
OED Conference Note

OED on Middle Income Country Strategies for Development

S. Ramachandran
Senior Evaluation Officer
Operations Evaluation Department, World Bank

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Unlike low income countries that are struggling to overcome economic stagnation, middle income countries (defined as those with real per capita incomes between US\$3,036 and US\$9,385) would appear to be proceeding well along the development path. But historically, sustained and balanced growth is relatively rare¹: policy making is fragile in many middle income countries like Argentina and Turkey. And the progress of even countries that consistently adopt sound policies is often interrupted by shocks in their terms of trade and/or capital flows. The 1997 crisis showed both the vulnerability of countries like Korea and Indonesia with decades of impressive progress and the difficulties of getting assistance from multi-lateral banks after an extended absence: the Bank's knowledge of Korea was outdated and even in Thailand, many affected sectors were poorly understood.

The Bank has played a useful role in such middle income countries, but it is different than where it is usually the main or only source of external finance and advice. The Bank's overall lending has fallen considerably in recent years although countries' total borrowings (i.e. from non-Bank sources) have not declined, and this decline is particularly pronounced for most middle income countries. This prompted the Bank to set up a Task Force in 2001 to examine how well it was meeting their needs and its recommendations on how to better tailor the Bank's assistance and products and to streamline its procedures have been approved by the management and Board² and are being implemented. The "cost of doing business" with the Bank could be reduced; but what some see as costs may actually be the benefits.

While OED has not been directly involved in these efforts, its many evaluations illustrate some of the issues that are germane. Evaluations of individual loans over the last 30 years emphasized the importance of sound analytical work as the basis of lending, of adequate project preparation and supervision and of country ownership of all programs. OED also began evaluating the Bank's assistance with a country (as distinct from a loan) focus in 1995, and the Country Assistance Evaluations (CAEs) examine whether the Bank engaged effectively in relevant sectors what effect it had on the country's development.

¹ *The Lessons from the 1990s* report (World Bank forthcoming 2004).

² *The Task Force on the World Bank Group and the Middle Income Countries: Final Report*, March 27, 2001 and *Enhancing World Bank Support to Middle Income Countries*, April 20, 2004. Indonesia, Russia and China accounted for about 60% of the lending decline; but the decline was widespread. The Task Force reports chart the decline by sector, region and instrument and identifies the many factors that may have been responsible.

Three recent CAEs, for Brazil, China and Tunisia, illustrate the issues that arise and what the Bank should and could learn from them — not just about *what* the Bank does but *how* it engages the country and how it could do so more effectively.

China

China turned to the Bank for help and advice from the beginning of its transition to a market economy. In the early phase starting in 1981, Bank reports were keenly read and influential. The Bank also brought in renowned experts to brief China's leaders on the needed changes in policies and their implications — without forcing the pace or sequence of the reforms. The Bank earned the trust of China's economic reformers especially when it continued to be engaged after the events of 1989, but although it remains effective in many areas, the Bank's prominence has since waned. This was inevitable as the Chinese became more knowledgeable, the private sector grew more important; but the CAE also describes how the scope and content of the Bank's work did not always keep pace with China's changing needs and increasing complexity of policy issues.

The CAE covers the 1992-02 period when the Bank's assistance strategy had four main objectives: (1) promoting market oriented system reform and better macroeconomic management, (2) poverty reduction, (3) supporting infrastructure development for growth and market integration and (4) environmental protection.

OED found the Bank's approach of building trust and supporting new techniques through lending and promoting policy reform through economic and sector work broadly effective. The Bank helped establish successful models of targeted interventions through integrated rural development projects, and helped promote better project management. Instituting competitive bidding for procurement, for example, greatly reduced project costs and probably also reduced corruption — and such procedures were welcomed and adopted in non-Bank projects also. Other procedures, such as those for resettlement of people displaced by a project, created resentment and suspicion with the counterparts. One such project was referred to the Bank's Inspection Panel which then found serious shortcomings with the Bank's handling of resettlement issues.

