

Corporate
Evaluation
Study

The Asian Development Bank's Engagement with Middle- Income Countries



Independent
Evaluation 

Raising development impact through evaluation

Corporate Evaluation
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Abbreviations

ADB	– Asian Development Bank
ADF	– Asian Development Fund
ASEAN	– Association of Southeast Asian Nations
CAPE	– country assistance program evaluation
CAREC	– Central Asia Regional Economic Cooperation
CPS	– country partnership strategy
CPSFRV	– country partnership strategy final review validation
DMC	– developing member country
EBRD	– European Bank for Reconstruction and Development
EIB	– European Investment Bank
GDP	– gross domestic product
GMS	– Greater Mekong Subregion
GNI	– gross national income
HIC	– high-income country
IADB	– Inter-American Development Bank
IBRD	– International Bank for Reconstruction and Development
IDA	– International Development Agency
IED	– Independent Evaluation Department
IFC	– International Finance Corporation
LIC	– low-income country
LMIC	– lower middle-income country
MDB	– multilateral development bank
MIC	– middle-income country
MTR	– midterm review
OECD	– Organisation for Economic Co-operation and Development
PPP	– public–private partnership
PRC	– People’s Republic of China
PSM	– public sector management
PVR	– project validation report
RBL	– results-based loan
RCI	– regional cooperation and integration
SDG	– Sustainable Development Goals
SMEs	– small and medium-sized enterprises
SOE	– state-owned enterprise
SPD	– Strategy and Policy Department
TA	– technical assistance
TFP	– total factor productivity
UMIC	– upper middle-income country
WBG	– World Bank Group
XVR	– Extended Annual Review Report Validation

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Foreword

The Asia and Pacific region has witnessed rising prosperity in the past half century. Many countries are now in the middle-income category, an increasing number are now upper middle-income countries, and some have marched on to join the OECD, a grouping of rich nations.

Yet the region continues to house half the world's poor, mostly in the lower middle-income economies, while the middle-class has grown rapidly, and its rising aspirations pose more development challenges. Some of these challenges have come with rapid growth and ambitious development plans that have led to chaotic urban conglomerations, degraded physical environments and fiscal imbalances that have raised the question of sustainability. The difficulty in further raising total factor productivity have surfaced in many countries as they go about diversifying and striving to design and implement complementary policies in the areas of education, social and physical infrastructure, access to finance and opportunities, and innovation. Increasing interconnectedness, climate change and the prospects of game changing developments also pose a whole new set of development challenges.

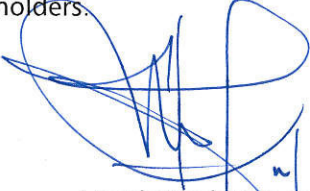
At the same time, the private sector is recognizing that in the medium term, its profitability and prosperity objectives should be pursued in harmony with social responsibility and environmental sustainability. And the ambitions and plans for South-South cooperation of some middle-income countries have opened the doors for ADB and other multilaterals to further their convening powers.

The raison d'être for the development community, including ADB, is becoming increasingly clear: to not let development challenges of client countries accumulate and not let events and circumstances undo their progress in tackling those challenges. That is precisely what the 2030 Global Development Agenda seeks to accomplish—and the entry into force of the Paris Agreement to combat climate change on 4 November 2016 is a serious step forward in operationalizing some of those sustainability goals.

Equally clear is the fact that large development programs, worth trillions of dollars, would be required for addressing the development challenges and realizing these sustainability goals.

The international development community is in the process of redefining its role in these emerging circumstances, where abject poverty will remain an important but not the only concern for an increasing number of countries, where some useful experience has already been gained worldwide in tackling poverty in all its dimensions (including attention to public goods), and where much benefit will be derived from sharing this experience.

This is precisely the current challenge for ADB: to redefine its relationships with a set of client countries that have prospered dramatically, in part as a reflection of ADB's good work, and remain open to effectively supporting their development no matter what their income levels are. We trust that the present assessment will contribute to the stock of knowledge and the analytical process that Board, Management and operational staff need to engage in at this juncture, in order to make the best choices for the future of the institution and its stakeholders.



Marvin Taylor-Dormond
Director General
Independent Evaluation

Executive Summary

This evaluation of the Asian Development Bank's (ADB's) engagement with middle-income countries (MICs) takes place against the backdrop of their rising numbers in Asia and the Pacific. In 2015, 37 of the 40 ADB member countries where ADB has operations belonged to the MIC category and 13 of these were upper middle-income countries (UMICs).

MICs in Asia and the Pacific face several evolving development challenges, including poverty, inequality, unplanned urbanization, environmental degradation and climate change, low productivity and lack of competitiveness, macroeconomic instability, and insufficient economic diversification. At the same time, these MICs have displayed dynamism that has created new opportunities. For ADB to engage with MICs effectively, it is critical that it understands these rapidly evolving challenges and opportunities. Examining ADB's actions at the corporate, country, and project levels, IED finds that ADB has been responsive to MICs but that there is room for improvement. As engagement with MICs is embodied in the ADB corporate strategy, ADB's graduation policy may need to be rethought. While country programs in MICs were generally successful, a recurring message from evaluations is the need to orient country programs to address the specific and new nature of their development challenges; this was reaffirmed through stakeholder consultations in many client MICs. Project performance raises concerns about efficiency and sustainability. Given the growing number of MICs, and the rapidly growing group of UMICs, ADB needs to make some strategic policy choices. These choices have to do with anchoring financial interventions on knowledge solutions, scaling up operations while also targeting the new challenges of this clientele, decisively supporting private sector and public-private partnerships, and revisiting the policy of graduating countries from regular support.

Evolving Development Challenges and Opportunities

The sharp rise in the number of ADB's middle-income countries (MICs) and upper middle-income countries (UMICs) underscores the dynamism of the Asia and Pacific region. Many MICs are increasingly plugged into regional and global economies and have access to finance from a number of sources. The external environment has become increasingly important to them, and their growing economic muscle has led to stronger regional integration, South-South cooperation, and mobilization of international resources for development, including through the creation of new multilateral banks. While this dynamism has paved the way for new opportunities for their peoples, these MICs continue to face several development challenges.

Although MICs in the Asia and the Pacific region have made significant progress in reducing extreme poverty since the early

1990s, they are still home to about half of the world's poor. Many MICs have significant pockets of poverty, and even where people have been lifted out of extreme poverty they continue to live in fragile conditions and can slip back into poverty.

Lower middle-income countries (LMICs) continue to have large numbers of extremely poor people, accounting for 40% of the world's poor. They are mostly in South Asia, but also in the LMICs of Southeast Asia and Central and West Asia. The UMICs have been more successful in reducing poverty; in this category, only the People's Republic of China (the PRC) now has significant numbers of poor despite its exceptional success in reducing poverty since the turn of the century. The difference in poverty incidence between these two sub-categories of MICs is a clear distinction between them.

MICs face a specific range of development challenges. These call for sophisticated and complex approaches to solving them.

- Some challenges are a result of economic growth, such as problems associated with rapid and unplanned urbanization (leading to congested roads and inadequate sanitation facilities, with consequences for human health) and insufficient attention to the preservation of natural capital and the physical environment. Per-capita CO₂ emissions have increased rapidly in UMICs since the early 2000s.
- Some challenges are associated with the need to continue improving productivity to sustain economic growth, when opportunities for easy productivity gains have been exhausted.
- On the macroeconomic front, stability has become a challenge, as is manifested by fiscal and current account deficits in several MICs. These reflect difficulties in adjusting monetary and fiscal policies, and undertaking structural reforms.
- Attaining economic diversification is also critical for MICs—particularly those that rely on one or a few export markets and/or one or a few industries or sectors.
- MICs are facing newer challenges that come from better connectedness and integration in global trade and financial systems, game-changing developments, and climate change.

The evolving needs and challenges of MICs are receiving growing attention from major international development agencies. These agencies recognize that the fight against poverty in MICs is not over, but that a more tailored approach to individual countries is needed to address their specific development constraints. The key is to tailor, adapt and develop new products and services that respond to the clients' new needs and emerging challenges and risks. The World Bank Group (WBG), Inter-American Development Bank (IADB), European Bank for Reconstruction and Development (EBRD), and

UN agencies are continuing to carry out research and make decisions on the challenges MICs face in sustaining their growth rates, and on the specific mix of development products and services they now require. This is likely to result in a wider portfolio of instruments and new lending products, and injecting more knowledge into product solutions. Stronger partnerships with institutions, private investors, and other stakeholders will be needed, and interventions that break away from the single sector mold will need to be designed. A change in the culture and mindset of international organizations will be required to promote learning, sharper knowledge-based engagements, and stronger internal coordination.

Lessons from ADB's Involvement in Middle-Income Countries

ADB's responsiveness at the corporate, country, and project level can improve. At the corporate level, Strategy 2020 and its midterm review (MTR) are quite clear on ADB's role in supporting MICs, and they provide the necessary guidance and mandate to engage with MICs. Strategy 2020 recognized that ADB has to engage with MICs to realize its vision of a region free of poverty, and the MTR advocated a differentiated engagement with MICs. However, ADB's graduation policy of 1998 (and its 2008 review) is not flexible enough to account for new development challenges and the new business environment for ADB—and ADB has acknowledged a need to revisit the graduation policy.

Country partnership strategies can be better reoriented to address the MICs' specific development challenges. At the country level, the country partnership strategies (CPSs) and country programs have success rates of more than 70%. However, a recurring message from the evaluation is the need for a greater thematic orientation to address the new development challenges. This was reaffirmed through consultations with stakeholders in many client MICs, which expect more knowledge-intensive support from ADB and greater value-added knowledge.

MIC stakeholders value their engagement with ADB and expect greater support for addressing their development challenges. MIC stakeholders value ADB's guidance and inputs in project design and project management, capacity development, the "seal of approval" associated with a private sector project that ADB supports, and ADB's convening powers in fostering regional cooperation and integration. They expect ADB to enable them to address their development challenges, such as improving governance, implementing structural reforms, increasing productivity, catalyzing the private sector in priority development areas, and expanding social and physical infrastructure. In so doing, they also expect, among others, more ADB support for subnational governments, public-private partnership projects, and financing in local currency.

The MIC portfolio continues to grow, indicating that MICs continue to demand ADB support. Overall, the volume of approvals allocated to MICs more than quadrupled from \$3.5 billion in 2006 to \$15.8 in 2015. Infrastructure dominated the allocation in both LMICs and UMICs in country portfolios, and accounted for more than 60% in UMICs and LMICs. The share of social sector projects has become significant in LMICs, which also account for a higher share of ADB's public sector management (PSM) support. Infrastructure also dominated in ADB's regional cooperation and integration (RCI) support programs, accounting for about 70% of these programs for both LMICs and UMICs.

Sovereign projects have had higher success rates in UMICs, while nonsovereign operations have better success rates in LMICs. IED rated about two-thirds of projects in LMICs *successful* or *highly successful*, compared with 90% in UMICs. A significant number of projects in LMICs tend to have concerns about implementation efficiency and/or sustainability. Projects in UMICs perform relatively well across all criteria, and demonstrate strong ownership and capacity from ADB counterparts. In nonsovereign operations, projects in LMICs have better ratings than those in UMICs. It is noteworthy that more projects in LMICs show better

development results and more profitability than those in UMICs.

Alternatives for Strategies, Policies, and Initiatives

ADB needs to provide stronger value addition and strategically orient its support to MICs in the coming years to remain relevant. Given that the economic strength of ADB's clientele has increased rapidly since the early 2000's, the relative significance of ADB operations (in US dollar terms) has diminished since peak of the late 1990s. ADB operations are now about 0.2% of the combined GDP of its client MICs, and excluding the PRC, about 0.5%. This in part is a reflection of the success of ADB work. Now a more strategic intervention (in mobilizing resources from others, in designing well targeted transformational engagements) is called for.

ADB needs to make some strategic policy choices to enable it to respond better to the evolving needs of its MIC clients. These choices are concerned with knowledge being an anchor for its financial interventions; interventions being scaled up using a mix of ADB's own resources and leveraging of funds from other sources; targeting the new development issues, including ensuring sustainable economic growth and meeting the aspirations of a growing middle class; decisively supporting private sector and PPP; revisiting the graduation policy; and taking suitable strategic initiatives to meet client needs.

ADB has the opportunity to anchor financing on knowledge and launch a business model that places learning and innovation at the center and increases the knowledge intensity of its operations. It is likely that ADB's continued relevance in MICs in the medium-term will come from the extent to which it supports national governments, subnational governments, the private sector, and other nonsovereign clients on the basis of: (i) analysis and unpacking of their key development and business challenges; and (ii) application of best international practices and learning from the experience of other countries and private sector agents (in the

region and beyond). The knowledge may be embedded in ADB interventions or separate and complementary to its operations. This does not mean that knowledge would be the main service provided by the organization. ADB is a bank and that is the nature of its business; we refer to the need to increase the value addition of financial operations by decisively complementing or embedding knowledge in them.

With respect to the scale of operations and strategic targeting of support, the magnitude of the development challenges facing MICs and the growing size of their economic base points to the need for ADB to scale up its operations and to intensify the leveraging and mobilization of other financial resources. The sustained growth of MICs indicates that trillions, not billions, of US dollars will be required to support their sustainable development. The right combination of volume, alignment with MICs' needs and smart targeting is fundamental. While a higher scale of operations is needed for ADB to have a meaningful impact and to maintain its influence, ADB cannot pretend that it will be able to play the same proportional financial role that it did in the past, because the economic base of MICs has grown dramatically and there are obvious limits to the possibility of increasing ADB's capital base.

The following five broad trends indicate opportunities for ADB to scale up and target its engagement in MICs.

- **Urbanization.** The development of clean, inclusive and competitive urban centers offers a massive opportunity for ADB's support. ADB can facilitate the replication of successful city experiences for city modernization, as has already been done in the PRC. The regional implications of massive urbanization also provide ADB with the opportunity to expand operations at the subnational level.
- **Environmental and climate change.** The environmental footprint associated with rapid growth and urbanization provides ADB with the opportunity to help address issues such as air pollution, inadequate waste management, pollution of rivers or coastal areas, and the shortcomings of environmental governance and sustainable management of natural resources. ADB is also naturally positioned to continue aggressively supporting climate change mitigation measures (in energy and other sectors) demanded by the region.
- **Regional and global public goods.** Public goods issues that by their nature are not addressed by the market or fail to receive sufficient attention from MICs governments individually can be dealt with at an international and a subregional level with ADB support. These include the coordination of regional transport infrastructure for good connectivity, regional energy cooperation, regional health programs to contain endemic diseases, financial regulation to limit cross-border contagion, water resource management, pollution abatement, climate change mitigation, and environmental preservation.
- **Productivity, competitiveness, and innovation.** Given the challenges MICs face in raising productivity and competitiveness, ADB could give high priority to supporting improvements to total factor productivity (TFP) by focusing on human capital and labor market efficiency issues, and on the policy environment and governance systems that encourage innovation.
- **South-South cooperation.** To facilitate the emerging trend of collaboration among developing countries (mostly MICs), ADB has an opportunity to promote sharing of knowledge and experience by systematically distilling lessons from the development successes of relevant public and private agents in MICs. ADB is also well positioned to mobilize financial resources (sovereign and nonsovereign) in the region to invest in MICs, by exploring such mechanisms as the Asset Management Company, established by the International Finance Corporation (IFC).

ADB could also be called upon to support resilience building to manage emergency situations. These situations can rapidly reverse the progress achieved by MICs, and can be related to transmission of external economic of financial shocks, and disasters that are triggered by natural hazards which are anticipated to be increasingly related to climate change.

Decisively supporting private sector and public-private partnerships (PPPs). The improved business climates in many MICs offer an opportunity for ADB to support the private sector strongly and decisively and at a large scale. Through this support, which should be based purely on market and competitive factors, ADB could produce attractive dividends that can be invested in public sector initiatives and lagging regions and countries. In parallel, ADB could also aggressively scale up its support to PPPs in key development areas for MICs given the increasing preparedness for PPP.

For better meeting the development challenges of MICs, several choices of strategic initiatives are outlined.

Knowledge services. ADB's recent initiatives toward increasing the knowledge intensity of operations could be furthered by: (i) strengthening knowledge partnerships to enable joint project preparation, project implementation and policy dialogue; (ii) supporting policy and other innovations where governments see the benefit of adapting to economic vulnerabilities and climate change, and embracing game-changing business approaches and technologies; and (iii) expanding fee-based services, to cover a wide spectrum of development issues—in addition to providing knowledge embedded in investment, technical assistance and stand-alone knowledge products. Such fee-based advisory services are provided by other multilateral organizations such as the World Bank Group (WBG), to UMICs and high-income countries (HICs). To mainstream such services, ADB will need to have credible in-house staff with expertise in the areas where ADB would

provide fee-based services who are able to tap into ADB's rich development experience.

Expanded financing options. In addition to issuing local currency bonds, raising official and commercial cofinancing, ADB could consider: (i) mobilizing other sources of finance such as pension funds and mutual funds from within and outside the Asia and Pacific region; and (ii) expanding the use of guarantee facilities and risk sharing in mature operations to promote South-South investments among MICs in the region and to attract non-regional investors to MICs. Although ADB has had a good experience with guarantees to date, it has used the mechanism sparingly. The use of guarantees has been held back partly by ADB policies that require guarantees to have the same capital provisioning as loans. This constraint can be overcome by reinsurance or counter-guarantees that can reduce the claim on capital, or a special set-aside fund that can absorb a significant portion of the guarantee amount. ADB could also encourage export credit agencies to participate in more mature operations by taking over some of the financing or guarantee obligations of the ADB-supported part of the project. In the process of off-loading some of its portfolio, ADB could free up capital resources and headroom for additional operations.

