – expansion in choice, it also contributes to the complexity of assessing and administering international aid programmes, and of monitoring performance.

Finally, we can synthesise the interplay of actors and products to characterise the aid industry by its component segments. This additional perspective helps better analyse the underlying trends and behaviours of the industry, and reveals five business segments at different stages of maturity. These are: (i) specialised support for basic needs, (ii) emergency aid, (iii) structural support, (iv) project finance, and (v) direct investment. As with all segmentations, some degree of overlap between segments remains, though the overall approach provides useful working distinctions between the main categories of users. Structural support and project finance – two of the segments that have historically driven growth – are becoming mature, and the remaining segments are unlikely to become a sustainable replacement.
Mixed track record:
Aid has a mixed track record of meeting objectives for economic and social development. While there has been a notable improvement in some social indicators, such as life expectancy or enrolment in education, much of the growth in income in the post war period was considerably offset by an unexpected population expansion. Over the past 30 years, LDCs have continued to sustain high levels of growth, but this has become increasingly volatile, with the volatility underscoring greater vulnerability to external market shocks, such as economic downturns, regional debt crises, and declines in commodity prices. In addition, average growth rates mask major variations in performance between regions – East Asia has enjoyed consistently high growth, while Africa has stagnated – and across countries within regions. Overall, the number of people living in poverty – on less than $2 a day – has not declined. Finally, the amount of aid a country has received does not appear to be linked to proportionately higher rates of growth.

An examination of the effectiveness of different delivery mechanisms raises several concerns. Many donors have not discriminated effectively between countries: in Africa, countries with good policies have received less assistance than countries with poor or mediocre policies. Even when aid is allocated in accordance with performance, it has not adequately addressed the need for poverty reduction. The implementation of evaluation methodologies has been far from perfect, given significant variations in the capacity of donors to evaluate performance. Conditionality – the practice of making aid flows contingent on the achievement of specific goals – has failed as a mechanism for inducing better performance, and the adoption of a more participatory approach to development assistance has yet to deliver tangible benefits. Technical Assistance, the primary aid instrument for building capacity in recipient countries, has been widely criticised as being supply driven, costly, and lacking effectiveness. Finally, NGOs have been increasingly used as a delivery mechanism for aid programmes, but in spite of their positive impact in “on the ground” programmes, they have proven to fall short of being a magic solution to improving overall aid performance.

Challenges ahead:
In our view, four issues will influence the evolution of aid in the future, and will likely call for an increase in support to the developing world. First, the continuing impact of globalisation is likely to call for an increase in aid, as income disparities widen and as LDCs face increasing pressure to equip themselves to compete effectively in liberalised markets. Second, with the developing world’s stock of debt at about $2.5 trillion, or close to 40% of its GDP, the debt problem is unlikely to disappear. Indeed, the slow progress of the Highly Indebted Poor Countries (HIPC) initiative will presumably argue for more grants. Third, the increasing importance of international public goods, such as controlling disease, limiting climate change and safeguarding global peace and security, will call for more internationally coordinated efforts and resource transfers. New avenues will have to be explored to ensure adequate support of international goods, possibly through association between the International Financial Institutions (IFIs) or other aid organisations and the private sector, including foundations that in many cases have played a pioneering role in this area. Finally, we believe that there will be an increasing focus on performance, which may underscore the extent to which continuing aid is required to meet the objective of poverty alleviation.

Set against the ever increasing demand for aid, and despite some recent indication by major aid donors that they will somewhat increase their commitments to the developing world, region’s future, the current outlook for aid appears to be increasingly bleak. The current pressing need to fight terrorism may incite some to emphasise the political short-term objectives related to this fight in the use of aid, and in the choice of beneficiaries. From a longer-term perspective, this potential renewed politicisation of aid could introduce some element of uncertainty in the ability of LDCs to plan their programmes. Research has demonstrated that the stability of aid flows is an important driver of aid effectiveness, and that flows related to short-term political considerations will likely be subject to frequent changes. On the private side, hopes of steady flows of private finance have been shattered by the East Asian crisis, and given the current economic situation in the US, there is no locomotive to drag the world around. Furthermore, recent events in Argentina and potentially in other LDCs, combined with an attitude of risk aversion towards the developing world, will also adversely affect the willingness of private bankers and capital markets to invest in the emerging markets. At a time when recession – or at least stagnation – strikes the developed world, getting donor countries to increase aid volumes is likely to be extremely difficult, yet of crucial importance.

Attempts have been made to respond to these issues. Indeed, a new paradigm for aid has evolved around a small number of general prescriptions designed to progressively improve the quality of life in LDCs. These represent a commitment to: focus on poverty reduction; adopt free market principles; develop trade; support democracy and human rights; leverage the private sector as the primary driver for growth; and recognise debt relief as a necessary condition for effective poverty reduction. The international community is increasingly aware of the urgency of improving the situation of the poorest countries, and of the complexity of implementing this new aid paradigm. Recent initiatives like the Millennium Declaration and the Millennium Development Goals (MDGs), covering a broad range of development goals, ultimately monitored by the UN Secretary General, result, indeed, in a major international commitment.

This new aid paradigm represents a welcome degree of consensus and focus on the part of the developed world. While it is intended to provide a comprehensive framework for approaching the future of aid, a number of critical issues still need to be addressed, in a systematic, decisive way. The five most important are: (i) the reduction of trade and investment barriers; (ii) a robust approach to fungibility and aid allocation; (iii) a solution to the problem of highly indebted poor countries; (iv) the reduction of future aid and the place of private sector financing. Aid is unlikely to achieve its objectives if these issues are not tackled.
THE ROLE OF INSTITUTIONAL INFRASTRUCTURE

The thesis of this report is that reforming the I.I. of recipient countries is one of the highest priorities for reforming development aid, and the lever that will have the greatest impact in increasing the efficiency in managing aid flows. The I.I. of a country can broadly be defined as the business framework and its operations. This has a number of components covering (i) the political system, (ii) the legal framework, (iii) the financial sector, (iv) corporate governance, and (v) trade and competition. For each of these components, three elements need to be “right”, they are the policies, the institutions and the management of operations. For example, the financial system policies are enshrined in its laws and regulations (e.g. the Banking Act). Its institutions comprise the supervisory authorities and banks, insurance companies, etc. Finally, its management of operations comprises many aspects, such as the ability to reliably transfer funds from one account to another within two working days. Unless all three elements work well for each component of I.I., it will fail in its ability to deliver what ODA and private investors require. It is not enough to have one or two of the three at acceptable, recognised international standards – they all need to be there. As a general observation, policies and institutions have tended to receive more attention and technical assistance than the management of operations, which has been neglected in relative terms. The report confirms the importance of Institutional Infrastructure through both a “top down” and a “bottom up” approach.

'Top down' structural analysis:
Having argued the case for reform, we require a tool for systematically identifying areas where improvement is needed. Our approach involves a business dynamics analysis that examines the industry’s market characteristics, products & services, marketing, operations, culture, and the nature of competition. This analysis focuses on International Financial Institutions (IFIs), as the most significant and most mature component of the industry. What emerges is that this appears to be a supplier-driven business that is not very close to its customers and that has developed a strong inward-focused culture.

Five recommendations are suggested as the best way to redesign this segment of the aid industry. First, the demand side needs to be strengthened at an operating level, which requires a development of institutional capabilities of LDCs on a grand scale. Second, a certain degree of competition amongst the providers of ODA should be encouraged, to ensure a more efficient and effective allocation of this scarce resource. Third, investments in product development should be made to ensure that financial and advisory products are relevant to changing customer requirements. Fourth, efficiency improvements are required, particularly in reducing processing times. Finally, the operating culture of IFIs should be changed to a more customer-oriented and efficiency-minded ethos.

While many of these recommendations require action at the level of IFIs, we believe that the most important priority is the full development of the I.I. of client countries. This will clearly improve the performance of recipients as they develop more in-depth skills to independently formulate their pipeline of projects and as they improve their implementation effectiveness. These benefits are likely to be matched by various changes amongst the providers of aid. IFIs will face more competition in response to more aggressive “shopping” for international financing by their clients. As a result, IFIs will likely develop more strategic differentiation and become known for being better in some product, service or advisory dimensions.

Finally, improvements in I.I. should make an important contribution to addressing the long term challenges facing the industry, namely aid fungibility, debt, corruption, private sector financing, and – perhaps to a lesser extent – trade.

'BOTTOM UP' COUNTRY STUDIES:
In order to validate the somewhat controversial finding – that demand side improvements are the key to reforming the aid industry – we have sought to complement the “top down” analysis with an “on the ground”, first hand assessment of the reality of development aid in a sample of countries. We have selected 8 countries for detailed analysis, chosen to reflect a mix of successful and unsuccessful reformers, of geographic regions, and of population sizes. The country studies reveal a marked difference between the I.I. ratings achieved by successful and unsuccessful reformers, which provides empirical confirmation of the connection between the quality and solidity of a country's I.I. with its development performance. Furthermore, the biggest differential generally lies in the management ratings, which underscores how effective management is a key distinguishing feature of the successful reformers.

It is difficult to infer causality from the apparent connection between I.I. and performance. However, a more detailed look at the individual case histories of surveyed countries brings this connection to life.

Amongst the countries analysed, Malaysia emerges as the most compelling case example of the beneficial impact of I.I. on development. Its development performance has been an unqualified success: GDP growth has averaged 7% p.a. over the past 30 years, unemployment and inflation remained at 3.1% and 1.6% in 2000 respectively. Poverty eradication has been achieved with the proportion of households below the poverty line dropping from almost 50% in 1970, to 7.5% in 1999, and on track for 0.5% by 2005. The country's trade structure has been transformed from an agriculture/extractive economy to a manufacturing and services one. Malaysia is the only country in the sample whose I.I. meets requirements on every dimension, while achieving world-class standards in its public administration and macro-economic management. These observations, of course, do not constitute a wholesale endorsement of every aspect of Malaysia’s development policies.

Poland and Trinidad and Tobago share similar attributes in that both countries have broadly sound I.I. – particularly in terms of rules and policies and in terms of institutions – and both have enjoyed generally successful economic development. However, both countries fall short of their full potential because of insufficient management capacity. Poland can, generally speaking, be
considered a success story created in a short 10-year period. However, its development has not reached all parts of society, mainly because of management constraints at the public administration level which are also beginning to undermine the ability of the country to absorb EU funds effectively. In Trinidad & Tobago, poor implementation capabilities due to patronage and under-resourcing have undermined the country's ability to effectively tackle poverty. Both examples illustrate how insufficient management capacity can undermine an otherwise strong Institutional Infrastructure.

The remaining countries in the sample – Ivory Coast, Morocco, Pakistan, Peru and Uganda – present very different case histories. They share the common trait, however, of having failed to achieve their development objectives, despite significant amounts of aid, largely because of inadequacies in their Institutional Infrastructure. Most of these countries have clear areas of strength. For example, Peru has recently reformed its customs authorities, which have now become a world-class organisation. The central bank of Pakistan is a well-respected institution, whose operations and supervisory functions have been substantially enhanced in the past 10 years. Uganda's ministry of finance is highly effectively managed by a small cadre of professional technocrats. In each case, however, these strengths are fully offset by weaknesses in other areas of Institutional Infrastructure, which highlights the critical importance of achieving satisfactory levels of performance in every aspect of the I.I. framework.

In summary, the impact of I.I. on aid's effectiveness can be illustrated by the mechanics of the major components of I.I. – policies, structure and management. Government policies affect aid in two ways: first, macro-economic policies define the country's fiscal balance and the sustainability of its expenditure plans. Secondly, sector policies determine how effectively resources are divided. Structures define design and implementation capacity, which has a direct impact on the effectiveness of aid. A survey of World Bank financed projects in countries with capable institutions had an 86% success rate – as compared to an average success rate of 68%. Finally, as discussed previously, management has perhaps the most dramatic impact on effectiveness, as skill gaps in key areas can weaken budget execution and programme implementation. As the third main actor in the development arena (with the government and private sector), Civil Society – a concept still undergoing conceptual research – should be given a proactive role in the development of policies and innovative ideas, and in the implementation of programmes, particularly those related to poverty alleviation.

IMPROVING THE EFFECTIVENESS OF INSTITUTIONAL INFRASTRUCTURE

Developing a programme to improve the management of I.I. involves drawing specific lessons from the experience of the 8 countries reviewed, synthesising these lessons into a simple yet comprehensive action programme, and articulating clear steps to ensure that action is taken. In addition, some changes would have to take place on the supply side to complement and facilitate the action programme. In that respect, preliminary ideas are also highlighted as considerations for further work.

Lessons from country studies:
Although there is no perfect model that can be applied to any situation, several lessons – we have selected 15 – can be learnt from the Malaysian experience about implementing an I.I. reform programme. These range from broad-based themes, such as creating the foundations for strong government, to more tactically oriented ideas, such as learning to manage crises. These lessons will need to be adapted and modified to suit local socio-political and cultural realities, but provide a rich menu of detailed actions – 4 or 5 for each lesson – resulting in a close to 60 point comprehensive programme to improve I.I.

In addition to the lessons gleaned from Malaysia's experience, similar conclusions can be drawn from the wider sample of 7 other countries that either reinforce and/or present a different perspective on the lessons already noted in Malaysia. Between all 8 countries, ten common themes emerge that could be construed as some sort of guiding principles for improving I.I.'s management.

Finally, specific positive lessons can also be drawn from the evolution of the individual countries, irrespective of their performance and success. Indeed, even countries that have not been successful in their economic performance or in building efficient I.I. have something positive to offer in their experience that can be of potential interest to other countries. The study defines a further ten examples of such interesting positive initiatives which could be considered by any LDC wishing to improve its I.I.

We acknowledge that these many lessons will need to be tailored to the specific circumstances of individual countries, but they nevertheless provide a rich menu of I.I. best practice.

Actions to enhance the management of I.I.:
As a result of our analysis above, our conclusion is that it is the operational management of I.I. that is the main determinant of successes in aid finance. Improving the operational management of the I.I. in a country is intended to enhance the ability of a country to 'consume' aid finance productively. Hence all related and complementary efforts made so far will only provide true value if the operational management of I.I. receives equal improvement efforts. It is that aspect and that aspect alone that the following recommendations focus on.

Five action programmes are proposed which develop the key I.I. themes of governance, public administration, project preparation and financing, implementation effectiveness and poverty reduction and social stability. They represent ultimate objectives to be achieved by, ideally, all LDCs over time.

1. Improve governance to international "benchmarks", which will require action at three levels: government, business and consumers. The governance of government will require the implementation of far-reaching democratisation
at national, regional and local levels. The governance of business needs a programme of improvements dealing with accounting and disclosure standards, monitoring and surveillance, director skills and responsibilities, minority shareholders rights, and intellectual property rights. New legislation and new institutions will be needed to introduce and monitor these changes. Linked to this, training for directors and broad watchdog/supervision roles will need to be developed. Finally, appropriate legislation on consumer rights, protection and complaint procedures will be needed to provide “governance” to consumer transactions. A transparent and efficient customs and excise mechanism is an important element in this equation.

2. Create a world-class public administration, with the aim to get every public body in the borrowing country to be accredited with ISO 9002 or similar. This will require action to build skills based on a professional recruitment process and appropriate compensation policies, with high quality staff attending compulsory training and continuously upgrading their skills. This is important throughout the machinery of public administration, though skills should especially be built at the local level in order to allow devolution of decision-making and administration to work effectively. Corruption will need to be tackled by a well-resourced and independent anti-corruption body with international support. Ideally, this should implement “principle-based” anti-corruption measures and not restrict itself to “rule-based” anti-corruption processes – i.e. it should follow the “spirit”, rather than just the “letter” of anti-corruption measures it seeks to implement. A service culture will need to be fostered by defining performance standards in published “charters” or similar, and by widely employing IT to boost efficiency and service levels. There should be continuous efficiency improvement programmes using business process re-design techniques. Finally, a “checks and balances” financial system should be designed which separates the power to raise revenue from the power to approve expenditure. Approvals of expenditure should be based on demonstrated success with implementation.

3. Build a sophisticated project development and financing system. The specific objective is to create a high-quality set of project financing proposals based on the country’s own analyses and project preparation skills. As before, this is unlikely to be achieved by a single action. This will require a well-defined planning machinery with institutionalised organisations, analysis capabilities, and procedures involving the highest levels of Government and also involving an intense dialogue with all economic agents, especially labour and employer organisations. Linked to the planning system, a high quality project preparation capability for analysing economic priorities and needs will need to be created. This must include project design and feasibility analysis. A set of prioritised development projects with full documentation (feasibility analyses, financing requirements and planning etc.) will need to be created as a “common” set of project financing requirements in dealing mainly with international aid financing institutions, but also with the private sector (foreign and local). The existence of such an annual list will also make co-ordination easier, though this may require a dedicated co-ordination unit of some kind. Finally, recipients will need to develop the ability to “shop around”, evaluate, and compare the various official and private financing possibilities in order to select the best financing for a particular project. The well-known concept of the “one-stop-shop” should be revisited as a vehicle for attracting private FDI efficiently.

4. Improve implementation capabilities, both to enhance the impact of development projects and to improve the chances of further finance. This can be achieved by creating several programmes that collectively drive implementation effectiveness. First, if they don’t already exist, specialised agencies should be created whose purpose is to avoid implementation activity by the public administration, and to assign such “operational” tasks to specialised agencies that have the skills and operating culture for project implementation. Recruiting the right calibre human resources for these implementation agencies will mean selecting a different profile from the typical public administration/civil servant profile. Second, an Implementation Co-ordination Unit, or similar, should be created which independently monitors all aspects of implementation progress. Ideally this should be as quantified as possible. This unit should also be charged with the special responsibility to reduce red-tape related to implementation (e.g. the number of licences needed). Third, a “strategic vision” should drive re-structuring reforms and high-quality supervision in the banking sector so that it is truly an efficient counterpart to specialised long-term aid finance. This will typically involve reform programmes within financial institutions (e.g. products, services, efficiency and IT); of the institutional system (e.g. mergers, consolidation, bad debt clean-up via “hospital” banks); and of the supervisory roles and effectiveness (e.g. issues like having a consolidated supervisor, issues like the balance between on-site/off-site supervision). Fourth, ownership and commercial rights should be clearly defined in law and dispute resolution procedures should be affordable and rapid. The process of establishing a “corporate” legal entity in order to start business should also be as easy and fast as possible and a low-capitalisation option for small businesses should also be available.

5. Design and implement an effective poverty reduction programme to secure social stability. Poverty reduction is widely accepted as the paramount development objective. This is not only for the readily obvious humanitarian reasons. There are economic reasons too. If it is not achieved and groups in society do not share the fruits of successful development, continuing inequalities and poverty will act as a destabilising force and ultimately undermine the successes of development. The lessons of the countries reviewed in this report, and of Malaysia in particular, suggest three pillars which should boost effective poverty reduction. The first involves a link to “local” I.I. management. Poverty reduction is about ideas and reaching the
right people as much as it is about resources. The relevance of local ideas and capabilities to reach the right target groups will be enhanced by improved local governance skills, a more efficient local public administration and by top quality local project development capabilities. In addition, like any private company undertaking detailed consumer research, the Government should carry out regular and detailed analysis of poverty reduction needs by sub-segment. This should emphasise local analysis of local needs. Finally, having an adequate policy environment for, specifically, poverty alleviation is a must and poverty reduction is not a mono-policy campaign. Practical experience shows that Governments should mix several major strands into their poverty reduction strategy. These would include: an emphasis on rural development and rural employment creation (supporting small holder agriculture is a "win/win" proposition); land reform and development schemes (including financing agriculture development); and the promotion of village-level civil society. These measures can help reduce migration to urban areas which typically swells the poverty problem. All these policies must emphasise local involvement and local outreach.

We recognise that such proposals will take time to implement, but that judicious prioritisation could yield rapid results in at least some areas. The introduction of the concept of sequencing of these five Action Programmes for most LDCs would, in our view, start with Action Programme 5 first, followed by Action Programmes 1 and 2 in parallel, followed by Action Programme 4 and then, finally, by Action Programme 3.

These proposals may not amount to a radically new solution, as the constituent components of I.I. are already generally well known. There are, however, at least three dimensions that are somewhat different: (i) The focus on elevating I.I. improvements to a priority objective at a global level; (ii) learning from tangible, practical experience in the 8 countries studied, and (iii) an implementation design programme, described below, contributing new ideas to ensure that action takes place. As a final thought, novelty is not the key issue; rather, it is the holistic nature of the recommended programme, of which implementation design is a key component. Indeed, successful reform of development aid will hinge less on the originality of solutions proposed, than on the prominence, energy and commitment devoted to this change programme.

**Putting the plan into action:**

The action programme is deliberately focused on a small number of "broad brush" initiatives to ensure that they are more easily communicated and implemented. In the spirit of "keeping it simple", the clearer the message, the more institutions and civil groupings will be enlisted and enthused to participate and play their part effectively.

While change management implementation is inevitably a detailed, multi-faceted endeavour, three ingredients will be key to success: a clearly defined measurable objective, a means of monitoring and supporting progress on an international basis, and local champions in each country to ‘own’ the implementation programme. These three key elements are described below.

**Clear objective – the "acquis developpementaire"**

The five action programmes are designed to move consumers of aid finance towards and beyond a global I.I. benchmark. This minimum benchmark could be known as the "acquis developpementaire" – drawing on the concept of the "acquis communautaire" for EU accession – and would be based on measurable achievements in the five I.I. action programmes. This benchmark would not just act as a yardstick, but would also form the basis of a segmentation of recipient countries, reflecting their ability to translate aid financing into sustainable development impact. It is proposed that countries exceeding the "acquis" standard have project and programme financing widely available and in larger amounts, while those countries below the "acquis" benchmark would primarily rely on grants for humanitarian and social purposes, while benefiting from larger amounts of Technical Assistance (TA) to support their I.I. reforms. This proposal is, of course, very similar to the distinctions already in existence between concessional and non-concessional finance provided by the major IFIs, such as IDA and IBRD funds. The difference is that these are presently assigned on per capita income grounds, while the "acquis" would be assigned on I.I. management grounds. These approaches are not incompatible, but will require some degree of harmonisation over time. The concept of the "acquis" goes in a similar direction to what is being considered by the New Partnership for Africa (NEPAD) concerning the African Peer Review Mechanism (APRM).

**International arbiter – "Organisation for the Development of I.I."**

Administering the "acquis" benchmark will require an international body to develop the standard, monitor progress, and offer support to countries undertaking reform. An LDC “OECD style” organisation specialised in I.I. – the Organisation for the Development of I.I. (ODII) – is proposed, with all member countries having an equal membership, to ensure its independence. This organisation would have a dual role: as a ratings agency for the "acquis developpementaire" benchmark, and as an institute/reference library for expertise in I.I. programmes. As a convenient source of high quality, independent knowledge readily available to member countries, the ODII would have the expertise and the resources to provide on-the-ground technical assistance to member countries. However, this service would be purely optional, and many countries could seek to achieve the "acquis" standard on their own accord. Concerning the role of civil society, the ODII could be a key point of contact for NGOs involved in aspects of I.I. reform. These, in turn, could act as a valuable window into local communities for observing or supporting implementation. From an organisational standpoint, it could be possible to create the ODII within an existing IFI. However, we believe that this could undermine the perception of its independence – a critical driver of its success. As an alternative, the ODII could reside under the “umbrella” of a more neutral organisation, such as a member of the UN family. In addition to autonomy, the ODII would need to be created to high standards of professionalism, to establish credibility amongst demand and supply side constituents.
We acknowledge that the ODII concept would be as useful as it is practical and realistic to implement. Indeed, the operational and organisational details, together with the roadmap to operationalise it, would be the critical factors to establish its validity and suitability to achieve its objectives (and thus, the “test” to really establish the validity of this important recommendation). All of these are yet to be developed in detail and go beyond the remit of this study. It should be mentioned, however, that the starting point would be the choice of the type of institution. Two main avenues appear possible in that respect: (i) the “political” approach – implicit in our presentation – according to which the attempt should be made by the sponsor(s) of the concept to “convince” as many – if not all – LDCs as possible to create ODII while – at the same time – convincing also the donor community, and the private sector that the I.I. rating system would result in adequate – increased – funding for those above the benchmark. This avenue would result in a “full” ODII upfront but it is likely to take time to launch; (ii) the “business” approach, which would consist in starting ODII as a rating agency for a number of LDCs which would become the sponsors of the concept, establish its validity amongst all aid players and then gradually “invite” other LDCs to join on the basis of its proven “track record” and benefits thereto. Obviously, the impact of such ODII would be more limited but it could be launched in a relatively short period of time.

**Local ownership – “Council of I.I. Change”**. Recent efforts at improving aspects of I.I. have suffered from being fragmented and lacking specialist skills at the country level. For each of the 5 action programmes, five corresponding specialist and highly empowered positions should be created – thus forming a five person “Council of I.I. Change” (CIIC) in each country. These will act as process managers, co-ordinators, experts, and most importantly, owners of the “acquis”-based targets. These individuals would draw resources and knowledge from the ODII, and as such, will not require dedicated staff – but they will need to be sufficiently empowered to instruct ministers and drive legislation.

This implementation architecture has proposed two new bodies to spearhead the reform programme: the CIIC leading change in each country, drawing on resources and expertise from the ODII. The creation of new institutions presents an opportunity for a cultural change in how programmes are implemented, by adopting a decisive, fast moving, results oriented operating culture more commonly found in the private sector. This may also require prioritisation of I.I. programmes with prospects for more rapid payoff, to ensure that “quick wins” further galvanise support and help build momentum.

**Broader ideas:**

This study has identified I.I. as a key lever for improving the effectiveness of aid, and has developed an implementation programme for addressing this issue. It is acknowledged that other factors contribute to the performance of aid – of which “supply side” effectiveness is amongst the most important. These considerations have not been exhaustively analysed, but in the spirit of contributing to the broader debate, some initial perspectives on these issues are presented in this document. In particular, it is suggested that IFIs could complement the demand side efforts by addressing improvements in 3 areas: enhancing the provision of TA, simplifying their internal processes, and revisiting their historic debts. Specific ideas for each of these areas are presented in the report. As a final observation, this report recognises, once again, the critical importance of trade liberalisation for LDCs. In parallel to efforts on the part of LDCs to improve their I.I., the industrialised world will need to demonstrate continued progress on this crucial issue.

In all, the proposed reforms constitute a way forward that is both wide-ranging and actionable. If implemented, this could have a significant impact on the way development aid is consumed and delivered so that it meets the challenges of the 21st century.

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OBJECTIVES

To provide the FRIDE Foundation (Fundación para las Relaciones Internacionales y el Diálogo Exterior) with a high level analysis on the evolution of development aid over the past 50 years, an in-depth case study analysis in specific countries, and an appreciation of how the lessons of the past can help define a better future.

SCOPE

To combine a global perspective on the philosophical, institutional and operational dimensions of development aid with a focus on the specific concrete and practical problems of the past and the opportunities for the future.

In this context, we define development aid as the provision of financing and know-how to less developed countries. This is both broader (and arguably vaguer) than the definitions of aid formulated by OECD and other inter-governmental agencies. However, it deliberately includes within the scope of the study the flows of private sector financing that have assumed increasing importance in promoting growth in the poorer regions of the world.

APPROACH

DFC approaches this critical issue from the viewpoint of experienced participants and critical observers of the development aid “industry” as defined above. We can therefore draw on our team’s first hand knowledge of both public agencies and private companies operating in all regions of the world over the entire period, supported by rigorous economic and institutional analysis.

Within the context of the Terms of Reference approved by FRIDE in October 2001 in Madrid, Phase I of the study (October 2001 – January 2002) addressed four key questions:
1. How has aid evolved over the past 50 years?
2. Why has it evolved this way?
3. How successful has aid been in improving the welfare of LDCs?
4. What needs to be done to make aid more effective?

Phase II (January – May 2002) tested the validity of the Phase I conclusions with a review of the “aid industry” business dynamics (“top down”) followed by a detailed and on-the-ground study of a sample of eight LDCs, selected to reflect a mix of country sizes and a mix of successful and unsuccessful cases for each major region (“bottom up”) and designed to test the validity of the general conclusions against the concrete record of the selected countries.

Phase III (June 2002 – November 2002) integrated the findings of Phase I and II documents with subsequent work on the implementation of improvements in Institutional Infrastructure, structured around three general questions:
1. Why is reform necessary in the aid “industry”?
2. What role can Institutional Infrastructure play?
3. How can the management of Institutional Infrastructure be improved and what actions are required to do so?

Finally, the Panel of Advisors’ comments were received in December 2002 and January 2003.
1.1 GROWING COMPLEXITY

1.1.1 Origin, global evolution and major trends

The notion that solidarity among nations is important and that therefore rich nations should help poorer ones is relatively recent. Up to the Second World War, many of the so-called LDCs were in the hands of colonial powers, particularly the United Kingdom, the Netherlands, and France. This was mostly true of Africa and Asia, with the exception of China. In the Western Hemisphere, the West Indies were still colonies of the UK, but nearly all Latin American countries had gained their independence during the 19th century.

The global evolution of aid can be characterised by three distinct eras: (a) the 40s to early 60s, where bilateral aid has been dominant; (b) the 70s and 80s, marked by the growing importance of multilateral aid and by the emergence of policy reform and conditionality; and (c) the 90s, characterised by an increase in private flows and a greater focus on tackling poverty, institutional capacity and public goods.

Late 40s to early 60s: bilateral aid dominates

The post-war years saw the beginning of an effort by wealthy countries (mainly the US) to help poorer ones. The focus initially was on rebuilding countries that had been devastated by the war. This was to be done partly through a new multilateral channel: the World Bank was created in 1946 and most of its initial lending was directed towards Western Europe and Japan. Bilateral aid, however, was dominant: the Marshall plan provided the equivalent of some $100 billion in today’s prices, to western European countries. Bilateral aid, however, was dominant: the Marshall plan provided the equivalent of some $100 billion in today's prices, to western European countries. Bilateral aid, however, was dominant: the Marshall plan provided the equivalent of some $100 billion in today's prices, to western European countries.

Typically, most of the aid provided in this period tended to concentrate on large infrastructure projects that served the bilateral economic interests of major donors, through procurement. Development assistance philosophy at that time tended to believe that investment and growth would “trickle down” to the poor and create employment and additional income. Import substitution policies were also in favour. While the contribution of the private sector to development was recognised – the private sector arm of the World Bank (the IFC) was created in 1956 – private flows to LDCs were minimal.

The Pearson Report (1969): This was a major step in development assistance thinking and would have a lasting influence on the philosophy, structure, and operating principles of aid. Some of the major findings and recommendations of the report were:

- Developed countries had both a moral obligation and self-interest in “reducing income disparities” in LDCs.
- Aid, trade, and investment policies should be integrated into a single strategy. The issue of mounting debt was recognised.
- The primary objective should be to help LDCs grow at 6% per year.
- This called for a transfer of resources of about 1% of GNP from the rich countries.
- Multilateral channels for aid (considered at that time as more efficient and less politicised than bilateral ones) should be strengthened and their share of aid should increase.

The 70s and 80s: aid expands and diversifies

The period from the mid-60s to the mid-70s saw a rapid growth in development assistance, with the increase larger in multilateral aid, which increased from under 10% of the total to close to about 40% by 1975 (Exhibit I.1). The concept of burden sharing among donors became important, at a time when new donors appeared prominently – Japan, Europe, and oil-producing countries. A number of new organisations were created. Building on the model of the IDB, other banks were established either at the regional level (the Asian and African Development Banks), or at the sub-regional level (Caribbean Development Bank, West African Development Bank, the East African Development Bank, the Central American Economic-Integration Bank) or with specific

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1 The IMF was also created, but for many years its role remained modest, in part because of the existence of a fixed exchange rate international system – the gold exchange system – until 1972. The IMF started playing a major role in providing BOP support to countries in crisis after the Suez crisis in 1956, when the UK and France requested its support, together with Egypt and Israel.
2 G. Marshall’s famous Harvard speech states that the plan is to fight “hunger, poverty, despair and chaos.” The longer-term goals of stability and growth were also clear, and to some extent may have reflected the need to ensure security in the face of a growing Soviet threat.
3 According to the World Bank, 80% of all lending to developing countries by the World Bank (over 1948-1961: $2.9 billion) was for power and transport. Over the same period the World Bank lent $1.7 billion to developing countries and $0.5 billion to their African colonies. India accounted for 22% of all lending to LDCs, and Latin American countries for 40%.
4 The first comprehensive review of the international aid landscape, initiated and implemented under the leadership of Lester Pearson, former Canadian Prime Minister.
5 Burden sharing in terms of contributions to development aid. The concept now is more used in relation to debt and debt relief sharing.

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mandates (the Islamic Development Bank, the OPEC fund, the International Fund for Agricultural Development (IFAD)). Under that model, there was a pyramid of banks at the global, regional/sub-regional and local levels that specialised either on a geographical basis, or in a particular sector (at the local level mostly). To different extents, these institutions provided funding on commercial terms or on a concessionary basis, through special windows.

Under MacNamara’s leadership at the World Bank, a new focus on anti-poverty programmes was developed, and financial assistance shifted progressively toward agriculture and the social sectors (Exhibit I.2).

The oil shocks of the 70s and the debt crisis of the early 80s led to a greater emphasis on the policy environment for resource allocation. In particular, lending for structural adjustment started, and donors started progressively attaching policy conditionality to their funding at the sector or country level. The IMF created its Structural Adjustment facility and agreement with the IMF on a macro-economic programme started becoming not only the sine qua non for balance of payments support by the donor community, but also the barometer of the macro-economic health of a country for both public and private lenders.

At the end of the 80s, the organisation and structure of aid had become very complex, funding mechanisms and aid instruments had expanded and diversified, and the role of the IMF and the World Bank had substantially increased (Exhibit I.3).

In terms of aid philosophy, some consensus had progressively evolved that a combination of adequate macro-economic policies and particular attention to specific sectors/aspects/people (the so-called Washington consensus) would allow for sustained growth and balanced development.

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6 Mexico defaulted in 1982 on its commercial borrowings, which triggered an international debt crisis, and led to a substantial reduction in private commercial flows to developing countries overall, and the beginning of a concentration of these flows.

7 Term coined by John Williamson – there were 10 elements: fiscal discipline, a redirection of public expenditure priorities towards fields offering both high economic returns and the potential to improve income distribution (such as primary health care, primary education, and infrastructure), tax reform (to lower marginal rates and broaden the tax base), interest rate liberalization, a competitive exchange rate, trade liberalization, liberalization of FDI inflows, privatization, deregulation (in the sense of abolishing barriers to entry and exit), and secure property rights.
The 90s: the post cold war

The 90s saw a continuous reduction in public aid, in the proportion of the GNP of developed countries and consequently in the volume of aid. This was caused by a number of factors. First, with the end of the cold war, the geopolitical objectives of aid did not have the same importance, and substantial resources were reallocated to assist the transition of the centrally planned economies of the former Communist Bloc. Second, there was the beginning of an “aid fatigue” in many donor countries, with some realisation that effectiveness of aid had not improved much while the complexity of development was becoming more apparent. Third, with rapid liberalisation of trade and financial flows, private flows increased very rapidly and largely exceeded public-aid flows. Finally, many countries had developed an unsustainable debt burden and the focus in many cases was on debt reduction rather than financing new investment.

Exhibit I.4, below, illustrates the major trends in bilateral and multilateral official development finance (ODF), while exhibit I.5 highlights the shift from public to private flows over the past 3 decades.

At the same time as public-aid flows reduced (while the number of recipients had increased) the complexity of aid increased further. With the realisation that institutions were important for development, a new focus was added. Public goods also appeared as being very important (health and fight against infectious diseases, protection of the environment). Poverty became the overarching objective. The number of institutions involved in aid did not decrease – in
Today the landscape of aid institutions is even more complex. The menu of instruments has expanded and new actors have appeared on the scene. The complexity of development is intensified and debt is now a major problem for many countries. Fact some new organisations were created to address specific problems (e.g. Global Environment Facility, the HIPC trust fund), and to develop specific regions (e.g. the European Bank for Reconstruction and Development – EBRD). At the same time, fora for a co-ordination of reduced financial support developed further, with the G7 as supreme body at the top and a number of mechanisms put in place at the country level. New instruments were created by aid organisations to either facilitate private flows (e.g. partial risk guarantees), to adapt the menu of lending choices to various situations (e.g. Learning and Innovative Loans, Programmatic Adjustment Loans by the World Bank), or to facilitate debt relief. To encapsulate both the development objectives and plans of a country, and facilitate the dialogue between “partners” and the co-ordinated provision of aid, strategic documents were refined. Two new documents were also added: the Comprehensive Development Framework, and the Poverty Reduction Strategy Paper (PRSP) that is needed for countries eligible for debt relief under the HIPC scheme.

Finally, with the end of the Cold War, there was a major realignment of the respective roles of the public and private sectors in many countries. Non-governmental organisations (NGOs) became a useful (and at times, vocal) instrument for the civil society to participate in public affairs wherever the governmental institutional setup and policies failed to adequately address issues of importance to society.

Therefore at the beginning of the new millennium, the landscape of aid institutions is even more complex. Their menu of instruments has expanded considerably and new actors have appeared on the scene. The complexity of development is even more pronounced and debt has become a major problem for many countries. Flows of public aid have decreased substantially, while private flows, after a surge in the mid-90s, are now concentrated on a few countries.

The remainder of this section summarises the key trends that have characterised the evolution of development aid over the last half century. Three major trends emerge, regarding (a) the evolution of net flows; (b) debt restructuring; and (c) the distribution of aid by region.

PRELIMINARY OBSERVATION

Data on both public and private flows are extensive, but very hard to reconcile. This is partly because of different definitions between institutions collecting and using these data and because of changes in definitions over time. It is also partly because some of these flows are difficult to identify, capture, or segregate (e.g. flows for civil versus military uses), or because debt restructuring may or may not be included. Also, many LDCs do not have well-established data. Sometimes it is difficult to reconcile data from creditors and those reported by debtors. The OECD database is good for bilateral aid and for ODA but does not seem to capture the multilateral flows as effectively. Generally, it is possible to have a relatively clear picture of public aid, which is normally scrutinised by representatives of taxpayers. For private flows, discrepancies between various public and private organisations can be huge, which makes analysis very difficult. For example the Institute of International Finance reports net private flows of $173.1 billion in 2000, the World Bank (Global Development Finance) reports $248.7 billion, and the IMF (World Economic Outlook) reports $5 billion of net capital flows for the same year. The major differences relate to debt flows, not FDI. After much scrutiny and research, we have decided to use primarily the World Bank data from Global Development Finance, which is based on data submitted by the country, while also sourcing data from the OECD for bilateral information. Data have to be interpreted with a great deal of caution, while trends are easier to capture.

8 HIPC – Heavily Indebted Poor Countries. This initiative aims at reducing by up to 80% debt service of these countries, provided they prepare and implement steadily a programme of reform and adjustment.
9 See Appendix A.1.
10 ODA – Official Development Assistance – grants and concessionary funding.
Evolution of net flows
Exhibit 1.6 shows that private flows have largely exceeded public flows since the mid-90s. They were below public flows in the 80s, were about 50% above in the early 90s, and now appear to be 4 to 5 times larger.

On the public aid side
- Public aid grew up to the early 90s — to $86 billion on average in 1990-94, and has decreased

The distribution of flows by region (see tables 1 to 6 in Appendix A.2) shows, however, that the picture is very different by region, and that the distribution across regions of public flows is much more balanced than that of private flows. Three quarters of private flows are directed to Latin America and East Asia (vs. 41% for public flows), and more than 90% to these two regions plus Europe and Central Asia (vs. 64% for public flows). This is true not only for net volumes of flows, but also in relation to the GDPs of the countries. Typically, net private flows to East Asia and Latin America have been around 4%-6% of GDP in the mid-90s, as compared to 1-3% in the other regions. The other main features are:

On the public aid side
- Public aid grew up to the early 90s — to $86 billion on average in 1990-94, and has decreased

Private flows have largely exceeded public flows since the mid-90s. They were below public flows in the 80s, about 50% above in the early 90s and now are 4 to 5 times larger but they are now concentrated on a few countries

### NET DISBURSEMENTS OF PUBLIC AND PRIVATE FLOWS

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<thead>
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<tbody>
<tr>
<td><strong>Public</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multilateral Long-Term (L-T) debt</td>
<td>9.6</td>
<td>18.0</td>
<td>17.4</td>
<td>15.9</td>
<td>18.9</td>
<td>10.0</td>
</tr>
<tr>
<td>Bilateral Long-Term (L-T) debt</td>
<td>16.9</td>
<td>20.3</td>
<td>5.2</td>
<td>12.2</td>
<td>-1.8</td>
<td>-2.3</td>
</tr>
<tr>
<td>Total</td>
<td>26.5</td>
<td>38.3</td>
<td>22.6</td>
<td>28.0</td>
<td>17.2</td>
<td>7.7</td>
</tr>
<tr>
<td>Grants</td>
<td>16.6</td>
<td>22.6</td>
<td>33.4</td>
<td>36.9</td>
<td>29.9</td>
<td>28.6</td>
</tr>
<tr>
<td>Technical Co-operation</td>
<td>9.6</td>
<td>13.6</td>
<td>18.9</td>
<td>19.6</td>
<td>18.2</td>
<td>16.5</td>
</tr>
<tr>
<td>IMF</td>
<td>2.1</td>
<td>3.3</td>
<td>5.1</td>
<td>1.8</td>
<td>8.3</td>
<td>-10.4</td>
</tr>
<tr>
<td><strong>Total Public</strong></td>
<td>54.7</td>
<td>77.8</td>
<td>79.9</td>
<td>86.3</td>
<td>73.6</td>
<td>42.5</td>
</tr>
<tr>
<td><strong>Private</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private creditors</td>
<td>36.8</td>
<td>39.7</td>
<td>24.1</td>
<td>18.0</td>
<td>30.2</td>
<td>23.5</td>
</tr>
<tr>
<td>PNG</td>
<td>13.2</td>
<td>5.6</td>
<td>32.3</td>
<td>22.1</td>
<td>42.5</td>
<td>6.7</td>
</tr>
<tr>
<td>FDI</td>
<td>11.7</td>
<td>18.7</td>
<td>110.9</td>
<td>61.6</td>
<td>160.3</td>
<td>172.2</td>
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<tr>
<td>Portfolio Equity Flows</td>
<td>0.0</td>
<td>0.9</td>
<td>30.2</td>
<td>25.8</td>
<td>34.6</td>
<td>46.3</td>
</tr>
<tr>
<td><strong>Total Private</strong></td>
<td>61.7</td>
<td>64.8</td>
<td>197.5</td>
<td>127.4</td>
<td>267.6</td>
<td>248.7</td>
</tr>
</tbody>
</table>


### FUNDS FOR PUBLIC GRANTS & TECHNICAL COOPERATION

Source: OECD DAC Online Database

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11 Partly because of substantial repayments by Korea to the IMF.
The analysis of gross flows (see table 7 in Appendix A.2) and of net transfers (see table 8 in Appendix A.2) shows similar trends. Interestingly, the data available on net transfers indicate that over the last 30 years the flow of public aid has been relatively steady, even though it decreased in the late 90s. By contrast, private flows have been much more irregular. The 70s saw an average annual positive transfer of about $10 billion of private funds, the 80s a negative transfer of about $20 billion per year, and the 90s positive net transfers of about $120 billion.