Such concerns have eroded, but not entirely eliminated, the openness and candor that characterized the early phase of the Bank's assistance to China. The change is felt in all sectors, and the Bank's work on poverty illustrates the issue. Although poverty has decreased in China, the background paper on poverty³ for the CAE describes how the rate of decline is not commensurate with its economic growth. Eastern and coastal areas (where manufacturing growth and exports originate) have prospered economically but poverty is *largely* rural and concentrated in central and western provinces. The Bank's correctly identified these issues in a 1992 report and helped improve the measurement of poverty, but it was only after the mid-1990s that policies to tackle this became discernable (e.g. the system of taxes and subsidies was regressive). The Bank's 2001

³ A.R.Khan (November 25, 2002) "An Evaluation of World Bank Assistance to China for Poverty Reduction in the 1990s".

Poverty Assessment, however, repeats the official view (based on statistics that fail to capture undocumented migrants in cities) that poverty is *entirely* a rural phenomenon. But while it endorses the government's strategy, and is silent on urban poverty, it is also critical of its inadequate targeting, noting that nearly half live outside the area targeted and urges increased investment in health, education and nutrition.

In a large country with many programs, it is inevitable that the Bank is more effective in some areas than in others: infrastructure project management improved with the Bank's involvement, but environmental protection was mixed. The Bank's work could have been more effective in the areas of enterprise and banking reforms where the advice continued to be generic although a few staff were aware of the complexities in practice. The Bank's advice was at a very general level in the early years — for example the importance of separating central banking functions from commercial banking — but as qualified technocrats trained as well as Bank staff rose in the bureaucracy, they needed more specific advice, and the Bank did not always meet these needs.

Even so, China still values the Bank's help — which is why it continues to borrow despite having substantial foreign exchange reserves, access to commercial funds and losing access to IDA facilities. Although China is the Bank's largest borrower, the Bank is not China's main lender; and its influence is more through persuasion and example, not loan conditions. Indeed, China only borrowed once through an adjustment loan.

It is not just the relations with the Bank that changed over the years but also China's own internal decision making. The *de facto* control that various levels of governments exercise varies by region and personalities involved. The Bank does not always know the inner workings of the government, and counterparts may have sometimes sought the Bank's involvement to further bureaucratic interests than for the advice *per se*. There are also many issues the authorities do not wish the Bank to be involved in. So the Bank's role became more complex — in ways that Bank staff did not always understand. But both the authorities and Bank staff are cognizant of the constraints under which the other operates and acutely conscious of avoiding frictions.

Ideas concerning policies and the pace and scope of reform ebb and flow in very different ways than even a decade ago. OED therefore suggests that the Bank broaden the audience for its work. While open debates are difficult when sensitive decisions are to be made, the analysis of issues could be discussed with a broader group than just the project counterparts, and OED suggests that they include researchers and other stakeholders, especially since they are increasingly influential in the country. Such researchers, even if as well qualified as Bank staff, are not always as knowledgeable about China because information does not easily flow *within* the country; so partnering with the Bank would help. This could be done in many areas such as poverty, water, health agriculture and rural development while one must be more careful with sensitive issues like privatization or banking.

The Bank was particularly successful in doing precisely this in Brazil, and the CAE notes that “The Bank’s strategy was underpinned by high quality analytical work on poverty and growth done with substantial participation by top Brazilian researchers.” And we turn to how this was done.

Brazil

Brazil entered the 1990s suffering the consequences of the “lost decade” of high inflation and low economic growth. Its earlier transition to democracy from military rule was peaceful, but the political difficulties of limiting spending to tax receipts resulted in periodic bouts of inflation. Much of Federal government spending was non-discretionary and its difficult financial relations with the provinces made expenditure control difficult. So curbing inflation was a major achievement but the accumulation of debts, both domestic and foreign, makes its continued stability especially vulnerable to market sentiments. In addition, trade and exchange restrictions instituted over decades had misallocated resources and created vested interests while years of low public investment made infrastructure a development bottleneck.