Use of country systems for procurement and safeguards. As many MICs are now able to access finance from alternative sources and have improved institutional capacities, ADB has sought to enable them to move toward adopting country systems. IED appreciates that use of such systems could increase government ownership of operations, reduce implementation delays and rationalize transaction costs. At the same time, because of the high risks involved (fiduciary, environmental, social, and reputational), the move in this direction requires ADB to continue applying a strongly cautious approach particularly regarding safeguards.

Other initiatives. Several other initiatives that could also have a special value for responding to MICs in the region include: (i) dialogue and consensus building for priority

regional projects; (ii) project development of regional public goods projects; (iii) strengthening governance and public sector management support at the national and subnational levels; (iv) disaster risk financing instruments and supporting the strengthening of the enabling environment; (v) setting up a fund dedicated to supporting innovation in MICs, including South–South cooperation; and (vi) introducing business advisory services for small and medium-sized enterprises, which can promote the transfer of regional knowledge.

Revisiting the policy of graduating countries from regular support. The universal and all-encompassing nature of the Sustainable Development Goals (SDGs) means that they apply to all countries, irrespective of income levels. This strongly indicates that development needs are not finite. Vulnerabilities to global business cycles and economic downturns, or to extreme weather events do not vanish when countries cross a certain gross national income (GNI) per capita threshold. Other multilateral agencies have continued to support both MICs and HICs and focusing on specific lagging regions or issues

in those countries. This has enabled them to have a well-diversified portfolio across more countries and better asset quality, ultimately helping to reduce borrowing costs. Given the growing number of UMICs, ADB could reconsider its graduation policy. Graduation from ADB regular assistance may not be viewed as a requirement, but rather as an indicator of a country's attainment of a higher economic, social, and institutional maturity and therefore a qualification for a different kind of support from ADB.

A revised approach toward graduation can produce stronger development benefits, which is why many multilateral organizations have continued to support the development programs of countries even after they have attained HIC status. Whether or not ADB discards its current graduation policy, it should continue to engage with all its client countries, irrespective of their per capita GNI. This could take the form of involvement in cross-border projects, a focus on more experimental projects and programs, utilization of lessons learned from development experience in these countries for the benefit of other client countries, and fee-based high-value knowledge services.

CHAPTER 1

Introduction

1. This evaluation of the Asian Development Bank's (ADB's) engagement with middle-income countries (MICs) takes place against the backdrop of their rising numbers in Asia and the Pacific. In 2015, 37 of the 40 countries where ADB has operations were categorized as MICs.

2. These MICs are heterogeneous, with large differences in income levels, gross domestic product (GDP) composition, population, urbanization rates, geographical areas, and natural resource endowments. ADB follows the World Bank Group (WBG) system of country classification, which considers a country as belonging to the MIC category on the basis of whether or not its per-capita gross national income (GNI) level falls within a certain range.¹ The WBG classifies countries on this basis not because it equates income with development, but because it considers per-capita GNI to be the best single indicator of economic capacity and progress.² This evaluation recognizes that a per-capita-GNI-based classification system is convenient and transparent, and that ADB does not equate income with development.

A. Purpose and Rationale

3. **MICs continue to experience a wide range of development challenges. Some upper middle-income countries (UMICs) and lower middle-income countries (LMICs) are pressing ADB, in varying degrees, to be more responsive to their requirements and more effective in delivering desired outcomes.** These countries are increasingly connected with others in the region and across the globe, and are parties to global commitments to tackle poverty and climate change. Their increasing ability to mobilize finance from other sources has, among other factors, influenced how and the extent to which they prefer to engage with ADB. Yet emerging challenges posed by globalization and climate change may affect their development priorities and outlook for engagement with ADB. Some MICs have become active proponents of South–South cooperation in the Asia and Pacific region and beyond, are in the process of forging a new world economic order, and expect to be seen as collaborators and partners with ADB rather than as recipients. Against this background, the evaluation addresses issues

¹ In this evaluation, the Independent Evaluation Department (IED) has adopted the World Bank system of country classification, which has been in place since 1987. Each year the World Bank updates the ranges of GNI per capita that determine a country's income classification. At the beginning of its fiscal year on 1 July, the World Bank estimates the GNI per capita for its member countries in United States (US) dollars for the immediately preceding calendar year using the Atlas methodology. For classifying countries as belonging to low, lower middle, upper middle, and high-income countries, the World Bank set the following thresholds on 1 July 2016: $\leq \$1,025$ for low-income category, $> \$1,025$ and $\leq \$4,035$ for lower middle-income category, $> \$4,035$ and $\leq \$12,475$ for upper middle-income category, and $> \$12,475$ for high-income category. For GNI per capita thresholds for previous years, refer to <https://datahelpdesk.worldbank.org/knowledgebase/articles/378833-how-are-the-income-group-thresholds-determined>

² International Monetary Fund. 2011. *Classifications of Countries Based on Their Level of Development: How it is Done and How it could be Done*, Washington DC.

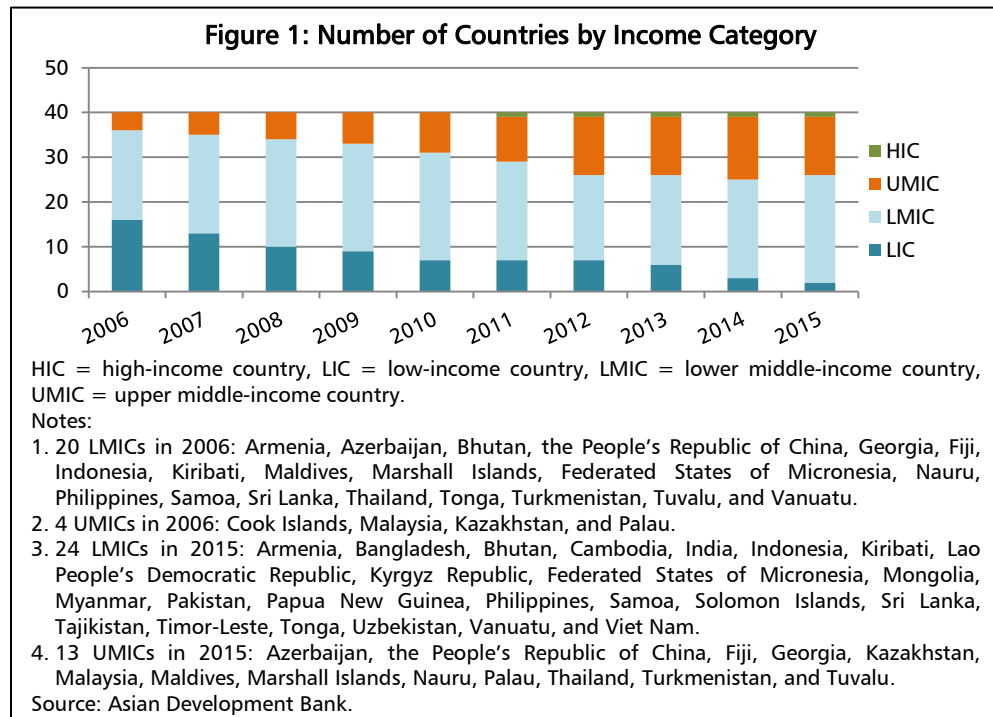
regarding ADB's continued relevance in Asia and the Pacific region. In so doing, it aims to provide some inputs into the formulation of ADB's new corporate strategy to 2030.

B. Objectives, Approach, and Methodology

4. The evaluation seeks to understand the options available to ADB that will enable it to remain relevant to the Asia and the Pacific region. It is based on the premise that ADB will expand its operations and align them with the needs of borrowing countries—which will mostly be MICs. It studies the key challenges faced by MICs in the region and by the region itself, and the implications of changes in the borrowing country profile and other external factors on ADB's strategies and programs for MICs. The evaluation covers:

- (i) Determinants of ADB's present and future relevance in supporting MICs as they address their development challenges and mitigate their vulnerabilities, while their dynamism paves the way for new development opportunities.
- (ii) Lessons to date from ADB's engagement with MICs, in particular, how ADB has responded to the challenges faced by MICs at various levels: corporate strategy and policy; country programs; and projects.
- (iii) Suggestions for further measures so ADB can adopt to continue providing value-adding support and remaining relevant to the needs of its client MICs.

5. The evaluation covers all ADB developing member countries (DMCs) where ADB has operations and that are MICs. Where data and information are available, it examines the experience and performance in UMICs and LMICs. It notes that the number of UMICs increased rapidly from 4 to 13 during the study period, while the number of LMICs has remained more or less unchanged, and that the number of low-income countries (LICs) has declined (Figure 1).



6. **The evaluation study period is 2006–2015, although reference is made to some ADB initiatives in earlier years. A two-tiered approach is adopted.** The evaluation focuses on 19 of the 37 MICs and for these countries specific issues are investigated. These 19 MICs include seven UMICs (Azerbaijan, the People’s Republic of China, Kazakhstan, Malaysia, Maldives, Thailand, and Turkmenistan) and 12 LMICs (Bangladesh, India, Indonesia, Mongolia, Pakistan, Papua New Guinea, Philippines, Sri Lanka, Tonga, Uzbekistan, Vanuatu, and Viet Nam). These 19 MICs accounted for more than 75% of all sovereign and nonsovereign operations (including cofinancing) during the study period. Excluding cofinancing, their share of sovereign lending operations exceeded 85% and for nonsovereign operations 80%. The remaining 18 MICs are covered mostly through a literature review that grouped MICs with particular characteristics (e.g., landlocked or small island states).

7. **The Independent Evaluation Department (IED) selected five of the 19 MICs as case studies. For these countries, the evaluation team held consultations with ADB staff, governments, and other stakeholders.** The countries were: (i) the People’s Republic of China (the PRC), which has received a large and steady stream of ADB support, and has set up a fund for regional cooperation and poverty reduction; (ii) Kazakhstan, which is a large resource-rich MIC that has received widely varying levels of ADB support from year to year; (iii) Malaysia, which has had a low level of ADB support since at least the mid–2000s; (iv) Thailand, which mostly preferred nonsovereign support during the study period; and (v) Indonesia, which has preferred policy-based loans in recent years, although ADB did provide a results-based loan (RBL) in late 2015.

8. **The five case study countries were selected with the objective of understanding ADB’s options to remain relevant in the region.** (i) The PRC was selected to better understand the government’s perspectives on ADB’s ability to provide knowledge-intensive and programmatic support as the PRC crosses the graduation threshold. (ii) Kazakhstan was chosen to gauge the government’s views on continued ADB support although its per capita GNI was well above the graduation threshold until 2013. (iii) Malaysia and Thailand were picked to understand their specific concerns about their limited engagement with ADB, and their perspectives on ADB support in addressing their development challenges in coming years, and (iv) Indonesia was selected to understand the issues it has with ADB support and the prospects for ADB to broaden this support. IED staff also participated in and gathered insights from about 30 MICs during country consultations conducted by the Strategy and Policy Department (SPD) as part of its Strategy 2030 formulation effort.

9. **The evaluation benefited from a number of evaluations and validations of country partnership strategies and projects in MICs.** In view of the significant increase in the number of UMICs, some of which are poised to enter the high-income category, the evaluation also considered findings and lessons from other multilateral banks that have significant and long-standing experience in engaging with UMICs and high-income countries (HICs). These are the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), Inter-American Development Bank (IADB), and the WBG. The evaluation also used material from think tanks such as the Center for Global Development, Center for Strategic and International Studies, and the Overseas Development Institute. The key evaluation questions are explained in Linked Document 1 (see Appendix).

C. Limitations

10. **The evaluation is strategic in its orientation.** Given the vast canvas of MICs covered in the evaluation, it builds on evaluations conducted by IED and evaluation findings from other multilateral organizations.

11. **The evaluation does not attempt to delineate the development challenges for any particular MIC, nor does it intend to suggest how ADB could maximize its development effectiveness in MICs.** It does not explicitly address issues that are often encountered by fragile and conflict-affected states, many of which are MICs, although these concerns are implicitly addressed in discussions focusing on issues such as climate change.

12. **Given limitations of time and resources, the study does not include a detailed analysis and examination of the relative importance of development challenges that MICs face, or the intensity of a particular development challenge in any particular MIC.** For the same reason, the study does not analyze ADB systems and processes that influence the time taken for project processing and project implementation (or the trade-offs, if any, from reducing these time periods). On ADB's graduation policy, the evaluation focus is on providing a rationale for continued ADB engagement with all MICs and suggests that there is a need to review and change the policy.

D. Report Structure

13. The development challenges of MICs are the main focus of Chapter 2, which also provides an overview of how other multilaterals view opportunities for supporting MICs. Chapter 3 presents lessons from ADB's involvement with middle-income countries. Chapter 4 provides options and alternatives for ADB on strategies, policies, and initiatives to meet the needs of MICs, including the revisiting of the graduation policy.

Evolving Development Challenges and Opportunities among Asian Middle-Income Countries

14. Asian MICs face some common development challenges and new development opportunities. These challenges and opportunities are evolving at a rapid pace.

15. Many ADB client MICs are plugged into regional and global economies; they increasingly access finance from a number of sources and have increased their share of world trade. With globalization, the external environment has become increasingly important for these MICs and with growth and higher income levels their development constraints have evolved. At the same time, the new economic muscle of these countries has created opportunities for stronger regional integration, South–South cooperation and mobilization of international resources for development, including through the creation of new multilateral development banks. The evolving needs and challenges of MICs are receiving growing attention from major international development agencies.

A. Challenges: Economic and Social Constraints

16. **The Asia and the Pacific region embodies a major paradox that can detract from the optimism of the “Asian Century.”**³ Although rising manufacturing and information technology-based services have driven prosperity in many Asian MICs to unprecedented levels since the 1980s, an estimated 80 million people in the region were unemployed in 2014.⁴ The region holds a large savings pool but many MICs suffer from an infrastructure deficit and inadequate education and social services. Many MICs are urbanizing rapidly but urban growth is unplanned and the cities are becoming unliveable. In the larger MICs, some regions continue to lag, and their development challenges remain more severe than in other parts of the country. The extent to which such situations impinge upon growth and well-being, and the policy and other initiatives from their governments, will differ across MICs.

³ ADB. 2011. *Asia 2050: Realizing the Asian Century*. Manila.

⁴ The 80 million excludes the number of unemployed in five Pacific small island developing states, for which World Bank does not compile data. Many of these MICs have recorded unemployment levels of more than 10% of their labour force although the overall average unemployment rate comes to about 4.5% of their combined labour force. <http://data.worldbank.org/indicator/SP.POP.TOTL>

1. Range of Challenges faced by MICs

17. **MICs in the Asia and the Pacific region have made significant progress in reducing extreme poverty since the early 1990s.** Using the international poverty line of \$1.90 per day (at 2011 purchasing-power-parity levels), the numbers living in poverty in these MICs have fallen from about 1.5 billion extremely poor in 1990 (77% of the world's poor) to 450 million in 2012 (50% of the world's poor).⁵

18. **Nevertheless, many MICs still have significant pockets of poverty.** Even where people have been lifted out of extreme poverty they continue to live in fragile conditions and can slip back into poverty. LMICs, in particular, have faced several challenges in eradicating extreme poverty. They accounted for more than 360 million extreme poor in 2012 (40% of the world's poor). LMICs have made slow progress on human development outcomes (related to life expectancy, education, access to clean water, and basic sanitation). UMICs account for 10% of the world's poor, these remain mostly in the PRC, which it has been exceptionally successful in reducing poverty.

19. **Data on extreme poverty indicate that many LMICs continue to have large numbers of extremely poor people.** Nearly 290 million extreme poor were in South Asia in 2012, mostly in India (230.8 million) and Bangladesh (57.6 million). Other LMICs with significant numbers of extreme poor in 2012 were Indonesia (29 million) and the Philippines (12.7 million) in Southeast Asia, and the Kyrgyz Republic (12.2 million) and Uzbekistan (8.1 million) in Central and West Asia. This is a clear distinction between the two subcategories of MICs, and it is likely that LMICs would therefore expect ADB support to address the issue of poverty directly.

20. **Some UMICs are finding it difficult to reduce inequality.** In the PRC, inequality has risen since the 1990s. Estimates of Gini coefficients⁶ indicate significant income inequality in many LMICs and UMICs.⁷ Only in Kazakhstan and Kyrgyz Republic is the Gini coefficient less than 30, i.e., comparable to that of Organisation for Economic Co-operation and Development (OECD) members.⁸

21. **Other development challenges have become prominent in MICs. Some of these are the result of economic growth.** For example, although urbanization brings important benefits for economic, cultural, and societal development, these can be threatened by rapid and unplanned urbanization. Likewise, inadequate governance systems and insufficient high-quality infrastructure are affecting many urban areas. Congested roads, power and water supply shortages, inadequate sanitation, and poor communication networks are particularly noticeable. Such problems have been associated with a deteriorating physical environment and the spread of disease.