On the private side

- The largest component of private flows is foreign direct investment (FDI) that has grown from about $10 billion annually in the 70s to more than $150 billion per year in the mid 90s.
- FDI appears to be more resilient to crises than private debt flows. They have been, however, substantially related to privatisation programmes. With the first wave of privatisation accomplished, perhaps these flows may not continue at that high level in the future.
- As indicated above, private flows are heavily concentrated on two regions. Within these regions there is also significant concentration on a few countries.

Distribution of aid by region

Exhibit I.8 below shows that aid flows are unevenly distributed among regions. In the last ten years, when the pattern of public and private flows changed considerably, two regions each received more than a third of private flows, while the other three regions received less than 5% of these flows... but they received 20% of public flows.

Debt restructuring

Debt restructuring influences the picture of flows to LDCs. According to data from Global Development Finance, since the 1980s the proportion of debt service that has been rescheduled annually has hovered around 10-15% for both public and private debt. This is not too surprising as in principle private and public debtors are to be treated equally in case of debt rescheduling or restructuring. As a proportion of the stock of debt, this figure is around 2%. This global picture masks huge differences between countries. Some of the largest borrowers of multilateral institutions (China and India) never went through any restructuring. By contrast smaller poorer countries mostly in Africa have regularly gone through restructuring exercises (mostly of public debt), and with the HIPC countries up to 80% of debt service can be rescheduled. In between, some medium-sized countries, particularly in Latin America, have gone through debt rescheduling exercises for a large proportion of private debt, particularly in the “lost decade” of the 80s following the 1982 Mexico crisis.

Aid flows are unevenly distributed among regions. In the last ten years, two regions each received more than a third of private flows, while the other three regions received less than 5% of these flows... but they received 20% of public flows.
Global policy setters
On the public side, the main body delineating broad new policies or arrangements for aid is the G7. It meets once a year to discuss the overall economic situation and prospects for the world economy, and the kinds of initiatives and/or new policies needed to ensure more growth and stability. This is also the forum where major aspects of aid, debt and trade are discussed, including the types of global initiatives and co-ordination needed to improve the effectiveness of aid.

Two other organisations play a major role in policy aspects of aid. They are the International Monetary and Financial Committee (IMFC) and the Development Committee (DC). They each have 24 members (typically Ministers of Finance or Central Bank Governors) and meet twice a year to advise the IMF and the World Bank on critical development issues and on resources needed for economic development. Half of their members are from industrialised countries, and the other half from developing or oil-producing countries. The Managing Director of the IMF and the President of the World Bank attend these meetings.

Multilateral institutions
The IMF is clearly the centrepiece for macro-economic and financial stability worldwide, and is at the forefront of any programme of reform and adjustment in the developing world that calls for balance of payments support. It has progressively shifted its focus on short-term crisis resolution to supporting longer-term adjustment programmes with funding for up to 3 years. In this process it has equipped itself with relevant expertise within the context of agreements with the World Bank that avoids duplication of expertise and recognises the relative roles and functions of the two institutions. The IMF has responsibility for macro-economic aspects, including the exchange rate, fiscal and monetary policies. The World Bank is responsible for the real economy, the social sectors, and the environment. The two institutions share responsibility for external trade and the financial sector.

The World Bank Group is composed of four main elements. The World Bank per se is the centre of expertise for overall development issues, with both an operational and research function, and is the funding arm for LDCs that can borrow at commercial terms. Its sister institution the International Development Association (IDA) is merely the funding vehicle for concessionary funding (e.g. Kenya, Côte d’Ivoire, Zambia, Tanzania, and, outside Africa, Pakistan). The decreasing contribution to aid by the UN family: UN specialised agencies have long been a major element at about 60% of the total gross funding of LDCs against political risk, and that has experienced remarkable growth since it was created a little more than 10 years ago.

The regional development banks. There are four, more or less built under the same model as the World Bank but with a specific geographic responsibility. They all have a private sector window and a concessionary window, and have much less of a research/policy function than the World Bank. They are (in historical order) the Inter-American Development Bank (IDB), the Asian Development Bank (ADB), the African Development Bank (AFDB), and the European Bank for Reconstruction and Development (EBRD) – financing primarily the private sector. In addition, the European Investment Bank (EIB) that initially focused on funding the less developed parts of what is now the European Union, is now active in all regions of the world. However, the volume of its financial support (mainly in favour of public entities) is less significant in each region than the respective regional development banks – with the exception of regions on the EU’s “doorstep”. While the share of these institutions in the transfer of resources to LDCs was less than 10% up to the mid-80s, it has expanded rapidly in the 90s. It now accounts for more than 25% of total debt owed to multilaterals, and more than half of the World Bank’s share (against less than 30% in the mid-80s – see table 9 in Appendix A.2). These shares vary considerably by region. The IDB, the ADB, and the AfDB, have signed MoUs with the World Bank to avoid duplication of efforts and specialisation wherever possible.

The increasing contribution by the EU group: The EU has followed a reverse trend. It now contributes about 35% of total multilateral ODA, compared to 20% in the 70s. If one were to include bilateral ODA from donors in the EU figures, the total ODA contribution from the EU would represent about 60% of total ODA at present.

Bilateral donors
Although the share of bilateral funding in public funding of LDCs has declined over time, it is still a major element at about 60% of the total gross flows (versus 80% in the 70s), though, as discussed earlier, net bilateral disbursements are now negative. An increasing part of bilateral aid has been channelled through multilateral institutions (33% in 2000 versus 27% in the 80s). In addition, some bilateral donors often co-finance programmes with various memberships and remits, and differing degrees of effectiveness.

Bilateral aid is mostly delivered in the form of grants with a substantial component for technical co-operation. Except for the Netherlands and Denmark, donor contributions declined in the mid-90s, and as a group now consist of 0.2% of donors’ GDP – well below the agreed 0.7% target.
or projects that have been assessed by multilateral/regional institutions, and thus the true discrete bilateral funding of development is probably less than 50% of their commitments. Bilateral aid, defined as originating in one country,\(^\text{18}\) is mostly delivered in the form of grants with a substantial component for technical co-operation. With the exception of the Netherlands and Denmark, all bilateral donors’ contributions declined in the mid-1990s, and as a group, they now contribute only about 0.2% of their GDP – much less than the target of 0.7% agreed long ago (Exhibit I.9).

Management of bilateral programmes is conducted through a specialised department in the relevant ministry (e.g. DFID in the UK) and/or through specialised institutions (e.g. USAID in the US, AFD in France, KfW in Germany, JICA in Japan). A number of countries have established financing institutions along the model of the IFC (FMO in the Netherlands, DEG in Germany). Furthermore, most of them have established an export credit agency and a risk mitigation institution (e.g. Hermes in Germany, CGCD in Canada, OPIC and Eximbank in the US, COFACE and BFCE in France, EXIMBANK in Japan, SACE in Italy etc.). As part of the liberalisation of the financial sector in many countries, some of these agencies were merged or disappeared, while international rules for the use of export credits were agreed upon.

### Private flows

There is no single institution that dominates private flows to LDCs in the way that the IMF and the World Bank dominate some aspects of public aid. However, various institutions play an important role in facilitating private flows.

18 Meaning funding from the European Union is not included, for example.

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<table>
<thead>
<tr>
<th>DONOR DETAILS – OFFICIAL DEVELOPMENT ASSISTANCE (ODA)</th>
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<tbody>
<tr>
<td>-------</td>
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<tr>
<td>Sbn 1999</td>
</tr>
<tr>
<td>Canada</td>
</tr>
<tr>
<td>Denmark</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Germany</td>
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<tr>
<td>Italy</td>
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<tr>
<td>Japan</td>
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<tr>
<td>Netherlands</td>
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<tr>
<td>Sweden</td>
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<tr>
<td>United Kingdom</td>
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<tr>
<td>United States</td>
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<tr>
<td>G7</td>
</tr>
<tr>
<td>Other DAC donors</td>
</tr>
<tr>
<td>Total DAC</td>
</tr>
</tbody>
</table>

<table>
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<tr>
<th>% GDP</th>
</tr>
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<tbody>
<tr>
<td>Canada</td>
</tr>
<tr>
<td>Denmark</td>
</tr>
<tr>
<td>France</td>
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<tr>
<td>Germany</td>
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<tr>
<td>Italy</td>
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<tr>
<td>Japan</td>
</tr>
<tr>
<td>Netherlands</td>
</tr>
<tr>
<td>Sweden</td>
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<tr>
<td>United Kingdom</td>
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<tr>
<td>United States</td>
</tr>
<tr>
<td>Other DAC donors</td>
</tr>
<tr>
<td>Total DAC</td>
</tr>
</tbody>
</table>

*Other DAC donors: Australia, Austria, Belgium, Finland, Ireland, Luxembourg, New Zealand, Norway, Portugal, Spain and Switzerland
Source: OECD DAC online database
rapid development of risk-mitigating instruments and institutions (both public and private – see below) has also helped, while private sector windows in multilateral agencies providing equity and term finance to private investors have contributed much, particularly to those countries with limited access to international capital markets. Finally, the existence of well-established export credit agencies (e.g. Eximbank in the US) has contributed substantially to investment and private flows in the developing world.

To a large extent the steep increase in private flows to the developing world, in the context of a rapid globalisation of financial markets, was fuelled by a combination of these and other factors. Returns were expected to be higher than in the developed world, where opportunities were also reduced – for example in the early 90s. As described above, the availability of risk insurance also helped. Finally, many LDCs had engaged in vast privatisation programmes and many had developed recourse to private investment for efficiency reasons or because of the tightness of their fiscal situation.

A few multinational enterprises may have dominated investment in specific sectors in the developing world (e.g. Vivendi and Suez-Lyonnais in the water utilities sector, a few US and UK companies in energy). Similarly, some banks may have dominated some areas (e.g. the Spanish banks in Latin America). However this has not always been the case in all regions and sectors. By contrast, private flows are known to have been concentrated on relatively few countries, and selectivity has increased dramatically after the East Asian crisis (see tables 11 and 12 in Appendix A.2).

One last observation: Stock exchanges have been established in many LDCs, although in general their capitalisation relative to GDP remains low compared to that of stock exchanges in the US or in European markets. With the progressive integration of capital markets worldwide, many enterprises in LDCs tend to prefer issuing new stocks or bonds in the developed world, in the context of a rapid development of risk-mitigating instruments and institutions that a catalytic one in governance and decision making that embraces poverty reduction, environmental sustainability, gender equality, and democracy.

The number and influence of NGOs has increased: More than 25,000 international NGOs are in existence compared to 400 a century ago. NGOs in consultative status with the Economic and Social Council (ECOSOC) presently number 1,350, compared to 377 in 1968. A prime example of their influence has been their role in pushing through 22 HIPC (see pages 42 and 91) initiatives at end 2000.

The influence of NGOs has been helped by their increasing tendency to organise along common goals or missions. Examples of such groups include AFRODAD, the Philippine-based Freedom for Debt Coalition, Eurodad, the Norwegian Forum for Environment and Development. NGOs are also affiliated with the multilateral organisations:

- Two umbrella groups, Conference of NGOs (CONGO) and Department of Public Information (DPI) offer points of interchange between the UN Secretariat and the NGO community.
- The umbrella group for European NGOs is known as CLONG. In existence since 1975 with a secretariat in Brussels, roughly 80 per cent of CLONG’s activities are in LDCs.
- The World Bank has long been involved with NGOs. It has engaged with them on discussions of specific subjects (e.g. the impact of structural adjustment programmes – the SAPRI initiative) and has used them as vehicles for project implementation, particularly in the social sectors. It has also sought NGO participation in the country strategic dialogue to develop programmes of assistance. Regional Development Banks have followed a similar pattern.

The increased pressure on aid budgets and the growing demand for transparency have led to closer scrutiny of NGOs. Government commissioned studies in Australia, the UK and the US found strong evidence to support the positive impact of NGOs on poverty alleviation, development sustainability and relief efforts. However, when judged against broader criteria, such as effecting social and economic changes, the impact of NGOs was weak.

1.1.3 Main Instruments

In addition to the growing number of actors involved in development aid, the global aid industry is further complicated by a fairly recent, and largely positive, proliferation of instruments. These can broadly be classified into 5 categories: (a) instruments for dialogue and co-ordination, (b) instruments for debt financing, including comfort instruments, (c) instruments for debt restructuring and relief, (d) instruments for research and policy development, and (e) procurement systems.

Dialogue and coordination

The main document is a country strategy paper. It is used to help present a country’s development strategy, the assistance (financial and technical) that a particular institution can provide, and how it co-ordinates with others. Various nomenclatures prevail across the different institutions, but the content is basically the same. The tendency now is to have this type of document prepared in consultation with all actors and the civil society in a country. The most elaborate of these documents at present is the Poverty Strategy Reduction Paper, which is used to assess eligibility for debt relief by the IMF, the World Bank, and other donors. It typically includes a matrix of policy measures that the country plans to take to reform and grow.

This document, together with economic analyses of the country, is used by both recipients and donors to discuss the country’s main development issues, prospects, and needs for assistance. This discussion takes place generally once a year, for most countries in a forum often called the consultative group meeting – although it can be called differently depending upon the organiser(s).
Debt instruments

Over time, the multilateral and bilateral institutions have developed a wide menu of funding instruments adapted to the nature of the programme funded, the creditworthiness of the country concerned, and the kind of currency and terms that the borrower may prefer. Broadly, there are now loans to support policy reform at the national or sector level, loans to support investment, modernisation and institutional development at the sector or individual project level, and loans to fund technical assistance and capacity building. Loans can be made at quasi-commercial terms for those countries considered creditworthy for such treatment, and the borrower may or may not have the choice of currency (ies), or of the term (fixed or variable). For non-creditworthy countries, loans (credits) are made at much longer-term (20-50 years) at concessionary rates, out of resources generally provided by grant subscriptions by donors. Sometimes, grants are also used.

In the last 10 years, aid agencies have also developed comfort instruments to facilitate investment and flows by the private sector in LDCs. The most frequently used instrument is syndication by an agency of a private loan for a private sector project. This permits the lenders to benefit indirectly from the preferred creditor status that the agency enjoys. Other instruments are typically partial risk guarantees by aid agencies for private funding of projects in LDCs – this has not been much developed. The more recent development and the most successful has been the provision of insurance against typical political risks incurred by private investors in the developing world, by MIGA. While political risk insurance is generally available from private or public insurers – and the development of that market has been considerable in the mid-90s – MIGA plays a useful role in that it does not duplicate these private providers. Instead, MIGA focuses on projects and countries that normally could not benefit from private insurance, but may associate with private insurance providers in doing so.

Debt restructuring and relief

Debt restructuring has a long history. With the growing problems associated with LDC debt in the last 50 years, new instruments for restructuring were added. Since 1956, the main instrument for restructuring the public debt of LDCs has been the Paris Club. Its role is to co-ordinate sustainable solutions for payment difficulties experienced by debtor countries, through postponement and reduction of debt servicing for public and publicly guaranteed debt. Since 1983, 344 agreements with the Paris Club were reached for a total of close to $400 billion. In parallel to the Paris Club, there is a London Club that meets to reschedule debt owed to private creditors. Following the Mexico crisis in 1982, another instrument – the Brady Plan – was added to help debt and debt service reduction for the private debt of LDCs. Today Brady-type restructuring has been implemented in more than 15 countries, resulting in a volume of more than $150 billion in Brady bonds. The latest instrument for public debt relief is the Highly Indebted Poor Countries Initiative (HIPC). The HIPC was launched by the World Bank and the IMF in 1999 to provide up to 80% relief to poor countries facing serious debt problems, when traditional debt reduction schemes were not providing a sustainable debt workout solution.

In all cases of restructuring of LDC debt, an agreement with the IMF on a suitable adjustment and reform programme is necessary. One issue that often complicates a debt workout is the burden sharing between public and private creditors. The principle is that there should be some equality of treatment between the public and private creditors, but there are difficult issues regarding certain types of debt (e.g. bonds issued by the country).

Research and policy development

Typically, all aid agencies have a wing for research and policy that analyses both countries’ receipt of aid and the development of operations in the aid agency itself. The tendency has been to do much more research on a collaborative basis with universities or practitioners, and to exchange inter alia experiences and best practices. With the development of information technology, this aspect of aid agencies is developing rapidly through traditional research, through partnerships with academia and the private sector, and through conferences. Also all multilateral and regional banks have training centres that allow for a more direct exchange of experience.

Procurement

There are two aspects worth mentioning. First, procurement for projects/programmes funded by aid agencies is usually done under the form of competitive bidding, to get the best qualified response at the lowest cost possible. Recipients of aid handle procurement, and aid agencies only verify that the procurement rules have been followed. As typically aid agencies fund only a portion of the cost of a project, the total amount of contracts put for bids is a multiple of the funding agreed and thus the total amounts can be huge. There has been some movement recently in some agencies to decentralise responsibility for procurement to the field (sometimes as part of a more general decentralisation drive), and this should be monitored to ensure that it does not affect the effectiveness of the procurement process.

The second aspect relates to “tied procurement”. Typically, many bilateral agencies have preferred that the use of their funding be reserved for their nationals. The tendency has been to try to
progressively reduce this “tied procurement” as it affects the overall effectiveness or procurement because of limited competition. Some progress has been made, but much more is needed.

### 1.1.4 Business Segments

The previous sections have underscored the growing complexity of the international aid landscape by charting its evolution over the past six decades, and describing the expanding set of actors and financing products. This final section synthesises the interplay of actors and products to characterise the aid industry by its component business segments (segmented by customer needs). This additional perspective helps better analyse the underlying trends and behaviours of the industry, and is also a starting point for the structural analysis undertaken in Chapter 2.

The combination of players and products described earlier results in five business segments, of which three are in the public part of development aid, and two in the private domain. As with all segmentations, some degree of overlap between segments remains, though the overall approach provides useful working distinctions between the main categories of users.

A comparison of some of the key parameters, such as age, growth, or key drivers, begins to explain the behaviours encountered in these sub-businesses. This analysis can be summarised in the following table.

**CHARACTERISTICS OF DEVELOPMENT AID BUSINESS SEGMENTS**

<table>
<thead>
<tr>
<th>Business segment</th>
<th>Age(^{3})</th>
<th>Drivers</th>
<th>Growth rate(^{3})</th>
<th>Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specialised support for basic needs(^{24})</td>
<td>Young (10-15 years)</td>
<td>Direct, close NGO &amp; sub-sovereign interaction</td>
<td>Rapid and recent</td>
<td>Influential beyond “dollars” provided</td>
</tr>
<tr>
<td>Emergency aid</td>
<td>Medium/old (30-40 years)</td>
<td>Natural disasters, epidemics, conflict, drought and others</td>
<td>Fluctuates with need &amp; disasters</td>
<td>Short-term “high” according to need</td>
</tr>
<tr>
<td>Structural support</td>
<td>Medium/old (20-30 years)</td>
<td>IFI &amp; Government policies</td>
<td>Slow/medium</td>
<td>Moderate</td>
</tr>
<tr>
<td>Project finance(^{27})</td>
<td>Old (50-55 years)</td>
<td>Project supply</td>
<td>Slow, almost static</td>
<td>Declining</td>
</tr>
<tr>
<td>Direct investment</td>
<td>Medium/young (15-20 years)</td>
<td>Economic cycles</td>
<td>Volatile depending on cycles</td>
<td>Recently high and visible</td>
</tr>
</tbody>
</table>

Exhibit I.10 provides the basis for two hypotheses. The first hypothesis is that the main historic growth of the development aid industry originated in two key business segments, the structural support and project finance segments. These are now both becoming relatively mature and are suffering from various structural issues in their business drivers. These issues are, in turn, reducing the two segments’ rate of growth. The second hypothesis is that the other segments do not have the business dynamics to offset the slowdown in the structural and project finance segments. These other business segments are susceptible to the economic cycle and/or other random events, and in the case of the NGOs have hitherto not had the financial resources to match the project finance and structural lending segments.

Another way of looking at these hypotheses is that the various segments of the development aid business are at different stages of the “life cycle” of business maturity. The structural and project finance segments are considered relatively mature while the NGO segment is younger and growing. The other two segments, FDI and emergency aid, are volatile and move with the economic cycle and the need for emergency relief, as well as other variables.

The two business segments in the mature part of the life cycle are slowing down, and in order to grow again they need to re-define their business dynamics. So far, it is not evident exactly what form this re-definition will take. The key components of that re-definition depend on an assessment of their strategic performance to date, as well as an assessment of their markets’ needs going forward.

In summary, the growing complexity of international aid described in the previous sections is one of the key reasons to undertake a fundamental reassessment of the industry. The next section argues that in addition to becoming more complex, aid has also had a mixed track record in achieving its development objectives.

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24 Of course these are strong generalizations applying to the bulk of activity in the business segment. Exceptions can be found, for example various churches were active in their version of development aid from the 1600s onwards in colonial environments, and similarly old trading companies were providing FDI in that period.

25 Again this applies to the total and not individual suppliers within the business category.

26 This category is intended to capture the most basic social requirements of an LDC’s population, and would likely include healthcare, primary education and rural development infrastructure, amongst others.

27 This segment differs from Specialised Support in both scale and objectives. Projects in this segment are clearly focused on more advanced, generally commercial applications (eg: major infrastructure works, industrial projects, etc.)
1.2 MIXED TRACK RECORD TO DATE

1.2.1 Economic and Social Development

Aid has a mixed track record of meeting objectives for economic and social development, for four main reasons:

(a) Growth in the post war period – the golden age – was considerably offset by unexpected population expansion. (b) Over the past 30 years, LDCs have continued to sustain high levels of growth, but this has become highly volatile, with the volatility underscoring greater vulnerability to external market shocks. (c) Average growth rates mask major variations in performance across regions and countries. (d) There appears to be a weak correlation between the volume of aid a country receives, and its performance in delivering growth and reducing poverty.

The Post-War Period: Growth offset by expanding population

The big push in development assistance during the post World War II period was accompanied by impressive improvements in economic performance. Between 1950 and 1970 most LDCs experienced rapid growth, with average annual GDP growth exceeding that of the industrialised countries (Exhibit I.11).

Within the total, sub-Saharan Africa grew at the satisfactory rate of 2.4 percent per year per capita, and among the developing regions only South Asia was lagging behind.

Not only did the LDCs’ growth match that in the industrial countries but social indicators improved markedly. Life expectancy increased for all groups of countries, and primary school enrolment increased significantly for middle-income countries (Exhibits I.12 and I.13).

However, much of the increase in income was offset by rapid population growth, which came to be seen as a prime obstacle to raising living standards in the developing world. The population “explosion” was unexpected. In 1951, the United Nations projected that the growth of population in Africa and Asia would be in the range of 0.7-1.3%. With the reduction in mortality rates resulting from improvements in health, by the mid-1960’s it was averaging around 2.5% a year.

Against this background, the Pearson report called for an increase in the volume of aid as well as efforts to make aid “administration” more effective.

The Recent Past: vulnerability to market shocks

Over the last 30 years (1970-2000), LDCs as a group continued to sustain higher per capita growth than the...
developed countries, driven increasingly by trade and private investment. Although growth rates fell during the 1980s – promoting the description of the “lost decade” – they recovered during the 1990s (Exhibit I.14).

However, year-on-year changes were highly volatile, with at least 7 periods of decelerating growth over the period, reflecting a range of external factors (Exhibit I.15).

Over the last 30 years, LDCs as a group sustained higher per capita growth than developed countries, driven increasingly by trade and private investment. Although growth rates fell during the 80s – promoting the description of the “lost decade” – they recovered during the 90s.
An analysis of the 7 periods of decelerating growth highlights the key forces at work and reveals some major vulnerabilities of LDCs. These are: (a) vulnerability to economic conditions in the developed world; (b) vulnerability to rapid changes in capital flows; and (c) vulnerability to commodity prices.

The first major challenge for LDCs was provoked by two consecutive oil price shocks (1973 and 1979) that wrought havoc with the development expenditures of most oil-importing countries (downturns 1 and 2, Exhibit I.15). The share of export earnings needed to finance oil imports rose suddenly, often leaving little for capital goods imports, let alone for servicing foreign debts. Exhibit I.16, below, illustrates the inverse relationship between oil prices and the current account balance.

During this period, many industrialised economies, including the United States, experienced slow growth as well as inflation (a combination known as stagflation). With the exception of Japan, the East Asian “Tigers”, and a few oil-exporting countries, most countries went through painful years of slow economic growth.

The period of economic malaise following the 2-step oil price increases affected development assistance in a number of ways. First, the serious economic problems of most industrial countries (and of the US in particular) overshadowed what interest the public had shown for overseas development issues. Putting one’s own house in order came first. Second, increasingly vocal demands for a “New International Economic Order” on the part of developing nations (including members of OPEC) polarised opinion and, on balance, eroded political support for development assistance. Third, poor economic performance in many LDCs (as well as civil unrest and armed conflicts) led to increased scepticism about the efficacy of development assistance.

In the event, high (real) oil prices proved to be a short-lived problem for energy importers, but the LDC growth has continued to be sensitive to the level of economic activity in the industrialised world, and has been evident again in 2000/2001 (downturn 7, Exhibit I.15).

The second major challenge was provoked by the Latin American debt crisis, starting in Mexico in 1982, which reduced global LDC growth to its lowest rate during the whole period (downturn 3, Exhibit I.15). This episode demonstrated the vulnerability of LDCs to changes in capital flows that was to be underscored in the late 1990’s when financial crises hit Asia and Russia.

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An analysis of the 7 periods of decelerating growth highlights the key forces at work and reveals some major vulnerabilities of LDCs. These are vulnerabilities to economic conditions in the developed world, to rapid changes in capital flows and to commodity prices.
In the 1990s, there have been renewed private sector financial flows to LDCs, driven by the new market-friendly paradigm, the lowering of global trade and investment barriers, and the fall in communications and transport costs. As a result, private capital displaced official development finance as the main source of external financing for LDCs (Exhibit I.18).

However, private flows are heavily concentrated on a narrow range of countries, sectors, and borrowers. Around 75% of net private capital flows go to a dozen countries, albeit including the largest LDCs (Exhibit I.19). This leaves over 100 LDCs with little access to private financing. Even in those countries that do receive private capital, borrowing is limited to a small set of “top tier” companies and is mainly for extractive industries, infrastructure, and financial sector activities.

The composition of private capital flows has also diversified. Prior to 1985, bank lending was the predominant source of foreign capital for LDCs. During the 1990s foreign direct investment (FDI) and portfolio equity investment became increasingly important, as seen in Exhibit I.20.

During the Asian crisis, a massive reversal of capital flows contributed to the collapse of currency and financial markets across the region. This led to severe criticism of the risks involved for LDCs in the liberalization of international capital markets and thus to proposals for restrictions and/or taxes on capital markets.

In general, private capital flows make a significant contribution to economic growth. However, capital inflows, through their volatility, can impose significant costs. Large-scale capital inflows place increasing demands on the domestic policies and institutions of the recipient countries (monetary stability, realistic exchange rates, financial risk management, regulatory capacity, and governance). Weaknesses in these areas increase vulnerability.

In particular, as demonstrated by the Latin American and Asian crises, the risks and costs of unregulated capital flows are substantially greater for short-term foreign currency denominated bank loans. While the direct impact of the financial crises was concentrated in middle-income countries, poorer countries were also affected through the impact of contagion in the capital markets.

Thus, the benefits for LDCs of the liberalization of capital markets depend on:

- The form of investment (in general FDI is most beneficial because it is more stable and improves...
However, private flows are heavily concentrated on a narrow range of countries, sectors and borrowers. Around 75% of net private capital flows go to a dozen countries. Borrowing in those countries that do receive private capital is limited to a small set of “top tier” companies and is mainly for extractive industries, infrastructure and the financial sector.

the quality of domestic investment through technological transfer and spill-over effects).
• The policy and institutional framework of the recipient country. A key question is whether increasing capital flows will support or detract from measures to promote pro-poor (labour intensive) growth.

The third source of weakness has been the vulnerability of commodity prices that are a major
### MATRIX SHOWING RELATIVE PERFORMANCE OF LDCs MEASURED IN GNP PER CAPITA COMPOUNDED ANNUAL GROWTH RATE (CAGR) BETWEEN 1973-1999

**Exhibit I.23**

<table>
<thead>
<tr>
<th>Improvers</th>
<th>Positive consistent Track</th>
<th>Negative consistent Track</th>
<th>Decliner</th>
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<td>&gt;10%</td>
<td>Taiwanese</td>
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30 This matrix assesses the performance of developing countries by comparing the GNP per capita CAGR from the 1970’s against the GNP per capita CAGR in the 1990’s being:
- Improvers: developing countries which have increased two or more pre-defined tranches
- Decliners: developing countries which have decreased more two or more pre-defined tranches
- Positive consistent track: developing countries which have maintained a positive performance
- Negative consistent track: developing countries which have maintained a negative performance

The impact of low commodity prices was signalled in 1985-86 (downturn 4, Exhibit I.15), when a slowdown in the industrialised countries led to then record low (real) prices for non-fuel commodities. Oil importers gained from the drop in oil prices but this was more than offset by declines for their other exports. Over the period as a whole, commodity prices, particularly for source of foreign exchange earnings for many LDCs.
non-oil products, have suffered a secular decline in real terms of 50% as shown in Exhibit I.21.

For heavily indebted countries, the loss of export revenues was compounded by the persistence (during the 1980s) of the historically high level of international interest rates (Exhibit I.22).

The structure of the world trade system resulting from multilateral negotiations – which discriminates against LDCs both as regards tariffs on their manufactured exports and subsidisation of agricultural production by industrialised countries – has perpetuated this source of vulnerability of the poor countries. Rectifying this imbalance in trade relations remains a critical element in improving their economic and social prospects. (This theme is revisited in sections 1.3.3 and 3.5).

Overall, LDCs as a group have achieved satisfactory growth during the past 30 years. Exhibit I.23 identifies a substantial number of good performers that have achieved a consistently high rate of economic growth throughout the period, including not only the Asian Tigers but also Egypt, Mexico and Bangladesh (albeit starting from a very low base).

This table demonstrates the reason for concern about the performance of LDCs after 50 years of aid, but also offers ground for hope if the lessons of the winners can be learned and applied.

Geographic variations in performance
In addition to the increasing volatility and vulnerability of LDC growth to market shocks, global average growth rates also mask major variations in performance between regions. As illustrated in the following chart, East Asia had achieved consistently high growth (until the Asian crisis of 1997). In contrast, Africa has stagnated with income growth failing to keep pace with population growth. Latin America, Eastern Europe and the Middle East have a less consistent record, experiencing periods of rapid growth and recession, as shown in Exhibit I.24.

There have also been wide differentials between good and poor performing countries within regions. Exhibit I.25, ranks countries by their average growth rate over the whole period (1973-1999). This table identifies the “winners” and “losers”. It demonstrates that the regional average rates – and the stereotypes they have engendered – hide a more complex picture. There are (a few) winners in Africa, such as Botswana and Mauritius, and some losers in Asia.

To date, the benefits of international economic integration have not been universally shared, leading to (the perception of) increased Polarisation between rich and poor. As shown in Exhibit I.26, the gap between the richest and the poorest countries has progressively widened.

At the same time, some middle-income countries have grown faster, so that the gap in average incomes between them and the industrialised countries has started to narrow.

The number of people living in poverty (< $2/day) has increased, including many in middle-income countries, as shown in Exhibit I.27 that presents the regional breakdown of poverty in LDCs.

In reaction to the imperfections of the distribution of benefits in a globalised economy (and the institutions that represent it), there have been increasing pressures for improved Participation and Governance in decision-making and service delivery associated with aid. Indeed as shown in Exhibit I.28 economic growth does not guarantee improvement in living standards, particularly for the poorer segments of the population.

This realisation has prompted a re-evaluation of the objectives and strategies of development aid along the following main lines:

- Concentration on social (poverty reduction) rather than monetary (income) indicators of welfare.
- Recognition of the complexities of the requirements for successful economic and social development, including the limits of government (and IFI) intervention aimed at “correcting market failures”.
- In addition, donors – especially the IFIs – are under increasingly critical scrutiny both to resist the temptations of “mission creep” and to subject their

![Regional Variations in Per Capita Growth](image-url)
operations to external review and criticism. In the United States, the Meltzer report recommends restricting the scope of WB and MDBs. In addition, UK/Canadian proposals have been formulated to limit scale of IMF operations, e.g. Argentina.

Overall, LDCs have achieved substantial increases in incomes over the past 30 years. And most of the transition countries of Central and Eastern Europe have accomplished a striking recovery following the disruption of their centrally controlled economies. However, in spite of this broad based progress, more than 40 LDCs with 400 million people have had negative or zero per capita income growth over the past 30 years. In these and in other countries, absolute poverty is still widespread, albeit geographically concentrated. Thus the challenge of development remains.

Weak correlation between aid and development
In general, the amount of (official) aid a country has received has not led to a proportionately higher rate of growth as shown in Exhibit 1.29.
Nor does economic growth guarantee improvements in the social indicators of the quality of life. For example, in Botswana, which has had one of the highest rates of GDP growth, life expectancy has gone down because of AIDS/HIV (see Exhibit I.28).

Globally, the benefits of aid in terms of economic and social development in LDCs have not been enough to sustain support for continued aid in the current world environment (cf. decline in ODA/GDP since 1997). The economic development argument for aid has been put in doubt, and appears weak relative to the case for market-generated growth. The end of the Cold War had already weakened the political case for aid, and the role of aid in the “war on terrorism” has yet to be made. The U.K Chancellor of the Exchequer, Gordon Brown has proposed (a) a US$ 50 billion annual trust fund to help meet the International Development Goals by 2015 and (b) a US$ 300 billion 4 year “Marshall Plan” for Afghanistan and the entire developing world, but has not indicated how these programmes would be implemented.

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demonstrated that the conditions of the disadvantaged have been improved.

To conclude, it is clear that thirty years on, the situation remains substantially as described in the Pearson report. The widening poverty gap is still “a central issue of our time”. Even though an impressive number of countries have “graduated” to middle income status, the residual poor remain marginalised.

1.2.2 Flaws in delivery mechanisms

The previous section argued that aid has had a mixed track record, for four reasons. First, much of the early economic growth has been offset by an unexpected population explosion. Second, growth has become increasingly vulnerable to exogenous factors. Third, average figures mask significant differences between regions and countries. Finally, there is little evidence of a correlation between levels of aid, and performance.

This section identifies the weaknesses in current delivery mechanisms for aid, as a potential contributor to aid’s under-performance. Six issues emerge: (a) donors have not discriminated effectively between recipient countries; (b) there has been insufficient focus on poverty alleviation; (c) implementation methodologies have been flawed; (d) conditionality has failed; (e) TA has had mixed effectiveness; and (f) NGOs have had a mixed track record.

Lack of discrimination by donors

Donors have not discriminated effectively between countries: in Africa, countries with good policies received less assistance than countries with poor or mediocre policies, as shown in Exhibit I.30

On the other hand, multilateral (IDA) aid has been more closely linked to country performance than other ODA (mainly bilateral). This is because Bilateral aid has been heavily influenced by political relationships, and many donor programme allocations are driven by supply side considerations, which creates an “approve and disbursement” culture that limit their responsiveness to country performance.

Insufficient focus on poverty alleviation

Even when donors effectively allocate aid according to performance, this does not always adequately address the needs of poverty reduction.
As argued by Hansen and Tarp in “Aid Effectiveness Disputed” (Foreign Aid and Development, page 124): “Using past performance as an indicator of future performance is especially dubious...given the existing limited understanding of the interplay between aid, macro-economic policy and political economy variables.”

Maximising marginal productivity of aid will not address problems of residual poverty, and if recent trends persist, Africa will continue to lag other regions.

Weaknesses in implementation methodologies
The implementation of evaluation methodology is far from perfect. The capacity and quality of the evaluation efforts of donors vary substantially, as shown in Appendix A.3.

The World Bank is a leader with a mixed record. By its own admission, the Bank’s contribution to institutional development at the country level has been modest, and the Bank’s diagnosis of institutional, political and governance constraints generally has been weaker than its economic and technical diagnosis. The quality of the Bank’s ESW is lower in poor performing countries, and the quality of WB projects in Africa continues to be significantly less satisfactory than other regions (Exhibit I.31).

Other donors do not appear to fare any better, as their approach suffers from resource, organisational or conceptual weaknesses. For example, evaluation units are too small and resources allocated remain limited. They fail to incorporate lessons learned from evaluation into improving the design of new projects/programmes.

Failure of conditionality
Conditionality has failed as mechanism for inducing better performance.
First, donor-designed reforms have been poorly adapted to specific country constraints and have been inflexible in responding to obstacles. Multitranche loans are not sufficiently flexible to adapt to the complex processes of institutional change.

Second, the implicit “leader-follower” relationship militates against autonomous commitment to reform by recipients. As argued by J. Stiglitz in the Prebisch Lecture, 1998: “Rather than encouraging recipients to develop their analytical capacities, the process of imposing conditionalities undermines both the incentives to acquire those capacities and confidence in the ability to use them”. The recent assessment that “adjustment lending can support policy changes and reforms at the macro-economic or sectoral levels but only when a critical mass of stake-holders become convinced of the need and direction of reform” (ARDE 2000 page 28) is akin to defining the problem away.

Third, donors have frequently failed (or been unable) to apply conditionality. Operations Evaluation Department (OED) 1992 reports that although compliance rates for Structural Adjustment Loans (SALs) were less than 50%, tranche release was nearly 100%. This pattern is driven by a pervasive “approve and disburse” culture among donor agencies. Changing this culture (e.g. by abandoning volume measures as goal) is an essential condition for improving aid effectiveness. The failure of the IMF programme for Argentina (2001) is a dramatic example of donor weakness. The Financial Times observed: “Though the IMF knew the dangers of excess government borrowing, it found it hard to stop either the government from borrowing or private sector investors from lending to it” (November 2001).

Finally, recipients have learned to “play the game”, as illustrated by Kenya’s example where the recipient turns weaknesses into strength and distorts the intended allocation process while remaining dependent on the flow of aid (Exhibit I.32).

A new orthodoxy in development thinking now aims to overcome the problems associated with coercive conditionality by promoting a participatory approach to development assistance, as formalised in the World Bank’s Comprehensive Development Framework (CDF). This revolves around the basic principle that recipient countries should “own and direct” their development strategy, which they should be encouraged to articulate in a Poverty Reduction Strategy Paper. A broad range of other partners should co-operate (or be consulted) in the

KENYA’S “MATING RITUAL”

<table>
<thead>
<tr>
<th>Exhibit I.32</th>
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</thead>
<tbody>
<tr>
<td>1 Government secures annual pledge of aid</td>
</tr>
<tr>
<td>2 Government fails to implement reforms</td>
</tr>
<tr>
<td>3 Donors threaten withdrawal of aid</td>
</tr>
<tr>
<td>4 Government offers “placatory rabbit”</td>
</tr>
<tr>
<td>5 Donors confirm aid pledge</td>
</tr>
</tbody>
</table>

Source: The Economist, 1995

EXTENT OF PRIMARY STAKEHOLDER PARTICIPATION IN WORLD BANK PROJECTS 1994-98

<table>
<thead>
<tr>
<th>Exhibit I.33</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project Phase</td>
</tr>
<tr>
<td>Identification</td>
</tr>
<tr>
<td>Design</td>
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<tr>
<td>Implementation</td>
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<tr>
<td>Evaluation</td>
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KEY FACTORS FOR PARTICIPATIVE DEVELOPMENT

<table>
<thead>
<tr>
<th>Exhibit I.34</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capacity</td>
</tr>
</tbody>
</table>
| High | • Strong institutions  
| • Ample supply of skills  
| • High degree of state captures  
| • Little political demand for reform/governance  
| Low | • Weak institutions  
| • Limited supply of skills  
| • High degree of state captures  
| • Little political demand for reform/governance |

<table>
<thead>
<tr>
<th>Will for Reform</th>
</tr>
</thead>
</table>
| • Strong institutions  
| • Ample supply of skills  
| • Low degree of state capture  
| • Political demand for reform/governance  
| • Weak institutions  
| • Limited supply of skills  
| • Low degree of state capture  
| • Political demand for reform/governance |


32 Cf Elliot J Berg, Aid and Failed Reforms, in Foreign Aid and Development, ed Finn Tarp.
34 Evidence of the persistence of these practices is given in W. Easterly, The Elusive Quest for Growth: Economists’ adventures and misadventures in the Tropics, MIT Press, 2001.
The major constraints on greater participation (cited in World Bank CDF Secretariat, Comprehensive Development Framework: Meeting the Promise? September 2001) are:

- Political resistance among recipient country governments.
- Limited capacity of stakeholder institutions.
- Incremental cost and time requirements, for governments, donors and Civil Society Organizations (CSOs) (can exceed 10% of total project costs).
- Need for change in donor management and staff attitudes.
- Inflexible multi-year donor programmes.