The CAE again looked at the 1990-02 period when the Bank’s central objective was the alleviation of poverty. The Bank had learnt a great deal from its earlier mistakes. Traditional agriculture projects (irrigation and extension) had excessively unsatisfactory outcomes in the 1980s as did energy projects and the Government also had reservations with the Bank’s involvement in resettlement.⁴ So the Bank’s strategy during the 1990s was not to lend significant amounts (net disbursements were negative between 1986 and 1995) but to focus on the poor Northeast and on activities that addressed the roots of poverty: education and health and the provision of basic services (water, sanitation, rural electricity etc.) to the poor. To do this, the Bank had to deal directly with the states and municipalities — and it did so by increasing its field presence, not just in Brasilia but also in the Northeast.

The proportion of Brazilians in extreme poverty had risen from 16.5 to 19 percent by the early 1990s, but it was over 41 percent in the Northeast. The Bank funded and helped improve the efficiency of education spending with impressive results: primary school enrollment rose from 72 to 93 percent in the Northeast *versus* 84 to 96 percent nationally; youth illiteracy declined from 22.7 to 9.6 percent in the Northeast *versus* 9.8 to 4.2 percent nationally. Similarly, infant mortality declined in the Northeast more than the national average: 73 to 44 *versus* 48 to 29 per 1,000 live births.

The Bank’s assistance underwent three phases: the first contracted lending and shifted to the social sectors and environment (1990-94); the second (1995-98, after the successful stabilization under the 1994 real plan) increased lending to support structural reforms; and the third (1998-2002) expanded lending to support stabilization. This third phase included several adjustment loans to support reforms in fiscal/public

⁴ The Bank cancelled a power transmission loan in 1992 because of the Government’s unwillingness to adjust tariffs. In 1992, when reviewing the environmental effect of Bank projects, OED noted that the cost of rural resettlement in the Itaparica project exceeded \$63,000 per family.

administration, social security, financial sector, and in energy. These have since given way to programmatic lending.

The CAE notes that while macroeconomic stabilization greatly contributed to the success of various projects, the success did not flow from stabilization alone: the Bank's role in redirecting spending and project management was important. The second component of the Bank's program was less successful: while Brazilian states are better able to manage their infrastructure, poor regulation stymies the contribution of the private provision of infrastructure and public investment remains low.

The Brazil program shows the importance of a sustained involvement but with an approach that evolves with the country's circumstances. When projects were less than satisfactory, the Bank changed its design and/or curtailed lending to the sector, but it did not disengage from the country. It was also important to engage authorities with the right level of responsibility (states, not just Federal) and to support the needed technical work on numerous details of policy and implementation. The CAE notes that "Government officials indicate that the Bank is multilateral institution that the Government mostly resorts to for technical advice. The Government has also indicated that the Bank can play an important "pedagogical" role in the country, informing Brazilian society about long term structural issues, their potential solutions and the tradeoffs involved." But despite the success, the CAE continues that "To play this role effectively, however, the Bank must make a greater effort to disseminate its work among several potential audiences and to the population at large."

Tunisia

Tunisia, with a current population of 9.8 million, is far smaller than China or Brazil and faces different development issues although its income also fall in the same range. A former French colony, Tunisia retained ties to Europe but adopted many dirigiste policies. Even so, it grew rapidly during the 1970s in the wake of the petroleum boom, but declining prices and reserves created problems during the 1980s.

Although the Bank had long lent to Tunisia (the recipient of the Bank's first education loan), the macroeconomic problems in 1987 prompted the necessary changes in economic policies. The Bank and Fund helped the government put its finances in order and advised on opening its economy to trade. These changes, begun in the mid-1990s, have paid off: although the state still plays a large role, manufacturing has developed in addition to tourism. Although Tunisia also borrows commercially, it did not do so between 1997 and 1999 in the aftermath of the East Asian crisis. Some 80 percent of its external debts are public and publicly guaranteed; but being long term makes it less vulnerable to bond market sentiments that plagued Brazil. Real GDP has grown faster in recent years recently: from 3% p.a. in 1985-90 to 5% in 1996-2002. Per capita income is now \$2,000, and absolute poverty fell from 40% in 1970 to 4% in 2000.

