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# Meeting the Challenges of Global Development

## A Long-Term Strategic Exercise for the World Bank Group

October 12, 2007

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THE WORLD BANK

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Designed, edited, and produced by Communications Development Incorporated, Washington, D.C.

# Table of Contents

Overview 1
*The global scope for action 1*
*The global framework for action 3*
*The instruments for World Bank Group action 4*
*Building blocks of a World Bank Group strategy 7*

Introduction: The World Bank Group in a changing world 15

The Global Scope for Action 17
*The future shape of global poverty 17*
*The likely evolution of financing flows to developing countries 27*
*Externalities and global public goods 33*
*Responding to the unexpected 35*

The Global Framework for Action 39
*The emerging synthesis in economic development thinking 39*
*Effectiveness of development assistance—and the changing shape of conditionality 42*
*Accumulating and monitoring knowledge—what's needed going forward 45*

The Instruments for World Bank Group Action 49
*The evolution of the World Bank Group and its instruments 49*
*The World Bank Group as a development cooperative—services and client segments 52*
*Trends in financial services to client groups 56*
*Knowledge services to country clients 63*
*Convening, coordinating, and catalyzing services 65*
*Implications for the future 66*

Building Blocks of a World Bank Group Strategy 67
*Four critical challenges 68*
*Modes of intervention for the World Bank Group—some ways forward 71*
*Enhancing knowledge and learning activity 78*

Epilogue 82

Notes 83

References and Background Papers 85

Boxes
*4.1 Dealing with uncertainty—is the strategy robust? 69*
*4.2 Managing the sectoral structure of interventions 72*

Figures

*1.1 Opening and closing demographic windows of opportunity, 1955–2045 22*
*1.2 Current and projected urbanization by region, 2005 and 2030 23*
*1.3 Fragile states relative to nonfragile low-income countries 26*
*1.4 Net private debt flows to developing countries, 1990–2006 28*
*1.5 Net private capital flows as a share of GDP in developing countries, 1970–2030 28*
*1.6 Developing country share of global GDP and foreign direct investment inflows, 1970–2030 29*
*1.7 Net debt flows as a share of GDP in developing countries, 1970–2030 29*
*1.8 Emerging market bond spreads, 1991–2007 32*
*1.9 Greenhouse gas emissions from energy use, observed and projected, 1990–2020 34*
*2.1 The causal chain of development effectiveness 43*
*2.2 Measuring statistical capacity in IBRD and IDA countries, 1999–2007 47*
*3.1 IBRD and IDA country services budget, unadjusted and adjusted, 2006 55*
*3.2 Sources and uses of funds—illustrative annual magnitude of IBRD and IDA financial flows 55*
*3.3 Total World Bank Group disbursements, by arm, 1995–2006 57*
*3.4 Total World Bank Group disbursements, by client group, 1995–2005 57*
*3.5 IBRD equity–loan ratio, 1982–2006 58*
*3.6 IBRD lending by major sector, 1988–2007 59*
*3.7 IDA lending by major sector, 1988–2007 59*
*3.8 Total IDA disbursements by client group, 1995–2006 60*
*3.9 International reserves by client group, 1995, 2000, and 2006 62*
*3.10 Trends in the sectoral allocation of economic and sector work, 2002–07 63*

Tables

*1.1 Transition matrices for developing regions in 2015 and 2030 19*
*1.2 Regional breakdown of poverty in developing countries 20*
*1.3 Under-five mortality, 1990, 2005, and 2015 24*
*1.4 Children not completing primary education, 1990, 2005, and 2015 25*
*1.5 People without access to safe water, 1990, 2005, and 2015 26*
*1.6 Financial flows to developing countries by type, 1995 and 2005 (billions of U.S. dollars) 30*
*1.7 Financial flows to developing countries by type, 1995 and 2005 (percent of GDP) 30*
*2.1 Five good practice principles based on the conditionality review 44*
*3.1 World Bank Group client services, by type (adjusted percentage of administrative budget) 56*
*3.2 Aggregate World Bank Group trust fund financials, 2002–06 62*

# Overview

With the absolute number of people in poverty falling, growth accelerating in most of the developing world, and globalization deepening, it is perhaps tempting for the World Bank Group to simply continue implementing its current strategy. But these trends are changing the structure of the global economy and along with it the development challenges the World Bank Group faces. So, these trends also provide reasons to ask whether the current strategy will still be relevant in the long run, 10–20 years from now. Will it serve us well in the very different world of 2015 or 2030?

This exercise lays the groundwork for a strategy that will enhance the development value of the World Bank Group over the next decade and beyond. It identifies the dominant trends in the global economy, the risks of various types of shocks and departures from trend, the emerging challenges for the international development community, and the needed policy responses. It also reflects on the Group's engagement, experience, operating environment, and action in accelerating poverty reduction, promoting sustainable growth, and managing risks. Placing special emphasis on knowledge and learning, it identifies the main challenges that must be addressed in formulating a long-term strategy for the Group, including the possible modes of intervention that provide the building blocks to meet these challenges.

This report does not describe the long-term strategy for the World Bank Group but simply an initial step in its development. It does not prioritize specific proposals nor consider operational tradeoffs and organizational consequences of possible restructuring. While identifying possible elements of the Group's comparative advantage, it does not attempt the more difficult task of considering what other international development institutions are and will be doing in the future—that would require a broad-based exercise involving many other institutions and stakeholders. Its primary contribution is to offer a view on the changing environment likely to face the Group in the future—global, developmental, and institutional—to provoke discussion.

## The global scope for action

Despite dramatic progress, the end of poverty is not imminent. In a base scenario the number of people in extreme poverty will decline by a quarter by 2015, concentrating in Sub-Saharan Africa and South Asia.[1] Poverty will fall more rapidly in South Asia, however, as development gains are slower to accrue in Africa. Within these regions extreme poverty will also concentrate in low-income countries under stress (LICUS, or fragile states), which face continuing instability and conflict, and only modest gains are expected, at best. As many better performing low-income countries graduate to middle-income status in a growing global economy driven by the inclusion of more than 2 billion people in India and China, fragile states will constitute an even larger share of low-income countries.

By 2015 some 720 million people will continue to subsist on less than $1 a day, the extreme poverty threshold. Deep poverty, at $2 a day, will remain widespread, with numbers staying close to 2 billion people, two-thirds of them outside International Development Association (IDA)–only countries. Many countries, including middle-income countries, will make only limited advances toward the nonincome Millennium Development Goals, including on child mortality and malnutrition.

### *Equitable global development*

The international development community must ensure that global development proceeds equitably. Sustained growth will dramatically expand a "global middle class." With increasing education and access to information,

societies are opening, and stronger civil societies thrive. Yet despite growing prosperity and citizen participation, demographic trends and accelerating technological change create worrying signs of increasing inequality, within and between countries. The inequality is reinforced in many countries by the low quality of basic services and inequitable access to them—often caused by poor governance and a lack of accountability.

Rising inequality may fan social tensions, with real costs to development. For some the benefits arising from deeper global integration may be viewed as coming at the expense of local practices and culture, and globalization may at times provoke protest or discontent. While social strife is unlikely to completely derail the momentum of globalization, it could reinforce protectionist pressures and, in some cases, efforts to disengage from the global economy, slowing progress and reducing the welfare gains that can accrue to global society.

### *Sustainable global development*

Globalization and continuing growth also raise the importance of global public goods and the role of developing countries in managing them. The most prominent is climate change. While industrialized countries have generated most carbon emissions, by 2020, 80 percent of incremental emissions will come from developing countries. The need to control communicable diseases is heightened by increased mobility. Global frameworks for trade, investment, intellectual property rights, and migration are also becoming critical, as are frameworks for regional public goods, particularly shared water resources, which could ignite conflict in several regions.

Despite proliferating initiatives, the institutions and frameworks to deal with many global and regional public goods are still lacking. Some issues, such as climate change, will affect poor countries especially, with huge costs for adaptation.

### *Priorities for action*

It follows that growth alone will be insufficient to resolve the concerns facing the international development community. Looking ahead, an emerging development challenge will be to make global development inclusive—both across countries and within countries—and sustainable.

For the global development community some clear priorities for action emerge from this imperative. First is to ensure that slower growing low-income countries in Sub-Saharan Africa and elsewhere fully participate in—and benefit from—the globalization process. Second is to do more to address the challenges facing fragile states. Third is to help slow-growing middle-income countries accelerate growth and help fast-growing and upper middle-income countries equitably share the benefits of growth. Fourth is to monitor and control global and regional externalities, especially their impact on development and poverty reduction at the country level.

### *Two trends in the global environment for development*

In pursuing these goals the global development community must take into account two important trends that may modify its future modes of intervention—the likely changes in international financial markets and the evolution of the global aid architecture.

As borrowing costs for developing countries have fallen to historic lows, private capital flows have soared to almost $650 billion a year, around $130 per capita. Sovereign external borrowing, by contrast, has stagnated in real terms at some $140 billion, and there has been enormous net repayment of official debt, together with rising reserves in many countries. But these figures hide wide disparities and segmented markets. Most developing countries remain unable to regularly access private debt markets at low cost. Many remain vulnerable to the risks of financial crisis, marked by rising spreads and abrupt financing cutoffs. Similarly, many second-tier private firms, and those in frontier regions, have limited access to global finance, even in low-risk countries.

So, many developing countries, particularly the poorest, will remain heavily dependent on development assistance. But the global aid architecture is becoming more complex. With

the proliferation of earmarked funds, private donors, and new donor countries, aid provision is more fragmented, raising transaction costs and the risk of policy incoherence. Despite the promise of the Paris Declaration and evidence of greater aid effectiveness, the country-led model of assistance—which puts aid recipients in full control of their development strategy and related development spending—is under stress. Many donors tie funding to specific causes, reimposing strong conditionality. This may prove difficult to reverse because of political considerations; it could also render aid less effective, further discouraging donors from fulfilling their pledges to increase development assistance.

These trends will shape the scope for World Bank Group action. In contributing to the general goal of inclusive and sustainable global development, the Group will need to respond to a changing international financial environment, where lower spreads limit its financial attractiveness to some investment-grade sovereign borrowers and first-tier private borrowers. It will also have to adapt to a more complex global aid architecture. And it will face many challenges that will differ by the countries and the people it tries to reach: slow-growing low-income and lower middle-income countries, fragile states, lagging groups and regions in middle-income countries, and the global population through global public goods.

## The global framework for action

A synthesis of what has been learned over the past 50 years from different development strategies is slowly emerging. This process is leading to a more pragmatic view of development policies, with a focus less on rules deduced from theoretical principles and more on the country-specific setting and on approaches that can be transferred from elsewhere.

### *Emerging wisdom on tackling the development challenge*

The emerging synthesis on development strategies is built on a few basic principles. Growth is essential, as is an equitable widening of individual opportunities that guarantees both social inclusion and faster, more sustainable growth. A competitive private sector and a dynamic export sector are also critical. Yet governments have to provide a supportive environment through sound governance and institutions. This emerging synthesis is less dogmatic than earlier approaches—and less driven by strong and excessively detailed donor-imposed conditionality. It recognizes country specificity and the absence of a single template for development.

The foregoing principles are fairly general. How to implement them depends on a country's geographic, societal, and economic environment and its history and institutions. Something that has worked in one setting might not work in another because of different constraints on policy implementation or different circumstances that will change outcomes. Implementation requires country ownership, careful design, and deep knowledge of national and local circumstances. But the reform experience in any country should be part of the knowledge base available to the global development community. If properly collected and analyzed (something to be dramatically improved), such knowledge can help in understanding why a particular reform worked or did not work, leading to better policy design and outcomes in other contexts.

While there is an emerging synthesis in development thinking, diverse circumstances and the need for care in adapting particular reforms to a given economy complicate policy choices. Embracing this complexity and developing the appropriate knowledge and analytical tools to approach it hold promise for overcoming the errors of the past, making development policies much more effective.

### *Important knowledge gaps to be filled*

A more complete body of experience-based knowledge is thus needed for this approach to development. This requires more research to understand how policy reforms in a specific setting produced particular development outcomes. Institutions and governance, including corruption, have rightly been identified as key factors shaping development potential and determining the effectiveness of development

policies in a country. But relatively little is known about what aspects really matter among the many elements that define institutions—and still less about how to modify them. This area stands out as a priority for development research.

Development thinking has also moved beyond a country focus to encompass externalities across countries within the global economy. As globalization progresses, it becomes more crucial to understand interactions among countries and policies and to grasp why global phenomena may work in favor of some countries and against others. Consider the different impacts of trade reforms or climate change. This understanding must then be translated into national, regional, and global policy recommendations.

### *Understanding what makes development assistance effective*

The nature of development assistance has evolved as well. Donors have moved away from detailed intrusive conditionality to "soft" conditionality, supplemented by greater selectivity in funding decisions based on development policies and results. Aid effectiveness is now far less frequently judged on whether strict conditionality was enforced. Instead, donors consider whether the appropriate policies were chosen, given the country's circumstances and the stock of development knowledge—and whether the expected results were attained. Greater accountability among donors, development agencies, and developing countries will reinforce this evolution in the future. But the evolution is not unidirectional. Stricter conditionality through aid earmarking is still a central feature of the burgeoning number of global vertical funds—and some aid from private donors—directed toward specific diseases or education.

### *Implications for the World Bank Group*

The two-pillar framework for thinking about development—improving the investment climate (including the technological drivers of future growth) and empowering people—continues to provide a valuable organizational device for describing the World Bank Group strategy for reducing poverty, especially with the increased emphasis on the complementarity of the two pillars and deeper understanding that growth and distribution are related processes.

Looking ahead, it is worth weaving two additional perspectives on development policies into the two-pillar structure: institutions and governance processes (especially in fragile states) and the implications of key global public goods, including environmental sustainability. Each topic has implications for both the growth and empowerment pillars that are recognized as increasingly important in promoting development. And the new country specificity in the relationship between policies and development outcomes puts a premium on measuring, monitoring, and understanding the impact of development projects, programs, and policies and on disseminating that knowledge to practitioners. Crucial tools include statistical systems, country and sector benchmarks, and impact evaluations that increase cross-country learning from development initiatives. The World Bank Group should continue to play a key role in all these areas, collaborating with practitioners, academics, and other development agencies.

## The instruments for World Bank Group action

The World Bank Group has retained a broad and continuing developmental mandate of raising living standards, particularly where the needs are greatest, but its priorities and activities have evolved to reflect changes in the development environment and in knowledge.

The five arms of the World Bank Group constitute a development cooperative that makes the low-cost, easy access to financial markets of its most developed members available to all members on equal terms. Similarly, knowledge and lessons of development experience are provided to all. The value of the cooperative to its members rests on its global membership and engagement in all developing regions, its endowment of capital and reserves, and its wide range of products and services.

Considered individually, these features are not exceptional. Together, they are unique.

They enable the Group to raise funds competitively, diversify risks, and combine many services to address development problems. And over an exceptionally wide range of policy issues, this mode of operation creates the opportunity to learn from country, cross-country, and global experience much faster than other providers of development services.

### *The three elements of the service package*

The services of the World Bank Group fall in three categories: finance, knowledge, and coordination. Financial services encompass a widening range of products—loans, credits, equity investments, guarantees, sovereign risk and wealth management, and trust fund administration. Knowledge services include country analytical work and technical assistance, global data and research, and gathering and dissemination of experience with implementing development projects in different contexts. Coordination services include working with development partners to overcome failures of collective action (both in countries and in areas of global concern), providing vehicles for cofinancing, and developing new products.

The International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) are overwhelmingly country driven. About 80 percent of services are directed to country clients, provided roughly equally to low-income and middle-income countries. Of these services some 30 percent are financial services, narrowly defined. Most of the remaining 50 percent consists of knowledge services, half embedded in financing operations. The 20 percent of services that are not country driven consist largely of sectoral and global knowledge-related activities, but also include a significant share of convening, coordinating, and catalyzing activities through global programs and partnerships and trust fund-related work. Unlike country services, where the World Bank Group's engagement is formalized through country strategies, the wide range of global activities is managed largely by thematic networks (following the overall approach laid out in a 2005 Board paper).

Finance, knowledge, and coordination services are connected through the budget. Spreads on IBRD loans roughly cover all services to IBRD country clients, and fees on IDA credits cover all services to IDA country clients. Earnings on the capital endowment cover global programs, or flow into IDA, knowledge building, transfers, and reserves. Much of the technical capacity sustained by the Group (especially in the International Finance Corporation and the Multilateral Investment Guarantee Agency) is thus paid for by its financing activities.

***Financing activity.*** As the World Bank Group's operating environment has changed, so has the balance of its activities. In line with the growth in private flows, International Finance Corporation (IFC) disbursements have increased 75 percent and Multilateral Investment Guarantee Agency (MIGA) guarantee contracts 45 percent in real U.S. dollar terms since 1995, crowding in much additional private investment. Their business has grown more rapidly with "frontier" countries and with "second-tier" firms unable to access global markets. IDA flows have remained about flat in real terms, with a recent tendency to account for a smaller share of total development aid. Some newer instruments such as guarantees have grown, leveraging private investments about 10 to 1 to bring in some $30 billion in total private financing. Subnational programs without sovereign guarantees are still modest. Trust fund activities have soared, with disbursements reaching half of IDA's. Fee-based financial services have also grown rapidly, contributing to around $11 billion in transactions to help sovereign governments hedge risks. In contrast, IBRD disbursements have fallen by 30 percent in real terms, with prepayments further boosting its equity–loan ratio from about 20 percent in the 1980s and the 1990s to around 33 percent by 2006. Its capital thus tends to be less than fully utilized.

The main factor constraining traditional IBRD lending has been the contraction of real external sovereign borrowing in developing countries. Other important factors include the sharp decline in market spreads, which

reduces the financial benefit that the IBRD can bring to middle-income members with easy access to international capital markets, and a reputation for slow, high-cost IBRD procedures (equally so for IDA). Benefits, in lower financial costs (only a few developing countries can borrow more cheaply than the IBRD lends) and gains from embedded knowledge, may outweigh the "hassle factor" (variously estimated at 0.5–1.0 percent of loan size). Yet, the gains accrue largely in the future, while the higher costs are borne today and therefore act as a disincentive to financial engagement.

***Knowledge services.*** Analytical knowledge products for country clients are generally of high quality, according to both internal and external evaluation, but they may not be evolving fast enough to meet changing demand. This can be masked for a time, since very little analytical work is exposed to a market test. Yet, as countries gain in income and capacity, their ability to source advice from other providers rises, increasing competition here as well. For advanced middle-income countries the IBRD cannot expect to retain a full range of expertise in highly sophisticated areas. It will need to be more selective. With more open access to information in many countries, inadequate dissemination implies missed opportunities to support coalitions for change. The shifting emphasis from the "what" to the "how" of development has not yet been adequately translated into greater emphasis on flexible, focused technical assistance complemented by a better understanding of the political economy of reform.

One drawback of the current country-based model is the inadequate incentive for leveraging country experience to provide global public goods. As exemplified in the spread of conditional cash transfer programs from Brazil and Mexico to more than a dozen countries, development efforts in one country can be as significant for their wider knowledge value as for their direct poverty-reducing impact. As a global institution, the World Bank Group has a comparative advantage in global learning, but many learning opportunities are still lost through inadequate focus on results and incomplete use of the lending, learning, and knowledge cycle to extract cross-country lessons from country operations.

***Coordinating services.*** While smaller than the financial and knowledge areas, convening, coordinating, and catalyzing services are essential to the World Bank Group's work. There is no single blueprint for engagement—in low-income countries it depends on the partner government, the role of donors, and the extent of coordination and alignment. The Group's engagement in global issues, including global and regional public goods, covers a wide range of areas: preserving the global and regional commons (climate change, including management of $2 billion in carbon funds, and shared watercourse management), controlling communicable diseases (avian flu, HIV/AIDS), building global frameworks (trade, financial stability), and creating and disseminating global development knowledge (research, statistics, comparative experience).

***In many areas the World Bank Group partners with more specialized agencies.*** The Group's comparative advantage lies in working at the country level through policy advice, capacity building, and finance; participating in global partnerships that complement country-level work and mobilize resources; and informing the global debate through objective research and analysis. In the past, global activities have at times been driven by shifting external sentiment or the availability of trust funds, without adequate attention to establishing clear priorities within the Group or ensuring that the global and regional priorities are reflected in country programs. Current efforts to design a more comprehensive framework in this area are thus welcome.

### *Implications for the World Bank Group*

The wide range of the World Bank Group's interrelated activities rests on a wide range of capabilities. Trust fund management, for example, rests on project and financial management, as well as on sector and country knowledge. Treasury expertise provides a basis for risk- and reserve-management services. Most important, the interaction of finance and knowledge provides the basis for learning

by doing, creating dynamic capacity. While some lines of business, as traditionally conducted, have been declining, others are growing rapidly. The question for members of the Group: how can its assets best be deployed to maximize shareholder value in the future?

## Building blocks of a World Bank Group strategy

Looking forward, the World Bank Group's priorities and business models will have to continue to evolve as shifts in the global development environment and in development thinking change the scope for the Group's contribution. The goal for the development community must be to ensure that global development is both inclusive and sustainable in the long run. Strategic choices for the Group should contribute to that goal.

### *Four critical challenges*

Given the likely evolution of the global economy, four areas of challenge would seem to be central to any World Bank Group strategy for global inclusiveness and sustainability: Sub-Saharan Africa, fragile states, inclusiveness among and within middle-income countries, and global public goods. To address these areas, the Group must use different modes of intervention that innovate and expand on its present lines of business. Current instruments offer only limited means to deal with these challenges, and the process would progressively reduce the absolute and relative importance of the World Bank Group in global development. In the new and expanded modes of intervention, knowledge services and learning are overarching.

***Sub-Saharan Africa.*** The World Bank Group's poverty focus implies continuing the emphasis on low-income regions, especially South Asia and Sub-Saharan Africa. But the prospect of faster gains in Asia suggests that future emphasis will shift progressively to Africa and a few slow-growing low-income countries in other regions. With the great diversity of these countries, approaches need to be differentiated. For some the priority is to reinforce recent strong growth and to make it sustainable. For others it is to assist with managing the rents from natural resources. For still others it is to generate the conditions for take-off. But some issues are common to many countries, such as strengthening the business climate and the private sector (including progress on governance and anticorruption), improving essential infrastructure, combating communicable diseases, managing shared resources, and promoting regional integration. The Group's role in Africa must also include working with partners to rationalize the chaotic aid architecture.

***Fragile states.*** Fragile states present a special challenge to the evolving model of aid because of the difficulty of providing them with effective assistance. Even by 2015 and beyond, more than half of their population will still live on less than $1 a day. In fact, outside the large countries in South Asia, it is likely that world poverty will increasingly concentrate in fragile states or in countries that were fragile for some long period. Because of the weak institutions and governance in those countries, the development community needs to seek ways to strengthen the effectiveness of the country-based model of engagement. An assistance model adequate for fragile states would need to coordinate a range of development partners, bypass dysfunctional or corrupt institutions, address the security dimension in overall programs, and change the way that work on these countries is organized and prioritized in the World Bank Group.

***Inclusiveness in middle-income countries.*** While making global development inclusive obviously requires progress in low-income, high-poverty countries, it also means ensuring that nobody is left behind elsewhere in the global economy. This requires helping slow-growing middle-income countries accelerate growth and fast-growing or upper middle-income countries share growth's benefits equitably. This concern is partly reflected in the persistence of large numbers of poor (measured at the $2 per day cutoff) already noted. But it goes beyond this: in countries where widespread extreme poverty ($1 per day) has been largely eliminated, continuing to focus on a specific poverty target may no longer seem relevant. But the fact remains that, despite high

growth, some lower middle-income countries among the top growth performers will continue to see large pockets of persistent deprivation and may experience increasing inequity. This can be remedied in some cases through interventions to foster growth—particularly through developing national infrastructure—and in other cases through work at the subsovereign level. In all middle-income countries the long experience of the World Bank Group in supporting growth- and equity-enhancing reforms within the two-pillar framework is an important advantage for promoting more inclusive development outcomes.

***Global and regional public goods.*** Climate change has rightly galvanized international attention. Other global public goods increasingly important in an interconnected world include water management, communicable diseases, and frameworks covering trade, finance, intellectual property rights, and possibly new areas such as migration. Development knowledge is another major public good. Some global public goods require knowledge-based advocacy and coalition-building to ensure that the scales are not tipped against developing countries. Some have country-level implications for development and poverty reduction. Successfully addressing global public goods will require major investments, underpinned by suitable financing arrangements. As a global institution with a wide range of service capabilities, the World Bank Group is uniquely placed to play a key role in a number of areas. But it must define that role and set priorities among the many global public goods as it begins the critical implementation of an expanded engagement in global public goods.

***Modes of intervention for the World Bank Group—some ways forward.*** How could the World Bank Group be structured to deal with these challenges? The approaches discussed here concern mostly the IBRD and IDA. Although IFC and MIGA are critical and growing arms of the Group, their activities raise relatively few major strategic issues. The main challenge for them is to ensure (and show) that they provide additionality—not simply substituting for investments that would have been made anyhow—and strong developmental impact, while continuing to innovate products and services to keep up with evolving market demand.

***Maintaining the status quo? No.*** Does the status quo permit the World Bank Group to satisfactorily meet these challenges? Under the status quo in low-income countries the focus often would be more on the Group's programs than on country progress and results or on efficiently mobilizing all development resources. Moreover, the increasing proportion of fragile states will, without a strengthened model for dealing with them, make IDA less effective. And without a change in risk parameters or significant product improvement, the risk-bearing capacity of IBRD capital will not be fully mobilized to address some of the emerging challenges in middle-income countries. Externalities between finance and knowledge will be progressively lost as selective declining engagement in middle-income countries reduces opportunities for learning and for sustaining a critical mass of development-related skills relevant to poor countries. Another lost opportunity would be that the Group contributes little to addressing the growing demand for regional and global public goods. Although the status quo is sustainable for some time and partly addresses the key challenges, it is not an effective response to these priorities.

With the increased focus in the development community on the private sector, and with the strong positioning of IFC and MIGA and the investment climate operations within IDA and IBRD activities, the World Bank Group is particularly well positioned to contribute further to development of the private sector. This raises the issue of how best to align the Group focus on the private sector at the corporate level and subsequently at the regional and country levels. A stronger focus on private sector development is important to better and stronger synergy across the World Bank Group. The modalities for operationally enhancing these private sector activities will be important in discussions going forward.

Looking beyond the status quo, a range of different adaptations and innovations can be envisioned. These extensions and innovations may be combined in different ways

as possible building blocks of a World Bank Group strategy.

***Leveraging IDA's funds and capacities.*** Progress in Africa and in fragile states—predominantly low-income groups—requires strengthening IDA. This would not be credible without core financial resources (in the first instance through a successful IDA–15 replenishment), strong knowledge capacity, and real progress on the ground by country programs supported by IDA. Beyond this, the proliferation of earmarked trust funds, many set up by IDA donors, presents both competition and an opportunity. In leveraging, IDA would influence the global aid architecture, engaging with donors and funds to maximize their use as harmonized cofinancing vehicles. In sectors where many other donors are active, IDA might systematically play an enhanced convening, coordinating, and catalyzing role, leveraging the capacity of others. This role would be particularly important for increasing the efficiency of vertical funds and addressing their inability to deal with general factors that strongly influence their main objectives but are distinct from them—general health system development needed to support focused HIV/AIDS programs, for instance.

Leveraging funds and capacity is more difficult and potentially less effective in fragile states. The problem is the absence of a reliable domestic administration that can implement development-oriented policies using donor resources. These cases clearly need to be handled differently, with simpler and clearer conditionality or more direct monitoring, by carefully providing support to weak institutions while ensuring that aid resources are used appropriately. Possible solutions might be to enhance oversight mechanisms in critical areas. Such efforts could include government representatives, local nongovernmental organizations and civil society, and donor representatives closely monitoring the use of the funds, with the World Bank Group in some cases taking the lead in organizing and managing such a scheme.

***Renewing and expanding services in middle-income countries.*** The World Bank Group can address inclusive global development in middle-income countries only if the volume of its activities remains above some threshold rather than contracting. One way of reversing the contraction is to make IBRD services more flexible, more attractive from both a financial and a knowledge perspective, and more adapted to these countries' development objectives. Simplifying and streamlining procedures are a necessary first step. Several approaches can be considered in turn.

- ***Unbundling finance and knowledge services.*** Unbundling traditional services should permit delivery of "bare bones" financial services at lower cost, with knowledge services funded by fees. Elements of this model, especially fee-based knowledge services, are essential to any efforts to make the menu of services offered to middle-income countries more flexible. But implementing this model excessively or exclusively could make it difficult for the World Bank Group to maintain its comparative advantages in knowledge and contribute financially as strongly to its development objectives. Nor is it clear how responsive the demand for IBRD lending would be from countries with ready access to international capital markets.

  Other approaches would enhance the present model of finance and knowledge intervention, taking into account the changing context. The goal would be to provide a full menu of innovative, flexible, and custom financial services while jointly offering knowledge products adapted to these innovations. The first step is improving knowledge wherever possible and making sure that the best international expertise is offered in all intervention areas where the Group remains engaged.
- ***Easing access to the IBRD.*** In view of the possible drop in demand from upper middle-income countries and strong growth performers and given the goal of inclusive global development, it will be important to reach out more to other lower middle-income countries. The rules governing access to IBRD lending

could be eased, including those for countries graduating from IDA–only status. Risk parameters could be modified to permit more exposure to lower middle-income and slow-growing countries, as well as to IDA graduates—to offset lower demand from more creditworthy IBRD clients. To illustrate this point, a halving of lending to the countries with the easiest access to international capital markets (Brazil, China, India, Mexico, and the Russian Federation) could be offset by an increase in exposure to other middle-income countries of around 30 percent. The likely graduation of some IDA countries to IBRD creditworthiness in the next decade could also increase demand. And there may well be opportunities for greater use of IBRD resources, even in IDA countries—for example, to finance infrastructure projects viable at IBRD rates but unlikely to be undertaken with IDA resources because of their size.

- ***Subsovereign lending.*** A priority in fast-growing middle-income countries is to avoid the exclusion of specific groups of people and geographic areas from the benefits of growth. Because of difficult administrative or political relationships between central governments and regional states, it may be developmentally more effective to consider changes in the Articles of Agreement that would allow subnational entities to borrow directly from the IBRD without sovereign guarantees, as some already do from the IFC. In some areas, such as infrastructure in Africa, there is an equivalent need to adapt and develop instruments to address supranational (regional) demands as well.
- ***Contingent financing and insurance.*** Instruments should also be developed to provide contingent finance against a range of shocks and some headroom for post-crisis assistance. Especially given the likelihood of increasing climatic instability, the Group could work toward a wider multilateral disaster guarantee facility, perhaps modeled on the Caribbean Catastrophe Risk Insurance Facility or on weather-contingent crop insurance programs.

***Expanding the delivery of global and regional public goods.*** The World Bank Group could move decisively to take a far larger role in addressing global public goods, capitalizing on its comparative advantage in linking global issues to action in widely differing country circumstances. There are important opportunities for the World Bank Group to enhance its contributions to this agenda, working in collaboration with UN and other specialized agencies. As primarily a country-focused development institution, for the Group the key will be its ability to work consensually with partner countries at the intersection of national development priorities and global challenges. Country knowledge, but also extensive involvement in global issues, offers the Group a broad knowledge base to draw on. The Group must work with member countries to find innovative solutions for issues where national benefits are not sufficient for taking action. Strategies for international collective action will have to reflect governments' perspectives on national priorities.