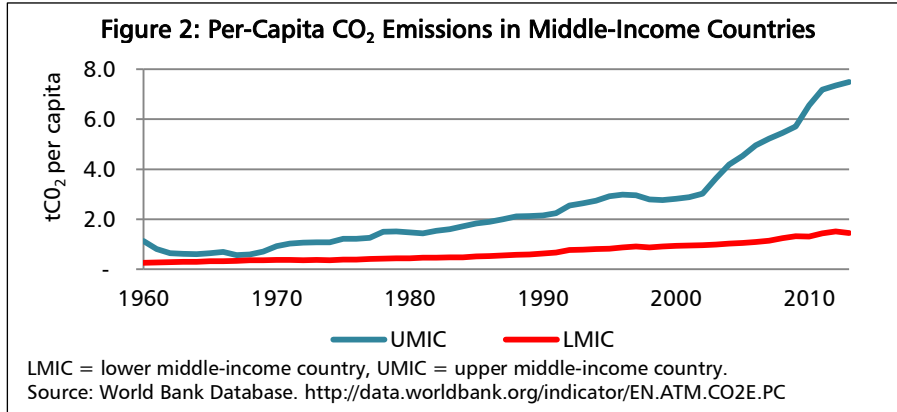
⁵ World Bank. 2015. *A Global Count of the Extreme Poor in 2012: Data Issues, Methodology and Initial Results (Policy Research Working Paper 7432)*. Washington DC and World Bank's PovcalNet Database.

⁶ The Gini coefficient measures the extent to which the distribution of income (or in some cases, consumption expenditure) among individuals or households within an economy deviates from a perfectly equal distribution.

⁷ Gini coefficient estimates for the most recent year for which data are available (between 2010 and 2013), were above 40 for some LMICs (Papua New Guinea, Philippines) and some UMICs (the PRC, Fiji, Malaysia); and between 35 and 40 for some others (Bhutan, Indonesia, Lao PDR, and Sri Lanka among the LMICs, and Maldives and Thailand among UMICs). <http://databank.worldbank.org/data/reports.aspx?source=2&series=SI.POV.GINI&country=#>

⁸ Gini coefficient estimates for the most recent year for which data are available (mostly 2012) were less than 30 for ten OECD countries (Belgium, Czech Republic, Denmark, Finland, Iceland, Netherlands, Norway, Slovak Republic, Slovenia, and Sweden) and between 30 and 35 for eight OECD countries (Austria, Estonia, Hungary, Ireland, Luxembourg, Poland, Switzerland, and the United Kingdom). <http://databank.worldbank.org/data/reports.aspx?source=2&series=SI.POV.GINI&country=#>

22. **Environmental degradation, a consequence of insufficient attention to preservation of natural capital, impedes the provision of environmental goods and services necessary to sustain growth and wellbeing.** It also reduces resilience to climate change. The relatively high emissions of carbon-dioxide (CO₂) per-capita in UMICs is indicative of these challenges. (Figure 2).



23. **Another set of development challenges are associated with the need to continue improving productivity to sustain economic growth, as opportunities for easy productivity gains get exhausted.** A growth trajectory to high-income country (HIC) status will demand initiatives that improve human capital, carry out structural adjustments, and place more emphasis on innovation. Evidence from Europe, North America, Japan, and other high-income Asian economies shows that entrepreneurship, continued economic diversification, industrial upgrading, policy innovation, small and medium-sized enterprise (SME) growth, and technological innovation have all contributed to their success.⁹

24. **On the macroeconomic front, maintaining stability has become a challenge, as manifested by the fiscal and current account deficits in several MICs.** The risk of instability reflects the difficulty in strengthening financial institutions and state-owned enterprises (SOEs), adjusting monetary and fiscal policies, and undertaking structural reforms. Additionally, MICs are facing new challenges from better connectedness, integration into global trade and financial systems, and climate change.

25. **Attaining economic diversification is critical for MICs.** Reliance on one or a few export markets exposes an exporting country to the risk of an economic slowdown in the importing country (or countries). An overreliance on one industry or sector makes certain MICs vulnerable to changes in the global economy. Oil-rich countries (notably Azerbaijan and Kazakhstan) are vulnerable to a fall in oil prices in the international market. For example, declining oil production in Azerbaijan and the fall in the oil price in 2014 have made the need for economic diversification urgent.¹⁰ By contrast, Kazakhstan continues to pursue an economic diversification program it began more than a decade ago and its oil exports are projected to increase as a new oil field goes into production, and production from some existing oil fields increases.¹¹

⁹ United Nations Industrial Development Organization. 2014. *Inclusive and Sustainable Industrial Development: Creating Shared Prosperity; Safeguarding the Environment*. Vienna.

¹⁰ From a peak of over 900,000 barrels per day in 2010 Azerbaijan's crude oil exports declined to about 707,000 barrels per day in 2014. See <https://www.eia.gov/beta/international/analysis.cfm?iso=AZE>

¹¹ In 2013, Kazakhstan exported nearly 1.4 million bbl per day of crude oil and condensate. Kazakhstan's exports seem likely to increase in coming years, as production begins at Kashagan and expands at Tengiz

26. **All MICs need significant investment in infrastructure.** Some MICs tend to focus on creating new infrastructure, while others are turning their attention to rehabilitation or better operation and maintenance of existing infrastructure. Some are beginning to demand more sophisticated infrastructure designs, e.g. multimodal hubs and logistics terminals to handle large volumes of traded goods, and/or urban transport systems with mass transit and integrated non-motorized transport in addition to road and rail transport systems. Technological progress can also change perceptions about the efficiency and safety of infrastructure as MICs begin to adopt emerging information and communication technologies for infrastructure applications, such as smart grids to improve the operational efficiency of power grid systems, and intelligent transport systems to improve road safety.

27. **Inadequacies at the sector level can affect development outcomes.** An inadequate education system affects a country's human development outcomes, contributes to inequality, poses difficulties in improving productivity and competitiveness, and makes it difficult to embrace technological change¹² and to address new types of challenges (e.g., increasing resilience to climate change). A broad outline of these development challenges is provided in Box 1, further details are in Linked Document 2 (see Appendix) and in Supplementary Appendix 1.

and Karachaganak. The rapid growth of oil production and exports will require an expansion of export capacity. See https://www.eia.gov/beta/international/analysis_includes/countries_long/Kazakhstan/kazakhstan.pdf

¹² The emergence of disruptive technologies can initiate a cascade of changes that can transform manufacturing or infrastructure construction methods or processes, or business processes, or financial management and governance systems, or some facet of human activity. The digital revolution means that the pace of development and application of new technologies is accelerating. It is transforming management and business approaches, and impacting (among others) education systems and labour markets. The risk of not embracing such transformations is huge as digital technologies boost productivity and competitiveness, although digital transformations also raise concerns about sustainability and inclusive development.

Box 1: Salient Development Challenges of 19 Selected Middle-Income Countries^a

Poverty and inequity. Pockets of poverty occur in practically all MICs, and some lower middle-income countries still suffer from high poverty rates. Social protection systems are generally inadequate. In addition to being cash-poor, affected people generally have less access to finance, social and utility services, and opportunities. The inequities are reflected in poor human development outcomes.

Governance. Institutional weaknesses, a weak financial sector, and corruption are issues of concern to all MICs. The level of sophistication in improving governance depends on the stage of development.

Infrastructure deficit. MICs are generally deficient in traditional infrastructure and require a mix of new investment projects, in addition to refurbishment and better maintenance of existing infrastructure assets. Modern and “smart” infrastructure designs can also be introduced and scaled up.

Economic structure. Several MICs need to diversify their economies and their major trading partners. Some resource-rich MICs need to diversify away from extractive industries. The relative shares of the primary, secondary, and tertiary sectors in gross domestic product (GDP) are important issues for some countries.

Improving productivity. Factor productivity in MICs is generally lower than in high-income countries. This reflects one or more of the following issues: insufficient investment in research and development and human resources development, structural factors (such as a high share of low-productivity agriculture), and insufficient support for small and medium-sized enterprise development.

Macroeconomic stability. Many MICs suffer from fiscal and current account deficits that constrain development expenditures. Low tax revenues, high welfare payments, weak financial institutions, and inefficient state-owned enterprises (SOEs) are some of the underlying reasons.

Demography. While at least one MIC, the PRC, suffers from rising dependency levels, many others with large young populations experience high youth unemployment.

Environment and climate change. All MICs experience environmental degradation, due to industrialization, improved living standards, population growth and increasing energy requirements (which increase CO₂ emission). Their locations mean that some MICs are more exposed to impacts from climate change.

Resilience. Many MICs are vulnerable to business cycles and financial crises (manifested as price shocks, and poor demand for their major export commodities). A proliferation of nonperforming loans can endanger long-term resilience to climate change and game-changing developments.

^a Includes seven upper middle-income countries (Azerbaijan, the People’s Republic of China, Kazakhstan, Malaysia, Maldives, Thailand, and Turkmenistan) and twelve lower middle-income countries (Bangladesh, India, Indonesia, Mongolia, Pakistan, Papua New Guinea, Philippines, Sri Lanka, Tonga, Uzbekistan, Vanuatu, and Viet Nam). Refer to Supplementary Appendix 1 for details.

Source: Asian Development Bank Independent Evaluation Department.

2. Geographical Dimensions of Development Challenges among Middle-Income Country Groups in ADB

28. **Certain geographical features of ADB client countries can influence the type and intensity of development challenges they face** as is the case for landlocked countries and small island developing states.

29. **Landlocked countries generally encounter difficulties in carrying out international trade as they require a number of border crossings and there are long distances to major markets.**¹³ These difficulties are often compounded by a combination of infrastructure deficiencies, and by regulatory and institutional impediments, particularly those related to trade facilitation.¹⁴ The major infrastructure-related challenges of ADB landlocked MICs include: (i) making significant improvements in and maintaining the transport infrastructure network; (ii) creating an environment that is conducive to the use of all transport modes; (iii) closing missing links in the transport infrastructure; (iv) shifting to air transport for high-value and low-volume

¹³ United Nations. 2003. *Report of the International Ministerial Conference of Landlocked and Transit Developing Countries and Donor Countries and International Financial and Development Institutions on Transit Transport Cooperation*. Almaty. (28–29 August).

¹⁴ This includes (i) rationalization and harmonization of customs procedures and documentation requirements; and (ii) establishment of a one-stop border control arrangement.

cargo; (v) developing a dry port; and (vi) improving communications for better cargo handling. The difficulty is exacerbated for some MICs (such as Tajikistan, Turkmenistan, and Uzbekistan) when neighboring countries are also landlocked. But when the major export commodity is oil, existing long-distance pipelines can reduce these challenges (as for Azerbaijan and Kazakhstan).¹⁵ For Mongolia, being landlocked is less of disadvantage as its two immediate neighbors (the PRC and Russian Federation) offer large markets for its commodities.

30. **All island economies are vulnerable to external influences that stem from their relatively small economic and natural resource bases.** Even small changes in world prices of commodities or other items, or volatility of economic and business cycles, can have large impacts on remittances from migrant workers and fuel import bills. Their fragile natural environments, high exposure to the implications of climate change (e.g., the increasing frequency and intensity of natural calamities, and sea level rise) pose further medium- to long-term development challenges.¹⁶ Many island countries have small populations dispersed over small and distant islands, and the key challenge is to make them viable and to provide cost-effective infrastructure and affordable public services.¹⁷ These island economies continue to be dependent on development assistance, including Cook Islands, which is dependent on tourism and has crossed the GNI per-capita threshold and entered the high-income category. ADB has outlined a three-pronged strategy for island countries that focuses on reducing costs, managing risks, and enabling value creation. This strategy is especially relevant to 11 small Pacific island countries, and generally applicable to all island countries, including Maldives in South Asia.¹⁸ Yet there are considerable differences across these island economies. With a population of more than 7 million, far bigger than the others, Papua New Guinea is unique; it also has vast natural resources. Nauru and Tuvalu (with populations of around 10,000) have limited natural resources. Cook Islands, Fiji, Samoa, Tonga, and Vanuatu with somewhat larger populations may have higher growth potential but remain vulnerable to externalities. The economic structure also influences the vulnerabilities of these island economies; for example, Maldives, which is highly dependent on tourism, is more vulnerable to global economic downturns than, say, Fiji and Vanuatu, which also have sizeable tourism sectors but whose economies are more diversified.¹⁹

¹⁵ Azerbaijan, Kazakhstan, and Turkmenistan have ports on the Caspian Sea, an inland water body. All three countries have important ports on the Caspian Sea: Baku (Azerbaijan), Aktau (Kazakhstan), and Turkmenbashi (Turkmenistan). It is noteworthy that (i) Kazakhstan is referred to as landlocked in the country partnership strategy (CPS), 2012–2016; (ii) Azerbaijan is not referred as landlocked in the CPS, 2014–2018, and (iii) Turkmenistan is not considered landlocked in the country operations business plans (COBPs) for 2014–2015, 2015–2016, and 2016–2017.

¹⁶ IED. 2015. *ADB Support to Small Pacific Island Countries*. Manila: ADB

¹⁷ Extensive spatial dispersion means that infrastructure costs are high, which undermines the government's ability to deliver affordable and high-quality public services. The shortage of skilled labor—partly because of migration to other countries, but also because it is simply not efficient to establish adequate education and training facilities for all types of required services—exacerbates the problem. Given the small population size and the small local market of island states, the possibility of achieving economies of scale in the manufacture of any product is limited. This makes them unattractive for private investors—unless a product can be priced competitively in the international market. Similarly, the high cost of tourism-related infrastructure and services coupled with the limited capacity to accommodate tourists has made developing the sector challenging in many small island developing states—although some have successfully developed tourism industries.

¹⁸ ADB. 2016. *Pacific Approach: 2016–2020*. Manila.

¹⁹ In 2015, the share of the tourism sector in GDP was as follows: Maldives (52%), Vanuatu (18%), and Fiji (14%). <https://knoema.com/atlas/topics/Tourism/Travel-and-Tourism-Direct-Contribution-to-GDP/> Direct-Contribution-to-GDP-percent-share?baseRegion=FJ. Similar data for Palau and Samoa are not available although the share of tourism is also significant in these island countries.

31. In addition to similarities across island economies, which is relevant mostly to the Pacific subregion, it is often—although not always—possible to discern broad distinguishing aspects of development challenges of MICs in a particular subregion.

32. **Central and West Asia.** Most ADB members in Central and West Asia consider economic diversification to be a major development challenge and objective: (i) Azerbaijan and Kazakhstan because they have suffered from low oil prices since 2014, and (ii) most MICs in the subregion as they strive to urbanize and industrialize, and move away from agriculture. Increasing productivity and income levels normally associated with urbanization will create demand for a diverse set of goods and services—but from the perspective of enabling economies of scale, it may be worthwhile taking a regional perspective on economic diversification and then identifying a diversification program for each country. In the more immediate term, however, many MICs in the subregion need to manage the adverse effects of vastly reduced remittances from migrant workers in the Russian Federation, and the general economic slowdown in the PRC.

33. **East Asia.** The PRC needs to address numerous development challenges that have accumulated during the decades of rapid investment and export-led growth. Since the GDP growth rate in the PRC began to slow down in 2012, financial risks have surfaced. Difficult reforms are now required along many dimensions to address these financial risks, rebalance the economy, and tap new sources of growth. Rising old-age dependency can pose additional challenges in the medium-term. With regard to Mongolia, its main development challenge is to diversify away from natural resource mining—also a characteristic of resource-rich MICs in other subregions.

34. **South Asia.** The key development challenges for MICs in South Asia are to bring about inclusive growth and bridge the rural–urban divide. To address these, countries need: (i) broad-based education and skills development;²⁰ (ii) more efficient infrastructure, governance, and public sector management (PSM); and (iii) an environment that encourages SMEs. This could help create jobs in manufacturing and services sectors. The ability to adopt new technology and knowledge sharing can provide an impetus to the overarching challenge of inclusive growth. It could also enhance competitiveness and contribute to increasing trade within and beyond the South Asia subregion. Nonetheless, investment in subregional infrastructure and improved connectivity remain a challenge. The development challenges of the Maldives are akin to those of the Pacific island countries.

35. **Southeast Asia.** Although not geographically contiguous, countries in Southeast Asia have made more progress in economic cooperation than those in other parts of Asia. All ADB members in Southeast Asia are members of the Association of Southeast Asian Nations (ASEAN), five are members of the Greater Mekong Subregion (GMS), four are members of the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area, and three are members of the Indonesia-Malaysia-Thailand Growth Triangle. The establishment of the ASEAN Economic Community in 2015 offers potential opportunities in the form of a huge regional market.²¹ However, if the anticipated Trans-Pacific Partnership is to be realized, it is likely that many MICs in Southeast Asia will find it challenging to open up their agriculture sectors (and perhaps other areas) to competition from global markets. These MICs also face other development challenges, the most prominent being: (i) political instability that feeds

²⁰ Requires measuring cognitive, noncognitive, and technical skills in a holistic manner so as to complement different kinds of skills from formal and nonformal sources.

²¹ Market size was estimated at \$2.6 trillion in 2014 and serving more than 620 million people.

into macroeconomic imbalances, as in Thailand; and (ii) infrastructure deficits and governance issues across various levels of government in all LMICs in the region.

3. Sustaining Growth in Middle-Income Countries

36. **Total factor productivity (TFP) is considered the main determinant of economic growth in the long run.**²² TFP accounts for differences in economic growth across countries, and differences within a country over time. National policies influence long-run growth²³ and to sustain high levels of growth regional MICs will have to implement policies that enable them to increase their TFP.