Thus, the more comprehensive the concept, the more complex the execution. There remains a major task of securing understanding and support among the political elite in recipient countries as participation requires both will and capacity. This is shown in Exhibit I.34, which illustrates the key factors involved in Participative Development.

Mixed effectiveness of Technical Assistance
Weaknesses of institutions and skills have been increasingly recognised as critical to development. Technical Assistance (TA) is the primary aid instrument for building capacity, particularly in critical “turnaround” countries.

However, the performance of TA has been widely criticised as being overly supply driven. TA’s over-reliance of long-term resident advisors is costly, confuses accountability and creates resentment among key recipient counterparts. Furthermore, the treatment of TA as a “free good” debases its potential benefits but does not avoid the opportunity costs to both donors and recipients. Finally, the absence of effective evaluation for TA has limited its required quality improvement, and the decentralisation of decisions on donor funded TA has resulted in a less transparent process.

The key factors for success in TA are generally similar to those for aid:

- Political support from recipient.
- Effective management.
- Availability of local counterparts.
- Focus on implementation (capacity utilisation vs. capacity building).

Mixed track record of NGOs
Since the 1980’s, NGOs have been increasingly used as a delivery mechanism for multilateral and bilateral aid programmes, particularly because of their field networks. In 1998, half of World Bank projects had NGO involvement.

However, NGOs are far from a magic solution to improving aid performance, as can be seen in Exhibit I.35, where NGO involvement in selected WB supported projects was deemed to be unsatisfactory on over half the cases. A DAC Expert Group found that although 90% of NGO projects were achieving their immediate objectives, there was a tendency for NGO projects to focus on outputs rather than objectives. Financial sustainability was usually very doubtful.

1.3 UNCLEAR FUTURE

Previous sections emphasised that aid should reform because of its growing complexity and its mixed track record in delivering results. Finally, we also argue that significant issues remain to be resolved: the landscape is becoming increasingly challenging, and while a new aid paradigm has emerged, it still fails to address some critical long-term issues.

1.3.1 Increasingly challenging landscape

One can assume that in the foreseeable future, the basic rationale for public aid, namely that rich countries should help poorer ones, partly for simple solidarity and humanitarian reasons, partly because such help contributes to making the world more coherent and stable, will continue to prevail. One could even argue that recent and prospective developments in the world should provide additional incentives for public aid to increase substantially. Typically, proponents of more public aid claim that its volume should double to permit to reach in a reasonable period of time the international development goals that have become the benchmarks for progress.

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37 Arndt, C. Technical Co-operation, in Foreign Aid and Development, ed Finn Tarp.
39 The most important is to halve poverty by 2015.
Four issues will influence the evolution of aid in the future. These are: (a) the continuing process of globalisation and liberalisation worldwide, (b) the approach to the debt problem, in particular the issue of new flows versus debt relief, (c) the increasing demand for international public goods, and (d) performance in aid utilisation and in the management of aid.

**Globalisation and liberalisation**
The continuing impact of globalisation is likely to call for an increase in aid. Nobody disputes that globalisation and liberalisation of trade and capital markets are bringing opportunities for all countries, even though it results in stiffer competition and in exacerbating income disparities. Thus, from the point of view that aid helps reduce disparities and contributes to improving long-term stability, more aid is needed to alleviate the increase in income disparities. In addition, to take advantage of the opportunities brought by liberalisation, LDCs need to equip themselves with the institutional capacity to operate effectively in those areas affected by liberalisation. In the trade sector, much more is needed to put in place the capacities to implement the Uruguay round, and this is an area where aid will continue to focus. Similarly, in the financial sector, most LDCs remain a long way from having efficient structures that can effectively mobilise domestic and foreign savings, and thus this is another area where more effort, and support, are needed.

While LDCs have done a lot to open their economies, under much prodding from the IFI, their ability to compete for exports is often severely hampered by the substantial protectionism that exists in the developed world, not only in the agriculture sector, but also in some manufactures (textiles for example). In that context, aid, interpreted in a larger context where trade becomes an important element, is necessary to level the playing field so that competition becomes more equitable. This is a political dimension of aid that has to be addressed directly by the developed world, rather than by the developing one.

While capital, goods, and to a lesser extent, services have been liberalised extensively, the free movement of labour and people has not followed the same trend, and indeed at present seems to be regressing. This brings two adverse consequences. One is the lack of opportunities for people from LDCs to gain experience and expertise and bring them back to their home country. The second is the likely effect that this restriction will have on remittances, which in a number of countries contribute much to balance of payments equilibrium, and to the mobilisation of savings. Again, this is an area on which aid, in a very broad and political definition, could focus to help alleviate the constraints resulting from this particular kind of protectionism.

**Debt financing - new flows versus debt relief**
The stock of debt by the developing world is huge: about $2.5 trillion or close to 40% of its global GDP. Typically, about 10-15% of its servicing (or 2% of the stock) is rescheduled every year.

The debt problem is not going to disappear, and most likely, new developments will occur. First, the issue of grant versus concessionary debt for poorest countries, which surfaced recently, will continue to be debated, and the very slow progress on the HIPC side will presumably argue for more, rather than less, grant. Second, the scope of burden sharing has progressively increased in the last years beyond bilateral loans and commercial loans to bond holders. One could envisage that this scope would be further expanded. The recent case of Argentina, to which the IFIs have a very large exposure, is likely to pose the question as to whether the IFIs can continue not participating in debt workouts and will not be forced to engage in some official restructuring of their own exposure. The packages recently put together by the IFIs for medium to large middle-income countries in serious trouble (Turkey, Argentina) have been quite large by traditional standards and have taxed further their financial systems. Currently no private lending can be envisaged for these countries (which goes against the traditional concept of sharing the burden for inflows) and one could envisage that private lenders will show much more caution than in the past in resuming lending. It is therefore likely that the IFIs will have to continue with a very large exposure to such countries, and the issue may be how to manage this exposure through restructuring of their current exposure, rather than new lending to replace old loans. The current proposition that the IMF help establish an organised bankruptcy procedure for countries in dire trouble is another element reflecting this lack of a satisfactory approach to a perennial problem.

A critical question in the future is going to be when, and under which conditions, private debt flows will resume and become steadier worldwide, beyond those few countries that have access to this form of international finance. Many LDCs are facing severe fiscal constraints that result in hampering future growth because of lack of public investment. At the same time recourse to the private sector to fund and/or manage public utilities has become extremely difficult partly because of some political backlash against this solution in LDCs (caused in part by some failures) and essentially because private commercial funding is mostly not available at present. As indicated above, FDI has been much more resilient than private debt flows since the Asian crisis. However, the first privatisation wave, that accounts for a large part of FDI, is now over, and there could be some question as to the political and economic sustainability of funding via FDI fiscal deficits and development through transfer of ownership of public domestic assets to foreign interests. The IFIs have developed risk-mitigating instruments to facilitate private funding of LDC projects and programmes. It may be necessary to widen the scope and coverage of these instruments, if private funding continues at this very low level and/or private risk mitigation is not able to provide the necessary comfort.

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40 The IFIs have occasionally and informally done in the past some ersatz restructuring through additional lending to allow for debt repayment.
41 One should note that this is not purely a North/South issue, as it would appear that nearly half of FDI in 2001 is coming from developing countries.
International Public goods
The demand for international public goods has grown with globalisation. Some of the most pressing development goals can be pursued only across borders, requiring internationally co-ordinated efforts and resource transfers. Examples of such public goods are controlling disease, limiting climate change, containing instability, and safeguarding global peace and security. Traditionally, official development assistance has been anchored around country programmes, and funding of international public goods has occurred mostly on an ad-hoc basis, very often to respond to an emergency (e.g. onchocerciasis in Western Africa, AIDS more recently, reform of the global architecture after the East Asia crisis).

Putting in place co-ordination mechanisms for the effective supply of public international goods is not easy, as economic agents do not normally take into consideration the shared benefits and costs of their actions, and those benefits and costs may be valued differently in different countries.

Still, an increasing share of development assistance has been channelled to support programmes in these areas, usually through a trust fund mechanism to manage the specific programme – the CGIAR\(^{42}\) and the Global Environmental Facility are good examples of that approach.

With demand for international goods increasing, new avenues will have to be explored to ensure adequate supply of these international goods, possibly through association between the IFIs or other aid organisations and the private sector, including foundations that in many cases have played a pioneering role in this area.

The still valid and essential country focus
The comments above deal mostly with aspects of aid flows to LDCs that are related to an ever increasingly interconnected and interdependent world, and attempt to provide some perspective in the evolution of supply and demand, and of some of the instruments used.

Nevertheless, for evident reasons, the main frame around which aid can be supplied and effectively managed has to be the country. This is where long term socio-political objectives are, or should be, defined in a cohesive fashion, and where effective mobilisation of resources – domestic as well as foreign – can help in achieving these objectives. This raises several issues. First, how to reconcile the country’s specific aspirations\(^{43}\) with the objectives and values of the suppliers of assistance, who typically take a geographically broader view and have their own political or social priorities. Second, if poverty reduction is the overarching objective, how to reach the poor in situations where governance and institutions are weak. Third, what proportion of aid can be channelled through international and local NGOs without circumventing the state and undermining local political processes. And, ultimately, how performance in utilising aid by the receivers and suppliers of aid is measured, and what critical ingredients are necessary to improve performance.

Performance
The basic idea is that aid is a scarce commodity, and therefore that its effective use is indispensable for aid flows to continue being provided, let alone increased. Three aspects of performance ought to be measured: (i) progress against objectives that may not be fully convergent among aid suppliers and receivers, (ii) performance of the receiver, and (iii) performance of the suppliers. Each of these aspects – and they are interrelated – raises tricky issues of measurement. Numerous researchers have extensively dealt with these aspects, which we will not revisit in detail.

Measuring progress against a country’s development objectives is a challenging task. Measuring growth and poverty reduction is relatively simple. Measuring other objectives such as gender equality, governance, or environmental sustainability, is more difficult. Measuring progress against objectives related to international public goods is even more difficult. As development is a rather complex subject, objectives have tended to multiply.\(^{44}\) In general, the more micro the objectives, the easier to measure performance, since at the macro-level, many more parameters and determinants (both indigenous and exogenous) come into play.

Measuring the performance of the aid receiver – and why some do better than others – has also been studied extensively. There is general agreement that countries having sound policies and good institutions use resources (including aid) better, although there are many diverse views on that subject.

Measuring the performance of public aid, and public aid suppliers, has been studied by many institutions and researchers, and is intimately linked to the performance of recipient countries in meeting agreed objectives. The main reason is that a lot of public aid originates in the budgets of donors and convincing the taxpayer to fund more aid needs some evidence of success, both on the part of the recipients, and also the institutions that channel aid. As a greater share of public aid has been channelled through multilateral institutions, more evidence of performance by the IFIs has been needed. However, some bilateral donors may have objectives that are different from, or complementary to, development objectives. For example, some bilateral donors have had, and still have, political objectives (developing their area of influence, getting business for their constituents etc…) and they may try to influence policies of aid institutions in which they participate to reach some of these objectives. There is much less available information on the progress made in reaching these objectives, which is regrettable as it would permit to see how much of the aid effort is in fact distorted by political ambitions, and how much this affects aid effectiveness. Leaving this aspect aside, it seems that aid suppliers have generally made progress in delivering aid in an effective fashion.

Surprisingly, there has been much less research on the measurement of the performance of private flows, in aggregate, at the country level, or at either the supplier or receiver end. This could be because

\(^{42}\) Consultative Group on International Research.  
\(^{43}\) Now reflected in the Comprehensive Development Framework and the PRSPs, which are supposed to be documents produced by the country itself, and used as a basis for determining assistance from aid organizations in a coordinated way.  
\(^{44}\) One author has mentioned the “creep” in the World Bank’s mission because of this multiplicity of objectives which the institution tries to meet.
these flows have been concentrated on a few countries, or because of a belief that instruments and/or institutions of corporate governance (rating agencies, auditors, SEC type institutions etc...) perform their role adequately, at least in the supplier’s country. It is certainly not true in many LDCs, where legal, financial, or fiscal institutions are in dire needs of improvement. It is also true that a substantial part of these flows is directed towards specific micro projects at the enterprise or institution level, where measurement of achieving the objectives initially set is easier. However, in as much as private flows have become a powerful ingredient in the funding of development needs, it would be useful to have some more information on the results reached, and how to measure their overall performance. Some of the issues relating to public aid (e.g. fungibility) would seem to also apply to some extent to private flows.

Bleak outlook for aid
The discussion above indicates that there appear to be good reasons why, assuming steady improvement in performance, more aid – in an increasing variety of forms and instruments – should be provided. However the outlook is rather bleak at present, despite some recent indications by major aid donors that they will somewhat increase their commitments in the near future.

The prevention of further international terrorist attacks requires not only enhanced security, but also efforts to address the huge income and opportunity gaps which exist between developed countries and LDCs – and the sense of injustice that this has engendered. This argues for a need for additional aid and support to tackle the root causes of these gaps. However, the effect of additional aid will not be felt immediately, and the pressing need to fight terrorism may take priority over the short term. This may even invite some to emphasise the political short-term objectives related to this fight in the use of aid, and in the choice of beneficiaries. From a longer-term perspective, this renewed politicisation of aid is regrettable. It also introduces some element of uncertainty in the ability of LDCs to plan their programmes. Research has demonstrated that the stability of aid flows is an important driver of aid effectiveness. If a substantial part of the flows is related to short term political considerations and thus subject to frequent changes, LDCs ability to use aid effectively will be hampered.

Second, in the past 20 years, crises that had affected flows of private debt to LDCs have had a nasty but relatively limited effect – both in terms of the risks of contagion and in terms of their duration (e.g. Mexico crisis of 1982, Tequila crisis in 1994). Unfortunately, this is no longer the case. With a few exceptions, the flow of private debt to the developing world has not resumed substantially after the Asian crisis, and contagion has taken place and is continuing. The issue therefore is whether policy makers in LDCs should assume that such flows are highly unlikely to resume in reasonable volumes in the years to come. If this is borne out, and if at the same time public flows remain modest, then policy makers will need to place even higher priority on their effectiveness in mobilising, allocating, and using their own resources. One could argue that in any case this has to take place irrespective of the volume of aid received. This is true, but internal resources in many countries are very meagre and securing additional resources is necessary to provide a useful boost on the way to growth and development.

Third, after many years of rapid growth, the economies in larger industrial countries are in a semi-recession, and thus electorates in those countries are likely to focus much more on income and employment at home, at the expense of altruistic objectives linked to LDCs.

One could therefore conclude that pressure to demonstrate improved performance in the use of aid would increase. Such pressure will be applied not only to recipient countries, but also to the providers of aid whether public or private (including NGOs).

So the entry into the 3rd millennium is much less encouraging than anticipated a few years ago. LDC needs are greater, but are unlikely to be met by an increase in ODA – that has further lagged behind as a proportion of GDP in developed countries. In addition, a number of countries face severe fiscal constraints, and both public and private investment remain at a very low level, affecting future growth. The magnitude of rescue packages for some middle-income countries in trouble will further tax the availability of public and private financial support to the developing world.

Despite the efforts of donors and aid recipients, progress in reducing the gaps between rich and poor, and alleviating poverty, is still very limited. At a time when recession hits the world, getting donor countries to increase aid volumes is likely to be extremely difficult.

How can donors demonstrate that aid flows will be used more effectively so as to convince taxpayers that, beyond the purely social aspects of transfers, a massive effort is required to ensure more equality in the distribution of wealth and income worldwide? Despite James Wolfensohn’s expectation that the events of 11 September 2001 have created “an international recognition of interdependence”, several donor countries are not willing to increase their aid expenditures. During the current discussion for the replenishment of IDA resources, France, Germany and Japan all want to reduce their contribution to the agreed global target of US$ 12.5 billion, citing domestic budgetary constraints. In particular, EU countries now bound by the Maastricht treaty stability and growth pact to keep their budget deficits to less than 3% of GDP will find it difficult to respond to calls for increased aid during an economic downturn.

1.3.2 A new paradigm for aid
As illustrated in section 1.1.1, the paradigm for aid has evolved considerably. Over the last 25 years, the relative roles and responsibilities of the various aid agencies have expanded and diversified due to profound changes in: (a) aid philosophy including a re-balancing of the roles of the private and public sectors, and (b) the emergence of new major issues.

Before the demise of the centrally planned system, bilateral agencies tended to cater to the geopolitical priorities of their governments. This was
manifested, for example by the UK’s and France’s focus on their ex colonies. Similarly, the US focused on supporting countries that would help it win the cold war economically or politically at the UN (e.g. the large programme for the numerous Caribbean countries to get their votes at the UN, or support to Pakistan to help out the Soviet Union from Afghanistan). Most of the bilateral funding was tied to national procurement. In addition, aid was also used as a vehicle to befriend countries with a rich resource potential irrespective of their regimes.

In the pursuit of these geopolitical goals, the major western countries did indeed try – sometimes rather successfully – to use the IFIs to support their own objectives. This sometimes had a positive focus – such as the US getting the IMF and the EBRD to assist Zaire, or France lobbying for French speaking African countries. In other cases, the focus was negative – such as the moratorium on World Bank lending to Chile during the Allende regime, or the lack of support to Ethiopia while the Mengistu regime was in place and had not initiated compensation for expropriation of foreign assets.

This geopolitical aspect in bilateral aid is not totally forgotten – witness the huge US programmes still in place for Israel and Egypt to foster a permanent peace following the Camp David accord, as illustrated by Exhibit I.36.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Share of Israel</td>
<td>2%</td>
<td>20%</td>
<td>16%</td>
</tr>
<tr>
<td>Share of Egypt</td>
<td>1%</td>
<td>19%</td>
<td>12%</td>
</tr>
<tr>
<td>Israel and Egypt</td>
<td>3%</td>
<td>39%</td>
<td>28%</td>
</tr>
</tbody>
</table>

Source: OECD

There are also signs that some major western countries are still considering using their leverage with the IFIs to provide rewards for “good behaviour” – e.g. Pakistan or some Central Asian countries following the September 11th events.

Generally, the evolution of aid patterns, particularly in the last 15 years, has moved progressively away from supporting direct political interests, and in favour of broader objectives of social progress leading to peace and stability in the world. With globalisation, benefits can be shared better, but poverty and inequalities can also generate powerful, even violent reactions. Therefore, from geopolitical and social perspectives, eradicating poverty, generating incomes and reducing disparities are pressing priorities and aid, properly utilised, should be a powerful lever rather than a ‘community’, more could be done to define and clarify the mandates and areas of competence of individual agencies. Clearly, the IMF has an established role in financial crises resolution (and also, now prevention) and its lead in the macro-economic area. The World Bank has taken leadership in sectoral and institutional policy areas. And there is evidence of collaboration between institutions – for example, the World Bank Group (WBG) is increasingly engaging with the IMF and the EBRD, and the EIB, and the WB and the EBRD are now the major financiers.

Generally, aid has moved away from supporting direct political interests towards broader objectives of social progress. With globalisation, benefits can be shared better, but poverty and inequalities can also generate powerful, even violent reactions. Therefore, from geopolitical and social perspectives, eradicating poverty, generating incomes and reducing disparities are pressing priorities and aid, properly utilised, should be a powerful lever.
develop the comparative advantages of the major
donor institutions, yet developing in parallel the
concept of “competition” to serve their clients
better.

In part due to the demise of central planning, a new
paradigm for aid has evolved around a small
number of general prescriptions designed to
progressively improve the quality of life in the LDCs:

- **Focus on poverty reduction** (including health and
  education) for all members of society, rather than
  increasing average income levels.

- **Free market principles**, and progressive
globalisation resulting in rapid growth of
international trade (and transfer of technology).
Appropriate government policies were defined by
the so-called Washington consensus.

- **Trade** has long been recognised as a very
  important factor in growth and development.
Overall, trade has grown at about twice the rate
of growth of GDP over the last 15 years. Global
trade is now about 45% of GDP, and higher in
LDCs (70% in East Asia). However, the share of
LDCs in the world trade remains low, at about
25%. All now agree that international trade has
the potential to act as a powerful source of
economic growth and poverty reduction, but that
it is not a substitute for aid. In parallel, some
economies (China, South Korea) demonstrated
that a carefully managed liberalisation
accompanied by an effective industrial policy can
contribute effectively to steady growth and to
export competitiveness.

- **Importance of democracy and human rights** –
  improvement in these areas were conditions for
  EU support to formerly centrally planned
economies in Europe.

- **Overwhelming role of the private sector** as a
  driver for growth. The role of government
should be kept at a minimum, but progressively
it became clear that it was crucial in a number of
areas (such as social protection) or as a
regulator.

- **Substantial debt relief** is considered a necessary
  condition for effective poverty reduction,
  particularly in the poorest countries.

- **Finally, it has been recognized that development is a very complex process** and that the
  participation of the civil society is critical.

Eradicating poverty, generating incomes and
reducing disparities has become a very pressing
priority and aid, properly used, should be a
powerful lever for achieving this.

Finally, it has to be mentioned that the international
community is increasingly aware of the urgency of
improving the situation of the poorest countries, and
of the complexity of the tasks involved in developing
this new aid paradigm. Recent initiatives like the
Millennium Declaration and the Millennium
Development Goals (MDGs), covering a broad range
of development goals to be achieved and being
effectively monitored by the UN Secretary General,
result, indeed, in a major international commitment.

### 1.3.3 Critical long-term issues outstanding

While the new aid paradigm is intended to provide a
comprehensive framework for approaching the future
of aid, a number of critical long-term issues still need
to be addressed, in a systematic, decisive, way. In our
view, the five most important are the following.

**Aid and Trade**

Section 1.3.1 argued that globalisation and
liberalisation would call for an increase in aid to
offset growing income disparities and to develop
institutional capacity. We argue here that
continuing protectionism on the part of developed
countries will continue to pose significant obstacles
to poverty reduction in LDCs.

The reduction of trade and investment barriers,
combined with technological developments that
reduced communications and transport costs have
led to the integration of world markets for goods
and services, financial flows and information. There
are sharply divided views on whether the process of
globalisation has benefited or discriminated against
poor countries.

In general, in our view, globalisation has had a
positive impact on growth. As shown in Exhibits
I.37 and I.38, more open economies and those that
have accelerated the process of integration have

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**RAPIDLY OPENING DEVELOPING COUNTRIES**

Exhibit: I.37

<table>
<thead>
<tr>
<th>Growth Rate (%)</th>
<th>1970’s</th>
<th>1980’s</th>
<th>1990’s</th>
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<tbody>
<tr>
<td></td>
<td>0</td>
<td>2</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: OECD DAC Online Database
recorded higher rates of growth. This holds true for poor countries also: a group of 18 rapidly opening developing economies have achieved accelerating rates of growth.45

However, there are costs of trade liberalisation, in particular the loss of employment and disposal of assets in non-competitive import substitution industries that can be exacerbated by inappropriate or unstable macro-economic policies. The burden of over-indebtedness of many of the poorest countries – to which IFIs and some bilateral agencies have contributed – has served to highlight that financial flows involve liabilities as well as assets.

To ensure LDCs benefit from globalisation will depend on creating a fairer international trading system, in which the WTO (and its members) commit themselves to poverty reduction as an objective and to helping the poorer countries to challenge the discriminatory policies and practices of stronger trading partners.

Trade has long been recognised as a very important factor in growth and development. An International Trade Organisation was proposed to be created along the World Bank and the IMF – but never got off the ground. In the eighties, the neo-classical school of thought went so far as to state that liberalisation of global markets would make aid redundant. This is no longer accepted. All now agree that international trade has the potential to act as a powerful source of economic growth and poverty reduction, but is not a substitute for aid. In parallel, some economies (China, South Korea) demonstrated that a carefully managed liberalisation accompanied by an effective industrial policy could contribute effectively to steady growth and export competitiveness.

However, the waves of trade liberalisation in the last twenty years also led to greater diversity and inequities among many LDCs, and to the need to govern globalisation and manage liberalisation. The so-called Uruguay round agreements were reached in 1995 after 10 years of long and protracted trade negotiations between industrialised countries and LDCs that began in 1986 at Punta del Este (Uruguay). Agreements reached included the creation of the WTO and wide-ranging aspects of trade in goods and services, amongst which the protection of intellectual property rights. Of particular importance were agreements on agriculture: to convert all non-tariff barriers to tariffs equivalents. As a major result of the Uruguay round, LDCs need to equip themselves with the capability to implement and monitor the agreements reached, and to take advantage of the flexibility that has been incorporated in some of the agreements. They should also prepare carefully for the next round to ensure that they get a better deal, in particular for the identification of export sectors of interest to them, and the equal treatment of capital and labour in relation to the supply of services.

While LDCs have generally reduced considerably their tariffs, the industrialised countries maintain still high tariffs and non-tariff barriers on some products that are of considerable interest to LDCs (agriculture and labour-intensive goods). They also continue providing substantial export subsidies to the agriculture sector, which affects development of that sector in the developing world – where a large part of the population still gets its income from agriculture production. Agriculture subsidies in OECD countries are close to $ 1 billion per day – a large multiple of all aid and all debt relief provided to the developing world. Tariffs facing LDCs manufactured exports to high-income countries are on average 4 times those facing exports from industrialised countries.

<table>
<thead>
<tr>
<th>Countries</th>
<th>Share of world trade 1990-98</th>
<th>Trade/GDP 1990-98</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upper middle income</td>
<td>Up from 8% to 11%</td>
<td>Now above 25%</td>
</tr>
<tr>
<td>Poorest 48 economies</td>
<td>Stable at 4%</td>
<td>Stable at less than 10%</td>
</tr>
</tbody>
</table>

Source: World Bank data

The recent WTO summit in Doha fortunately resulted in building up, after some difficult compromises, a degree of consensus between developing and developed countries to engage into a new round of trade discussions. However, the experience of the last decade also demonstrates the difficulties of reducing trade barriers or subsidies in the EU or the US, given the very strong political lobbies in these countries. The Clinton administration could not secure the authorisation for fast track negotiation of trade agreements from the US Congress, and the agriculture lobbies in the EU are known to be very powerful. At a time when the world is in recession, it is likely that resistance to change will continue to be strong in the US and in the EU. However there is relatively little more that LDCs have to do to open their economies, and there is much that the developed countries should do – eliminating trade barriers would progressively add $1.5 trillion to LDC incomes, and lift 300 million people out of poverty by 2015. The specific areas in which progress is the most important would be:

- Ensuring that the phase out of the Multi-Fibre Agreement is completed as planned in 2005 - it is presently delayed.
- Ensuring that the implementation of the Trade-Related Aspects of Intellectual Property Rights (TRIPS) do not result in affecting LDCs ability to fight infectious diseases.
- Ensuring that poorest countries get free access for their exports to the US and the EU.
- Increasing grant financing of assistance to LDCs for building up the institutional capacity to implement the Uruguay Agreement.

Fungibility and Aid Allocation

Aid is said to be fungible if the marginal increment in expenditure to an aid inflow is not the expenditure towards which the aid was given. While there has been some disagreement on the extent to which aid is indeed fungible, it is generally agreed that there is some fungibility. If this is the case, then the ability of any country to allocate its resources in the most effective way becomes of utmost importance, even if the particular project financed by aid has very high returns. The issue then becomes that in the absence of good policies and capacity to allocate public expenditures in an economic way, the impact of aid may become minimal or even negative. Research on that aspect has shown that in well managed environments, 1% of GDP in aid translates in a sustained increase in growth of at least 0.5%, and in a reduction in poverty of 1%.

As a result of this, overall policy performance (taking into account external shocks) has become in many aid agencies a major criterion for distributing aid among countries, which leads to two questions currently debated:

- In the case of good performers with effective ability to allocate resources, should not aid be less directed toward specific projects, and more toward funding a certain percentage of public expenditures? And would it be possible for donors to pool resources and let the recipient country use it (or part of it) relatively freely under some agreed set of principles, which would minimise the administrative costs of aid? In some ways, this should build on the experience developed with sector loans, which use this approach in a limited fashion, though rarely with more than one donor.

- In the case of bad performers but very poor countries with little institutional capacity, how can aid be used selectively but effectively for programmes with high economic social returns, without risking some misuse given the weak environment, and assuming some willingness to improve it.

The response to the last question is not an easy one, but typically calls for a combination of support for policy and institutional improvements together with targeted support to poor people, social sectors, micro-finance in projects designs that often include a high participation of civil society, communities and NGOs. In addition, it is important to ensure that there is some continuity of aid. While difficult to document, it is generally accepted that steady flows of aid have a correlation with effectiveness in its use.

Debt – Problem or Solution?

Debt problems have continuously affected many LDCs, and not only the low-income ones, as demonstrated recently by the Argentina crisis. Without some more permanent solution to this debt problem, progressively more generous levels of debt relief has been granted to LDCs. This culminated recently in the so-called enhanced HIPC Initiative.

As shown in the beginning of this Chapter, the proportion of grant funding in aid net disbursements has increased over the last 25 years. For middle-income countries there is little justification for providing all aid in the form of grants, as it would defy the accepted objective that these countries should progressively establish the ability to mobilise their external resources directly from the international markets (the so-called graduation process in the WB jargon), and aid is only a temporary help during this process. However the issue still remains valid for low-income countries, and the question can be centred on whether concessory resources should be accepted for specific programmes or projects to provide partial debt relief to highly indebted poor countries.

IFIs argue that providing relief purely as grant would reduce the flow of aid as it would reduce the repayments from previously disbursed concessory funding. Because of the co-operative nature of the institutions, granting full debt relief to some would penalise others as reflows could not be used for new commitments. Furthermore, borrowing even under concessional terms is a first step toward progressively getting access to private international markets. In any case, the argument goes, there is nothing wrong about funding development from debt – as evident from success registered by a number of countries in terms of growth and poverty reduction, and the HIPC should be seen as a one-time action.

The issue is still very much alive. The poorest countries are far from being able to tap the international capital markets, so receiving aid in the form of grant rather than debt (even concessional

46 HIPC countries have been receiving an average of $10 billion per year in grants and concessional loans, after HIPC debt relief is taken into account, their debt service will fall to less than $2 billion a year. If that debt service is not forthcoming because of total cancellation of debt, aid flows would be reduced by about 20%, according to the argument.

47 Note that the terms of concessional aid provided by the IFIs have hardened somewhat, precisely to ensure higher reflows in the context of declining aid volumes. The real issue is not the terms, but the willingness to provide more aid – assuming continuous progress in its use.
Two principal considerations led to the enhanced HIPC Initiative (2000). The first recognised that highly indebted poor countries needed more debt relief than provided traditionally under rescheduling via the Paris and London Clubs, even when that relief had become more generous over time. The second recognised that the multilateral institutions needed to participate in debt relief, but in a way that did not impair their creditworthiness or ability to borrow from the markets. The enhanced HIPC Initiative aims at reducing the debt service of highly indebted poor countries by up to 80% (more in difficult cases), provided that these countries implement a strong programme of reform leading to sustained resumption of growth and reduction of poverty.

The details of the HIPC initiative are rather complex, and call for countries to prepare a programme (the Poverty Reduction Strategy Paper – PRSP) through an internal consultation process. Once finalised and reviewed by the IMF and the WB, this PRSP becomes the basis on which programmes of assistance by aid agencies will be delineated. This would include support by the IMF (Poverty Reduction and Growth Facility - PRGF that replaced the ESAF), IDA (Poverty Reduction Support Credit –PRSC) and other MDB’s concessional windows.

Steady implementation of the PRSP leads to finalising the agreement to provide debt relief – the key signposts are the decision point when the PRSP is finalised, and the completion point, when the PRSP has been correctly implemented for some time.

Thirty-eight countries are expected to benefit from the enhanced HIPC initiative – nearly all of them in Africa. By October 2001, twenty-four had reached the decision point and 3 the completion point.

The total cost - in terms of foregone debt servicing - for 34 countries is estimated at about $133 billion in 2000 NPV terms, of which about half for bilaterals and half for multilaterals. The funding of these costs comes from a Trust Fund managed by the WB, from contributions by bilateral, MDBs (from their profits) and the EU, and from grants and concessionary lending by the IFIs.

This will free up around $50 billion in payments, which in turn will allow additional spending on social and developmental projects of around $1.7 billion per annum in the countries affected. However, despite these considerable successes, the total mountain of debt facing the HIPCs is estimated at around $460 billion - debt relief still has a long way to go.

Source: Global Development Finance, 2001

debt) hardly jeopardises the provision of aid for others. In addition, the process to benefit from the HIPC initiative is long and arduous. As of August 2001, only 23 of the 42 designated HIPCs had reached their “decision point”, which confirms eligibility, and 15 of those had not sustained their policy “track record” in terms of implementation of their macroeconomic programmes. One can therefore wonder whether the HIPC initiative is not proving “too little too late” in reducing the debt overhang of the poorest countries.

The Impact of Corruption

Corruption features prominently in discussions of governance. There is a growing consensus that development efforts will not have the desired impact unless well-functioning political and economic institutions are in place and are operational. Corruption plays a very negative role in the performance of the Institutional Infrastructure. The most common forms relate to bribery of public officials, improper use and abuse of public funds and the extraction of economic rents for personal use/gain by those in positions of political or commercial power. The consequence is (ultimately) to reduce the economic well being of an economy. Indeed a number of studies have examined the ways in which the Institutional Infrastructure can stem corruption.48

How does one measure corruption?49 Up until the mid-1990s, most of the empirical findings on corruption relied on anecdotal evidence. Over the past seven years, there have been many efforts to provide an empirical measurement. These efforts have relied for the most part on opinion surveys that poll the general population, the private and public sectors. The most quoted one has been the ‘Corruption Perception Index’ (CPI) provided annually by Transparency International from 1995. Other surveys are examined in Exhibit I.41. For the most part, these surveys have tried to measure the extent to which the further development of business has been hampered by corruption.

The CPI (Corruption Perception Index), which is the most widely quoted source, puts countries on a continuous scale facilitating comparison on the extent of corruption. The CPI collects perceptions from business people and risk analysts.46 The CPI is a composite index – a survey of surveys. It draws on 14-different data sources from seven different institutions: the World Economic Forum, the World Business Environment Survey of the World Bank, the Institute of Management Development (Lausanne), Price Waterhouse Coopers, the Political and Economic Risk

49 The following paragraphs rely on segments from the 2001 Annual Report of Transparency International.
50 Unlike previous years, the 2001 Index did not include a survey of the general public, owing to the scarcity of these surveys.
Consultancy (Hong Kong), the Economist Intelligence Unit and Freedom House’s Nations in Transit.

Corruption is defined as the misuse of public power for private benefit, which includes the bribing of public officials, kickbacks in public procurement and the embezzlement of public funds. Exhibit I.42 examines the CPI for 1997 and for 2001. The term ‘level of corruption’ in Exhibit I.42 includes the frequency of corruption and the total value of bribes paid. The countries are ranked by score. Those countries where corruption is ‘highest’ are those in the 0-3.99 group, while those in the middle are in the 4-6.99 group and the least evidence of corruption is found in the 7-10 group for both 1997 and 2001. Only six countries changed their ranking between 1997 and 2001 (highlighted in bold on Exhibit I.42). Botswana, Brazil and Peru moved from a high perception of corruption to a medium perception (the individual country scores in 1997 were 3.6, 3.58 and 2.9 respectively, while the Slovak Republic (3.65) and Guatemala (3.87) did not move in the four-year period). Japan, Chile and Spain moved from a medium perception of corruption to a low perception from 1997 to 2001. (France and Cyprus with higher scores in 1997 had not made the transition by 2001).

Notes: Although this grouping uses all of the scores allotted, not all countries were ranked by Transparency International, as some countries did not return the requisite number of surveys (four). Scores approaching 0 indicate full corruption, while those approaching 10 indicate no corruption.

The Place of Private Sector Financing

Again, as shown at the outset of this Chapter, private net flows to LDCs increased rapidly up to

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### CORRUPTION SURVEYS

<table>
<thead>
<tr>
<th>Survey</th>
<th>Organisation</th>
<th>Coverage</th>
<th>Measure</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>World Business Environment Survey</td>
<td>World Bank</td>
<td>10,000 enterprises in 80 countries</td>
<td>Incidence of irregular payments to government officials</td>
<td>Significant differences between small, medium and large enterprises. Over 60% of respondents in East Asian LDCs reported irregular payments to government officials – just 28% of Latin American and 12% of OECD respondents reported such payments.</td>
</tr>
<tr>
<td>Private Sector Survey</td>
<td>Price Waterhouse</td>
<td>Chief Financial Officers of major companies, equity analysts, bankers, and PWC employees</td>
<td>Estimating the adverse effects of public sector opacity on the cost and availability of capital in several countries</td>
<td>Pending</td>
</tr>
<tr>
<td>Control Risk Group Survey</td>
<td></td>
<td>121 Companies in US and Northern Europe</td>
<td>Number of companies deterred from investing in high corruption countries has increased. Number of companies with anti-corruption codes is increasing.</td>
<td></td>
</tr>
<tr>
<td>The Conference Board</td>
<td></td>
<td>Interviews, focus groups and working groups with executives of 151 companies from all major industries and regions</td>
<td>Single most important stimulus to development of anti-corruption strategy is the leadership and commitment of senior management</td>
<td></td>
</tr>
<tr>
<td>Bribe Payers Index</td>
<td>Transparency International</td>
<td>119 leading exporting countries</td>
<td>Perception of bribe-paying in order to win business abroad</td>
<td>Ranked 119-exporting countries based on perceptions</td>
</tr>
<tr>
<td>PREM Network</td>
<td>World Bank</td>
<td>7,011 public officials in 16 countries</td>
<td>Where political patronage is low, organisational performance tends to be high. Reward or recognition of individual staff performance by senior staff leads to increased productivity, even in high patronage environments</td>
<td></td>
</tr>
<tr>
<td>Dow Jones Sustainability Group Index</td>
<td>Private sector sustainability leaders</td>
<td>Major companies that perform particularly well against a variety of environmental, economic and social indicators</td>
<td>82% of US-based companies had explicit codes prohibiting employees from offering items of value to government officials, compared with 66% of Japanese companies and 50% of South American-based companies</td>
<td></td>
</tr>
</tbody>
</table>

One could fear that, even when the recession subsides, LDCs may not share in renewed growth as much as they could because of lasting reluctance on the part of private investors. In some countries there are not that many attractive public assets left for privatisation, and in many there is greater reluctance to undertake such programmes, for political and social reasons.

1996, when they reached more than $300 billion. Following the East Asian crisis that year, debt flows precipitously fell – and have been negative for the last three years. Direct equity investment has been more resilient, in part due to the large privatisation programmes in many emerging countries. Flows of both debt and equity have been concentrated on a few countries, mostly in Asia and Latin America.

Prospects for a recovery are dim at present and are highly sensitive to what may happen to Argentina (that has about 25% of outstanding sovereign bonds issues from emerging countries) and Turkey, as well as to the evolution of burden-sharing between public and private creditors at times of difficulties.

Before the East Asian crisis, there was general optimism that the continuation of substantial flows of private money to LDCs would accelerate growth and would marginalise the IFIs, particularly as regards the medium to high-income countries. Since then, some hoped that flows would resume rapidly as had been the case previously, including after the so-called Tequila crisis in 1995. This is not likely to happen, particularly during a recession, as investing in emerging markets is generally much more risky than in the EU or the US – even if the returns or the spreads are larger.

The effect of this prolonged crisis may be quite detrimental to the LDCs, particularly at a time when public investment in many of them is severely constrained by fiscal restraint. One could fear that, even when the recession subsides, LDCs may not share in renewed growth as much as they could because of lasting reluctance on the part of private investors. In addition, privatisation programmes in a variety of forms have contributed substantially to equity and debt flows; in some countries there are not that many attractive public assets left for privatisation, and in many there is greater reluctance to undertake such programmes, for political and social reasons.

Evidently, part of the solution is to develop as quickly as possible efficient capital markets in the LDCs, and to support programmes that do this while at the same time trying to have a more direct social effect (SME, micro-finance). The impact of these efforts will not be immediate (financial sector development) or modest (SME, micro-finance). In parallel, it should be possible for the aid agencies to be more innovative in trying to help mobilise private capital from abroad in a way that reduces the fears that the “jewels of the crown” are sold to foreigner.

On paper, many of the IFIs have precisely this role. The EBRD was launched to boost private investment in Central and Eastern Europe. The World Bank and other IFIs have developed instruments (partial risk and credit guarantees) that are geared at mobilising private finance for both private and public projects. The IFC and other multilateral or bilateral agencies have been mobilising both equity and loan finance for private investment in developing markets. Also, since it was created 10 years ago, MIGA has been very successful at developing its capacity to provide political risk insurance for private sector investments in developing markets. Finally, private or bilateral forms of political risk insurance for investments in LDCs have experienced substantial growth, at least until recently.

When the World Bank was created, it was envisaged that its main focus would be providing guarantees rather than direct lending. Its evolution has shown a different path, and its guarantee programme (and that of the other IFIs) has stayed at a very low level, partly because of competition with lending, partly because of strong views (some would even say prejudices) both in some LDCs and in the institutions, against guarantees. Given the current dismal picture as regards private flows to LDCs, it would appear that a serious renewed effort at developing this kind of instrument or other risk management devices by aid agencies would be warranted. This should not be at the detriment of an increase in aid flows.