The CAE (July 2004) reviews the Bank's substantial assistance to Tunisia, both financial (some 5% of external inflows, although net transfers are slightly negative) and

advisory. The bulk of Bank's lending (39%) was for economic, financial and private sector policies, but it also supported education and health (21%). Tunisia benefits from its free trade agreement with the European Union, and the Bank's analytical work (e.g. Private Sector Assessment and updates) help in ensuring policies that benefit the economy. The Bank's economic and sector work increasingly focused on education and health and on infrastructure modernization.

The OED evaluation found that although Tunisia is a relatively small country, the Bank respected the government's pace of reforms: so while these proceeded slowly, there were no reversals. Its competent civil service ensured that agreements with the Bank were fully carried out, and this fostered trust on both sides. The CAE recommends that the Bank follow through on programs that further private sector development since unemployment remains high and to continue support for the social and rural sectors.

What Can the Bank Learn from Assisting Middle Income Countries?

The Bank offers its member countries a package of services, and while the package details differ by country and evolve over time, funds are tied to advice. The Bank's relations with middle income countries is a litmus test of whether the package is appropriate because they could instead borrow commercially.

The Bank's advice covers policies relating to the economy or to particular sectors and with procedures that apply only to its projects and funds. Some of the advice is sought, sometimes it is heeded, and occasionally it is resented. That countries like China still borrow despite losing access to IDA funds suggests that the Bank's package is valuable; but overall value could hide problems with its components. So it may be useful to look at four of these in turn.

1. The Bank as a funding source

While the Bank remains the primary source of external funds for some (especially sub-Saharan African) countries, it is not so for most others. Middle income countries generally have access to commercial borrowings, but such borrowings create problems as well: countries could be caught in a squeeze when market sentiments change and debts cannot be rolled over on similar terms as before. Brazil's predicament illustrates this situation well: Argentina's default in 2001 made nervous markets more jittery. The higher interest rates that were required to roll over Brazil's debts that were maturing threatened its macroeconomic stabilization program. Borrowing from the Bank and Fund helped, both to calm markets and to lower its interest costs, allowing the government to pursue its development efforts.

Countries with access to international capital markets are a diverse group. The Bank's Task Force put 69 such middle income countries into four categories: (1) 22 had good policies and investment grade access to capital markets, (2) 10 had poor policies and impaired credit worthiness (e.g. Venezuela and Indonesia), (3) 20 had generally satisfactory policies but volatile market access (e.g. Brazil and Turkey) and (4) 17 IBRD

eligible (including blend) countries had satisfactory performance but insignificant market access and therefore depended on Bank or other MDB financing.

Even countries with good policies and access are vulnerable to changes in market sentiments. The speed with which such changes occur require the Bank to act quickly when the need arises; but it can lend responsibly only when it knows the country well. The 1997 crisis in East Asia showed the dangers of neglecting “graduating” countries such as Korea and Thailand. Continuing to work with these countries not only benefits the countries⁵ in times of crises but also others through the transfer of knowledge (the “Knowledge Bank”).

2. The Bank for ESW & Policy advice

The CAEs illustrate the added value the Bank brings to policy discussions — even when much of the analytical work is done by or in partnership with local staff. The Bank brings not just the technical skills but also the experience and perspective — and, as in China, provides access to data and/or policy makers that a country’s internal structure does not otherwise allow.

The quality of the Bank’s policy advice is sometimes questioned: Vaclav Klaus, when Finance Minister of the Czech Republic, asked the Bank’s country director “Why should we pay hard money for soft advice?” Disagreement with the advice should not be confused with its value, and there have been numerous instances when the Bank’s advice was initially spurned but later adopted.