Concessional resources and other incentives will be needed to encourage countries to address global public goods. The World Bank Group has demonstrated a capacity for financial innovation—carbon funds, the International Finance Facility for Immunisation (IFFIm), and ongoing preparations for the Advance Market Commitment pilot are important achievements. Specialized health funds, carbon finance, the Global Environment Facility, and grant funding from bilateral sources show the potential for blending (including from non-official sources) between grant funding and Group loans and credits. Such subsidies could be expanded to address situations where global benefits significantly exceed national benefits. Through the combination of different funding sources, including IDA, IFC, MIGA, and carbon finance, the Group should be able to leverage additional private sector funding, particularly for emerging economies with growing financing needs for energy, infrastructure, and forestry management.

Looking beyond the global public goods framework currently being developed, the World Bank Group—including the IFC and MIGA—could introduce a global partnership strategy to further clarify priorities on global public goods and the organizational and resource arrangements needed to address them. Limited use of IBRD net income also could be considered for specific global public goods objectives, perhaps raised by investing part of its capital less conservatively to provide higher returns than are currently achieved, or given its strong capitalization, contributing some income that would otherwise be used to increase capital. While the Group cannot finance such initiatives on its own, it can serve a catalyzing role. Mobilization of new funding sources and instruments should take place only when a clear funding gap has been identified and the funds are to be used for a specific, targeted objective. These resources, together with IBRD lending and other Group instruments, would be used to leverage investments, for example, in clean energy. The Group could create a pool of resources to form the core of a "global public good facility" that would expand and possibly diversify the existing Global Environment Facility. Its catalyzing role would also include monitoring outcomes to ensure accountability and facilitating research on innovations.

***Enhancing knowledge and learning activity.*** No matter which challenges receive greatest emphasis and what combination of modes of intervention is selected, the World Bank Group will succeed only if it retains and improves its role as the development community's "knowledge bank," especially with its purely financial value-added likely to decline.

***Research priorities.*** The World Bank Group should concentrate first on generating and analyzing evidence on the impact of policies on development outcomes in diverse country contexts. Research should tackle frontier questions on institutions and governance, including on fragile states, and on the implications of environmental sustainability and other global concerns for country programs. Progress is also needed in data collection. Statistical systems, country and sector performance benchmarks, open information, and impact evaluations that can increase cross-country learning from development initiatives are indispensable tools for monitoring and promoting effective development policy.

***Core expertise.*** To sustain the World Bank Group's agenda-setting role, it must maintain and strengthen technical expertise. Core groups of experts familiar with key issues must be retained in-house. Top expertise can be sourced as consultants, but external expertise cannot be effectively used without internal expertise to absorb and adapt it to context. Similarly, the Group will need a critical mass of in-house expertise to function in middle-income countries, where its crucial knowledge role is to link with external knowledge networks and adapt knowledge to local conditions.

***Global learning.*** An institutional effort is needed to strengthen the cycle of lending, learning, and knowledge. Initiatives such as the Development Impact Evaluation (DIME) initiative will set incentives to rigorously evaluate development impacts and thus strengthen accountability and produce a global public good—development knowledge.

Two considerations for enhancing the World Bank Group's modes of intervention must be added. The first concerns the competitive or collaborative landscape, and the second concerns the authorizing environment. On the first the Group is both a complement to and a competitor with other public and private institutions. It clearly has a collaborative relationship with the International Monetary Fund in day-to-day country support work. The International Monetary Fund looks after macroeconomic stability, and the World Bank Group looks after long-run growth and development potential. The need to reconcile both aspects during macroeconomic turbulence is clear. Likewise, the Group often collaborates with regional development banks in designing and financing particular country projects, often bringing its worldwide experience into the collaboration. But they may also compete on specific projects, sectors, and partner countries. The World Bank Group may also compete with private entities in finance or knowledge.

There is nothing intrinsically wrong with such competition—it may be in the client's best interest—as long as the World Bank Group fully recovers its costs and provides developmental "value-added" relative to its competitors. Hence, the future will reveal whether competitive or comparative advantages evolve in such a way that the Group has to withdraw from some area or product. But shared development objectives encourage the Group to collaborate or partner with other international organizations or with private entities wherever it may benefit member countries.

On the authorizing environment, the governance procedures of the World Bank Group may require tradeoffs regarding the relative emphasis given to the key challenges, and between modes of intervention. In particular, while the suggestions here may all contribute to development, they often target different beneficiaries. High-income countries may be more in favor of global public goods interventions, while developing countries may prefer interventions that contribute more directly to their development. Given the cooperative structure of the Group and its governance rules, such tradeoffs are perhaps unavoidable. At the same time, tradeoffs are much easier to resolve in a growing environment than in one that is stagnating or declining. The strategic orientations considered here are fully compatible with an expanding World Bank Group, with growth coming in part from renewed and enhanced IBRD lending and in part from the diversification of activities made possible by making more use of IBRD capital.

***Measuring long-term progress—the need for self-evaluation.*** The need for evaluation also applies to the World Bank Group. Strategic decisions would be better informed if they could rely on some estimate, however rough, of the developmental contribution of the Group's various activities. Self-evaluation also matters for the relationship between the Group and the international development community, allowing wider recognition of its comparative advantages and generating support for its convening, coordinating, and catalyzing role.

The Independent Evaluation Group provides an indispensable contribution to this self-evaluation, providing a regular flow of reports on aspects of the World Bank Group's activities—assistance to middle-income countries, regional programs, fragile states, and sectoral and country programs, to name a few. And there are other units within the Group that are responsible for assessing performance in various dimensions, suggesting the possible need for better coordination and perhaps some rationalization of these efforts. But the challenge goes beyond simply increasing efficiency—further improvement is needed in current efforts to better measure the relative *developmental* contributions of the various activities that the Group pursues. Greater progress toward better evaluation of specific Group actions against counterfactuals is essential.

Easier, less rigorous measures of progress toward possible new objectives may rely on well-designed indicators giving information about whether results intended with a specific strategy are being reached. The analysis here suggests some general indicators of how the Group might measure performance along various strategic directions.

- Financial and technical support to the private sector, weight of "frontier" and "second-tier" clients, degree of financial leverage, and improved indicators for development impact.
- Use of IBRD financial capacity, including the share of funding supporting equitable development in lower middle-income and slower growing clients.
- IDA disbursements and improvement in indicators of development effectiveness, with an emphasis on fragile states.
- Measures of the World Bank Group's convening, coordinating, and catalyzing achievements, notably in IDA countries and fragile states, including partnering with vertical funds.
- Flexibility of country analytical work and technical assistance, as well as of the range of specialized financial services; extent of reliance on "market tests" for analytical work and technical assistance to ensure client value.

- Clarity of priority setting for intensive engagement in global and regional public goods; measures of the effectiveness of mechanisms to encourage engagement with national authorities.
- Targeted funding mobilized for specific global public goods priorities, such as clean energy and climate change adaptation.
- Intensity of the lending, learning, and knowledge cycle to ensure maximum learning from operational engagements and a systematic focus on results.
- Existence of critical knowledge mass in selected areas, as well as results on data and statistics gathering and analysis; quality of development outcome monitoring and effectiveness of performance-based programs.

# *Introduction*
# The World Bank Group in a changing world

The world has changed a great deal in the six decades since the International Bank for Reconstruction and Development began operation to support post-war reconstruction in Europe and other regions. With that task completed, the roster of clients shifted, as services began to be provided to private clients, and the wave of nation-building created dozens of new developing countries, many of them extremely poor. And more recently the nature and pace of change in the global arena have intensified—globalization has helped foster unprecedented growth, especially among developing countries able to take advantage of new opportunities, and has contributed to significant reductions in extreme poverty.

The World Bank Group has, of course, changed as well, with the formation of new "arms" (the International Finance Corporation, International Development Association, International Centre for Settlement of Investment Disputes, and Multilateral Investment Guarantee Agency) and a constantly evolving range of instruments and products (see chapter 3). The size and scope of the Group's collective operations today is far more expansive than that envisioned by the participants in the Bretton Woods conference in 1947.

Despite this ongoing adaptation and evolution, the World Bank Group today faces questions about its continuing relevance and its appropriate role in the coming decades. While the challenge of reducing global poverty and promoting sustainable growth still looms large on the global agenda, the global playing field where this struggle is occurring has changed considerably. Rapid growth and improved economic policies in many large and populous developing countries have rendered many of the traditional Group services less relevant. The number of groups engaged in development efforts at the country or global level has proliferated—involving regional development banks, bilateral aid organizations (including several from new "emerging" donors), a broad range of UN agencies, "vertical" funds focusing on specific sectors or issues, and a growing list of private foundations. These changes have led to a shift in the political landscape as well, as questions over aid effectiveness move to the forefront of discussions of the development process. Public debates have questioned whether the World Bank Group's mission is still relevant, and various initiatives have focused on harmonizing and improving cooperation among different agencies (including the recent Malan Report examining collaboration with the International Monetary Fund[2]).

As the global environment evolves, the World Bank Group is considering possible strategic changes that would enable it to better respond to the current and future needs of the wide range of clients and stakeholders it serves. This is a daunting task. There are many, often conflicting, demands and pressures at play, and any changes must occur in real time, given the pressing nature of the development challenges. Because the fundamental issues that must be confronted concern the Group's "comparative advantage," this strategic rethinking cannot occur in isolation. What the Group can and should do depends on what others in the global community choose to do—from the regional development banks (several are rethinking their own strategies) and bilateral aid agencies, to specialized UN agencies, to the goals and intervention strategies of the numerous vertical funds and private foundations.

This strategic repositioning will thus take time to elaborate—and even longer to implement. The Long-Term Strategic Exercise described in this report represents an initial step in this process, providing input for the subsequent formulation of new strategic directions. It identifies the dominant trends in the world economy, as well as their associated risks,

and highlights the emerging development challenges and appropriate policy responses. It reflects on the World Bank Group's efforts to accelerate poverty reduction, promote sustainable growth, and manage risks—in terms of engagement, experience, operating environment, and types of action. In assessing the developmental role of the Group and emphasizing the critical role of knowledge and learning, the report identifies critical elements to consider in framing a long-term strategy, including the major challenges and possible building blocks for action.

To reiterate, this report does not present the long-term strategy for the World Bank Group, but rather an initial step in its development. It does not present or prioritize specific proposals regarding strategic choices, nor does it consider the operational tradeoffs and organizational consequences of possible restructuring. It identifies the possible elements of the Group's comparative advantage, without attempting the more difficult task of considering what each institution is doing now and will be doing in the future—that would require a broad-based exercise involving many other development institutions and stakeholders. Its primary contribution is to offer a view on the changing environment likely to face the Group in the future—global, developmental, and institutional—to provoke discussion.

* * *

The report was prepared under the guidance of François Bourguignon, World Bank Chief Economist and Senior Vice President, Development Economics, supported by a core drafting team comprising Alan Gelb and Jeffrey Lewis, and a working group drawn from across the World Bank Group that included Hans-Martin Boehmer, Shantayanan Devarajan, David Dollar, Antonio Estache, Gloria Grandolini, Isabel Guerrero, Arthur Karlin, Toshiya Masuoka, John Page, Nadia Piffaretti, Mark Sundberg, and Hasan Tuluy. Invaluable assistance was provided by numerous World Bank Group staff, and the final report has benefited from comments and suggestions received through discussions with staff, management, and Executive Directors, and feedback from participants in a range of external meetings over the last several months.

# The Global Scope for Action

*chapter* 1

This chapter lays the groundwork for a long-term strategy for the World Bank Group. It considers how the global environment facing the development community and the institution is likely to change over the next decade and beyond. The objective is not to predict the evolution of the global economy—it is to identify some paths along which further movement seems likely and to extract the implications for how the scope for World Bank Group action might change.

Many elements of the evolving global environment—and social and political changes in individual countries—affect current and future activities of the World Bank Group. The focus here is on three of those elements.

- ***Growth, poverty, and inequality.*** The extent and location of poverty, the success of different groups of countries in reducing poverty, and progress toward reducing nonincome poverty (including the Millennium Development Goals).
- ***Financial flows and aid.*** The changing financial landscape for developing countries, the proliferation in the sources of aid flows (led by new sovereign and private sector donors), and the fragmentation of the donor community.
- ***International spillovers.*** The increasing importance of cross-country externalities (including global public goods) as a natural consequence of globalization.

The chapter also considers possible departures from the base scenario, examining how that could modify the conclusions. It concludes by asserting that inclusive and sustainable global development should be the objective of international development actors, particularly the World Bank Group.

## The future shape of global poverty

This analysis of the likely evolution of the extent, depth, and location of poverty in the next 10 to 20 years takes as its starting point the World Bank's *Global Economic Prospects 2007: Managing the Next Wave of Globalization*. The long-term scenarios are derived from a multisector, multicountry, multiyear model that provides a laboratory for simulating how different assumptions about factor growth (labor, skills, investment) and technology (changing energy efficiency, technological change) might affect global economic performance.

### *The impact of growth*

Since economic growth is a primary driver of poverty reduction, the outlook for growth is crucial to the poverty story. We start from the *Global Economic Prospects 2007* central scenario to 2030. The trends and forces driving globalization over the last quarter century are likely to continue, strengthening trade and financial market links. Global growth will be steady, with growth remaining stronger in developing countries than in high-income countries.

By World Bank Group criteria there are some 147 developing countries, with a total population of 5.4 billion in 2005. These countries are heterogeneous, but it helps to regroup them in a few categories. As often as possible, we use the same categorization as the Group uses for operational purposes: International Development Association (IDA)–eligible, blend, and International Bank for Reconstruction and Development (IBRD). This categorization depends on many criteria, but because per capita income is a dominant one, it makes sense to use this grouping to get a first rough idea of the evolution of global poverty. Such analysis will also show the likely evolution of the Group's

clientele. The categorization is based on the following cutoffs:

| | |
|---|---|
| IDA-eligible | Less than $1,075 per capita |
| IDA | |
| LICUS/fragile states | |
| Blend | $1,076–$1,675 |
| IBRD | $1,675–$6,055 |
| Noninvestment grade | |
| Investment grade | |
| Graduated | More than $6,055 |

While the income levels used as cutoffs are somewhat arbitrary, they matter in how the international community engages with the different countries. The types of financial instruments differ (loans, concessional credits, or grants), and the nature of the dialogue and the role of donors are strongly influenced by the operational categorization. Looking ahead, the mobility of countries across these categories is likely to have a substantial impact on the global development scene, as fewer countries remain eligible for aid and more depart from developing country status.

Beyond income criteria, two further distinctions are worth making. First, among IDA-eligible countries, the low-income countries under stress (LICUS), often referred to as "fragile states," pose particular development challenges. Many are characterized by conflict or post-conflict environments that make the delivery of development finance and technical assistance difficult. While individual countries may transition into and out of fragile state status, this status tends to persist for many countries.[3] Second, among middle-income countries there is an important distinction between countries with investment-grade credit ratings and those with lower creditworthiness. That difference affects the relevance and relative attractiveness of official development finance and other development expertise and services.

Analysis has been undertaken of the potential growth of 112 (of 147) developing countries with sufficient data—home to 98 percent of developing countries' population (the 35 omitted countries are mostly small)—to produce predictions of growth from now until 2015 and from 2015 to 2030.[4] A first view of the evolution of global poverty can be obtained by analyzing the evolution of the number of countries and the total population in each category (table 1.1).

In this sample 48 countries had per capita incomes in 2005 below the IDA-eligible threshold, 12 fell in the blend range, 41 were IBRD borrowers, and 11 were above the graduation cutoff (although several continued to borrow). Projected growth over the next decade and beyond dramatically changes this outlook. By 2015 only 38 countries will still be IDA-eligible. More than half the population now living in IDA-eligible countries will shift to blend countries (1.4 billion), but India alone will account for much of the movement.[5] Nine countries (of twelve) would move from blend to IBRD eligibility, but they would be replaced by 10 countries moving from IDA to blend. Finally, 13 countries, with a total population of 425 million, would graduate from IBRD eligibility.

As the forecast moves out to 2030, there will be 32 IDA-eligible countries, 11 blend countries, and 35 IBRD-eligible countries (compared with the initial 48, 12, and 41). China, with its nearly 1.5 billion people, will have graduated from IBRD eligibility in 2030. Similarly, India will have moved to IBRD eligibility, dropping the population of blend countries to only 403 million, down from 1.5 billion in 2015. The population in currently IDA-eligible countries is projected to rise from 2.2 billion in 2005 to 3.1 billion in 2030. But as countries graduate from IDA the population in IDA-eligible countries will drop dramatically to 1.1 billion. Much of the population shift can be explained by the graduations of India and China.

The overall picture shows a sizable shift in the distribution of countries by income. For the World Bank Group this means that its clientele will shift toward higher income countries, with implications for the demand for finance and the full range of Group services.

### *Poverty is persistent—and more concentrated*

The overriding objective of the global development community over the past several decades

**Table 1.1 Transition matrices for developing regions in 2015 and 2030**

| *Transition from 2005 to 2015—number of countries* | | | | | |
|---|---|---|---|---|---|
| | **IDA** | **Blend** | **IBRD** | **Graduated** | **Total 2005** |
| IDA | 38 | 10 | 0 | 0 | 48 |
| Blend | 0 | 3 | 9 | 0 | 12 |
| IBRD | 0 | 0 | 28 | 13 | 41 |
| Graduated | 0 | 0 | 0 | 11 | 11 |
| **Total 2015** | **38** | **13** | **37** | **24** | **112** |
| *Transition from 2005 to 2030—number of countries* | | | | | |
| | **IDA** | **Blend** | **IBRD** | **Graduated** | **Total 2005** |
| IDA | 32 | 11 | 5 | 0 | 48 |
| Blend | 0 | 0 | 11 | 1 | 12 |
| IBRD | 0 | 0 | 19 | 22 | 41 |
| Graduated | 0 | 0 | 0 | 11 | 11 |
| **Total 2030** | **32** | **11** | **35** | **34** | **112** |
| *Transition from 2005 to 2015—population (millions)* | | | | | |
| | **IDA** | **Blend** | **IBRD** | **Graduated** | **Total 2005** |
| IDA | 1,143 | 1,420 | 0 | 0 | 2,563 |
| Blend | 0 | 32 | 532 | 0 | 564 |
| IBRD | 0 | 0 | 2,007 | 425 | 2,431 |
| Graduated | 0 | 0 | 0 | 1,205 | 1,205 |
| **Total 2015** | **1,143** | **1,452** | **2,539** | **1,630** | **6,763** |
| *Transition from 2005 to 2030—population (millions)* | | | | | |
| | **IDA** | **Blend** | **IBRD** | **Graduated** | **Total 2005** |
| IDA | 1,117 | 403 | 1,532 | 0 | 3,052 |
| Blend | 0 | 0 | 646 | 3 | 649 |
| IBRD | 0 | 0 | 664 | 1,963 | 2,627 |
| Graduated | 0 | 0 | 0 | 1,252 | 1,252 |
| **Total 2030** | **1,117** | **403** | **2,842** | **3,218** | **7,580** |

Source: World Bank Group staff estimates.

Note: Population refers to end-of-period populations in the respective panels. They do not sum to the total world population because of missing countries.

has been to reduce poverty, with special emphasis on extreme poverty—people living on less than $1 a day. Since 1990 extreme poverty has been substantially reduced (table 1.2). The absolute number of poor people continues to decline, falling by almost 200 million over the last 10 years to around 1 billion. This is an enormous achievement. Historical estimates suggest that the number of poor people has been consistently above 1 billion since the late 19th century. Since then the global population has quadrupled, but economic progress has overcome this demographic explosion.

Looking ahead, strong growth is associated with continuing declines in poverty.[6] Based on the $1 a day poverty threshold, the number of people in extreme poverty is projected to fall to 720 million in 2015 and 570 million in 2030. Because many countries will change income-based categories over time—for instance, the blend countries in 2015 will not be the same as blend countries in 2005—table 1.2 presents projections of poverty prevalence using a conventional breakdown of countries by region.

***Several notable points.*** First, extreme poverty is projected to fall to almost insignificant

**Table 1.2 Regional breakdown of poverty in developing countries**

| | Millions of people living on: | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Less than $1 a day | | | | Less than $2 a day | | | |
| | 1990 | 2004 | 2015 | 2030 | 1990 | 2004 | 2015 | 2030 |
| East Asia and Pacific | 476 | 169 | 48 | 12 | 1,113 | 684 | 312 | 148 |
| China | 374 | 128 | 37 | 9 | 819 | 452 | 196 | 76 |
| Rest of East Asia and Pacific | 102 | 41 | 11 | 3 | 294 | 232 | 115 | 72 |
| South Asia | 479 | 462 | 304 | 191 | 954 | 1,124 | 1,015 | 962 |
| India | 376 | 386 | 282 | 180 | 734 | 876 | 853 | 754 |
| Rest of South Asia | 103 | 76 | 22 | 11 | 220 | 248 | 162 | 207 |
| Europe and Central Asia | 2 | 4 | 2 | 2 | 20 | 46 | 23 | 9 |
| Middle East and North Africa | 5 | 4 | 3 | 3 | 49 | 59 | 40 | 26 |
| Sub-Saharan Africa | 240 | 298 | 326 | 326 | 396 | 522 | 597 | 656 |
| Latin America and the Caribbean | 45 | 47 | 38 | 38 | 115 | 121 | 109 | 87 |
| **Total** | **1,247** | **985** | **721** | **571** | **2,647** | **2,556** | **2,095** | **1,889** |
| **Total excluding China** | **873** | **857** | **684** | **562** | **1,828** | **2,104** | **1,899** | **1,813** |
| | Percentage of the population living on: | | | | | | | |
| | Less than $1 a day | | | | Less than $2 a day | | | |
| | 1990 | 2004 | 2015 | 2030 | 1990 | 2004 | 2015 | 2030 |
| East Asia and Pacific | 29.8 | 9.1 | 2.4 | 0.6 | 69.7 | 36.6 | 15.3 | 6.7 |
| China | 33.0 | 9.9 | 2.6 | 0.6 | 72.2 | 34.9 | 14.1 | 5.2 |
| Rest of East Asia and Pacific | 22.1 | 8.8 | 2.5 | 0.4 | 63.7 | 50.2 | 25.1 | 9.7 |
| South Asia | 43.0 | 32.0 | 18.0 | 9.7 | 85.7 | 77.7 | 60.1 | 49.0 |
| India | 44.3 | 35.8 | 22.1 | 12.8 | 86.4 | 81.1 | 66.9 | 53.5 |
| Rest of South Asia | 38.9 | 28.8 | 8.3 | 1.9 | 83.4 | 94.2 | 61.6 | 37.4 |
| Europe and Central Asia | 0.5 | 0.9 | 0.5 | 0.2 | 4.3 | 9.8 | 4.8 | 2.0 |
| Middle East and North Africa | 2.3 | 1.5 | 0.8 | 0.3 | 21.7 | 19.7 | 10.9 | 5.4 |
| Sub-Saharan Africa | 46.7 | 41.1 | 35.4 | 30.5 | 77.1 | 72.0 | 64.7 | 58.3 |
| Latin America and the Caribbean | 10.2 | 8.6 | 6.0 | 3.5 | 26.3 | 22.2 | 17.3 | 12.1 |
| **Total** | **28.7** | **18.4** | **11.8** | **6.4** | **60.8** | **47.7** | **34.2** | **21.1** |
| **Total excluding China** | **27.1** | **21.1** | **14.5** | **7.5** | **56.8** | **51.8** | **40.1** | **24.3** |

Source: Data for 1990 and 2004, Chen and Ravallion (2007); data for 2015 and 2030, World Bank Group staff estimates.

levels in East Asia by 2015. Second, global $1 a day poverty will be concentrated in two regions: South Asia (in effect, India) and Sub-Saharan Africa, each accounting for roughly 40 percent of global poverty. There will be a big difference between the two regions, however. Extreme poverty will have fallen substantially in India but stagnated in Sub-Saharan Africa.[7] As the projection moves out to 2030, global extreme poverty will be concentrated more in Africa (60 percent). Third, country calculations behind the regional figures show that the lack of progress in that region is closely linked with its high proportion of fragile states.

The regional story is only a bit different when looking at $2 a day poverty. There will still be more than 2 billion poor people in 2015, a third of the global population. East Asian countries continue to perform better than the others, but they will still have 300 million poor people in 2015. In South Asia too $2 a day poverty declines, but that region will still account for almost half the global total. Although less important in absolute numbers, $2 a day poverty increases fairly rapidly in Sub-Saharan

Africa. And the number of people consuming less than $2 a day declines very slowly in Latin America; there might still be more than 100 million poor people in the region by 2015.

Where does this analysis lead? First, continuing growth will have enormous implications for developing countries, as the number of countries eligible for aid declines sharply—and as more countries become creditworthy and access IBRD finance or even graduate from active borrowing. Second, progress in reducing poverty will likely continue, with the extreme poor concentrated in fragile states and IDA-eligible countries, mostly in South Asia and Sub-Saharan Africa. But the number of poor people will fall in South Asia and possibly remain constant in Sub-Saharan Africa. Third, attention will shift to alternative definitions of poverty—such as $2 a day poverty, which will remain prevalent in all country groups and regions—or to nonincome dimensions of poverty.

### *Technology, income distribution, and a possible widening of inequality*

The foregoing poverty projections are based on projected growth rates of national economies and assume no change in the distribution of income or consumption within countries. But there is now some evidence of systematic changes in the income distribution. Over time these changes could introduce a systematic and persistent wedge between economic growth and poverty reduction. Some factors that could affect trends in distribution, such as technological change and demographic pressures, may weaken the position of households that have to rely exclusively on their unskilled labor for income.

While the outlook for growth and poverty reduction is fairly favorable, it is also possible that the uneven distribution of growth's benefits—both across and within countries—could raise global tensions. Robust real growth for both middle- and low-income countries over the last five years has produced significant income convergence between developing and developed countries for the first time in decades. For low-income countries the last five years is the first time since the 1960s that their per capita income growth has been substantially higher than the average for the Organisation for Economic Co-operation and Development (OECD)—a possible turning-point and the beginning of a "catching-up" period. But even with current growth differentials, it would take more than 100 years for Africa simply to regain its 1970's position relative to the high-income world, and the risk of widening differentials cannot be ignored. Is such slow progress acceptable given the historically high income differential between rich and poor countries? And what would be the consequences if this differential were to start widening again?

Of equal concern, strong forces in the global economy may increase inequality within national economies. There will clearly be winners. By 2030 an estimated 1.2 billion people in developing countries, 15 percent of the world population, will belong to the global "middle class," up from 400 million today. "Middle class" means people who can afford and demand access to standards of living previously reserved mainly for the residents of developed countries. Together with greatly increased information flows and more accessible media, the growth and spread of this group could reinforce long-run social and political trends toward more participatory political systems.

But there will also be losers. Some social groups within countries may be left behind or marginalized by the growth process. Among other factors, the spread and further acceleration of technological progress is likely to increase demand for skills at the global level and to widen the gap between skilled and unskilled wages. Estimates in *Global Economic Prospects 2007* suggest that income inequality may worsen in as many as two-thirds of countries in the coming quarter century. Unskilled workers, in particular, are likely to face continuing pressures and risk falling even further behind, accentuating dualistic trends in economies and societies.

Overall, there is thus a risk that global growth will exclude some countries, particularly fragile states, and some groups within countries, even among high growth performers.

### *Demographic pressures will intensify*

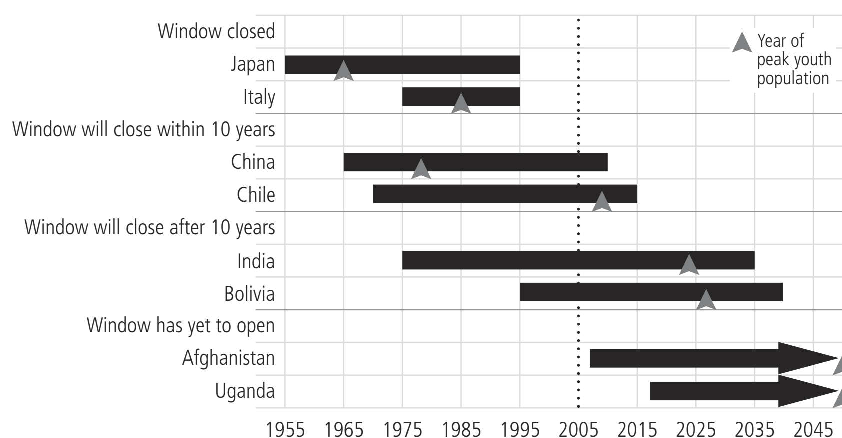
Between 2005 and 2030 the world will welcome 1.8 billion more people (from 6.5 billion to 8.3 billion), 97 percent of them in developing countries.[8] The poorest regions are projected to see most of the increase, with Sub-Saharan Africa adding 540 million people and South Asia 600 million.

The population structure is changing as well.[9] In developed countries the huge drop in fertility rates, to well below the replacement rate, is responsible for declining labor forces and rapidly aging populations. With a considerable lag, developing countries—some earlier than others—are now also seeing significant declines in fertility, a substantial reduction in the number of children per worker, and a "youth bulge." The labor force is still growing rapidly in most developing countries, owing to the large number of births over the last two decades, and most are seeing only modest increases in the share of the elderly in the population.[10]

For developing countries the transition offers an opportunity. Many are in—or will soon enter—a phase when a larger share of the population is of working age. A workforce with fewer children and elderly to support provides a window of opportunity to spend on other things, such as building human capital. That window of falling dependency rates can stay open for up to 40 years, depending on the rate of fertility decline. Then aging will close it. (Figure 1.1 shows examples.) The good news is that almost all developing countries are still in this window. Of those where the window opened early, some have taken full advantage. But others have not. One study attributes more than 40 percent of the faster growth in East Asia over Latin America in 1965–90 to the faster growth of its working-age population and to better policies for trade and human capital development.

These demographic trends may make global growth less inclusive. Population pressure is one factor that explains the slow decline in the number of poor people and their concentration in particular regions or countries, as just discussed. Economic growth cannot always offset this pressure. The scattered entrances into the demographic window of opportunity, and the unequal capacities to equip new cohorts with adequate human capital, add to country disparities. Within countries a growing labor force and unequal access to education often imply that large shares of younger cohorts cannot get good jobs, leaving them marginalized. Adding further to the disparities are migration incentives driven by the asymmetry between demographic trends in developed and developing countries. Because more migrants from developing to developed countries are skilled workers, this migration often reduces the growth potential of their countries or places of origin.

**Figure 1.1 Opening and closing demographic windows of opportunity, 1955–2045**




Source: World Bank 2006f.

Note: Bars show the range of years for which the dependency ratio (the number of dependents relative to people of working age) is falling.

### *Urbanization and the spatial dimension of poverty*

Along with pressures that worsen distributional outcomes, spatial factors affect the nature and extent of poverty in developing countries. The rapid urbanization in the developing world is often associated with growing urban–rural and interregional disparities in income growth. Economies of scale and agglomeration explain the attractiveness of big cities for investors and entrepreneurs. This is good for overall economic growth. But imperfect factor mobility tends to accentuate the rural–urban or interregional income differentials.

There are also cases where urbanization takes place because of "push" rather than "pull" factors. Rural residents migrate to big cities more because of worsening conditions in their place of origin than because of fast-growing activity, incomes, and employment in big cities. This explanation has sometimes been offered for the fast urbanization in Sub-Saharan countries without particularly fast growth. Urbanization then appears more as a consequence of widening spatial income differentials than a cause.

The urban population in developing countries is currently estimated at 43 percent of the total, up from 35 percent in 1990, and it is projected to increase to 56 percent by 2030 (figure 1.2).[11] Virtually all the future population growth in developing countries will be urban, with growth in rural areas slowing to zero by 2019 and then turning negative. There are some exceptions. In Sub-Saharan Africa both rural and urban populations will grow rapidly through 2015, but even there urban growth will far outpace rural.