### CORRUPTION SCORES FOR 1997 AND 2001 RANKED INTO 3-CLASSES, HIGH, MEDIUM, LOW.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Score 1997</th>
<th>Score 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-3.99</td>
<td>Albania, Algeria, Angola, Argentina, Bahrain, Bangladesh, Belarus, Bolivia, Botswana, Brazil, Bulgaria, Cameroon, China, Colombia, Cuba, Ecuador, Egypt, El Salvador, Ghana, Guatemala, Honduras, India, Indonesia, Iran, Iraq, Ivory Coast, Kenya, Lebanon, Libya, Mexico, Morocco, Myanmar, Nigeria, Oman, Pakistan, Panama, Paraguay, Peru, Philippines, Qatar, Romania, Russia, Saudi Arabia, Slovak Republic, Syria, Tanzania, Thailand, Turkey, UA Emirates, Uganda, Ukraine, Venezuela, Vietnam, Yugoslavia, Zaire, Zambia, Zimbabwe</td>
<td></td>
</tr>
<tr>
<td>4-6.99</td>
<td>Belgium, Chile, Costa Rica, Cyprus, Czech Republic, Estonia, France, Greece, Hungary, Italy, Japan, Jordan, Kuwraith, Malaysia, Nicaragua, Poland, Portugal, South Africa, South Korea, Spain, Sri Lanka, Taiwan, Uruguay</td>
<td></td>
</tr>
<tr>
<td>7-9.99</td>
<td>Australia, Austria, Canada, Denmark, Finland, Germany, Hong Kong, Iceland, Ireland, Israel, Luxembourg, Netherlands, New Zealand, Norway, Singapore, Sweden, Switzerland, United Kingdom, United States</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rank</th>
<th>Score 1997</th>
<th>Score 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-3.99</td>
<td>Argentina, Azerbaijan, Bangladesh, Bolivia, Bulgaria, Cameroon, China, Colombia, Croatia, Czech Republic, Dominican Republic, Ecuador, Egypt, El Salvador, Ghana, Guatemala, Honduras, India, Indonesia, Kazakhstan, Kenya, Latvia, Lithuania, Luxembourg, Mauritius, Namibia, Peru, Poland, Portugal, Slovenia, South Africa, South Korea, Taiwan, Trinidad and Tobago, Tunisia, Uruguay</td>
<td></td>
</tr>
<tr>
<td>4-6.99</td>
<td>Botswana, Belgium, Brazil, Costa Rica, Estonia, France, Greece, Hungary, Italy, Jordan, Lithuania, Malaysia, Mauritius, Namibia, Peru, Poland, Portugal, Slovenia, South Africa, South Korea, Taiwan, Trinidad and Tobago, Tunisia, Uruguay</td>
<td></td>
</tr>
<tr>
<td>7-9.99</td>
<td>Australia, Austria, Canada, Chile, Denmark, Finland, Germany, Hong Kong, Iceland, Ireland, Israel, Japan, Luxembourg, Netherlands, New Zealand, Norway, Singapore, Sweden, Switzerland, United Kingdom, United States</td>
<td></td>
</tr>
</tbody>
</table>
2.1 ‘TOP DOWN’ ANALYSIS

2.1.1 Business Dynamics analysis

Many objectives have been formulated for development aid since the business was launched when the Bretton Woods institutions started operations. These do shift over time to reflect new priorities and currently the overall objective is the reduction of poverty. Although this overall objective is clear enough, and measurable, the breadth of this objective can be made more “operational” by focusing on two sub-objectives in the overall mission to reduce poverty:

- First, to improve the operational effectiveness of public flows, i.e. ODA. This can be measured, as presently happens with widespread evaluation analysis undertaken by the international financial institutions, nearly always on an ex-post basis. But apart from such measurement, the objective also aims to improve the perception of effectiveness by financiers as well as beneficiaries. These perceptions will drive the volume and terms of financing available for this business.
- Second, to improve the stability and volume of beneficial private flows, both of debt financing as well as FDI.

These two sub-objectives are inter-related. If the first is achieved, it is likely that this will promote the achievement of the second.

One of the most authoritative recent studies concludes that aid has been “highly effective, totally ineffective and everything in between”51. While noting that donors have been slow to respond to new development challenges (HIV, Asian crisis, and conflict situations), the report observes that aid has been “effective” in a good policy and institutional environment. Indeed, as shown in Exhibit II.1, countries with a positive environment can also attract private investment by giving confidence to investors and supporting the delivery of public services. Aid can also help attract private investment in much the same way. However, for the recipients to realise the benefits of private investment depends on having effective and equitable regulatory and governance structures and practices (key elements in good institutional environment).

These conclusions are not widely shared. The methodology of the study has been challenged, especially for ignoring the time lags between aid and growth52. Furthermore, the policy environment is not always stable. “Successful reformers” frequently backslide, such as Ghana in 1992, while “Transitional” economies of CEE have achieved a rapid turnaround. Finally, effectiveness also depends on exogenous environmental factors, such as terms of trade, export stability and climatic conditions53.

While this is an important conclusion, it does not yet pinpoint the “magic formula” to make all development aid “highly effective”. The Pearson report’s conclusion moves a little closer to identifying the “key factors for success” in its general statement that “further growth will require that aid, trade, and investment policies are integrated in a single strategy which rests firmly upon the performance of the LDCs themselves and the sustained commitment of the richer countries”. This identifies at least two key ingredients for greater future success: the integration of public and private aid and trade and investment, and also the performance of the LDCs together with the commitment of the richer nations.

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However, these are still very “macro” recommendations and are not easily translated into action at the practical level. In order to achieve the objective of poverty reduction, the development aid business needs to restructure aspects of its two older and more important business segments: project finance and structural/programme lending. In order to move towards such actionable recommendations, it is necessary to examine the business dynamics of the aid business i.e. the interaction between the IFIs, their clients (beneficiaries), and the private financiers. Most of that analysis will deal with the IFIs and their clients, as private financiers tend to react directly to the policies and institutional environment, which are themselves a product of the interactions between these clients and the IFIs. This analysis of the IFI business dynamics reveals that:

- Some of the IFIs development aid businesses are now “mature” and need re-defining.
- The “business processes” in the IFIs reveal about five main areas for re-definition, especially viewed against “generic benchmarks” drawn from other businesses.
- Of these five main re-definition areas, improving the Institutional Infrastructure in client states will have the widest and most beneficial impact on ODA effectiveness as well as boosting private financing.

We assess the IFI structural and project finance segments for their strategic performance and business by using only generic strategic and business process analysis tools to review these businesses. Our approach is, therefore, that of an “outsider” analysing the aid business. This analysis tends to reflect the main features of the industry, and some caveats need to be made:

- Diversity: There are significant differences amongst IFIs, and a uniform presentation of their operating ways does not do justice to some of them directly to the policies and institutional environment, which are themselves a product of the interactions between these clients and the IFIs. This analysis of the IFI business dynamics reveals that:

With these caveats, the key findings of our analysis are tabulated as follows:

### IFIs STRUCTURAL AND PROJECT FINANCE BUSINESS SEGMENTS
#### STRATEGIC PERFORMANCE ASSESSMENT

<table>
<thead>
<tr>
<th>Key business variable</th>
<th>Performance assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Market Characteristics</strong></td>
<td>Although a well-defined market, it appears to be mainly supplier-driven with little evidence of strong demand-side drivers in the overall shape of the business. A wide range of customer segments exists requiring multi-variable categorisation and management.</td>
</tr>
<tr>
<td><strong>Competition</strong></td>
<td>Notwithstanding some overlaps, the key providers operate almost on an oligopolistic basis and there is little effective competition in the business. Indeed, discussions are regularly under way to precisely define “territories” and avoid overlapping of mandates.</td>
</tr>
<tr>
<td><strong>Business Objectives</strong></td>
<td>Overall business objectives are mainly determined by the “suppliers”, and there is a regular failure to achieve publicly-stated targets. Some contradictory objectives co-exist at the same time.</td>
</tr>
<tr>
<td><strong>Products and services provided</strong></td>
<td>The key products have not been fundamentally changed in nature (rather “adapted” to the “perceived” priority needs). Although there is regular dialogue with the customers about their needs, there is little product “R&amp;D” to design new products driven exclusively by customer needs.</td>
</tr>
<tr>
<td><strong>Customer interaction</strong></td>
<td>Despite sector, strategy, and poverty alleviation papers etc, it is not a “consumer-led” business. This may be because customers have little interest in the product, or do not have the capability to lead as consumers.</td>
</tr>
<tr>
<td><strong>Marketing techniques</strong></td>
<td>Linked to the oligopolistic supplier situation, there is little “market research” and less knowledge of real customer needs per customer segment than prevails in other businesses.</td>
</tr>
<tr>
<td><strong>Operations</strong></td>
<td>Processing times are long and driven mostly by supplier’s “internal” considerations.</td>
</tr>
<tr>
<td><strong>Distribution</strong></td>
<td>Although re-designed and increasingly decentralised, key policy and operational decision making remains mainly centralised.</td>
</tr>
<tr>
<td><strong>Operating system and organisation</strong></td>
<td>The organisation structure is not fully transparent to customers or outsiders and is designed around internal objectives.</td>
</tr>
<tr>
<td><strong>Operating culture</strong></td>
<td>Operations appear “mono-lingual” in that there is a standardised industry speak which reflects the slow, somewhat bureaucratic operating culture and format- and process-driven operations</td>
</tr>
<tr>
<td><strong>Results</strong></td>
<td>An overall impression of surprise at a business that is supplier-driven, not very close to its customers, and which has developed an inward looking culture that does not encourage adopting business practices commonly found in other industries.</td>
</tr>
</tbody>
</table>
Our “outsider” status leads to some somewhat radical conclusions. Little that is commonly found in other businesses is recognisable in these development aid business segments. Instead, it appears to be a supplier-driven business that is somewhat removed from its customers and has developed a strong inward-focused culture. Although there has been change over past decades, these changes have not served to introduce techniques widely used in other businesses, but instead have mostly created adaptations in its own, inward looking culture. And it is difficult to know whether this amounts to successful strategic change or not.

Five recommendations emerge as the best way to re-design the operating processes of these segments in order to enhance their future growth and effectiveness. These are (a) strengthening the ‘demand side’ of the operations, (b) introducing more competition amongst IFIs, (c) enhancing product innovation and adaptation, (d) re-designing the business processes underlying the operating efficiency of the IFIs, and (e) improving the operating culture of the IFIs, as follows:

- First, strengthen the demand/customer side at the operating level. This needs various actions. One element is the development of the “clientele” in the use of the key business parameters and rules of the game so that they can function as an equal counter-weight to the suppliers (i.e. IFIs) in the business. This will require developing institutional capabilities in recipient countries on a grand scale, which will then allow many client LDCs to be more assertive in defining the development projects and programmes which they want, and also determining how, and from where, these should be financed. Another element is to create a “market research” line in the operating budgets of the IFI suppliers so there is an in-depth continuous programme of broad market research. Based on this market research, outright marketing strategies and roles need to be created. Another element is a re-design of distribution and organisation around customer processes, not internal functional disciplines. And perhaps the most important element is to develop multi-variable customer segmentation techniques that allow for detailed adaptations in products and operations per customer segment.

- Second, encourage competition amongst the providers of ODA. Notwithstanding the fact that ODA will be considered a “public good”, it is not necessarily true that it should be allocated and distributed by quasi-monopolies. To the contrary, the public good will be allocated more efficiently and effectively if there is some competition which leads to strategic differentiation amongst the IFI suppliers. Competition provides a yardstick to measure themselves against, it provides products and techniques to copy from competitors, it provides the incentive to develop strategic specialisation, and it provides an external disciplining mechanism for internal efficiency. Rather than campaigning for “public good” resources from “shareholders” to be allocated on an exclusive basis to a “few players”, competition should be welcomed and encouraged – within the geographic remit of each institution.

- Third, modernise and design customer-suited products. Research needs to be increased in order to design truly adapted financial and advisory products relevant to customers today and capable of replacing the dated project-finance parameters initially used in the 1950s. A product “R&D lab” could be considered, possibly to be “housed” in a leading IFI but operating autonomously.

- Fourth, step up efficiency. The long processing times that characterise the bulk of product delivery in the IFI business tend to turn off customers and reduce value added. Radical business process re-design is needed.

- Fifth, change the operating culture. This refers to the soft variables that characterise the way in which an industry does business, including elements such as customer responsiveness, processing methods and speeds, real decision processes (as opposed to written procedures), morale and initiative, innovation, etc. In many ways this intangible improvement is the most difficult to achieve, but it must be tackled in parallel with the other elements of the list, as it itself serves as the facilitating mechanism for achieving them.

This list is long and the question naturally arises; can these all be achieved at once, or are some more important than others? This is a difficult judgement, but in our view the most important priority is the further full development of the Institutional Infrastructure in client countries. Not only will this have the greatest impact in itself, but it will also have the highest “knock-on” effects in two ways:

- First it will help improve other aspects of the public finance ODA business. This will occur through strengthening the “customer-drive” and “customer-control” by developing the Institutional Infrastructure. This, in turn, will force a response by the IFIs and make other changes happen.

- Second, as also observed in Chapter 1 of this report, development of the Institutional Infrastructure should improve the volume and stability of private financing flows as these are determined in large part by policies and the business environment.

The key question then is: what is Institutional Infrastructure? This will be discussed in the next section.

### 2.1.2 Impact of Institutional Infrastructure

The “Institutional Infrastructure” of a country can broadly be defined as the business framework and its operations. This in turn has a number of components covering about 8 major areas, including but not necessarily limited to:

- Political System (democracy)
- Legal Framework
- Financial system (including Central Bank independence and regulatory)
- Corporate Governance (comprising the crucially important concepts of corruption, ethics and governance)
• Trade, customs and competition
• Employment and labour skills
• Infrastructure services
• Media (embracing the important concept of information and public scrutiny through transparency)

It is widely acknowledged that these areas are essential pre-conditions for successful development and various similar notions have been promoted in previous calls for development aid reform. The “enabling environment” concept had a similar though not identical perspective, and the more recent 2002 World Development Report deals broadly and deeply with many aspects of the same theme.

But, in terms of improvements, identification of these 8 broad areas is not enough. A finer set of action areas must be distinguished in order to create a programme that can develop the Institutional Infrastructure. In our view, for each of the 8 areas, there are three distinct dimensions that need to be “right”. They are:

• The policies
• The institutions
• The management of operations

For example, the financial system policies are enshrined in its laws and regulations (e.g. the Banking Act etc). Its institutions comprise the supervisory authorities and banks, insurance companies etc. Finally, its management of operations comprises many aspects, such as the ability to reliably transfer funds from one account to another in 2 working days (or less). Another example could relate to the legal framework. Here the policies are the approved laws, such as the Commercial Code, or Property law. The institutions comprise the judiciary, i.e. the courts and their professional standards and skills. The management of operations comprises practical aspects such as being able to claim title to an item of real estate in a fast 3-month claims procedure, or being able to clarify rights of minority shareholders in a commercial dispute in a streamlined 4-month process. These policy, institutional and operational management processes are therefore all important in determining the overall effectiveness of the Institutional Infrastructure.

The Institutional Infrastructure of a country comprises the following matrix:

<table>
<thead>
<tr>
<th>Definition of Institutional Infrastructure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policies</td>
</tr>
<tr>
<td>Political System</td>
</tr>
<tr>
<td>Legal framework</td>
</tr>
<tr>
<td>Financial system</td>
</tr>
<tr>
<td>Corporate Governance</td>
</tr>
<tr>
<td>Trade and Competition</td>
</tr>
<tr>
<td>Employment &amp; Labour</td>
</tr>
<tr>
<td>Infrastructure services</td>
</tr>
<tr>
<td>Media</td>
</tr>
</tbody>
</table>

There are a number of important hypotheses and general observations relating to this broad concept of Institutional Infrastructure:

First, unless all three aspects – policy, institutional and management of operations – work well for each broad area of Institutional Infrastructure, the area will “fail” in its ability to deliver what ODA and private investment requires from it. So policies, institutions and management of operations are all important and it is not enough to have one or two of the three at acceptable, recognised, international standards – they all need to be there.

Second, in general the policies and institutions aspects have received more effort, attention and technical assistance than the third area – management of operations – which has been neglected in relative terms. Given the interdependence and need for all three aspects to work well before the area will deliver what is needed, this implies that much of the investment in new laws and institutional strengthening is wiped out by the relative failure of operational management. For example, it is of relatively little value if there is a “good” Commercial Law if the judicial system for implementing it fails to operate to adequate levels of competence, and independence. This also implies that the last column in the matrix is where the bulk of future effort should be made.

Third, there is simultaneously an interdependence, but also a sequence of priorities in the 8 Institutional Infrastructure areas. They all need to be up to required standards, or else failings in one or two areas could destroy the achievements in others. That is the interdependence. Yet at the same time it is fair to say that for development aid to be successful it will rely on the Institutional Infrastructure areas in the approximate order of priority indicated in the matrix.

So this is the full breadth of the Institutional Infrastructure concept, and it is indeed broad as acceptable, recognised, international standards need to be achieved in 24 different areas. There are two implications for development aid of achieving acceptable, recognised, international standards in Institutional Infrastructure.

The first concerns the changes in behaviour and performance by the beneficiaries, or client countries.

• It is expected that client countries will develop more in-depth skills to independently formulate their pipeline of projects and adjustment programmes. This should mean that the selected projects/programmes reflect their own priorities and needs more convincingly, and generate higher commitment. At the same time the project/programme specification will be at full
always channelled funds to opportunities promising aid on the basis of need, the private sector has financing. Indeed, while IFIs have typically disbursed
Finally, improvements in I.I. should play an
And all these trends should result in a higher supply of ODA development finance. This will be in reaction to a chain of events comprising better project formulation and higher commitment to certain projects, which in turn enhances project/programme implementation quality, and thus achievement of objectives. This enhances “consumer power” and promotes the ability to shop for ODA funds, which in turn will lead to more differentiation and efficiency amongst the IFIs. That should help convince the donor community and markets to provide more funds to the IFIs.

Finally, improvements in I.I. should play an important positive role in attracting private financing. Indeed, while IFIs have typically disbursed aid on the basis of need, the private sector has always channelled funds to opportunities promising the most attractive risk/reward trade-off. In doing so, private investors have always, and will continue to, assess the enabling environment of recipient countries. Achieving internationally recognised standards of I.I. will clearly have a very favourable impact on this assessment - thus likely to pave the way for greater and more stable flows from the private sector.

2.1.3 Institutional Infrastructure and long-term issues

As argued in the previous section, building the Institutional Infrastructure in recipient countries will address the problems highlighted in our structural analysis of the aid industry. Beyond this, however, we believe that Institutional Infrastructure will go a long way in addressing the long-term issues outstanding in the aid business, raised in section 1.3.3 – namely the fungibility of aid, indebtedness, corruption, private sector financing, and trade.

Fungibility of aid: Greater institutional capacity will translate into an enhanced ability to allocate resources effectively to the highest impact projects, thus maximising the effectiveness while minimising the administrative costs of aid. The combination of appropriate policies, independent institutions and world-class management will enable the recipients of aid to identify and assess suitable projects, manage implementation, and funnel support from the suppliers of aid.

Debt: A stronger Institutional Infrastructure, particularly in the financial sector, will better position a recipient country’s access to international debt markets, through a legal framework that protects creditors, greater sophistication and understanding of available products and better transparency for debt analysts. While stronger I.I. may not fully tackle the problem of the current debt overhang, it will significantly curtail the risks of excessive future indebtedness, given a greater appreciation of the potential risks.

Corruption: The role of institutions in tackling corruption has been documented in numerous studies, as described in Chapter 1. A stronger legal framework, independent institutions, open (and critical) media and the resources to investigate allegations will all contribute to address levels of corruption.

Private sector financing: I.I. will provide the basis for developing efficient capital markets and a stronger financial system to channel resources to the most appropriate projects. In doing so, it will create the conditions for attracting and retaining FDI.

Trade: We leave the discussion regarding trade until last as it is likely to be the only issue for which improvements in I.I. will only have a partial impact. To a certain extent, stronger managerial capabilities will result in a more robust and sophisticated bargaining position in future trade talks. There remain, however, broader political factors that are likely to have a far greater influence on the course of negotiations on trade. This issue is discussed more extensively in Chapter 3.
Public aid agencies recognise that adequate institutional capacity in LDCs is a must and are providing assistance to improve the policy and general institutional environment in the LDCs. Also, providers of private capital have favoured countries with a more effective policy and institutional environment. But little has been done to define the essential operational capabilities of the institutions concerned.

The next step of the study was designed to test the validity of these general conclusions against the record of 8 specific countries. More specifically, the objective of the country studies was to analyze in the field and for a selected number of countries:

(a) the components of the I.I. matrix and their importance and “alignment” (or lack thereof), test the correlation between effectiveness in the use of public and private aid funds in the country and the I.I. components, particularly adequate management capacity at the institutional level and
(b) what are the main issues faced at the level of the management of the operations of institutions relevant to aid implementation and the kind of actions/solutions that could be envisaged to improve these implementation difficulties.

This ambitious objective has been adapted to the budget limitations and to the resulting need to: (i) limit the scope of the countries to a “representative” sample of countries, (ii) focus the functional coverage of the country studies to the main aspects of the I.I. matrix, and (iii) centre this analysis in the institutions and issues that have a direct impact in the operational efficiency of the aid activities in the country. Each of these aspects is presented below.

### Country selection

The aim has been to use the following broad criteria:

- limit to eight the countries to analyse as this provides a large – yet manageable enough – sample to allow for a minimally-in-depth analysis per country
- to have a “mix” of two cases per major LDC continent (Africa, Asia and Latin America) one relatively successful and one unsuccessful, plus one each – in Middle East /North Africa and Central and Eastern Europe.
- to select countries that are not outliers (i.e.: GNP per capita compound rate of above 10% p/a, or below 2.5% in the last 30 years, as illustrated in Exhibits I.23 and I.25 in Chapter I). The countries chosen, therefore, have experienced some modicum of progress in the development of their economies in the last 30 years.
- to define “successful and unsuccessful” cases within the above group using “soft” criteria resulting mainly from the country’s more recent evolution particularly in the area of economic and institutional reform i.e.: countries where such reform programmes have taken place are deemed more “successful” than others where they have not.
- introducing one “small” and one “large” country, in population terms, in the sample with the other six having populations between 15 and 40 million.
- considering countries that have been beneficiaries of aid resources to varying degrees i.e.: from high dependence to low reliance – given other resources available to them – and everything in between.

As a result of these criteria, the countries chosen for the studies are:

<table>
<thead>
<tr>
<th>Population Million</th>
<th>GNP per capita growth (1)</th>
<th>Reform Performance54</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ivory Coast</td>
<td>16.4</td>
<td>2.9%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>22.2</td>
<td>7.2%</td>
</tr>
<tr>
<td>Morocco</td>
<td>28.5</td>
<td>4.9%</td>
</tr>
<tr>
<td>Pakistan</td>
<td>141.1</td>
<td>5%</td>
</tr>
<tr>
<td>Peru</td>
<td>27.4</td>
<td>4.4%</td>
</tr>
<tr>
<td>Poland</td>
<td>38.6</td>
<td>3.5%</td>
</tr>
<tr>
<td>Trinidad &amp; Tobago</td>
<td>1.3</td>
<td>5.8%</td>
</tr>
<tr>
<td>Uganda</td>
<td>24</td>
<td>2.8%</td>
</tr>
</tbody>
</table>

(1) Compound rate 1973 - 1999

Focus of I.I. analysis in each country study. Five of the eight elements of the institutional infrastructure listed as forming the I.I.55 matrix were considered as being priorities to carry out the evaluation in each country:

1. The Political System
2. The Legal Framework
3. The Financial System
4. Corporate Governance
5. Trade and Competition

54 Ingoing assessment based on IFI analysis of reform programmes, which encompassed a broad range of criteria, beyond economic growth.
55 The full list included also Media (communications /information), Employment and the labour market, and Infrastructure services. It is arguable that there might be others with significance influence in a country’s Institutional infrastructure, i.e., for instance, the importance of a Civil Society, and its impact on policy design, prioritization and implementation, and the Education System.
Each element was assessed in terms of the following three basic questions:

1. Is the “policy” framework in place? This includes laws, rules and codes of conduct to achieve the desired outcomes.

2. Are there organisations in place to administer and enforce the rules? Given the time and budget constraints, the country analysis focused on a few key institutions as a proxy for the entire I.I. selected in each case according to the local situation and peculiarities and by applying three basic criteria: simplicity, relevance and comparability.

3. Are these organisations effectively managed? Here we looked at how well, in practice, they carried out their assigned role.

The scope of the analysis can be summarised in the following matrix:

<table>
<thead>
<tr>
<th>Policies</th>
<th>Organisations</th>
<th>Management</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Political System</strong></td>
<td>Does the Constitution (written or not) provide an effective and stable basis for the exercise of political power?</td>
<td>Are the political institutions effective and democratically responsive?</td>
</tr>
<tr>
<td><strong>Legal Framework</strong></td>
<td>Do the laws of the country provide an effective and stable basis for settling disputes (particularly regarding commercial activities)?</td>
<td>Is the court system soundly established? Including staffing by qualified judges.</td>
</tr>
<tr>
<td><strong>Financial System</strong></td>
<td>Do the rules (laws and regulations) provide a sound basis for the development of a sound (a) banking system and (b) capital markets?</td>
<td>Are the regulatory institutions (Central Bank, SEC, etc.) soundly established? Mandate, staffing, etc.</td>
</tr>
<tr>
<td><strong>Corporate Governance</strong></td>
<td>Are there adequate rules defining the application of the Principles of Corporate Governance?</td>
<td>Are there organisations in place to administer and enforce the rules?</td>
</tr>
<tr>
<td><strong>Trade and Competition</strong></td>
<td>Do the rules (laws and regulations) provide a basis for open access and competition in all sectors of the economy?</td>
<td>Are there organisations in place to administer and enforce the rules?</td>
</tr>
</tbody>
</table>

Country reports and fields visits. These assessments have been based on a combination of rigorous research/desk analysis and field visits to each country. The detailed work plan listing, per topic, the key issues/information required, the research source to use and the field work visits to undertake are presented in Volume II. They present the methodology used to carry out the analysis required to achieve the objectives defined in the ToRs.

We have summarised the conclusions of these analyses in two scorecards per country studied covering:

- Overall Institutional Infrastructure Assessment, and
- Institutional Infrastructure: Management

In each case and for each item forming the Assessment, we have rated the performance of on a scale from 1 i.e.: “Fundamentally Unsound” to 6 i.e.: “Consistently good”. Models of these two scorecards are attached in Volume II. These ratings, based on our best professional judgement of the situation in each country, provide a quantitative basis for inter-country comparisons and testing the general validity of our overall conclusions.

Each country report has three parts:

1. Development Performance, summarising the main aspects of the country’s development performance mainly in terms of
   - Economic performance
   - Development Aid
   - Poverty reduction
   - Relative performance compared with other LDCs
   - Role and impact of NGOs

Five of the eight elements of the Institutional Infrastructure listed as forming the I.I. matrix were considered as being priorities to carry out the evaluation in each country: the political system, the legal framework, the financial system, corporate governance and trade and competition.
2. Evaluation of Institutional Infrastructure in the country; Policies, Institutions and Management of:

- Political System
- Legal Framework
- Financial System
- Corporate Governance
- Trade and Competition

3. Conclusions: The final section of each country report highlights the major distinguishing features of the I.I. and assesses its overall quality. The detailed country studies are presented in Volume II of this report.

### 2.2.2 Overall findings

Our detailed, “bottom-up”, assessment of 8 countries shows a marked difference in the quality of their Institutional Infrastructure, based on a scale ranging from 1: “Fundamentally Unsound”, to 6: “Consistently Good”.

The full scorecards are presented at the back of this section. Exhibit II.2, below, illustrates how only three countries, Malaysia, Trinidad & Tobago, and Poland have overall assessments above the average of 3.3. The first two constitute the only cases where existing Institutional Infrastructure can be considered clearly “satisfactory - good”, with Poland moving towards “satisfactory” whereas Peru, Uganda, Pakistan, Morocco and Ivory Coast assessments can only be described as between “inadequate and unsatisfactory”. Admittedly the scores reflect the fact that the sample was weighted (a) towards lower income countries and (b) deliberately included the same number of failures as of successes.

We have benchmarked the ratings of ‘successful’ against ‘unsuccessful’ countries in each of the major LDC regions. Exhibit II.3, below, shows the differentials in the ratings obtained between Uganda (successful) and Ivory Coast (unsuccessful); Malaysia (successful) and Pakistan (unsuccessful); and Trinidad (successful) and Peru (unsuccessful).
This provides some empirical confirmation of the connection between the quality and solidity of a country’s Institutional Infrastructure with its development performance, which is the theme established in Chapter 2. Furthermore, in both Africa and Asia, the biggest differentials are encountered in the management ratings, which also underscores how effective management is a key distinguishing feature of the successful reformers.

As illustrated in Exhibit II.4, these differences in management ratings are generally consistent across all 5 categories – the political system, legal framework, financial system, corporate governance and trade & competition – with two exceptions:

(i) The differential in favour of Ivory Coast vs. Uganda on the Management of its Corporate Governance is due to the very weak capabilities in that area existing in Uganda.

(ii) The same happens in Peru in the area of Trade and Competition compared with Trinidad and Tobago given the relatively high level of capabilities in that area in Peru (including in the customs area), an anomaly in the country.

More generally, our management ratings are systematically below the overall ones for all of the countries studied. This reflects the general “dysfunction” between the I.I.'s “set-up” (as defined by the rules, regulations and the structure of the five elements forming the I.I. of the country), and the operating management performance of this “set-up”, including implementation capacity and results, to “do” things as they are supposed to be done. Indeed, our overall rating is - at 3 - rated as “unsatisfactory” for the eight countries as a whole. In summary, we are confident that our ‘on the ground’ analysis of 8 countries provides a sound basis for arguing that Institutional Infrastructure can, to a significant extent, explain the different levels of effectiveness of aid.

We are confident that our ‘on the ground’ analysis of 8 countries provides a sound basis for arguing that Institutional Infrastructure can, to a significant extent, explain the different levels of effectiveness of aid.

2. In assessing rules, structure and operating management in each of the five areas we have not assessed the value, or otherwise, of reform programmes envisaged, recently announced, or under way. This is because our assessment should be based on facts rather than on declared intentions, irrespective of their solidity, inherent value, or consistency with objectives. This means that, in some cases, if one were to have scored the contents of these reforms, it may have scored them higher – or lower – than what we actually did. However, our objective in the country studies is basically to find explanations as to why things have or have not worked. This can only be done on the basis of what exists, has happened, and why, not by trying to assess the quality of reform programmes underway or their likelihood of success.

3. The scorecards give equal weighting to each element in the I.I. matrix. This reflects our belief that every item in the matrix needs to be up to required standards, and that failings in one or two areas could offset the achievements in others.

4. It could be noted that the two countries that come on top in our I.I. assessment - Malaysia and Trinidad and Tobago - are “petroleum economies”. Indeed, this is true but what the evolution of these two countries, when compared with others as petroleum rich if not more than them, like Nigeria, Venezuela, etc., shows is that what matters is how these resources were used, not just simply having them. Our point is that the “good” effective resource utilisation can only take place if the adequate Institutional Infrastructure is built, and that has been the case of Malaysia and Trinidad and Tobago.

2.2.3 Country-based findings

While the numbers support the thesis that I.I. is an important driver of effective development, the argument is brought to life by a qualitative, case-by-case discussion of the 8 countries reviewed. Each
Each country study, of course, tells a unique story, and these are captured in some detail in the Country Studies, presented in Volume II of this report. However, for the purpose of supporting our thesis, we have categorised our case discussions into three groups:

a) Malaysia – a potential “role model” for other LDCs, and the most compelling case example of the impact of I.I. on development.

b) Poland and Trinidad & Tobago – the “strong runners-up”. These countries have developed a strong Institutional Infrastructure, but have been held back from achieving their full potential by gaps in management capacity.

c) Ivory Coast, Morocco, Pakistan, Peru and Uganda – the “missed opportunities”. These countries have failed to meet their development objectives, despite significant aid flows, because of significant gaps in their Institutional Infrastructures.

**a) The Malaysian Role Model**

Malaysia's development performance has been an unqualified success. Following its initial years of independent economic development based on a “laissez-faire” export-oriented agricultural economy, in the last 30 years Malaysia's GNP per capita has increased tenfold to around $3,600. This underpins an overwhelming and impressive economic success story supported by, at least, four overall reasons:

- A broad selection of macroeconomic indicators shows strong to very strong performance in all, with GDP growth averaging 7% per annum during the last 30 years, unemployment at 3.1% in 2000 and annual inflation down to 1.6% in the same year. Export-led growth results in balance of payments showing a healthy current account surplus throughout, to an equivalent to 10% of GDP in 2000 and foreign reserves equal to 52 months imports.

- Poverty eradication has been achieved with the proportion of households below the poverty line dropping from almost 50% in 1970 to about 7.5% in 1999, and a target of 0.5% by 2005 on track. Most social indicators have been consistently improving since 1980 and they compare favourably with other selected Asian countries.

- Public sector finances have been prudent for most of the period and the rate of national savings is high (mostly above 30% of GDP) and has outstripped investment in recent years. National development expenditures on the social sectors (education, health and housing) have increased from 24.8% in the 1986-90 to 34.1% in the 2001-2005.

- The trade structure has been transformed from an agriculture/extractive economy (43.2% of GDP in 1970) to a manufacturing and services one (81.4% of GDP in 2000) with a dramatic shift in the composition of exports from an overwhelming natural resources one in 1970 to 85.5% from manufacturing today.

This success has been achieved by applying an independent and pragmatic development model - Malaysia's own - which has been largely self-financing and which is tailored to the real needs of the country rather than representing a wholesale adoption of standard recipes provided by outsiders. This is a powerful illustration of the thesis developed in section 2.1.2 – that structural shortcomings in the ‘supply’ of aid can best be addressed by reforms on the ‘demand’ side. This development model displays four distinctive features in Malaysia:

- It shows strong elements of being “demand driven”, in that it exercises consumer choice and rejects those products and services of the international development model that do not suit its objectives.

- It has used little official finance/aid in the implementation process – official aid represents less than 1% of GDP throughout the entire 90s – relying instead on private capital flows, and especially FDI, for its international funding. Annual net private capital flows averaged $7.9 billion in the 90s compared to $3 billion during the 80s and an already substantial $1.7 billion in the 70s.

- It does not constitute a standard recipe or ideology. It applies instead a pragmatic collection of tools to suit specific objectives corresponding to realities, but which do not add up to a consistent policy ideology as generally understood. It has to be said that these policy “inconsistencies” are often of a temporary nature and are designed to steer the country through a difficult period or achieve other adjustments.

- It has responsiveness to the lessons of setbacks and openness to improve further and deal with strong cyclical and structural challenges, which should set the stage for further innovation in the next decades of economic development.

Doubtless, one reason for Malaysia's strong economic development performance is the attractive natural resource endowment that the country enjoys (i.e.: rubber, tin, palm oil, timber, petroleum) as well as a strong human resource base and its strategic geographical location at the crossroads of important trade routes and maritime connections. But other countries with similar, or better, resource endowment have failed to fuel the engine of economic development. It is not a matter of simply having natural and human resources, it is a matter of how they are deployed. Here Malaysia has excelled: it is the high quality management of the economy and solidity of its Institutional Infrastructure that provide the main explanation of its economic success.

Our assessment of Malaysia's Institutional Infrastructure as presented in the overall scorecard shows a rating of 4.6, the highest of the eight countries studied, with the Management Scorecard ranked similarly as befits the high quality management that the country has been able to enjoy and develop. The key considerations of our

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56 Indeed, Malaysia is not an exception to the dramatic fall in FDI experienced in all LDCs in 2002: it has declined from M$ 18 billion in 2001 to M$ 2.2 billion in the first six months of 2002.
assessment could be encapsulated in the following five key elements:

(i) Political Framework and Public Administration
Malaysia enjoys a democratic political system providing stable governments that are prepared to take tough decisions combined with a high quality public administration to achieve effective implementation of its policies.

It is frequently acknowledged that the British left behind an efficient administrative system, which independent Malaysia subsequently proceeded to build upon. Today, the public administration machinery is a professional civil service with a highly developed set of rules and structure. There are extensive regulations, and institutions at several levels are of several types: the federal institutions, state and local, and the administration branch and implementation agencies. In all there are around 900,000 people on the state payroll in these numerous public bodies. The Auditor General exercises financial control, the Malaysia Administrative Modernisation and Management Planning Unit (MAMPU) exercises operational control, and the National Institute of Public Administration (INTAN) is responsible for training and development.

While the rules and structure of the political framework and the public administration are extensive and sophisticated, it is the operational management that has some impressive features which provide interesting lessons:

- The public administration is managed tightly on aspects that boost its operational effectiveness. Many of these measures, such as mandatory training, ISO 9000 accreditation, service charters, exchange programmes and anti-corruption initiatives are implemented by INTAN.

These aspects provide some indication of the high levels of efficiency and effectiveness in the operational management of the public administration. Not all these aspects are unique to Malaysia, and indeed some of these principles are also found in most OECD countries. But overall they illustrate the general notion that “things work” and Government is aware that it needs “to improve further”. This includes spending to improve; investing in IT, investing in training, investing in new facilities etc.

While the force of democratic process is an important background for a well functioning Institutional infrastructure, it is not an integral part of it – and is hence not a core focus of this study. We would argue that Malaysia’s track record in delivering growth and stability to date – i.e. of increasing the “size of the pie” – has been impressive. As illustrated by Exhibit II.5, below, the Bumiputra share of corporate equity ownership has increased from 2.4% in the 1970s to 19.1% by 1999, primarily at the expense of foreign investors, whose share has declined from 63.3% to 32.7%. More importantly, the total market capitalisation has increased from RM 5.2bn to RM 310bn. This should provide a basis for drawing lessons for other countries, but does not guarantee success in the future.

(ii) Macro-economic management
Malaysia has an unusually pragmatic, hands-on, economic management process that is business-like and open, puts a strong emphasis on communications and information, and is able to effectively combine sophisticated planning techniques with an open economy market mechanism.

The rules and structure of the macro-economic management machinery comprise the normal key

| CORPORATE EQUITY OWNERSHIP (% TOTAL) |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Bumiputra (indigenous) | 2.4 | 30.0 | 19.93 | 20.6 | 19.1 | 12.3 |
| Other Malaysians | 32.3 | 40.0 | 46.8 | 43.4 | 40.3 | 10.5 |
| Chinese | 27.2 | 45.5 | 40.9 | 37.9 | 10.0 |
| Indians | 1.1 | 1.0 | 1.5 | 1.5 | 18.0 |
| Other | 4.0 | 0.3 | 1.0 | 0.9 | 29.9 |
| Foreigners | 63.3 | 30.0 | 26.4 | 27.7 | 32.7 | 15.6 |
| Nominee | 2.0 | 8.5 | 8.3 | 7.9 | 11.4 |
| TOTAL (% Total) | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| TOTAL (RM bn) | 5.2 | 108.4 | 179.8 | 310.1 |

- There is significant innovation and a commitment to reform and improve in many areas of Government, as evidenced by significant IT investments, and a clear willingness to reduce red tape.
- The financial structure of Government contains some practical checks and balances which boost the operational management of the entire government machinery, such as the separation of revenue collection and spending, and the maintenance of competition for funds based on performance.

It is not a matter of simply having natural and human resources, it is a matter of how they are deployed. Here Malaysia has excelled: it is the high quality management of the economy and solidity of its Institutional Infrastructure that provide the main explanation of its economic success.
Government ministries, such as the Ministry of Finance, but with several important additions.

The first feature is the widely quoted and sophisticated economic planning system. This comprises long-term planning (20-30 year strategic visions and targets e.g. “Vision 2020”); medium-term planning (five year development plans and reviews); and short-term planning (the annual budgets).

Second, the planning system is driven by several specialist institutions and groups, of which the key player has been the Economic Planning Unit (EPU) of the Prime Minister’s Office. It has a permanent specialist staff that conducts the necessary analysis and provides several important committees and inter-agency groups with the required reports for decision taking. Since 1998 the National Economic Action Council (NEAC), which was initially charged with crisis management, has been added as an important senior group providing inputs on longer-term strategic aspects to the planning process.

And third, as an over-arching concept, the macro-economic management is driven by “Malaysia Inc.”, which basically views the country as a business and has a number of working committees promoting aspects of that business. The rules and structure of this planning framework are possibly the most elaborate of any market economy nation, but it is the operational management of this macro-management framework that has the really interesting features which provide important lessons:

- The management of the planning process provides a number of important benefits – such as guidance and information, a strong sense of purpose, and close and intensive consultation between the public and private sector – that feed directly into the impressive economic performance of Malaysia.
- The control of implementation associated with the planning process is another important advantage of this macro-management tool. The ADB has also commented favourably on Malaysia’s capacity for implementation, quoting in its country assessment report; “Overall, ADB’s post-evaluation experience in Malaysia has been favourable”. First, project implementation is usually left to specialist agencies and authorities. Second, implementation is controlled and monitored by the Implementation and Co-ordination Unit (ICU) that evaluates progress.
- The planning process is also an effective vehicle for launching new initiatives. One prominent example of this is the several initiatives driven by the National Information Technology Council (NITC), which is building on the Multi-Media Super Corridor (MSC) and driving a wide range of programmes to promote the spread of technology amongst different community groups.

(iii) Financial system

Malaysia’s financial sector has responded to past shortcomings and is being swiftly restructured adopting many aspects of international best practice.