37. **A study of 12 Asian economies has shown that the contribution of TFP growth to economic growth increased in the post-2000 period (compared with 1970-2000).** The major source of TFP growth was the catch-up effect in the early years, although the role of human capital in influencing TFP is gradually rising. Further increases in TFP levels to 2030 will depend on the effects of catch-up, life expectancy, human capital, and research and development.²⁴

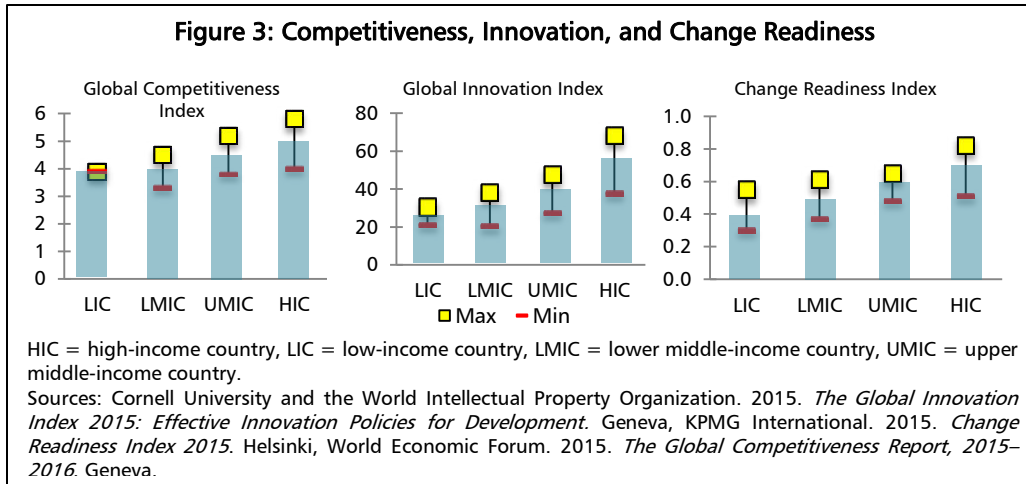
38. **TFP depends on all economic sectors and all economic activities. There are numerous links within and between these sectors and activities—which relate to (among other) physical infrastructure, social infrastructure, public institutions, financial systems, systems of governance, private enterprises, and the business environment.** While many of these parameters influence the competitiveness of an economy, a subset can be considered to contribute to better human development or a clean physical environment.

39. **Competitiveness, innovation, and change readiness are critical.** In general, MICs lag behind the high-income OECD economies in competitiveness, innovation (creativity that can enhance competitiveness), and change readiness (ability to anticipate, prepare for, manage, and respond to change drivers to preserve and possibly enhance competitiveness)—Figure 3.

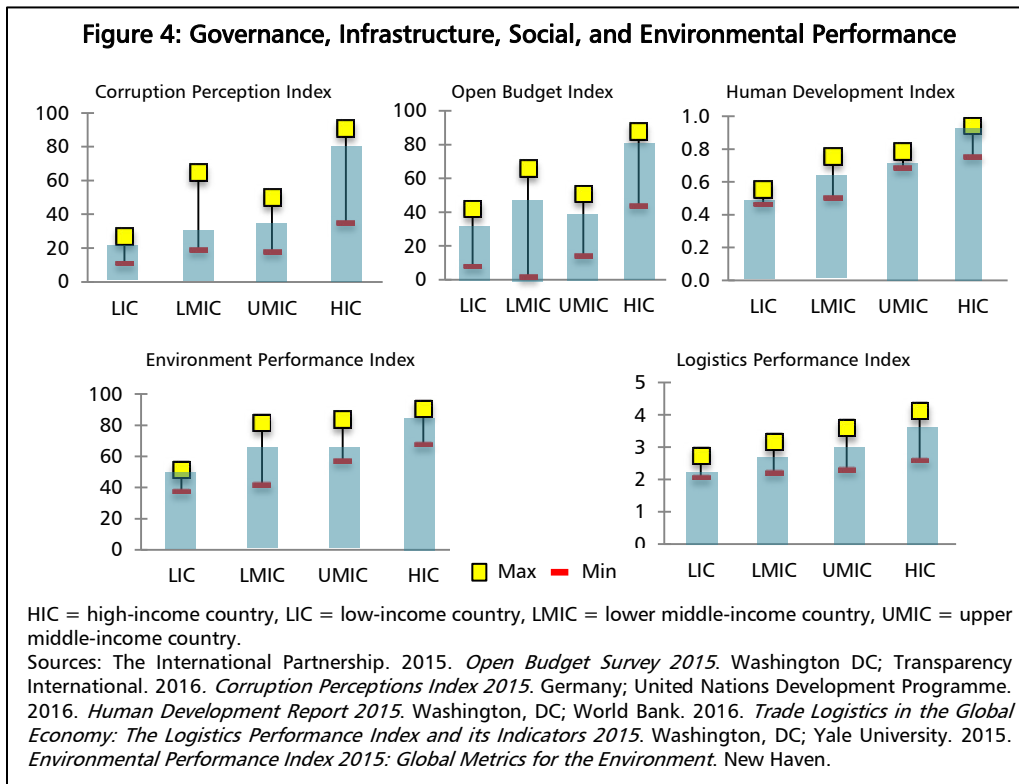
²² National Bureau of Economic Research. 2001. *New Volume in Productivity Analysis*. Cambridge, Massachusetts (USA). Published by University of Chicago Press; Chapter on *Total Factor Productivity: A Short Biography*, by Charles R. Hulten. <http://www.nber.org/chapters/c10122.pdf>

²³ World Bank. 2001. *What Have We Learned from a Decade of Empirical Research on Growth? It's Not Factor Accumulation: Stylized facts and Growth Models*, Washington DC; published in *The World Bank Economic Review*, Vol. 15, no.2, pp. 177-219.

²⁴ J. Park. 2010. *Projection of Long-Term Total Factor Productivity Growth for 12 Asian Economies: ADB Economics Working Paper Series No. 227*. Manila. Asian Development Bank. The 12 Asian economies are the PRC; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.



40. The same broad trend is observed for other indexes on human development, logistics, and environmental performance.²⁵ However, as can be seen in Figure 4, for the two governance-related indexes, LMICs appear to be doing better than UMICs. Overall, revamping and sustaining growth will require MICs to improve their physical infrastructure and logistics, education and health care and other social infrastructure, institutional mechanisms, governance and markets, financial systems and enterprises, and physical environment. Further information can be found in Linked Document 3.



²⁵ The high score of HICs on the corruption perception index means they are less corrupt—the scoring system assigns a score of zero to a country where the public sector is perceived as highly corrupt and 100 where it is perceived as very clean.

41. **It is very likely that during the 14-year period to 2030, many LMICs will attain, or move close to attaining, UMIC status, and some UMICs may attain HIC status.** Their pace of development will be influenced by the complex interplay among numerous external and internal factors that can affect competitiveness, governance systems, human development, and the physical environment.

B. Opportunities: Fostering Regional Integration and South–South Cooperation

42. **A recent IED study has argued that East and Southeast Asia, which comprise a number of UMICs and LMICs in addition to some HICs, have achieved about 60% of their regional integration potential.** The ASEAN countries have made the most progress toward economic integration through cross-border capital flows and trade. Market-driven cross-border private activity, propelled by liberalization efforts in some countries, has made this possible.²⁶ South and Central Asia have lagged in terms of regional integration, and, despite being mostly geographically contiguous, these regions have achieved only about 33% of their potential.²⁷ Correspondingly, intraregional trade at the subregional level is highest for East Asia (35%) and Southeast Asia (24%) and less than 10% for the other subregions.²⁸

43. **Some MICs have spearheaded the setting up of two new multilateral banks, the Asian Infrastructure Investment Bank and the New Development Bank.** Both these MIC-led multilateral banks are based in Asia and they promise to strengthen regional integration. A comparison between MICs in the Asia and the Pacific region with those in the Latin America and the Caribbean region indicates that MICs in Asia have strong potential to attract more foreign capital as their income levels increase and their financial systems become stronger and more integrated. Further information on cross-border financing and trade is provided in Linked Document 4 (see Appendix) and Supplementary Appendix 2.

44. **Several MICs are actively pursuing South–South cooperation.** These countries see such cooperation as a means of building on their links with other lo LICs and MICs, and of enhancing their presence within and beyond the Asia and Pacific region.

45. **Some MICs have become both recipients of and contributors to regional cooperation and integration programs (RCI) initiatives on cross-border infrastructure and other regional public goods.**²⁹ To date, the PRC has actively supported RCI in various ways, through a mix of investment and knowledge sharing initiatives. Prominent infrastructure initiatives include the Silk Road Economic Belt and the 21st

²⁶ ASEAN institutions have helped harmonize rules and regulations. To extend this integration, and to forge a highly cohesive, interconnected, competitive, and resilient region by 2025 which is well integrated with the global economy, the ASEAN Economic Community was formed in 2015.

²⁷ Regional integration potential is estimated in relation to benchmark performance of other regions under similar circumstances. Data envelopment analysis methodology is used to assess the untapped potential. A multidimensional indicator—covering trade and financial integration, cross-border mobility of people, and remittances—is used to rank regions according to their current degree of regional integration, which allows for a direct comparison of Asia' regional integration performance with that of other regions across the globe. For further details, refer to IED. 2015. *Asian Development Bank Support for Regional Cooperation and Integration*. Manila: ADB.

²⁸ ADB. 2015. *Asian Economic Integration Report 2015: How Can Special Economic Zones Catalyze Economic Development?* Manila.

²⁹ J.A. Alonso, J. Glennie, and A. Sumner. 2014. *Recipients and Contributors: Middle income countries and the future of development cooperation*. UN DESA Working Paper No. 135.

Century Maritime Silk Road,³⁰ among others.³¹ It is envisaged that the Silk Road initiatives will connect East Asia with West Asia and South Asia, as well as other parts of the globe. These initiatives will go beyond the various traditional subregion-based programs that ADB has engaged in to date (although ADB is now promoting integration between South Asia and Southeast Asia).

46. **The PRC has been providing financial and technical assistance to its neighbours in Central and Southeast Asia.**³² It established the PRC Regional Cooperation and Poverty Reduction Fund in March 2005, which is managed by ADB's Economic Research and Regional Cooperation Department. This supports both country-specific and multi-country activities, with the latter focusing on the Greater Mekong Subregion (GMS) and Central Asia Regional Economic Cooperation (CAREC) programs. Many of the TA projects supported by the fund attract multilateral and bilateral development partner cofinancing.

47. **The PRC has cofinanced several GMS TA projects, and has also benefited from GMS activities, such as cross-border road infrastructure, a subregional power grid, biodiversity conservation corridors, and control of cross-border epidemics.**³³ Through its CAREC membership, it has provided financial and technological support for railways and roads that connect it with landlocked Central Asian DMCs. It has also provided technical assistance in the agriculture and environment sectors and for capacity building.³⁴

48. **The PRC aims to promote South–South cooperation** in mutual learning from its development experiences through its regional knowledge sharing initiative.

C. Other Multilateral Organizations' Perspectives on Middle-Income Countries

49. **International development agencies increasingly recognize that the fight against poverty in middle-income countries is not over, but that a more tailored approach to individual countries is needed to address their specific development constraints.** They emphasize that MICs are home to 70% of the world's extreme poor and contain many people affected by fragility, conflict, and violence, who are least able to cope with external shocks, including natural disasters. At the same time, these countries are emerging as engines for growth and trade, and are central to progress on global public goods, especially in relation to climate change, and the achievement of Sustainable Development Goals. The key is to tailor, adapt, and develop new products and services that respond to the clients' new needs and emerging challenges and risks.

³⁰ It is envisaged that, under these initiatives, roads, railways, seaports, oil and gas pipelines, and other related infrastructure will connect East Asia through Central Asia, with Europe, Russia, West Asia, South Asia, the Persian Gulf, and the Mediterranean. The maritime initiative looks at connecting the coastal eastern China through South China Sea with archipelagic Southeast Asia, Pacific, and India, Sri Lanka, Pakistan, Iran and Iraq, as well as Mombasa in Kenya, and to the Mediterranean, northern Africa, and Europe through the Suez Canal.

³¹ For example: (i) the Pan-Beibu Gulf Economic Initiative, which targets maritime connectivity with archipelagic Southeast Asia, and (ii) the Greater Tumen Initiative, which focuses on Northeast Asia bordering the People's Democratic Republic of Korea, Republic of Korea, and the Russian Federation. The PRC is also supporting the development of a road and economic corridor from the newly opened land port of Karasu in western Xinjiang Province, through Tajikistan and Pakistan to the southern Pakistan port city of Gwadar. IED. 2015. *Effectiveness of Asian Development Bank's Partnerships*. Manila: ADB.

³² ADB. 2015. *Country Assistance Program Evaluation: People's Republic of China*. Manila.

³³ The PRC cofinanced 33 of the 48 GMS TA projects approved by ADB during 2006–2013.

³⁴ The PRC cofinanced 13 of the 37 CAREC TA projects approved by ADB during 2006–2013.

50. **The World Bank Group, Inter-American Development Bank, European Bank for Reconstruction and Development, and UN agencies are investigating and making decisions on the challenges middle-income countries face in sustaining their growth rates, and on what specific mix of development products and services they now require.** This is likely to result in a wider portfolio of instruments and new lending products, injecting more knowledge into product solutions, stronger partnerships with institutions, private investors, and other stakeholders, and designing interventions that break-away from the single sector mold. A change in the culture and mindset of international organizations will also be required to promote learning, sharper knowledge-based engagements, and strengthened internal coordination³⁵.

51. **To retain its relevance in middle-income countries, the WBG stresses the need to develop a mix of products and services.** These include:

- (i) A stronger operational framework for countries experiencing fragility, conflict and violence, including stepping up International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency efforts in countries eligible for support from the International Development Association (IDA) and fragile environments, and making efforts to establish a sustainable concessional financing facility. Small states would receive special attention due to their special development challenges and fragility.
- (ii) Building buffers and flexibility to respond to changes in the global context, e.g., to respond to financial crises.
- (iii) Building up the International Bank of Reconstruction and Development (IBRD) portfolio for lower middle-income countries, including IDA graduates, by significantly increasing lending to lower middle-income countries over the next decade. LMICs face the biggest challenges in terms of poverty reduction and shared prosperity and are vulnerable to external shocks. Many IDA countries are due to transition to IBRD over the coming decade.
- (iv) Expanding the products offered to upper-middle income countries beyond financing. This includes setting targets for mobilizing international and domestic resources, joint financing with other multilateral development banks, a stronger global public goods content, sharper knowledge-based engagements, and more use of reimbursable advisory services, guarantees, and tailor-made instruments.
- (v) Taking the lead on the global public goods agenda, including an emphasis on fragile and conflict-affected states, implementation of the Climate Change Action Plan, and enhancing WBG crisis response.
- (vi) Scaling up mobilization efforts, including through the private sector window. IFC's mobilization instruments can further enhance the role that commercial capital can play. The WBG will expand its work with the private sector, bringing together the joint capabilities of the IFC, the Multilateral Investment Guarantee Agency, and IBRD and IDA.

52. **There is a strong emphasis on the need for a multifaceted response that combines the World Bank and IFC capabilities to deliver multisectoral and cross-institutional solutions to address complex needs.** By working with the private sector, civil society organizations, social entrepreneurs, and humanitarian groups, the WBG is

³⁵ World Bank. 2016. *Forward Look: A Vision for the World Bank Group in 2030*. Washington, DC.

able to respond to major outbreaks of disease such as the Ebola crisis. The key message is that the WBG cannot act alone and needs to continue to leverage its resources to increase financing for development on a much larger scale as part of the 2030 agenda.

53. **By 2020, most clients of IADB will be upper middle-income economies.³⁶ IADB recognizes that it has a role to play in reducing poverty and increasing sustainable growth, meeting the needs of small and vulnerable countries, and fostering development through the private sector.** To achieve this, it has adopted guiding principles which call for solutions to be more tailored and responsive to specific country needs, which suggests a wider portfolio of instruments. IADB has promised to continue to work in partnership with others to find innovative pathways in private sector financing. It supports multisector, interdisciplinary solutions to country challenges rather than a sector-by-sector approach. IADB acknowledges that the different client segments with which it works require tailored services, e.g., fee-based services or more knowledge products to upper middle-income countries. It aims to take a more strategic approach based on an understanding of the nature of the particular development problems of each country.

54. **To remain relevant in middle-income countries, United Nations agencies expect to provide more support to build resilient societies and institutions so that countries can withstand threats and crises.** The approach mirrors that of the WBG in terms of helping MICs that experience fragility, conflict, and violence. The UN also aims to strengthen national capacities in the justice and security sectors and to provide high-level policy advice and assistance with policy implementation to address social equity, environmental sustainability, youth bulges, aging populations, and migrant remittances.

55. **EBRD is considering a strategy for its regional members to help re-energize transition in its middle-income client countries.** Priorities include the need to improve the investment climate, greater social cohesion and inclusion, regional integration, climate change, resource depletion, and food security.³⁷ The PRC's accession to EBRD in January 2016 is significant in this context. There is strong potential for a two-way relationship. EBRD could provide valuable suggestions and proposals to facilitate the PRC transition to a system where the market can play a bigger role, while the PRC could contribute at least at the project levels in EBRD's other client countries.

D. Summary

56. Asia and Pacific MICs face several development challenges, but at the same time, their dynamism has paved the way for new development opportunities. Many of these MICs are increasingly plugged into regional and global economies, and access finance from a number of sources. It is important to understand the dynamics of these rapidly evolving challenges and opportunities.

57. Although MICs in the Asia and Pacific have made significant progress in reducing extreme poverty since the early 1990s, they are still home to about half of the world's poor. LMICs continue to have large numbers of extremely poor people and account for 40% of the world's poor. UMICs have had more success in reducing

³⁶ IADB. 2015. *Partnering with Latin America and the Caribbean to Improve Lives: Update to the Institutional Strategy 2010-2020*. Washington, DC.