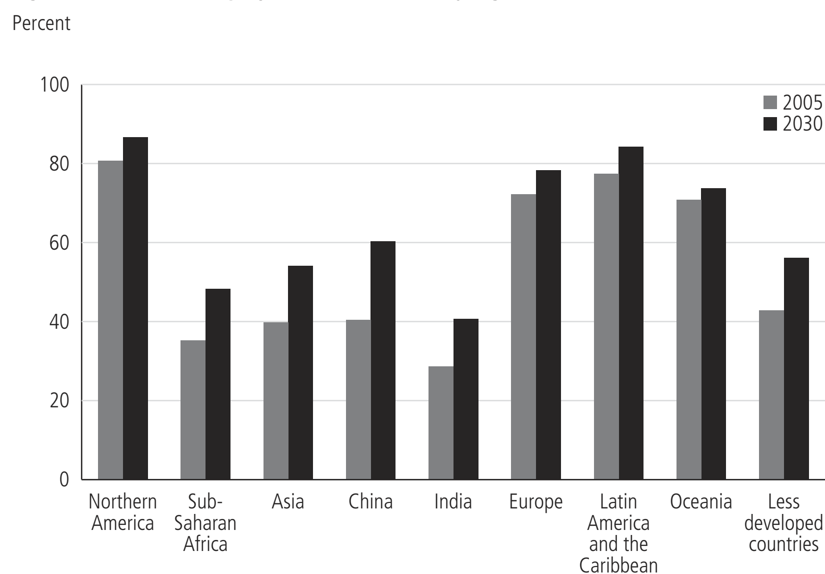
There are many instances where this rapid transformation has been accompanied by increasing rural–urban or interregional inequality. Take China. Between 1990 and 2002 inequality increased in both rural and urban sectors, but the main contribution to the overall increase in inequality was the widening gap between the two.[12] Historically high in big Latin American countries, interregional inequality is also increasing in other fast-growing countries, like India. A focus on income inequality may underestimate welfare inequality between the rural and urban sectors. It is typically easier and cheaper to get health, education, and other public services in urban settings.

### *Nonincome poverty and future development challenges*

There is increasing attention to nonincome dimensions of poverty—education, health, access to basic infrastructure—as evident in the widespread commitment by the global community to achieving the Millennium Development Goals. To project likely future achievements and identify where the Millennium Development Goals might remain unmet in 2015, this section extends historical trends and identifies reasonable rates of accelerated development based on performance and the potential for faster progress. The assessment, however tentative, can provide insights into the geographic and sectoral characteristics of future development challenges. What might be the changing relative relevance of primary, secondary, and tertiary education? How important is the shift in education from quantity (enrollment) to quality (learning)? What might be the changing demands for different types of infrastructure (electricity, water, sanitation)?

Because of a lack of reliable statistical information, measuring and monitoring Millennium Development Goal achievements are major challenges, as underscored in the annual *Global Monitoring Report*.[13] These difficulties, along with the possibility that countries can—some already have—dramatically accelerate their progress toward these goals over a fairly short period, make projections especially speculative. The focus here is on three Millennium Development Goal indicators with data available for a large number of countries—under-five mortality, primary education completion, and access to safe water. For each country group data are presented on the evolution of

**Figure 1.2 Current and projected urbanization by region, 2005 and 2030**
Percent




Source: UNDESA 2005.

the indicator and on two projections of future progress. The first projection is based on the assumption that each country continues to advance until 2015 at the same rate as it did during 1990–2005. The second captures the possibility of faster progress by assuming that each country's progress occurs at a pace that is one standard deviation faster than that observed historically across countries.

### *Under-five mortality*

Of the 118 million children born in 2005, 10 million were expected to die before reaching age 5, or 8.5 percent of the relevant population in developing countries (table 1.3). With future progress based on the most recent country trends, this number would fall to 9.2 million by 2015, or 7.6 percent of the relevant population, still far from the Millennium Development Goal target (which calls for a drop of two-thirds between 1990 and 2015, to 3.3 percent). In this scenario under-five mortality would increasingly be concentrated in fragile states, where mortality would even increase, and in other countries below the IDA income threshold, despite some reduction in mortality.

The comparison with 1990 is striking. In 1990, 41 percent of under-five mortality was in low-income countries (IDA and LICUS). In 2015, if no decisive action is taken, this proportion is expected to be 72 percent. Much faster progress would be achieved in today's blend countries (including India) and core IBRD countries (including China), with mortality rates dropping by more than half in each group. Yet even this progress would fall short of the Millennium Development Goal target. These aggregate rates hide disparities across countries or across regions within countries.

With faster progress the average under-five mortality rate could fall to 5.4 percent rather than 7.6 percent in 2015. Given the initial mortality rates, much of this progress would be concentrated in low-income countries. Even so, in 2015 these countries would still account for more than two-thirds of children expected to die before age five.

### *Primary school completion*

As of 2005 and among the 99 countries with adequate data, 71 million children ages 6–11, or 13.7 percent of the relevant population, were not on track to complete primary school. Based on extended trends since 1990, this proportion would be expected to fall only modestly, to 63 million children (12.1 percent of the relevant population) by 2015 (table 1.4). Most of the decline would be in IBRD countries and in India. As with under-five mortality, incomplete or absent primary schooling will increasingly be concentrated in low-income countries. These countries are projected to account for some four-fifths of children

**Table 1.3 Under-five mortality, 1990, 2005, and 2015**

| | Rate (percent) | | | Number of children (millions) | | | Proportion of total (percent) | | |
|---|---|---|---|---|---|---|---|---|---|
| **Country category** | **1990** | **2005** | **2015** | **1990** | **2005** | **2015** | **1990** | **2005** | **2015** |
| IBRD, investment grade | 3.8 | 2.8 | 0.024 | 0.3 | 0.2 | 0.2 | 3 | 2 | 2 |
| IBRD, core | 6.4 | 3.2 | 0.021 | 1.1 | 0.6 | 0.4 | 10 | 6 | 4 |
| China | 4.9 | 2.7 | 0.018 | 1.1 | 0.5 | 0.3 | 10 | 5 | 4 |
| Blend, excluding India | 10.8 | 6.8 | 0.054 | 1.0 | 0.6 | 0.5 | 9 | 6 | 5 |
| India | 12.3 | 7.4 | 0.053 | 3.1 | 1.8 | 1.2 | 27 | 18 | 14 |
| IDA, core | 15.0 | 14.7 | 0.132 | 2.9 | 4.1 | 4.0 | 26 | 41 | 44 |
| LICUS | 17.1 | 17.3 | 0.176 | 1.7 | 2.2 | 2.5 | 15 | 22 | 28 |
| **Total** | **10.0** | **8.5** | **7.6** | **11.1** | **10.1** | **9.2** | **100** | **100** | **100** |

Source: World Bank 2007l.

Note: Under-five mortality is the probability that a newborn baby will die before reaching age 5. Data are available for 142 countries covering 100 percent of developing countries' population in 2005, excluding countries that are not members of the World Bank, such as Cuba and the Democratic Republic of Korea.

**Table 1.4 Children not completing primary education, 1990, 2005, and 2015**

| | Rate (percent) | | | People (millions) | | | Proportion of total (percent) | | |
|---|---|---|---|---|---|---|---|---|---|
| **Country category** | **1990** | **2005** | **2015** | **1990** | **2005** | **2015** | **1990** | **2005** | **2015** |
| IBRD, investment grade | 12.6 | 3.0 | 2.2 | 5.9 | 1.2 | 0.8 | 5 | 2 | 1 |
| IBRD, core | 16.7 | 4.8 | 3.1 | 14.0 | 4.0 | 2.7 | 12 | 6 | 4 |
| China | 2.3 | 2.3 | 2.3 | 2.7 | 2.7 | 2.3 | 2 | 4 | 4 |
| Blend, excluding India | 10.3 | 1.1 | 0.3 | 2.9 | 0.3 | 0.1 | 3 | 0 | 0 |
| India | 33.6 | 10.6 | 4.9 | 40.2 | 14.8 | 6.9 | 36 | 21 | 11 |
| IDA, core | 54.2 | 36.1 | 29.0 | 33.1 | 29.0 | 26.2 | 29 | 41 | 41 |
| LICUS | 62.1 | 57.3 | 56.3 | 14.0 | 19.4 | 24.3 | 12 | 27 | 38 |
| **Total** | **23.5** | **13.7** | **12.1** | **112.8** | **71.3** | **63.2** | **100** | **100** | **100** |

Source: World Bank 2007l.

Note: The primary completion rate is the number of students in the last grade of primary school minus repeaters divided by the number of children of graduation age. Data are available for 99 countries covering 81 percent of developing countries' population in 2005, excluding countries that are not members of the World Bank, such as Cuba and the Democratic Republic of Korea.

not completing primary school by 2015. The actual share will probably be higher still, because many countries with missing data are low-income countries with low completion rates.

An improvement in country progress of one standard deviation of observed national trends would lead to dramatically faster progress toward universal completion, a result that reflects the large variance in past performance across countries. In this more optimistic scenario developing countries' weighted average noncompletion rate could drop to 3.5 percent in 2015, down from 13.7 percent in 2005 and from 12.1 percent in the base scenario. Most of the progress would again come in low-income countries. Even in this case, however, school completion difficulties would remain sizable in low-income countries. In 2015 their incompletion rates (at 11.5 percent and 8.6 percent, respectively) would be substantially higher than even the 2005 rates of the other groups.

A further serious education gap: quality. That data on educational outcomes in developing countries are so limited is alarming. By the fourth grade in Argentina, Colombia, and Morocco fewer than half the children can read at the lowest threshold of literacy on an international test normed for OECD countries. Similarly distressing results come from tests taken in Southern African countries at the sixth grade.[14] These poor results reflect many problems, including poor school governance, financial mismanagement, and weakly motivated and managed service providers, often including high rates of teacher absenteeism. Even if enrollment rates are increased rapidly, quality deficits in education delivery can be expected to persist for many years.

### *Access to safe water*

In 2005 a billion people still lacked access to safe water—19.3 percent of the population in the 109 developing countries with data. On recent trends, this number could fall by 2015 to 950 million people, or 16.2 percent of the population (table 1.5). While water access problems and needs would be concentrated in low-income countries, this shift would be much less pronounced than for child mortality or lack of education. The proportion of people without water access in IBRD or blend countries would remain substantial—more than 50 percent of the total, with half that share in China.

Under the alternative projections the proportion of developing countries' population without access to safe water would decline much faster. Accelerating progress by one cross-country standard deviation of the trends between 1990 and 2005, developing countries' weighted average rate of people without access to safe water would fall to 10.5 percent in 2015 (from 19.3 percent in 2005), more than twice the decline in the base scenario.

**Table 1.5 People without access to safe water, 1990, 2005, and 2015**

| | Rate (percent) | | | People (millions) | | | Proportion of total (percent) | | |
|---|---|---|---|---|---|---|---|---|---|
| **Country category** | **1990** | **2005** | **2015** | **1990** | **2005** | **2015** | **1990** | **2005** | **2015** |
| IBRD, investment grade | 9.1 | 3.6 | 2.4 | 38.4 | 17.1 | 11.4 | 3 | 2 | 1 |
| IBRD, core | 12.8 | 8.3 | 7.2 | 82.2 | 66.2 | 66.6 | 7 | 7 | 7 |
| China | 30.0 | 22.6 | 18.7 | 340.6 | 294.4 | 257.2 | 31 | 29 | 27 |
| Blend, excluding India | 23.1 | 16.5 | 13.2 | 73.4 | 67.4 | 61.9 | 7 | 7 | 7 |
| India | 30.0 | 13.3 | 7.7 | 254.9 | 145.1 | 96.0 | 23 | 14 | 10 |
| IDA, core | 43.3 | 37.3 | 33.5 | 213.8 | 233.4 | 254.2 | 19 | 29 | 34 |
| LICUS | 46.2 | 37.1 | 34.4 | 146.8 | 183.9 | 217.1 | 9 | 11 | 14 |
| **Total** | **27.1** | **19.3** | **16.2** | **1,150.0** | **1,007.6** | **964.5** | **100** | **100** | **100** |

Source: World Bank 2007.

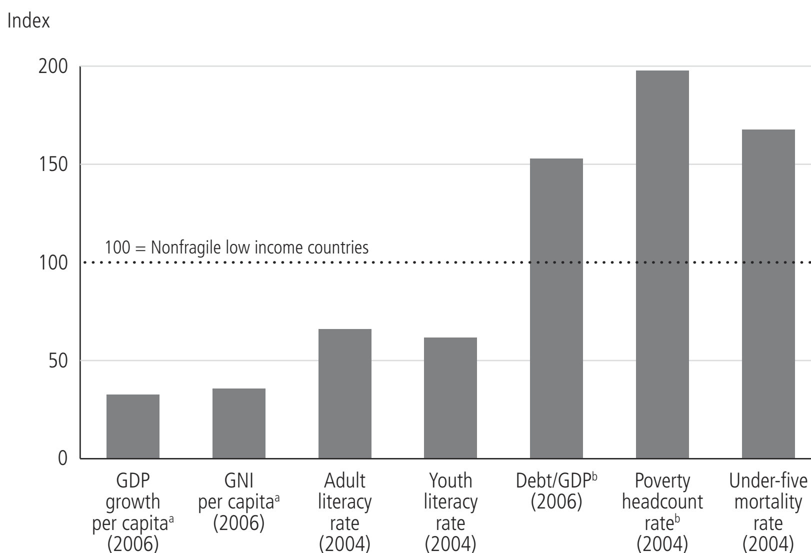
Note: Access to an improved source of safe water refers to the percentage of the population with reasonable access to an adequate amount of water from an improved source. Data are available for 110 countries covering 97 percent of developing countries' population in 2005, excluding countries that are members of the World Bank, such as Cuba and the Democratic Republic of Korea.

## *Implications for nonincome poverty*

While the data limitations and mechanistic projections suggest caution, several tentative inferences can be drawn. First, the projections based on extrapolating recent trends suggest that most groups will continue to progress in reducing nonincome poverty in health, education, and water over 2005–15. Second, in all three areas the challenge will be concentrated in low-income countries, as it is for income poverty. Note, however, that country projections do not take into account possible disparities within countries, known to be important and possibly growing in several countries. Third, much faster progress is possible, as suggested in more optimistic scenarios. This essentially reflects differences between high and low performers in the sample of countries with available data. Yet, even under the more optimistic projections, progress would fall short of the Millennium Development Goals, and the gaps will be concentrated in low-income countries.

**Figure 1.3 Fragile states relative to nonfragile low-income countries**

Index




Source: World Bank Group staff estimates.

a. Excludes oil exporters.

b. Comparator group includes IDA and blend countries.

## *Fragile states face multidimensional disadvantages*

Fragile states—countries with weak governance, policies, and capacity—pose particular challenges. The countries in this group comprise around one-fifth of the population of low-income countries, and they perform more poorly on nearly all indicators of development (figure 1.3). With per capita income of about one-third that of other low-income countries, they also grow only around one-third as fast, so that the gap with other developing countries widens steadily. Debt to GDP ratios are 50 percent higher, poverty rates are nearly double, and under-five mortality is significantly higher than in other low-income countries. Literacy rates are lower, and youth

literacy lags behind adult literacy, highlighting the intergenerational impact of the fragile environment.

State fragility may be considered transitory, with countries losing that status as they emerge from conflict or transition to a more stable political regime. There are success stories—like Mozambique and Rwanda—but there are also many examples of persistent or recurrent fragility. Eighty percent of the fragile states identified in 1980 are still fragile today. Achieving the Millennium Development Goals is particularly problematic in those countries, and looking ahead calls for increased attention to research, policy initiatives, and efforts to mobilize resources. Despite enormous needs, aid flows to fragile states are uneven, irregular, and fragmented, and modes of engagement by donors are especially difficult.

## The likely evolution of financing flows to developing countries

A core function of the World Bank Group is to promote private capital flows to developing countries and to augment them when they are inadequate, either because of insufficient creditworthiness or because of uncertain and long-term returns—say, to educational investments. Each arm of the World Bank Group targets a different clientele with a range of products to provide or enrich financial flows.

But the global context for World Bank Group institutions has been transformed over the past several decades, as maturing international financial markets and proliferating new financing instruments and practices have altered the landscape for development finance. As recently as a decade ago, following the domino-like spread of financial contagion among East Asian economies, there was widespread pessimism about the availability of finance, both public and private, for developing countries. But in hindsight such concerns were much too gloomy. Despite occasional crises in individual countries (as in Argentina), systemic contagion has been avoided and global financial markets have stayed robust, as have flows to developing countries.

This section reviews financing flows to developing countries and the determinants of access to international capital markets. The objective is to consider the likely evolution of developing countries' access (both sovereign and corporate) to global capital markets, the conditions for such accessibility, and the nature of the financial products being sought and accessed by the categories of recipient countries. The section also reviews trends in foreign aid from both traditional and "new" donors, including its level and allocation among recipient countries and sectors.

### *The strong current environment*

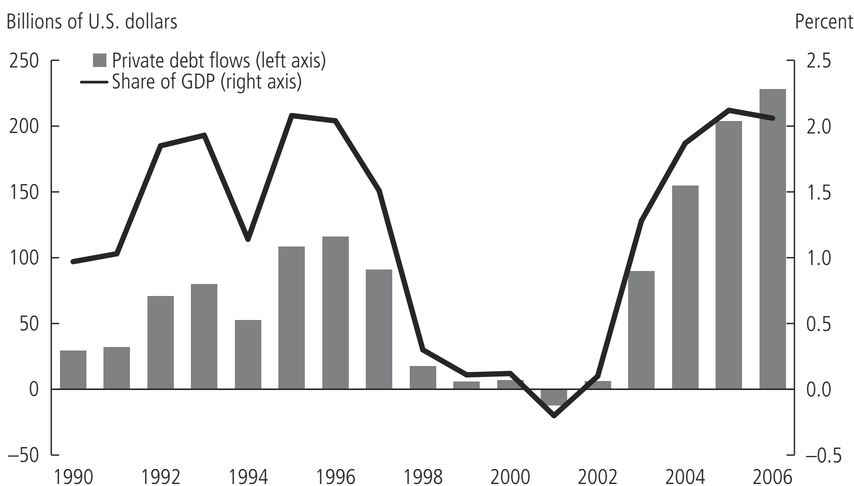
Recent volatility notwithstanding, the global financial environment remains strongly supportive of emerging market economies. Another banner year, 2006 continued the strong upturn in capital flows to developing economies that began in 2002. Net capital inflows from private sources reached $647 billion, or 5.8 percent of developing country GDP—almost double the previous peak just prior to the 1997 Asian financial crisis. Equity flows totaled $419 billion in 2006, accounting for three-quarters of the capital flows, up from two-thirds in 2004. Strong gains were recorded in both portfolio equity and foreign direct investment (FDI) in emerging markets and other developing countries. A wave of cross-border mergers and acquisitions boosted FDI flows to developing countries in 2006 to a new high of $325 billion, roughly a fourth of worldwide flows.

The increase in private capital flows in recent years has been broad-based, extending across both debt and equity flows and encompassing much of the developing world (figure 1.4). Long-term bond issuance, medium- and long-term bank lending, and portfolio equity have shown strong gains. The creditworthiness of most developing countries continued to improve, so much that ratings upgrades outnumbered downgrades by around 10 to 1 in 2006.

Many countries have engaged in more active and aggressive debt management—issuing bonds with longer maturities in international markets (in some cases in local

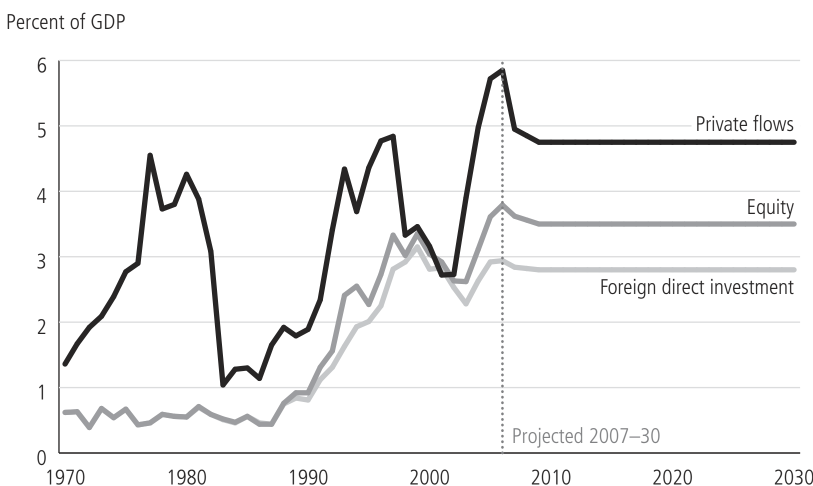
currency), prepaying high-cost loans or buying back high-cost bonds, and taking advantage of favorable market conditions to prefund future financing requirements a year or more in advance. Better fiscal performance and reserve accumulation mean that sovereign governments are borrowing less and relying less on external sources when they do borrow. As a result, the ratio of external public debt to GDP for developing countries as a whole fell from a peak of 39 percent in 1999 to 23 percent in 2006. The cost of bond issuance has been low for several years, as spreads on emerging market sovereign bonds plummeted, reaching a record low of 165 basis points in April 2007 (see figure 1.8 later in this chapter). In 2002 only one country in five in the Emerging Markets Bond Index had bond spreads below 200 basis points—in April 2007 the proportion was three countries in four.

**Figure 1.4 Net private debt flows to developing countries, 1990–2006**




Source: World Bank Debtor Reporting System and World Bank Group staff estimates.

**Figure 1.5 Net private capital flows as a share of GDP in developing countries, 1970–2030**




Source: World Bank Group staff estimates.

Many factors underlie this strong performance. Start with better policies and performance in developing countries. Many countries responded to the financial crises of the late 1990s by placing macroeconomic policy on a more sustainable footing, strengthening domestic financial markets, and adopting more flexible exchange rate policies to help cushion the impact of external shocks and facilitate adjustment. Strong global economic performance contributed as well. Growth in high-income countries has remained solid, and developing countries have enjoyed continuing robust growth, expanding by 7.3 percent in 2006 (5.9 percent excluding China and India), the fourth straight year that growth exceeded 5.5 percent. Abundant liquidity in global markets and low returns in high-income markets have fostered an ongoing "search for yield," fueling interest in emerging markets. In many respects it has been a golden era for emerging market finance.

### *The future of financing flows to developing countries*

The rapid pace of structural change and deepening in global financial markets suggest caution in efforts to outline the evolution of development finance over the next decade and beyond. An observer making such predictions a decade ago on the eve of the Asian financial crisis would have had a very different outlook from an observer writing a year later, and both would no doubt be astonished to see where financial markets are today. Even so, it is possible to develop a broad outline of possible future directions based on the outlook for growth, extrapolating some of the market trends.

The recent capital flows to developing countries are likely at a peak. Net private capital inflows (debt and equity) to developing countries are expected to decline by around a percentage point of GDP, from 5.8 percent in 2005–06 to 4.8 percent over the next few years and to stabilize there over the long

term (figure 1.5). Net equity inflows (FDI and portfolio) will continue to predominate, accounting for about three-quarters of total private flows. Following a sharp increase in FDI relative to GDP in the 1990s, this share has been fairly stable over the past decade at 2.8 percent, where it will likely remain.

FDI flows will remain buoyant, despite the assumption of a constant share of GDP. Because developing countries are expected to continue growing faster than high-income countries over the next few decades, they should account for a growing share of global FDI inflows. Developing countries' share of global GDP (at market prices) has already risen from an average of less than 18 percent over 1970–2003 to 23 percent in 2006, and that share is expected to rise gradually to reach a third by 2030 (figure 1.6). As a result, the developing country share of global FDI will grow from 30 percent in 2004–05 to nearly half by 2030, with a particularly dramatic increase over the next few years as FDI inflows to high-income countries decline more sharply.

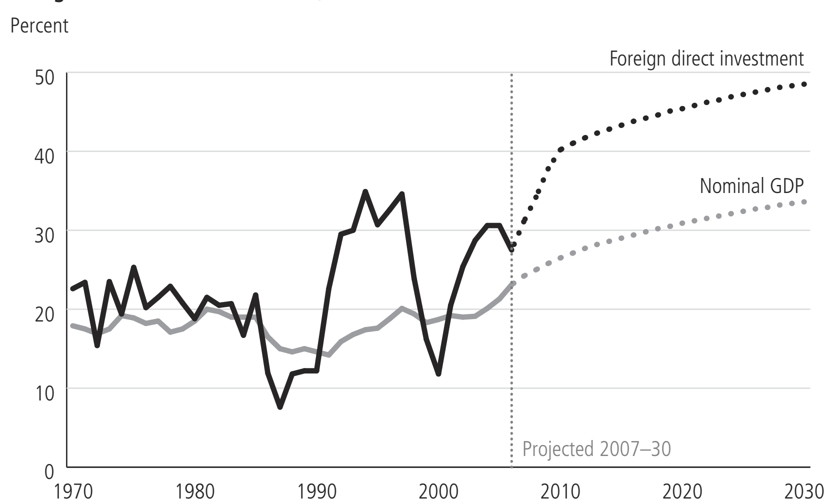
On the debt side, as noted, there has been an enormous net repayment of official debt over the last several years, as some countries repaid crisis-related International Monetary Fund debt and many borrowers took advantage of the favorable financing environment to prepay Paris Club and other official debts. But because the outstanding stock of official debt has already been substantially reduced, this trend cannot continue, so in coming years the composition of net debt flows is expected to shift from private to official sources. Private debt flows are expected to decline from 2 percent of GDP in 2005–06 to 1 percent of GDP over the next few years, while net official lending recovers from a net outflow of 0.7 percent of GDP to a net inflow of 0.25 percent of GDP (figure 1.7). It is even more difficult to project debt flows than equity flows over the long term because of the high uncertainty about how expected (or needed) increases in savings rates in many countries will play out, the likelihood and impact of continuing reserve accumulation, and the way current global imbalances unwind.

## *Changing patterns of access to global financing flows*

Projections of global aggregate financing flows, while useful, do not tell the whole story, for the allocation across countries is also important. Tables 1.6 and 1.7 show how the allocation of key development finance flows—FDI, equity, bonds, and loans—has changed over the last decade, according to this chapter's country typology.

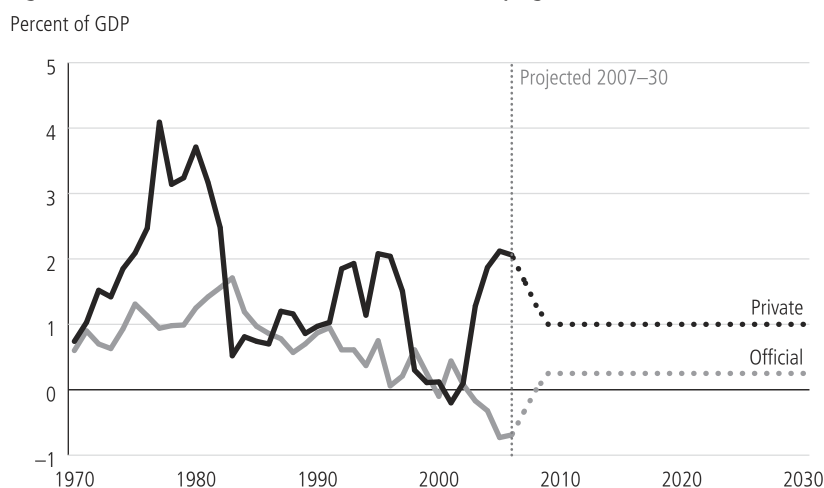
Net private flows more than doubled over the last decade, rising from $158 billion to $349 billion (using three-year averages). The figures

**Figure 1.6 Developing country share of global GDP and foreign direct investment inflows, 1970–2030**




Source: World Bank Group staff estimates.

**Figure 1.7 Net debt flows as a share of GDP in developing countries, 1970–2030**




Source: World Bank Group staff estimates.

**Table 1.6 Financial flows to developing countries by type, 1995 and 2005 (billions of U.S. dollars)**

| Type of flow | Year | IBRD Investment grade | IBRD Core | Blend | IDA, core | LICUS | China | India | Total |
|---|---|---|---|---|---|---|---|---|---|
| Bank loans, net flows | 1995 | 2.2 | 8.5 | –0.7 | 0.0 | –0.1 | 1.9 | 0.4 | 12.3 |
| | 2005 | 39.0 | 5.8 | –1.7 | 0.2 | 1.0 | 3.1 | 3.5 | 50.9 |
| Debt, net flows | 1995 | 14.6 | 10.9 | 1.0 | 0.0 | 0.0 | 1.8 | 0.2 | 28.5 |
| | 2005 | 21.4 | 14.5 | 2.2 | 0.2 | 0.0 | 2.5 | –1.1 | 39.7 |
| FDI, net inflows | 1995 | 26.6 | 16.9 | 3.9 | 3.0 | 2.8 | 32.4 | 1.2 | 86.9 |
| | 2005 | 77.0 | 51.8 | 8.5 | 8.0 | 7.9 | 60.4 | 5.6 | 219.1 |
| Portfolio equity flows | 1995 | 8.9 | 10.9 | 2.2 | 0.0 | 0.0 | 0.0 | 2.8 | 24.8 |
| | 2005 | 11.7 | 8.2 | 1.2 | –0.1 | 0.0 | 13.0 | 9.7 | 43.6 |
| Private net resource flows | 1995 | 53.0 | 47.5 | 6.8 | 2.9 | 2.7 | 39.0 | 5.8 | 157.7 |
| | 2005 | 147.8 | 79.7 | 9.9 | 8.2 | 8.5 | 77.3 | 17.5 | 348.9 |
| Official net resource flows | 1995 | 9.9 | 4.0 | 5.6 | 11.8 | 6.1 | 5.5 | 1.1 | 43.9 |
| | 2005 | –11.9 | –2.5 | 2.8 | 19.0 | 8.2 | –0.4 | 0.7 | 16.0 |
| Total net resource flows | 1995 | 62.8 | 51.5 | 12.4 | 14.7 | 8.7 | 44.5 | 6.9 | 201.5 |
| | 2005 | 135.9 | 77.2 | 12.7 | 27.3 | 16.7 | 76.9 | 18.3 | 364.9 |

Source: World Bank Group staff estimates.

Note: To minimize the impact of short-term fluctuations on flows, data are three-year averages for the two endpoints: 1995 is the average of flows for 1993–95, and 2005 is the average for 2003–05.

**Table 1.7 Financial flows to developing countries by type, 1995 and 2005 (percent of GDP)**

| Type of flow | Year | IBRD Investment grade | IBRD Core | Blend | IDA, core | LICUS | China | India | Total |
|---|---|---|---|---|---|---|---|---|---|
| Bank loans, net flows | 1995 | 0.1 | 0.5 | –0.2 | 0.0 | 0.0 | 0.3 | 0.1 | 0.2 |
| | 2005 | 1.3 | 0.2 | –0.4 | 0.1 | 0.4 | 0.1 | 0.4 | 0.5 |
| Debt, net flows | 1995 | 1.0 | 0.6 | 0.3 | 0.0 | 0.0 | 0.2 | 0.1 | 0.6 |
| | 2005 | 0.7 | 0.6 | 0.5 | 0.1 | 0.0 | 0.1 | –0.1 | 0.4 |
| FDI, net inflows | 1995 | 1.8 | 0.9 | 1.3 | 1.8 | 2.7 | 4.4 | 0.3 | 1.7 |
| | 2005 | 2.6 | 2.0 | 1.8 | 2.4 | 3.2 | 2.7 | 0.7 | 2.3 |
| Portfolio equity flows | 1995 | 0.6 | 0.6 | 0.8 | 0.0 | 0.0 | 0.0 | 0.8 | 0.5 |
| | 2005 | 0.4 | 0.3 | 0.2 | 0.0 | 0.0 | 0.6 | 1.2 | 0.5 |
| Private net resource flows | 1995 | 3.5 | 2.5 | 2.3 | 1.7 | 2.5 | 5.4 | 1.6 | 3.1 |
| | 2005 | 5.0 | 3.1 | 3.1 | 2.5 | 3.5 | 3.5 | 2.2 | 3.6 |
| Official net resource flows | 1995 | 0.7 | 0.2 | 0.2 | 7.0 | 5.7 | 5.7 | 0.3 | 0.9 |
| | 2005 | –0.4 | –0.1 | 0.1 | 5.8 | 3.4 | 3.4 | 0.1 | 0.2 |
| Total net resource flows | 1995 | 4.2 | 2.7 | 2.7 | 8.7 | 8.2 | 8.2 | 2.0 | 4.0 |
| | 2005 | 4.6 | 3.0 | 3.0 | 8.3 | 6.8 | 6.8 | 2.3 | 3.8 |

Source: World Bank Group staff estimates.