At first sight, the rules and structure of the financial system look impressive. But in fact the operational management of the sector reveals a number of severe issues. In order to obtain a realistic picture, it is necessary to separate the pre-1998 crisis period from the more recent 3-4 year period.

The pre-1998 period was characterised by three major problems which came to a head in the crisis. The first problem was significant institutional fragmentation in the sector, which in turn triggered numerous other operational weaknesses in financial institutions which were basically too small. The second issue related to over-heating and inadequate risk management, which lead to non-performing loans reaching around 20% of total banking assets before deducting interest in suspense and specific provisions. This problem was concentrated in the construction and real estate sectors, as well as lending for the purchase of securities. And a third issue, closely linked to the first two, was that financial sector supervision did not yet include all financial institutions, so there were several un-regulated development finance institutions etc.

But what has happened over the last 3-4 years, post-crisis, is more relevant to an assessment of the operational management of the Malaysian financial sector. On the whole, the actions and planning of remedial re-structuring have been impressive and together read like a thorough analysis of world-class benchmark targets and actions. Although implementation is still underway and it is premature to evaluate many of the results, some of the positive aspects of recent action include:

- BNM, the central bank, has developed a “Financial sector master plan; building a secure future” that is truly masterly56. It reads like a textbook containing all the right actions and objectives over a wide range of financial sector issues. It defines the vision, details the consolidation process which is envisaged57, lists a wide range of operational improvements banks are expected to achieve, opens up the sector by allowing foreign banks greater operational scope, and increases the supervisory net to include non-bank financial institutions. Similar objectives are set for the insurance sector. Both the banking and insurance sector restructuring will be achieved in three phases.
- For the capital markets a high quality “master plan” also exists that the Securities Commission has developed.
- Through the operations of Danaharta and Danamodal, two specialist institutions set up to deal with the bad debt problem and required re-capitalisation, the non-performing loans problem is being tackled quite aggressively.
- All this has happened quickly and with top-level attention to ensure that implementation is rapid.

57 The documentation and analysis produced by BNM is first class. The institution has been rated the second most operationally effective central bank of emerging markets by a US research company.
58 The target is to move to 10 domestic banking groups each comprising a commercial bank, an investment/merchant bank, and a finance company.
and effective, at least in comparison with other countries attempting to do similar things. So by end-2000 capital adequacy ratios were around 12.4% on average and have remained at those levels. In the words of the ADB: “Malaysia has made considerable progress in financial sector restructuring”.

- But some crisis-management measures are still in place that will need to be reviewed for the financial sector to flourish again, such as the selective capital and currency controls. There is now some debate on their relaxation.

Overall, the financial sector recovery plan and the first achievements under that plan are impressive. But there is still a long road to travel and the three phases of the master plans need years to be completed.

(iv) Competition and trade
Malaysia has a highly driven competition and trade structure at the international level that has fuelled economic growth notwithstanding the – normally temporary – existence of some subsidies and other distortions.

The rules and structure of competition in Malaysia are dominated by extensive consumer protection legislation which is considered to be best-practice standard, and on an international scale by the World Trade Organisation and complies with its requirements, and Malaysia will also be a founder member of Asia Free Trade Association (AFTA) which is in the process of establishment.

The operational management of the competition structure suggests that the general trend is to boost the competitive “openness” of the Malaysian economy. Some of these measures are quite recent and include:

- Reductions in tariffs
- A liberalisation of the financial sector, with prospective greater freedoms for foreign banks (see section (c) above)
- Relaxation of foreign equity ownership restrictions

(v) Corporate Governance
Like the financial sector, a review of governance should be split into the pre- and post-crisis period.

The pre-crisis period before 1998 has not been reviewed for this report. However, the reforms in governance practices after the crisis were triggered by the shortcomings of the system that prevailed before. This included accusations of inadequate disclosure, cronyism in top job appointments, and areas of insufficiently defined standards.

But governance in the post-crisis period is more encouraging and headed in the right direction. The actions are largely based on the Finance Committee on Corporate Governance report of March 1999 and comprise three thrusts which affect the “rules, structure and operational management” of governance and standards:

- Transparency and disclosure are to improve
- Codes and acts are to be reviewed
- Institutions are to be more pro-active and effective

In order to give some teeth to these measures, the Securities Commission (SC) has restructured its enforcement department and placed greater emphasis on corporate compliance with assistance from the Attorney General’s office. The SC reports non-compliant corporate activities to the Attorney General who holds the power to prosecute. The powers of the KLSE have also been strengthened considerably following the Securities Commission (Amendment) Act in 2000. Moreover, in 1999, the KLSE introduced a memorandum on merger and acquisition rules designed to improve transparency in the business conduct of stockbroking firms.

With this broad array of new measures and new institutional powers and responsibilities, as well as with the compulsory director’s training courses at the Securities Commission, it can confidently be expected that corporate governance and standards are improving and will improve further. With a little more time, these improvements - in transparency, disclosure, compliance control, corporate reporting, accounting standards, minority shareholder’s rights and creditor’s rights - will filter through to improve the overall quality of business decisions and investor confidence.

However, the process needs time. New institutional responsibilities need to be properly resourced and generally need to “find their feet”. In addition there needs to be real “will” to ensure that the appointments to top jobs are based on merit; those performing poorly need to be removed and new appointments should be based on proven credentials for the task. There will be a time gap between achieving an improvement in governance standards and others perceiving that this is truly a reliable improvement. During 2001, Malaysia...
appeared to be exactly in that time gap as international investors (e.g. ING Barings, Morgan Stanley) reduced their Malaysia weightings. Failings in corporate governance practices were still cited as the main reason based on the continued perception, lagging behind changes in the reality, of shortcomings in corporate governance.

(iv) Commercial law and stability
The rules and structure of the Malaysian courts resemble those of England. Laws are both written (the Constitution and the acts passed by Parliament) and unwritten (i.e. like “common law” as practised in England). Islamic law applies to Muslim citizens with respect to personal status matters.

The subordinate courts comprise the magistrate and sessions courts, and there are three superior courts; two High Courts for peninsular Malaysia and the states of Sabah and Sarawak, the Federal Court (formerly Supreme Court) and the Court of Appeal\(^6\). There is also an Attorney General, and the three legal “roles” found in Malaysia are that of lawyer, notary public and commissioner for oaths (again resembling the system in England).

The review of the legal system is restricted to its commercial aspects, which are most relevant to the issue of economic development. No comments are therefore made on various international accusations levelled at the “independence” of the Malaysian court system\(^7\).

The operational management of the commercial aspects of the law prompt the following observations:

- Through tough laws and penalties, social stability and “law and order” has been high. This has provided a welcome environment for business, especially considering the less stable situations prevailing from time to time in other Asian countries.
- Although time consuming, interviewees did not comment adversely on foreclosure on collateral title, nor on commercial dispute resolution. If anything, there were signs of recent improvements and “title” was usually clear.
- The International Centre for Commercial Law comments that “While foreign investors do not relish the prospect of going to court in Malaysia, their view is generally that the legal system does not present a problem to entry and that it offers a satisfactory level of protection”.

b) The “strong runners-up”
Poland and Trinidad & Tobago share similar attributes in that both countries have broadly sound Institutional Infrastructure – particularly in terms of rules and policies, and in terms of institutions – and both have enjoyed generally successful economic development. However, both countries fall short of their full potential because of insufficient management capacity. Poland can, generally speaking, be considered a success story created in a short 10-year period. However, its development has not reached all parts of society mainly because of management constraints at the public administration level, which are also beginning to undermine the ability of the country to absorb EU funds effectively. In Trinidad & Tobago, poor implementation capabilities due to patronage and under-resourcing have undermined the country’s ability to effectively tackle poverty. Both examples illustrate how insufficient management capacity can undermine an otherwise strong Institutional Infrastructure.

Poland – the EU ‘magnet’ as an engine for wealth creation
Poland’s growth record has been impressive. After an initial contraction of the economy following its transition to a market economy in 1990, and with the blueprint provided by the unprecedented economic reform plan known as the Economic Transformation Programme, the country has seen a remarkable period of unbroken growth with GDP averaging 5% per annum since 1992. This decreased marginally to above 4% since 1999 as a result of the fallout from the Russian crisis and the slowdown in EU demand. The reforms which fuelled this growth record were driven by the rapid expansion of the new private sector, which today, generates 70% of GDP. External debt which was at the crisis level of 63.7% of GDP at the beginning of the transition period decelerated annually to reach 35% in 1999. This was helped by agreements reached with the official creditors in the Paris Club in 1999 and with private creditors in the London Club in 1994 that included generous forgiveness packages. As a result, Poland returned to the international capital markets in the mid-90s, with Standard and Poor’s raising their sovereign debt rating for Poland to BBB+ in 2000. Foreign trade in Poland was very limited before the implementation of the Economic Transformation Programme. In spite of its three fold growth in the decade, it remains low compared to Central and Eastern European countries with similar levels of development (Poland’s exports represent 19% of GDP in 1997 compared to 47% in the Czech Republic and 55% in Slovakia).

Official Aid played an important role in the early stages of the reform period, helping the country to initiate economic reforms and to set up the infrastructure to attract private investment. Yet aid as a proportion of GDP has hovered in the 1-3% range and followed a declining trend in the second half of the decade, when net private capital flows – averaging a significant $ 5.6 billion per year during the 90s – escalated significantly. Net private capital flows increased from 0.1% of GDP in 1990 to 6.7% in 1999, largely driven by FDI. However, aid institutions had a significant role in promoting reforms in all sectors and are now focused exclusively on supporting Poland’s access to the EU in 2003 by helping the country meet the Accession criteria (the “acquis communautaire”).

However, this growth has not reached all parts of society, particularly those in rural areas. Despite the impressive performance of the economy in the last

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66 There is also a Special Court to hear cases brought against rulers.
67 While this report does not analyze the legal system as a whole, it is worth noting that in June 2002, the Asia Intelligence Report quoted the Political and Economic Risk Consultancy (PERC) as stating: “Malaysia has largely overcome the questions of its independence raised during the trial of former Deputy Prime Minister Datuk Sri Anwar Ibrahim. Throughout that controversial period, a lot of debate over the integrity and independence of the legal system was carried out by lawyers and judges. This is, therefore, an example of the checks and balances that still exist in Malaysia.”
decade, poverty – affecting 18.4% of the population – remains relatively high compared with other advanced transition countries. Factors that determine poverty in Poland are similar to those of other transition countries: the unemployed, large families and low levels of education being the main ones. Unemployment at a high rate of over 17% at the end of 2001 hits particularly strongly the rural areas. While Warsaw registers a 3% unemployment rate some rural areas in the east of the country record rates above 25%. Job losses stemming from privatisation and declining exports to Russia, together with declining farm incomes as a result of depressed producer prices, have been exacerbating the situation in what is an overly restrictive and inflexible labour market.

It is noteworthy in any discussion of poverty in Poland to mention the role of the very large but unevenly organized NGO sector in Poland. Nearly 30,000 registered NGOs - though many are small, under-funded or inactive – have been active in education, healthcare, social welfare, culture, human rights, local economic development and the environment. Some of these NGOs are important professional associations including those dealing with gender issues, one with a 1 million membership. Many polish NGOs, remain financially dependent on international donor support for substantial parts of their budgets but, currently a growing number of them are developing other sources of revenue particularly forming partnership with the local Government. The sector is also beginning to evolve from organizations based on its pioneer founders into more institutional structures. But the main problem is that NGOs still do not have legal representation and their contacts and dialogue with the Government are weak in practice, thus limiting their impact.

The new Government has asked the World Bank to help it prepare a comprehensive programme to facilitate private investment and the creation of new jobs in rural areas, focusing on: rural infrastructure, human capital development, and private sector development. The programme is "demand driven" with local government responsible for preparing and implementing their own projects from the menu of activities supported under the programme. In spite of the uneven distribution of its growth to the detriment of the rural areas, Poland has been capable to improve most of the social indicators in the last 3 decades and is well above the average of most social indicators when comparing with similar countries in particular concerning infant mortality and life expectancy.

Institutional Infrastructure. Our assessment over Poland's I.I. as presented in the overall Scorecards shows a rating of 3.6 with high assessments given to the Financial Sector, the Political System and the Trade and Competition Structure. Poland constitutes a clear example of how weak management and implementation capabilities – mainly at the public sector level – represent an increasing source of concern as it represents a serious drawback from an otherwise satisfactory and comprehensive set of policies, rules and institutional structures in practically each of the areas analyzed. As a result, the Management Scorecards shows an average rating.

Poland has strengthened many aspects of its Institutional Infrastructure:

- a rationalized, reformed, financial sector with a properly functioning independent central bank and commercial banks dominating the sector and an increase in privatisations and foreign participation together with a rapidly developing capital market constitute a good base for efficient distribution of financing to corporates, but not to the SME sector.
- rapid trade liberalization as a pre-requisite for Accession and the, parallel, creation of competition bodies have taken Poland into increasing alignment with the EU in this area (except that smuggling is still a problem, being addressed).

However, significant weaknesses remain in its managerial capacity:

- Poland has been able to efficiently establish a well functioning democratic process within all institutions, but it suffers from very poor provision of public services. In particular, the small percentage and quality of the civil service (i.e.: the managers) within the overall administration is a cause of serious concern, together with local Government’s ability to service delivery together with its lack of transparency and accountability. The magnitude and importance of the reforms and changes being put in place in a fairly short period of time is putting an additional strain on a public administration which already does not have sufficient human and financial resources to cope with the existing situation.
- a similar drawback occurs in the legal framework where an elaborate, democratic, wide ranging Constitution sees its impact seriously diminished by the lack of implementation capabilities resulting in serious backlogs, practical inefficiencies (i.e.: law on bankruptcies and the exit of firms) and, to some extent, corruption.
- corporate governance structures, recently developed, are not effective in stemming corruption – particularly in public procurement of works, goods and services – and in applying adequate principles of corporate governance in the private sector. Indeed, recent governance indicators indicate that Poland has worsened in practically all of them in the last 3 years.

Poland’s growth record has been impressive and its reform record very significant, but this has not reached all parts of society, particularly in rural areas.

Trinidad and Tobago - Building success on a strong heritage

Trinidad & Tobago has achieved growth with diversification. In the last 30 years real GDP and GDP/capita growth rates evolved following oil price fluctuations but in the last ten, in particular, successive governments diversified the economy, divested state assets and rationalized public agencies. As a result, in the last decade the role of the oil sector in the economy decreased from 26% to 23% of GDP and the economy has grown at a 4% p/a in the last 7-8 years. T and T has become a vibrant manufacturing and business center providing financial and commercial services, all fuelled by a very attractive legal and regulatory framework to encourage foreign and local investors with the result that more than 130 international companies are now established in the islands. The country has today a Moody’s (sovereign) rating of Ba 1 and has a relatively easy access to capital markets, having escaped the successive Mexican, Brazilian, Russian and Asian financial crisis practically unaffected.

Trinidad & Tobago has achieved growth with diversification. Yet poverty levels remain significant and unchanged.
Yet poverty levels remain significant and unchanged. Net public flows to finance aid have fluctuated in a "contrario sensu" with oil revenues in the last 30 years but they have finished at a lower level than they were at the beginning of the period. The average throughout has been a meagre 1% of GDP and it has been used as a prop to public sector expenditures during and following economic downturns. This contrasts with the important levels of private foreign inflows which have been, on average, about seven times more important during the period. In spite of this, the Government’s Development Strategy has not been successful in transferring economic benefits accruing to the country to the least advantaged, with more than 20% of the population still living below the national poverty line, a stable percentage during the last 10 years, which is compounded by the appearance of the “new poor”, a significant part of the population active in the labour force but subsisting at very low wages. These poverty levels are evenly distributed in the rural and urban areas and they are associated mainly with unemployment, standing at 14% nationally but affecting particularly youth (31% unemployed) and women. Despite the increase in poverty most social indicators have increased due to the improvement in the infrastructure of the basic services. Indeed, for the most part, social indicators of development in T and T are better than those for Latin America and also for the upper-middle income as a whole.

Institutional Infrastructure. Our assessment over Trinidad and Tobago’s I.I. as presented in the overall Scorecards shows a rating of 4.3 indicating that the country constitutes a good example of how strongly developing its – inherited and already robust – Institutional Infrastructure has acted as a good platform from which to base economic development. This has also helped to overcome some of its potential disadvantages in terms of size and ethnic diversity to attract inward investment and diversify its economy. The management scorecard shows a somewhat reduced rating of 3.6 reflecting the implementation difficulties, political interferences with management, particularly in the public sector, and relative deficiencies of the educational base of the country (its only social indicator at level below averages for the region).

In summary, Trinidad & Tobago's I.I. demonstrates some key strengths...

- a sound financial sector operating within an appropriate regulatory framework and a truly independent Central Bank. This has been compounded by the efficiency and good management of the sector in general, the limited state presence and the progressive transfer of good practice;
- trade and competition rapidly liberalized and open, quickly establishing linkages with other countries to maintain competitiveness. Successive Governments have shown full commitment to the attainment of a totally market driven economy and successfully encourage foreign and local investment;
- a constitution that has provided over time an effective basis for the exercise of political power through democratic process. This has been, historically, the framework within which ethnic diversities have found their “natural” expression;
- a legal system and structure based on the British system with recent legislation drawing on best practices from the USA have provided a solid basis on which to develop efficient services in commercial cases, but clearly less so in the criminal cases with a serious backlog of the court system having to be resolved;
- ...offset by weaknesses in management capacity
  - infrastructure bottlenecks resulting from inefficiencies in the public administration, which have hindered private sector activity;
  - poor implementation capabilities and political interference, which have been the reasons for the failure to successfully implement major public sector investments;
  - despite a working democratic constitution which has served the country well, the political system has become increasingly tainted with allegations of corruption and patronage, as again demonstrated in the run-up to the recent elections;
  - whilst efforts have been successfully made to reduce employment in the public sector, remuneration has fallen so far behind that of the vibrant – foreign led – private sector that retrenchment has also affected the ability to manage institutions in the public sector efficiently.

c) The ‘missed opportunities’
Ivory Coast, Morocco, Pakistan, Peru and Uganda present very different case histories. They share the common trait, however, of having failed to achieve their development objectives, despite significant amounts of aid, largely because of inadequacies in their Institutional Infrastructure.

Most of these countries have clear areas of strength. For example, Peru has recently reformed its customs authorities, which have now become a world-class organisation. The central bank of Pakistan is a well-respected institution, whose operations and supervisory functions have been substantially enhanced in the past 10 years. Uganda’s ministry of finance is highly effectively managed by a small cadre of professional technocrats.

In each case, however, these strengths are fully offset by weaknesses in other areas of Institutional Infrastructure, which highlights the critical importance of achieving satisfactory levels of performance in every aspect of the I.I. matrix.

Ivory Coast: The miracle misappropriated
Ivory Coast is West Africa’s second richest country as a result of the boom of its cocoa and coffee sectors since the 50s, with GDP growth rates in the 5-15% p/a in the period. But this economic “miracle” came to an abrupt end in the early 80s with the drop in commodity prices and the ensuing negative GDP growth, macroeconomic instability, escalating external debt, and donor sponsored adjustment programmes which have been pursued until now. Since the CFA devaluation in 1994 improved competitiveness has again ensured strong growth rates in the 7% range until the 1999 military coup together with yet another drop in cocoa/coffee prices, with the resulting contraction by 2.5% of GDP in 2000. The burden of non-performing public investment made in the booming 60s-70s, and more generally, over-optimistic fiscal policies have severely aggravated the impact of the adverse price shocks. In this sense, inadequate
Ivory Coast is “one of the most reformed countries on earth”. As a large African country endowed with relative political stability until recently, Ivory Coast attracted large volumes of aid from major donors, in particular since structural reforms begun in the 80s, all under strong policy conditionality which directly influenced economic policies and, increasingly so, institutions. As a result, development aid flows, which were relatively constant until the mid 80s, rose annually until the mid nineties when they reached a peak of over $117 per head. This trend came to an abrupt end in 1998 when major donors, including France, suspended disbursements on most of their programmes as a result of the uncovering of fraud on budgetary assistance, followed by the renege on debt service obligations vis-à-vis multilateral creditors following the December 1999 coup. Net private capital flows, significantly less important than public funds, fluctuated over the last 30 years but with a very clear decreasing trend (from around 800 mill $ p/a during the 70s to one tenth this amount in the 90s). With the formal approval of the country’s Poverty Reduction and Growth Facility by the IMF in 2002, following the normalization of the electoral process one year before, all major funding agencies have resumed their assistance to Ivory Coast. But a targeted national poverty alleviation strategy still needs to be adopted by the government as top priority to improve the poverty situation which deteriorated rapidly in the last 20 years with the proportion of poor households rising from 11% in 1985 to 32% in 1993 and 37% in 1995. Under pressure from the donor community the country adopted a National Programme for Poverty Reduction in 1997 and, today, most social indicators of development are slightly better than those for the region but clearly worse than the LDCs as a whole.

NGOs are playing a critical “substitute” role in fulfilling weaknesses within the public services – particularly in health services and in micro-finance – and acting as substitutes to formal democratic oversight institutions by, for instance, putting pressure to increase transparency, and eliminate corruption in the administration of public resources. There are 15 micro-finance NGOs providing micro credit schemes to the agriculture and commercial sector. The potential of cooperation with NGOs and Civil Society Organizations is well understood in Ivory Coast and donors have worked with NGOs to:

- Implement educational and training programmes centered on governance issues.
- Strengthen the NGO sector in governance related areas and in capacity building so that it can extend its role in the areas of justice and local democracy, where the potential for using NGOs appears very strong.

Institutional Infrastructure. Our assessment over Ivory Coast’s I.I. as presented in the overall scorecard shows a rating of 2.5, the lowest amongst the 8 countries studied, on account of the important weaknesses of its Legal Framework, Trade and Competition and Political system. Management scorecard shows a similar assessment, at an even lower 2.3.

Weakest areas are:

- Although the Constitution provides for an independent judiciary, it is in practice subject to executive branch and other outside influences and the country has not been able to succeed in the implementation of the needed reforms of the Judiciary.
- The deficiencies and corruption of the political system leading to subsequent coups d’etat and political disturbances in the late 90s, have seriously affected the country’s international credibility and its economic performance.
- Ivory Coast’s competition regulatory structure and regulatory bodies have been so ineffective that regulations have been transferred to the regional level.
- It is interesting to note that these three major weaknesses share one common factor: they were purely national – as opposed to regional – reform efforts, and global public service factors such as personnel/pay incentives appear to have had a significant part in the failure of the reforms at the national level.

Strongest areas are:

- Financial sector and corporate governance have managed to build acceptable levels of I.I. and, in both cases, the fact that reforms and supervision have been carried out at supranational level has been a clear facilitator of success.
- A common regional approach to reform appears to produce economies of scale and reinforces the economic benefits of regional trade and monetary integration. But, most importantly, it also generates more trust from the population in general and the private sector in particular to strengthen the belief that reforms will effectively go through, not being impeded by national political considerations.
- In the financial sector, good cooperation with NGOs has resulted in better access to credit by the poor.

The future challenge. Development reforms, particularly at the institutional level, are sorely needed, and will rest on three factors. The first is greater political stability in a genuine multiparty democratic system. The second is the continuation of donor support, which will be greatly helped by recent improvements in the transparency of budgetary procedures – particularly the clear and unique line of responsibility in the fund disbursement procedure. The third is greater confidence of both local and international private investors. These factors are all re-starting in the 2000s and they are likely to require some time before producing results and taking the country into harmonious growth with economic and social development. But, most importantly and independently from the above, Ivory Coast needs to break its poor implementation record and build up adequate management capacities in order to implement reforms efficiently.

Morocco: The case of drip-fed reform forestalling real progress

A growth problem. Although macroeconomic stability has been a key priority since the introduction of the reform programmes in the early 80s, economic growth in Morocco has been on a declining trend over the last 30 years, averaging barely 2% in the last ten. Continued high dependence on agriculture (30% of GNP and 45% of the population but 70%...
Morocco has a limited window of opportunity during which to accelerate the reform process while strengthening human resources and addressing social deprivation. This will require stronger government commitment to real reform, and closer coordination with donors on competitiveness issues and with NGOs on poverty issues of the poor live in rural areas) has made growth extremely volatile due to the – increasing – recurrences of drought and declines in annual growth of the non-agricultural sector. The country’s slow growth trend in the past ten years has contrasted sharply with that of many comparable middle-income countries of a similar size.

**Significant external assistance but with modest development impact.** Public flows of development aid fluctuating in real terms in the last 30 years – but in a clear declining trend in the last ten – representing from 10 % of GDP in 1985 to less than 1 % in 2000 as a result of the availability of concessionary funds and revenues coming from privatisation. Private Capital flows, also on a downward trend until very recently, have represented similar amounts and % of GDP. Although a large part of development aid has rightly been allocated to the social sector, it has not been successful in narrowing the gap between rural and urban areas with poverty and unemployment increasing markedly in both and with practically all social indicators showing that the country has been falling behind its neighbours in the development of its education and health sectors. This process has been compounded with the lack of real progress in upgrading the competitiveness of Moroccan agriculture and industry, as time is running short to the deadline for the Association Agreement with the EU.

**Important factors explain this failure,** which include:

- The deceleration of the reform process engaged in the late 80s and early 90s leaving major aspects of the existing Institutional Infrastructure relatively untouched, like the judicial reform, the civil service reform and the revamping of the Labour Code.
- The unwillingness of the powerful vested interests which surround the Court to allow a quicker pace of liberalization. This has been compounded by the lack of engagement of the private sector in the bureaucratically inspired “mise à niveau” process and of appetite to embrace the opportunities and face the challenges of the Association Agreement with the EU.
- The Government’s centralized approach to development has failed to adequately address the issues of provision of social services and basic infrastructures particularly in the rural areas. This has been partially compensated through the efforts of NGOs operating in these sectors although there is a need for capacity building and improvement in the enabling environment in that area.
- The lack of coordination between donors, actively “encouraged” by the Government, and between Government departments and agencies, which has delayed efficient transfer of resources and negatively impacted delivery mechanisms.
- The absence of transparency and accountability of a significant segment of public finance (i.e. the royal “purse”) notwithstanding the recent dynamic change which, while encouraging some degree of political openness, is yet to show that it is willing to allow structural reforms to go forward.

**Institutional Infrastrucutre.** Our assessment over Morocco’s I.I. as presented in the overall Scorecards shows a rating of 2.7 with Financial Sector, Corporate Governance and Trade and Competition marked higher than the Political System and the Legal Framework. The Management Scorecards is even lower – at 2.5 – reflecting the country’s serious deficiencies in implementation performance and capacity.

**Weakest areas are:**

- political power concentrated effectively in the Palace hands
- management process hampered by a bloated civil administration
- judiciary neither transparent nor fully independent
- apparent reluctance of Government to take decisive steps to fully withdraw from the banking sector and lack of depth of financial markets
- lack of financing and of appropriate distribution channels for credits to the rural community

**Strongest areas are:**

- effective management of foreign aid by the Department of the Treasury at the Ministry of Finance with no corruption scandals reported in the last years (somewhat of an exception in the overall system)
- relatively clear definition of rules and structures for corporate Governance and administrative structures thereto
- recent increases of direct foreign investment which has doubled in the past 3 years, even after excluding the proceeds from telecom sales, showing a moderate success in attracting and diversifying FDI.

**The future challenge.** Morocco has a limited window of opportunity during which to accelerate the reform process while strengthening human resources and addressing social deprivation. This arises from a successful track record in economic stabilization, the prospect of windfall revenues from privatisations, and the measures already taken to decentralize administration and to facilitate inward investment. This will require stronger government commitment to real reform, and closer coordination with donors on competitiveness issues and with NGOs on poverty issues. The outcome of the recent parliamentary elections will be a broad-based coalition government, which may face similar problems to its predecessors in moving reforms forward. The growth in support for the moderate Islamist party may add to these difficulties. The willingness of the Palace and the elite surrounding it to relinquish some of its political influence remains an open issue. Failure to do so could result in increasing tensions as social disparities lead to instability or worse.

**Pakistan: Back to the basics?**

**Significant growth in spite of important shocks.** Since independence about 50 years ago, Pakistan’s economy has grown at an average rate of 5 % p/a – superior to that of the population – which is remarkable given three wars with India, an unsettled situation in Afghanistan, and frequent changes of Government between civilian and military regimes. Attempts to achieve democratic governments have generally failed mostly because of internecine party politics68. The country has, in the 90s suffered from permanent fiscal deficits, hovering around 6-7% of GDP for many years, which resulted in an unsustainable level of debt (100% of GDP), lack or investor confidence and until very recently, very low

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68 Indeed, it can be argued that democracy as has been practiced in Pakistan has simply allowed the elites to capture power through elections without sharing it with its citizens. And with this came corruption, incompetence and inefficiency and, thus, reduction of growth in those – supposedly democratic – periods.
levels of foreign exchange reserves. In spite of this, the country has developed a reasonably efficient and dynamic external trade sector although its exports are concentrated on textiles and clothing, reducing the negative trade balance through the last few years. The military government that took over in 1999 has launched a comprehensive reform programme that attempts to address the issues of governance, slow growth, social gap and the heavy debt burden. The programme, supported by the IMF and the donor community in general and detailed in the Interim Poverty Reduction Strategy Paper, focuses on six areas: governance, investing in people, macroeconomic sustainability, the financial sector, the investment climate for the private sector, and agriculture and irrigation.

But over-dependency on aid. Pakistan is a clear example of aid dependency having extensively relied on foreign savings (aid and remittances) to fund its deficits while maintaining an intimate relationship with donors. But flows have often been irregular because of political events, either internal or external. This has introduced an element of volatility and uncertainty in aid’s role and impact. In spite of this, over the last 30 years net official financing flows in Pakistan as a proportion of GNP have generally been above those for the South and Central Asia region and for LDCs in general. The continuous reliance on the donor community – particularly the World Bank – coupled with the country’s inability to diversify its external funding out of official flows, has resulted in 80% of Pakistan external public debt being owed to multilaterals and the Paris Club and other bilateral donors. This is a much higher portion than most other Asian countries of this size. Overall, aid has been managed relatively efficiently especially in the early years when it focused on traditional project financing. But this effectiveness has been eroded progressively when the aid focus switched substantially to reform, support and balance of payments funding. At the same time the very weak administrative capacity has affected implementation of complex and multi-faceted programmes at the local level. The well developed NGO sector – accounting for at least 5,000 active NGOs plus a similar number registered but inactive – is recognized as being effective contributors to poverty reduction in rural and urban areas and are today recognized by the Government – and donors – as an appropriate channel for that purpose. But their capacity to deliver development initiatives remains, nonetheless, limited. Their “standing” in the country as allocators of resources to the social sectors including local infrastructure projects and micro credit schemes, and their local presence, makes them increasingly eligible for capacity building schemes and funding programmes at local level.

Yet poverty continues to be an endemic problem. It has risen in the 60s, decreased in the 70s and 80s and worsened again in the late 90s. Still today about a third of the population lives in poverty, and the income distribution has followed a similar pattern. Pakistan lags behind other countries of similar levels of income on almost all social indicators, and its public spending on health and education – totalling about 3.5% of GDP (against significantly more in an area, defence expenditures, that is not known for its social impact) – is also lower than what it should be. Progress in economic growth has not been translated in the social sectors: Pakistan was 127 out of 162 countries on the Human Development Index in 1999 and gender disparities are clearly more pronounced than in most other countries. This social gap is likely to continue affecting the country’s ability to sustain growth and development.

Institutional Infrastructure. Our assessment of Pakistan’s I.I. as presented in the overall Scorecards shows a rating of 2.8 with the Financial Sector and Trade and Competition showing a 3.3 assessment and the others significantly below. Management scorecard, not surprisingly, is valued even lower – at 2.5 on average witnessing the lack of managerial capacity at practically all levels.

Weakest areas are:
- mismanagement and particularly corruption, which still pervades all branches of Government (Pakistan is ranked 71st out of 91 countries in the corruption index of Transparency International) has been a key obstacle to improve Pakistan’s ability to manage its own future in an effective and sustained way. Political Governance has deteriorated and the country has remained highly centralized administratively. Local Governments have played little role until now. The system has been abused by political parties and by elitist interests which have increasingly captured access to resources irrespective of the political regime in power.
- the effectiveness of the Judicial System has been repeatedly compromised by political practices and has not garnered the necessary degree of independence from the Executive, particularly in terms of securing adequate and predictable budgetary resources. As a result, the level of confidence of the population in it is extremely low, particularly at the subordinate level.
- concerning private Corporate Governance, laws and standards are on paper satisfactory but years of political uncertainty, the pervasive corruption at the administrative level, and law and order problems have not been conducive to the development of ethical standards of behaviour in the business sector which has, indeed, been a party in the overall “system abuse” that has historically taken place in the country.

Strongest areas are:
- the Central Bank of Pakistan is a well-respected institution whose operations and supervisory functions have been substantially enhanced in the last 10 years with assistance from the IMF, the World Bank and the Asian Development Bank. This process, initiated by the Central Bank and the Ministry of Finance under a programme of “home-grown” reforms in 1997 should continue with the current reforms which address the root causes for the bad performance of the financial sector in the past.
- Pakistan has gone a long way in liberalizing the trade regime while restructuring and increasing efficiency in the key bodies responsible for trade management. Reforms and improvements have consistently taken place and its pace is accelerating lately.
- the Ministry of Finance has been responsible for coordinating and managing development aid programmes in the country and constitutes another area of exception to the general mismanagement and corruption that has plagued the country.

The future challenge. A major effort, and one that is more comprehensive than in the past, is being put by the current Military Government to try...
to set Pakistan on a steady and effective growth and development path. Governance issues are at the forefront of this effort, which includes major reforms of the political, judicial, financial and administrative set ups. The Government’s programme also includes a very ambitious plan to devolve political and fiscal central power to a series of new local governments, and a Poverty Reduction Strategy designed to improve social services delivery as the country’s top priority. The questions are whether reforms of that amplitude and depth would have better chances to succeed if implemented by a military government and whether that growing participation of the armed forces in the management of the economy will affect the need to develop democratic institutions.

Finally, Pakistan has little choice but to continue depending upon steady support from donors to implement its reform programmes. Yet this is, in itself, dependent on three factors:

• stability in the region is crucial for Pakistan’s ability to grow on a steady footing;
• the envisaged reforms are long-term oriented and a “new” consensus is required to secure donor- Government support on a long-term basis too;  
• irrespective of the above, Pakistan must improve its ability to manage its own future and its credibility with its external partners.

**Peru: Significant investment failing to improve people’s lives.**

**Performance volatility.** Since the 70s Peru has had a volatile economic performance, although it has become a more stable country in the past decade following the 1980s’s economic mismanagement, hyperinflation and rampant terrorism. During 1980 to 1985, a period of debt crisis, real GDP advanced by just over 1% per annum and plummeted by 11.8% in 1983. A retreat into protectionism from 1985 produced an unsustainable boost to economic growth in 1986 and 1987 and real GDP fell by 11.6% in 1989. Macroeconomic reform in the 1990s produced strong growth – real GDP advanced by over 4% on average per annum during 1990 to 1997. The strong growth in 1994 to 1995 reflected strong investment fuelled by large capital inflows. The drying-up of foreign capital in the wake of the Asian financial crisis hit the Peruvian economy hard in 1998 and growth in 1999 came from the primary sectors of the economy only. Real GDP increased by less than 1% in 1999. The domestic economy continued to endure the effects of the El Niño weather phenomenon that hit agricultural harvests in late 1997 and early 1998. Domestic demand remained depressed in 2000 with the increase in public expenditure in the run-up to the elections in April and May offset by low levels of investment caused by the political uncertainty. Real GDP accelerated by 3.1% in 2000.

Yet extensive funding available. Net official financing as measured by net flows of ODF (Official Development Finance) has increased in real (constant $US 1999) terms since the 1970s. Accounting for approximately $1 billion annually on average in the 1990s, compared with $653 million during the 1980s and $428 million in the 1970s, net ODF reached a high of $2.2 billion in 1997. From 1977, net ODF as a proportion of GNP in Peru has remained above that of Latin America and fluctuated around that for developing economies as a whole. Net ODF as a proportion of GNP reached a high of 6.3% of GNP in 1992. In 2000, net ODF as a proportion of GNP was 2.1% in Peru, 1.1% in developing economies and 0.8% in Latin America.

Net private capital flows peaked in 1975 and again in 1982 before escalating in the latter half of the 1990s, reaching a period high of $6 billion in real terms in 1996. Averaging $1.2 billion per annum in real terms (constant US $1999) during the 1970s, the annual average decreased to just $542 million in the 1980s before increasing again by $2.6 billion per annum in the 1990s. Net private capital flows reached a high of $5.8 billion in real terms in 1996. Net private capital flows now account for 6% of GDP, compared to less than 1% at the beginning of the period. In the 1990s portfolio investment flows helped to drive the increase in net private flows and was helped by foreign direct investment flows in the latter half of the decade.

**With little results.** Despite the improvement in economic performance, particularly in the 1990’s and relatively large amounts of ODF and private capital flows during the decade, inefficient public investment management and poor monitoring of aid programmes by some of the bilateral and multilateral lenders resulted in poor targeting and low or negative returns of such programmes. Peru’s GNP per capita is below the average for Latin America and the Caribbean and over 54% of all Peruvians live in poverty.

Although NGOs in Peru are important social actors in development and are perceived as an efficient service reaching the poor and improving their lives while at the same time identifying real local needs (a World Bank report on Peru in 1996 stated that NGO-administered programmes has a significantly better targeting record than most public programmes), they are not making significant inroads into reducing the significant poverty suffered by the country’s citizens.

**Institutional Infrastructure.** Our assessment of Peru’s I.I. as presented in the overall Scorecards shows a rating of 3.1 mostly on account of the deficiencies in the rules, structure and, above all, management of the Political System, its Legal Structure and Corporate Governance. The management scorecard shows that only the Financial System and Trade and Competition merit a score above a very low 2.

**Weakest areas are:**

• The 1993 Constitution was designed to provide more efficiency in Government and greater autonomy to the Judiciary. Its “on paper” rules and structure are well designed but its management has been poor; political interference and moves by the Fujimori administration to curtail such autonomy only worsened the situation of inefficiency, poor human resources and corruption. The common perception is that the current state of management of the Judiciary is seriously damaging the economy. The good intentions of the new Toledo Government are on the other hand likely to improve this situation as and when political and judicial reforms are introduced.

• In Corporate Governance, the country has only recently undertaken moves to improve the viability of public investment and should start to see positive results in the medium to long term. However, unless
all the multilateral and bilateral donors ensure that they also control and monitor investment projects after disbursement, the overall efficiency of aid is unlikely to be ensured. In private corporate governance reform, the importance of good positioning, especially with respect to the general adoption of international accounting standards, such issues as the protection of minority interests are not well developed. Proposals are on the table to provide a greater protection for shareholders. This is due to the fact that the majority of Peruvian companies are characterized by their family shareholdings. The law has, until now been focused on “closed companies” and did not introduce mechanisms of control over management, protection of minority shareholders nor information obligations for shareholders.

**Strongest** areas are:

- Peru’s financial sector is relatively well established and regulated and has managed crises effectively. In addition, the recent growth and success of institutions that are focused on small and micro businesses are a good example of the benefits that can be derived from providing the right regulatory framework which encourages formalisation. The 1997 banking law permitted the creation of EDPMES (Development Institutions for SMEs) and enabled the formalisation of NGOs which had been undertaking micro-lending activities, by lowering the barriers of entry (mainly capital requirements) into regulated banking. It, additionally, has had the benefits on the one hand of providing access to COFIDE funding and on the other of motivating the formal banking sector to downscale and initiate lending to the “real economy”.
- Peru’s customs is also an outstanding example of the benefits that institutional management reform can bring. At the beginning of the 1990s Peru’s customs authorities could be described as outdated, poorly equipped and corrupt. Today, they are acknowledged as a world-class organization.

**The future challenge.** The challenge for Peru is to ensure that the highly necessary judicial reforms that are widely agreed upon take place. Both the World Bank. Judicial Reform Project as well as the Judicial Training Programme of the Bankers’ Association should be expeditiously implemented. The Corporate Governance Reforms which have taken place and those in the pipeline should be consolidated and implemented respectively to ensure better targeting and greater transparency in public spending. The efforts of NGOs should continue to be encouraged and funded, especially those that have converted their MSME lending into formal FIs.

**Uganda: Managing a Post-Conflict Economy**

Donor supported and led reforms successfully turned the economy around. Following more than two decades of turmoil and civil war which all but destroyed the transport network, power and water facilities, eroded the country’s competitiveness resulting in negative net exports, reserves providing less than two weeks import cover, accelerating inflation and negative growth rates, Uganda long hesitated to define and implement policies designed to stem the decline which was further exacerbated by the insolvency of the banking sector and the continuous deterioration of the already weak private sector. By the late 80s the Museveni Government issued from the end of the civil war embarked on an Economic Recovery Programme (ERP) with the support of the IMF and the World Bank and, in the early 90s, introduced wide ranging economic reform policies supported by successive - 25 policy based Structural Adjustment Loans which by the end of the 90s had resulted in:

- GDP growth rate averaging 7.6% p/a
- private sector investment increasing to 13% of GDP (from 9% a decade earlier)
- gross domestic savings raising from 2% to 8% in the decade
- inflation declining to an average 8% p/a (down from 190% in the period 1987-91)
- current account deficit to GDP ratio narrowing to 4% in 1996 (from 6% at the beginning of the period) and monetary deepening occurred with the ratio M2/GDP increasing to 11.7% from 8.2% in the same period.

In spite of the deterioration in terms of trade that has occurred in 1999 and 2000, Uganda still managed reasonable growth rates of around 5% each year, fuelled by the development of agricultural production, exports of traditional commodities (coffee, tea, tobacco, cotton) and the beginnings of an export diversification strategy which is essential to the country’s future.