³⁷ A. Williams. 2015. *EBRD to Step-up Response to Challenges in Transition Economies*. EBRD Blog <http://www.ebrd.com/news/2015/ebrd-to-step-up-response-to-challenges-in-transition-economies.html>

poverty, but it remains a challenge, particularly in the PRC. One clear distinction between UMICs and LMICs is the difference in poverty incidence. Inequality also remains a challenge for many MICs.

58. MICs face a broad range of development challenges that call for sophisticated and complex approaches. Some of these are a result of economic growth, such as problems associated with rapid and unplanned urbanization and insufficient attention to the preservation of natural capital and the environment. Other development challenges are associated with the need to continue improving productivity to sustain economic growth, as opportunities for easy productivity gains become exhausted. Maintaining macroeconomic and financial stability has also become important, as many countries face fiscal and current account deficits. Achieving economic diversification can also be critical for MICs—particularly those whose exports and/or industries are highly concentrated. MICs are also facing newer challenges from greater competition, better connectedness, more integration into global trade and financial systems, and climate change.

59. At the same time, the dynamics within the region present a number of opportunities to continue fostering development through South–South cooperation, investments in infrastructure and connectivity, and mobilizing resources for development through the two new multilateral banks.

60. ADB is not alone in addressing the evolving challenges of MICs. Other major international development agencies increasingly recognize that the fight against poverty in MICs is not over, but that a more tailored approach to individual countries is needed to address their specific development constraints. The WBG, IADB, EBRD, and UN agencies are investigating and making decisions on the challenges MICs face in sustaining their growth rates, and on the specific mix of development products and services they now require.

Lessons from ADB's Involvement with Middle-Income Countries

61. This chapter examines how ADB has responded to the challenges faced by MICs at various levels. It covers corporate strategy and policies, country programs, and projects.

A. Middle-Income Country Engagement in the Corporate Strategy and Policies

1. Strategy 2020 and its Midterm Review

62. At the corporate level, ADB's long-term strategic framework, **Strategy 2020**, recognizes that engaging with MICs is a strategic priority for ADB if it is to realize its vision of a region free of poverty.³⁸ It is noted that MICs can also contribute to the provision of regional and global public goods (especially environmental goods). The strategy acknowledged the diversity among MICs only implicitly. It noted that (i) there were different requirements across countries (including MICs) for the achievement of inclusive growth, environmentally sustainable growth, and regional integration; and (ii) in some MICs, there may be a need for ADB to intervene at the policy level or for capacity development, while in others ADB may provide assistance through work at the subsovereign level. The strategy appeared to acknowledge that some MICs remain fragile.

63. Differentiated engagement with MICs was emphasized in the midterm review (MTR) of Strategy 2020 in 2014.³⁹ A key step was distinguishing between LMICs and UMICs and the MTR called for ADB to respond to a new business environment characterized by the changing development priorities of countries that attain upper middle-income status. It suggested that ADB needs to differentiate its strategic engagement across MICs as it supports their specific development goals and builds on their unique capacities and expertise. It recognized that UMICs generally have higher levels of human development than LMICs and LICs, better access to infrastructure, more developed financial markets, greater private sector participation in development, and a better ability to tap diverse sources of finance. The MTR envisaged: (i) an increasing role

³⁸ ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank 2008–2020*. Manila. A background paper on MICs, *Enhancing Asian Development Bank Support to Middle-Income Countries and Borrowers from Ordinary Capital Resources*, was prepared in 2006 and fed to the strategy.

³⁹ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

for the private sector in developing infrastructure, creating jobs, reducing poverty, and supporting economic growth; and (ii) an increasing need for knowledge solutions to address complex challenges.⁴⁰ It sought to continue the focus on infrastructure development in MICs and other client countries, but with increased attention to operations in social sectors.⁴¹

64. **As ADB prepares its new corporate strategy to 2030, new approaches to deepen the engagement with MICs can be expected.** This will be informed by, among others, the framework for engagement with upper middle-income countries,⁴² and a note on information and communication technologies.⁴³ ADB also intends to promote inter-subregional knowledge product development.⁴⁴

65. **In parallel with the MTR exercise, IED reviewed ADB's progress in implementing Strategy 2020 and found that MICs need to respond to the aspirations of a growing middle-class. It suggested a greater role for the private sector.**⁴⁵ In light of the increasing importance of the private sector as a source of growth, particularly in MICs, and the decreasing importance of official development assistance relative to other financing sources, IED noted that the corporate target of increasing private sector development and private sector operations (combined) to 50% of ADB's annual operations by 2020 is a good goal. It observed that ADB will promote PPP in all core operational areas under Strategy 2020 and that there had been some success at the country level, especially in MICs, in adopting PPP policies and laws and strengthening PPP units. It recommended that ADB's MIC and private sector development strategies should be updated and that ADB should provide more support for PPP in the lagging regions of MICs.

66. **IED also suggested that ADB needs to pay greater attention to the knowledge needs of its growing MIC clientele.** It noted the value of two-way knowledge transfer highlighted by MICs. It considered that, given the influence of MICs on regional and global public goods, a possible justification for ADB's presence in MICs could be its ability to facilitate inbound and outbound knowledge transfer.

⁴⁰ LMICs will continue to face issues similar to those in LICs. ADB has extensive experience in addressing many such development challenges.

⁴¹ The MTR called for (i) strengthening outcomes in infrastructure sectors by improving sector engagement, leveraging private sector investment, and emphasizing operations and maintenance; (ii) pursuing the vision of a region free of poverty by expanding support for achieving rapid and inclusive economic growth, supporting infrastructure projects that connect the poor to markets, emphasizing financial inclusion and social protection, strengthening governance systems, and institutional capacities; (iii) promoting natural resource management, scaling up support for climate change adaptation, maintaining support for climate change mitigation, strengthening integrated disaster risk management, and helping countries access global and regional funds for environment and climate change; and (iv) supporting cross-border infrastructure investments, expanding regional connectivity, facilitating trade, strengthening financial and monetary cooperation, and supporting regional public goods.

⁴² ADB. 2015. *ADB's Approach to Upper Middle-Income Countries: A Refined Framework*. Manila.

⁴³ ADB. 2016. *Road to 2030: Information and Communications Technology in ADB's Corporate Strategy and Operations*. Manila.

⁴⁴ ADB. 2016. *Operational Plan for Regional Cooperation and Integration: Promoting Connectivity, Regional Public Goods, and Collective Action for Asia and the Pacific (2016–2020)*. Manila.

⁴⁵ IED. 2014. *Inclusion, Resilience, Change: ADB's Strategy 2020 and Mid-Term*. Manila: ADB.

2. Graduation Policy

67. **ADB's graduation policy needs to be attuned to the emerging development challenges of MICs.** As per the 1998 graduation policy and its 2008 review,⁴⁶ the criteria for the termination of regular ADB support to a country are (i) a per-capita GNI of \$7,185 at 2013 prices; (ii) the availability of commercial capital flows on reasonable terms; and (iii) the attainment of a certain level of development by key economic and social institutions. The policy states that graduation from regular ADB support is expected to occur within 5 years of a country meeting all three graduation criteria, and indicates ways in which ADB can partner with countries after they have graduated.⁴⁷ It considers the graduation of a particular country to be part of an evolving relationship between ADB and that country. However, MICs, including UMICs, not only continue to face their traditional development challenges, but are also confronted with new ones. The static nature of the graduation policy is not flexible enough to account for this and ADB is currently reviewing the policy.

68. **The MTR acknowledged the need for ADB to continue to assess its graduation policy, consider the changing circumstances of Asia and the Pacific region, and take into account the graduation policies of other multilateral banks.** Additionally, while addressing graduation from regular support, the MTR recognized the need for ADB to facilitate MICs to learn from successful international experience and global best practices in order to overcome their remaining challenges. The MTR considers that LMICs continue to face development challenges that are similar to those of LICs, so its reference to "remaining challenges" appears to be in the context of UMICs.

B. Responsiveness of Country Programs in Middle-Income Countries

1. Addressing Middle-Income Countries' Development Challenges

69. **Of the 28 country assistance program evaluations (CAPEs) and country partnership strategy final review validations (CPSFRVs) in MICs completed from 2010 to February 2016, IED found that the country programs had been *successful* in 20 cases—a success rate of more than 70%.** The evaluations found 83% of the country programs in MICs to be strategically positioned, 82% *relevant*, and 82% *effective*. But there were efficiency problems on how the programs were delivered. Only 32% of the country programs were rated *efficient* or better. Only 54% of these were assessed to be *sustainable*, while 61% had *satisfactory* development impacts.

70. **These CAPEs and CPSFRVs, however, continue to bring out the need to address development challenges in MICs.** Many of them have suggested a focus on certain sectors: 15 CAPEs and CPSFRVs recommended attention to poverty and inequality related issues, 11 stressed environmental and climate change issues, 5 each emphasized economic diversification and productivity improvement, and 4 suggested a focus on governance. Among sectors, a focus on one or more infrastructure sectors (energy, transport, and water) was recommended in 14 CAPEs and CPSFRVs, and PSM was recommended in 12. Support for the financial sector was recommended in 8 CAPEs

⁴⁶ ADB. 1998. *A Graduation Policy for the Bank's DMCs*. Manila; ADB. 2008. *Review of the 1998 Graduation Policy of the Asian Development Bank*. Manila.

⁴⁷ These include (i) emergency assistance, (ii) provision of expert services and technical assistance, (iii) bond issues, (iv) transfer of technology, (v) cofinancing, (vi) promotion of private-to-private flows, and (vii) subregional cooperation.

and CPSFRVs, and for private sector development in 8. Of the social sectors, 9 CAPEs and CPSFRVs recommended ADB support for the education sector, 2 recommended health, and 2 social protection. Box 2 illustrates an approach to working with an MIC government that relies on addressing development challenges.

Box 2: Country Partnership Strategy Final Review Validation for Indonesia: Findings, Lessons, and Recommendations

As a lower middle-income country, Indonesia faces complex development challenges, including worsening urban deprivation and disparities across provinces. Both these have impeded inclusive growth. Indonesia is also susceptible to environmental shocks that hamper overall development. However, Indonesia's development challenges and opportunities have not always been well captured in ADB's country partnership strategies.

In future, ADB's country program must be anchored in rigorous analysis of Indonesia's development challenges and constraints. ADB needs to tap its experience and knowledge of the operational challenges in the infrastructure, social and environmental sectors, and in policy and institutional reforms—gathered from over five decades of engagement in the country. This would help the government to identify priority sectors for development and to implement reforms.

Realizing inclusive growth could depend to a large extent on designing projects that include and mobilize the people who have been left out of the growth process. Environmental sustainability aspects could be integrated into infrastructure and energy projects and programs, to enhance their resilience to extreme weather events, diversify the energy mix, and promote energy security.

The IED validation reiterated the need for a programmatic approach that would help address the policy and institutional reforms needed to improve the delivery of infrastructure and social services. The recommendations highlighted the need to foster inclusive growth in project designs, promote climate-change-resilient infrastructure and renewable energy, focus on innovative approaches to development (i.e., transformative knowledge solutions and use of impact evaluations), and strengthen diagnostic work to facilitate proper project designs and selection of priority sectors.

Source: IED. 2015. *Indonesia: Validation of Country Partnership Strategy Final Review, 2012–2014*. Manila: ADB.

2. Perception of Client Middle-Income Countries

71. IED visited a number of MICs to validate the reflections and evidence presented in CAPEs and CPSFRVs and to deepen the understanding of (i) preferences for certain types of products and services and the reasons for these, (ii) the extent to which ADB's on-the-ground presence, skill-sets, systems and procedures, and comparative advantages (real or perceived) have influenced the type of support countries have sought from ADB; and (iii) key differences that client MIC governments notice in their interactions with ADB in contrast to their relationships with other multilaterals active in the country, including the suite of products and services.⁴⁸

72. **IED found that MIC governments and other stakeholders value their engagement with ADB.** They consider ADB to be a credible development partner that can offer wide-ranging support to address their specific development priorities. They appreciate: (i) ADB's guidance and inputs in project design, safeguards, and project management, coupled with its support for capacity development (project management in many cases); (ii) the "seal of approval" that is normally associated with any private sector project that ADB supports; and (iii) ADB's convening powers in fostering regional cooperation and integration.

⁴⁸ <https://www.adb.org/sites/default/files/evaluation-document/182893/files/eap-adb-mics.pdf>. In addition to the five client MICs IED visited (the PRC, Indonesia, Kazakhstan, Malaysia, and Thailand), IED also participated in country consultations organized by SPD, which covered about 30 MICs.

73. **MIC stakeholders expect greater value added knowledge from ADB to enable them to improve economic governance and implement structural reforms,** tap new sources of growth, tackle the environmental and social development challenges associated with urbanization, reduce regional disparities, establish better regional connectivity, expand social and physical infrastructure, diversify their economies and improve productivity, catalyze private sector operations in priority development areas, and facilitate regional cooperation.

74. **MIC stakeholders value ADB's efforts in forging knowledge partnerships across a broad spectrum of disciplines as a good start**—with the next step being to ascertain the flow of knowledge and expertise from these knowledge partners to ADB for the design of investment and TA projects. MICs that have been successful in addressing their development challenges believe that ADB can help them to share lessons from their development experience with other developing countries. A desire for such outbound knowledge sharing has been articulated by both the PRC and Malaysia; and ADB has made a beginning in working along these lines with the PRC government.

75. **MIC clients would like ADB to increase: (i) its support for subnational governments and SOEs, (ii) advisory services for and financing of PPP projects; (iii) use of guarantee products to encourage private sector investments; and (iv) financing in local currency.** At the same time, they broadly find ADB's suite of lending products and modalities for sovereign and nonsovereign operations to be relevant.⁴⁹ All the MICs generally consider TA project support to be useful.

76. **MIC clients suggest that ADB could improve internal coordination, empower resident missions, and strengthen capacity so it is able to offer knowledge-intensive support that can be translated into practice through policy or investment.** They also recommend better development partner coordination for information exchange, sharing of lessons, fostering cooperation in areas of mutual interest, and ensuring that issues are covered without duplication and without unintended gaps. MIC stakeholders feel that with such measures ADB will be able to realize its objective of becoming stronger, better, and faster.

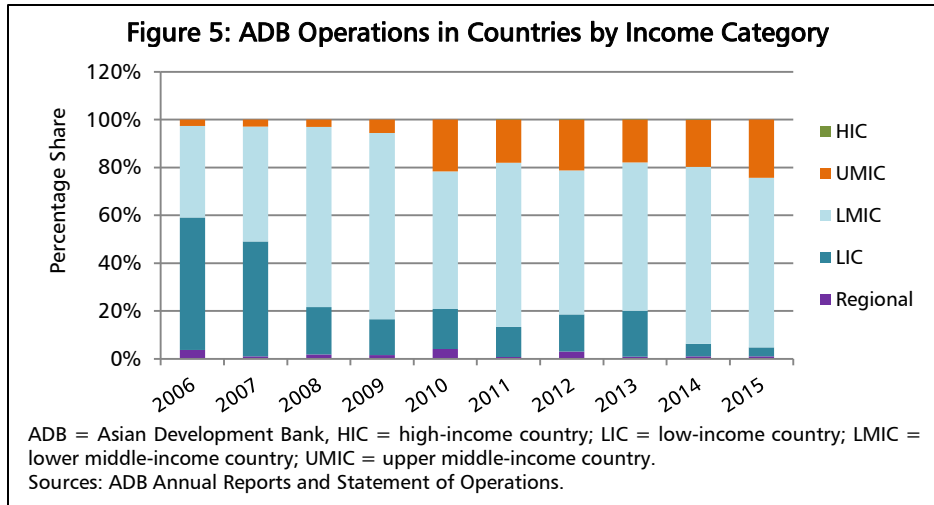
77. The expectations, suggestions, and observations of client MIC stakeholders are elaborated further in Linked Document 5 and Supplementary Appendix 6.

C. Allocation of Resources to Middle-Income Countries

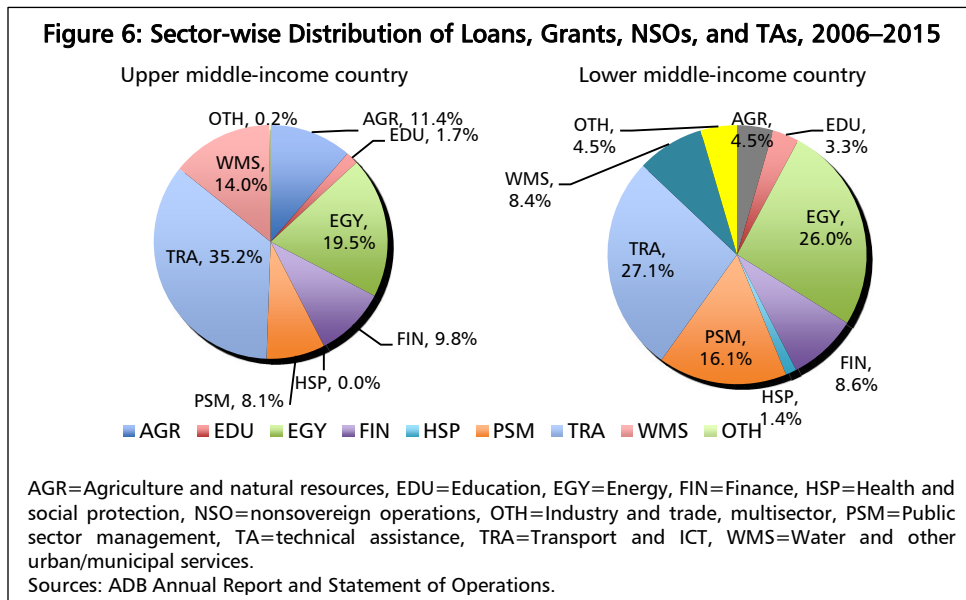
78. **Lending to MICs has grown significantly over the years.** From 2006 to 2015, the volume of approvals allocated to MICs more than quadrupled from \$3.5 billion in 2006 to \$15.8 billion in 2015. Their share of ADB's portfolio more than doubled from 41% in 2006 to more than 96% in 2015.⁵⁰ Figure 5 shows that operations in both LMICs and UMICs increased during the period. ADB has provided development support regularly to all LMICs, all small island UMICs, and many other UMICs.