Note: To minimize the impact of short-term fluctuations on flows, data are three-year averages for the two endpoints: 1995 is the average of flows for 1993–95, and 2005 is the average for 2003–05.

in table 1.6 confirm the common perceptions that most private financial flows go to the emerging market IBRD countries and that the more creditworthy investment-grade countries receive the largest amounts. Somewhat surprising, the increase in private flows has been much smaller as a share of GDP—from 3.1 percent to only 3.6 percent. Moreover, once the larger size of emerging markets is taken into account, the differences across country groups are smaller: while investment-grade IBRD countries get the largest flows, the shares of the other country groups are more similar.

There are even a few surprises: FDI flows, often viewed as the most desirable form of development finance, appear to be more important in core IDA and LICUS countries than in blend and core IBRD countries. While this result may reflect large resource-based FDI projects (which have fewer spillovers into the rest of the economy), it casts doubt on the view that low-income countries are left out of global financial flows entirely. Indeed, adding official flows (which include official debt and aid) increases the importance of net financial flows substantially, reaching more than 8 percent in IDA countries and nearly 7 percent in LICUS countries. The marginal official flows in IBRD countries are readily apparent: net official flows are negative for both IBRD groups in 2005 and only 0.6 percent of GDP in blend countries, a third the level of a decade earlier.

Despite the generally robust picture for private flows, not all economies have benefited equally. For example, the record expansion in sovereign bond issuance—a major component of net debt flows—remains highly concentrated, with 10 countries accounting for 70 percent of the issuance. Not all IBRD clients have access to such markets. A quarter of IBRD countries have no rating, 10 countries with ratings have not floated any bonds, and 36 countries are ranked below investment grade. Nor does having a credit rating guarantee "regular market access." For many countries with ratings there have been extended periods when access was virtually closed (or prohibitively costly). Only a few countries qualify as established bond market borrowers, able to go to the market regularly and with sufficiently broad investor interest to achieve stable spreads.

For many middle-income countries without access to bond markets, bank lending provides the main source of private capital. While weaker legal and institutional environments and macroeconomic uncertainty contribute to the perception that these countries pose higher credit risks, the countries can often access bank credit because of well defined revenue streams and the ability of banks to monitor country circumstances more closely than dispersed bond investors can. During 2002–05, 80 percent of bank loans were to borrowers that had no credit rating or were below investment grade and thus had no access to bond markets. Experience during the Asian crisis and similar events suggests that net bank lending can reverse very quickly, making it a volatile and potentially costly option.

Despite the favorable conditions, few low-income countries have gained access to the international bond market over the past few years. A few have become rated and issued a bond, but their access is irregular. More have obtained bank loans, but even here access remains limited. In general, most low-income countries cannot regularly get private capital to meet their financing needs. The future ability of countries to gain frequent access will depend on many of the same factors that underpin sustainable growth: developing sound institutions, improving governance, and adopting supportive economic policies. Most low-income countries will likely continue to depend on official sources of financing for the foreseeable future. For low-income countries that have benefited from the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI), there is evidence of an increase in lending to take advantage of the newly created "borrowing space." For many of them debt is likely to rise sharply in the next few years.

In sum, the financial environment for developing countries has probably never been as favorable as today, except perhaps in the late 1970s, when oil producers were trying to recycle their bonanza. The question is whether this favorable environment signals

structural progress in the access of developing countries to international financial markets or whether it is essentially cyclical and may change entirely under the pressure of a crisis.

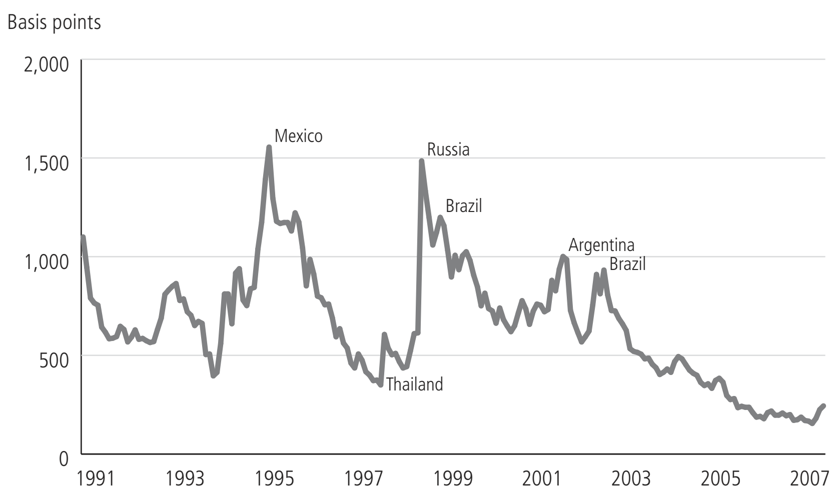
There are many reasons to believe that it signals structural progress rather than cyclical patterns. Creditworthiness increases with economic progress, and financial markets evolve to manage risk better than before. Domestic financial markets in developing countries are also becoming more efficient. Globalization increases business contacts between firms in developing countries and international financial actors. And so on. The problem is knowing what share of the evolution of financial flows since the recovery from the Asian crisis can be explained by these factors—and what share by a buoyant global economy flush with liquidity.

In comparing peak years in basic time series on capital flows to developing countries, numerous series show improvement. There is little doubt that private capital flows, whether in real terms or as a proportion of GDP, are today above past peaks. Also striking is that the spreads on emerging market bonds are lower today than ever, even than during the favorable times in 1993 or just before the Asian financial crisis of 1997–98 (figure 1.8).

That external financial constraints are easing—and will most likely continue to do so despite occasional crises—is encouraging for the development outlook. But progress in low-income countries has been marginal, and financial flows to IBRD countries are highly concentrated. Despite the overall progress, therefore, financial constraints are still binding for many countries and will remain so for some time.

**Figure 1.8 Emerging market bond spreads, 1991–2007**

Basis points




Source: JPMorgan.

### *The changing aid arena*

There have also been important changes in the players and channels for providing aid to low-income countries.[15] The aggregate surge in net private capital inflows to developing countries over the past few years has coincided with a dramatic decline in net official lending. Repayments on loans owed to governments and multilateral institutions outstripped lending by $145 billion in 2005–06, as middle-income countries made voluntary prepayments to the Paris Club of creditors and multilateral institutions, especially the International Monetary Fund. High oil prices enabled several major oil-exporting countries to prepay such debt, led by Algeria, Nigeria, and Russia. Of course, there is a natural limit to debt repayment, and net external official lending is expected to turn positive again in the near future, though probably at a level much below that in the 1970s and 1980s (see figure 1.7).

Again, however, many developing countries cannot access private debt markets, and they remain heavily dependent on development assistance to meet their financing needs. Official development assistance (ODA) fell almost $3 billion in 2006, following a record $27 billion increase in 2005. The change reflects mainly the extraordinary debt relief provided to Iraq and Nigeria by their Paris Club creditors, more than $19 billion in 2005 and $14 billion in 2006. At the 2002 UN Conference on Financing for Development in Monterrey, donors pledged that debt relief would not displace other components of ODA. They later committed to boost aid substantially over the rest of the decade, particularly to low-income countries in Sub-Saharan Africa. Little progress was made toward meeting these commitments in 2006: excluding debt relief, net ODA disbursements were static. But the commitments were reaffirmed on several occasions, so non-debt-relief ODA will eventually increase.

ODA from the 22 member countries of the OECD's Development Assistance Committee (DAC) provides only a partial view of aid, since other countries have emerged as donors over the past few years. Brazil, China, India, and Russia are now both donors and recipients of development assistance. It is difficult to quantify the volume, allocation, and composition of aid from most new donor countries because their activities are not reported comprehensively. Fifteen of them report their aid activities to DAC. Their net ODA disbursements increased from about $1 billion over 1995–2001 to $4.2 billion in 2005 (the most recent year with data), a figure likely to rise further as additional donors emerge.

Nongovernmental organizations (NGOs) are also a growing source of financial resources for developing countries. Government contributions to NGOs active in international development are already included in ODA tallies, but private contributions are not. Private aid contributions totaled $11 billion in 2006, equal to 13 percent of the aid provided by DAC donors (excluding debt relief), up from 9 percent in the 1990s. Development assistance provided by NGOs drawing on private resources is difficult to quantify.

The Bill & Melinda Gates Foundation is the largest charitable foundation in the world, with an endowment valued at $33 billion at the end of 2006. Its goals are to enhance health care and reduce extreme poverty worldwide and to expand education opportunities and access to information technology in the United States. It is projected to disburse about $2.8 billion in 2007, equal to almost 3 percent of projected ODA disbursements by DAC donors. But data limitations make it very difficult to assess the overall contributions of private philanthropic foundations to development, even though they are presumably on the rise.

A striking recent tendency in aid is to earmark contributions, possibly to show taxpayers how aid flows are being spent. External financing that targets key sectoral initiatives—such as health and education—has nearly doubled in real terms since the Millennium Development Goals were adopted.[16] Aid commitments for education are expected to have increased again in 2006 and after, owing in part to a major initiative by the United Kingdom.

Funding for health has grown even more. From private sources, such as the Gates Foundation. From global partnerships, such as the Global Fund for AIDS, Tuberculosis, and Malaria. And from bilateral donors: France, Norway, Spain, and the United States have increased health funding two- to fourfold since 2000. Innovative financing mechanisms targeting health are also getting off the ground. The International Finance Facility for Immunization ($1 billion in 2006), the Advance Market Commitment pilot for vaccines ($1.5 billion expected in 2007), and the airline ticket tax implemented by 21 countries ($300 million expected in 2007)—all are mobilizing new funds for health interventions.

The growing role of nontraditional donors such as China and India, the recent proliferation of sectoral (or "vertical") funds, and the expansion of private foundations bring needed resources to global development challenges—as well as new ideas, expertise, and approaches. But this expanding roster of participants also focuses attention on the fragmentation of aid and possible loss of efficiency. The donor community must come to terms with the need to coordinate a growing number of players in country-level aid efforts. And recipient countries have to deal with more donors and aid channels. Both trends, likely to continue, underscore the need for greater harmonization and alignment of aid programs.

## Externalities and global public goods

National poverty reduction and development do not depend solely on national factors and policies. They are also affected by what occurs in other countries and globally. Because of globalization and global growth, cross-country and global externalities will affect the development landscape in the decades to come—the link between progress on providing global public goods and on achieving development objectives is becoming stronger over time.

There are several types of global public goods:

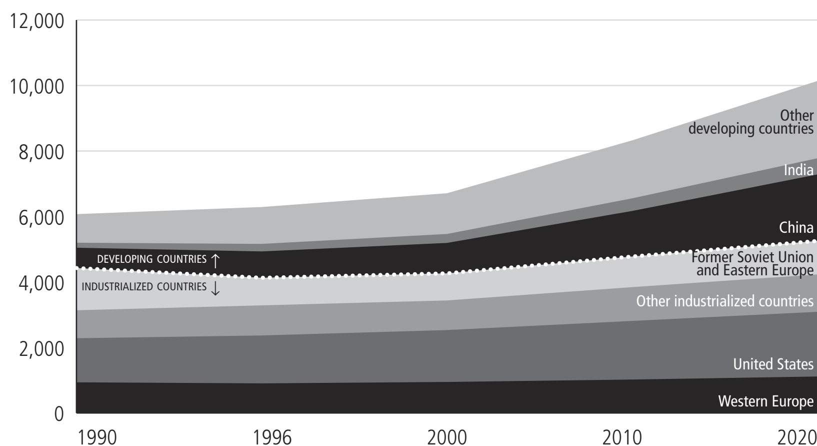
- Global rules of the game or frameworks to support development: trade agreements, regulation of capital flows (global financial stability), intellectual property rights and technology transfer, coherent framework for official development assistance (the Paris Declaration), migration agreements, the emerging global good-governance framework.
- Preservation of the global commons: climate change (from the perspective of mitigation; adaptation is a country-level issue), biodiversity, depletion of ocean fish stocks, water (a shared resource with the potential to ignite conflict in several regions).
- Emergency responses: avian flu, other communicable diseases, possibly regional conflict.
- Multicountry cooperation (possibly regional) to achieve scale economies: multicountry power pooling, interconnectedness (network externalities).
- Development knowledge, with at least three dimensions: development data and analysis (both cross-country and cross-time to enable the global community to monitor progress and to enable citizens to benchmark their countries' performance and hold governments accountable), transfer of development experience between countries ("what works" in a variety of institutional settings), and science and technology particularly relevant for developing countries (research on food staples and on vaccines for tropical diseases).

There is a general perception that these externalities, regional and global, are becoming more important. For global frameworks this is a consequence of increasing global interdependence; for communicable diseases, of increased global mobility; for global commons, of global growth itself. Concern over science and technology arises partly because of the growing role of the private sector in research and development: without public support, there is a danger that the global technological frontier will expand most rapidly in areas of greatest value to high-income groups, neglecting the interests of the poor.

Many global issues being discussed today—such as multilateral trade negotiations and intellectual property rights—will remain at the center of the global debate in the years to come. It is unclear whether and when agreements will be reached, but such agreements have the potential to boost global development. Consider climate change, water scarcity, and international migration—three areas likely to attract more attention in the next decade or so that might call for deeper engagement from the world's development community.

**Figure 1.9 Greenhouse gas emissions from energy use, observed and projected, 1990–2020**

Millions of tons of carbon equivalent




Source: IPCC 2001.

### *Climate change and global warming*

One externality that ties countries together is the growing threat to the global environment from rising concentrations of greenhouse gases. Some argue that this is a rich-country problem, but that misses the point. While industrial countries were responsible for three-quarters of the emissions in 1990, this share has already fallen to around 60 percent and will fall to around half by 2020 (figure 1.9). The bulk of future incremental emissions will come from fast-growing developing countries. Efforts to curb emissions should target countries where the marginal cost of conservation is lower, but the global community must

ensure that this does not impede development and poverty reduction.

For developing countries most vulnerable to climate change, global warming is likely to have severe, adverse consequences, particularly from rising temperatures and declining rainfall. Countries at lower latitudes are expected to be hardest hit. These countries still have a higher percentage of their activities in climate-sensitive agriculture and use less irrigation. Some countries—particularly those with large river deltas such as Bangladesh, Egypt, and Vietnam—will also be flooded by rising seas. The effects will be felt at the country level, but an effective response will require mobilizing the global community. The response will include scaled-up agricultural research, insurance against severe weather events, and increased multilateral aid to fund expanded irrigation or infrastructure to deal with rising sea levels.

### *Water scarcity*

Pure water is becoming scarce around the world.[17] Scarcity has long been a fact of life in the Middle East around the Jordan River Basin, but global warming is making water scarce in other regions—for example, by melting glaciers in the Andes, the Himalayas, and in other mountainous areas.

Compounding the problem are water pollution and the increasing demand for water, which can lead to conflict over how to share available water and how to keep it clean. Typically, downstream users complain about upstream users diverting water—say, for irrigation—or discharging pollutants. Potential for conflict is already evident in the Indo–Gangetic, Nile, and Tigris–Euphrates basins, among others. Development in these areas will depend on finding and implementing win-win solutions that optimize the use and conservation of water.

### *International migration*

International migration—particularly from developing to developed countries—has been considerable over the last 50 years. The stock of migrants in developed countries is now close to 120 million, or 12 percent of the total population; in Australia and Canada the share of migrants now exceeds 20 percent. Decisions to migrate can involve such factors as networks, family reunifications, and civil conflicts. But a primary reason is the prospect for greater economic opportunities for oneself and for relatives, immediately and over the longer term. Migration between developing countries has been relatively limited to selected corridors, toward the Middle East, South Africa, and some parts of Asia.

Whether international migration will continue at the same pace is uncertain. Most economic factors that promote migration are likely to become stronger, but social resistance may also grow, already observed in several developed countries. The gap between developed and developing countries will remain high for most countries—even when corrected for cost of living differences. So, the economic pressures to migrate are likely to persist. At the same time return migration of skilled workers to fast-growing Asian countries might intensify. Network effects might be strengthened as better information flows between growing migrant communities (diasporas) and source countries lower the transaction cost of migrating. Declining labor forces in many developed countries will also be a pull factor. This might produce a shift in the skill bias of migration from developing to developed countries toward less skilled workers—particularly in hospitality, construction, and medical care. Yet many developed countries are increasing restrictions on migration—particularly for the low-skilled—driven largely by concerns for social stability.

The pressing demand for the global community will be to strengthen the institutions that can address the challenges associated with migration and to develop policies that balance the legitimate concerns of both sending and receiving countries in a way that protects the migrants and maximizes the enormous benefits to all parties.

## Responding to the unexpected

Much of the discussion of the changing global context has focused on identifying broad trends that would generate a steady, almost

inexorable set of changes in the international environment. But the base scenario is only one possibility. As is evident looking back over the last several decades, there will inevitably be unexpected events and surprising dynamics that may affect the nature, urgency, and difficulty of the challenges facing the global development community.

Unexpected events can range from the natural, such as the tsunami that devastated Asia in 2004, to the politically driven, perhaps linked to continuing or spreading conflicts. They can also be linked to global economic forces (the global impact of higher oil prices), sparked by events in industrial countries (disorderly unwinding of global imbalances), rooted in developing country vulnerabilities (as with the Asian financial crisis), or related to climate change.

Unexpected events do not always affect long-run trends. The effects may be transitory, and both global and national economies may return in time to their initial trends—the ones used in the projections above. But it is also possible that some events will prove long-lived, leading after a time to a bifurcation in the dynamics of the global economy. For instance, an oil-supply disruption with political causes might lead, after a time of economic hardship, to an enduring shift in the geopolitical equilibrium and to different expectations for the global economy.

Various well known projections from a range of public and private organizations point to the possibility that the global economy could be partitioned into a few large and more or less autonomous economic blocks. Are the basic forces for such a partition latent in today's global economy? If they are, it is not implausible that a major crisis—whether caused by oil supply disruptions, the unwinding of global imbalances, or political turmoil—could trigger such a partition. As another example, consider the possibility that multiple natural disasters attributable to climate change trigger aggressive international measures against carbon dioxide emissions. Besides the direct effects of the natural disasters, such measures would inevitably slow global growth for some time, probably until technological progress permits better mitigation and adaptation.

How might such uncertainties—or their occurrence—affect the environment for the development community and the World Bank Group? It depends on whether they are isolated events that do not modify long-run global economic trends or long-lasting structural changes.

### *Isolated events?*

One clear vulnerability is another extended period of global financial instability, either from financial imbalances or from the behavior of the global economy. Recent trends would seem to minimize this possibility: continuing expansion of financing flows in a low-risk global environment will allow a broadening group of countries to access low-cost finance for the foreseeable future. Much has changed since the Asian financial crisis, and economic fundamentals in most developing countries are sounder than a decade ago. But history suggests that it is premature to declare that the possibility of future crises has disappeared.

Even if the frequency or severity of crises have declined, there remains the need to ensure adequate resiliency after a crisis. For example, the "crisis" part of the Asian meltdown was over fairly quickly, but the aftermath and recovery took much longer.

In particular, the newfound access of a large segment of developing countries to international capital could be easily jeopardized by changing market conditions and sentiment. An unexpected global growth slowdown or easing of commodity prices could dampen debt flows. Rising interest rates increase the prospects of price corrections in broader credit spectrums. Countries lower on the credit risk spectrum—which are more vulnerable—could suffer a more abrupt deterioration of financing than countries with better risk ratings, especially as rising benchmark rates place pressure on the fiscal situation in countries heavily dependent on shorter term bank lending.

To place these arguments in historical perspective, look at movements in emerging market bond spreads over the last decade and half (see figure 1.8). As noted, a prominent

feature is the decline in the average spread—fairly steady since the difficulties in Brazil in late 2002—to historic lows over the last several years. But equally instructive are the frequency and prominence of unexpected sharp upward movements in spreads—often following fairly quickly after relative lows. It is striking how rapidly the conditions facing emerging markets can shift. For example, the Mexican crisis in May 1995 led to a surge in average spreads to 1,555 basis points, an increase of 1,141 basis points over 16 months from the average in January 1994, while the rise in spreads from September 1997 (on the eve of the Asian financial crisis) to the Russian default a year later was 1,135 basis points. Such huge movements may be unusual, but the more recent difficulties in Brazil in 2002 led to a 364 basis point widening in average spreads in only seven months.

What is salient here is not to predict when—or even whether—conditions will worsen. It is to highlight the uncertainties inherent in global markets and the potential volatility that they create in the cost and availability of financing. International financial institutions such as the World Bank Group have often been instrumental in the response to such crises. Although small in absolute terms, the World Bank Group (especially the IBRD), the International Monetary Fund, and other international financial institutions are often large players during crises, as market-based creditors cut their exposure. At such times it is not the overall size that matters but the capacity to channel targeted resources to countries suffering a collapse in confidence and capital flows. In these circumstances additional resources from official lenders often make up a large part of overall net flows. Such engagements can also be catalytic: one factor contributing to the return of global markets to crisis countries is the success (or failure) of the international rescue packages to which the international financial institutions contribute.

In natural disasters these multilateral institutions are also influential. Other agencies (particularly in the UN) may be better equipped to deal with the immediate aftermath of crisis—say, by providing emergency housing, water, and food. But as was evident in Indonesia after the tsunami, the bigger challenge was mobilizing and delivering the resources to allow those affected to rebuild their lives. That means housing, jobs, schools, clinics, infrastructure, and much more. The scope for engagement by the World Bank Group—across sectors and countries—and its ability to combine strategy and resources to achieve results on the ground create a unique opportunity for it to deliver in such circumstances. Because the poor are likely to be affected most by tsunamis, tropical storms, landslides, and earthquakes, reducing poverty is very much at risk.

### *Long-lasting structural changes?*

The possibility of major events modifying the long-run course or even the organization of the global economy is more complicated than events with only transitory consequences, even if the transitory effects take several years to dissipate. In comparison with the present trajectory of the global economy, most such events would point to slower global and national growth, increased volatility, and a slowdown—or a reversal—in the integration of the international system. Whether it is a switch from a multilateral to a multipolar world or the need to aggressively curb greenhouse gas emissions worldwide, the economic outcome could make the development challenges listed above even more daunting. With slower global growth and less dynamic integrative forces, reducing poverty in low-income countries and promoting inclusion among and within middle-income countries will become harder. Slower international integration—starting with financial markets—would also mean a lack of progress on many global public goods, while preserving the global commons would remain pressing.

### *Inclusive and sustainable global development?*

Predicting the future is always chancy. But the discussion here suggests rather clear priorities. Even in the plausible scenario that global growth remains strong and the global economy continues to integrate at the pace of

the last 15 years or so, development challenges will remain formidable. Extreme income and nonincome poverty will fall only slowly, increasingly concentrated in low-income countries and fragile states, many of them in Sub-Saharan Africa. Inclusiveness for middle-income countries, whether measured across or within countries, will remain elusive, with poverty still considerable at the $2 a day line.

Even if global financial markets become more efficient in channeling increasing flows of resources to developing countries, many countries will remain outside these channels. And for low-income countries it is uncertain whether the expected increase in aid will compensate for the more complex aid architecture. Indeed, the inclusiveness and sustainability of global growth is itself under threat because of the lack of international agreement on the rules to govern some aspects of the international economy and because of the possible depletion of the global commons.

Globalization may be going strong, and it has recently improved many development outcomes. Yet the major challenges of the inclusiveness and sustainability of global economic growth remain as vital as ever.

Inclusive and sustainable global development should become a central objective of international development actors, particularly the World Bank Group. This chapter laid out the challenges associated with this objective and their relevance for the Group. The next chapters examine how the Group can contribute most effectively to meeting these challenges.

# The Global Framework for Action

chapter 2

Knowledge about development effectiveness is central to the global development community—developing countries and international agencies, including the World Bank Group, other multilateral donors, and bilateral donors. Knowledge must underpin strategic planning and thinking about the best way to promote global development. The effectiveness of alternative development strategies has generated enormous debate. But substantial—if partial—consensus on the main outlines has grown over time. This chapter has three objectives:

- It presents what have emerged as the elements of a consensual framework for analyzing development issues and identifies the main areas they point to for policy intervention.
- It shows how this synthesis is reflected in the changing partnership between development agencies and developing countries—in new thinking about development effectiveness and in the changing shape of conditionality.
- It considers what these factors mean for producing, monitoring, and disseminating knowledge about development.

## The emerging synthesis in economic development thinking

Sixty years ago the dominant views on economic development could have been roughly summarized as follows. Development is synonymous with aggregate economic growth. Growth results essentially from the accumulation of productive factors—mainly capital and labor—and from technical progress, determined largely exogenously. The state has a key role in planning and controlling economic activity to take advantage of economies of scale and prevent market failures. And there is a unique model of development—the one historically followed by the then–industrialized countries.[18]

Opinions have evolved considerably on each of these views, punctuated by major events and crises. While development thinking has steadily evolved, extreme stands on development policy have tended to alternate following those events and crises. The dominant paradigm shifted in the 1960s, taking into account elements of social and economic change. Eradicating poverty emerged as a central focus of development, illustrated by the basic needs approach. And the distributional aspects of growth and development received more emphasis, as in the influential 1974 World Bank report, *Redistribution with Growth*.[19]

By the end of the 1970s the crisis triggered by higher oil prices led to severe macroeconomic imbalances throughout the world, which in the early 1980s produced major debt problems in most developing countries. A "neoliberal" reaction emphasized the central role of markets and the private sector, progressively shaping conditionality in the heavy structural adjustment lending offered by development agencies in an effort to reestablish macroeconomic equilibrium and growth in the countries most affected by the debt crisis. Besides monetary and fiscal rigor, that conditionality also included liberalizing trade and foreign direct investment, privatizing inefficient state-owned enterprises, eliminating price distortions, deregulating markets, and protecting property rights. Those principles were later described as the "Washington Consensus."[20]

The disenchantment with structural adjustment grew during the 1990s as many countries under adjustment failed to accelerate or even to renew growth, even after several years of "adjustment." It was recognized that markets and the private sector alone cannot guide development without a proper environment. Acknowledged particularly were the implications of weak regulation and poorly functioning land, labor, and credit markets. And

attention focused again on poverty and distribution. The Washington Consensus, by now an overtaxed cliché, was seen as a simplistic and restrictive view of development strategy, with little space for government interventions and neglect of the policy implications of widely different circumstances across countries.

Reflection on development and poverty reduction broadened in the late 1990s and early 2000s. Thinking shifted, and awareness grew that if markets are to generate shared growth, their institutional foundations cannot be overlooked. It is one thing to identify the policies to trigger growth and reduce poverty. It is another to guarantee that these policies will be well implemented by ruling governments. Governments must be well governed: they must uphold the role of law, limit corruption, encourage competition and voice, and support entrepreneurship. Also at this time the notion of poverty was broadened to include not only standards of living but also the provision of social services—health care, education, and some types of collective infrastructure—and the participation of poor people in decisions affecting their lives.

This description of the evolution of development thinking over the last 60 years emphasizes contrasts, because it often refers to extreme views that tended for a while to contradict each other. But in fact the changes in development thinking have occurred continuously and incrementally in the light of accumulated experience. Today, a partial synthesis is emerging, with a more nuanced view of development mechanisms and the policies they call for.[21] Although a synthesis of views cannot be comprehensive, there are conceptual areas where development thinking has coalesced and broad agreement has been forged.

### *Broad agreement on six core principles*

The key principles underpinning development strategies today are far less doctrinaire than in the past—a major evolution from the days of structural adjustment and the Washington Consensus. Today's consensus begins by recognizing that development is synonymous with poverty reduction, using "poverty" in its broader sense to include participation and voice as well as economic and social needs. Beyond this simple objective, it is fair to say that there is broad agreement on six core principles.

***Principle 1. Growth is critical to poverty reduction.*** In the long run growth is necessary to lift the welfare of people above any predetermined poverty line. Through both theoretical development and intensive comparative work, considerable progress has been and continues to be made in understanding the determinants of growth. From factor accumulation and technical progress, emphasis shifted first to the incentives and constraints affecting accumulation and productivity gains by private actors; next to the institutional conditions that facilitate good or poor policymaking; and then, at the frontier of this work, to the determinants of institutional change. Because empirical work (based mostly on cross-country comparisons) is often inconclusive, some have concluded that "we don't know anything" about growth's determinants. This is an extreme position, because much is known about the basic mechanisms of growth. Practically, however, it is true that in a particular country it is often difficult to identify the constraints that hamper these mechanisms.

***Principle 2. Sustainable growth and poverty reduction require attention to the distribution of income and opportunity.*** Growth and distribution are not independent (as examined in *World Development Report 2006*). Both are affected by the distribution of opportunities in the population (including human and physical capital endowments, access to education and health care, fairness of market mechanisms, justice, and opportunities to exercise voice). Growth generates changes in income distribution that reinforce or weaken poverty reduction. It also modifies the distribution of opportunities. At the same time, changes in the distribution of opportunities through policy can modify the pace and structure of growth. In particular, more nearly equal opportunities can accelerate long-run growth, even though opportunity-enhancing policies may have a short-term cost.

***Principle 3. The main agent for growth is the private sector, but the public sector has an essential facilitating role.*** In any analysis of the

development process, the private sector is now seen as the main agent for creating jobs and wealth. But the public sector is also seen as critical in providing an environment that supports a dynamic private sector and increases its developmental value (with adequate infrastructure, skilled labor, macroeconomic stability, and effective and predictable regulation). The public sector must also intervene in cases of market failure, which are more frequent in developing countries.

***Principle 4. Openness and a dynamic export sector are powerful drivers of development.*** There is no doubt that trade has been a tremendous driver of growth and employment for successful developing countries and regions. Over the past 50 years no developing country has achieved consistently high growth without a vibrant export sector, and trade will continue to be a major factor framing the opportunities for growth. But debate persists about the best way to obtain this result and about the factors facilitating export development (for example, the role of infrastructure, overall or selective liberalization of imports, and de-protection of foreign markets). And there is recognition of the costs from liberalization to some population groups, with social and economic consequences that should not be overlooked.

***Principle 5. Good governance and institutional capacity are critical to sustainable development, but there is no unique governance trajectory.*** Bureaucratic capability is essential for the efficient and adequate supply of essential public services. Checks and balances ensure that different offices and levels of government are accountable to the public. And mechanisms allowing citizens and private firms to participate in decisionmaking strengthen accountability and governance outcomes. All that is widely understood. But there are different paths for strengthening these elements and along which development outcomes may be strong and sustained. And much remains that is not well understood, both about the effects of governance and institutions on development and about the dynamics of governance and institutions.

***Principle 6. There is no unique template for development.*** It is well recognized that there is no single successful development path,[22] and history often fails to repeat itself. The circumstances facing developing countries today are fundamentally different from the historical conditions in which today's industrialized countries developed. Circumstances may also differ widely across developing countries, depending on their natural and accumulated endowments, their institutions, and their history more generally. It is also recognized that growth does not always result from a linear combination of "basic determining factors," as postulated in the familiar linear growth regression model. Some elements may be especially important at some times and in some cases, making the model highly nonlinear, complex, and essentially country specific.