The three CAEs underscore that the *process* is also important: that involving the country, both the official counterparts and others increases country “ownership” and often improves its quality. But China also illustrates the problems that sometimes arise when officials are accustomed to operate in secrecy. Yet this is an important aspect of institution building and is the spirit behind the PRSP in low income countries.

Good economic and sector work (ESW) requires effort and expense. Funding ESW is easier when the country borrows. But when circumstances do not justify lending, as with Brazil during much of the 1990s, continuing the ESW pays off later. The real dilemma arises not with episodic reductions in country borrowings but when there appears to be a secular decline as was the case with pre-1997 Korea and Thailand when the Bank scaled down its activities. Should the Bank be lending if it reduces what more “needy” countries could borrow? And if it does not lend to prospering countries, how to fund its ESW? Some high income (oil-rich) countries reimburse the Bank’s costs without borrowing; but other countries are less willing. Besides, lending allows the Bank to

⁵ China borrows from the Bank, despite the loss of access to IDA and its large foreign exchange reserves in part because it allocates such borrowings to the provinces where the projects are located. This internal accounting mechanism encourages provincial and municipal fiscal discipline and a similar notion across line Ministries.

“push” for changes in myriad ways that “purchased ESW” cannot. The Bank is grappling with such questions in countries such as Hungary with increasingly rosy prospects.

3. The Cost of Doing Business with the Bank

The Bank’s procedures for disbursement, procurement etc. are meant to ensure that the funds are used for their intended purpose and apply only to the Bank’s project and/or own funds. But some procedures had become obsolete and archaic: the old practice of the Bank choosing the currency disbursed while ignoring its likely depreciation when setting the interest charges, for example, was changed. Other sensible procedures (such as procurement through competitive bids) should apply to all of the government’s procurement, not just that “traceable” to Bank funds.

The Bank responded to middle income country concerns of administratively burdensome requirements by moving to the “fiduciary assessments” that a country’s general procedures and safeguards are adequate. If so, different procedures for Bank projects and funds would not be required. But such simplification and harmonization may not always be possible: there could be a huge chasm between current practice in some countries and what the Bank desires. “Ring fencing” is the term used; but fungibility could make the fence become perverse as explained below.

Most Bank procedures are meant to benefit countries that borrow (after all, the government guarantees repayment regardless of the project’s financial return); but some may also reflect the views its non-borrowing shareholders. Many of the environmental and resettlement safeguards, for example, are viewed thus — but even if they ultimately benefit the borrower, they may not immediately perceive these benefits. As with recommended policies that the authorities are not convinced of, the procedures would only be grudgingly accepted for Bank projects or funds, not adopted for all its activities.

Regardless of the merit of the procedure and/or safeguard, the real danger of imposing such requirements on unconvinced countries stems from fungibility: countries could use the Bank only for projects that entail fewer procedural safeguards but proceed with the contentious projects using other funds. China built the Three Gorges dam without involving the Bank — and its environmental and resettlement safeguards did not apply.

The Bank must of course follow its procedures, but we must also recognize that countries will follow only if they are convinced — and, as with policies, requires persuasion. Sound analysis and explanation goes further than attempts at imposition.

4. The Bank as a Learner & Conduit

However often one hears the term “best practice” and however tempting it is to think that this could be identified and propagated, the very notion is contrary to what we also know to be important — local adaptation and experimentation. We have, for example, sought to establish “best practice” independent regulatory authorities —

whether for electricity price setting or for banking — and are constantly disappointed when they do not act as independently as their US counterparts. Successful countries do not just have good policies and practices but good mechanisms that permit them to respond to shocks and for learning by doing. Such “institutional development” is the result of trying variants, not the blind mimicking of OECD models or the rigid adherence to standards set elsewhere.

The success of middle income countries may make them a more useful model for low income countries, and the Bank could be an effective conduit to convey such knowledge. The Bank’s international staffing and the use of consultants familiar with many countries allows this — voucher schemes to assist farmers in central America have been adapted to Turkey, etc. — but it could be done far more often.

So clearly, the Bank still has a lot to learn.