⁴⁹ These include multitranches financing facilities and results-based loans .

⁵⁰ These include support from (i) ordinary capital resources through loans, equity investments, and guarantees; (ii) Asian Development Fund through loans and grants; and (iii) other special funds through technical assistance and other grants. This figure excludes official and commercial cofinancing.



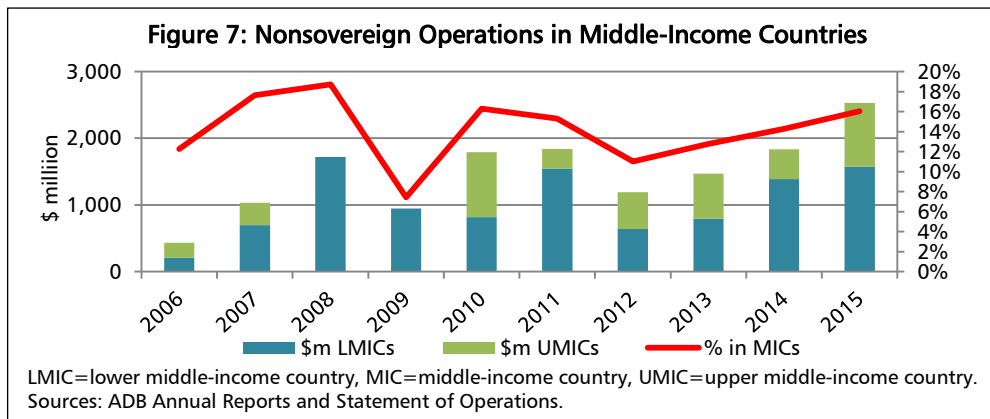
79. **The MIC portfolio continues to be skewed towards infrastructure and some adjustments are needed to respond to other development challenges of MICs.** For the 19 MICs whose country-specific issues were investigated by this evaluation, Figure 6 shows the dominant share of the infrastructure sectors during the six-year period (2010–2015). Support for transport and energy accounted for about 53% in LMICs and 55% in UMICs; while the share of support for water and other urban services in LMICs (8%) was significantly less than that in UMICs (14%). During the same period, the share of ADB support for PSM in LMICs (16%) was significantly higher than in UMICs (8%); and similarly, the share of ADB support in social sectors was also significantly higher in LMICs (5%) than in UMICs (2%). ADB has also tried to increase its thematic orientation to address, among others, the challenges of climate change, environmental management, governance, and urbanization. Recent efforts by ADB to emphasize knowledge in its country programs are discussed in Linked Document 6.



80. **While ADB's financing for MICs has continued to grow over time, its engagement with some MICs has been highly variable with no consistent pattern.** ADB considers UMICs generally to be collaborators, and recognizes that they are in a better

position than other countries to raise investment capital from other sources. However, each UMIC is unique. ADB has supported projects with design innovations in some UMICs and focused on supporting the private sector in others. ADB has engaged continuously with: (i) the PRC, where annual approvals have shown a steady growth over the past 5 years; (ii) Azerbaijan and Kazakhstan, where approvals have tended to fluctuate substantially from one year to the next; and (iii) Thailand, where ADB interventions mostly support the private sector. ADB's engagement with Malaysia was reduced to regional technical assistance following the 1997–1998 Asian financial crisis, although it prepared an interim country partnership strategy (CPS) covering 2011–2012. ADB has engaged with Turkmenistan since 2011 and is preparing an interim CPS.⁵¹

81. **Approvals for nonsovereign operations in MICs increased six-fold from about \$0.4 billion in 2006 to \$2.5 billion in 2015.**⁵² This resulted in a moderate rise in the share of nonsovereign operations in MICs from 12% of total ADB operations in MICs in 2006 to 16% in 2015, although it peaked at 19% in 2008 (Figure 7). During this 10-year period, about 70% of ADB's nonsovereign operations (in terms of the US dollar amount) were in LMICs.

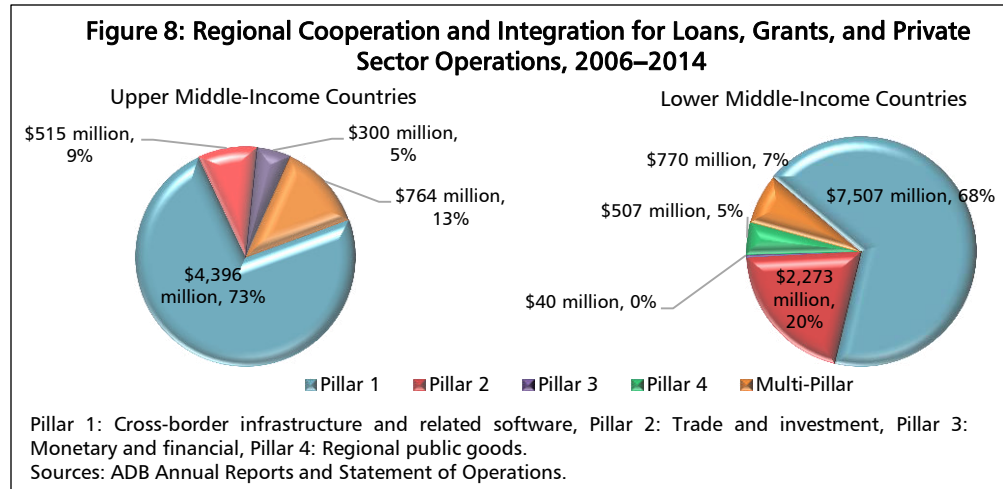


82. **Fostering RCI among MICs has been a growing area of support by ADB.** Approvals with RCI components increased more than seven-fold, from less than \$450 million in 2006 to over \$3.2 billion in 2014. Cross-border infrastructure and related software are large in both UMICs and LMICs, about 70% of total investment project approvals (sovereign and nonsovereign). However, nearly all investment approvals for cooperation in regional public goods (pillar 4) were in LMICs (Figure 8).⁵³ In terms of TA project approvals, however, the share of pillar 4 was significant (7%) although about one-third that for LMICs (20%). These ADB interventions have been through the CAREC, GMS, and South Asia Subregional Economic Cooperation programs.

⁵¹ Following an advisory technical assistance project that was approved in 2007, the first lending project was approved in 2011 with the North–South Railway. There is as yet no CPS for Turkmenistan, and an interim CPS has been in preparation in consultation with the government since 2011. ADB has updated the draft strategy each year to keep it current, and annual COBPs have been formulated in line with the draft interim CPS.

⁵² Includes loans, equity investments, partial credit guarantees, political risk guarantees, and supply-chain finance.

⁵³ ADB. 2006. *Regional Cooperation and Integration Strategy*. Manila.



D. Performance of Projects in Middle-Income Countries

83. The performance analysis of ADB operations is based on: (i) 131 project validation reports (PVRs) of sovereign projects in MICs, for which project completion report (PCRs) were circulated during July 2012 to June 2015; and (ii) 38 validation reports (XVRs) of nonsovereign operations projects in MICs, for which extended annual review reports were circulated during July 2012 to September 2014.

1. Sovereign Operations

84. Overall, the share of ADB-financed sovereign projects rated *successful* or *highly successful* has increased in recent years. Between July 2012 and June 2015, the share of validated PCRs rated *successful* or *highly successful* was 72%, well above the shares in 2010–2012 (59%) and 2007–2009 (60%). ADB needs to continue emphasizing project outcomes to maintain these high success rates.

85. Project success rates in UMICs are higher than those in LMICs. Of the 131 PVRs, 102 were for projects in LMICs and 29 for projects in UMICs. Projects were rated *successful* or *highly successful* in 68 (67%) of PVRs covering projects in LMICs and 26 (90%) covering projects in UMICs. The following sectors had projects in LMICs with success ratings below the overall average of 67%: water and urban infrastructure (60%), transport (43%), and financial sector (40%). In UMICs, transport (80%) and public sector management (60%) projects had success rates below the average of 90%.

86. Nearly a quarter of sovereign loan projects in UMICs received high ratings and more than 60% received median ratings under the relevance and effectiveness criteria (Table 1). Sovereign projects implemented in UMICs were deemed to be consistent with ADB and government strategies, as well as having appropriate project design. The sustainability ratings indicate that UMIC governments have the financial and institutional capacities to operate and maintain the projects well. These projects have also generally delivered the expected outcomes and outputs, which demonstrates a strong commitment from governments as well as implementation capacity.

Table 1: Distribution of Ratings of Sovereign Projects in Upper Middle-Income Countries (%)

Rating (Value)	Relevant	Effective	Efficient	Sustainable
Highly/Most Likely (3)	24	24	3	14
Relevant/Effective/Efficient/Likely (2)	69	62	69	59
Less than (1)	7	10	28	24
Irrelevant/Ineffective/Inefficient/Unlikely (0)	0	3	0	3
Total	100	100	100	100

Source: Independent Evaluation Department

87. For LMICs, most projects were rated at the median level in all four criteria, but the performance of many projects was below the median level for efficiency and sustainability (Table 2). The efficiency issue raises concerns about net economic benefits, while the performance on sustainability reflected the financial viability and capacity of the relevant agencies to sustain project outcomes.

Table 2: Distribution of Ratings of Sovereign Projects in Lower Middle-Income Countries (%)

Rating (Value)	Relevant	Effective	Efficient	Sustainable
Highly/Most likely (3)	12	4	2	6
Relevant/Effective/Efficient/Likely (2)	77	67	58	59
Less than (1)	11	27	37	34
Irrelevant/Ineffective/Inefficient/Unlikely (0)	0	2	3	1
Total	100	100	100	100

Source: Independent Evaluation Department

2. Nonsovereign Operations

88. LMICs performed better in nonsovereign operations than UMICs. Of the 38 XVRs, 25 were for projects in LMICs and 13 for projects in UMICs. Overall, 29 (76%) XVRs rated the projects as *successful* or *highly successful*. In LMICs, 88% of the projects were rated *successful* or *highly successful*, significantly higher than the 54% for projects in UMICs. This can be explained largely by a comparison of ratings for the ADB's additionality criteria across LMICs and UMICs: 52% of projects in LMICs were rated *excellent*, compared with 15% of projects in UMICs. Given that ADB's main value addition lies in providing assurance to other financiers and in improving project design, this reflects the relatively lower capacities in LMICs. Likewise, ADB's work quality is appreciated more in LMICs than in UMICs (Tables 3 and 4).

89. LMICs have higher ratings in development results and ADB investment profitability than UMICs. In LMICs, 88% of projects have at least *satisfactory* development results, compared with 54% in UMICs. With regard to ADB's investment profitability, 84% of projects in LMICs have at least a *satisfactory* rating for profitability compared with 61% for those in UMICs.

Table 3: Distribution of Ratings of Nonsovereign Projects in Upper Middle-Income Countries (%)

Rating	Development Result (%)	ADB's Investment Profitability (%)	ADB Work Quality (%)	ADB's Additionality (%)
Excellent	8	15	0	15
Satisfactory	46	46	38	62
Less than Satisfactory	23	15	46	15
Unsatisfactory	23	23	15	8
Total	100	100	100	100

Source: Independent Evaluation Department

Table 4: Distribution of Ratings of Nonsovereign Projects in Lower Middle-Income Countries (%)

Rating	Development Result (%)	ADB's Investment Profitability (%)	ADB Work Quality (%)	ADB's Additionality (%)
Excellent	24	20	8	52
Satisfactory	64	64	56	36
Less than Satisfactory	0	4	28	12
Unsatisfactory	12	12	8	0
Total	100	100	100	100

Source: Independent Evaluation Department

E. Summary

90. The role of ADB is to help MICs address their development challenges. Examining ADB's responsiveness at the corporate, country, and project levels, IED finds that ADB has been responsive but needs to improve in some areas. At the corporate level, Strategy 2020 and its MTR are quite clear on ADB's role to support MICs, and to provide the necessary guidance and mandate. Strategy 2020 recognized that ADB's engagement with MICs is essential if it is to realize its vision of a region free of poverty, and the MTR advocated a differentiated engagement with MICs. These documents provide the guidance and mandate for ADB to engage with MICs. However, ADB's graduation policy of 1998 (and its 2008 review) is not flexible enough to account for new development challenges and the new business environment facing ADB—and ADB has acknowledged the need to revisit this policy.

91. At the country level, more than 70% of country programs have been rated successful or better. However, a recurring message from CAPEs and CPSFRVs is the need to orient country programs to address a broad range of development challenges. This was reaffirmed through consultations with stakeholders in many client MICs.

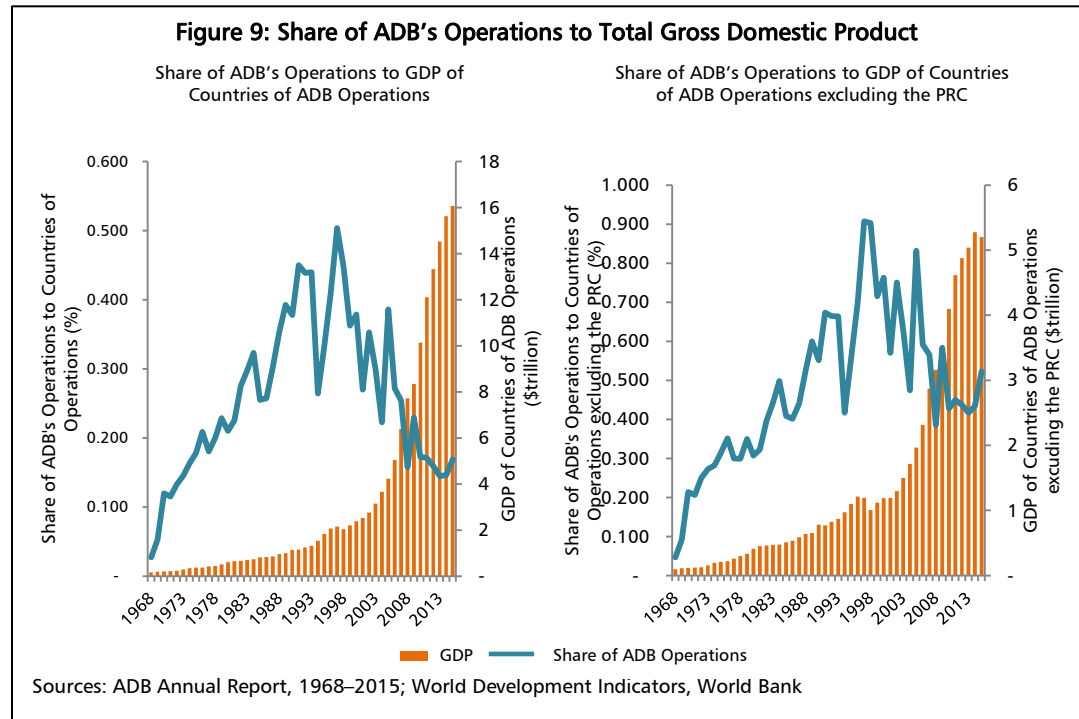
92. The MIC portfolio continues to grow, indicating that MICs continue to demand ADB support, with infrastructure continuing to dominate the allocation in both LMICs and UMICs. The share of social sector projects has become significant, particularly in LMICs, and accounted for about 6% of ADB's support since 2010. IED rated about two-thirds of projects in LMICs as *successful* or *highly successful*, compared with 90% in UMICs. A significant number of projects in LMICs tend to have concerns about implementation efficiency and/or sustainability. Projects in UMICs perform relatively well across all criteria, and demonstrate strong ownership and capacity from ADB counterparts. In nonsovereign operations, projects in LMICs are rated more highly than those in UMICs. It is surprising to see more projects in LMICs and with better development results and more profitability than in UMICs.

Alternatives for Strategies, Policies, and Initiatives to Meet Middle-Income Country Needs

93. This chapter takes into account lessons from ADB's previous engagement in MICs, findings from country visits, and the positions taken by other multilateral organizations with regard to MICs. It aims to offer options for the policy directions and strategic initiatives that ADB could consider adopting to enhance its role in MICs, including revisiting the graduation policy. The chapter is structured as a menu of alternatives in recognition of the need for ADB—through its different decision-making bodies—to deliberate and make decisions at this important juncture.

A. Broad Policy Directions

94. **The economic strength of ADB's clientele has increased rapidly since the early 2000s, and the significance of ADB operations (in US dollar terms) has diminished from a peak of the late 1990s. It is clear that ADB needs to provide more value adding and strategically oriented support to MICs in the coming years to remain relevant.** Figure 9 shows that as a share of GDP of its client MICs, ADB's total approvals in 2015 were less than 0.2%, having declined from a peak of about 0.5% in the late 1990s (during the Asian financial crisis period). By 2015, the ratio was back to the level of the mid-1970s. Excluding the PRC, the share of ADB's total approvals to GDP of other client MICs was about 0.5% in 2015, having reduced from a peak of 0.9% in the late 1990s, and reverting back to the level of the mid- to late-1990s.