### *Articulation of a two-pillar strategy summarizing the six principles*

Following *World Development Report 2000/01* on poverty, a two-pillar framework was articulated to define the World Bank Group strategy for reducing poverty.[23] The first pillar is building a strong climate for investment, jobs, and sustainable growth, and the second pillar is investing in the empowerment of poor people to participate in development. This simple organizational approach summarizes the six principles.

The growth and distribution principles are essential to the two-pillar investment and empowerment framework. The investment climate pillar supports policies that facilitate economic growth. The empowerment pillar addresses the distribution of opportunities, by ensuring that all people, including the poorest, can participate in public decisionmaking and both benefit from growth and contribute to it. And preeminence is given to the private sector in both areas. In each case, private agents—whether firms, households, or individuals—are in the driver's seat. At the same time, the public sector is critical for providing a good environment for private agents to realize their potential, whether in new business ventures, productivity gains, or human capital formation. This requires an appropriate regulatory system, sufficient openness for foreign competition to play its role in export and import

markets, appropriate infrastructure, and satisfactory social services in education or health, whether through public or private channels. For policy to be effective, good governance is an important condition.

This two-pillar approach, though relying on solid analysis,[24] describes an action-oriented strategy rather than an analytical framework for development. It provides a helpful expository device, rather than theoretical principles or dogma. Its real contribution—novel at the time—is to insist on the dual nature of policy interventions: pure growth-related policy areas (adequate infrastructure) must be combined with regulatory authority, efficient administration, and improved distribution in related areas such as education, health, and voice and representation for the poor. A measure of the approach's success is the extent to which the World Bank Group and others view it as embodying a shared philosophy of development. It is useful for reflecting on the range of development policies that need to be implemented at the country level and balance among them, taking into account all country specificities. But it is too general to identify broad strategic priorities and rationalize the multiplicity of Group interventions today. Similarly, the "comprehensive development framework," articulated around the same time, cannot really be construed as rationalizing direct Group involvement in most sectors.[25]

In sum: thinking on development strategy has evolved over recent decades to a set of broadly shared principles around which the development community has coalesced, conveniently summarized in the World Bank Group's two-pillar strategy.

Moving forward poses two main challenges: first is to further deepen our knowledge of the more familiar policy areas of the two-pillar approach (sound public finance, efficient infrastructure, effective service delivery), and second is to invest in the frontiers of development thinking. One frontier area, where understanding is still at an early stage and much greater investment in knowledge is clearly needed, is governance—how to build institutional capacity and governance systems that deliver development results. A second is the global and regional externalities that increasingly affect the development of individual countries. Particularly important is expanding the supply of global public goods to protect the global commons.

The development literature has not focused enough on the circumstances for taking policy decisions that determine development performance. It has also tended to consider single countries as the unit of analysis, whereas regional and possibly global constraints may be as important as domestic factors in determining development outcomes.

## Effectiveness of development assistance—and the changing shape of conditionality

Development thinking is important not only for guiding overall development strategies but also for determining the types of conditionality required by development agencies and international financial institutions. The World Bank Group has been prominent in shaping the conditionality embedded in development assistance. The hard conditionality initially used by most development agencies has been under severe attack because it intruded into country sovereignty and too seldom promoted development. The evolution of development thinking and the progressive accumulation of knowledge on development effectiveness has important implications for the way conditionality is viewed today—and thus for development assistance. Aid effectiveness is about the impact of external development assistance on development outcomes. Development assistance is taken here to include not only grants and concessional lending by development agencies to low-income countries, generally categorized as aid, but also all nonconcessional lending at below-market interest rates to middle-income countries.

There is a long causal chain between transfers of foreign assistance and development outcomes. To clarify thinking about development effectiveness and external agents, consider the three main links in that chain (figure 2.1).[26] In working from country outcomes backward, the first link is from country

policies (macroeconomic, regulatory, tax, and the like) to final development outcomes (GDP growth, poverty, income distribution, education levels, life expectancy, and the like). This is where knowledge about the effectiveness of policies is essential to policymakers. It is also where economic research on understanding development mechanisms and evaluating the impact of microeconomic and macroeconomic policies can generate a continuously expanding knowledge base for policymaking.

The second link, between policies and policymakers, is fundamentally about governance, defined here very generally as the capacity of policymakers to choose policies that improve development outcomes. This involves such elements as a country's bureaucratic capability, institutional capacity, and checks and balances on government action. The third link—the starting point—is from development agencies or international financial institutions to policymakers. The international development community provides financing and technical assistance, which influence policy choices by loosening the budget constraints on policymakers and, indirectly, by adding knowledge to the existing stock and informing the policy debate.

External agencies often seek to influence the policy process and even impose policies by attaching conditions to financial assistance. This conditionality has been a basic characteristic of external assistance since the birth of the aid industry. But it may be ineffective. External agents can operate with highly imperfect knowledge and with little control over policy implementation. In particular, the fungibility of money implies that it is not always sufficient to tie financial resources to a specific use for development assistance, because the money may be diverted from that use.

### *Changes in conditionality*

Changes in the application of conditionality reflect the evolution of development thinking and approaches. Since policy-based lending was introduced at the end of the 1970s, thinking about conditionality has changed profoundly. The World Bank Group has undertaken numerous reviews of adjustment lending over the years, reflecting ongoing concern about whether the conditionality-based model of development assistance promotes development. The first review, published in 1986, less than a decade after structural adjustment loans were introduced, reflected prevailing views on development. Four reports have been written since then.[27] The 2006 review reflects the synthesis on the development strategy principles discussed earlier.

It is understood today that development effectiveness requires both theoretical and context-specific factual knowledge about how policies affect country outcomes—and that it is more effective to embed this knowledge in conditionality rules that emphasize ownership and alignment. These rules should be based on results and expected performance rather than on detailed policy rules derived from doctrine or preconceived best-practice views of development policy. The review concludes with five good-practice principles to strengthen the World Bank Group's operational policies for development policy lending (table 2.1).

Pointing to the central role of country ownership rather than agency-driven development

**Figure 2.1 The causal chain of development effectiveness**

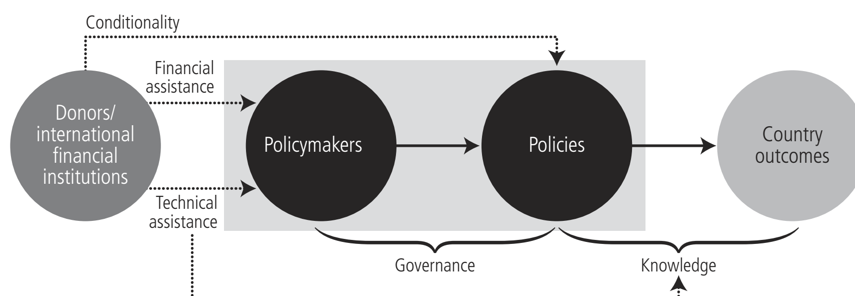


**Table 2.1 Five good practice principles based on the conditionality review**

| Topic | Good practice principles |
|---|---|
| Ownership | Reinforce country ownership. |
| Harmonization | Agree up front with the government and other financial partners on a coordinated accountability framework. |
| Customization | Customize the accountability framework and modalities of World Bank Group support to country circumstances. |
| Criticality | Choose only actions critical for achieving results as conditions for disbursement. |
| Transparency and predictability | Conduct transparent progress reviews conducive to predictable and performance-based financial support. |

Source: World Bank 2006d.

norms, the principles underscore customizing an accountability framework in light of the client's institutional and governance practices. Actions chosen as conditions are to be sparing, demonstrably critical to immediate development outcomes, and applied transparently and predictably. Implementation of these new practices in IBRD loans and IDA credits is evident from various indicators, including the average number of conditions per loan, which fell from around 35 in the mid-1990s to 12 in 2006.

### *Aligning aid with country strategies—using performance-based allocations*

Even though there are suggestions that conditionality remains too strong, the current approach represents a major change from the way conditionality was applied in the 1980s. It reflects deep changes in the thinking of much of the donor community, not only the World Bank Group, about development effectiveness and particularly about aid effectiveness in low-income countries. Illustrating those changes are two new features of the aid relationship over the last decade: the emphasis on aligning aid with each country's development strategy and the increasing use of country performance to shape aid allocations. The first, reflected in the Group's principles for the application of conditionality, is the main objective of the Paris Declaration on Aid Effectiveness approved by major donors in 2005. It provides further evidence of the major shift from past aid practices.

The second feature is the growing emphasis on performance-based aid allocations across countries. The levels and modalities of aid are to be based on the general strength of country policies and institutions—and on the monitorable results (intermediate indicators) they deliver. Most multilateral aid now flows through a performance-based allocation system, as is increasingly true of bilateral aid. There is evidence that aid selectivity based on country performance has increased significantly since the end of the Cold War.[28]

These elements of the new development assistance framework—country ownership, conditionality focused on results, and performance-based allocation systems—are transforming development assistance.[29] Conceptually, the emerging model attempts to follow the familiar principal-agent model of the theoretical microeconomic literature. The principals (development agencies, international financial institutions) recognize that they cannot directly determine the agent's (recipient's) development efforts because deep, intrusive conditionality cannot be enforced. But principals can observe and monitor outcomes (such as improved literacy, immunization coverage, and poverty incidence), with the caveat that outcomes are "noisy" and do not truthfully reflect efforts. Given this asymmetry of information, the best contract between the principal and the agent is to make assistance conditional on outcomes.

There is still a long way to go toward this ideal of donor and recipient incentives harmonized and aligned to deliver results, particularly in low-income countries—for several reasons. Only some low-income countries have strong ownership of the development dialogue, and many fail to meet minimum standards of governance and institutional quality. Appropriate conditionality in this second group of

countries, particularly fragile states, must center on less complex actions and more robust monitoring of progress and results. Another challenge stems from the time it takes to deliver results: if performance is measured over too short a period, development assistance will remain volatile. If it is measured over too long a period, incentives for recipients to perform well are weakened. While some outcomes are swift, such as rising immunization coverage and falling disease incidence, many development outcomes, including institution strengthening, take several years.

A further challenge is balancing assistance between rewarding good performance and addressing needs. Emphasis on performance risks focusing aid on a small number of countries that are already doing well. Emphasis on need risks putting resources in poorly managed, inefficient, and likely ineffective environments, perhaps undermining incentives for better performers. How should aid be given to fragile or failed states with chronic and persistent weak governance but also often where the need is greatest?

These cases have to be handled differently, with careful consideration of how to support weak institutions while ensuring that aid resources are used appropriately. Actions and priorities agreed with governments in fragile states should focus on support for peace-building and state-building, avoiding reforms that are too technically ambitious or that exacerbate conflict or tensions. Fiduciary monitoring on budget support operations should devote more attention to direct expenditure tracking. Efforts to enhance oversight in critical areas might enlist government representatives, donor representatives, and local nongovernmental organizations and civil society to closely monitor the use of funds. In some cases the World Bank Group could take the lead in organizing and managing such oversight.

### *A remarkable decline in conditionality, but . . .*

The evolution of conditionality reflects better understanding of development mechanisms and of the circumstances that lead to proper policy choices. From that point of view the decline in the conditionality of development assistance to middle-income countries and the evolution toward a results-based relationship over the last 10–15 years has been rather remarkable. In low-income countries, however, some elements of conditionality have been on the rise. This is particularly so with the multiplication of vertical funds, nongovernmental organizations, and private foundations that target narrowly defined goals, without due consideration of the need to adequately finance policies that complement these goals. An important example is aid targeted at reducing HIV/AIDS with no accompanying support to health care systems.

## Accumulating and monitoring knowledge—what's needed going forward

Knowledge and development go hand in hand, and improving development effectiveness depends on investing in knowledge—knowledge of how to translate political authority into informed policies, of how policy changes can deliver more sustainable development outcomes, and of how particular local and national institutions and contexts affect policy results. Donors and international institutions provide financing and other support to generate knowledge and can have a significant impact, albeit indirect, on policies and development outcomes.

How to gain such knowledge? Generating new research and basic knowledge on development has several core elements. One is building and maintaining a knowledge base about how different policies and interventions affect development outcomes under different conditions. Another is strengthening basic knowledge of development at the frontier, in new areas where a basic understanding is still being built. And a third element is constructing basic data systems and country-level statistical capacity for accurate monitoring and analysis. Each is an essential element of knowledge and research on development.

### *Mining development experience for knowledge*

An enormous amount of local knowledge can be gained from monitoring development

outcomes and analyzing their relationship to policy interventions. This requires systematic evaluation of outcomes, a task that can be conducted "hands on" through direct involvement in designing reforms and managing programs and projects or "hands off" through typical analytical work. Evaluation methodologies may differ too—from cross-country regression techniques and construction of counterfactuals, to country and project case studies comparing situations before and after policy implementation and impact evaluations using experimental, quasi-experimental, or nonexperimental designs.[30] With direct involvement of analysts, evaluations can also be coordinated to compare experiences across regions and countries, generating knowledge of potentially broad use internationally.[31]

Little attention has been given to systematic and reliable evaluation of project impact, a shortcoming only beginning to be recognized and addressed. For example, when impact evaluations are carefully structured and conducted within a cross-country or cross-regional comparative framework, they can provide valuable inputs for policymakers to improve policy interventions and project and program designs. But impact evaluations are seriously undersupplied, though their benefits are widely appreciated and known. Why? They can be expensive and their results are nonexcludable, reducing the incentives to conduct them. In some instances vested interests would rather not have their programs evaluated. The development community has begun to address this gap through ad hoc programs. But systematic and rigorous knowledge generation across a sample of projects and program interventions is needed to reduce costs and generate a rich knowledge base to better inform country strategies and improve the international development community's advice.[32]

### Expanding the knowledge frontier

Basic research on economic development is critical for expanding development knowledge, necessary both to deepen knowledge of familiar elements of strategy and to invest in new frontier areas of development knowledge. Maintaining a strong knowledge base on the more traditional areas of development knowledge—such as infrastructure, education, and agricultural technology—is essential. Frontier areas for knowledge building emerge as new technologies, crises, or previously overlooked or underemphasized development factors come to light. Three noteworthy examples: governance and its link to development outcomes, global public goods and approaches to expanding their supply and protecting the global commons, and statistical systems and their role in guiding analysis of what works in development.

***Governance.*** An encompassing area, governance is broadly recognized as critical to development outcomes, as articulated in the *2006 Global Monitoring Report*. But understanding of the determinants of governance outcomes, the direct role of governance systems in generating development results, and effective approaches for reforming governance is still weak. There remain puzzles with no clear answers. For example, under what circumstances will generally weak governance indicators lead to consistently strong development outcomes, as in Bangladesh? What design and which instruments for voice and accountability translate into more broadly shared economic and social opportunities for poor people, as well as better public services? Are reforms in accountability determined by policy decisions, or are they essentially endogenous? Such questions are fundamental for determining development outcomes, yet understanding of how to approach them remains superficial, and even the capacity for measuring these problems is limited. As knowledge on the impact of policies on development outcomes improves, the frontier for understanding development will be on comprehending how and why policy decisions are taken and policies are implemented—to take advantage of the increasing knowledge.

***Global and regional public goods.*** Development depends not only on country policies but also on the country's global and regional environment. Understanding that relationship better is essential, since the scenarios sketched in chapter 1 suggest that increased globalization

and global growth will sharpen the externalities among countries.

There are many such externalities: global frameworks (trade and property rights agreements), regional public goods (the scarcity of pure water), and the global commons. In all cases it is important to understand the differentiated effects that changes in these externalities may have in different countries, as well as the role of individual countries in generating them.

In areas such as climate change, biodiversity, and the protection of fish stocks, the gap is widening between the demand for instruments to protect and generate the public goods and their supply. For climate change the need to close the gap is intensified by the likelihood that the impacts will be most severe for low-income countries. But the ability to act is complicated by the absence of markets to help establish values and to address the intertemporal tradeoffs in climate change. The case for greater multilateral involvement and collective action is nowhere more compelling than for the protection of the global commons—yet capacity remains severely limited.

Deepening the knowledge base and building capacity in these two priority areas require coordinating work among academics and the many international agencies involved in different aspects of building knowledge on global public goods and on measuring and monitoring governance. Lacking are the mandate and the institutional capacity to bring diffuse efforts together and provide greater coherence to the process.

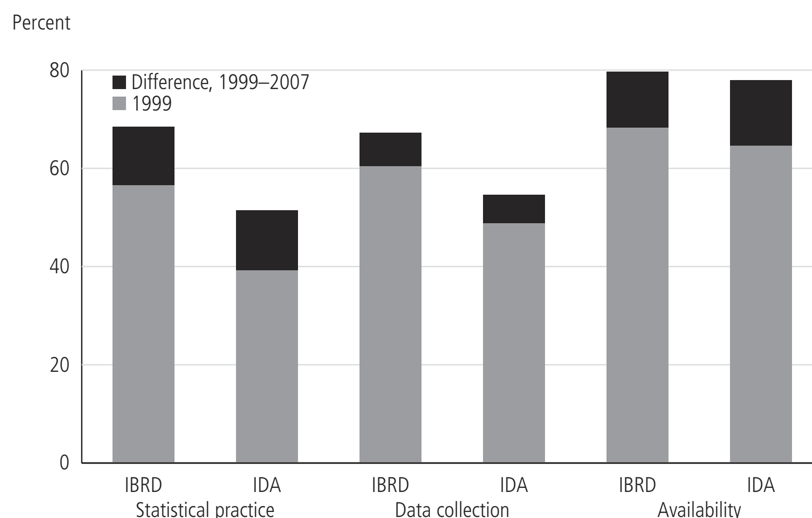
***Statistical systems.*** Accurate and timely statistics are essential to measuring outcomes, monitoring progress, and guiding analysis of what works and what does not. Monitoring development outcomes (including poverty, under-five mortality, primary enrollment, and educational achievement) requires timely and representative surveys along with reliable administrative data and a capable, independent statistical system. Too often, the data needed to measure poverty, health, or economic activity are not available or are of poor quality.

The quality of aggregate indicators and their comparability across countries and over time depend strongly on the quality of the underlying data collected by countries and the use of established international standards and methodologies. Developing, applying, and overseeing data standards for monitoring development outcomes requires specialized expertise and international partnerships. International agencies, including the World Bank Group, are important in maintaining the international statistical system. The International Monetary Fund's expertise gives it a unique role in collecting, standardizing, and publishing international financial statistics. The Group's work on measuring poverty and living standards has improved measurement of social outcomes.

But a minimum set of comparable statistical data measuring development outcomes across low- and middle-income developing countries remains far off (figure 2.2). According to a World Bank Group measure of statistical capacity, shortcomings are greater in low-income countries. Just over half of IDA countries do not produce a reasonable range of comparable statistics that adhere to international statistical standards. Among middle-income countries about a third fall short of such statistical standards. And even though some international data series appear to be nearly complete, this

**Figure 2.2 Measuring statistical capacity in IBRD and IDA countries, 1999–2007**

Percent




Source: World Bank Group staff estimates.

Note: *Statistical practice* measures a country's ability to adhere to international standards and methods for macroeconomic and social statistics. *Data collection* reflects whether a country collects data in line with internationally recommended periodicity and whether data from administrative systems are reliable for estimation purposes. Indicator *availability* looks at whether key indicators (covering the Millennium Development Goals) are available to users.

may be the result of "gap-filling" by international agencies. For under-five child mortality, for example, the World Development Indicators database includes data annually for all but 2 percent of developing countries, yet few developing countries conduct surveys or maintain records for deriving these data regularly. There are also serious shortcomings in the comparability of data across countries and sometimes over time, as well as in the consistency of the underlying assumptions used to estimate them. These shortcomings undermine the validity of cross-country analysis—and the Group's ability to understand development outcomes and generate knowledge.

* * *

Due to the essential public goods aspects of these three elements of knowledge generation and dissemination, the World Bank Group is well placed—even uniquely suited—to provide leadership, particularly through its model of engaging directly throughout the development process. As a result, the Group's development knowledge should evolve and even improve over time. Indeed, the breadth of its country and sector work generates a dynamic comparative advantage through what has been called the lending, learning, knowledge-building cycle.

# The Instruments for World Bank Group Action

chapter 3

Relative to global financial flows and the resource needs of developing countries, the World Bank Group's programs are modest. But with 185 members, capital and reserves of some $50 billion, and more than 13,000 staff in some 100 countries, the Group is the world's largest development cooperative. Its goals have evolved with development priorities and thinking. But they are consistent with a continuing broad developmental mandate of contributing to better living standards, particularly for its client countries with the greatest need. Reducing poverty is central to the Group's mission. But the Group is not a narrow "poverty bank" focusing exclusively on the absolutely poor. It provides development resources and works to strengthen economywide performance and inclusive growth. And reconstruction after natural disasters, conflicts, and other crises continues to be a focus, absorbing some 10 percent of the portfolio.

This chapter outlines the package of development services that the World Bank Group offers to its members, how the services have evolved, and the operational and budgetary relationships among them.

## The evolution of the World Bank Group and its instruments

The International Bank for Reconstruction and Development (IBRD) began operating in 1946 to help reconstruct Europe and other regions after World War II. Important early loans went to establish Air France, provide nuclear power for Italy, and finance Japan's bullet train. Established in 1955 to serve private clients, the International Finance Corporation (IFC) became able to make equity investments in 1961 after amendments to its articles, and its Capital Markets Department was created in 1971 to encourage private portfolio flows to developing members. The International Development Association (IDA) was created in 1960, and in 1966 the Convention of the International Centre for the Settlement of Investment Disputes (ICSID) entered into force. While the possibility of multilateral investment insurance was proposed as early as 1962, the Multilateral Investment Guarantee Agency (MIGA) was established only in 1988.

### *Development of new instruments*

The World Bank Group's instruments have continually evolved to diversify the services offered to its members and to respond to development needs. In 1975 the first "third window" loan was made, using OPEC and other funds to buy down interest charges to terms between IBRD loans and IDA credits. The first structural adjustment loan was in 1980—in response to an acute need for nonproject funding and to support policy reform. "B-Loans" to facilitate commercial project cofinancing were initiated in 1983, and the first direct subnational loan with a sovereign guarantee was in 1997. New loan and hedging products were created in 1999 to increase flexibility and responsiveness, as were policy-based guarantees. That year also saw the initiation of debt relief to heavily indebted poor countries, with the goal of shifting repayment streams to fund Millennium Development Goal–based development programs. Other new instruments include IBRD and IDA guarantees, mainly to encourage private investments in large infrastructure projects. And more recently a range of specialized asset and liability and risk management services has been offered to clients on a fee basis.

### *Changes in operational focus*

The focus of the World Bank Group's operational work has broadened from its early emphasis on infrastructure. By 1973 agricultural lending was the largest sector, an emphasis that later declined. The first loan for environmental management was to Finland in 1975. The

Environment Department was created in 1987, and the Global Environment Facility in 1990.

Poverty reduction was an explicit goal at least as far back as 1973, when then-president Robert MacNamara defined "absolute poverty" at a speech in Nairobi. This emphasis intensified, with the mission statement stressing poverty reduction in 1998 ("Our dream is a world free of poverty") and the 1990 and 2000 *World Development Reports* on poverty. The 1999 "Voices of the Poor" study stressed empowering poor people rather than seeing them as passive objects of development. In parallel came an increasing concern for development in Africa, as economic conditions there fell behind those of other regions. The Special Program for Africa (SPA), convened in 1987, encourages and coordinates donor support for quick-disbursing assistance.

There has always been concern that the World Bank Group's funds be used "for their intended purpose." This concern underpinned and motivated fiduciary safeguards and provoked debate on whether funds earmarked for specific expenditures could, given fungibility, really be assumed to finance the intended priorities. Strengthened country governance and explicit concern for the use of all development resources, not just those provided by the Group, became more explicit priorities only in the late 1990s after the end of the Cold War. With reduced pressure from donors' strategic concerns, which had previously driven aid programs, a more open discussion of fungibility became possible. The stress on governance increased at the turn of the century following the introduction of the Heavily Indebted Poor Countries Initiative. Debt relief provided budget support to recipient countries and heightened concern that the savings be spent on poverty-reducing programs. The emphasis on governance has recently been expanded. Following global multistakeholder consultations, an *Implementation Plan for Strengthening World Bank Group Engagement on Governance and Anticorruption* is under preparation.

### *The growing importance of knowledge*

The importance of knowledge in development was recognized early. Country analytical work, including sector and country studies, dates almost to the founding of the institution. The Economic Development Institute, later the World Bank Institute, opened in 1956 to disseminate knowledge and good practice. Knowledge creation remains an important objective, partly through research but also through the synthesis of operational and policy experience—and guidelines for operational and analytical work—by the many professional networks formalized in the World Bank Group's structure. At the urging of the 1969 Pearson Report to support development-relevant research, the IBRD's first loan purely for knowledge was in 1971 to Spain for agricultural research.[33] The first grant to the Consultative Group on International Agricultural Research came a year later, and the World Bank Group continues to support this institution through grants financed from profits.

The World Bank Group also has a long tradition of disseminating development knowledge for wider discussion. The 1974 study, *Redistribution with Growth*, anticipated the two-pillar investment-climate and empowerment framework,[34] later formalized as the conceptual underpinning of the Group's approach. It was followed in 1978 by the first of 30 *World Development Reports,* widely recognized as the world's leading development research publications, synthesizing and interpreting knowledge across many development issues, including trade, agriculture, infrastructure, equity, and the role of the state. The 1993 report on health influenced the creation of the Gates Foundation development fund. The 2004 and 2005 reports formalized thinking on the two pillars of the Group's approach to development, empowering people and improving the investment climate. The 2006 report on equity reflected the concern that, in many cases, growth processes were inadequately accompanied by equalizing access to opportunities, raising the danger of widening divergence both between countries and within them.

These centrally produced knowledge studies are complemented by country, regional, and sector work produced by operational regions, professional networks, and specialized groups.

### *A growing role in data and country benchmarking*

Development data have also long been recognized as a key part of development knowledge. First published as part of the *World Development Reports*, the *World Development Indicators* have since been spun-off as a separate publication and database—now widely used for analysis by some 11 million subscribers. The Development Data Platform, which assembles and integrates information from many sources, was created to increase staff access to information. Since 2002 the World Bank Group has coordinated the largest statistical exercise in the world, the International Comparison Project, which produces globally comparable data on prices and living standards.

As part of helping countries understand their strengths and weaknesses across different policy areas, the World Bank Group has produced and compiled comparative policy benchmarking information. Starting in 2004, the annual *Doing Business* report set benchmarking estimates on many dimensions of the investment climate. Starting in 2005, the Country Policy and Institutional Assessment (CPIA) ratings—produced for many years for all developing countries and used as inputs into the IDA allocation process—were made public for IDA countries. The annual *Global Monitoring Report* (a joint product of the World Bank Group and the International Monetary Fund) reports on actions of countries, donors, and international financial institutions in support of the Millennium Development Goals. The Worldwide Governance Indicators and the trade policy indicators are also produced by Group staff, although they are not formally endorsed by the institution and play no role in resource allocation decisions.

### *Broader engagement in global public goods*

Global growth and the deepening of globalization and economic interdependence make global public goods more important. At the 2006 Annual Meetings in Singapore the Development Committee called for the World Bank Group to develop a framework for providing global and regional public goods.[35] The framework presented in *Global Public Goods* in response to this request maintains the focus on the five areas of special emphasis endorsed by the Development Committee in September 2000: preserving the environment, controlling communicable diseases, strengthening the international financial architecture, enhancing developing countries' participation in the global trading system, and creating and sharing knowledge for development.

These challenges remain critical to poverty reduction, growth, and global stability. Preserving the environment—in particular addressing climate change—has emerged as perhaps the biggest challenge, while control of communicable diseases remains an important priority for World Bank Group involvement. Strengthening the world trading system and enhancing international financial stability are additional areas where the Group has been active. Increasing development knowledge is the fifth area in which the Group has done much work in creation and dissemination. Cutting across the other areas, it encompasses more. And with the renewed emphasis on implementation, comparative research to improve transmission of country experience (how particular interventions can be effective in particular conditions) comparative data and performance benchmarking information to improve transparency have become essential development tools.

With other multilateral and specialized institutions engaged in these same areas, the World Bank Group's rationale for involvement is an issue. Building on its country engagements, one natural role for the Group lies at the intersection of national development priorities and programs and global interests. But the Group's knowledge and financial capacity contribute to the provision of global public good-related services in other ways. In broad terms, the Group's comparative advantage involves:

- ***Integration.*** Understanding country-level sectoral and cross-sectoral development issues and providing access to a range of financial instruments enables the Group to link global issues to country programs through country

strategies, analysis and advice, lending and grants, and global programs and trust funds.

- ***Partnership.*** The Group's global span, country knowledge, and trust in its financial, administrative, and implementation capabilities make it a valuable partner and a source of innovative financing mechanisms to support development and respond to global challenges.
- ***Constructive advocacy.*** The Group's research and analytical capacity make it well suited to communicate the perspective and interests of developing countries in international arenas. It can also help bridge the gap between the perceptions and interests of countries at different stages of development.

## The World Bank Group as a development cooperative—services and client segments

The World Bank Group—which makes the low-cost, easy access to the financial markets of its most developed members available to all members on equal terms and shares with all members the knowledge and lessons of its development experience—can be viewed as a development cooperative. Its value as a development cooperative rests on three features. First is global membership, with activities and operational involvements spanning all developing regions. Second is a strong financial structure, with endowments of paid-in capital reinforced by pledged capital for the IBRD. Third is demonstrated knowledge and management skills to provide a broad range of products and services to diverse private and public clients. None of these attributes is unique, but together they differentiate the Group from other organizations.

This global cooperative structure confers great strength. It enables the World Bank Group to raise funds at very competitive costs and to diversify risks, with all arms of the Group benefiting from preferred creditor status. It also sustains a deep reservoir of experience and skills, able to learn from cross-country and global development experience and to combine services to provide a wide range of product solutions to development problems. Over many policy and development issues, the Group can learn from country-specific, cross-country, and global experience much faster than other providers of development services can.

The cooperative structure also imposes constraints. The World Bank Group can survive as a global cooperative only if seen by all members as "their" institution. Although shareholder voting rights are heavily concentrated in a few countries, the Group needs to seek a reasonably wide consensus on major decisions and to balance priorities among different groups of constituents, which can have different interests. Some decisions, such as product pricing, require Board approval, though they might be seen as management decisions in other organizations. This can slow decisionmaking and reduce agility. There has also been a tendency toward uniform treatment despite country differences. For example, the IBRD does not price sovereign risk differently for different clients, though the MIGA effectively does. By contrast, access to Group resources is differentiated between clients. For the IBRD access is based on creditworthiness assessments, and for the IDA, on the performance-based allocation system, which relies heavily on the CPIA ratings.

### *Operational externalities*

The World Bank Group's three features—global membership, strong financial structure, and demonstrated knowledge and management skills—create a range of externalities in country engagements and types of activity. The IFC and MIGA, for example, benefit from the country knowledge and preferred creditor status of the Group. IDA countries benefit from the body of experience and technical expertise that can be sustained only by a critical mass of engagement in IBRD countries. Similarly, competence in financial and project management gained through lending activities can be useful for other purposes, such as managing trust funds. The financial capacity derived from managing the Group's own capital, borrowing, and investments can

be applied to help clients better manage their own portfolios and risks.

These externalities imply that any vision of the future structure and roles of the World Bank Group must consider not only the comparative or competitive advantage of individual activities in isolation but also their externalities and spillovers. A development program or activity in a middle-income country might be valuable for its direct poverty-reducing impact, but even more valuable for imparting knowledge on how to better deliver poverty-reducing services in other, often poorer, countries. Conditional cash transfers, after their introduction in Mexico, are now being tested in at least a dozen developing countries and in the United States.