The Government has demonstrated “ownership” of the reforms, because it has factored the conditionality brought about by donor support into its own policies and reform programmes. Multilateral aid flows dominated total net ODA flows until the mid 90s and the EU member countries as a group represented more than 50% of total ODA in the second half of the decade. There has been a strong steady build up in grant disbursement to Uganda in the last two decades, while net private capital flows have increased dramatically during the 90s, with FDI being the main driver to represent 104% of net private capital flows in 1999. Post-conflict Uganda has, indeed, benefited from generous foreign aid and the country made exceptionally good use of that support to the point of being, in many respects, at the forefront of the changing face of aid utilisation and effectiveness: it became the first country to be eligible for debt relief under the HIPC initiative, but this was based on Uganda’s prior design of its “home grown” Poverty Eradication Action Plan founded on four pillars under which strategies and priorities that are key for poverty reduction are identified and targets set. These pillars are:

- Economic growth and structural transformation for poverty reduction
- Good Governance and security
- Increasing the ability of the poor to raise their incomes
- Improving the quality of life of the poor

This constitutes the framework within which operates a strong partnership between government, donors and civil society with the sole purpose of designing, implementing and managing pro-poor and social reforms. And NGOs play an important role: They have excelled in the provision of advocacy and monitoring (economic policy and community development and political reconciliation) including also services delivery, all within the participatory approach set by the Government, and made a very positive contribution to the Government’s pro-poor development policies to date. Other than the major international NGOs there
has also been a positive emergence of well-managed local NGOs acting as effective lobbyists and monitoring the Poverty Action Fund. But the Government is concerned that the large number – more than 3000 – of NGOs makes it difficult to coordinate initiatives and plan for the equitable allocation of resources and furthermore, weak management and professional capacity in many inhibit the quality of their influence and contribution to policy design aimed at poverty reduction.

However, and in spite of this strong policy and institutional focus on poverty reduction and development of the social sectors, specifically education and health, plus the fact that the distribution of financial resources (both national budget and development aid, and those of the Poverty Action Fund which “captures” the savings resulting from debt relief) is clearly skewed towards the sectors with immediate and direct impact on poverty alleviation, a lot is still to be done. Uganda’s relative performance compared with similar LDCs is still below averages in most social indicators (except primary gross enrolment). Indeed, in spite of growth rates of 6% average in the last decade, the country remains one of the poorer countries of the world, with a GNP per capita of US $ 291.

Institutional Infrastructure. Our assessment of Uganda’s I.I. as presented in the overall Scorecards shows a rating on 3 with the Financial Sector and the Political System marked significantly higher than Corporate Governance and Legal Framework and above Trade and Competition. The Management Scorecard at a similar level is a reflection of the country’s deficient management capabilities (except at the excellent Ministry of Finance –see below) and the pervasive importance of corruption.

Weakest areas are:
- Uganda does not have a history or culture of good governance and a tremendous amount of work needs to be done to bring best practices, particularly on corporate governance (as opposed to political one) which is still in its infancy at both the Government and private sector level. Indeed, the private sector organizations have been more inclined to provide resources to macro-economic policy formulation than on focusing and

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• Overall Management ratings have been rounded up to the highest decimal to make this presentation consistent. This is why these figures do not exactly coincide with the Overall Management Ratings as per next table.
• Malaysia partial ratings include a decimal assessment because we have introduced in the country report in addition of an evaluation of the political system an evaluation of the macroeconomic management. See Volume II.

Uganda’s performance relative to similar LDCs is still below average in most social indicators. In spite of average growth rates of 6% over the last 10 years, Uganda remains one of the world’s poorest countries, with a GNP of US $ 291 p/c
The challenge for Uganda is to implement further structural changes in favour of the productive sectors to achieve sustainable development and reduce reliance on aid flows by creating an environment which facilitates private sector growth to replace public sector dominance in economic production and the provision of essential services.

### MANAGEMENT SCORECARDs

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The record of the countries assessed as having a strong I.I. indicates they made better use of the aid they received. The converse relationship is more tenuous; aid can have a positive impact on the development of I.I. but does not always. Aid can do unintended harm resulting from how donors allocate funds and implement aid programmes.

The future challenge. The challenge for Uganda is to implement further structural changes in favour of the productive sectors to achieve sustainable development and reduce reliance on aid flows by creating an environment which facilitates the growth of the private sector to replace the dominance of the public sector in economic production and the provision of the essential services. What will be required is a confirmation of the improvements in the institutional framework (rules and structures) and, mostly, upgrading the effective management in the line ministries, and in the supporting regional agencies to the same level as seen in the Ministry of Finance and the Central Bank. Further ahead, and following President Museveni’s second election as President in 2001, the challenge would be to translate the effective reforms introduced in economic policy matters into the political sphere and the jury is out as to how this should be guaranteed to ensure that future governments continue to give absolute priority to eradication of poverty, still the country’s most poignant problem.

2.2.4 Interaction of I.I. and aid effectiveness

Our study confirms and elaborates the conclusion that the quality of a country’s Institutional Infrastructure has a major impact on the effectiveness of aid to it. As discussed in the previous section, the record of the countries assessed as having a strong I.I. (relative to other countries of comparable income level) indicates they made better use of the aid they received. This section of the report summarises the mechanics of how the major components of I.I. – policies, structure and management impact on aid effectiveness.
supporting countries with sound reform policies. Aid allocations have been supplied driven by pre-determined country preferences and there is a high degree of inertia of aid flows to countries (good and bad performers). In addition, as noted in our Phase 1 report (page 76) “conditionality has failed as a mechanism for inducing better performance.”

A World Bank study of how aid affected economic policy in 10 countries in Africa indicated that aid supports reform in some countries but sustained poor policies in others. The study showed that countries characterised as “mixed reformers” (Nigeria, Kenya and Zambia) or “post-socialist” reformers (Ethiopia, Mali and Tanzania) received substantially higher levels of aid than “successful” reforming countries (Ghana and Senegal).

Structures Define Design and Implementation Capacity

There has been increasing awareness in the aid community that institutional capacity in recipient countries is critical to development effectiveness. This is reflected in the shift in the agenda from emphasis on macro-economic stabilisation to institution and capacity building and reforming public sector management. This shift has been driven by the force of experience. Weak institutional capacity is an acute problem in many LDCs. In public agencies, civil servants are often poorly paid and inadequately equipped with the basic facilities and information to allocate and administer aid programmes. If key posts are under-paid, they will fail to attract the competent, honest people but will open way to patronage and corruption. These limitations have a direct impact on the effectiveness of aid. A survey of WB financed projects found that whereas the average success rate of projects was 68%, projects in countries with sound policies and capable institutions had an 86% success rate.

Our studies illustrated the benefits and defects of institutional arrangements.

- In Uganda, despite major practical constraints on capacity which was emerging from a period of civil conflict, the major economic policy making units (Ministry of Finance and Central Bank), insulated from day-to-day political pressures and enjoying strong political support, have demonstrated a high level of policy design and management have contributed to the effective use of aid in the country, particularly in directing it to poverty reduction.

- In Morocco, a highly centralised administration effectively controlled by a political elite has limited the impact of substantial amounts of aid on social programmes. As the recent Global Corruption Report 2001 concludes “public institutions need to be strong, effective and the right size to ensure that the opening up to the global market does not allow the state to be captured by private interests.”

The effectiveness of aid reflects in an important part the extent to which private capital supports and complements the inflow of ODA. Motivating private investors to invest depends on the depth, efficiency and integrity of the financial legal systems. However, in cases where the formal financial sector is either inefficient or restrictive, informal micro-finance institutions offer a credible and developmentally efficient alternative. In Peru, the refinement of the regulatory system by reducing the entry requirements to bring small business financing institutions (EDPYMES) within the formal system has stimulated their growth (and improved the performance).

Conversely, aid supplied by donor agencies does not always support sound institutional development in the recipient countries they are designed to assist. In some cases, their programmes – particularly in cases where they claim to the limited counterpart support of recipient countries – can have a detrimental impact on overall institutional development. In addition, many donor projects fail because they are poorly adapted to the local environment: some are overly complex; others transfer programme designs that have been effective in one country to another for which is not appropriate. These failures demonstrate that donors do not assess realistically the quality of the I.I. in recipient countries.

Our study of Trinidad highlighted that institutional capacity constraints are compounded by donor policies and practices, including

- Excessively complex conditionality;
- A rigidly standardised (one size fits all) approach to programme design;
- Lack of donor co-ordination – a striking example in a country where both the scale of the programmes and the size of the country should facilitate such coordination.

In other countries, donors are often involved in too many sectors creating donor “overload” for recipients, especially in popular sectors such as health, education and agriculture.

Even when aid projects are intended to support institutional development they are not always effective. Recent studies by the World Bank’s OED have concluded that much of the Bank’s support for institutional development has been ineffective, because of either a narrow focus on institutional design, a bias to supplying capacity building inputs (e.g. training) before reforming structures as well as reliance on inflexible lending instruments.

There has been increasing awareness in the aid community that institutional capacity in recipient countries is critical to development effectiveness. This is reflected in the shift in the agenda from emphasis on macro-economic stabilisation to institution and capacity building and reforming public sector management. This shift has been driven by the force of experience.

71 “Country programme budget allocations are relatively invariate with respect to country policy and project performance and are not always fully aligned with the Country Assistance Strategy.” World Bank Operations Evaluation Department, 2000 Review of Development Effectiveness.
73 World Bank, Assessing Aid, page 89.
74 See Phase 2 report, Annex 3 page 302.
• Although large amounts of aid have been channelled to Peru, political interference and inefficient management of aid within the public administration have had a major negative impact on the results achieved.

Skill gaps in key areas (even basic accounting) weaken budget execution and programme implementation in general. The World Bank acknowledges that in the past it tended to overestimate the capacity of counterparts and the quality of government control systems to ensure compliance with procurement and financial management standards. Our studies indicated that this is a continuing problem:

• In Pakistan, “A major effort by donors to address the major issues in the social sector resulted in little being achieved (mostly) because of the weak administrative capacity at the local level to implement a complex programme”.

• In Trinidad, poor implementation capacity has resulted in a failure to implement a number of major investment projects and under-utilisation of available funding, leading to the cancellation of the second tranche of the EU’s Lomé Convention allocation.

Design of delivery systems is critical to the quality and access of efficient public services funded by aid programmes. This requires innovative and flexible approaches, such as promoting the participation of the private sector and civil society participation in programmes. In cases, donor agencies are too bureaucratic to successfully develop these type of programmes.

The Integrity of the Institutional Infrastructure Is Critical For Aid Effectiveness

Giving development assistance to countries with weak institutional frameworks, low capacity and often poor law enforcement poses substantial risks. Aid is less effective in a weak governance environment where funds leak due to corruption. Evidence even suggests that aid inflows can contribute to a decrease in public spending, weaken accountability and governance while providing ample opportunities for corruption. Misappropriation of aid funds reduces both the volume of financing available for real development purposes. Examples abound:

• The Global Corruption Report 2001 quotes a World Bank review of a road project in Paraguay, for which the Minister of Public Works increased the contract value from US$ 13 million to US$ 24 million without justification in order to secure additional funds, apparently for his own purposes. 77

• The former President of Nicaragua is accused of misappropriating nearly US$ 100 million before leaving office in 2001 – equivalent to the annual health budget of the country. 78

Corruption also (a) undermines the integrity of the public administration and (b) encourages donors to resort to “enclave” structures (project implementation units) segregated from recipient government structures to manage their aid. While this latter approach has advantages for the donor agencies, it is not the best way to address the broader issues of institutional inefficiency in the recipient countries, particularly where it involves attracting relatively qualified staff from government service by offering them higher salaries. The World Bank has concluded that it repeatedly underestimated the opportunity costs of creating semi-autonomous units to speed up implementation of specific projects in terms of foregone development of the core public sector, for example, in Albania, Bolivia and Yemen. 79

A persistent problem in the management of aid has been the scope and quality of monitoring and evaluation. Inadequate attention to evaluating the outcomes of aid-funded projects and programmes, particularly on poverty reduction, by both recipients and donors has meant that there are major gaps in information on the benefits achieved. As a result, defects in project design and implementation have gone undetected and uncorrected resulting in continuing inefficiencies.

On the other hand, where governments are committed to reform and have competent and dedicated officials to manage the reform process, aid-funded support can be critically important in implementing effective programmes. For example:

• In Uganda, the success of the programme to return nationalised property to private citizens required foreign technical assistance as well as the strong political support of the government.

• In Peru, the reform of the customs administration has had a major impact in stimulating imports and increasing government revenues.

Conclusions:

1. The quality of the Institutional Infrastructure determines the effectiveness of aid in many ways. Previous studies have stressed the importance of sound macro-economic policies and effective institutions as major influences on the success of aid programmes. Our study suggests the important interdependencies between policies, structure and, most importantly, with management.

2. As the third main actor involved in the development equation (i.e. with Government and the private sector) Civil Society should be “given” a pro-active role in the definition of policies, the development of innovative ideas and the implementation of programmes, particularly those related to poverty alleviation. 80

3. Change takes time. While most countries need to improve all the dimensions of the I.I. (rules, structure, management), it is seldom practical to tackle all simultaneously. Recommendations for improving the I.I. in individual countries need to be based on a specific diagnostic evaluation of each country’s existing capacities and constraints.

4. But determined action, even if it is only partial and focused on one or a few aspects of I.I., can achieve rapid results.


78 The Economist, Waiting for the fat man to sing, 24th August 2002, page 43.

79 Country Assistance Evaluations, quoted in N.Girisshaker, Evaluating Public Sector Reform, page 27.

80 But the concept of Civil Society is not yet widely defined and still underresearch. Not much is known about how civil society organisations really function and there is a need to create an appropriate framework for them to be organised and regulated. The report does not, therefore, enter into the details about how concrete civil society organisations would play specific roles compared with those from governments and the private sector.
CHAPTER 3:

IMPROVING THE EFFECTIVENESS OF INSTITUTIONAL INFRASTRUCTURE

The previous chapter argued that Institutional Infrastructure should be improved in order to boost the effectiveness of aid.

From a 'top down' perspective, an analysis of the aid industry's business dynamics highlighted its generally uncompetitive nature, contributing to an "immature" interaction between the suppliers and consumers of aid. This interaction can be characterised by a relative lack of product development, rather basic customer segmentation, inflexible operations and limited flexibility in financing decisions. We argued that improving the Institutional Infrastructure of recipient countries could make a significant contribution to addressing these shortfalls, primarily by creating a more mature and capable set of aid consumers. Greater consumer maturity and capability would allow the dynamics of the aid business to become more competitive, more efficient and more geared to producing acceptable results from aid finance – in effect, developing a fragmented demand side to counterbalance the strength of the supply side.

From a 'bottom up' perspective, our in-depth analysis of a sample of 8 countries confirmed the strength of the correlation between a country's development track record and the quality of its Institutional Infrastructure.

This chapter now turns to the issue of implementing a programme for improving the management of Institutional Infrastructure, and deals with five topics:

i. Country lessons: Lessons that can be drawn from the country studies about implementing I.I. reforms (section 3.1);

ii. I.I. improvement measures: Synthesising these lessons into a simple yet comprehensive action programme to boost I.I. management (section 3.2);

iii. Implementation conditions: Key steps to ensure that action is taken (section 3.3);

iv. Other broader reform ideas: "Supply side" ideas that would complement the I.I. improvement measures in order to bolster aid's effectiveness (section 3.4);

v. The trade liberalisation issue: Aid alone will not improve the lot of LDCs, and significant trade liberalisation – a geopolitical issue – would transcend and support any I.I. improvement programmes (section 3.5).

3.1 IMPLEMENTATION LESSONS FROM COUNTRY STUDIES

3.1.1 The Malaysian Experience

Although there is no "perfect model" that could be applied to any situation, the evolution of Malaysia constitutes the closest example of "what works" within our sample of 8 countries. A review of the performance and improvement of Malaysia's Institutional Infrastructure has shown that I.I. management is an integral, but not sole, driver of the country's enviable and impressive development performance over more than 30 years.

Before examining the lessons from Malaysia's experience, some words of caution:

a) A well-functioning Institutional Infrastructure is no magic wand; it is needed in addition to resources, sound economic policies, and other development inputs. In other words it is necessary but not sufficient.

b) Methods of achieving top-flight Institutional Infrastructure are not always transferable across borders. They need to be adapted and modified to suit local socio-political and cultural realities.

c) Like all economic processes, time is needed. There is no overnight fix. A long-term vision and patient and consistent investment structured in prioritised phases are required to build a well-functioning Institutional Infrastructure.

d) Finally, we believe that the Malaysian experience has a great deal to offer other countries seeking to improve their Institutional Infrastructure. However, our observations are not intended as a wholesale endorsement of Malaysia's political and economic system – and potential issues regarding the country's democratic process have been discussed in the previous chapter.

With these important provisos, fifteen lessons emerge from Malaysia's experience:

Lesson 1: Create the foundations for strong Government. This will comprise:

• Introducing (or enhancing) democracy at all levels; national, regional and local. This should be based on universal suffrage and entail frequent and fair elections.

• Encouraging the formation of political parties representing a wide range of views and policies to enrich the diversity of Government talent.

• Promoting the emergence of coalitions to provide a broad base for parliamentary majorities and thereby probably strengthen Governments and the actions they could take.

• Supporting the development of visionary and hands-on leadership.

Lesson 2: Invest in a high quality public administration. Key elements of this will be:

• Attracting and motivating the best human skills by structured recruitment programmes and performance assessments tied to bonuses.

• Ensuring that there is widespread and compulsory training to modernise and develop skills (this could include exchange programmes with the private sector).

• Instilling a service culture and setting service standards linked to an efficient and transparent complaint procedure.

The evolution of Malaysia constitutes the closest example of "what works" within our sample. A review of the performance and improvement of Malaysia's Institutional Infrastructure has shown that I.I. management is an integral, but not sole, driver of the country's enviable and impressive development performance over more than 30 years.
• Investing in efficiency tools, including the physical infrastructure of the public administration, and especially the IT applications.
• Providing all needed resources to ensure that anti-corruption agencies can do their work effectively.

Lesson 3: “Re-invent” the operations of Government on a regular basis. This includes:
• Re-organising the institutions in Government and the public administration to respond to new needs.
• Reviewing the “business processes” and workflows employed, and proposing improvements.
• Introducing new tools and methods (preferably IT-based) such as best-practice benchmarking, accountability and performance measures.
• Boosting the “openness” and accessibility of Government at all times by setting the example at ministerial levels.

Lesson 4: Employ a sophisticated economic planning system. This is very wide ranging and must incorporate:
• Establishing well-defined planning machinery with institutionalised organisations, committees, procedures, timetables, and decision taking processes involving the highest levels of Government.
• Creating clear time horizons, with distinctions between short, medium, and long-term, while emphasising the latter.
• Institutionalising regular in-depth consultation and dialogue with a wide range of economic, business, labour and social groups.
• Catering for identified “customer segments” in the planning process e.g. foreign investors, a region, a minority group etc. and developing planning policies tailored to them.
• Learning that planning does not mean doing: once the plan defines priorities, leave the “doing” to the business sector.

Lesson 5: Develop analytical and policy formulation capabilities. While this sounds innocuous, it is in fact the foundation of several other important elements in a well-functioning Institutional Infrastructure and comprises:
• Running a programme to identify and train the necessary analytical staff: economists, financial specialists, business people, exporters, etc., which should include overseas training.
• Providing a “home” for this team, typically as part of the planning unit but possibly in an advisory unit or think tank of some kind.
• Developing world-class analytical techniques through a programme of exchanges and study tours.
• Producing the country’s “own” economic analyses and development programmes of an even better quality than what is typically provided by the multi-lateral development institutions.
• Promoting original and innovative policies tailored to the socio-economic realities of the nation, thereby avoiding standard recipes developed elsewhere for a different context.

Lesson 6: Ensure that poverty reduction policies are effective. In some ways this is the most important development policy because all groups in society should benefit from the full array of economic policies in order to ensure social stability. This should include:
• Undertaking detailed analysis of social groupings and their poverty reduction needs.
• Designing an integrated package of poverty reduction policies to suit the separate segments, including rural development programmes, land development programmes, village level civil society promotion and re-distribution objectives.
• Implementing these policies sensitively so that no group loses out, but that redistribution is achieved with sufficient growth to ensure that all groups gain in absolute terms, even if some lose out in proportionate terms.

Lesson 7: Learn to manage crises. Again, this sounds like “motherhood”, but in fact this is an important element in earning international respect and maintaining independence in decision-making. This comprises:
• Introducing early warning systems to identify crises as early as possible so that they can be tackled while still manageable and not yet out of control.
• Assembling the right team to deal with all aspects of crises (analytical, prescriptive and decision aspects) and ensuring that the most senior representation allows tough decisions to be taken.
• Creating clear organisational and authority lines between the crisis management team and the normal economic management apparatus.
• Maintaining originality in the adopted crisis management measures, and avoiding standard recipes which may not fit the bill.

Lesson 8: Become as selective as possible in external finance. Admittedly this is partly a matter of what a country can afford, but it is also a question of economic and attitudinal behaviour. It should include:
• Defining the international financing needed for the development plan.
• Maintaining extensive information on availability and terms and conditions of international finance from all sources.
• Shopping around for the best deal which suits the country’s needs, thereby avoiding the “automatic” nature of many long running development finance programmes.
• Developing negotiation skills in order to ensure the best deal is structured for the country.

Lesson 9: Strengthen implementation capabilities. This comprises:
• Allocating implementation responsibilities exclusively to specialised agencies that already have, or will develop, the skills and appropriate behavioural style which suits the implementation objectives (i.e. avoiding implementation responsibilities in the public administration).
• Creating an implementation management team along the lines of the Implementation and Co-ordination Unit (ICU) in Malaysia that is responsible for performance monitoring and support.
• Reporting frequently and at senior level on implementation performance, triggering remedial action if necessary.

Lesson 10: Instil key principles in public development finance. While this exists on paper in many countries, it must actually work in practice by:
• Separating the revenue collection and expenditure processes, at least at the authorisation levels.
• Allocating funds for development expenditure only on the basis of a bidding process driven by a demonstrated track record in implementation.
• Checking that all projects for financing are objectively and independently selected by complying with approved selection criteria.
• Ensuring that procurement and contract awards are transparent and in accordance with international practice and standards.
Lesson 11: Establish a long-term vision for financial sector restructuring. The health of the financial sector and its ability to mobilise and allocate domestic and international financial resources is a critical influence on overall development performance. It will require:

- Conducting an open debate on the main operational and structural configuration of the sector, taking into account international benchmarks and best practice.
- Creating and publicising a long-term vision for the financial sector drawing on that debate and analysis.
- Designing the implementation mechanism and authority for achieving the vision.
- Providing the resources and institutions needed to clean up and eliminate current problems in the sector.

Lesson 12: Ensure that financial supervision is tight and applied equally. There are two main aspects to this:

- Establishing the full range of financial supervision institutions and creating world-class capabilities within them to really perform their on-site and off-site supervision tasks well.
- Avoiding “exceptions” so that all sub-sectors within the financial sector are supervised and that all institutions operating in those sub-sectors fall into the supervision net.

Lesson 13: Promote and protect competition. This may appear another “motherhood” statement, but in practice there are specific Institutional Infrastructure aspects to develop, including:

- Protecting consumers with appropriate legislation backed by some form of watchdog system and associated legal rights.
- Creating a transparent and efficient customs and excise institution.
- Minimising licensing requirements for economic activity, but if there are any, ensuring that the licensing process and authority is efficient and transparent.
- Announcing that any distortions in free competition from, for example, price subsidies and/or customs duties, if they are applied, are temporary and designed to achieve specific quantified objectives.

Lesson 14: Achieve the best levels in corporate governance. This is a worldwide pre-occupation and is difficult to achieve, but key elements will comprise:

- Reviewing the legal basis of governance by strengthening four areas: accounting and disclosure standards, monitoring and surveillance, directors’ accountability, and minority shareholders’ rights.
- Improving transparency and disclosure by enhancing accounting techniques and legislation.
- Empowering (new) institutions to play their part in achieving improvements in corporate governance, such as by providing training to directors, reviewing the listing information submitted by companies, or acting as a watchdog group for minority shareholders.

Lesson 15: Keep the business sector happy with their legal rights. This is a programme involving four main aspects:

- Creating “law and order” and a secure environment by providing the necessary laws as well as enforcement mechanisms.
- Introducing a full set of commercial laws that clearly define rights and obligations, especially ownership title rights.
- Ensuring that the court system to resolve disputes operates efficiently and impartially.
- Introducing safeguards to protect intellectual property rights (copyrights and patents).

To be of greater practical value for any nation wishing to take action on these lessons, they will need to be detailed, prioritised in a phased programme and assigned to working parties that possess the right skills to do the design and implementation work. They also need budgets and should report to the democratically elected government head who should take a personal, hands-on role. It is a great effort but, as demonstrated by the case of Malaysia, the rewards of a well-functioning Institutional Infrastructure are substantial.

3.1.2 Lessons from other countries

In addition to the lessons gleaned from Malaysia’s experience, similar conclusions can be drawn from the wider sample of 7 other countries which either reinforce and/or present a different perspective on the lessons already noted in Malaysia. Between all 8 countries some common themes emerge that could be construed as a list of 10 ‘guiding principles’ for improving I.I.’s management. These are:

1. Behaviour of the controlling “elites” – whether financial, political or professional – is crucial in either blocking or unlocking reforms, irrespective of policies, economic performance, priorities etc. Two extreme cases exemplify this point. On the one hand, in Morocco the entrenched economic interests have effectively and consistently “put the brakes” on real reforms in spite of “good” macroeconomic policies. On the other hand, in Uganda a small group of technocrats at the Ministry of Finance and, to some extent the Central Bank, have defined and implemented real reforms with the support of the country’s President. These reforms have been specifically geared to reducing poverty in a very difficult environment resulting from the country’s devastation prior to the 90s. This observation links with the first lesson from Malaysia about good quality strong Government.

2. Successful countries score particularly highly on the Political System: Creating an efficient public administration is a must to build up sustainable development aid policies and programmes (again this reinforces the observations from Malaysia). Without that there is no efficient implementation and programmes turn into failures time and time again. Peru, Ivory Coast, Pakistan, and Poland constitute clear examples where the lack of public administration capacities is one of the key elements explaining why results have not been commensurate with the investments (aid flows) made.

81 Many countries have failed to supervise some key parts of the financial sector, such as for example the non-bank financial intermediaries, and also many countries allow public sector financial institutions to be partly or fully exempted from compliance with prudential limits, thereby leaving them effectively un-supervised.
3. Decentralisation of decision making (devolution) seems to have produced positive results only if/when adequate resources have been allocated to build some management capacity base in the region. This has been the case of Malaysia but also in a limited way in Ivory Coast and Uganda. But when this is not the case, decentralisation fails and may become a further constraint to development. The case of Poland is an example of that. Obviously allocation of resources follows overall politico-economic ambitions and objectives. Entrusting local administrations with the responsibility for certain services and providing them with adequate resources to carry them out is also, basically, an effort to recreate elected political institutions – i.e. effective democracy – at the local level for objectives of long-term socio-political stability.

4. Reform needs to be “owned” by the LDCs if implementation performance is to be improved. The reform programmes in all countries analysed, with the exception of Malaysia, have been prompted by the aid agencies mainly led by the World Bank and the IMF. But implementation of these programmes has been universally weak, with glaring examples being Peru, Ivory Coast, and Morocco. In contrast, sometimes the Government has really taken “ownership” of the programmes and has genuinely integrated them into their own overall policies even factoring in the conditionalities: Uganda has excelled in that approach.

5. Economic growth, measured as GDP growth rates over a period of time, is a necessary – but not sufficient – condition to reduce poverty. Wide-ranging policies specifically addressing poverty reduction need to be adopted – and be made an absolute development priority – by Governments, which then should ensure that they can be adequately funded and properly managed. Examples include Pakistan, Poland and Trinidad and Tobago, where poverty has not been reduced in spite of achieving consistently high growth rates. Obviously, population growth is the other relevant factor that defines the poverty equation. Pakistan’s impressive economic growth failed to meet the needs of an increasing population. Indeed, the only country in which poverty has been reduced significantly is Malaysia. It is clear that poverty reduction is the main indicator of development success – and will increasingly be so given the very disappointing results in this area in the past. Governments have a crucial role to play (probably in collaboration with NGOs; see below) in ensuring that relevant programmes are in place. The development of specifically targeted “pro-poor” policies and related institutional capabilities will be the main challenge of development aid in the years to come.

6. Practically all 8 countries reported a lack of coordination concerning aid development programmes at three levels:
   - At an “internal” level within the Governmental departments having to do with aid administration / implementation;
   - at an “external” level between the aid agencies themselves (be it multilaterals, bilaterals, etc.);
   - at “both” levels in the interface between the aid/donor community and the Government agencies dealing with them.

Some steps in the direction of improving the situation above have taken place in some countries which have centralised all aspects of development aid in one technical group such as the Ministry of Finance in Uganda or the Treasury in Morocco. But a lot more action in this area is needed on the part of Governments and donors.

7. Significant aid flows – If properly allocated and efficiently managed – are a factor of significance to “launch” countries in their development path. But it is not until a country has been able to attract significant private sector investment on a regular basis that it can be ensured to have a solid platform on which to base sustainable development policies

8. The countries to which we have given lowest assessments of I.I. management (Ivory Coast, Morocco, and Pakistan) have low educational indicators that are below the averages for similar countries. At the other end, when education has been a consistent top priority, such as in Malaysia, the positive impact is widespread and long-term. Indeed, it is clear that human capital development, as measured by educational attainment, has been one of the main drivers in economic growth and one of the main causal factors in poor countries catching up with richer countries.

9. Corruption is, unfortunately, a widespread phenomenon which negatively affects all countries, albeit to varying degrees. This is so in most areas defining Institutional Infrastructure including the public administration, the legal system, corporate governance, all of which appear to be areas where corruption is pervasive, followed by the trade and competition area and, perhaps generally less so, in the financial sector. Attempts by most of the countries in the sample to deal with the problem by creating “anti corruption units” appear somewhat fragmented and not “heartfelt”, with the possible exception of Malaysia. However, as mentioned in chapter 1 (see the surveys by Transparency International), the issue is not restricted to LDCs. In the aid interface with LDCs there are developed country and supply-side aspects to be addressed too. Clearly more global work covering all countries is needed in order to ensure that the systems to prevent corrupt practices really work, and that “whistle blowing” is actively encouraged so that no-one needs to “look the other way” 82.

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82 The real issue here is what has been called the difference between “rule-based” behaviour and “principle-based” behaviour. Many rules promoting transparency exist, but these can still be ineffective unless key principles underlie them and are rigorously applied. To illustrate the point, consider an example from the technical assistance area where IIFs interface with beneficiary countries and consulting firms (often from developed countries). The rules for selecting consulting firms in IFI-financed TA require a selection committee to score several proposals. Usually, the rule-based approach stops at confirming that the selection committee met and indeed scored the proposals, whereas the principle-based approach reviews scoring patterns to detect bias and evidence of possible corruption by the scorers e.g. if one committee member consistently scores all the proposals at zero, while other members give it a high score. Needless to say, rule-based transparency controls are quite widespread but principle-based transparency controls are much more difficult to formulate and implement. (See also section 3.4.)
10. The existence of a real democratic process becomes a condition for sustainable, harmonious and continued success in development performance accompanied by reductions in poverty. Weak democracies and even authoritarian regimes can, however, produce periods of economic growth, as witnessed by Peru and – until recent elections – Pakistan, as well as Uganda for the last ten years. These situations do not, however, lend themselves naturally to boosting the Institutional Infrastructure. Measurable development without democracy can take place if – and only if – the Government genuinely focuses on development issues and supports them with adequate resources. But typically this is so only for a while and in an initial period. After that, only real democracy can sustain the policies, rules, structures and management needed to create sustainable development.

Finally, some country-specific positive lessons can be drawn from the evolution of the individual countries and our assessment of their I.I. management, irrespective of their performance and success. Indeed, even countries that have not been successful in their economic performance or in building efficient I.I. have something positive to offer in their experience which can be of potential interest to other countries.

In the Ivory Coast two interesting features are evident:

- The NGOs are playing a very useful and significant role in three key areas: (a) filling gaps created by weaknesses within the public services, (b) developing micro-finance schemes, and (c) acting as substitutes to formal democratic oversight institutions. They achieve this in a very difficult environment and within a national framework which does not lend itself to development and poverty alleviation.
- A regional (i.e. supranational) approach to reform (as opposed to a national one), including the transfer of key regulatory responsibilities, appears to produce economies of scale, reinforce regional trade and monetary integration, and generate more trust from the population and particularly the private sector.

In Morocco there has been consistently effective management of foreign aid by the Department of Treasury at the Ministry of Finance, which remains an exception to an otherwise bleak picture for implementation capacity. This is a lesson on how to make sure that the country’s relations with donors – which have been the main providers of finance until recently – are always kept on an even keel even if the country’s performance on reform has rarely matched or justified this positive impression.

In Pakistan there are again some noteworthy observations:

- Even within the constraints imposed by the country’s Institutional Infrastructure, the Central Bank (State Bank of Pakistan) has been able to consistently develop in an ever-increasingly independent and professional way. Today it is a highly respected institution, and that standing offers hope for success with the financial sector reforms to a degree that would be difficult to envisage without it.

- Pakistan gave an early priority and has gone a long way in liberalising its trade regime while restructuring and increasing efficiency in the key bodies responsible for trade management. The main gist of this process has been to orient activities in – and build up adequate institutional capacity of – the modernisation of the export policy framework to encourage higher value and improve competitiveness of exports.

In Peru, NGOs undertaking micro lending were formalised and integrated into regulated banking by the 1997 Banking Law. This lowered barriers of entry (mainly capital requirements) and has resulted in a boom in micro-lending activities which are amongst the most successful in Peruvian banking today, and act as a magnet to the formal banking sector to downscale. This measure regulated the creation of EDPYMES (Development Institutions for SMEs) which increased impressively in the last couple of years while showing bad debt ratios at levels below the universal banks. The result of this “pioneering” role is that Peru’s banking sector has started to provide financing to SMEs and individuals, an exception to the situation in all other countries studied.

Poland’s evolution, starting with the Economic Transformation Programme in the early 90s and continuing relentlessly, achieved in a very short period of time a significant and comprehensive transformation in practically all aspects of the country’s political and economic life. From macroeconomic policies, through the role of the private sector (which now generates 70% of GDP) and the build-up of an Institutional Infrastructure, progress has been uniform and comprehensive, i.e. without any area being “left behind” from an array of very significant changes. The magnet offered by the “acquis communautaire” which Poland has to comply with in the context of its joining the EU in 2003 has, indeed, powerfully driven the process. The existence of serious problems today (as presented in our separate country report) does not detract from the interest of, and lessons from, the experience.

Trinidad and Tobago has given priority to consistently develop its Institutional Infrastructure as a solid platform on which to base sustainable development. This approach, together with the judicious use of external advice and funding and the efficient management of its oil and gas resources has helped to attract investment and diversify the economy. This has helped the country overcome some of the potential disadvantages derived from its small size and its potentially complicated ethnic diversity. It provides a good example of how to turn potential weaknesses into strengths by the consistent development of its I.I.

Finally, for Uganda there are two further interesting aspects to note:

- Uganda is an example where the “conditionality” brought about by the donors is genuinely “owned” by the country as the Government factored this into its own reform programmes. This is the main reason why the country has made exceptionally good use of the significant development aid received. It responds to the priority given by Government to poverty reduction as evident in its homegrown Poverty
Improving the operational management of a country's Institutional Infrastructure is intended to enhance the country's ability to consume aid finance productively

Becoming a more mature and capable consumer of aid finance places a heavy burden on LDCs. Yet it is a burden that they recognise and have accepted

Eradication Action Plan, which is a comprehensive approach to the problem.

- In spite of its real lack of parliamentary multi-party democracy, the country has developed an effective participatory approach to economic development issues and, particularly, to poverty reduction. The strong partnership between Government, donors and civil society has driven the design, implementation and management of “pro-poor” and social reform policies.

Before moving on to discuss how to improve I.I. management in section 3.2, it is important to consider whether these lessons are of universal relevance, as they are drawn from a sample of only eight countries from a world total of 190.

On the whole, allowing for all the dangers of generalisations, we take the view that these lessons are universally relevant, based on our experience with working with over 100 LDCs over the past 20 years. Furthermore, the lessons from this report are derived from real, practical case study reviews of a fairly diverse set of countries that were deliberately chosen to be a representative sample of LDCs. This therefore implies that the lessons discussed in this section are not intended only to apply to countries similar to the sample of eight, or only to a sub-set of countries in a specified income category, geographic area, or socio-cultural-ethnic group. To the contrary, it is a global best practice concept with universal relevance.

It could be argued that some countries will be unable to embark on I.I. management improvements unless some basic pre-conditions within the country are met. These could include high levels of administrative sophistication, relatively high levels of GDP per capita and so on. In other words, improving I.I. management is reserved for those already capable and relatively rich, but the “basket cases” are exempted from this due to poverty, lack of capability, etc. We reject that suggestion and believe that there are no pre-conditions required to embark on I.I. management improvement programmes. The reason for this view lies in “what it takes” to develop I.I. management. Reduced to its bare essentials, all that is needed is a willingness to seriously embark on this. Provided this willingness is convincingly entrenched, information on what to do is available and can be obtained, and human capabilities can be developed through training. Naturally, existing levels of knowledge about what to do as well as existing human resource skills will determine how easily and quickly a country can reach best practice levels. But low levels of knowledge and rudimentary human skills are not grounds for exempting a country from I.I. management improvement efforts.

Finally, countries that have already achieved and exceeded the required global standard in I.I. management could claim exemption. This view is also rejected, if for no other reason than that these standards are themselves changing all the time; generally evolving and becoming tougher. Chasing the standard to keep up with best practice should be a global pre-occupation. So all countries need to make tailored efforts to improve their operational management of I.I., some starting from a near-zero base and others from a much more advanced level.

However, having said that, there are several important caveats at the beginning of this section which acknowledge that transferability across borders and “one size fits all” are important issues. These issues derive from the enormous diversity amongst the world’s 190 countries (see also chapter 1). For example, population sizes range from 99,000 for Grenada to 1,271 million for China; with 10 countries having a population over 100 million, 66 with a population between 10-100 million, 74 between 1-10 million, and as many as 37 which have below 1 million. Similarly, annual per capita income differs from about US$ 100 for Burundi and Ethiopia to around US$ 35-36,000 for Japan, the US and Switzerland. And of course size, geographic, resource, social, religious, political and many other differences are only too well known. But these differences do not eliminate the relevance of a universal standard of best practice in I.I. management; they merely affect its practical application. The diversity amongst countries will imply that for each country (a) their own starting point relative to “global I.I. management best practice” diverges widely, and (b) their own path to reach that global best practice will perhaps also vary considerably. But such differences need not eliminate the core commonality, which is that there is a global best practice and that there are methods of achieving it. This is the subject of the next section.

3.2. ACTIONS TO ENHANCE THE MANAGEMENT OF INSTITUTIONAL INFRASTRUCTURE

A great deal of effort by financiers as well as recipients of aid has already gone into establishing the policies and institutions that make up the Institutional Infrastructure of a country. However, as explained in chapter 2, it is the operational management of I.I. which is the main determinant of successes in aid finance. Hence all related and complementary efforts made so far will only provide true value if the operational management of I.I. receives equal improvement efforts. It is that aspect and that aspect alone that the recommendations in this section focus on.

Improving the operational management of the Institutional Infrastructure in a country is intended to enhance the ability of a country to “consume” aid finance productively. Or, to use an old-fashioned phrase, the overall objective is to improve the effective absorptive capacity. This means many things, all under the common banner of becoming more “mature and capable consumers” of aid finance:

- Improving project identification and design skills
- Making project implementation more effective
- Developing “shopping around” skills for aid finance

83 This figure is drawn from the United Nations membership, which will reach 190 countries in 2002 with Switzerland joining the UN.
84 This should include developed and OECD member countries as they deal with new issues such as, for example, the Enron-related governance scandal currently under debate in the US.
85 Figures quoted are using the World Bank Atlas method, not the purchasing power parity method.
• Harnessing the people's contributions in all these efforts
• Measuring results and being accountable

Becoming a more mature and capable consumer of aid finance places a heavy burden on LDCs. Yet it is a burden that they recognise and have accepted. For example, LDCs have recently said:

“We understand that if there is to be development assistance, then we have to put our house in order. We have to deal with building our human capacity, we have to deal with legal systems that protect rights, we have to have financial systems that are transparent, and we must fight corruption. We don’t expect any money unless we can deal with those issues. This is not something we are responding to because the rich world is forcing it on us, it is something which we know to be correct; in other words, without such actions we are not going to solve the issues in our own countries.”

Other prominent figures have made the same observation from different perspectives. For example, World Bank President J. Wolfensohn has written:

“People do not want charity, they want a chance. People do not want solutions imposed from without; they want the opportunity to build from within.”

The theme is the same as building the operational management of I.I., i.e. emerging economies want to help themselves and, by implication, need to equip themselves to achieve this aim.

Yet another more detailed observation comes from former US Treasury Secretary Paul O’Neill in his recent speech entitled “Caring greatly is not enough”:

“First, a truth we’ve always known. All people everywhere can do great things when they are given the tools and incentives for success. Second, that with leadership – honest, accountable, and committed to progress – everything is possible. Without leadership, nothing is possible. And finally, that in the right environment focused on growth, enterprise and human development, aid works. Knowing that it can work, we have a moral imperative to demand as much. Assistance should make a real difference in people’s lives…There are no second class citizens in the human race.”