95. To respond to the current context and meet the needs and expectations of its already high and growing number of MIC clients, ADB needs to consider evolving towards a business model that places learning and innovation at the center and increases the knowledge intensity of its operations in order to contextualize and customize its support. The broad range of development challenges faced by MICs and the size of their economic base after years of sustained growth (in part a reflection of ADB's successful contribution to the region), indicates that trillions, not billions, of US dollars will be required to support their continued sustainable development. This implies that ADB has to scale up operations and intensify the leveraging and mobilization of financial resources.

96. The stage of development and improved business climate of its MIC clientele also suggest that there is a need and an opportunity for stronger private sector development support from ADB, directly and through PPP. Additionally, the middle class has been growing in many MICs (including LMICs) and governments in both LMICs and UMICs face the challenge of responding to its aspirations and demands for a greater say in the development process. Other priority areas of support will emerge from the development challenges that a growing number of MICs are facing. Adopting these broad directions would influence ADB's engagement with MICs as well as the delivery mechanisms.

1. Anchoring Finance on Knowledge

97. It is likely that ADB's continued relevance in MICs will come from the extent to which it can support national governments, subnational governments, the private sector, and other nonsovereign clients in: (i) analyzing their key development or business challenges, unpacking their key issues, and using this to form a basis for ADB's engagement over the medium-term; and (ii) applying best international practices and

learning from the experience of other countries and private sector agents (in the region and beyond) that have already addressed or are addressing similar challenges. The knowledge may take the form of content that is embedded in ADB interventions (e.g., procurement, safeguards, and corporate practices) or knowledge that is separate from and complementary to lending. If this path is adopted, a strong learning culture will need to be encouraged and systems for capturing, storing and disseminating knowledge will need to be developed. This does not mean that knowledge would become the main service provided by the organization. ADB is a bank and that is the nature of its business; we refer to the need to increase the value addition of financial operations by decisively complementing or embedding knowledge in them.

2. Scaling Up and Mobilizing Finance for Targeted Engagement in Middle-Income Countries

98. **Given the economic growth that the Asia and Pacific region has experienced, the economic base of regional MICs has also grown significantly.** Although ADB could be expected to continue supporting efforts to address a range of specific development challenges (Chapter 2), emerging trends will also require a massive mobilization of funds and targeted ADB support. The right combination of volume, alignment with MICs' needs and smart targeting is fundamental. While a larger scale of operations will be needed if ADB is to have meaningful impact and maintain its influence, it will not be able to play the same proportional financial role that it did in the past, because the economic base of MICs has grown so dramatically and because there are obvious limits to increasing ADB's capital base.

99. The five broad trends outlined below offer ADB opportunities to scale up and target its engagement in MICs.

- (i) **Urbanization.** A rapid urbanization process has been unleashed in MICs, entailing huge risks for a growing number of people. If these MICs are to enjoy clean, inclusive, and competitive urban centers, ADB's support is urgently needed to support better access to affordable and reliable utility services by the urban poor, promote environmentally sustainable growth, enable efficient power distribution, and provide capacity development (e.g., in the spatial aspects of planning urban expansion). Support is also needed for city modernization programs, including replicating successful city experiences, as has already been done in the PRC. Economic and urban growth offer ADB the opportunity to expand its operations at the subnational level, for many of the urban issues have taken a regional character, not only in their impact but also in their management.
- (ii) **Environment and climate change.** ADB's support for urban environmental management could help address: (i) city-wide problems such as ambient air pollution and inadequate waste management; and (ii) impacts of urban activities beyond city limits, such as the pollution of rivers or coastal areas. Such support areas span several Sustainable Development Goals (SDGs). ADB support could also include the strengthening of environmental governance at national and subnational levels, and capacity development to enable the sustainable management of natural resource endowments. Given that each country's greenhouse gas emissions contribute to increases in overall concentrations, and any country's greenhouse gas abatement

programs will contribute to addressing this global problem, ADB is well positioned to continue aggressively supporting climate change mitigation measures (in energy and other sectors) demanded by the region.

- (iii) **Public goods.** Public goods issues that by their nature are not addressed by the market or do not receive attention from MIC governments can be dealt with at an international and a subregional level with ADB support. These include the coordination of regional transport infrastructure for good connectivity, regional energy cooperation, regional health programs to contain endemic diseases, financial regulation to limit cross-border contagion, water resource management, pollution abatement, climate change mitigation, and environmental preservation.
- (iv) **Productivity, competitiveness, and innovation.** Given the challenges regional MICs face in raising productivity and competitiveness, ADB support for improving human capital could emphasize systems of education and training that match skills development with market needs, as well as policies and factors that improve TFP (including labor market efficiencies, and policy environments, and governance systems that encourage innovation).
- (v) **South–South cooperation.** The growing collaboration among countries of the South fosters self-reliance through exchanges of experience and the pooling and sharing of technical, and other resources. The emergence of the Asia Infrastructure Investment Bank and the New Development Bank are in part manifestations of this trend. Such collaboration can be fully embraced and facilitated by ADB, through its lending and non-lending modalities. Given the interest some UMICs have shown in sharing their knowledge and experience with other countries in the region, it makes sense for ADB to distil lessons from such development successes and to promote the transfer of knowledge and experiences from successful public and private agents, facilitating the sharing of solutions and experts. More importantly, ADB can become a center for mobilizing the abundant financial resources (sovereign and nonsovereign) in the region and supporting their investment in MICs, by exploring the creation of mechanisms like the Asset Management Company established by IFC.⁵⁴

100. **ADB could also be called upon to support resilience building to manage two broad types of emergency situations.** These include emergency situations that are related to transmission of external economic or financial shocks, and disasters that are triggered by natural hazards which are anticipated to be increasingly related to climate change.

- (i) **Resilience to economic vulnerabilities.** Better connectedness and integration in global trade and financial systems that can potentially increase vulnerabilities to global or regional business cycles and economic downturns, could call for ADB support to reduce the

⁵⁴ http://www.ifc.org/wps/wcm/connect/8b089e004f36e66f9c1ede032730e94e/AM2014_IFC_Issue_Brief_AMC.pdf?MOD=AJPERES

disruptive effects of economic and financial crises. Among the various approaches could be support for structural reform, and diversification of sector or industry mix and trading partners.

- (ii) **Resilience to disasters triggered by natural hazards.** Climate change-related weather events of increasing frequency and intensity and other natural hazards that trigger a disaster could call for ADB support for incorporating disaster risk reduction principles into projects, support disaster risk management activities in addition to post-disaster reconstruction works.

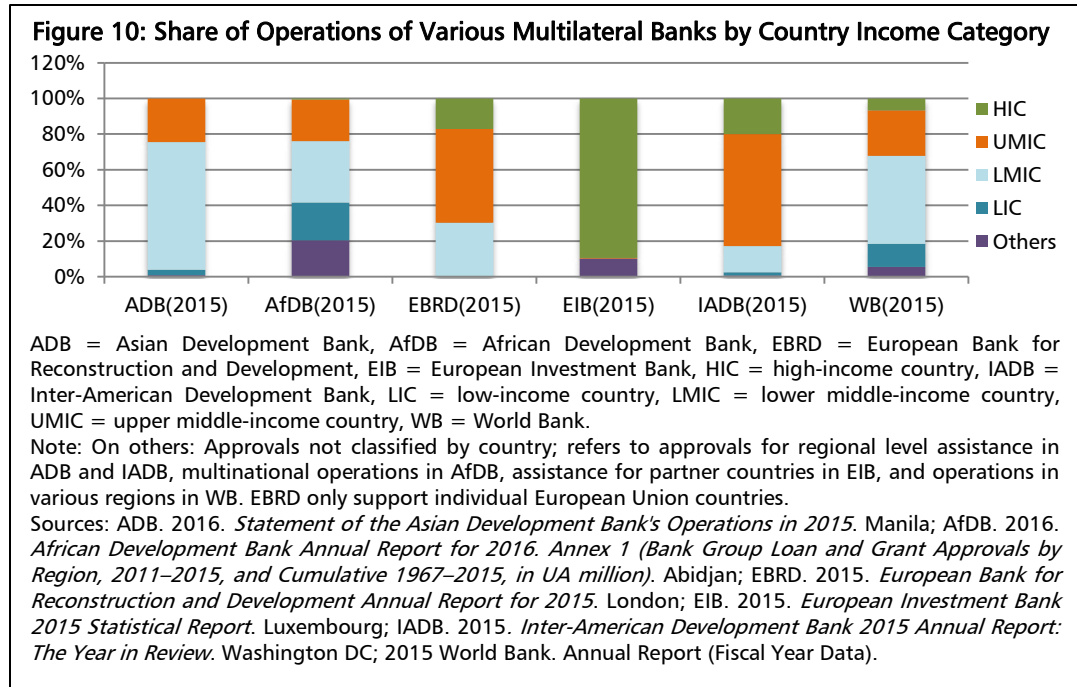
3. Decisively Supporting Private Sector and PPP

101. **A realization of the importance of the private sector for development with growth, coupled with improving business climates in MICs offer ADB an attractive opportunity to support the private sector strongly and decisively through large-scale interventions.** Given current circumstances, this support, which can be on a purely market and competitive basis, could also produce attractive dividends that can be invested in public sector initiatives and in lagging regions and countries. Parallel to this, ADB could aggressively scale up its support to PPPs in key development areas of MICs. The Economist Intelligence Unit classifies the PPP maturity of countries into “nascent” (countries with the least developed enabling environment), “emerging” (countries with an enabling environment under construction), and “developed” (countries with a well-established enabling environment). The scores for various MICs in the region have improved since 2011, and India and the Philippines are now classified as developed in this classification.⁵⁵ The conditions for successfully promoting PPP are promising in MICs and ADB is positioned to take advantage of this opportunity.

B. Rethinking Graduation from Regular Support

102. Multilateral banks have continued to engage with UMICs and HICs. IADB and the WBG promote energy efficiency, social policies, climate change mitigation, regional connectivity, and other valuable objectives through their engagement with HICs and UMICs. These countries accounted for 30% of the WBG’s support in 2015, more than 70% each for EBRD and IADB (Figure 10). Most notably, HICs account for 90% of EIB operations, which reflects the EIB approach of supporting relatively less developed pockets in HICs to bring them on par with other parts of those countries.

⁵⁵ <https://www.adb.org/sites/default/files/publication/158409/2014-infrascopes.pdf>. Scores for PPP maturity have improved from 2011 to 2014 for Bangladesh, the PRC, India, Indonesia, Kazakhstan, Mongolia, Pakistan, Papua New Guinea, Philippines, Thailand, and Viet Nam.



103. **EIB acts as the European Union's financial institution and provides a range of services to high-income countries in the European Union to support convergence in regional productivity and incomes.** It plays an important role in implementing the European Union's infrastructure and other programs. EIB focuses on key areas where it has proven expertise and the capacity to deliver a positive impact on the European economy. For example, it runs the European Commission's European Fund for Strategic Investments launched in 2014, the focus areas being: (i) strategic infrastructure, including digital, transport, and energy; (ii) education, research, development, and innovation; (iii) renewable energy and resource efficiency; and (iv) support for small businesses and midcap companies.

104. **Other multilateral organizations have also noted that the development finance needs of countries do not vanish when they cross the income threshold to attain the HIC status, and that their development successes form a rich resource that can be shared with MICs and other countries.** The experiences of multilateral organizations in Chile and Poland are summarized in Box 3 and detailed in Linked Document 7 (see Appendix).

**Box 3: Multilateral Engagement with High-Income Countries:
The Cases of Chile and Poland**

Chile’s growth performance has declined in recent years^a and inequality remains high despite substantial poverty reduction.^b

To move successfully beyond this stage, Chile needs to upgrade its power supply, address infrastructure bottlenecks, strengthen the education system, and raise the technology intensity of its manufacturing industry.

Both the Inter-American Development Bank and the World Bank Group (WBG) have moved from sovereign to nonsovereign support for infrastructure in Chile. They have also provided knowledge support; e.g., the WBG focuses on priority areas, including public sector modernization, and promotion of sustainable investment.

The WBG has established a research center on global development issues in Chile, one of its key objectives being to provide lessons from Chile’s successful development experience to other countries.

Poland needs to move away from low value-added manufacturing. It needs to improve its trading links, reduce inequality, and manage an unfavorable demographic trend.

The European Bank for Reconstruction and Development, the European Investment Bank, and the WBG have been engaged in investments in strategic infrastructure, support to small and medium-sized enterprises (SMEs), privatization of state-owned enterprises (SOEs) and financing of public–private partnership projects, along with knowledge work.

The WBG recognizes that Poland is a global development partner, and in 2013–2014 organized debates and conferences on key development topics, initiated knowledge exchange between Poland and other countries, and prepared a number of publications summarizing Poland’s accomplishments over the past 25 years.

^a Due largely to the depressed prices of minerals (a major export item) in the international market, and a reduction in the rate of TFP growth as it continues with low value-add manufacturing.

^b Since the early 1990s, the Gini coefficient has remained above 50, while poverty rates have fallen sharply in recent years, from 7.7% in 2003 to 2% in 2014 (assuming a poverty line of \$2.50 per day), and from 20.6% to 6.8% for moderate poverty (\$4 per day) during the same period. World Bank. World Bank Overview: Chile. <http://worldbank.org/country/chile/overview> (accessed 27 June 2016); International Monetary Fund World Economic Outlook Database.

Source: Independent Evaluation Department

105. **The SDGs, cover poverty in all its dimensions, and are to be pursued in all countries, including high-income OECD economies.** In future, the WBG intends to channel knowledge, experience, and resources across its entire membership, including the HICs.⁵⁶ In line with this vision, ADB’s knowledge orientation of recent years could position it to offer knowledge-intensive support to some HICs and UMICs.

1. Graduation Policies and their Application

106. **ADB and IBRD have policies for graduating client member countries from regular nonconcessional assistance.** Neither accepts that GNI per capita alone is a good indicator of development. Their articles of agreement do not refer to the graduation of client countries from regular support, but have been interpreted as allowing these organizations an essentially finite role in the development of client countries. In the case of ADB, this interpretation was made more than two decades after the organization was formed with a graduation policy formulated in 1998 and updated 10 years later.⁵⁷ It is noteworthy that, in 1982, the US Government Treasury Department recommended that IADB should adopt a policy on graduation from regular assistance—although this recommendation was never implemented. Clearly, perspectives on

⁵⁶ World Bank Group. 2016. *Forward Look: A Vision for the World Bank Group in 2030*. Washington DC.

⁵⁷ Footnote 46.

graduation can differ from one stakeholder to another, and can change over time. Yet the fact remains that at present, the articles of agreement of many multilateral organizations are interpreted differently from the way that ADB's are.

107. **Four economies have graduated from regular ADB assistance to date.** These are Hong Kong, China; Republic of Korea; Singapore; and Taipei, China. All four graduated in 1998 upon immediate recognition by ADB Management that the criteria for graduation had been met; hence the graduation policy itself effectuated their graduation.⁵⁸ Since then, none of these graduated economies has sought assistance from ADB, including emergency assistance. Since then, ADB has not graduated any other economy from regular support.⁵⁹

108. **The experience of IBRD is very different as its graduation process has evolved over time.** A comprehensive graduation policy was approved in 1992, although many member countries had permanently ceased borrowing from IBRD by the early- to mid-1970s. By 2010, more than 20 countries had graduated from IBRD. Of these, seven have sought and received further assistance from IBRD after graduation, of which four can be considered to have received emergency support, while the other three "de-graduated" and began receiving support on a regular basis.⁶⁰ Yet there is no evidence of official "de-graduation" from IBRD, and there is no reverse-graduation policy.

109. **EBRD was set up in 1991⁶¹ and graduated the Czech Republic from EBRD support in 2007.** No other EBRD member country has graduated since then.

110. Republic of Korea graduated from ADB support in 1998, at around the same time it was borrowing from IBRD to offset shocks from the 1997–1998 Asian financial crisis. This may signal a need for better coordination across multilateral banks regarding graduation. For further information on graduation policies and their application, see Linked Document 8 (see Appendix).

2. Advantages and Disadvantages of Graduation

111. **ADB's graduation policy documents refer to graduation from both concessional and regular assistance.** In both cases, the graduation policy envisages continuing engagement with the graduated country. With graduation from concessional assistance, a country becomes ineligible only for concessional assistance (fully or partly,

⁵⁸ There is no evidence of consultations prior to the announcement of their immediate graduation. There is also no evidence that any of the graduated countries contested the finding of eligibility and subsequent graduation from regular assistance.

⁵⁹ There is a view that Brunei Darussalam also graduated from regular ADB support, but this may not be correct. Brunei Darussalam joined ADB on 27 April 2006. In 2008, it accepted a \$600,000 reimbursable TA project for capital market development. It has not accepted any other support from ADB. Its development status was left undetermined and a country classification under ADB's Graduation Policy was not undertaken until 2013, after which it was given the option of being classified as an ADB developing member country through execution of a draft resolution (ADB, 2013. *Brunei Darussalam: Development Status*. Manila). The resolution was never executed, and Brunei never became a developing member country of ADB.

⁶⁰ The four countries and their years of graduation and receiving emergency support are: (i) Trinidad and Tobago, 1984, 1990; (ii) Republic of Korea, 1997, 1998; (iii) Hungary, 2007, 2008; and (iv) Latvia, 2007, 2008. The three countries and their years of graduation and "de-graduation" are: (i) Iraq, 1973, 2003; (ii) Venezuela, 1974, 1989; and (iii) Gabon, 1977, 1988. World Bank. 2011. *Crossing the Threshold: An Analysis of IBRD Graduation Policy (Policy Research Working Paper 5531)*. Washington, DC.