Similarly, some knowledge-related activities can be separated from financing activities, but others cannot easily be undertaken in isolation. These include learning-by-doing activities, such as how to implement major, innovative investment projects or how to adapt generalized development programs to particular country conditions. Measuring these externalities and spillovers is difficult and not enough effort has gone into quantifying them, but they clearly are important drivers.

### *Dynamic comparative advantage and catalytic action*

Modern trade theory recognizes the essential role of learning effects and of creating critical mass in particular areas of competence in shaping a country's dynamic comparative advantage and export competitiveness. Dynamic advantage is equally relevant for the World Bank Group. Competence in specific areas evolves from ongoing engagements in development problems, conscious efforts to anticipate needs and gaps in the development process, and continuing investments in improving capacity and strengthening results.

Pilot or demonstration projects—or the prospect of financial support for sound programs—can also create demand for innovative programs that can be replicated more widely. For example, the upfront commitment of $2 billion to African countries through the Multi-Sector AIDS Projects encouraged country programs that would later elicit funding by other donors on a far larger scale. The World Bank Group's catalytic role has also been important in the capital market development work of the IFC, the establishment of the carbon finance market, and the opening of sovereign asset, liability, and risk management services.

In thinking through future priorities and organization, this dynamic advantage—preserving the capacity to experiment and learn—needs to be kept in mind.

### *The menu of services*

The World Bank Group's activities could be described through the evolution of its arms—IBRD, IFC, IDA, ICSID, and MIGA—but this might be misleading, since the arms sometimes provide joint products. In addition, they provide overlapping services to different groups of clients. And they are increasingly supplemented by new service areas, notably the management of trust funds, that can cut across client groups. So, it may be more helpful to first consider three types of services: finance, knowledge, and coordination.

- ***Financial services.*** These include grants, concessional credits, loans, equity and related investments, financial enhancements (guarantees), trust funds management, sovereign asset and liability management services, and risk management services.
- ***Knowledge and other specialized services.*** The Group's broad knowledge component includes country-level analytical work, technical assistance, and capacity-building; cross-country development and benchmarking data; global studies and research; and detailed understanding of how to implement development projects successfully in different contexts.
- ***Convening, coordinating, and catalyzing services.*** Directed at overcoming institutional coordination failures, these services include mobilizing and managing aid from other donors, providing vehicles for cofinancing, chairing consultative group meetings, and developing new services.

***Complementarity and competition in service provision.*** Each of the World Bank Group's arms partners with regional development banks, other multilateral and bilateral entities, private financial markets, academic and other knowledge institutions, and nongovernmental organizations. In some cases the Group also competes with other institutions to supply financial or knowledge services or to lead a development initiative. Such competition should lead not to confusion and redundancy but to new approaches and better performance.

## *How services are delivered to different clients*

There is great variety in how services are provided to different clients. The different arms of the World Bank Group generally serve different clients, whether sovereign governments, subnational entities, private firms, or in some cases the broader development community. That is why they have different business models. But there are strong externalities across services. Financial services involve more than transferring money—they can also be a vehicle for imparting knowledge (through designing a project) and for producing it (through monitoring project implementation and outcomes). So, the Group's activities can be justified on any of three grounds: their developmental (poverty-reducing) impact, the knowledge externalities they generate, and their effect in catalyzing action or coordinating other actors. Understanding and measuring impact require attention to all three outcomes.

While the World Bank Group's functions translate into services for different clients in many ways, there are some broad patterns in the ways the menu of services is provided.

***Low-income countries with low capacity.*** Typically facing a broad and politically complex range of basic development priorities, these countries may be relatively standard from a technical perspective. In these cases the World Bank Group seeks to be a full-service institution, providing a wide range of financing, knowledge, and convening services. Services respond to country needs as articulated in the Poverty Reduction Strategy Papers and the Country Assistance Strategies, taking into account specific gaps that result from the contributions and activities of other partners. Within this group, fragile states, often coming out of conflict, pose a particular set of challenges.

***Middle-income countries.*** Typically facing a wider set of more technically demanding problems, some middle-income countries have achieved investment-grade status, and many look to the Organisation for Economic Co-operation and Development (OECD) countries for guidance in economic management. The World Bank Group's program responds to the needs of a particular country for development solutions, but how it responds may also be shaped by the areas of specialization it emphasizes. Specialization goes hand in hand with increasing complexity, and no institution can expect to have full expertise in all areas.

***Engagement with global and sectoral clients.*** The comparative advantage of the World Bank Group often rests in country-level implementation of global public goods-related programs, but it also provides other specialized services. Engagement at the global level has also heavily emphasized knowledge creation and dissemination, knowledge-based advocacy and convening services, and trust fund management.

This grouping of clients is not the only one possible. There are a few blend countries, combining IDA eligibility with IBRD access. But they are large. The small-state members of the World Bank Group also face distinctive problems and for some purposes can be considered as a distinct client segment.

IBRD and IDA are overwhelmingly country driven. In 2006 lending accounted for 29 percent of country services and supervision for 35 percent, with country analytical and advisory services at 26 percent and other services at 10 percent (figure 3.1).[36] This administrative breakdown does not reflect the balance among the different services offered—financial, knowledge, and coordination. Nor does it take into account that some spending on project preparation and supervision relates to the World Bank Group's own fiduciary and other due diligence requirements and thus supports

financial services. And some relates to project-embedded learning for both the Group and the client, and thus supports knowledge services. Both project preparation and supervision involve the generation and transfer of development-related knowledge, and staff working on loan preparation and supervision are often also involved in other knowledge-related activities.

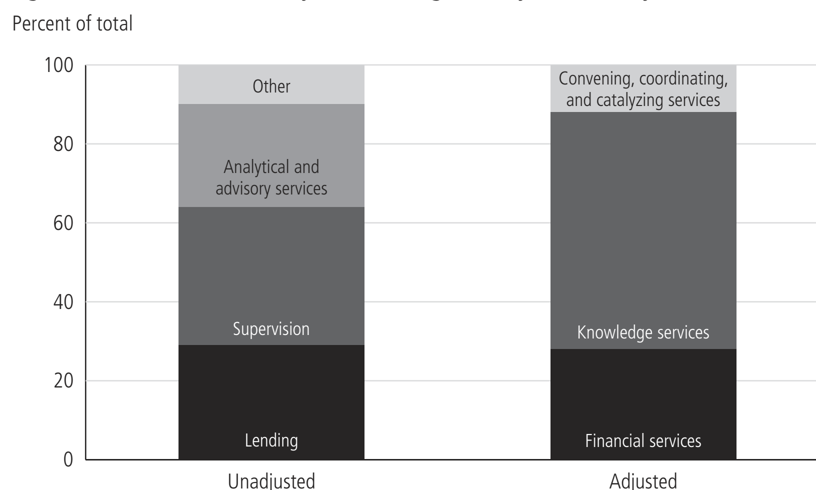
Consider what it implies if half of project lending and supervision activity is attributed to knowledge services. About 28 percent of the allocable administrative budget would support financial services, more narrowly defined; about 60 percent would support knowledge-related services; and about 12 percent would support convening, coordinating, and catalyzing services.

Services are provided roughly equally to low-income countries (40 percent) and middle-income countries (40 percent), with the remainder provided to India and other blend countries and China (20 percent). In the 2006 administrative budget, country and regional services accounted for almost 80 percent of client services, with 20 percent for largely sectoral and global services (table 3.1). About half of country knowledge services consist of knowledge-related activities embedded in project and nonproject lending operations, with the other half consisting of freestanding analytical and advisory services. Convening and associated services represent 12 percent of country services. The illustrative allocation of global public goods and sectoral resources across the different activities shows that knowledge and convening activities tend to be large relative to specifically financial activities in this area.

Finance and other services are connected through the budget and the activity. Illustrative sources and uses of World Bank Group funds are shown in figure 3.2 (excluding the IFC and MIGA). Income is generated mainly by spreads and charges on IBRD loans and IDA credits and by earnings on the IBRD's endowment of paid-in capital and reserves. Broadly speaking, spreads on IBRD loans cover all services provided to IBRD country clients, and fees on IDA credits cover all services to IDA clients. With total lending and supervision costs averaging $800,000 on IBRD and IDA investment operations and $400,000 on nonproject loans, both IBRD and IDA lending are profitable activities, especially large loans.[37] They cover their own administrative costs and embedded knowledge activities, as well as nonembedded analytical and advisory activities, together with a prorated share of overhead expenses. Income from lending and other financial services also sustains the pool of professional expertise available to contribute more broadly to other activities. Earnings on IBRD equity depend

**Figure 3.1 IBRD and IDA country services budget, unadjusted and adjusted, 2006**

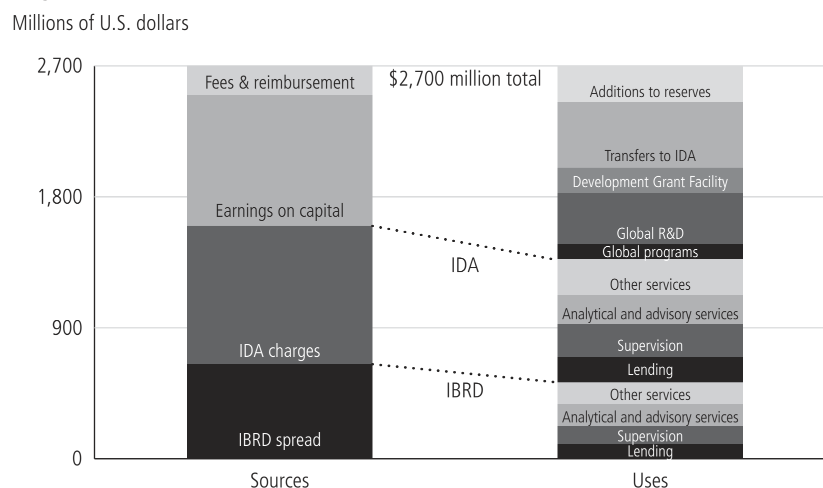
Percent of total




Source: World Bank Group staff estimates.

**Figure 3.2 Sources and uses of funds—illustrative annual magnitude of IBRD and IDA financial flows**

Millions of U.S. dollars




Source: World Bank Group staff estimates.

Note: Overhead supporting services are distributed proportionally to identifiable services. "Other services" include country program support, client training, and donor coordination.

**Table 3.1 World Bank Group client services, by type (adjusted percentage of administrative budget)**

| Service | Middle-income country clients (40) | Low-income country clients (40) | Global and sectoral clients (20) |
|---|---|---|---|
| Financial services to sovereign clients, subsovereign clients, private sector clients | IBRD loans, guarantees, asset, risk, and treasury management services | IDA credits, grants, guarantees | Management of global trust funds, treasury services Support for certain regional public goods (financing country programs to address global public goods, included in country services) |
| | IFC investments and other financial services (about 70 percent of portfolio), MIGA guarantees | IFC investments and other financial services (about 30 percent of portfolio), MIGA guarantees | |
| (28) | (12) | (12) | (4) |
| Knowledge and other specialized services for global development community, public sector, private sector | IBRD analytical and advisory services | IDA analytical and advisory services | Research and other analytic work |
| | Implementation support, supervision | Implementation support, supervision | Knowledge-based advocacy |
| | IFC/MIGA advisory work and technical assistance (about 30 percent of portfolio) | IFC/MIGA advisory work and technical assistance (about 70 percent of portfolio) | |
| (60) | (24) | (24) | (12) |
| Convening, coordinating, and catalyzing services | Convening role on special issues | Coordination of multiple donors in support of Poverty Reduction Strategy Papers | Building coalitions, coordinating multiple constituencies |
| (12) | (4) | (4) | (4) |

Source: World Bank Group staff estimates.

Note: Intensity of shading denotes emphasis, with deeper shading denoting more emphasis.

on the return from investments—and cover global programs, transfers to the Development Grant Facility, additions to reserves, and transfers to IDA. Much of the technical capacity sustained by the Group (especially for the IFC and MIGA) is therefore funded by its financing activities. They mainly finance sectoral and global work programs, including research and development (formal research is only 2 percent of the administrative budget).

## Trends in financial services to client groups

As the World Bank Group's operating environment has changed, so has the balance of its activities. In line with the growth in private flows IFC disbursements have increased 75 percent and MIGA guarantee contracts 45 percent in real U.S. dollar terms since 1995, crowding in much additional private investment. The business of the IFC and MIGA has grown more rapidly in "frontier" countries (core IDA, LICUS, and blend countries plus India and China) and with "second-tier" firms unable to access global markets.

IDA flows have remained roughly flat, with a recent tendency to account for a smaller share of total development aid and a slight increase in the share of low-income countries under stress (LICUS), which are mostly post-conflict countries. Some newer instruments, such as guarantees, have grown, leveraging private investments by about 10 to 1 to bring some $30 billion in total private financing. Subnational programs without a sovereign guarantee are still modest. Trust fund activities have soared, with disbursements reaching half of the IDA's. Fee-based financial services have also grown rapidly from a small base, and along with options embedded in loan products, support around $11 billion in transactions to help sovereign governments hedge risks. In contrast, IBRD disbursements have fallen 30 percent.

The main factor constraining traditional IBRD lending has been the contraction of real sovereign borrowing. But other factors are also important. They include the sharp decline in market spreads, which reduces the financial benefit that the World Bank Group can bring to middle-income members, and a reputation for slow, high-cost procedures for the IBRD. Benefits in lower financial costs (only a few developing countries can borrow more cheaply) and in embedded knowledge may outweigh the "hassle factor." But the benefits accrue mainly in the future, while the higher costs are borne today, a strong disincentive to financial engagement.

Trends in the financial services of IBRD, IDA, IFC, and MIGA can be assessed from two perspectives. How are services evolving in volume terms and relative to market demand? Is the financing shifting to frontier countries and clients—those likely to have less access to private financial markets—or continuing to finance countries and private clients likely to have good access to financial markets? New services, including trust fund administration and specialized fee-based financial services, also figure in a forward-looking analysis.

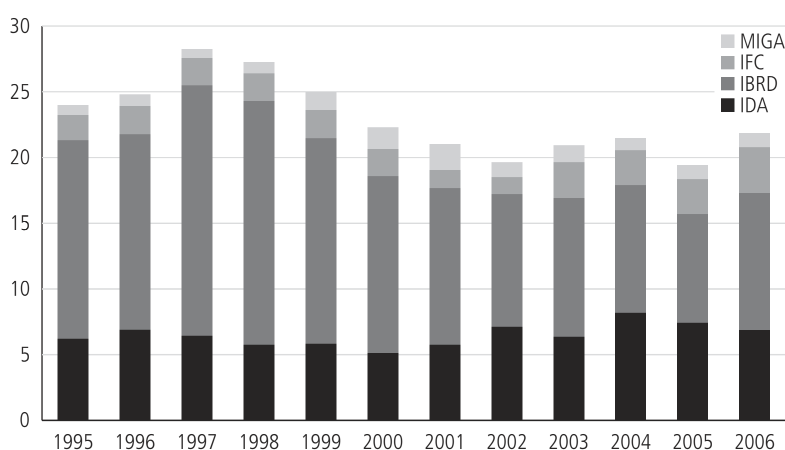
Disbursements, rather than commitments or levels of portfolio, are the best indicator of current business activity. Figure 3.3 shows disbursements for each of the World Bank Group's arms in 1995–2006 in real U.S. dollars. For MIGA the indicator is gross contracts of guarantee issued.[38] Figure 3.4 shows real disbursements broken down by client groups.

Total World Bank Group disbursements in real terms contracted by about 10 percent in 1995–2006, taking into account the exceptional countercyclical lending in the aftermath of the Asian financial crisis, when net private lending to developing countries fell from more than $100 billion to turn negative. IDA's disbursements increased 10 percent in real terms, MIGA's 46 percent, and IFC's 75 percent. IBRD disbursements, however, contracted about 30 percent from their 1995 level, falling from more than 60 percent of the Group's total business in the mid-1990s to around 45 percent by 2006. Shrinking disbursements, along with $26 billion in accelerated prepayments of older high-cost loans over the last several years, caused IBRD's portfolio to contract to barely $100 billion.

As a result of these trends, the IBRD's equity–loan ratio increased sharply, from an average of about 20 percent in 1982–2000 to around 33 percent in 2006 (figure 3.5). Since market risks (as measured by market spreads for IBRD borrowers) dropped dramatically over the same period, this suggests that the IBRD is "over-capitalized" and out of equilibrium. Either it does not need as much capital as it currently has, or it should be possible to

**Figure 3.3 Total World Bank Group disbursements, by arm, 1995–2006**

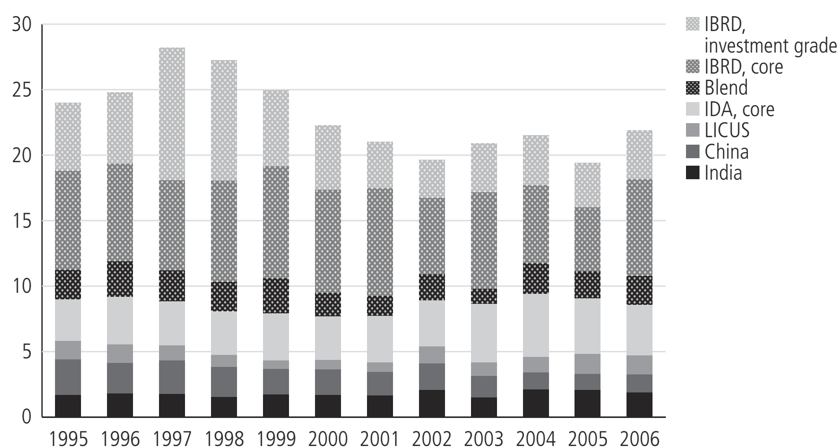
Billions of 2000 U.S. dollars




Source: World Bank Group staff estimates.

**Figure 3.4 Total World Bank Group disbursements, by client group, 1995–2005**

Billions of 2000 U.S. dollars

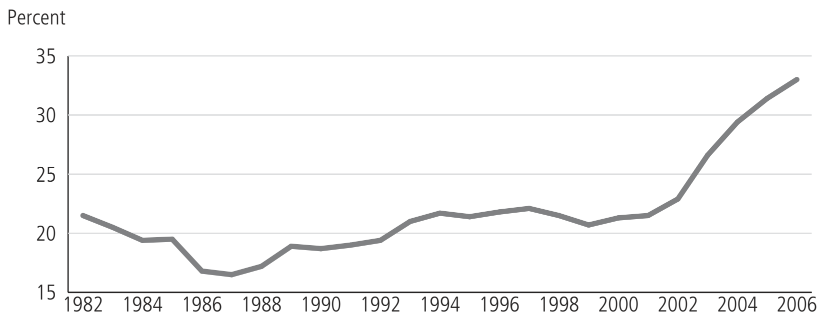



Source: World Bank Group staff estimates.

Note: Client group composition is as of 2006.

**Figure 3.5 IBRD equity–loan ratio, 1982–2006**

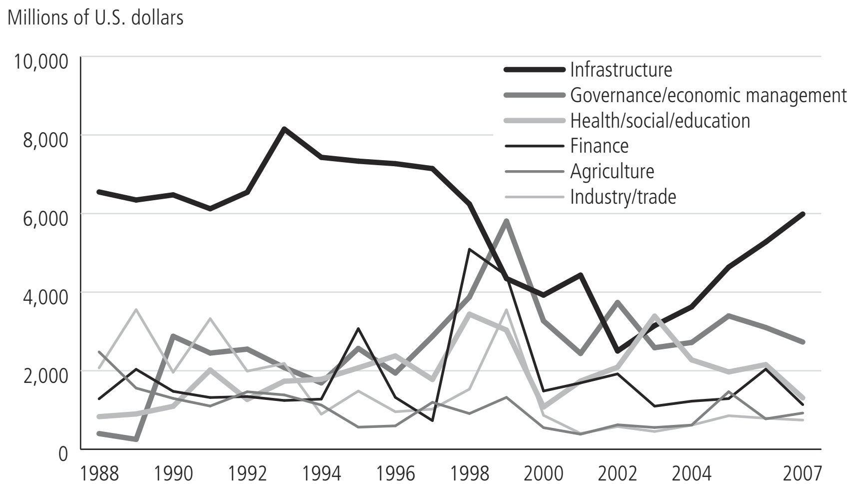
Percent




Source: World Bank Group staff estimates.

**Figure 3.6 IBRD lending by major sector, 1988–2007**

Millions of U.S. dollars

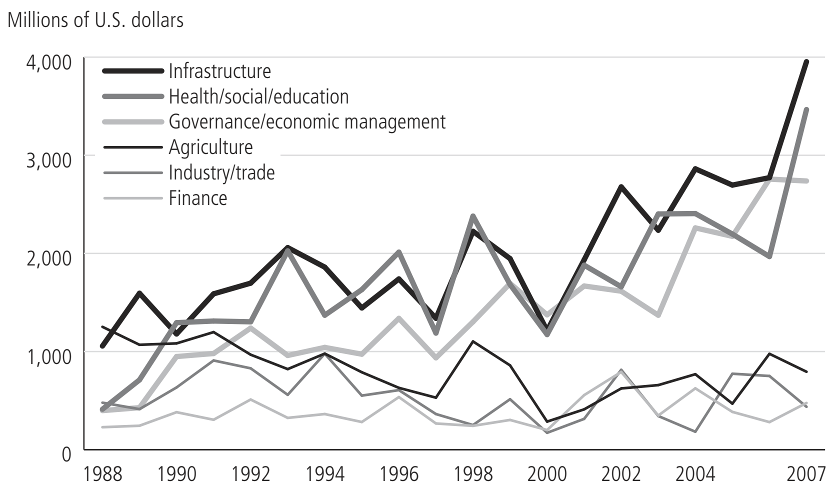



Source: World Bank Group staff estimates.

Note: Infrastructure includes mining, energy, transport, water, sanitation, and communications.

**Figure 3.7 IDA lending by major sector, 1988–2007**

Millions of U.S. dollars




Source: World Bank Group staff estimates.

substantially expand its loan portfolio, including more lending to noninvestment grade borrowers.

A consequence of the World Bank Group's country-based model for operations is strong financial and knowledge services for most clients, both low and middle income. For most low-income developing countries there is active lending across major sectors, reflected in the diverse loan portfolio in those countries. In middle-income countries there is somewhat greater selectivity but still broad representation. This breadth is also reflected in basic economic and sector work—country economic memoranda, public expenditure reports, sector strategy reports, and so on—prepared periodically across core business areas and informing the Country Assistance Strategies. Figures 3.6 and 3.7 show the lending trends by sector from 1988 to 2007.

For IBRD borrowers there was a significant decline in commitments for infrastructure beginning around 1997, from roughly $7 billion a year to around $4 billion in 1999–2004, before recovering to $6 billion in 2007. Partially offsetting this was a temporary increase in commitments classified as economic management, finance, and industry and trade, attributable to the Asian financial crisis of 1997/98. Infrastructure's major decline does not appear to have been due to the financial crisis. Social lending has been fairly steady at $2–$3 billion a year, with agriculture trending gradually down.

By contrast, IDA lending commitments for infrastructure, for industry and trade, and for economic management and governance have increased steadily since the second half of the 1990s. Commitments to social sectors, finance, and agriculture have been fairly constant, with their shares declining.

### *The International Bank for Reconstruction and Development—lending into a constrained market*

The contraction of IBRD lending reflects three main factors. First, sovereign external borrowing by middle-income countries has stagnated since the Asian financial crisis at some $140 billion in nominal terms, even as

private-to-private flows surged severalfold. Second, the declines in world interest rates and in developing country spreads to historic lows—by some 200 basis points over the last several years—imply a reduction in the franchise value of the World Bank Group for middle-income country borrowers of about $2 billion a year. Even so, only about 11 IBRD-eligible borrowers are currently able to borrow at lower than IBRD lending rates.

Third, the impact of stagnant demand and low market interest rates and spreads has been compounded by a falling IBRD market share relative to the lending of other multilateral banks. While the overall Millennium Development Goal share in sovereign external borrowing has remained constant, that of the IBRD has fallen from 12 percent before the Asian financial crisis to 10 percent after, as regional banks increased their shares. Lower "competitiveness" may not be the main cause of the contraction in lending, since 60 percent of the decline in real IBRD lending can be attributed to the contraction in the real demand for sovereign external financing. But the trends raise concern over the attractiveness of traditional sovereign loans for middle-income countries relative to alternatives available from other sources, including financial markets.

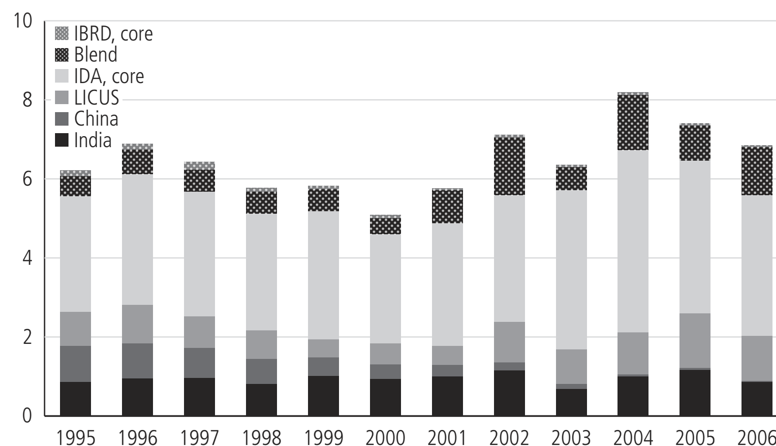
Many clients with ample foreign resources and strong capacities, such as Brazil, Chile, and China continue to borrow from the IBRD, at least at some level, usually for projects where the embedded knowledge and learning services are seen to add particular value. These are often for innovative or complex projects, including projects to ensure that development in the Amazon Basin is sustainable, environmental and poverty-related projects in China, and projects that develop new public-private partnerships to extend services to remote areas.

Even so, IBRD's lending to the investment-grade client group has fallen most sharply. This might be expected, since the IBRD does not price-discriminate for differences in country risk. For investment-grade clients the nonfinancial costs of borrowing from IBRD, in slow speed and the need to comply with due diligence and safeguard policies, often outweigh any slight financial advantage, particularly for routine projects. In addition, the hassle factor of dealing with IBRD or IDA, informally estimated at 0.5–1.0 percent of the loan value, are borne by a limited group of current government counterparts, while the financial gains and many of the knowledge benefits will accrue only long into the future. The quality of knowledge services may also not have risen as quickly as the capacity of some middle-income countries. Even if loans are attractive in net present value terms, it would not be surprising if many were turned down. For many countries lending has become demand-constrained at less than maximum exposure.

The IBRD has also been slow in expanding lending to its less creditworthy frontier countries—real lending has not increased to any of the broad IBRD client groups. In these cases the constraint is more likely to be on the supply side, raising the question of whether the IBRD is adequately using the possibilities afforded by its capital to take on country risk. The distinction between IBRD-eligibility and market access is also blurring—a number of current IDA clients appear to be transitioning toward private market borrowing without being considered eligible for IBRD borrowing. This suggests some rethinking of the current IDA/IBRD boundary.

**Figure 3.8 Total IDA disbursements by client group, 1995–2006**

Billions of 2000 U.S. dollars




Source: World Bank Group staff estimates.

### *The International Development Association—challenges to the country-led model*

IDA disbursements have grown only slightly in real terms (see figure 3.3). There has been some increase in the share of countries designated as LICUS—to some 15 percent in 2006 (figure 3.8), largely as a result of exceptional post-conflict allocations to several of them.[39] Since rapidly growing IDA clients account for a large share of IDA disbursements, the composition of its clients will shift toward LICUS countries, especially when some large countries, such as India, graduate to IBRD lending. For a number of years, however, the composition of IDA countries will change relatively little, even as debt relief causes a severe decline in IDA's portfolio, sharply raising the needed funds from the IDA–15 replenishment. Another priority is to address the impact of debt relief on the income that the World Bank Group receives for administering IDA—income needed to fund ongoing lending, knowledge, and convening services to IDA clients.

The IDA and the country-based model of development that it supports face growing competition in the global market for aid (chapter 1). IDA's share in total development assistance has recently fallen, as core official development assistance has grown less rapidly than total official development assistance. With a proliferation of donors and channels, including a vast array of earmarked funds, the global development aid architecture has become ever more complex. Even with efforts to pursue harmonization and improve compliance with the guidelines of the Paris Declaration, the aid system is marked by fragmentation and earmarking—some 60,000 aid activities have been recorded in one year, and the average size of donor-funded activities has fallen to $1.5 million. New official donors and private foundations are increasingly prominent, providing welcome funding but adding to the complexity of the global aid architecture.

These factors help explain why IDA's role as the linchpin of the global aid architecture has come under pressure, along with the country-led development model, where aid recipients are in full control of their development strategy and related development spending, and country-specific needs are consistently taken into account. Sustaining support for the model will require recognition of the reasons for donor preferences for clearly targeted funds and continuing efforts to demonstrate and improve the effectiveness of country-based programs.

A further issue for IDA is responding to the financing flows from other donors. The focus on the Millennium Development Goals has sharply increased the share of the social sectors in sector-allocable official development assistance. For Sub-Saharan Africa the social-sector share rose from 33 percent in the first half of the 1990s to 60 percent in 2000–04. Especially when additional private funding is provided—particularly in such specific health-related areas as HIV/AIDS and malaria—IDA's role as the dominant financier is being eclipsed, though it still provides other critical services, such as strengthening sector frameworks and coordinating resource flows.

IDA's role in financing infrastructure in low-income countries and encouraging additional financing, including that from the private sector, has become even more critical. The share of infrastructure in total official development assistance declined from 29 percent in the early 1990s to 19 percent in 2000–04, raising the prospects of severe infrastructure constraints to the growth of the poorest countries. In much of East Africa investment climate surveys show that power supply is the binding constraint to investment and growth.

### *The International Finance Corporation and the Multilateral Investment Guarantee Agency—more business with the private sector*

Since 1995 the World Bank Group's business with private clients has grown sharply, mirroring the dramatic global increase in private international financial flows. Almost half of all business in investment-grade countries now consists of IFC and MIGA activities. The increased reach and role of private business in the vast majority of developing countries suggest further growth opportunities for

these arms of the Group and increase their future strategic importance.

Both IFC and MIGA have also been increasing the share of business in lower-income frontier clients. The share in IFC's business of such frontier clients—core IDA, LICUS, and blend countries plus India and China—has risen from 24 percent to 31 percent, and the share rises if further frontier regions are included.[40] These countries' share in MIGA's business has also grown, from 30 percent of contracts to about 40 percent. Relative to GDP, investment, or private market flows, both MIGA and IFC are "overweight" in their frontier markets. There have also been increases in the share of second-tier and domestic businesses in the overall client pool, indicating increased penetration of these services beyond the first-tier companies with strong capacities and good financial market access.

The main issue for IFC and MIGA is thus not their ability to grow—it is to ensure that their services maximize their development impact, subject to adequately diversified portfolios and acceptable rates of return. The possibility of expanding the financing frontier is facilitated by their ability to price products to allow for different degrees of country risk, even though they are part of the World Bank Group's development cooperative. Growing the business at the frontier requires pushing the composition of financing and associated services toward frontier countries, regions, and clients and allocating part of net income to technical assistance and business development services in such areas. As the analytical and technical assistance activities of IFC and MIGA grow, it is also important to ensure that they are well coordinated with those of the Group.