These various quotes are different ways of saying basically the same thing: LDCs should become better at managing their Institutional Infrastructure. To achieve this goal, five action programmes are proposed which develop the key I.I. themes of governance, public administration, project preparation and financing, implementation effectiveness, and poverty reduction and social stability. These action programmes are perhaps a bit of a Trojan horse because they are multi-component and more complex than they might initially appear. Nevertheless, as explained later, there are good reasons for structuring them as five programmes.

The description of these recommendations which follows is highly summarised because it contains the lessons of the country studies where much of the detail is to be found (see section 3.1 of this chapter, as well as chapter 2 and Volume II of this report with the country studies). So the proposals are presented like a list of topics that will need to be developed; rather like a menu specifying the dishes but without providing the recipes. This is partly because the “recipes” will vary per country-specific situation, and partly because it would be too repetitive to provide all the detail from the country reports again here.

**Action programme 1: Improve governance to international “benchmark” levels.** This speaks directly to the leadership references made by Treasury Secretary O’Neill, who went so far as to say that without (the right) leadership, nothing was possible. It also addresses directly the management of I.I., because governance, leadership and management are all intertwined. The proposal to improve governance to “world-class” international standards as an objective will require action at three levels:

- **Government:** the governance of Government will require the implementation (or enhancement) of far-reaching democratisation at all levels, national, regional and local. Regular and fair elections must be held and the formation of political parties should be promoted. Coalitions should be encouraged to achieve some breadth of policies and some political checks and balances. Reasonable democratisation should also reduce the potentially harmful impact from controlling elites.
- **Business:** the governance of business needs a programme of improvements dealing with accounting, disclosure standards, monitoring and surveillance, director skills and responsibilities, minority shareholders’ rights, intellectual property rights, etc. New legislation and new institutions will be needed to introduce and monitor these changes. Linked to this, training for directors and broad watchdog/supervision roles will need to be developed.
- **Consumers:** appropriate legislation on consumer rights, protection and complaint procedures will be needed to provide “governance” to consumer transactions. A transparent and efficient customs and excise mechanism is an important element in this equation.

**Action programme 2: Create a world-class public administration.** This proposal directly improves the management aspects of I.I. from within the public sector. The aim is to get every public body in the borrowing country to be accredited with ISO 9002 or similar. It will need action in several areas:

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86 This is part of the “Monterrey Consensus” reached in March 2002 at the International Conference on Financing for Development, Monterrey, Mexico.
87 Remarks by the then Treasury Secretary on June 5, 2002 at Georgetown University after his 10-day trip through Africa with the rock-star Bono to understand aid better.
88 Obviously, this objective would have to be adapted, in practice, to the situation of each individual country at the “departure point” and particularly to its educational base, institutional and technical capacities, etc.
89 This could be extended at a later date by also implementing one of the ISO 14000 family dealing with environmental standards. Accreditation procedures should not be different than those existing today in national and international legislations.
• Skills: based on a professional recruitment process and appropriate compensation policies, high quality staff should attend compulsory training and continuously upgrade their skills.

This is important throughout the machinery of public administration, though skills should especially be built at local level in order to allow devolution of decision taking and administration to work effectively;

• Anti-corruption: there should be a well-resourced and independent anti-corruption body with international support. Ideally this should implement “principle-based” anti-corruption measures and not restrict itself to “rule-based” anti-corruption processes. As described earlier in section 3.1.2, “principle-based” measures are more effective as they follow the “spirit”, rather than just the “letter”, of the anti-corruption measures they seek to implement.

• Service culture: performance standards should be defined in published “charters” or similar, and it should be widely employed to boost efficiency and service levels. There should be continuous efficiency improvement programmes using business process re-design techniques;

• Financial: a “checks and balances” financial system should be designed which separates the power to raise revenue from the power to approve expenditure. Approvals of expenditure should be based on demonstrated success with implementation.

Clarity of purpose will be a key ingredient in delivering results. I.I. management improvement is a complex task, but under the banner of “keep it simple” we have proposed only five action programmes.

This is a device designed to allow change management to be effective. In addition, a key ingredient in implementation success is often the clarity whereby actions and objectives can be communicated. And five programmes can be communicated clearly and effectively, whereas a much larger set of actions cannot

Action programme 3: Build up a sophisticated project development and financing system. The specific objective is to create a high-quality set of project financing proposals based on the country’s own analyses and project preparation skills. As before, this is unlikely to be achieved by a single action:

• Planning: set up a well-defined planning machinery with institutionalised organisations, including analysis capabilities and procedures involving the highest levels of Government and also involving an intense dialogue with all economic agents, especially labour and employer organisations;

• Project preparation: linked to the planning system, create a high quality project preparation capability for analysing economic priorities and needs. This must include project design and feasibility analysis;

• Common set of projects: establish a set of prioritised development projects with full documentation (feasibility analyses, financing requirements and planning etc.) which can serve as a “common” set of project financing requirements in dealing mainly with international aid financing institutions, but also with the private sector (foreign and local). The existence of such an annual list will also make co-ordination easier, though this may require a dedicated co-ordination unit of some kind;

• Financing skills: develop the ability to “shop around”, evaluate and compare the various official and private financing possibilities in order to select the best financing for a particular project. The well-known concept of the “one-stop-shop” should be re-visited as a vehicle for attracting private FDI efficiently.

Action programme 4: Improve implementation capabilities. No doubt ambitious, the intention of this proposal is to directly improve the implementation performance of projects that have received aid finance, thereby enhancing the development impact of the project and also improving the chances of replication/further finance. This can be achieved by creating several programmes that collectively drive implementation effectiveness:

• Specialised agencies: if they don’t already exist, these should be created. The purpose is to avoid implementation activity by the public administration and to assign such “operational” tasks to specialised agencies that have the skills and operating culture for project implementation. Recruiting the right calibre human resources for these implementation agencies will mean selecting a different profile from the typical public administration/civil servant profile;

• Performance monitoring: an Implementation Co-ordination Unit, or similar, should be created which independently monitors all aspects of implementation progress. Ideally this should be as quantified as possible. This unit should also be charged with the special responsibility to reduce red-tape related to implementation e.g. the number of licences needed, etc.

• Financial sector: a “strategic vision” should drive re-structuring reforms and high-quality supervision in the banking sector so that it is truly an efficient counterpart to specialised long-term aid finance. This will typically involve three main reform programmes: (a) within financial institutions e.g. products, services, efficiency and IT etc.; (b) of the institutional system e.g. mergers, consolidation, bad debt clean-up via “hospital” banks etc; and (c) of the supervisory roles and effectiveness e.g. issues like having a consolidated supervisor, issues like the balance between on-site/off-site supervision etc.;

• Legal system: ownership and commercial rights should be clearly defined in law and dispute resolution procedures should be affordable and rapid. The process of establishing a “corporate” legal entity in order to start business should also be as easy and fast as possible and a low-capitalisation option for small businesses should also be available.

Action programme 5: Design and implement an effective poverty reduction programme in order to secure social stability. Poverty reduction is widely accepted as the paramount development objective. This is not only for the readily obvious humanitarian reasons. There are economic reasons too. If it is not achieved and groups in society do not share the fruits of successful development, continuing inequalities and poverty will act as a destabilising force and ultimately undermine the successes of development. The objective therefore raises no controversy; the question is how can the effectiveness of poverty reduction be enhanced? The lessons of the countries reviewed in this report, and of Malaysia in particular, suggest three key pillars which should boost effective poverty reduction:

• Link to “local” I.I. management: poverty reduction is about ideas and reaching the right
people as much as it is about resources. The relevance of local ideas and capabilities to reach the right target groups will be enhanced by improved local governance, skills, a more efficient local public administration and by top quality local project development capabilities;

- Needs analysis: like any private company undertaking detailed consumer research, the Government should carry out regular and detailed analysis of poverty reduction needs by sub-segment. This should emphasise local analysis of local needs;

- Integrated policies: having an adequate policy environment for, specifically, poverty alleviation is a must and poverty reduction is not a mono-policy campaign. Practical experience shows that Governments should mix at least three major strands into their poverty reduction strategy. The first is an emphasis on rural development and rural employment creation (supporting small holder agriculture is a “win-win” proposition), the second deals with land reform and development schemes, including financing agriculture development, and the third deals with promoting village-level civil society etc. These measures can help reduce migration to urban areas which typically swells the poverty problem. All these policies must emphasise local involvement and local outreach91.

We acknowledge, firstly, that these proposals do not amount to a radically new solution. The basic concept of becoming more mature and capable consumers of aid financing has been commented on by many from the LDCs (e.g. the Monterrey declaration), as well as by those in the aid finance business (e.g. the quote from J. Wolfensohn) and those looking into that business (e.g. the observations from Paul O’Neill). Furthermore, the constituent “components” that comprise well-functioning I.I. management are already well known and receiving some attention. This being said we also acknowledge that our five proposed action programmes are not so “compartmentalized” as a package. This is in line with the “key headings” that will enable LDCs to tailor and create detail in their own five programmes by studying the more successful examples – Malaysia, Trinidad & Tobago and Poland in our small sample, and other successful cases further afield.

Secondly, and much more importantly, we would argue that the novelty of the approach is not the key determinant of success. Often successful reforms are driven more by re-defining the energy levels and prominence devoted to the objective than exclusively by the “newness” of the approach92. This also applies to aid I.I. management: the concept may have been identified and tried before, but if it is still not at the desired levels it simply needs more effort, regardless of whether that represents an altogether “new” formula or not.

Thirdly, the issue of sequencing should be considered. Not all LDCs could realistically tackle the five proposed action programmes at the same time, and a certain “logical” sequencing could be considered as follows: first starting with Action Programme 5 is a must, then, in parallel, get Action Programmes 1 and 2 going, followed by Action Programme 4 and, later on, Action Programme 3 should start after all others have. Finally, we would argue that there are at least three dimensions of our recommended action programmes that are in fact somewhat different, even if they don’t amount to a new scientific “I.I. improvement formula”. The recommended action programmes contain several changes in emphasis and approach:

a) Elevate to priority objective: achieving, as an objective, world-class operational management of I.I. should be a top priority development objective at global level. It should rank with reducing poverty as the single most important aim of the LDCs in their partnership with public and private aid financiers. The reason is self-evident and discussed in chapter 2; better operational management of I.I. will cause greater development achievements across the board. And if resources are seen to be used successfully, more will follow, both from public and private sectors.

b) Use real, practical experience: the content of the five programmes is derived directly from the practical experience of the 8 countries studied. The findings of those reviews summarised in section 3.1 have been “condensed” into the five programmes outlined below in a generic manner. At this point the recommendations are not detailed as a recipe for countries to implement. They provide, however, the “key headings” that will enable LDCs to tailor and create detail in their own five programmes by studying the more successful examples – Malaysia, Trinidad & Tobago and Poland in our small sample, and other successful cases further afield.

c) Implementation design: Finally, the proposed approach for implementation incorporates some new ideas to ensure ownership, and monitoring of I.I. reform. These ideas are explored in more detail in the next section.

3.3 IMPLEMENTATION CONDITIONS: PUTTING THE PLAN INTO ACTION

This report has recommended five action programmes to improve I.I. management, drawing heavily on the lessons learnt from our sample of 8 reviewed countries.

As discussed above, the value of these recommendations does not necessarily lie in their novelty, as it is acknowledged that many of the topics are not new. Instead the value lies in the combination of ideas and reforms which complement each other as a package. This is in line with the objective, stated in the introduction, to maintain a practical perspective on making aid more effective.

Clarity of purpose will be a key ingredient in delivering results. I.I. management improvement is a complex task with many components, but under the banner of “keep it simple” we have proposed only five action programmes. This is a device designed to allow change management to be effective. Having only five

Our implementation programme rests on three cornerstones: clarity of objectives and consequences of succeeding or failing to meet them, responsibility for assessing and supporting I.I. management performance of recipient countries (the “keeper” of the I.I. standard), and ownership for driving implementation in recipient countries

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91 For a detailed analysis, reference is made to the following paper: Proposal for Oxfam GB Livelihoods Strategy, Final draft: October 14, 2002.
92 For example, in the corporate world, Procter & Gamble, a company with US$ 40 billion p.a. in sales, about 100,000 employees and operating globally in over 100 markets, provides a good example of this type of “try the core concepts again without being particularly new” turnaround which has been very successful at P&G over the last 2 years.
programmes provides focus, thereby allowing better implementation and greater achievements. In addition, a key ingredient in implementation success is often the clarity whereby actions and objectives can be communicated. The clearer they are, the more institutions and civil groupings will be enlisted and enthused to participate and play their part effectively. And five programmes can be communicated clearly and effectively, whereas a much larger set of actions cannot.

Any reform programme will need a detailed implementation strategy covering many aspects, including but not restricted to:

- Leadership to drive the process
- Definitions of participants and roles
- Changes in operating culture and conditions for success
- Incentives for participation and effort
- Possible painful repercussions, and key constituent groups
- Budgets to cover the inevitable costs
- Priorities for what to do first and leave for later
- Available time
- Requirements for a successful launch
- Measurement of results

We believe that the above amounts to a “check-list” for implementation design. Against this list, our implementation programme rests on three cornerstones:

- Clarity of objectives, and consequences of succeeding or failing to meet them
- Ownership for driving implementation in recipient countries

More specifically, our proposals for addressing these three key themes are presented below.

**Clear objective – “Acquis Developpementaire”**

The five action programmes are designed to make countries more mature and capable consumers of aid finance by moving them towards and beyond a global I.I. management benchmark. This minimum standard, or benchmark, could be known as the “acquis developpementaire”, drawing on the concept of the “acquis communautaire” for EU accession. Indeed, there are many international examples of such minimum standards prior to being admitted into markets or activities. For example, the EU has defined 30 achievements that comprise the “acquis communautaire” which countries need to reach prior to becoming members. The BIS has set the Cooke ratio minimum standard for capital adequacy so that banks can be compliant and operational. The rating agencies have set minimum standards for investment grade bonds. And of course the ISO 9000 and 14000 standards are becoming more widespread in their use by all sorts of organisations to reinforce their credibility.

The 18 components of the acquis developpementaire will each be scored and consolidated into an aggregate score, possibly with weightings to reflect higher importance of some aspects. The consolidated score forms the “rating” which will be published and based on measurable achievements in the five I.I. management programmes:

### COMPONENTS OF ACQUIS DEVELOPPEMENTAIRE

<table>
<thead>
<tr>
<th>Measurable and quantifiable achievements in:</th>
<th>Governance:</th>
<th>Public Administration:</th>
<th>Project Development:</th>
<th>Project Implementation:</th>
<th>Poverty Reduction:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government &amp; democracy</td>
<td>Government &amp; democracy</td>
<td>Skills &amp; training</td>
<td>Planning system</td>
<td>Specialist agencies</td>
<td>Ideas &amp; targeting</td>
</tr>
<tr>
<td>Business</td>
<td>Business</td>
<td>Anti-corruption measures</td>
<td>Project preparation</td>
<td>Implementation performance monitoring</td>
<td>Needs analysis</td>
</tr>
<tr>
<td>Consumer protection</td>
<td>Consumer protection</td>
<td>Service levels &amp; IT</td>
<td>Development project list</td>
<td>Financial sector efficiency</td>
<td>Integrated multi-component policies</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Financing procedures</td>
<td>Financing skills</td>
<td>Legal system effectiveness</td>
<td></td>
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The five action programmes are designed to make countries more mature and capable consumers of aid finance by moving them towards and beyond a global I.I. management benchmark. This minimum standard could be known as the “acquis developpementaire”, drawing on the concept of the “acquis communautaire” for EU accession.
Improving I.I. management to the acquis developpementaire standards clearly places a heavy burden of effort on emerging economies that are already stretched on all fronts. A solution is required for countries that fail to achieve needed levels of I.I. management, or who simply need more time to get there. Our proposed approach uses the “threshold” concept: Countries exceeding acquis standards can be expected to use aid financing effectively and to achieve successful development impact, while those below the acquis standard will probably fall short of development impact expectations and may only be ready for some types of aid finance. According to this view, the acquis should act as the basis for aid allocation decisions.

This proposal is of course very similar to the distinctions already in existence for a long time between concessional and non-concessional finance provided by all major IFIs, for example IDA funds and IBRD funds. The difference is that these are presently assigned on per capita income grounds, while the acquis standard would represent a more holistic, and qualitative, assessment of I.I. performance. While these approaches are clearly not incompatible, there should be a degree of harmonisation over time.

The measure of whether countries “pass the I.I. management test” will be done by an independent body, which will determine whether the country is ready to be a player in the aid finance markets, or whether it should rely on other forms of aid support until it reaches the "acquis developpementaire”. This is discussed more extensively in the next section.

Implied in this segmentation is a dynamic movement from one group to the other. As all countries build their I.I. management capabilities and become more capable and mature consumers of aid, they should reach the acquis standards and graduate to join the group of countries exceeding the benchmark. The objective is clearly that all countries should reach the standard as rapidly as possible and that there are no countries below the acquis levels i.e. it is an “empty segment”.

Using the acquis as a threshold, we can define specific aid financing characteristics of the two groups of countries, as detailed in the table below.

<table>
<thead>
<tr>
<th>Countries below the “acquis” standard</th>
<th>Countries exceeding the “acquis” standard</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expected aid utilisation</strong></td>
<td>With I.I. management capabilities exceeding the minimum standards, aid finance should meet the development impact requirements</td>
</tr>
<tr>
<td><strong>Main objective</strong></td>
<td>To maintain the I.I. management capabilities and further improve them to exceed the acquis standard by a progressively larger margin with each rating report</td>
</tr>
<tr>
<td><strong>Available financing</strong></td>
<td>• Project and programme aid financing not generally available</td>
</tr>
<tr>
<td><strong>Available financing</strong></td>
<td>• Emphasis on grants for humanitarian and ‘social purposes’ finance which is the core financial product for this group of countries. Available in larger amounts than to date</td>
</tr>
<tr>
<td><strong>Available financing</strong></td>
<td>• “Comfort” instruments from IFIs available to support private FDI flows (likely to be used primarily in countries showing a clear trajectory towards the acquis threshold)</td>
</tr>
<tr>
<td><strong>Technical assistance</strong></td>
<td>Much larger amounts available than hitherto, all focused on the five I.I. improvement action programmes94</td>
</tr>
<tr>
<td><strong>Technical assistance</strong></td>
<td>Clearly, less available than previously as improving I.I. management capabilities from a high level does not require TA</td>
</tr>
</tbody>
</table>

Countries exceeding acquis standards can be expected to use aid financing effectively and to achieve successful development impact, while those below the acquis standard will probably fall short of development impact expectations and may only be ready for some types of aid finance. According to this view, the acquis should act as the basis for aid allocation decisions.

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93 See also Chapter 1.
94 There could be a case to earmark some of these TA funds to facilitate, for example, establishing public – private partnerships which are becoming more and more an efficient instrument to reach out to the poor in particular – least developed – LDCs.
Finally, it has to be mentioned that the concept of the “acquis” goes in a similar direction to what is being considered by the New Partnership for Africa (NEPAD) concerning the African Peer Review Mechanism (APRM).  

On the assumption that LDCs are persuaded that they should strive to achieve acquis status, this raises the question of who will develop and monitor this standard and where LDCs obtain the detailed blueprint for improving I.I. management. One possibility is the creation of an “LDC only” organisation specialised in Institutional Infrastructure, which could be called the Organisation for Developing Institutional Infrastructure. This will be a non-financing independent institution acting as a reference centre on I.I. and as a rating agency specialised in the five programmes that make up I.I. management.
possibility, which we recommend, is the creation of an “LDC only” organisation specialised in institutional infrastructure, which could be called the Organisation for Development Institutional Infrastructure (ODII). This will be a non-financing independent institution which has a dual role, acting on the one hand as a research institute/reference centre on I.I., and on the other hand as a rating agency specialised in the five programmes that make up I.I. management. This will provide a convenient source of high quality independent knowledge made readily available to ODI member countries so they can rapidly progress to substantial gains in I.I. management performance.

Although essentially an organisation providing a technical service to its members, the ODII could be viewed as a “counter-ODI” i.e. as a professional body representing its member states in their efforts to improve I.I. management. On occasion, this could be a useful support for LDCs in their dealings with the OECD’s DAC and other interactions. The ODII could conceivably be developed under the aegis of a leading IFI, though it will be unlikely to meet its objectives if it is – or is perceived to be – under the institution’s control. Alternatives could be under the “umbrella” of a more “neutral” organisation (i.e. UN family?). A first cut at the key policy, strategy and operational parameters of the ODII are presented in the box below. A more detailed blueprint will clearly need to be developed at a later stage if this proposal is adopted.

Provided it acts as a reference centre and “sign-poster” of information and avoids duplicating what is done better elsewhere, the ODII will provide a convenient service to assist member countries with the question of “how to” improve I.I. management. Furthermore, it is an institution with LDC members thereby avoiding any possible problems with the “ownership” of its recommendations, which will not be seen as imposed by the donor countries. And it is independent. With all member countries having an equal membership irrespective of size and location, no one country could influence it to bias its ratings analysis or “bend” the institution in one direction or another. It should obviously be created to high standards of professionalism which together with its independence and autonomy should become the third pillar on which ODII would establish its credibility amongst both the “demand” and the “supply” side of the development aid industry.

The issue of choice should again be highlighted (see also the box above). Ideally, it should be compulsory for a developing country to join the ODII as it will review member country progress towards achieving the defined I.I. management standards in its regular ratings reports. And, as outlined below, these rating reports are a crucial determinant of a country’s aid configuration. But it is not compulsory to use the ODII services for improving I.I. management. Any country is free to find its own way directly to source information that suits its needs. It may, for example, prefer to deal directly with a specific “model” country on how it implemented improved governance in the business sector successfully, obtaining all relevant legislation, administration, implementation techniques etc. from that model country direct. As long as the standards defined by the ODII are borne in mind, so that the developing country knows the benchmark it is working towards, it can get there in any way that suits it.

We acknowledge that the ODII concept would be as useful as it is practical and realistic to implement. Indeed, the operational and organisational details, together with the roadmap to operationalise it, would be the critical factors to establish its validity and suitability to achieve its objectives (and thus, the “test” to really establish the validity of this important recommendation). All of these are yet to be developed in detail and go beyond the remit of this study. It should be mentioned, however, that the starting point would be the choice of the type of institution. Two main avenues appear possible in that respect: (i) the “political” approach – implicit in our presentation – according to which the attempt should be made by the sponsor(s) of the concept to “convince” as many – if not all – LDCs as possible to create ODII while – at the same time – convincing also the donor community, and the private sector that the I.I. rating system would result in adequate increased funding for those above the benchmark. This avenue would result in a “full” ODII upfront but it is likely to take time to launch; (ii) the “business” approach, which would consist in starting ODII as a rating agency for a number of LDCs which would become the sponsors of the concept, establish its validity amongst all aid players and then gradually “invite” other LDCs to join on the basis of its proven “track record” and benefits thereeto. Obviously, the impact of such ODII would be more limited but it could be launched in a relatively short period of time.

Finally, concerning the role of civil society, the ODII could act as a point of contact for NGOs involved in aspects of I.I. reform. These, in turn, could act as ‘windows’ on local communities in LDCs for observing or supporting reform. As already described in chapter 1, the NGO world is diverse and densely populated. Not only is it estimated that there are more than 50,000 but their range of tasks, size and approach to their activities diverge widely. Not all are concerned with aid and development issues, and not all have a multi-country scale of operations. However, some are, and these NGOs are involved in aid and operate on an international, even global level.

The relevance of NGOs for I.I. management improvement can be fairly direct as many of them operate at a very “local” (regional, town and village) level in LDCs. Through their operations, these NGOs often make positive contributions to:

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100 Crucial to the establishment of that credibility would be that the individual in charge of ODII’s creation and development is a high powered individual with international standing and solid reputation (i.e. former President, Prime Minister, etc.) ready to dedicate a few years to ODII.

101 As an alternative, LDCs could choose not to join – though this would result in more difficulties in receiving support for I.I. enhancements.

102 The process is exactly the same as that which applies to an institution seeking to obtain an ISO quality standard. Provided it knows what it needs to comply with, it can either get to the benchmark standard under its own steam, or use any one of many external advisers, or “models” that have already reached the standard etc. in its efforts.

103 NGOs active in many fields including: children & youth, communications, conflict resolution, disarmament, disaster relief, drug abuse, education, environmental activities, ethics and values, family issues, health and nutrition, human resources, human rights, law, natural resources, energy, peace & security, religion, trade, finance and transport, population & human settlements, refugees, science & technology, sustainable development, status of women and others.

ODII is an institution with LDC members thereby avoiding any possible problems with the “ownership” of its recommendations. And it is independent. With all member countries having an equal membership, no one country could influence it. It should obviously be created to high standards of professionalism which together with its independence and autonomy should become the third pillar on which ODII would establish its credibility amongst both the “demand” and the “supply” side of the development aid industry.
We propose that for each of the five programmes, a corresponding specialist and highly empowered responsibilities are assigned, each country will have a senior “Council of I.I. Change” composed of five people, one each in charge of governance improvements, fixing the public administration, identifying projects, boosting implementation capabilities, and making poverty reduction effective. These appointees need to be seriously empowered to be able to instruct Ministers and push legislation through

- Improving the quality of local decision taking and governance
- Improving local (village-town level) administration and record keeping
- Professionalizing local project formulation and design
- Rendering local project implementation more efficient
- Making local poverty reduction efforts more effective

So NGOs have a positive impact for many of the I.I. management variables. Generally speaking, they also add resources which would otherwise not be available, perform tasks which would otherwise not be done, and provide opinions, views and experience which would otherwise not be readily available at local level. Clearly, they should be an important ally for the big players in aid development. They should also be an important ally for all LDCs in their effort to improve I.I. management.

Local ownership – “Council of I.I. Change”

Typically, recent efforts to improve I.I. management capabilities have been widely fragmented and dispersed within a country and are often handled by organisations whose prime task (and skill) is something quite different. So, for example, up to five or more Ministries may be charged at any one time with improving governance and accountability in their implementing agencies, even though their primary skills and tasks lie in, say, agriculture, transport, trade and industry. This approach will tend to make I.I. management improvements less effective.

Instead we propose that for the five programmes, five corresponding specialist and highly empowered responsibilities are assigned. So each country will end up with a senior “Council of I.I. Change” (CIIC) composed of five people, one each in charge of governance improvements, fixing the public administration, identifying projects, boosting implementation capabilities, and making poverty reduction effective. They are likely to be individuals with practically no staff, working with others who are responsible for action and implementation. These appointees need to be seriously empowered to be able to instruct Ministers and push legislation through. For their assigned I.I. management action programme CIIC members will act as drivers of processes, co-ordinators of actions, providers of information, masters of the inherent complexity, communicators and publicists, and above all, as achievers of targets. Overall, they are the “champions of change” for their programme and area of responsibility 104.

Organisationally there are several options for accommodating the CIIC, each with its advantages and disadvantages. They can be in a matrix formation with the line Ministries, or they could be “dual appointees” within the existing structure. For example, the Minister of Finance would double as the CIIC member for the governance programme, and the Interior (or Home Affairs) Minister may double as the CIIC member for the poverty reduction programme. Whichever detailed organisational form is chosen, consolidating the actions into five programmes will allow specialist responsibilities to be assigned to drive the changes successfully into the system.

Other implementation considerations

The issue of timing is an important consideration, as to whether results can be expected in a short time in line with the urgency with which they are required. Provided there is a pervasive willingness to embark on the action package (see the comments on “incentives” below), there are several arguments to suggest that results can be achieved in a relatively short time frame in most countries:

- Selectivity. The CIIC in each country can choose to focus initial effort on one or two of the I.I. management improvement programmes that, in their view, will have a faster pay-off than others. For instance, if the right approach is used there could be quite quick and visible results from the governance improvement and project identification programmes. It is not unrealistic to think as short as a couple of years for benefits to flow through. Furthermore, such positive results tend to snowball, accelerating other achievements in other reform programmes. Further ideas on possible “sequencing” of the proposed Action Programmes are presented in paragraph 3.2.

- Culture change. The creation of a new institution in the ODII presents an opportunity to instil a new and more decisive, action-orientated culture in the aid arena. This would enable country-level reforms to be implemented free from elements that would slow them down105. Notwithstanding recent scandals and failures amongst *blue chip* Fortune 500 corporations, there are examples of large multinational companies that have achieved real turnaround in a short period of time. The key to such successes lies in the change management techniques used, and there is a wide body of knowledge available on the subject in the corporate sector. The CIIC in each developing country, as well as some of the major official aid funding institutions, would benefit from adopting similar change management approaches.

- Additional interim support. No matter how decisive and swift the reform actions will be, there is no denying that time will be needed. Overall, a 5-year programme is envisaged, though obviously many results should filter through much earlier in that period. However, as discussed previously, during those 5 years there should be increases in humanitarian aid and funding for social projects made available, largely as grants, to the countries that do not meet the acquis developpementaire. Such additional interim support will help them through the change effort while still addressing their more urgent aid requirements. This reform programme will require significant effort and investment. The incentive to pursue these

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104 This concept is often used successfully in change management in the private sector.
105 Reform processes that require numerous multi-party reviews, steering committees, consultations, draft papers etc. are likely to proceed very slowly, if at all.
reforms is clear, namely: “better results and more money”. Indeed, this will affect all players in the business: LDCs can expect better development impact for every dollar spent and aid financiers can look forward to better results from aid finance. When these positive results are sustained, more money should follow. In short, the package of reforms should set the stage for growth and better performance in the aid financing business.

These recommendations will be more persuasive in the context of a cost/benefit trade-off. Very rough estimates of the costs and potential benefits of the 5 recommendations are provided below:

- Estimated one-off investment cost:
  - US$ 8-10b, for 120-140 countries, over 5-8 years
  - i.e. US$ 7-17 million per country, per year.
- Costs borne by: LDCs
- Estimated annual benefits:
  - Additional resources of US$10-20b from official sources, plus US$10-25b from private FDI
- Benefits accruing to: LDCs

Although the costs are dauntingly large, they are spread over many different players and over time. The ballpark estimates for the annual level of benefits are larger still, outstripping the costs around 3-4 times. At these benefits are likely to be annual, while most of the cost estimates are one-off investment costs, the ratio between the costs and the present value of the benefits stream would be significantly larger. Hopefully these reforms could therefore result in a win-win situation, where money spent leads to better performance, which attracts more money each year and so on. Indeed, if this beneficial circle could be established, it may help persuade the DAC countries to increase their annual contributions to aid.

For many years the DAC countries have had a target of 0.7% of GDP as an annual contribution to the aid business. The current level, however, is only around 0.22%108. The difference between the two, based on current GDP sizes, is about US$ 100-110 billion p.a. Not only is this far short of target, but it also occurs at a time when many OECD public sector deficits have shrunk significantly with some sceptical about the results. Hopefully these concerns will fade as the reforms outlined in this report are aimed directly at addressing that issue by creating mature and capable consumers, exercising responsible choice in their dealings with a competitive and regulated industry.

However, moving to the 0.7% of GDP target will not be achieved in one year and some pragmatic phasing should be proposed. This could be linked to an “ability to pay” assessment of the public sector deficits in individual DAC economies. There is an important caveat to all this: the additional public money should stimulate more private flows to emerging markets, and not become a substitute for dwindling private flows. There is every confidence that this can be achieved by the overall improvements that should derive from the reform programme as well as the specially expanded comfort instruments that should boost the volume of private sector money.

In all, it is an ambitious re-visiting of well-known themes. But in pursuing reforms to improve the performance in the aid financing business, the words of Robert McNamara, former World Bank President are a reminder of the broader picture:

“Surely that must be our hope, not only our dream, but our steadfast objective. Some may consider such a statement so naive, so simplistic, and so idealistic as to be quixotic. But as human beings, can we be at peace with ourselves if we strive for less?”

3.4 BROADER IDEAS FOR FURTHER “SUPPLY SIDE” ACTIONS

All the effort to improve I.I. management is “demand side” effort, i.e. the DACs need to do the work that “puts their house in order” so as to become more mature and capable consumers of aid finance. As argued in Chapter 2, demand side reform is the most powerful lever for improving the effectiveness of aid, and will, over time, also drive supply side reform. However, complementary additional measures may be required to (a) support the I.I. management improvement efforts and (b) to provide further financial benefits over and above the immediate I.I. management benefits. This observation is especially true of the leading IFIs, who are: (i) the trend-setters of the aid industry, (ii) the providers of ODA, and (iii) the creators of enabling environments which favour private investment in LDCs.

The performance of IFIs, and which reforms may improve their effectiveness, has been analysed exhaustively by a variety of organizations, foundations, think tanks, and politicians. We do not pretend, in the context of this study, to propose another set of drastic reform proposals. However, since our thesis is that better management of I.I. is crucial for countries to progress effectively in reaching their overall development objectives, we have focused on a few “supply side” aspects that are broadly related to I.I. management, so as to make some suggestions that, we hope, may be of help. These are ideas more than elaborated proposals, offered to contribute to the dialogue and debate on aid effectiveness, and based on experience in the field. In this context, three key aspects emerge:

- Re-design and enhance the provision of Technical Assistance for I.I.
- Improve some aspects of the performance of IFIs to simplify LDC dealings with them

Results can be achieved in a relatively short time frame in most countries. This reform programme will require significant effort and investment, the incentive being: “better results and more money”. This will affect all players: LDCs can expect better development impact for every dollar spent and financiers can look forward to better results from aid finance. When these results are sustained, more money should follow. In short, the package of reforms should set the stage for growth and better performance in the aid financing business.

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106 The intention of the reform package is that it truly spells gains for all LDCs and aid supply side institutions. The reforms represent a change in modus operandi that should lead to an increase in the volume of business operations. In no way should the proposed changes be seen as a downsizing and lay-offs programme. It is exactly the opposite; creating the platform for real growth in the aid business.

107 The individual country contribution performance within the OECD/DAC group varies considerably, from 1.06% of GDP for Denmark to 0.84% for the Netherlands and 0.10% for the USA (2000 data).

108 The reduced (relative) pressure on public finances is evident from OECD data; over the last five years (i.e. between 1996 and 2001) Government net financial liabilities as a percentage of GDP fell from 49% to 44%.
Additional measures may be required to support the I.I. management improvement efforts and to provide further financial benefits. This is especially true of the leading IFIs who are the trend-setters of the aid industry, providers of ODA, and creators of enabling environments which favour private investment in LDCs.

- Consider new avenues for debt restructuring and cancellation

### 3.4.1 Re-design and enhance the provision of technical assistance for I.I.

In chapters 1 and 2 there have been various references to "institution building" technical assistance in the context of improving I.I. management. Two overall messages emerge: first, that the effectiveness of institution building technical assistance has been patchy and often disappointing, and second, that the volume of IFI funding allocated to institution building technical assistance has fluctuated. Yet, as described earlier, each country will need to incur significant investment expenditures in order to reach the acquis developmentale. In line with normal competitive practice, it should be free to spend money wherever it chooses to obtain the information, design and other support it needs to reach this objective. It may spend money with the ODII or with a wide range of other institutions and private advisers, and there is therefore a real compelling case to:

- Re-emphasise financial support for institution building TA;
- Re-design the delivery of this TA in order to make it more effective.

It is recognised that efforts are already underway to boost the volume of TA funding for the components of I.I. management programmes. However, these should be further enhanced by allocating truly significant sums of money to a dedicated programme. Just as the EU PHARE and TACIS programmes devoted around Euro 13 billion over 8 years to bringing potential member countries up to standard in the 30 "acquis communautaire" areas, so the donor community could agree on a very major effort, also running to billions of dollars for a concerted 5-10 year period to bring about the "acquis developpementale". Such a large-scale TA programme would be devoted exclusively to funding advisory work for LDCs to reach the benchmark. It could be called the "TA Programme to improve the Management of I.I. (or TAPMII for short). TAPMII would be different from the current fragmented practices in being very large scale and focused exclusively on the five acquis areas. It would not be a new institution: TAPMII would be a programme that acts as an umbrella under which TA executed by various different institutions and beneficiaries could be funded on a consistent basis.

TAPMII would need a modest-sized team (resembling a technical secretariat) that programmes the funding of TA work in the five I.I. management fields. This involves work to mobilise and manage TAPMII resources and also various activities to set eligibility criteria, procedures etc for allocation of the TAPMII funds. This team could be attached to any appropriate international institution, or even to the ODII. The main developing country counterpart for TAPMII would be the "Council on I.I. Change" in each country (CIIC; see section 3.2) who would present their work programme of I.I. management improvement activities to TAPMII for funding.

Clearly such magnitudes of TA funding, starting with around US$ 16-18 billion for a multi-year I.I. improvement effort, shows real commitment to making things happen in this area and is consistent with placing I.I. management improvements as one of the key objectives on the global development stage.

This big money approach, combined with a "new banner" dedicated to improving TA management will do much to re-emphasise the TA needed in this area. But over and above quantity, careful attention must also be paid to quality issues. The design and delivery of TA has raised much comment in the past, suggesting that a fresh look could lead to some re-design proposals aimed at improving value, i.e. results, per TA-dollar spent. Based on our experience, we have proposed some preliminary ideas for improving the TA business process, with an emphasis on supporting improvements in I.I. management. Over and above the magnitude of the effort, careful attention should also be paid in terms of quality.

### POSSIBLE STRUCTURE OF TAPMII

#### TAPMII initial 5-8 year programme US$ 16-18 billion

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<tbody>
<tr>
<td>Initial 5-year allocation; US $ 3.4 million per country</td>
<td>Initial 5-year allocation; US $ 3.4 million per country</td>
<td>Initial 5-year allocation; US $ 3.4 million per country</td>
<td>Initial 5-year allocation; US $ 3.4 million per country</td>
<td>Initial 5-year allocation; US $ 3.4 million per country</td>
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109 See earlier references for example to the World Bank’s Operations Evaluation Department; "...the Bank’s contribution to institutional development has been modest both in middle and low income countries...". And other studies have shown that the Bank has focused too narrowly on institutional design and training, as well as using inflexible lending instruments.

110 For the financial sector, for example, the First Initiative has been established, and for governance and many other topics there have been TA components in project and programme loans for a number of years.

111 From 1990-98, the PHARE programme commitments reached Euro 8.8 billion while those for TACIS were Euro 4.3 billion. The PHARE programme alone continues to run at Euro 1.6 billion per annum for about 12 eligible countries. This is clearly TA funding on a grand scale.

112 Such magnitudes are not out of line with what has been achieved by the EU PHARE and TACIS programmes.
3.4.2 Improve some aspects of the performance of IFIs

There are about 20-25 major “official” international aid financing institutions comprising the major multilateral financial institutions (the World Bank and the big regional development banks such as the ADB, AfDB, IDB, EBRD, EIB), other major institutions such as the Islamic Development Bank, BADEA, the EU, the Black Sea Development Bank etc. and about 10-15 major bilateral institutions of the DAC countries such as USAID, CIDA, AFD, SIDA, DANIDA, DFID and others.115

Taking a broad view that aid includes public and private flows, a statistical analysis might in the first instance suggest that these 20-25 significant “official” international financial institutions are not that important anymore. As evident in the table below and from the more extensive data in chapter 1, the private sector flows have recently eclipsed the collective IFI flows, making the latter look like small players on the world stage:

But such simple quantitative snapshots are misleading and in fact the role of these major IFIs is of crucial importance for the entire aid-financing picture. There are a couple of reasons for this:

- First, the IFI influence on aid finance extends beyond the quantitative “dollars transferred” amount. IFIs are a knowledgeable tone-setting influence in the aid business through their analysis, TA activities, policy influence and role as co-financers with the private sector.
- Second, although the volume of IFI aid finance is periodically eclipsed by private FDI flows, the latter is volatile and highly concentrated in a few countries.

This means that official IFI aid is in fact the most important source of aid for most developing countries and over defined periods of time, and thus of real significance despite some snapshot headline statistics. Furthermore, there is some case for exploring reform:

- One reason is because the many reforms of the IFI sector have not produced radical results, generally speaking. Although as a set of institutions there have been numerous changes and adaptations over the past decades, these are by and large gradualist116.
- Furthermore, as amply discussed in chapters 1 & 2 of this report, the performance record of the IFIs has generally been patchy and in places disappointing, suggesting that there is further room for improvement.
- Finally, we maintain that I.I. improvements in recipient countries will indirectly force reform upon IFIs over time, and should remain the over riding priority. Nevertheless, there is merit in considering ideas for improving some aspects of IFI performance in parallel, and at an early stage.

3.4.3 Innovate in debt restructuring and cancellation

Debt relief buys an important breathing space and releases resources for I.I. management (and other) activities. Any ideas to further promote debt relief

### Major Aid Transfers By Source (US$ Billion)

<table>
<thead>
<tr>
<th>Source</th>
<th>1990</th>
<th>1997</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFIs</td>
<td>60</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Private sector flows</td>
<td>30</td>
<td>300</td>
<td>150</td>
</tr>
</tbody>
</table>

Source: World Bank

113 These ideas are more fully described in the article “Technical Assistance should be privatised”; DFC Spotlight, Autumn 1999.
114 It is true that some donor-funded TA has already started to address some of the issues in the TA business process, but examples remain of the descriptions in the TA today column.
115 The IMF is not included in the definition of an “aid financing” institution, even though lately it has been active in operations that are closely related to aid (e.g. HIPC debt relief).
116 This is not to deny that many well-intentioned and analytical efforts have gone into IFI reform, but much of it has been gradualist in nature and most of it is driven internally i.e. IFIs coming up with their own suggestions for change and implementing these themselves.
117 In the last two years alone there have been three major reports calling for changes in IFI strategy and operations, and there are many more piecemeal and less prominent calls for change. In fact, the level of scrutiny that public aid providers faces is extremely high be it from governments, academia, think tanks, civil society, NGOs etc. This is partly explained by the “public” character of aid and the fact that governments fund the IFIs or guarantee their resource mobilisation, and also because many of these IFIs are seen partly as instruments of the political ambitions of their main shareholders, which leads to further analysis and discussion. Indeed, a large part of the issues that the IFIs have been facing in streamlining their operations comes from the multiplication of objectives that their shareholders, in particular from industrialized countries, impose on them – the so-called mission creep.
should therefore help the I.I. objectives outlined in section 3.2.