⁶¹ EBRD was set up with the objective of fostering the transition of mostly newly independent countries of the former Soviet Union toward open market-oriented economies and applying the principles of multiparty democracy and pluralism.

depending on its debt sustainability capacity). However, with graduation from regular assistance, the basic nature of ADB's relationship with the country undergoes a change—even though the graduation policy envisages continuing engagement.⁶² In particular, graduation from regular assistance severs the link between advice and the financial resources required to implement it. This makes it less likely that ADB will be in a position to share lessons and knowledge from the development experience of graduated countries for the benefit of other client countries.

112. **It is noteworthy that there is no trigger for automatic graduation in ADB's graduation policy, but the policy appears to allow a country about 5 years to graduate** (allowing variations as per country circumstances) upon crossing the per-capita GNI threshold.⁶³

113. **The fact is, however, that ADB has not initiated a graduation process for some UMICs** that have been above the GNI per capita threshold for several years.

3. A Way Forward on Graduation Policy

114. **Given the growing number of UMICs, ADB could reconsider its graduation policy.** The experience of some MICs that have reached or exceeded the per-capita GNI threshold in the past decade clearly shows that 5 years after crossing the graduation threshold is too short a period for a country to attain sufficient institutional maturity to ensure sustained economic, social, and environmental performance.

115. **The fragility of countries that have recently enjoyed economic success can be seen from a number of ADB members.** Cook Islands is now classified as a high-income country, yet it remains vulnerable to movements in international oil markets and extreme weather events caused by climate change. The economic wellbeing of its people is also affected by its extensive spatial dispersion, which makes it difficult for the government to deliver affordable and high-quality public services. The economy of Kazakhstan, a UMIC whose per-capita GNI crossed the graduation threshold in 2011–2013, has suffered reverses following a slump in international oil market prices and the declining fortunes of its major trading partners. Many UMICs in the region that are at or nearing the graduation threshold, such as the PRC and Malaysia, continue to have Gini coefficients above 40 (according to the most recent available data), which indicates significant inequality in them—in addition to significant incidence of poverty in the PRC.⁶⁴

116. **Regarding the benefits of not graduating UMICs and HICs, it is likely that in this case ADB would provide such countries with support that calls for sophisticated and innovative interventions that go beyond traditional areas of support.** This would enhance ADB's ability to offer knowledge-intensive support in all its client countries (which now are mostly MICs). It is also noteworthy that multilateral banks that support private and public sector clients in the more prosperous countries (UMICs and HICs) can

⁶² This refers to: expert services and technical assistance upon request, managing emergencies, technology transfer, bond issues, cofinancing, promoting private-to-private flows, and subregional cooperation. Footnote 46.

⁶³ IBRD adopts a flexible approach, but notes that graduation from new IBRD lending normally occurs within five years after a country crosses the graduation threshold, with variations according to country-specific conditions.

⁶⁴ World Bank, Development Research Group. Based on primary household survey data obtained from government statistical agencies and World Bank country departments.

demonstrate good asset quality and a well-diversified portfolio across countries.⁶⁵ Should ADB choose to continue operating in UMICs and HICs, the likelihood of it building a portfolio with good asset quality will increase, and the portfolio will be diversified across a larger number of countries. This would ultimately lead to lower borrowing costs for ADB.

117. **The benefit to ADB from a strict application of the graduation policy, in terms of more predictability in planning financial resource allocations, is marginal, if it exists at all.** In the current situation, when lending headroom constraints are considerably less following the merger of ordinary capital resources and the Asian Development Fund, there is no financial pressure to graduate any country. Even in the foreseeable future when this situation no longer prevails, and ADB could benefit from better predictability in planning country resource allocations, the benefit of graduation is likely to be minimal from the financial resource allocation perspective. It should be noted that a CPS provides a good measure of the financing requirements for countries that are active borrowers (i.e., the resource allocation in the CPS), while no financial resources would be allocated to a graduated country. In emergency situations, the difference between resources sought from ADB whether or not a country has graduated will most likely not be significant. A graduation policy cannot be considered a tool for improving the predictability of financial requirements.

118. **The issue of ADB members graduating from regular assistance appears not to be whether the criteria for graduation need to change, but rather whether the graduation policy itself—particularly the implied requirement for graduation—is still relevant, especially concerning graduation from regular support.** With a continuing need for development in the region and an associated sensitivity to externalities, graduation from ADB regular assistance should not be viewed as a requirement, but rather as a real indicator of a country's attainment of sustained high economic, social, and institutional maturity.

119. **The universal and all-encompassing nature of the SDGs strongly suggests that the development needs of any country are not finite.** Vulnerabilities to global business cycles and economic downturns, or to the increasing incidence of extreme weather events, do not vanish when countries cross a certain GNI per capita threshold. A relaxed approach toward graduation will produce stronger development benefits, which is why many multilateral organizations have continued supporting the development programs of countries even after they have attained HIC status. It is noteworthy that many multilateral organizations (including the newly established multilateral banks) that support ADB's client MICs do not have any graduation policy.

120. **By graduating its more prosperous client countries, it would appear that ADB would be ceding space to other multilateral organizations.** Whether or not ADB discards its graduation policy, it could consider continued engagement with all its client countries, irrespective of their per capita GNI. This could take place through: (i) involvement in cross-border projects, particularly those that generate regional and global public goods and have positive spillovers; (ii) a focus on more experimental projects and programs, aimed at piloting new approaches in frontier policy areas; and (iii) utilization of lessons learned from development experience in these countries for the benefit of other client countries. ADB could also consider supporting and catalyzing the private sector in inclusive and sustainable projects. However, like many other

⁶⁵ <https://www.fitchratings.com/site/pressrelease?id=996293>;
<https://www.fitchratings.com/site/pressrelease?id=995876>

multilateral organizations, it may be worthwhile for ADB to retain the option of responding to the needs and demands of all MICs—large or small.

C. Strategic Initiatives

121. **In order for ADB to meet the needs and development challenges of MICs, some key strategic initiatives are suggested below and further details are provided in Linked Document 9 (see Appendix).** Where a suggested initiative has been used by other development partners (e.g., WBG, IADB, and EBRD), it is noted.

1. Knowledge Services

122. ADB's recent initiatives toward increasing the knowledge intensity of its operations (Linked Document 6) could be furthered by, for example, strengthening knowledge partnerships, supporting policy and other innovations, and expanding fee-based services,

123. **ADB could make full use of the potential of knowledge partnerships to evolve into a "knowledge bank".** Although many partnerships are perceived as adding value, there are constraints on the development and full use of the potential of knowledge partnerships. It would be useful to base relationships with external think-tanks and knowledge centers on clear and mutually shared objectives of operational relevance. The sector and thematic groups could redefine their knowledge needs and partner networks, and expand and deepen the knowledge partnerships to enable joint project preparation, project implementation, and policy dialogue.

124. **ADB could support fit-for-purpose policy innovations.** The call for policy innovations could depend on the openness of MIC governments to adapt to (among other) managing economic vulnerabilities and climate change, and embracing new technology. ADB support could be in terms of sharing the experience of other MICs from within or outside the Asia and Pacific region, and/or customizing the policy framework to suit the social, cultural, and institutional landscape.

125. **In addition to providing knowledge embedded in investment, technical assistance and stand-alone knowledge products, ADB could expand its fee-based services for MICs across a wide spectrum of development issues.** Fee-based advisory services are provided by other multilateral organizations, such as the WBG and the International Fund for Agricultural Development. In addition to UMICs, the WBG has provided fee-based services to some HICs, including Italy and Poland. If ADB is to mainstream fee-based services, whether by recovering costs fully or partly, it will need to have in-house staff with expertise in the areas where ADB provides fee-based services (since staff with limited direct experience will find it difficult to supervise specialized consultants). It will also need to be responsive to client demands for short turnaround times. Once again, this does not mean that knowledge would be the main service to be provided by the organization. ADB is a bank and that is the essential nature of its business.

2. Expanded Financing Options

126. In addition to issuing local currency bonds,⁶⁶ ADB could consider mobilizing other sources of finance, expanding the use of guarantee facilities and risk sharing in mature operations to promote South-South investments among MICs in the region as well as to attract non-regional investors to MICs. Although ADB efforts to date have focused on identifying other official cofinancing sources or private sector partners for syndicated loans, it could also help bring other sources of finance (e.g., pension funds and mutual funds) into development programs.

127. Guarantees build on the strengths of multilateral banks, including their good understanding of political risk (given their close relationships with governments over a long period of time), and their strong credit standing.⁶⁷ Despite this potential appeal, ADB and other multilateral banks have used guarantees sparingly. ADB approved 46 guarantees for \$5.6 billion during the period 1988–2012, of which 21 were sovereign-guaranteed and 25 nonsovereign, mostly for electricity generation and the financial sector. Of these, only one was called, for \$150,000.⁶⁸

128. Use of the guarantee mechanism has been held back partly by provisioning policies followed by ADB and many other multilateral organizations that require guarantees to have the same capital provisioning as loans. This constraint can be overcome by using reinsurance or counter-guarantees to reduce the claim on capital, or by establishing a special “set-aside” fund to absorb a significant portion of the guarantee amount. The WBG has established a \$2 billion special “set-aside” fund, which is not country-specific and absorbs 75% of the guarantee amount. As a result, only 25% of the guarantee amount is counted against a country’s indicative planning figure. ADB could consider a similar arrangement as this would help unlock capital and enable ADB to increase its operations.

129. ADB could also encourage export credit agencies to participate in more mature operations—subject to regulations and the specifics of a transaction—that allow them to manage with ordinary capital resources financing terms. Once the international competitive bidding process has been completed and the winning bidder identified, the agency from the winning bidder’s country could take over some of the financing or guarantee obligations for the project components supplied by the winning bidder. In the process of off-loading some of its portfolio, ADB could free-up capital resources and headroom for additional operations. ADB could negotiate framework agreements with the export credit agencies of ADB member countries.

⁶⁶ ADB has issued local currency bonds in a number of Asian markets, and was the first foreign issuer in the domestic capital markets of the PRC; India; Republic of Korea; Malaysia; Philippines; Taipei, China; and Thailand.

⁶⁷ Guarantees are a form of insurance related to financial transactions, in which the risk of noncompliance by one of the two sides is taken by a third party external to the original transaction. In a typical guarantee operation involving ADB, a lender (financial intermediary) provides funds to a borrower (national government, subsovereign entity, or company), with ADB guaranteeing the repayment in case of government actions that impact repayment (political risk guarantee) or any event that leads to the obligation not being honored (credit guarantee). For that guarantee, the borrower pays ADB a fee. Guarantees can be tailored to the specific features of a transaction and have straightforward calling procedures. They can be partial guarantees, covering only specific political risk (e.g., nationalization) or certain segments of the repayment schedule (e.g., late maturity payments, or the first payment on a rolling basis). They crowd in unfamiliar financiers, and increase the amount of available development financing.

⁶⁸ Overseas Development Institute. 2014. *Guarantees for Development: A Review of Multilateral Development Bank Operations*. London.

3. Use of Country Systems

130. **As many MICs are now able to access finance from alternative sources and have improved institutional capacities, ADB has sought to enable them to move toward adopting country systems for procurement and safeguards.** ADB has endeavored to support capacity development and contribute to improving country systems. IED appreciates that use of country systems could increase government ownership of operations, reduce implementation delays, and rationalize transaction costs. However, because of the high risks involved (fiduciary, environmental, social and reputational), moves in this direction requires ADB to continue applying a strongly cautious approach particularly regarding safeguards. Further information is in Linked Document 9 (see Appendix).

4. Other Initiatives

131. **Several other strategic initiatives that could have a special value for responding to MICs in the region include:**

- (i) **Dialogue and consensus building for priority regional projects.** The scale of regional infrastructure projects, the large number of national governments involved, and the long gestation periods of such projects strongly justify the involvement of ADB in pre-investment activities. ADB's contribution could be to: (a) promote debate and eventually consensus on priority connectivity projects and initiatives; and (b) enable a fair consideration of the technical and economic aspects that balance the often political and diplomatic nature of alternative proposals. ADB could also conduct feasibility studies; first broad studies of alternative options, followed by detailed feasibility studies that could be used to elicit the interest of possible complementary financiers.
- (ii) **Development of regional public goods projects.** The facilitation and financing of regional public goods should continue to be a central focus of ADB, especially in the context of the SDG targets, which require simultaneous implementation across two or more countries. ADB could focus on preparing projects and bringing them to a level of implementation readiness and sale to interested implementers (public or private). ADB may also need to engage more intensively in policy dialogue, and to strengthen staff expertise.
- (iii) **Governance and public sector management.** Strengthening ADB's support for governance and public sector management at the national and subnational levels, given the challenges that MICs face in this area, seems an obvious opportunity for ADB to enable them to move to the next stage of development.
- (iv) **Disaster risk instruments.** ADB needs to incorporate disaster risk reduction principles into projects and to continue to support disaster risk management activities. These activities are critical given the accelerating pace of climate change and environmental risks associated with the rapid pace of growth of ADB client MICs.⁶⁹ ADB can consider a full array of potential disaster risk financing instruments (such as sovereign risk transfer products and public-private partnerships to expand property insurance) and support a strengthening of the

⁶⁹ IED. 2015. *Asian Development Fund X and XI Operations: Opportunity Amid Growing Challenges*. Manila: ADB.

enabling environment (e.g., by addressing gaps in disaster risk modeling, improving actuarial capacity, and increasing awareness of disaster risk financing instruments). ADB could expand its support to governments as they try to reduce the fiscal risks from natural hazards affecting crops, homes, enterprises, and infrastructure.

- (v) **Contingent credit arrangement.** ADB is working toward establishing contingent credit arrangements that would allow a government to draw down funds quickly to provide emergency relief following a disaster, and to pay a holding fee in exchange.⁷⁰ This arrangement is being piloted through the existing policy-based loan modality, but ADB may need to put in place a standalone dedicated modality for this purpose.
- (vi) **Innovation fund.** ADB can consider setting up a fund that is dedicated to supporting innovation in MICs, including South–South cooperation. This would enable ADB to support pilot-testing of policy and other innovations that provide useful lessons and could be a basis for initiating large-scale (perhaps nationwide) programs. A multi-donor program supported by the World Bank provides entrepreneurs in developing economies with early-stage financing, business training, and access to global networks of business incubators and innovation hubs in selected areas (clean technologies, agribusinesses, and digital innovation).⁷¹
- (vii) **SME advisory services.** Improving corporate and production practices is vital for the continued and sustainable growth of MICs. ADB can develop a line of advisory services for enterprises, promoting the transfer of regional knowledge. EBRD and IADB routinely provide business advisory services to small enterprises and IFC is planning to revamp its well-known line of services in this area. For example, IADB's Inter-American Investment Corporation offers advisory services to meet the requirements of SMEs for strategy, planning, and management support to enable them to compete in the open market.⁷² Through its small business advisory services program, EBRD advises small enterprises on strategy, marketing, operations, quality management, financial management, energy efficiency, among others.⁷³

D. Summary

132. The number of ADB members eligible for support who are classified as MICs is growing, and the fastest growing group is the UMICs. ADB needs to make some strategic policy choices to improve its response to the evolving needs of this clientele. These choices concern: (i) using knowledge to anchor ADB's financial interventions; (ii) scaling up the size of interventions both by using ADB resources and by leveraging additional funds in order to address the scale of development problems, and targeting new challenges stemming from rapid and often unplanned urbanization, insufficient attention to environmental management over several years, slow progress in developing the human capital that is vital to continue fostering growth, growing need for attention to regional and global public goods, and South-South Cooperation; (iii)

⁷⁰ ADB has begun working on a contingent credit arrangement for Cook Islands. Further support is planned for Palau, and possibly a regional facility for the Pacific islands.

⁷¹ <http://www.infodev.org>

⁷² <http://www.iic.org/en/what-we-offer/advisory-services#.V3NPIWfVzIU>

⁷³ <http://www.ebrd.com/small-business-support.html>

decisively supporting private sector and PPP; (iv) revisiting the policy for graduating countries from regular support; and (v) taking other strategic initiatives to meet the needs of MICs more effectively.

Appendix

APPENDIX: LIST OF LINKED DOCUMENTS

1. Evaluation Approach and Methodology
<https://www.adb.org/sites/default/files/linked-documents/1-Evaluation-Approach-Methodology.pdf>
2. Development Challenges for Selected Middle-Income Countries
<https://www.adb.org/sites/default/files/linked-documents/2-Development-Challenges-Selected-MICs.pdf>
3. Distinguishing Middle-Income Countries from Low-Income and High-Income Countries
<https://www.adb.org/sites/default/files/linked-documents/3-Distinguishing-MICs-from-LICs-and-HICs.pdf>
4. Finance and Trade
<https://www.adb.org/sites/default/files/linked-documents/4-Finance-and-Trade.pdf>
5. Findings from Country Consultations
<https://www.adb.org/sites/default/files/linked-documents/5-Findings-from-Country-Consultations.pdf>
6. Overview of ADB's Recent Knowledge Initiatives
<https://www.adb.org/sites/default/files/linked-documents/6-Overview-of-ADB-Knowledge-Initiatives.pdf>
7. Multilateral Support in High-Income Countries: Chile and Poland
<https://www.adb.org/sites/default/files/linked-documents/7-Multilateral-Support-in-HICs-Chile-and-Poland.pdf>
8. Graduation from Regular Support: Comparative Analysis
<https://www.adb.org/sites/default/files/linked-documents/8-Graduation-from-Regular-Support-Comparative-Analysis.pdf>
9. Suggested Initiatives for ADB Engagement with Middle-Income Countries
<https://www.adb.org/sites/default/files/linked-documents/9-Suggested-Modalities-for-ADB-Engagement-with-MICs.pdf>