### *Guarantees—potential for expansion*

Since 1994, when IBRD and IDA partial-credit and partial-risk guarantee programs were launched, 31 operations have been approved for a total exposure of $3 billion. With an average leverage ratio of almost 10 to 1, they have mobilized almost $29 billion in private financing, mainly for large infrastructure projects. They also extend the reach of MIGA and IFC guarantees to larger and more risky investments. Guarantees still tend to be "one-off" products with high preparation costs and long preparation times. For example, all guarantees are required to undergo central review in addition to regional review, adding some six weeks to processing time. They have reached a stage where they can be mainstreamed as a regular business line.[41]

### *Subnational lending—potential unmet demand*

Subnational lending has remained modest. With the IBRD unable to lend without a sovereign guarantee, projects are the responsibility of a joint IFC–IBRD department, and loans are booked against IFC capital. Eight closed operations, with a total exposure of $250 million, have mobilized some $1 billion for subnational governments. The goals extend beyond providing finance to include improving the ability of subnational governments to access financial markets more widely. Projects therefore include capital market development components, as well as assistance to improve financial disclosure.

### *Trust funds—a growth industry*

Trust funds are the World Bank Group's most rapidly growing business segment. Even though donors have sought to strengthen the earmarking of their resources, their demand for Group management and program services for their funds has continued to rise. By 2006 disbursements had risen to almost $4.4 billion (table 3.2), half the level of IDA, and by the end of 2007 trust funds under management will have increased to more than $20 billion.

Trust funds tend to focus on two broad areas of donor interest. The first consists of programs to help achieve the Millennium Development Goals in low-income countries, particularly in Sub-Saharan Africa and in health. Other programs support natural disaster relief and post-conflict recovery. The second broad area is global public goods, especially for the environment. This area has seen exponential growth of funds beyond the Global Environment Facility, including the Ozone Phase-Out Fund and carbon funds.

**Table 3.2 Aggregate World Bank Group trust fund financials, 2002–06**

| | 2002 | 2003 | 2004 | 2005 | 2006 | Average annual growth (percent) |
|---|---|---|---|---|---|---|
| Contributions (millions of U.S. dollars) | 2,732 | 3,899 | 4,940 | 4,750 | 5,214 | 18 |
| Disbursements (millions of U.S. dollars) | 1,931 | 2,561 | 3,277 | 4,128 | 4,374 | 22 |
| Funds held in trust (millions of U.S. dollars) | 5,342 | 6,887 | 8,587 | 9,308 | 10,293 | 18 |
| Number of funds | 921 | 933 | 903 | 840 | 929 | 0.2 |

Source: World Bank Group staff estimates.

Note: Funds held in trust are year-end stocks. Before fiscal 2004 they do not include unrealized gains or losses allocated to trust funds, as the numbers were reported on a cash basis; from fiscal 2004 on they do, as the numbers were reported on a mark to market basis. Contributions and disbursements are flows of funds during the year.

From one vantage point the increased flow of trust funds offers encouraging evidence of increasing reliance on World Bank Group expertise to manage development funds. But looked at differently, the tendency toward sectoral earmarking represents a move away from the country-based model. Even though Millennium Development Goal-related and environmental trust funds support IDA countries, they are not a substitute for IDA since they are earmarked for specific applications. This raises the question of how best to integrate the specific interventions supported by the funds with country-based development programs.

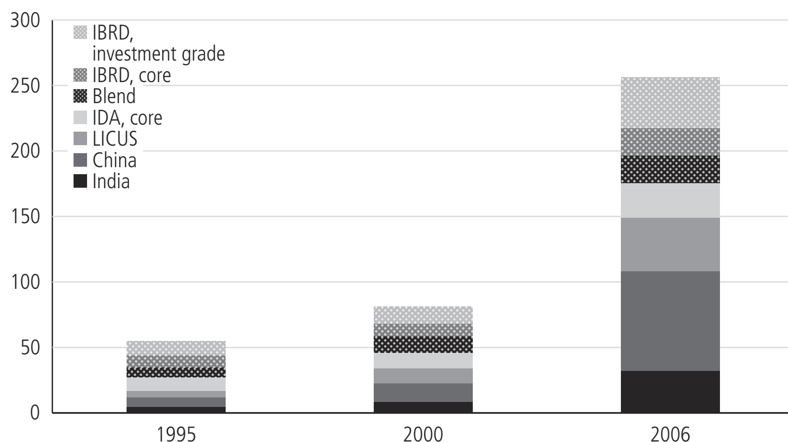
### *Other fee-based financial services*

Fee-based services have developed in two directions. First, the treasury offers services relating to asset management, public debt management, and capital market access strategy and implementation. In fiscal year 2007 these included contracts with 24 countries and 29 programs to provide advice on reserves management, with estimated revenues totaling just over $8 million. The second type of fee-based service is for knowledge, mostly analytical and technical assistance services provided by country and sectoral units, considered below.

The treasury's financial advisory services increased significantly in each of the last three years. While income is still modest, this is an area of potential growth as more countries recognize the gains from improving their asset and liability management and from increasing the returns on their reserve portfolios. Reserves have risen sharply in recent years for all client groups (figure 3.9), particularly for countries that have been running substantial current account surpluses, such as oil exporters. In some countries reserves have increased to well beyond levels that provide normal buffering against trade shocks or short-run capital flows.[42] In the long run countries will choose from a range of sovereign wealth service providers. The World Bank Group is by no means a monopoly player in this area, but its role is catalytic, helping clients gain the knowledge and confidence needed to work with a wider range of investment advisers and service providers.

**Figure 3.9 International reserves by client group, 1995, 2000, and 2006**

Percent of 2000 GDP




Source: World Bank Group staff estimates.

## Knowledge services to country clients

Knowledge-related services represent about 60 percent of total country services (see

figure 3.1). For a typical country about half these services are in lending-embedded knowledge and half are free-standing analytical and advisory work, comprising economic and sector work and nonlending technical assistance. In addition, IFC and MIGA have stepped up their policy advisory work and technical assistance, with IFC setting aside a share of profits to finance more in the future, largely in frontier countries and regions. The objectives are to support improvements in the business climate, develop business in these countries, and extend support to smaller indigenous businesses.

One critical component of the World Bank Group's knowledge services derives from the extensive intellectual commitment and financial resources devoted to research on development. The Group's position here is unique. With a large central research department and myriad research activities throughout the organization, the Group constitutes the largest concentration of development researchers in the world. The presence of this critical mass of expertise spanning the full range of development issues represents an enormously valuable intellectual resource to support the Group's activities and those of the entire development community, a point stressed in a recent external evaluation of the Group's research during 1998–2005.[43] While noting areas where improvements were possible, the evaluation endorsed an even more prominent role for research in the Group, viewing research as the cornerstone of the Group's knowledge-based strategy for engaging with clients. The evaluation also stressed the importance of sustaining a strong internal research department with continuing engagement between research and operations.

Maintaining a strong research capacity matters because development projects are more likely to be effective when they are preceded by sound analytical work. In addition, country analytical products that draw extensively on research have been assessed as higher quality than those that do not. There is thus an organic link—from knowledge generation to successful development financing and then back to knowledge—that is fundamental in reaping the benefits of development experience—the lending, learning, and knowledge cycle. Strengthening the cycle and shortening the time for feedback loops, both within and between countries, are key to the World Bank Group's effectiveness.

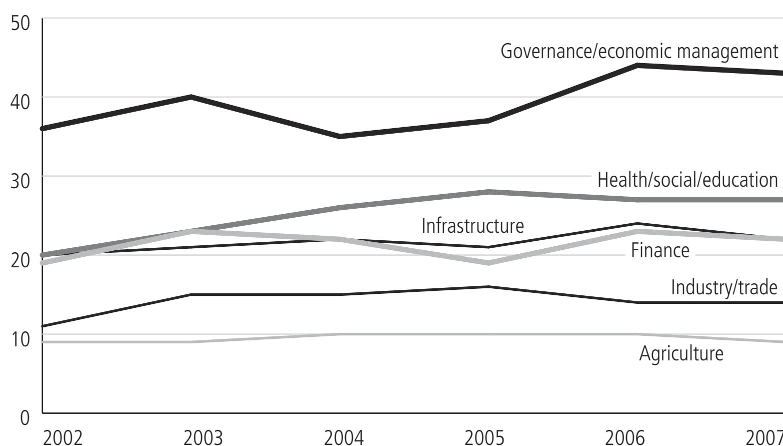
Quality assurance reviews of the World Bank Group's analytical and advisory programs suggest that the technical quality of individual tasks is generally high. Surveys suggest that clients in most cases value the Group's knowledge inputs, including the ability to present the experiences of other countries. Programs increasingly include provisions for learning between developing countries, including visits to other countries facing similar development priorities. A growing share of knowledge products are undertaken collaboratively, with country counterparts or other development partners, and the quality of these tasks is on a par with—and often better than—those undertaken by Group staff alone.

Time series for economic and sector analytic work suggest broadly stable spending by sector to maintain knowledge services, even as financing commitments have shifted (figure 3.10). Spending on country analytical reports has changed very little since 2002.

This partial evidence is consistent with the country-based model, in which a multisector presence supports a coherent and sound

**Figure 3.10 Trends in the sectoral allocation of economic and sector work, 2002–07**

Millions of U.S. dollars




Source: World Bank Group staff estimates.

Note: Infrastructure includes mining, energy, transport, water, sanitation, and communications.

development dialogue and increases overall development effectiveness. World Bank Group Country Assistance and Partnership Strategies are multisectoral and build on an extensive cross-sector knowledge base. And there is evidence that a strong analytic underpinning for Group lending leads to better project and program outcomes. Analytical work on the relationship between the Group's economic and sector work and the quality of projects suggests a measurable and significant positive impact over the two decades from the mid-1970s to the mid-1990s.[44] More recent work broadly confirms the positive correlation between the quality of Group country economic and sector work and project outcomes.[45]

Reviews also raise some issues for the future. Where the resource-transfer role of the Group is important, the analytical and advisory program tends to be seen as secondary to lending. Where it is not, knowledge services can sometimes lead a productive engagement, particularly in middle-income countries. But this requires higher levels of skill, as middle-income-country capacities are increasing, in some cases toward OECD levels.

The World Bank Group has not always been able to engage clients productively—because of fundamental differences on policy views or, more often, because the services offered do not keep pace with evolving country needs. This can be masked for awhile, since analytic and advisory services seldom face a market test, being financed mainly out of the Group's administrative budget. But with rising incomes and technical capacities countries can source advice from consulting firms and universities and through the knowledge-sharing mechanisms of the OECD. The Group's country-based knowledge services are therefore open to competition.

Reviews suggest that those services need to evolve in several ways. First, to respond to more demanding clients, the World Bank Group must maintain core groups with top-quality skills, especially in the newer areas of knowledge requested by clients. Second, the composition of analytical services has not yet fully adjusted to reflect the changes in development thinking (chapter 2). With a growing consensus on many basic principles of development policy and a move toward country-specific adaptation, countries are focusing more on the "how" than on the "what" of development. Supporting them calls for an increase in demand-driven technical assistance relative to sometimes repetitive analytical studies and for more flexibility in programs and staffing to accommodate short-term requests.

Third, how analytical work is disseminated and discussed is often inadequate. Reports tend to be long and often are not fully read even by policymakers. In many cases they are not translated into local languages or discussed outside a limited group of government counterparts. Given greater literacy and access to information, more open media, and in many cases more contestable political systems, the World Bank Group is losing opportunities to build coalitions for policy change toward better development outcomes.

Fourth, the knowledge services funded out of World Bank Group resources are not subject to a market test. Trust funds support some services, but fees fund only a small part. Of fee-based knowledge services, 87 percent are funded by the longstanding seven-country Gulf States Technical Cooperation Program ($3.5 million in fiscal year 2006) and by five relatively large programs (Venezuela, Algeria, South Africa, Kazakhstan, and Mexico, totaling $11.8 million). Only the programs with the Gulf States and Kazakhstan, together totaling about $5.3 million, are ongoing annual programs. The rest are occasional requests that may or may not be repeated. A few fee-based activities are policy analyses, but consistent with the shift from the "what" of development to the "how," more tend to involve technical assistance or institutional development.

Although fee-based analytical services are an exception, some programs suggest possible future trends. Under the Joint Economic Research Program between the World Bank Group and the Republic of Kazakhstan, the costs of joint economic work have been shared between the country and the Group, originally 50–50 but with the country share rising

as the volume requested increases. Both partners are jointly responsible for the quality and relevance of the program. Another example is the specialized advice provided by the Foreign Investment Advisory Service, funded by a combination of budget allocations, trust funds, and fees.

Fifth, the country-based model provides only limited incentives for leveraging country knowledge to provide global public goods. As shown by the dissemination of conditional cash transfer programs from Brazil and Mexico to more than a dozen countries, development efforts in one country can be as significant for their wider knowledge value as for their direct poverty-reducing impact. As a global institution the World Bank Group has a comparative advantage in global learning, but many learning opportunities are still lost through an inadequate focus on results and the incomplete use of the lending, learning, knowledge cycle to extract cross-country lessons from country operations.

## Convening, coordinating, and catalyzing services

Though smaller than lending and knowledge activities in resources used, convening, coordinating, and catalyzing services are essential to the World Bank Group's work. They include working with low-income countries and other donors to strengthen the Poverty Reduction Strategy process, convening consultative donor groups to support them in a coordinated way, and working with donors and other financial institutions in budget support groups.

There is no single blueprint for the World Bank Group's engagement—it depends on the partner government's engagement, the role that donors are willing to play or are already playing, and the degree of coordination and alignment. For IDA countries the areas of involvement include donor meetings, joint assistance strategies, common performance assistance frameworks, coordinated budget support, and sectorwide approaches. For example, in Bosnia and Herzegovina the Group cochaired five international donor meetings with the European Commission that mobilized more than $5 billion in support. In Uganda IDA initiated a joint assistance strategy that coordinated assistance from a range of donors. In Nicaragua the Group helped coordinate and harmonize budget support instruments for a range of donors and develop performance assessment tools. In Ghana the Group supported the sectorwide approach in health, which over the last decade has aligned the delivery of assistance by various donors through a single-sector strategy and better planning, budgeting, and evaluation procedures.

Coordinated action may also be needed to catalyze programs on multicountry issues. One example is the Nile Basin Initiative, a major effort by 10 countries to manage their shared resources to support development and contribute to regional stability. The World Bank Group has supported the initiative since its start in 1997, coordinating donor contributions through a multidonor trust fund, providing technical assistance and advisory services, promoting institutional development, and perhaps most important, using its convening authority to encourage the parties to meet and discuss the issues. Another example is the Group's role in chairing the Strategic Partnership for Africa. Formerly a donor forum to coordinate quick-disbursing assistance, the Strategic Partnership for Africa has evolved to include African representatives and donors in addressing a wider range of issues.

The World Bank Group has been active in development data and statistical capacity-building, including leading the Marrakech Action Plan for Statistics, which has brought together donors and international agencies to coordinate support for statistical capacity in developing countries, and managing the International Comparison Project.

For many global public goods the World Bank Group's engagement involves a mix of financial services, knowledge, and convening, coordinating, and catalyzing activities—these last are often particularly important. As part of its environmental mandate, the Group has managed the Global Environment Facility—committing $3.1 billion in Global Environment Facility financing for about 450 projects in more than 100 countries—and $739 million

in trust funds to combat ozone depletion. Following adoption of the Kyoto Protocol of 1998 the World Bank Group pioneered carbon funds, drawing on its financial expertise and convening and coordinating authority, with about $2 billion under management. Similarly, many partnerships and funding vehicles have been developed for other areas, such as the response to avian flu.

Naturally, the World Bank Group should not expect to lead all convening, coordinating, and catalyzing activities. Its role will vary by area, depending on its contribution relative to those of other partners.

## Implications for the future

The World Bank Group has not instituted a focused process to set priorities for its engagements or to ensure that global public goods priorities are included in country programs. Moving ahead on this would require considerable institutional change.

The World Bank Group is primarily a country-driven institution, with the lending program a critical driver. Incentive for the country program to be concerned with global public goods is small unless the impacts at the country level are already well appreciated. There is thus a wide gap between the priorities of Country Assistance Strategies and the global issues stressed by the network anchors. The Group's emphasis on decentralization may have exacerbated this tendency, even as the importance of addressing global public goods has increased. In addition, there is an asymmetry in the ability to offer incentives to country programs to encompass issues of regional and global public goods, with IDA countries an easier target because of the availability of concessional or grant finance. At the network level incentives are focused on raising trust-fund resources from interested donors, but the absence of a clear institutional strategy for integrating global public goods concerns at the country level makes it difficult to monitor performance and assess accountability throughout the Group.

The World Bank Group thus does not fully capitalize on what should be one of its greatest comparative advantages—its ability to link issues of global importance to action in widely differing country circumstances. No other institution has this capacity on a global basis. Similarly, with the breadth of its research, analysis, and operational activities, the Group should be able to work effectively across sectors and disciplines to address cross-cutting global issues. But there is too little ability to capitalize on its cross-country experience. Only 2 percent of sector staff time supports the activities of other regions (the *Global Public Goods* report lays out several proposals to address these concerns).[46]

# Building Blocks of a World Bank Group Strategy

*chapter* 4

Ever-deepening globalization is the context for the World Bank Group's goal of poverty reduction. Globalization may be slowed by different events, and it may stop or even reverse in some areas or for short periods. But it is now largely irreversible—and will proceed. This momentum offers a valuable opportunity for durable poverty reduction—and a formidable challenge.

Globalization may be a powerful source of progress, improving the lives of all people and strengthening the relationships among them, possibly leading in the very long run to an integrated global community. Or it may lead to a much less favorable outcome, with the benefits accruing only to some countries or some groups, or with the global, regional, or national environments irreversibly damaged.

Successful global development must be inclusive, leaving nobody behind and reducing income disparities worldwide. It must also be sustainable, so that overall economic progress and the reduction of disparities do not cause irreversible damage to the environment—damage that could erase previous achievements. Sustainability and inclusiveness are not independent. Exclusionary outcomes would likely be socially and politically unsustainable. Environmentally unsustainable development would likely provoke exclusion, affecting people and nations in very diverse ways.

The World Bank Group has an important role in pursuing inclusive and sustainable global development. Its role derives from the comparative and competitive advantages it has accumulated over its long existence: its financing capacity, its knowledge and expertise in development, its catalyzing role with the private sector and various development actors, its global reach joined with its country focus, and above all its ability to combine these advantages in the provision of unique development solutions.

The World Bank Group has experience in dealing with the inclusiveness challenge. Inclusive development means fighting poverty everywhere, reducing or preventing the buildup of inequality within countries, and durably reducing disparities among countries, whether between broad groups (high, middle, low) or within them (for diverse middle-income countries). This has been the mission of the World Bank Group since post-war reconstruction ended.

Sustainable global development means ensuring that development and global growth do not deplete natural capital within countries or around the globe. In that, the World Bank Group has been an innovator—for example, by developing carbon trading with developing countries. Now is the time for the global community to raise the game. And the Group—with its experience, its global reach and country focus, and its proven capacity to combine financial incentives and knowledge in preserving global commons—is perhaps most qualified to lead this effort in developing countries.

Despite these advantages, the World Bank Group should not try to do it all. Encouragingly, the number of actors promoting global development is increasing, along with awareness of the importance of inclusion and sustainability. The arenas for pursuing global development are proliferating too. But having all actors present in all arenas is inefficient. Efficiency requires concentrating on the tasks where an institution can be competitive. Maximizing the developmental value of the Group requires choosing the areas for action and the associated modes of intervention where it naturally has—or can build—competitiveness and can contribute to global development objectives.

This chapter describes the building blocks for a World Bank Group strategy. It lists

possible areas and modes of intervention in a "flat" way, with comments on strengths and weaknesses, but without explicit priorities or relative weights. It takes a first analytical step in the decision process that must lead to a strategy. But the chapter deliberately stops short of final choices. It does not consider organizational structures or resource allocations, because they can be dealt with only when actual strategic choices are being made.

The chapter's three main sections list the possible building blocks to consider in making strategic choices. The first identifies the key challenges that seem most relevant in pursuing inclusive and sustainable development in a globalizing world. The second deals with possible changes in the World Bank Group's modes of intervention to contribute most effectively to these areas. The third focuses on the key role of knowledge and learning, which cut across the key challenges and associated modes of intervention and highlights the critical need for self-evaluation by the global development community and the World Bank Group. One difficulty in making strategic choices today is our relative ignorance of the developmental value of the various actions. Progress requires a better capacity for evaluation. A possible first step is to establish basic indicators for measuring effectiveness.

A word of caution. It is difficult to imagine that inclusiveness and sustainability could not be fundamental objectives of the global development community. Yet all shareholders of the World Bank Group may not view some implications of these objectives in the same way. Some might put more weight on different aspects of inclusiveness. Others might give more importance to sustainability and global public goods. At stake here is the governance of the Group and whether it allows for maintaining an appropriate balance between the Group's operational independence and its responsiveness to the political concerns of its diverse range of shareholders. This can be especially challenging for a cooperative. The balance of benefits is essential if low-, middle-, and high-income shareholders are to continue to see the Group as "their" institution. Meeting this challenge raises governance and organizational issues beyond the scope of this exercise, but addressing them will be necessary as a new strategy is identified.

## Four critical challenges

A major objective for the development community is ensuring that the benefits of global development are widely shared and that the process is economically, socially, and environmentally sustainable. These goals are clearly interrelated—raising the living standards of poor people, whether in low- or middle-income countries, and expanding their opportunities to better their lives—and are essential components for the growth-enhancing process of globalization to endure. These goals continue or extend the poverty reduction objective that the World Bank Group has pursued over the past decades. And while there are important questions of balance among the four areas identified that must be addressed, the basic content and direction in these four areas appear relatively robust with respect to uncertainties in the global environment (box 4.1).

From this vantage point it is possible to identify four global challenges that seem particularly important in the years ahead: Africa, fragile states, inclusiveness in and for middle-income countries, and global and regional public goods.

### *Sub-Saharan Africa*

The World Bank Group's poverty focus implies a continuing emphasis on low-income regions and a stronger focus on the sectors most relevant for them. These regions will continue to be South Asia and Sub-Saharan Africa. Both are critically important, and the number of poor people is larger in South Asia today than in Sub-Saharan Africa. But the prospect of more rapid gains in Asia suggests that the emphasis will shift progressively to Africa and to a few slow-growing, low-income countries in other regions.

Given the great diversity of the countries in Africa, approaches need to be sharply differentiated. For some the priority is to reinforce recent strong growth trends and to make them sustainable. For others it is to assist with

**Box 4.1 Dealing with uncertainty—is the strategy robust?**

Many forces could push the global economy from its long-run trends. Financial crises of the type seen in the 1990s may strike again, further disruptions in oil supply might occur, or a pandemic threat might suddenly emerge, as with SARS some years ago. In each case the global economy would slow down, but with an uneven impact across countries. Poverty could surge in the countries most severely hit. While the effect of such a crisis (or series of crises) will likely be transitory, the political and economic feedback could cause a more persistent slowdown in global performance.

Does the possibility of short-term or even long-term deviations from current trends modify the strategic elements presented in this chapter? Probably not, but it must be acknowledged that dealing with such contingencies can change the weights assigned to the priorities identified.

For example, the need to assist countries in crisis and to attenuate the effects of short-term crises on poverty is likely to divert resources from their intended use. IBRD capital intended for possible redeployment—perhaps to help finance a global public goods facility, for instance—might have to be redirected for rescue loans or for increased lending to countries suddenly facing liquidity constraints, as during the Asian financial crisis. But even in this case the key point is that while crises may lead to transitory deviations from the long-term strategy, the underlying priorities will not necessarily change.

If a crisis slows global growth and development for a much longer period, the core challenges are likely to become even more important. This is certainly true of poverty in Sub-Saharan Africa and in fragile states—most likely to be severely hurt in a persistent global slowdown. But this is also true of the poorest social groups in middle-income countries, and some global public goods will require even more urgent attention. In such circumstances demand for traditional World Bank Group services is likely to increase, leading to greater expansion along the traditional lines of business rather than through more extensive expansion by diversification, as proposed here.

managing rents from natural resources. For still others it is to generate the conditions for take-off. At the same time many issues are common to all: strengthening the business climate and the private sector (including progress on governance and anticorruption), dealing with communicable diseases (HIV/AIDS and malaria), managing shared resources, and working toward regional integration. The World Bank Group's role in Africa should also extend beyond its own programs to include working with partners to rationalize the complex aid architecture.

### *Fragile states*

Because of the difficulty of providing fragile states with effective assistance, these countries present a special challenge to the evolving model of aid. Even by 2015 and beyond more than half their people will still live on less than $1 a day. In fact, it is likely that, outside the large countries in South Asia, world poverty will concentrate in fragile states.

To improve development outcomes in fragile states, the development community needs to adapt the standard country-based model, which is often better suited to countries where basic institutions perform more or less satisfactorily. For fragile states the model must recognize the different conditions across countries and the intrinsic difficulties of engagement in the absence of basic institutions—in an uncertain and sometimes dangerous environment. Further developing this model would require coordinating a range of development partners, bypassing nonworking or corrupt institutions, addressing security, and changing the way that work on these countries is organized and prioritized within the World Bank Group. Doing all this is a high priority.

### *Inclusive global development: challenges in middle-income countries*

While making global development inclusive obviously requires progress in low-income, high-poverty countries, it also means ensuring that nobody is left behind elsewhere in the global economy. To reduce poverty in fast-growing countries, growth must be equitably shared. Slow-growing middle-income

countries must accelerate growth. And lower middle-income countries—including those transitioning from low-income status—must have easier access to international financial markets.

In 2015, and even in 2030, the vast majority of people living on $2 a day will live in China, India, and other IBRD countries. In some middle-income countries where widespread extreme poverty ($1 per day) has been largely eliminated, continuing focus on such specific "poverty" targets (whether $2 per day or some variant) may no longer seem relevant. But the fact remains that, despite fast growth, some lower middle-income countries among top growth performers will see large pockets of persistent deprivation. They may experience an increase in inequality, not only in income but also in access to services and opportunities, perpetuating wide disparities across generations. These trends will be accentuated by demographic pressures, geographic differentiation (driven by continuing urbanization and lagging rural areas) and decentralization, and rising skill premia. Technical change will continue to increase the importance of "second-generation" human development, including education quality and post-primary learning, for moving out of poverty.

Long-run trends suggest that middle-income countries may grow for some long periods at rates substantially lower than their potential and sometimes even lower than mean world income per capita or income per capita in rich countries. The poor and disadvantaged suffer most from such low performance. A possible explanation may be shortcomings in the business climate. Another is that many middle-income countries will continue to have only modest access to world capital markets. Financing infrastructure needs for growth will remain a major challenge for them and for their rapidly growing cities and lagging regions. Attention must thus be paid to countries graduating from low-income status. In these countries too growth must be equitably shared in the population to be economically and socially sustainable in the long run.

In all middle-income countries the long experience of the World Bank Group in supporting growth and equity-enhancing reforms within its two-pillar framework represents an important advantage for promoting inclusive global development.

### *Global and regional public goods*

The prospect of climate change has galvanized international attention on global environmental public goods. But other areas—including trade, finance, intellectual property rights, and potentially migration, communicable diseases, and shared water resources—are important determinants of national development performance in an interconnected world. Some areas require knowledge-based advocacy and coalition-building to ensure that the full range of developing countries' interests are taken into account.

Development knowledge is another major public good. It involves better understanding the mechanisms of development and development policies through monitoring country experiences around the world and collecting data to benchmark the policies or programs in a country. It also involves evaluating the implications of global public goods at country level—the consequences of global public goods for specific countries and the impact of country policies on global public goods.

Addressing certain global public goods at the country level will also require major investments, underpinned by suitable financing arrangements that provide resources and incentives for producing more global public goods. As a global financial institution combining a wide range of service capabilities, the World Bank Group is uniquely placed to play a key role in a number of areas. But for this promise to be realized, current efforts to articulate a framework must be followed by even more attention to establishing priorities and evaluating tradeoffs among global public goods to define the Group's role more clearly.

Should these global development priorities also be those of the World Bank Group? Yes. It is difficult to identify any one of them as irrelevant to the Group's future objectives. It is also difficult not to recognize that the Group has some comparative advantage in these areas. Yet there remain questions of the

relative emphasis or weight of these areas in the Group's future portfolio of activities and of its precise role in a given area. Only the second will be (briefly) considered below. Note that these priorities are described in terms of beneficiaries or objectives of development efforts, rather than sectoral fields of intervention. Each area of engagement includes numerous sectors such as infrastructure, agriculture, human development, energy production, governance, pensions, organization of the financial sector, and so on. The precise needs will be country or region specific, including consideration of the country-level implications of global priorities.

## Modes of intervention for the World Bank Group—some ways forward

Examined here are modes of intervention for addressing the four challenges identified above. While it would be possible—and to some extent almost natural—to consider priorities among different *sectoral* interventions, we do not do so at this juncture. Instead, as discussed in box 4.2, the choices among sectors will be determined largely by the relative emphasis placed on the four challenges. Concentrating more on fragile states and Africa might lead to expanded emphasis on infrastructure, while shifting more toward global public goods would suggest a different mix. For now it is perhaps most useful simply to emphasize that making sectoral choices will involve judgments and tradeoffs among priorities, and these can best be informed by the demands from the different client groups.

The possible modes of intervention point to the need for a hard look at the tradeoffs among the interests of the member groups of the World Bank Group cooperative—the OECD countries, with a traditional interest in maximizing transfers to IDA; the middle-income countries, facing the choice of how to finance their development and looking for specific knowledge in specific development areas; and the low-income countries, which stand to benefit from financial transfers, unless these simply displace other contributions to IDA, which is not unlikely. Low-income countries also benefit from continuing Group engagement with the middle-income countries as sources of experience and expertise. There is clearly a range of choice in evaluating these tradeoffs, but this has narrowed with the decline in the financial benefit of IBRD lending to middle-income countries, especially those at or approaching investment grade.

An important question for the cooperative is how such issues can be dealt with more transparently. Various approaches are possible—for example, creating a country-specific "entitlement" to a package of goods and services that can be customized, or offering members virtual dividends on their shareholdings in IFC and IBRD, which they can allocate in a variety of ways, including contributing to IDA.

The approaches discussed here concern the IBRD and IDA. Although IFC and MIGA are critical and growing arms of the World Bank Group, their activities raise fewer major strategic issues. The main challenge is to ensure (and show) that they provide additionality—not simply substituting for investments that would have been made anyhow—and strong developmental impact, in addition to adequate financial returns and an acceptable risk profile. IFC's recent strategy document points in this direction, emphasizing frontier clients, long-term partnerships, environmental and social sustainability, and attention to strengthening financial markets and overcoming constraints in infrastructure, health, and education.[47] Both IFC and MIGA are transitioning to do more in frontier countries, regions, and business segments, underpinning this change by moving staff and decisionmaking closer to clients. Under an aggressive plan these efforts to innovate products and services to keep pace with evolving market demand would continue. The Group's sharper focus on results requires evaluating the developmental contribution of both IFC and MIGA more precisely, building on efforts such as IFC's Development Outcome Tracking System (DOTS).

With the increased focus in the development community on the private sector, as discussed in chapter 2, the strong positioning

**Box 4.2 Managing the sectoral structure of interventions**

Does it make sense to establish sectoral priorities at the same time that modes of intervention to support a long-term strategy are being defined? While at first it might seem sensible to do so, on closer examination, the answer is mixed. Within each of the challenges identified, the sectoral themes will mostly be demand driven, leaving little room for planning or selectivity. But there may be themes or sectors where future demand is expected to be strong, calling for anticipatory investments in creating knowledge and expertise. Consider three groups of sectors: core sectors with strong demand by a large number of countries, emerging sectors likely to become core sectors, and other sectors where demand is less strong, less predictable, and more diverse.

***Core sectors.*** Many fields of intervention are common to many countries, even though activities may be quite different. Numerous interventions will be about transport, rural infrastructure, agriculture, health care provision, energy, education, and so on. Deepening engagement on the governance and anticorruption agenda also calls for expanded resources and expertise. The World Bank Group must have extensive and diversified capacity in these core sectors, shaped by the number and size of interventions. The importance of each sector will be determined by demand, and internal capacity will have to adjust at the margin depending on the evolution of demand. With existing capacity already above some minimal "critical mass," adjusting dynamically to changing demands should not be a problem.