There are two aspects of debt relief that deserve some emphasis. The first is whether in the future a larger proportion of aid should be in the form of grant rather than aid. This is mostly relevant to lower income countries that are already part of the HIPC process. The second concerns the recent proposal by the IMF to put in place a new framework (the Sovereign Debt Restructuring Mechanism – SDRM) that would allow countries with clearly unsustainable debt burdens to restructure their debts in a fashion that preserves economic activity and assets values, while protecting creditor’s rights. This would provide for equitable treatment among all private creditors, and would be mostly used for middle income countries as lower income countries typically have generally not been able to attract substantial flows of private debt.

Debt versus grant
For lower income countries, the proportion of grant financing should be substantially increased, and indeed in our presentation on the acquis developmentaire, we suggest that countries below the threshold should only receive grants. We believe that the major issue raised by most public creditors and governments, namely that such a switch may not be sustainable because the reflows of concessional aid are a crucial element of future funding of aid for developing countries, masks the real issue which is the wholly insufficient volume of public aid flowing to developing countries. There are other considerations like the incentive for better performance that debt funding, as opposed to grant, provides. This may be true, but that issue could probably be finessed through a better link between overall performance in aid utilisation, and availability of aid. In any event, we would also submit that countries receiving aid primarily as grant should be on a trajectory to exceeding the acquis threshold, and thus to diminishing their reliance on grants over time.

The SDRM
The issue of burden-sharing between private creditors of various types has been progressively surfacing in the last years, and indeed the proposal by the IMF would provide for more equitable treatment of various creditors (including bond holders), that would share in the costs of the restructuring. The mechanism would allow for a super majority of creditors to vote to provide temporary limitations on the enforcement of creditor claims, while agreeing on the provision of new money on a senior basis. The proposal will progressively be fleshe out – it is very innovative and complex, raising a large number of issues that need to be tackled. Perhaps one question that needs to be addressed is whether this would provide some incentive for private flows to resume, rather than hinder them. Second, the IFI traditionally have enjoyed a privileged creditor status, and the scope of this privilege has progressively been increased as it has de facto been expanded to cover additional IFI instruments (e.g. loans syndicated by the IFIs, or MIGA risk insurance policies). It may well be that in some cases the proportion of external debt owed by a country to the privileged creditors is such that leaving them out of the restructuring process may not be possible. The situation in Argentina may be relevant in that regard. While IFIs are generally not permitted to restructure their portfolio, de facto this may have happened indirectly, and informally through the provision of new funding to refinance old debts under an agreed adjustment programme. Considering formal restructuring of IFI debt may open a Pandora’s box, with adverse effects on their privileged creditor status, and their ability to raise resources from the market at the lowest cost possible. However this needs to be explored, as there may be situations where the participation of the IFI in debt restructuring would be necessary for the success of the debt workout.

Other considerations
In addition to current approaches to this problem, there could be value in developing an integrated perspective on this issue across all LDCs, and presenting a single, and unified, point of contact for negotiations with creditors. A potential vehicle for achieving this could be the Organisation for Developing Institutional Infrastructure, described earlier, given its broad-based representation of LDCs, its insights into the I.I. of each member country, and its expertise in implementing I.I. reform programmes. Debt rescheduling would clearly not be a core remit of the ODII, but could become an area of activity as the institution develops.

An additional idea would be to develop an approach which side steps, at least temporarily, the obstacle on “how to pick up the tab” for any debt relief mechanism. This alternative approach tries to get away from the notion of an outright payment for debt relief/cancellation. Instead some financial deferral process should be designed. The idea is based on drawing the (very close) parallel between “bad debts” at international and national levels. For instance, in many countries the aid financing institutions are supporting financial sector restructuring programmes that are usually triggered by dangerous levels of bad debts and weakened bank balance sheets. In many of these cases the concept of a “bad bank” or rehabilitation fund of some sort is used to clean up the balance sheets and provide a fresh start for lenders and borrowers. These bad banks typically receive support from the international aid financing community. This situation at national level presents a very close parallel with debt forgiveness at international level; it is a financial problem where debtors cannot afford to pay creditors. Neither can afford to walk away from their historic financial obligations, but they could transfer them to a third party and postpone the final resolution of the problem. Building on this idea, it could be possible to explore the merits of establishing an “international bad bank”, perhaps better called the International Debt Consolidation Fund (IDCF). Essentially this would amount to little more than using the national level recipe at an international level, with some differences in the design. There is also a close parallel between this proposal and the Brady Bonds launched initially in 1989. The essential difference is that the IDCF will deal with all official debt and there is less reliance on the role of markets. Instead the IDCF will eventually, on a highly deferred basis, pick up the tab for debt which will not be repaid.

The main impact of the IDCF will be to allow much more debt to be cancelled for truly impoverished nations. The ideas of how it might operate are very
3.5 RECOGNISE THE LINKS BETWEEN I.I. MANAGEMENT IMPROVEMENTS AND TRADE LIBERALISATION

Although discussed as a general global issue in chapter 1 of this report, the liberalisation of international trade is revisited because of its transcendental importance. While it extends beyond the remit of the study, it is flagged as a critical issue. Indeed, the economic benefits of free trade – domestic and international – vastly outstrip any aid financing which has been achieved or can reasonably be expected to materialise. This relative value is at the heart of the well-worn slogan “aid versus trade” which has already received much attention for decades. Naturally, detailed quantitative estimates are tricky but a few headline figures remind us of the magnitude of the contrast (see also chapter 1):

- Official aid transfers (excluding private sector flows) are currently around US$ 50-60 billion p.a.
- The OECD countries spend about US$ 1 billion per day, i.e. around US$ 350-360 billion p.a. on agricultural subsidies alone, representing 6-7 times the annual official aid figure.
- The OECD trade barriers and subsidies are estimated to result in lost export income for the LDCs in excess of US$60 billion annually.
- By some estimates, eliminating trade barriers worldwide could lift 300 million people out of poverty in the next 15 years.

The pattern of trade, both domestic and international, has at least three reasons for being slow to change:

- It is a critical element of economic management. Imposing barriers and tariffs will strongly determine the structure and employment pattern of an economy, at least in the short term. So world-wide, Governments are reluctant to cede sovereignty and control over one of their key economic management tools;
- Import duties and licences are an important source of public sector revenue. And furthermore, in many markets they are more easily collected than alternative revenues such as income tax or VAT. So again, Governments will remain very reluctant to forego the income they derive from trade distortions;
- Trade liberalisation can have some painful effects, namely to exacerbate income disparities between countries, and to require that uncompetitive industries be restructured.

Trade liberalisation is not the focus of this study and it would be inappropriate to make comprehensive recommendations on accelerating trade liberalisation. We have, however, taken the liberty of making some tentative observations on this issue. There is considerable choice in moving forward and at least three approaches, or tactics, could be pursued in seeking further progress towards the broad goal of further liberalisation: at country-level and in seeking bilateral agreements; at regional level in striving for more effective regional free trade zones, and at global level with a comprehensive solution. It is possible that the first approach is the most desirable, the second may be the most practical, and the third may be the most difficult. Yet whatever is pursued and achieved by the experts in this field, the headline data show clearly that the value of trade liberalisation should benefit I.I. management improvement efforts substantially. More specifically, it could support I.I. management improvement programmes in at least two ways:

- Significant financial benefits should accrue to LDCs which will help provide resources for the upgrades needed to improve I.I. management.
- Significant “learning” benefits should also accrue to LDCs as they would have the chance, through trade, to be fully exposed to world standards and market forces. That is a direct parallel to the world standards that LDCs will need to apply in the management of their Institutional Infrastructure.

The economic benefits of free trade – domestic and international – vastly outstrip any aid financing which has been achieved or can reasonably be expected to materialise. The value of trade liberalisation should benefit I.I. management improvement efforts substantially.
APPENDICES

A.1 THE DATABASE ISSUE
A.2 SUPPORTING TABLES
A.3 COMPARATIVE ASSESSMENT OF EVALUATION BY MAJOR AID AGENCIES
A.4 POTENTIAL CHANGES TO TA BUSINESS PROCESSES
A.5 CONSIDERATIONS FOR IMPROVING IFI INTERNAL PROCESSES
A.6 POTENTIAL IDEAS FOR THE INTERNATIONAL DEBT CONSOLIDATION FUND (IDCF)
APPENDIX A.1

The Database Issue

Studies of development aid draw on statistics from a variety of sources, using different definitions.

Foreign aid is usually associated with Official Development Assistance (ODA) and targeted normally to the poorest countries. ODA\(^{119}\) comprises grants and concessional loans, i.e. loans that have at least a 25% grant component\(^{120}\). ODA may be also categorised into bilateral and multilateral components. Bilateral\(^{121}\) assistance is administered by agencies of donor governments, e.g. USAID. Multilateral assistance is funded by contributions from wealthy countries and/or borrowing from the markets and is administered by agencies such as the United Nations Development Programme or the World Bank.

ODA is a subset of Official Development Finance (ODF), which refers to all financing that flows from developed country governments and multilateral agencies to the developing world. It too can be divided into bilateral and multilateral components.

The data are derived for the most part from the OECD online DAC database, although data are also used from the World Bank. The objective is to deliver a view on net disbursements of development aid over the past three decades. The data are therefore illustrative. It is outside the terms of reference of this project to reconcile the two principal data sources. It should be stated, however, that the fact that these two sources exist and bear no resemblance to one another clouds the issue of knowledge of the underlying databases. For example, the definition of multilateral institutions and the treatment of grants differs between the two sources. The OECD data include grants from the UN agencies and the EU in ODF (official development assistance), whereas the World Bank does not record these flows in the multilateral category, using instead the total OECD grant figure when calculating total flows to all countries.

The World Bank definition of developing economies includes all low-income and middle-income countries, except those with a population of less than 30,000 and includes also countries in transition. The latter refer to most of the countries in transition in Eastern Europe (Bulgaria, the Czech Republic, Hungary, Poland, Romania and the Slovak Republic), the Baltic countries (Latvia, Estonia and Lithuania), Russia, Belarus, Moldova and Ukraine. The OECD maintains two lists of countries for development aid purposes. Part 1 of the DAC list includes all LDCs and territories, while Part 11 includes countries and territories in transition (in Eastern Europe) as well as more advanced LDCs and territories. Several of the more advanced economies were transferred from Part 1 to Part 11 in 1997\(^{122}\), thus aligning more closely the OECD and World Bank’s definition of developing economies from that date. Official development finance (ODF) to all aid recipients comprises official development assistance (ODA) for Part 1 countries, official aid for Part 11 countries and other official flows (OOF) for both Part 1 and Part 11 countries.\(^{124}\)

Private capital flows are examined from the two principal sources, WB and OECD. Private capital flows from the former refer to net private capital flows, which is the sum of foreign direct investment, portfolio investment flows and bank and trade-related lending.\(^{125}\) Private capital flows from the OECD refer to the sum of bilateral and multilateral private flows. Net disbursement of private aid includes direct investment by bilateral donors, other bilateral securities and claims and purchase securities. Multilateral private flows refer to the sum of purchases of newly issued securities and other transactions. The data do not include equity investment and are therefore not comparable with World Bank data on private flows.

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119 Work by Chang et al., 1998 questions the use of ODA as a true measure of development aid. The authors propose an alternative measure – effective development assistance – which uses the sum of grants and the grant component of the concessional loan.
120 The grant element is defined as the difference between the face value of the loan and the present value calculated at a discount rate of 10 percent of the debt service payments to be made over the lifetime of the loan, expressed as a percentage of the face value.
121 Some bilateral aid is ‘tied’ meaning that it must be used to procure goods and services from the donor country.
122 The grant element is defined as the difference between the face value of the loan and the present value calculated at a discount rate of 10 percent of the debt service payments to be made over the lifetime of the loan, expressed as a percentage of the face value.
123 Examples include Bermuda and Israel.
124 ODA refers to flows that meet the criteria for ODA but are provided to aid recipients on Part 11 of the DAC List. OGF comprises flows for development purposes that have too low a grant element to qualify as ODA and excludes officially supported export credits.
125 Net private capital flows consist of private debt and non-debt flows. Private debt flows include commercial bank lending, bonds and other private credits; non-debt private flows are foreign direct investment and portfolio equity investment. Foreign direct investment is net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of an investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital and short-term capital as shown in the balance of payments. Portfolio investment flows are net and included non-debt-creating portfolio equity flows (the sum of country funds, depositary receipts and direct purchases of shares by foreign investors) and portfolio debt flows (bond issues purchased by foreign investors). Bank and trade related lending covers commercial bank lending and other private credits (World Bank, 2001).
## NET PUBLIC AND PRIVATE FLOWS – EAST ASIA PACIFIC REGION

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Source: Global Development Finance 2001
### NET PUBLIC AND PRIVATE FLOWS – SUB-SAHARA AFRICA REGION

| Source: Global Development Finance 2001 |

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| Multilateral L-T debt | ..    | 0.01  | 0.19  | 0.12      | 0.25      | 0.24 |
| Bilateral L-T debt   | ..    | -0.02 | 0.10  | 0.16      | 0.03      | -0.05|
| **Total**         | ..    | -0.02 | 0.28  | 0.28      | 0.28      | 0.20 |
| Grants            | ..    | 0.01  | 0.59  | 0.53      | 0.64      | 0.73 |
| Technical Cooperation | ..    | 0.02  | 0.27  | 0.15      | 0.39      | 0.43 |
| IMF               | ..    | -0.09 | 0.21  | 0.16      | 0.27      | -0.07|
| **Total Public**  | ..    | -0.08 | 1.35  | 1.13      | 1.58      | 1.29 |
| **Private**      |       |       |       |           |           |      |
| Private creditors | ..    | 0.40  | 0.56  | 0.43      | 0.70      | 0.93 |
| Private non-guaranteed debt | ..    | 0.01  | 0.45  | 0.11      | 0.80      | 0.12 |
| Foreign direct investment | ..    | 0.03  | 1.22  | 0.37      | 2.07      | 2.76 |
| Portfolio equity flows | ..    | 0.00  | 0.24  | 0.06      | 0.42      | 0.53 |
| **Total Private** | ..    | 0.44  | 2.48  | 0.96      | 3.99      | 4.34 |

Source: Global Development Finance 2001
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Source: Global Development Finance 2001
### NET PUBLIC AND PRIVATE FLOWS – SOUTH ASIA REGION

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| Multilateral L-T debt | 0.40  | 0.76  | 0.64  | 0.88      | 0.41      | 0.21 |
| Bilateral L-T debt  | 0.90  | 0.37  | 0.11  | 0.26      | -0.05     | 0.04 |
| Total            | 1.30  | 1.13  | 0.75  | 1.14      | 0.36      | 0.25 |
| Grants           | 0.69  | 0.82  | 0.57  | 0.69      | 0.45      | 0.40 |
| Technical Cooperation | 0.21  | 0.33  | 0.34  | 0.43      | 0.25      | 0.18 |
| IMF              | 0.06  | 0.11  | -0.02 | 0.14      | -0.17     | -0.05|
| Total Public     | 2.26  | 2.39  | 1.64  | 2.40      | 0.88      | 0.78 |
| **Private**     |       |       |       |           |           |      |
| Private creditors| 0.02  | 0.73  | 0.24  | 0.42      | 0.07      | 0.93 |
| Private non-guaranteed debt | 0.00  | 0.04  | 0.13  | 0.10      | 0.15      | 0.17 |
| Foreign direct investment | 0.05  | 0.08  | 0.45  | 0.22      | 0.68      | 0.51 |
| Portfolio equity flows | 0.00  | 0.01  | 0.44  | 0.43      | 0.45      | 0.34 |
| Total Private    | 0.07  | 0.86  | 1.26  | 1.17      | 1.35      | 1.96 |

Source: Global Development Finance 2001
### NET PUBLIC AND PRIVATE FLOWS – LATIN AMERICA AND THE CARIBBEAN REGION

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Source: Global Development Finance 2001

### GROSS DISBURSEMENTS – PUBLIC AND PRIVATE FLOWS

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Source: Global Development Finance
### NET TRANSFERS – PUBLIC AND PRIVATE FLOWS

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Source: Global Development Finance

### CUMULATIVE OUTSTANDING MULTILATERAL DEBT BY INSTITUTION (US$ BILLION, CURRENT)

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Source: OECD: DAC online database
### NET DISBURSEMENTS OF PRIVATE CAPITAL FLOWS BY CATEGORY

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<td>219.1</td>
</tr>
</tbody>
</table>

Source: World Bank: World Bank Development Indicators

### NET DISBURSEMENTS OF PRIVATE CAPITAL FLOWS
### BY INCOME GROUP – SELECTED YEARS

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Low-income countries</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign direct investment</td>
<td>32.3</td>
<td>45.5</td>
<td>42.5</td>
<td>54.9</td>
<td>55.4</td>
<td>55.4</td>
<td>60.4</td>
<td>455.9</td>
</tr>
<tr>
<td>Portfolio investment flows</td>
<td>-0.1</td>
<td>6.1</td>
<td>9.9</td>
<td>21.5</td>
<td>39.6</td>
<td>39.6</td>
<td>25.3</td>
<td>3.2</td>
</tr>
<tr>
<td>Bonds</td>
<td>-0.1</td>
<td>6.1</td>
<td>5.5</td>
<td>21.1</td>
<td>9.2</td>
<td>9.2</td>
<td>16.9</td>
<td>-118.2</td>
</tr>
<tr>
<td>Equity</td>
<td>0.0</td>
<td>0.0</td>
<td>4.4</td>
<td>0.4</td>
<td>30.4</td>
<td>30.4</td>
<td>8.4</td>
<td>121.4</td>
</tr>
<tr>
<td>Bank &amp; trade-related lending</td>
<td>67.8</td>
<td>48.4</td>
<td>47.6</td>
<td>23.6</td>
<td>5.0</td>
<td>5.0</td>
<td>14.3</td>
<td>-359.1</td>
</tr>
<tr>
<td>Net private capital flows</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Middle-income countries</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign direct investment</td>
<td>29.4</td>
<td>34.0</td>
<td>67.0</td>
<td>59.0</td>
<td>51.4</td>
<td>51.4</td>
<td>57.2</td>
<td>61.8</td>
</tr>
<tr>
<td>Portfolio investment flows</td>
<td>1.2</td>
<td>18.2</td>
<td>16.9</td>
<td>29.9</td>
<td>31.5</td>
<td>31.5</td>
<td>26.6</td>
<td>19.1</td>
</tr>
<tr>
<td>Bonds</td>
<td>1.2</td>
<td>17.7</td>
<td>9.5</td>
<td>17.1</td>
<td>15.7</td>
<td>15.7</td>
<td>16.3</td>
<td>13.5</td>
</tr>
<tr>
<td>Equity</td>
<td>0.0</td>
<td>0.5</td>
<td>7.4</td>
<td>12.9</td>
<td>15.7</td>
<td>15.7</td>
<td>10.3</td>
<td>5.6</td>
</tr>
<tr>
<td>Bank &amp; trade-related lending</td>
<td>69.5</td>
<td>47.8</td>
<td>16.1</td>
<td>11.1</td>
<td>17.1</td>
<td>17.1</td>
<td>16.2</td>
<td>19.1</td>
</tr>
<tr>
<td>Net private capital flows</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: World Bank: World Bank Development Indicators

### COMPONENTS OF PRIVATE CAPITAL FLOWS (% SHARE)

Source: World Bank Development Indicators
## APPENDIX A.3

### COMPARATIVE ASSESSMENT OF EVALUATION BY MAJOR AID AGENCIES

<table>
<thead>
<tr>
<th>Agency</th>
<th>Organisational Independence</th>
<th>Staffing</th>
<th>Design of Evaluation System</th>
<th>Quality of Output</th>
<th>Effectiveness of Monitoring</th>
<th>Use of Feedback</th>
</tr>
</thead>
<tbody>
<tr>
<td>World Bank</td>
<td>Evaluation Unit established in 1970 OED reports directly to Board.</td>
<td>50 (1998)</td>
<td>Shift from evaluation of individual projects to country programmes and its overall effectiveness. QAGroup assess quality at entry. Logframe used but not uniformly throughout the Bank.</td>
<td>Regarded as the lead example for others to follow. Implementation Completion Reports (IMC) and Annual Report on Portfolio Performance (ARPP) have set standards for the sector.</td>
<td>Wappenhams Report critiqued emphasis on mechanics of physical implementation and too little attention to risks and factors influencing outcome. Monitoring performance indicators since defined for 17 sectors.</td>
<td>Widely disseminated within the Bank and through seminars and conferences. OED database contains information on all completed operations. But too much detail and not easily usable. Lessons learned are fed in to new projects.</td>
</tr>
<tr>
<td>Asian Development Bank (ADB)</td>
<td>Post Evaluation Unit (PEO) established in 1978 PEO reports directly to President</td>
<td>36 (1998)</td>
<td>Project Performance management System – systematic capture of project's outputs, effects and impacts. PEO undertakes broad-based evaluations (impact evaluations, special studies...) apart from project evaluations.</td>
<td>Since 1995, Annual Performance Evaluation Programme introduced.</td>
<td>Project Administration Committee (PAC) and Beneficiary Monitoring Evaluation (BME) where only 30% of completed projects evaluated. Need to fine-tune methodology for assessment of development effectiveness.</td>
<td>Developed dissemination mechanism and large database in PES (Post Evaluation Information System). Lessons learned are fed in to new projects.</td>
</tr>
<tr>
<td>United Nations Development Programme (UNDP)</td>
<td>Central Evaluation Office (CEO) founded in 1983 Director of Evaluation Office reports to Administrator</td>
<td>11 (1998)</td>
<td>Shift towards programme evaluation, but no uniform approach. Reports prepared by country offices.</td>
<td>Status of mandatory evaluations unclear. Less structured approach but more beneficiary participation.</td>
<td>According to survey only 17% of projects judged to be successful.</td>
<td>Not institutionalised. Publication of evaluations carried out through country offices may be restricted.</td>
</tr>
<tr>
<td>World food Programme (WFP)</td>
<td>Office of Evaluation (OED) reports directly to Executive Director</td>
<td>7 (1998)</td>
<td>No in-depth evaluations on impacts and outcomes. Recent focus has been on emergency and protracted relief operations.</td>
<td>No completion reports. Self evaluations by Country Offices (COPRs) contain too much detail and lack analytical rigour.</td>
<td>Primarily responsibility of recipient Government. Since 1990 uses BCM approach (Beneficiary Contact Monitoring). Mixed results according to region.</td>
<td>No formal or institutionalised mechanism for feedback. All evaluation reports are shared and discussed internally and given wider circulation. OED has started data base with summaries of completed reports.</td>
</tr>
<tr>
<td>European Commission (EC)</td>
<td>Since 1.1.2001 Evaluation Unit in EuropeAid Reports to the Commissioner for Development. All evaluations are contracted out to independent consultants</td>
<td>8</td>
<td>Annual rolling programme for major multi-country programmes/Projects. Non-programmed evaluations contracted by Delegations with advice from Evaluation Unit.</td>
<td>Logical Framework planning technique is generally used. Too early to assess.</td>
<td>Monitoring is being decentralised to Delegations. In the past monitoring was widely criticised. The implementation delays in many programmes coupled with findings of Court of Auditors tend to substantiate this.</td>
<td>Evaluation reports completed since 1998 are on web-site together with current summaries (Evinfo). Feedback in to new programmes Projects encouraged but not always applied.</td>
</tr>
<tr>
<td>USAID</td>
<td>Central Policy Bureau reports to the Office of the Administrator</td>
<td>n.a.</td>
<td>Central evaluations by CPE Operating unit evaluations (both impact analysis and operational). Goal–area evaluations.</td>
<td>Goal area technical analyses conducted on specialised topics –used to validate or modify programme strategies.</td>
<td>Operating –unit evaluations capture project progress as well as performance issues and operational problems.</td>
<td>Extensive library and database. Since 1995 has integrated results reporting and performance in to the way it plans and implements future programmes.</td>
</tr>
</tbody>
</table>
**COMPARATIVE ASSESSMENT OF EVALUATION BY MAJOR AID AGENCIES**

<table>
<thead>
<tr>
<th>Agency</th>
<th>Organisational Independence</th>
<th>Staffing</th>
<th>Design of Evaluation System</th>
<th>Quality of Output</th>
<th>Effectiveness of Monitoring</th>
<th>Use of Feedback</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Department for International Development (DFID)</strong></td>
<td>Evaluation department established in 1970</td>
<td>14 (2001)</td>
<td>DFID’s evaluation criteria follows DAC recommendations</td>
<td>Use of Logical Framework technique</td>
<td>Feedback thorough monitoring gathered systematically during the process of implementation to check performance of project/programme</td>
<td>Reports are widespread through the UK parliament members, IDC, UN bodies… Most studies are released to the public</td>
</tr>
<tr>
<td></td>
<td>Evaluations are contracted out to External consultants</td>
<td></td>
<td>Shift from projects evaluation to examination of themes (e.g. gender), sectors (e.g. basic education) and country programmes</td>
<td>Some evaluations are conducted with stakeholders analysis and participatory approaches</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Evaluation unit reports to Project and Evaluation Committee</td>
<td></td>
<td></td>
<td>Finance and economic analysis have been the main focus of evaluation</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>The National Audit Office undertakes some independent studies on some Projects/Programmes</td>
<td></td>
<td></td>
<td>DFID have been criticized for: 1) superficial and short field research and 2) few impact analysis</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Danish International Development Assistance (DANIDA)</strong></td>
<td>Evaluation unit established in 1980</td>
<td>4 (1995)</td>
<td>DANIDA evaluation criteria follows DAC recommendations</td>
<td>DANIDA is experienced in evaluating institutional development</td>
<td>Quality assurance takes place by means of day-to-day monitoring of the implementation of the development assistance and the ongoing evaluation (DAC has described it as one of the best in the world)</td>
<td>Informal feedback, but there are also follow-up memos prepared to be given to involved departments with follow-up activities</td>
</tr>
<tr>
<td></td>
<td>Evaluations executed by external consultants</td>
<td></td>
<td>Shift from project evaluation to sector, country and thematic evaluation</td>
<td>Better quality evaluation reported than other donors thanks to DANIDA’s methodological analysis and time devoted to field research</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>DANIDA has a complete procedural evaluation for the NGO-Aid</td>
<td></td>
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</table>

## TA BUSINESS PROCESS: OBSERVATIONS AND SUGGESTED CHANGES

<table>
<thead>
<tr>
<th>TA “business process” step</th>
<th>Observations about TA today</th>
<th>Proposed changes to aim for in re-design</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Initiative</td>
<td>- TA frequently a condition of an IFI for the provision of other funds. - Beneficiary institution can be chosen for its effectiveness as a channel for international assistance rather than as the most logical institution which should be responsible for receiving and implementing the advice. - TA occasionally not at the initiative of the beneficiary so there is little or no ownership. Indeed, it may be unwanted. - Financing of TA by grants or soft loans diminishes ownership.</td>
<td>Ensure the request for consultancy work comes direct from the beneficiary to enhance real interest, real ownership and real co-operation. Ensure the beneficiary has real jurisdiction and responsibility to enable implementation. Avoid “free” TA and create a financial stake for the beneficiary.</td>
</tr>
<tr>
<td>2. Definition of task</td>
<td>- Beneficiary does not always write the TORs. - Tasks are typically described in complex, multi-task TOR with broad coverage addressing wide range of issues that go beyond the responsibilities of one institution. - Increasing “latitude” of interpretation in TORs about actual coverage (particularly on implementation issues).</td>
<td>Ensure the tasks are defined by the beneficiary with an emphasis on a few clear outputs and results. “Un-bundle” TORs to make them clearer and more manageable.</td>
</tr>
<tr>
<td>3. Tender process</td>
<td>- Detailed bureaucratic requirements result in inches-thick standardised proposals which discourage ideas, innovation and ingenuity. - Formalised and ritualised time-consuming process for tenderer and evaluator alike.</td>
<td>Make the bidding process more informal and flexible to resemble the free market (with only a sample of situations audited to prevent malpractice). Emphasise creativity and innovation. Require short proposals focusing on outputs and end results of the work.</td>
</tr>
<tr>
<td>4. Selection i.e. decision</td>
<td>- Usually done by a selection committee on which beneficiary may be only lightly represented, if at all. - Decision based on mechanical scoring criteria which comply with procedures but can obscure the suitability of choice (i.e. provided a score is assigned, the consistency and level of that score is not questioned).</td>
<td>Focus selection criteria on consulting and advisory skills as much as historic functional experience. Make the recipient the key decision taker, subject to reasonable controls.</td>
</tr>
<tr>
<td>5. Volume/size of services</td>
<td>- Increasingly large, multi-task assignments with risk of heterogeneous quality. - TA covers more and more non-advisory activities e.g. travel for study tours, equipment etc. which consultants are not well equipped to provide efficiently. - Budget usually set by financing agency which may reflect other influences e.g. remaining unallocated funds, size of annual programme, country-wide framework agreements etc., yet be inappropriate for the size of the task and professional requirements.</td>
<td>Structure a series of smaller tasks in such a way that decisions on whether to continue or not are taken at the end of each stage. Focus on advisory elements only and avoid procurement of other services under TA.</td>
</tr>
<tr>
<td>6. Team</td>
<td>- Strong emphasis on people with functional experience rather than effective advisory skills. - Tolerance of teams hired for the job i.e. collections of independents. - Often little real client team involvement: nominal counterparts usually skip doing the real work.</td>
<td>Emphasise people with effective advisory skills i.e. who are good consultants (also implies stronger bias in favour of permanent employees who are trained as consultants). Ensure there is real involvement of the client team by allocating real tasks to them (thereby also reducing the size and cost of the consultant team).</td>
</tr>
<tr>
<td>7. Fees</td>
<td>- Dichotomy of client (beneficiary) and payer (IFI) can create a distortion in pricing as fee levels could bear little relation to the value of the advice to the client. - General squeeze on fee levels. - Increasingly complex construction and breakdown of fees and expenses in proposals. - Administratively cumbersome billing and payment procedures with broad scope for delays and disputes.</td>
<td>Radically simplify and streamline administration and payments. Extend the use of lump-sum contracts with expenses expressed as a global percentage of fees.</td>
</tr>
<tr>
<td>8. Decisions on findings</td>
<td>- Frequent use of Steering Committees tends to make acceptance of recommendations more unlikely as there are “many masters” to please. - Increasing habit of accepting or rejecting an entire report rather than selecting from the substantive content what is acceptable and rejecting what is not. - Occasional threats of non-payment unless the consultant writes what the client wishes them to write.</td>
<td>Decide on basis of selectivity; the client learns to select what is useful. Ensure recommendations are reviewed by beneficiary directly focusing on issues of content rather than wording. Allow independent views and simply ignore recommendations which are not acceptable, rather than forcing changes with non-payment threats.</td>
</tr>
<tr>
<td>9. Implementation</td>
<td>- Can be significant political hurdles to overcome which can create impasse. - With the objective of promoting competition and preventing malpractice, the rules of consultant procurement usually prevent the same team from assisting with implementation and a tender is required from which the existing firm is excluded, thereby losing the learning curve and cumulated experience.</td>
<td>Make the implementation of accepted recommendations a priority. Allow the consultants who have worked on the analysis to be retained to support that process, provided their performance was satisfactory.</td>
</tr>
<tr>
<td>10. Timetable</td>
<td>- Can be lengthy and slipped. - Frequently tied to other timetables which have no relation to the content of the advice.</td>
<td>Reduce timetables in line with smaller tranches of work. Avoid tying timetables of consulting work to other milestones which are un-related.</td>
</tr>
</tbody>
</table>
APPENDIX A.5

Considerations for improving IFI internal processes

This appendix describes preliminary ideas for IFI reform that should be particularly relevant for improving the effectiveness of aid delivery, including the management of I.I.

- **Increase the correlation between LDC performance and volume of aid delivered.** There is no shortage of internal strategic documents, at global, country, and sector level that advocate relating the provision of aid to LDC performance. In practice, however, this correlation is less evident, as reflected in the IFIs own internal evaluation documents. Irrespective of – the admittedly significant – difficulties faced in determining the performance of the aid suppliers, aligning more closely performance and aid delivery will remain a crucial objective. Our suggestion is that IFIs introduce the concept of “acquis developpementaire” as the basis for linking aid to performance, given the crucial importance of I.I. management to the effectiveness of aid.

- **Address the tradeoffs between the need for coordination and competition amongst aid suppliers.** Greater coordination amongst aid suppliers is required to reduce wasteful overlaps and duplications and to alleviate the burden that users face in relating to the large number of institutions and organizations involved in aid delivery. While work is proceeding on many aspects of coordination (eg: creating new coordination mechanisms, or involving representatives of various constituencies) more is needed to reduce the administrative burden imposed on under resourced LDCs. Another avenue for introducing improvements on these aspects would be to introduce more competition among public aid providers. While some competition exists, in practice it is limited by the desire to use as effectively as possible a rare commodity (aid) and thus coordination has been more emphasised. It should be possible to introduce more competition in certain areas to provide users with more selectivity, more ability to force changes and reduce transactions costs etc. Evidently this could work mainly with countries that have achieved a level of I.I. that gives them the ability to play that role, i.e. those that have reached the acquis developpementaire.

- **Abolish any remaining annual programming within the IFIs.** This idea involves:
  a) Eliminating any remaining annual programming i.e. not defining lending volumes per country and per sector in advance;
  b) Changing IFI staff performance appraisal systems to emphasise portfolio quality, overall development impact and replication aspects; and
  c) Insisting on the principle of selectivity in funding decisions, with demonstrated “rejections” at all stages of the funding cycle including at board/credit committee level.

- **Boost other aid instruments.** This idea proposes that the volume and transfer of resource objectives are addressed by boosting considerably two other, existing, instruments:
  a) Enhance humanitarian aid. For countries that have not reached the “acquis developpementaire”, humanitarian aid should be provided to needy target groups. This humanitarian aid should increasingly have conditions attached, so as to avoid Governments relying on this as a convenient way of solving national problems without addressing the underlying causes. Similarly, to minimise the risk of corruption and malpractice, humanitarian aid should be distributed by private organisations (e.g. NGOs) appointed by competitive tenders for these tasks.
  b) Develop “last-resort” guarantees and other mechanisms for boosting private FDI. This refers to the type of facilities provided by MIGA i.e. for long-term finance as opposed to short-term commercial credit insurance etc. The number of providers of such guarantees should be increased, and there should be an expansion in the product range and volume of business of these specialised institutions. This will provide significant choice and a real “comfort” factor for private investors which should boost the volume of FDI. This point is developed further, below.

- **Explore new avenues to facilitate private flows.** As discussed in chapter 1, private aid flows have been concentrated on few countries and the combination of the end of the first wave of privatization, and some backlash emerging against privatization or other forms of partnership with the private sector (e.g. concessions for infrastructure), may also affect FDI in the future. On this basis, there seems to be some good justification for the IFIs to consider expanding the menu and scope of instruments to facilitate foreign private investment and flows in the LDCs. Evidently this should not substitute for countries themselves continuing their efforts to provide an environment where domestic investment can also expand – a solid and effective institutional infrastructure is critical for investment irrespective of its origin.

- **Create an IFI Regulator (IFIR).** Like any financial institution, IFIs should also have a higher level of accountability than to shareholders alone, i.e. they should be supervised and regulated. As the aid industry has expanded its institutions, grown its volume of business and has generally “matured”, it is normal that it too should now have a regulator. The idea of an IFI regulator or supervisor is geared to protecting the consumers

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126 See for example Easterly (The cartel of good intentions – Foreign Policy Magazine, June 2002).
127 The issue of IFI accountability is not necessarily aimed at monitoring financial solvency which is one of the key concerns of “normal” financial supervisory activity, because with government shareholders these issues are likely to be minor. Instead, the main concerns centre more on operational matters; are broad policies and objectives being achieved by the aid institutions? Are corrective actions needed? Should sanctions be applied? This concept goes well beyond the “Operational Evaluation Departments” that many aid financiers have, as an external regulator can be tougher and take more far-reaching decisions.
128 It should be recalled that banking systems were also not regulated initially in the “younger” phases of their development. And so in the first 50 years of the aid financing business, IFIs too have not been regulated. However, with the combined balance sheets of the multi-lateral development banks and their subsidiaries reaching around US$ 500 billion in 2001, it is time to address that omission.
of aid finance if the market opens up to competition amongst the IFIs. To directly address this objective, the IFIR could create an “Aid Ombudsman” who will receive and investigate complaints against an IFI by a borrowing country. This suggestion in no way implies that the IFIs are irresponsible institutions that need careful watching, but it simply extends the principle found in national economies to the international economy, i.e. that financial institutions need to be supervised. The IFIs themselves already promote this principle in their operations so there should be no difficulty in introducing a light form of self-regulation. The key parameters of the idea are outlined in the box below.

### A POSSIBLE IFI REGULATOR (IFIR)

An IFI Regulator (IFIR) should be established which will function partly as a central banking style “supervisor” and partly as a “watchdog” for the aid business, ensuring that consumers are protected in a more competitive environment.

**Status:** the IFIR should be an international institution with the IFIs, lead by the major 20-25, as members. Membership is compulsory. The status of the regulator would be that of a “self regulatory organisation” (SRO). It need have no shareholders and it would be funded by membership fees.

**Governance:** a Board should be composed of representatives from the membership (i.e. the IFIs), the “clients” (i.e. the beneficiaries) and other relevant participants in the aid process such as multi-national companies (i.e. providers of FDI), international investment banks and NGOs.

**Staff:** a technical staff team drawn from outside the aid financiers should be recruited in order to undertake the required analyses and inspections. Overall, with a lean and mean philosophy, there is no need to create a disproportionately large organisation.

The functions of the IFIR would resemble those of a “watchdog” of a recently privatised industry, with in addition some elements resembling central banking supervision. Key roles include:

- Setting rules and a framework for the competitive mechanism and operational objectives in the delivery of international aid finance (very similar to what the privatised industry “watchdogs” have done);
- Granting licences to its member institutions, renewable annually and assessed on the basis of ability to make a positive contribution in the aid market;
- Monitoring compliance with the rules & framework, and assessing overall performance through on-site and off-site supervisory processes;
- Creating an Aid Ombudsman which receives and investigates complaints against an IFI from a borrowing country;
- Applying sanctions to member institutions when needed;
- Publishing audit-style reports on its members activities.

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129 For example, the International Centre for Settlement of Investment Disputes (ICSID) has been expanding its activities since it was established in 1966. And more recently, most major IFIs are broadening the mandate for their Inspection Functions to deal also with compliance issues and some measure of consumer protection.

130 Staff size will depend on focus and operating style. Each member IFI should have their own team of compliance officers to interact with the IFIR and submit quarterly reports to it. IFIR should use samples and existing audit reports in its work allowing a relatively small staff to check for compliance in each member IFI. On this basis, if IFIR were to have around 25-30 initial IFI members, a staff of around 75-100 should be adequate i.e. a staff to membership ratio of around 4:1.

131 This Aid Ombudsman primarily receives complaints about breaches by IFIs of rules developed by the IFIR. It could also serve as an additional forum in which more direct consumer complaints against IFIs are heard, perhaps acting as a “higher court” if complaints cannot be resolved by the IFIs own inspection and compliance processes.
POTENTIAL IDEAS FOR THE INTERNATIONAL DEBT CONSOLIDATION FUND (IDCF)

Appendix A.6

**Overall objectives:** The IDCF will promote sovereign debt relief by taking over eligible debt from eligible countries and issuing long-term bonds to the “official lending institutions” to the value of the outstanding balance of these debts. The bondholders will receive interest on the bonds which will eventually be redeemed by the IDCF.

**IDCF shareholding:** Initially the DAC countries, though this could be extended to other countries at a later date

**Eligible debt:** There should be several criteria.
- a) All official debt to the eligible countries, irrespective of whether it is on concessional terms or not;
- b) Debt must be in arrears on principal and interest payments for more than a year;
- c) Separate public finance analysis must show that the country cannot expect to repay any interest or principal over the next 2 years.

**Eligible countries:** Again there could be several criteria.
- a) Countries defined to be eligible for HIPC (i.e. using the current definition that the net present value of debt servicing should not exceed a given number of months of export earnings);
- b) Perhaps a “country bankruptcy” criterion could be added where a country has halted debt service payments and is awarded a “chapter 11 style” breathing space in which to re-structure its finances.\(^\text{132}\)

**IDCF bonds:** A wide range of variables could create various classes of bonds. Key variables will include currency, maturity, face value, coupon, guarantee, warrants, options, amortisation methods (bullet or amortising), trading and secondary markets etc. For the IDCF bonds to be effective in their debt relief task it is likely that they will need to be around 30 year maturity with a bullet amortisation. The IDCF should have some value recovery rights if the country achieves certain defined financial targets following the debt relief. These rights may stimulate trading and secondary markets, thereby injecting liquidity and reducing the overall cost of eventual bond redemption to the shareholders.

**Capital:** An initial callable capital of about US$ 20 billion is probably needed. If initial paid-in capital is set at US$ 10 billion and a leverage ratio of 10:1 is acceptable, then US$100 billion of bonds could be issued for debt relief. The capital will need to be invested in AAA or similar instruments in order to generate the interest earnings to pay the bond yield.

**Operations and staff:** The IDCF should rely heavily on the depth of knowledge and resource within existing IFIs, especially the IMF. It could therefore afford to operate as a “balance sheet” with a fairly small staff dealing with debt and country eligibility, bond issuance and bond servicing.

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132 See the IMF proposal on this subject presented by Anne Krueger, Deputy Managing Director, in November 2001.
REFERENCES

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