***Emerging core sectors.*** In a few areas demand may now be limited but expected to grow fast in the future, so some capacity must be built to adequately respond to demand as it emerges. This may be the case for sectors linked to climate change. Anticipating that this may become an important line of business in the future, the World Bank Group may want to begin scaling up its capacity by investing in in-house research on mitigation strategies and by expanding the number of pilot projects and interventions for in-house experts to train and learn. Likewise, adaptation policies are likely to rely heavily on rural and agricultural policies and on technical innovation. Because of this expected increase in demand, it might be good to start scaling up the capacity of intervention in the agriculture sector, even though it is already a core sector.

But identifying emerging sectors and pushing for greater selectivity may not be simple. Take education, where the World Bank Group has more than 50 years of lending and analytic experience. One might expect demand for assistance for primary education to decline over time, particularly in middle-income countries, and demand for more specialized or advanced education loans to expand. But evidence suggests otherwise. Over the last two decades demand for primary education has been fairly stable (with a peak in the mid-1990s) at around 30–35 percent of total education lending (including middle-income countries), but demand for tertiary education has declined (from 35 percent to 15 percent), and general education—which may represent support to education systems or simply a residual—has expanded rapidly.

Setting priorities across sectors will thus require attention to several factors beyond comparative analysis of the quality of project outcomes. Fitting World Bank Group services to client demand requires flexibility in resource reallocation. Group capacity to respond to areas of sudden new demand will require maintaining requisite professional skills and response capacity. The Group's comparative advantage will need to be viewed against alternative and less costly sources of expertise. And Group governance and risk-sharing may also affect where client countries prefer to source services. Such filters need to be kept in mind as pressures to be more selective and identify the Group's comparative advantage move forward.

***Noncore sectors.*** There should also be limited in-house capacity in some noncore sectors where demand exists but is less frequent. Logically, capacity here should be lower priority, less specialized, and more reliant on external expertise to respond flexibly to fluctuations in demand. Interventions should be consistent with core objectives for each challenge, an issue that arises more for middle-income countries because of the diversity of their demand once most basic needs have been filled.

In some upper middle-income or fast-growing countries, inclusiveness is the goal—making sure that no social group or region is left behind in development. Many World Bank Group interventions in these countries are in areas where poverty can be reduced. But there are also areas where the link to inclusiveness is less obvious.

Whether specific interventions contribute to social inclusion and poverty reduction or have only an indirect impact for the poorest segments of society may require careful judgment—a difficult but necessary task.

Another criterion for building or retaining capacity in noncore sectors is the competitiveness of the World Bank Group and the existence of satisfactory substitutes in the market or in other multilateral institutions. Areas where the Group intervened 10 or 15 years ago have been dropped because competitors offer better services through economies of scope. In other areas the Group may be more competitive and in higher demand. A good example is advice on tax policy. The Group has given up interventions in general tax reform, in part because many consulting firms give excellent advice. But the Group retains capacity in mining taxation, because this complements its activities and advice in mining and in broader natural resources management.

* * *

In sum: the sectoral structure of interventions must be managed dynamically, with attention to demand. The issue in core sectors is not so much whether to be present but the relative importance to give each sector. That importance is likely to change, and the size of the in-house capacity must react dynamically but progressively to perceived changes in demand. For noncore activities demand should play a more decisive role. Sectors with low and declining demand, or demand that does not fit priority objectives, should be progressively abandoned and replaced by sectors where demand is more dynamic or more closely matches development priorities.

of the IFC and MIGA, and the investment climate operations within IDA and IBRD activities, the World Bank Group is particularly well positioned to contribute further to development of the private sector. This raises the issue of how best to align the Group focus on the private sector at the corporate level and subsequently at the regional and country levels. A stronger focus on private sector development is important to better and stronger synergy across the Group. The modalities for operationally enhancing these private sector activities are beyond the scope of this report but likely to be important in discussions going forward.

### *The status quo? No.*

If current trends continue, services to private clients would grow, while sovereign IBRD lending would decline further, particularly in large upper middle-income and fast-growing lower middle-income countries with better access to capital markets. True, this evolution could be reversed temporarily during crises. Less likely would be a persistent reversal due to a permanent change in the structure of the global economy. IDA may be sustained in real terms, at least until major clients graduate. But it would shrink as a share of total development assistance and might lose effectiveness as earmarked global programs grow and new donors, including private funds, provide a larger share of aid. A widening range of fee-based services would be provided. The World Bank Group would continue to undertake a modest range of regional and global activities while remaining mainly country driven.

Does the status quo permit the Group to satisfactorily meet the four challenges? In low-income countries the focus now is often more on the World Bank Group's own programs than on country-level progress and results or on the efficient mobilization of all development resources. Moreover, the increasing share of fragile states, without a better model for dealing with them, will make IDA less effective. Without a change in risk parameters, the risk-bearing capacity of IBRD capital is not fully engaged to address some of the priorities in middle-income countries. Externalities between finance and knowledge will be progressively lost as selective declining engagement in middle-income countries reduces the opportunities for learning and for sustaining a critical mass of development-related skills relevant for poor countries. This would further reduce the effectiveness of the Group. Another lost opportunity is that the Group would make little contribution to addressing the growing demand for regional and global public goods.

Thus, while the status quo is sustainable for some time and may permit some progress toward meeting these challenges, it is not an effective response to these priorities.

A range of adaptations and innovations can be envisioned that would allow greater progress. These extensions and innovations are not mutually exclusive, but may be combined in different ways as possible building blocks of a World Bank Group strategy.

- Leveraging IDA's funds and capacity.
- Renewing and expanding services in middle-income countries.
- Expanding delivery of global and regional public goods.

Whatever combination of building blocks is selected, it is essential to drastically cut the nonfinancial costs of doing business with the World Bank Group, often prohibitive for partner countries. This may require extending the certification and enhancing the use of country systems where possible. Elements of such an approach, under discussion for some time, need to be considered as a comprehensive package and linked to the emerging challenges.

### *Leveraging the funds and capacities of the International Development Association*

Progress in Africa and in fragile states—where low-income countries predominate—requires strengthening IDA. This would not be credible without core financial resources (in the first instance through a successful IDA–15 replenishment), strong knowledge capacity, and real progress by country programs supported by IDA. The World Bank Group has only limited control over financial resources but much more over knowledge capacity and country progress. IDA can also be strengthened through the efficient leveraging of other funds and intervention capacities.

The proliferation of earmarked trust funds, many set up by IDA donors, presents both competition to the country-based model and an opportunity. In leveraging, IDA would influence the global aid architecture, engaging with these donors and funds to maximize the use of these funds as harmonized cofinancing vehicles. This would require increasing the capacity to support core systems (especially in the social sectors), continuing to focus on strengthening country financial management, and monitoring results. Programs also need to encourage carefully evaluated experiments, including alternative delivery mechanisms, to improve the quality and effectiveness of service delivery from all funding sources. IDA would also leverage other funds to supplement its operational resources and rationalize lending and supervision, country analytic work, and technical assistance. To build capacity, an increasing part of this work would be done by local experts and institutions.

***In infrastructure.*** IDA needs flexibility to respond to country needs and to the activities of other donors even if it is not formally a "residual donor." In infrastructure the funding needs far outstrip the resources available from IDA and the few other donors active in the area. Where possible, IDA should combine growth in infrastructure lending and guarantees to private investors (including more investment between developing countries) with major projects implemented on a multicountry or regional basis, financed through an augmented regional IDA window.

To get greater leverage from the World Bank Group's resources, partial-risk and other guarantees would need to be streamlined into standard components of the menu of services offered to IDA, blend, and IBRD countries. An added aim of IBRD or IDA guarantees would be to extend the reach of guarantees, in size and risk, offered by other members of the Group, drawing on combined strengths and financial base.

***In the social sectors.*** Where many other donors are active, IDA might systematically engage with other sources of funds, enhancing convening, coordinating, and catalyzing activities. Coordination is demanded by the multiplication of donors and the channels for transferring their resources to a country. IDA's convening, coordinating, and catalyzing activities would be particularly important for increasing the efficiency of vertical funds and addressing their inability to deal with general factors that strongly influence their

main objectives but are distinct from them—general health system development to support focused HIV/AIDS programs, for instance.

Bringing consistency to the interventions of bilateral donors, new donors, vertical funds, and private foundations requires shared knowledge of country needs and plans in social sectors. This assumes that some strategy—internally consistent and consistent with other development objectives—has been established by the country, with expectations for what it can expect from all donors. The convening power of the World Bank Group should help in making donor decisions consistent with each other and with country strategies. The Group might also provide analytical help to countries in establishing their strategies in social sectors. Instead of pursuing its own programs and projects, it could leverage the intervention capacities of other donors to enhance aid effectiveness. Such a model already works in some countries. It should be extended to other countries and to more complex cases of aid architecture at the country level. Knowledge and expertise are the keys to success.

***In fragile states.*** Leveraging funds and capacity is more difficult and potentially less effective in fragile states. The problem is the absence of a reliable domestic administration that can use donor resources to implement development-oriented policies. These cases clearly need to be handled differently, with simpler and clearer conditionality or more direct monitoring, carefully providing support to weak institutions while ensuring that aid resources are used appropriately. Possible solutions might be to enhance oversight mechanisms in critical areas. Such efforts could include government representatives, local nongovernmental organizations and civil society, and donor representatives closely monitoring the use of the funds, with the World Bank Group in some cases taking the lead in organization and management.

### *Renewing and expanding services in middle-income countries*

The World Bank Group can address the challenge of inclusive global development in middle-income countries only if the volume of its services remains above some threshold. One way of reversing the current contraction is to make IBRD services more flexible, more attractive from both financial and knowledge perspectives, and more adapted to the development objectives in these countries.

***Unbundling finance and knowledge services.*** Services are already being unbundled for some middle-income countries offering rigorous management guarantees. Expanding it might be an option. The idea is that unbundling traditional services should permit the delivery of "bare bones" financial services that could be priced to pass on to members the maximum value from IBRD's AAA status. Knowledge, analytical, and other services above an entitlement set by the country's share of the administrative budget and possibly of trust funds would be funded by fees. Management services could be offered on a fee basis for development projects that others fund.

Several elements of this model, including fee-based knowledge services, are essential to any efforts to make the menu of services offered to middle-income countries more flexible. Offering separate services in response to client diversity is important, particularly for knowledge services in areas where the World Bank Group has some comparative advantage. But implementing this model too extensively or exclusively could make it difficult for the Group to maintain its comparative advantages and contribute effectively to its development objectives.

There are three risks in extending this business model too far. First, doing so would impede the way that the World Bank Group builds expertise through cross-country and cross-activity externalities and through combined financial, managerial, and technical engagements. And greater reliance on fee-for-service could mean that countries, having paid directly for advice, would consider this proprietary information and resist sharing with others unless contractual obligations are introduced stipulating that such advice is public.

Second, the developmental value of more flexible financial services, in marginally lower spreads and increased lending, may be modest.

That value is essentially the difference between the spread offered by commercial lenders on the international credit market and that offered by the IBRD. Commercial spreads are low for middle-income countries expected to respond most strongly to lower IBRD prices—that is, the low commercial spread is one possible explanation for shrinking IBRD lending in those countries. If these spreads remain low, the development value of substituting for commercial loans will be limited.

Third, resources from the IBRD should be used for the objective of inclusive global development. Pure financial services with little or no monitoring of the use of the loans may be justified in countries offering sufficient institutional guarantees, but extending the model too far in other countries would increase the risk that resources would be misused.

Rather than unbundling services, another approach would be enhancing the present model of World Bank Group finance and knowledge intervention, taking into account the changing context. The goal would be to provide a full menu of innovative, flexible, and custom financial services while jointly offering knowledge products adapted to these innovations. The necessary first step in this approach is improving knowledge wherever possible and offering the best international expertise in all intervention areas. This knowledge aspect is dealt with in the next section. More financially related lines of expansion are discussed here.

***Easing access to the IBRD.*** Both the possible drop in demand from upper middle-income countries and strong growth performers and the goal of inclusive global development point to the importance of reaching out more to lower middle-income countries. Greater reliance on country systems can help reduce the nonfinancial costs of doing business with IBRD and increase competitiveness. The rules governing access to IBRD lending could be eased, including those for countries graduating from IDA–only status. Risk parameters could be modified to permit more exposure to lower middle-income and slow-growing countries, as well as to IDA graduates. Pricing rules could also be reexamined in conjunction with risk parameters to optimize the developmental value of IBRD lending. New blending arrangements could be envisaged for IDA and the IBRD, possibly extending the income cutoff for blended finance to support programs with global externalities or to provide "challenge funds" to encourage programs in areas of severe and persistent deprivation in lower middle-income countries. And there may well be opportunities for greater use of IBRD resources even in IDA countries—for example, to finance infrastructure projects that are viable at IBRD rates but unlikely to be undertaken with IDA resources because of their size.

***Subsovereign lending.*** The promise of subsovereign lending lies largely in its potential to mobilize financing that can promote more inclusive development, especially in middle-income countries. Even where rapid growth has reduced or nearly eliminated absolute poverty, some regions lag behind the leading economic centers. While these subnational areas may have economic and social indicators as poor as those for low-income countries receiving aid, political-economy considerations—difficult administrative or political relationships—combined with resource constraints can prevent them from receiving the attention they deserve.

The appropriate blend of IBRD lending, IFC investments, and knowledge services may provide the needed boost to permit these regions to start narrowing the gap with the rest of the economy. Consideration could be given to allowing subnational entities to borrow directly from the IBRD without sovereign guarantees, as some already do from the IFC. This may require revisiting the IBRD Articles of Agreement and might involve a new IBRD window with different pricing structures, loan maturities, and risk parameters—or alternatively, mechanisms to use IBRD capital for existing instruments if warranted by demand. In some areas (for example, infrastructure in Africa) there is an equivalent need to adapt and develop instruments to address supranational (regional) demands as well.

***Contingent financing and insurance.*** Instruments should also be developed to provide contingent finance against a range of shocks and to create some headroom for post-crisis assistance. Especially considering the likelihood of

increasing climatic instability, the World Bank Group could work toward a wider multilateral disaster guarantee facility, modeled perhaps on the Caribbean Catastrophe Risk Insurance Facility or on weather-contingent crop insurance programs. Product innovation should move away from individual lending targets and toward wider financial engagement and leveraging, based on the balance sheets and capabilities of all arms of the World Bank Group.

These enhancements and innovations would increase the relevance of the World Bank Group in middle-income countries, particularly those below investment grade. They would also extend the Group's ability to engage a range of new clients, including subnational ones. And they would sustain the global nature of the cooperative and the engagement of middle-income countries in many areas important for low-income countries.

### *Expanding the delivery of global and regional public goods*

The World Bank Group's current mode of operation does not capitalize sufficiently on one of the Group's greatest comparative advantages in contributing to the global public goods area—its ability to link issues of global importance to action in widely differing country circumstances.

The *Global Public Goods* report notes that there are important opportunities for the World Bank Group to enhance its contributions to this agenda.[48] As primarily a country-focused development institution, for the Group the key will be its ability to work consensually with partner countries at the intersection of national development priorities and global challenges. Country knowledge, but also extensive involvement in global issues, offers the Group a broad knowledge base to draw on. The Group must work with member countries to find innovative solutions to issues for which national benefits are not sufficient for taking action. Strategies for international collective action will have to reflect governments' perspectives on national priorities.

For the World Bank Group to be effective, global public goods programs must be widely endorsed, not seen as priorities of a particular set of countries, and supportive of development efforts rather than diverting attention from them. From the range of global public goods, four broad areas would seem to meet these criteria:

- Ensuring that global frameworks support the interests of developing countries—in trade, financial flows, intellectual property rights, international governance, and potentially in migration.
- Sustaining the environment—including the energy-climate link, depletion of forests, and protection of oceans.
- Combating communicable disease—with a focus on strengthening health systems.
- Creating and disseminating development knowledge—deriving lessons from experience (including rigorous impact evaluations), strengthening the availability of good data, and renewing the emphasis on science and technology.

The World Bank Group would also engage more on a range of regional public goods (particularly management of shared water resources and joint infrastructure), especially where it can complement regional development banks with expertise and financing.

Concessional resources or other incentives will be needed to encourage countries to address certain public goods, notably the reduction of greenhouse gas emissions.[49] The World Bank Group has demonstrated a capacity for financial innovation—carbon funds, the International Finance Facility for Immunisation (IFFIm), and ongoing preparations for the Advance Market Commitment pilot are important achievements. Specialized health funds, carbon finance, the Global Environment Facility, and grant funding from bilateral sources show the potential for blending (including from nonofficial sources) between grant funding and IBRD and IDA loans and credits. Such subsidies could be expanded to address situations where global benefits significantly exceed national benefits. The Clean Energy Investment Framework provides a sound policy basis for mobilizing new resources

for climate change–related activities, both mitigation and adaptation. By combining funding sources, including IDA, IFC, MIGA, and carbon finance, the World Bank Group should be able to leverage additional private sector funding, particularly for emerging economies with growing financing needs for infrastructure and forestry management. Limited use of IBRD net income also could be considered for specific global public goods objectives. But the Group cannot finance such initiatives on its own, and new funding sources and instruments should be mobilized only when a clear objective and funding gap has been identified.

### *Operational implications*

Any substantial changes in the blend of activities undertaken in response to the challenges ahead would have obvious ramifications for the World Bank Group's operations. The purpose of this report is to provide an analytical framework for considering strategic choices, rather than considering detailed operational alternatives of changing modes of intervention. But it is useful to identify two broad areas where there will be important issues to consider.

At a *corporate* level important issues are related to how different parts of the World Bank Group interact, especially whether the current structure and modes of operation—with largely separate functioning arms, distinct income streams and country offices—are optimal over the long term. Would the Group have its current structure if it were recreated today? Is the current deployment of the Group's capital conducive to efforts to address the challenges ahead? Under what circumstances should net resource/income transfers be made among different arms? As the Group looks forward, these questions are pressing because of the need to balance the perspectives and priorities of the members of the cooperative.

From an *organizational* perspective the emphasis given to each of these responses will affect how the World Bank Group is organized and how resources are allocated. Greater attention to the challenge of promoting African development would likely shift resources away from other regions. An expanded agenda on fragile states would involve greater efforts on donor coordination and likely require engaging more staff in these difficult environments, with implications for the Group's decentralization efforts and for its staffing and incentive structure. Expanding efforts to deliver innovative financial and knowledge services to middle-income countries would necessitate further efforts to encourage the development and marketing of innovative financial products, as well as the capacity to deliver—either directly or through the use of external expertise—world-class expertise and policy advice. Similarly, increasing the Group's capacity to deliver financial resources and expertise in select global public goods areas would call for considerable expansion of technical expertise in specific areas (climate change, clean energy investments, water resource management) and more extensive collaborative efforts with other agencies working in the same areas.

While illustrative only, this list suggests the breadth of changes that must be considered as a long-term strategy is further defined and implemented. Of course a great deal will depend on the environment in which changes are made: if change is associated with an expanding World Bank Group engagement in developing countries, finding the resources needed to achieve these initiatives will be much easier than if reallocation must occur in a static or shrinking context.

## Enhancing knowledge and learning activity

Whatever the mix of building blocks chosen for acting most effectively and regardless of the relative weight given to the areas selected, the World Bank Group will have to enhance its role as a knowledge bank. Through research, data work, and operational experience the Group has always been prominent in setting the development agenda. It is by no means the only focal point for new thinking. But none of the modes of activity outlined here can be successful if the Group abdicates its knowledge role and loses the capacity to add value to the development efforts of its members, especially with its financial value-added likely to erode for many sovereign borrowers and for first-tier private clients. To enhance its knowledge role,

the Group must retain the capacity to learn from the experience of its members and from its programs in those countries.

First, the World Bank Group must develop new knowledge in the many areas where understanding of basic mechanisms in development policy is unsatisfactory. This is mostly the task of research. Second, existing knowledge must be put to work in the various areas and modes of intervention. This is the role of expertise. Third, the experience derived from these applications must feed into both research and expertise. This is where learning comes into play, with the potential for a dynamic comparative advantage in an institution where all these activities take place simultaneously.

### *Research priorities*

It is always risky to try to pinpoint future knowledge priorities, but the challenges identified here suggest some broad directions. One is to better understand the context specificity of how policies affect development outcomes. This requires gathering and analyzing evidence on country approaches and experiences in addressing a range of development objectives, combining observations in low- and middle-income countries. A second priority is to examine how governance and institutions generate inefficient policy decisions or implementation and how they can be reformed—an agenda particularly important for fragile states. A third priority is to learn more about how global and regional public goods affect the long-run development of particular countries, and vice versa. A fourth area is to strengthen data gathering. Statistical systems, country and sector performance benchmarks, open information, and impact evaluations can increase cross-country learning from development initiatives, all indispensable for promoting development policy effectiveness. The World Bank Group has played an important convening, coordinating, and catalyzing role. That role must be enhanced.

### *Strengthening core expertise*

To sustain the World Bank Group's knowledge role, the Group must maintain and strengthen its high-level technical expertise. Core groups of experts on key topics must be retained in-house (including those for cross-sectoral and systemic issues). Top expertise can also be sourced as consultants, but this is not an exclusive solution, since external expertise cannot be effectively used without internal expertise to absorb it and adapt it to context. The Group must remain competitive for highly skilled staff in the long run, taking into account the rising global competition for skills. This need for critical mass in core areas is another reason to take a long-run view, set priorities, and develop skill profiles accordingly.

The World Bank Group's knowledge role in middle-income countries also bears on the types of skills needed. In some areas this may involve a knowledge-broker role, helping countries link with external networks and adapt knowledge to their particular conditions. This requires maintaining top-class knowledge capabilities with a wide and integrative perspective—if not necessarily the most specialized knowledge on all topics. The Group must maintain a critical mass of experience for problems common to many countries. It cannot do so in every knowledge area.

### *Strengthening global learning*

The dynamic comparative advantage of the World Bank Group is closely linked to its capacity to manage the cycle of lending, learning, and knowledge. It lends to a country or intervenes in some other way, accumulating knowledge thanks to the learning from direct operational involvement. Too often learning opportunities have been lost because of inadequate incentives to produce the global public good created by rigorous and comparative evaluations of country-level programs or policies. Efforts such as the Development Impact Evaluation initiative, which encourage coordinated country-level programs to derive global public knowledge in specific fields of development intervention, need to be expanded and institutionalized. This implies a change in the way projects and programs are typically evaluated, to focus on impact rather than mainly on implementation. The same effort should take place in other development institutions and within countries. In this domain, too, the

Group has an important convening, coordinating, and catalyzing role.

The World Bank Group's demonstrated knowledge advantage is in operations, including projects, finance, trust funds, and risk management. To continue to play a major integrative role in the global development architecture, the Group can draw on first-mover advantages in many areas. But it will need to work continually to sustain and enhance its effectiveness at the frontier of operational knowledge.

### *Measuring long-term progress—the need for self-evaluation*

In knowledge services the emphasis has been on building capacity for more systematic evaluation of country experiences, with or without direct involvement of the World Bank Group, to learn what works, what does not, and why. The need for evaluation applies to the Group too. Most strategic decisions would be easier if they could rely on some estimate, even if rough, of the developmental contribution of various activities of the Group. For instance, better integration of the balance sheets and net incomes of the arms of the Group requires information about whether a dollar of capital has a higher value in some specific use. Self-evaluation is also important in the relationship between the Group and the international development community, allowing wider recognition of its comparative advantages and furthering its convening, coordinating, and catalyzing role.

The Independent Evaluation Group provides an indispensable contribution to this self-evaluation through a regular flow of reports examining different aspects of the World Bank Group's activities—assistance to middle-income countries, regional programs, fragile states, and sectoral and country programs, to name a few. Its reports are carefully read by Group staff and shareholders and by the international development community. And there are other units within the Group responsible for assessing various dimensions of performance, suggesting the possible need for better coordination and perhaps some rationalization of these efforts, to ensure that they are well-aligned with the results agenda.

But the challenge goes beyond these activities to a need to better measure the relative *developmental* contributions of the various activities that the World Bank Group pursues. To be sure, the methodological challenge for measuring these contributions is formidable. It involves evaluating the outcomes of Group interventions—already considerably more difficult than evaluating outputs, as is most often done—and assessing the additionality of these interventions, which requires identifying a counterfactual, or what would have happened without the interventions.

Simpler, less rigorous measures of progress toward possible new objectives may rely on indicators giving information about whether results intended with a specific strategy are being reached. These indicators should depend on the long-term strategy being pursued. The analysis here suggests some general indicators to measure how the World Bank Group might perform on various strategic directions.

- Financial and technical support to the private sector, weight of "frontier" and "second-tier" clients, degree of financial leverage, improved indicators for development impact.
- Use of IBRD financial capacity, including share of funding supporting equitable development in lower middle-income and slower growing clients.
- IDA disbursements and better indicators of development effectiveness, with an emphasis on fragile states.
- Measure of the Group's convening, coordinating, and catalyzing achievements, notably in IDA countries and fragile states, including partnerships with vertical funds.
- Flexibility of country analytical work and technical assistance, as well as the range of specialized financial services; extent of reliance on "market tests" for analytical work and technical assistance to ensure client value.
- Clarity of priority setting for intensive engagement in global and regional public goods; measure of the effectiveness of mechanisms to encourage

country-level engagement with national authorities.

- Targeted funding mobilized for specific global public goods priorities, such as clean energy and adaptation to climate change.
- Intensity of the lending, learning, and knowledge cycle to ensure maximum learning from operational engagements and a systematic focus on results.
- Existence of critical knowledge mass in selected areas, as well as results on gathering and analyzing data and statistics; quality of development outcome monitoring and effectiveness of performance-based programs.

# Epilogue

Development is—and will continue to be—a long-term priority for the global community. Even under a favorable scenario of rapid and sustained progress, the challenge of reducing global poverty and exclusion will persist for decades. At the same time, if global development is to be sustainable and inclusive, there is an urgent need to address the emerging global and regional public goods agenda within a framework that recognizes and complements country-level efforts to raise living standards.

This report provides a vision of the likely evolution of the world economy and offers a synthesis of recent thinking and consensus on development strategies, policies, and programs. It also lays out some preliminary thoughts on how these perspectives might shape the long-run evolution of the World Bank Group, with full awareness that this exercise provides only a starting point in a much longer process of moving the Group into the future to enhance its contribution to development.

But this is not just about renewal for the World Bank Group. The issues raised are critical for the entire development community. To maximize progress, these efforts must be part of a wider process involving the full spectrum of development partners—other development banks and multilateral agencies, bilateral donors, foundations, and recipient countries—that will ensure that each organization can contribute according to its comparative advantage.

# Notes

1. In its projections this Long-term Strategic Exercise relies on a conservative baseline scenario. While making more optimistic or more pessimistic assumptions would change the projected severity of various factors, doing so does not affect the direction of the main priorities.
2. Report of the External Review Committee on Bank–Fund Collaboration (2007).
3. Of the countries categorized as LICUS today, 80 percent had the same status 20 years ago. That is why it is implicitly assumed in the projections that today's fragile states will remain so in the next 10 to 20 years. Some countries will get out of this category while others get in.
4. These techniques use very long historic time series on growth, to which the International Monetary Fund's medium-term forecast has been spliced to project growth through 2015. Between 2015 and 2030 the estimate is based on constant productivity improvement and savings and investment behavior. In both periods growth expectations do not incorporate major shocks, such as natural disasters or regional conflicts. Nor do they reflect major breaks with current trends—either positive or negative.
5. The population numbers in this section refer to the end-of-period population, not initial population.
6. The historical poverty estimates are from World Bank (2007d).
7. These projections are based on a rather low estimate of the long-run growth rate of per capita consumption in Sub-Saharan Africa (1.6 percent). The rate of growth has been twice that in the last five years for the whole region. The data in table 1.2 may thus have to be interpreted as at the upper end of the range of projected poverty in that region.
8. UNDESA (2006).
9. Details are from World Bank (2006f).
10. There are some outliers. For example, the Russian Federation and some other former Soviet states have sharply falling birth rates, aging populations, and declining life expectancies.
11. UNDESA (2005).
12. Gill and Kharas (2007).
13. World Bank (2007d).
14. Examples are taken from World Bank (2007d)
15. This section takes much from World Bank (2007c).
16. World Bank (2007d).
17. See Camdessus (2003) and Comprehensive Assessment of Water Management in Agriculture (2007).
18. This section draws on Bourguignon and Wolfensohn (2004).
19. Chenery and others (1974).
20. This term was coined by John Williamson in articles published in the late 1980s. See Williamson (1990).
21. This section borrows from Bourguignon and Wolfensohn (2004).
22. Fleisig and de la Peña (2003).
23. World Bank (2001a, b).
24. Stern, Dethier, and Rogers (2005).
25. The comprehensive development framework aimed to provide a framework describing adequately the complex and multiple interactions within the development process and bringing strategy into alignment with four elements: long-term vision, country ownership, development partnerships, and development results.
26. This section draws on Bourguignon and Sundberg (2007).
27. After the first review in 1986, "Structural Adjustment Lending: A First Review of Experience," (World Bank 1986) three additional large-scale reviews were undertaken in 1990, 1992, and 2001. The World Bank Group also published a related "Review of Bank Conditionality" in 2005 (World Bank 2005e) and a report on good practice in applying conditionality in 2006 (World Bank 2006).
28. IDA is still the most selective institution among development agencies—far more selective than bilateral aid agencies (see World Bank 2007d).
29. Paradoxically, conditionality has recently been increasing with the greater earmarking of aid, for example, for HIV/AIDS or primary education.
30. On evaluation methodologies in income distribution, see Bourguignon and Pereira da Silva (2003).
31. This is the approach of the World Bank's Development Impact Evaluation initiative.
32. For a general discussion of impact evaluation and development, see Duflo (2004) or Banerjee (2006). The Center for Global Development, along with a consortium of donors and agencies including the World Bank, has initiated an effort to promote and strengthen measurement of the impact of development programs on individuals and communities,

provisionally titled the International Initiative for Impact Evaluation (see www.cgdev.org/content/publications/detail/7973).

33. Pearson (1969).
34. Chenery and others (1974).
35. For a description of the Group's programs and role, see World Bank (forthcoming).
36. The mix of expenditure differs surprisingly little across country categories, although some differences exist. Lending services to core IDA clients, for example, constitute a slightly larger share of the administrative budget than lending services to LICUS, many of which receive little or no financing.
37. The net present value of lending and supervision costs is higher for larger loans, but does not vary much with loan size given the type of operation. Large loans are therefore more profitable than small ones.
38. The deflator is the U.S. Consumer Price Index. To the extent that the dollar has depreciated in real terms, this understates the price correction and overstates the growth in real aggregates.
39. The distribution of total official development assistance (ODA) across the country client groups is broadly similar to IDA, except that core and investment-grade IBRD countries receive abut 15 percent of total ODA while the share of China, India, and other blend countries is lower, at 15 percent. LICUS's shares are comparable to their shares in IDA.
40. IFC's frontier clients' share in its total business would increase to around 50 percent, considering frontier regions in other countries.
41. For a review of experience with guarantees, see Annex 1 in World Bank, Quality Assurance Group (2006).
42. Summers (2007).
43. See Banerjee and others (2006).
44. Deininger, Squire, and Basu (1998).
45. World Bank, Independent Evaluation Group (2007d).
46. World Bank (forthcoming).
47. IFC (2007a).
48. World Bank (forthcoming).
49. Without additional resources, any limitation on the increment of greenhouse-gas emissions within a country, whether through emission permit trading or through domestic taxes, would inevitably reduce its potential growth rate.

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