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1998 Annual Review of Development Effectiveness (ARDE)

November 23, 1998

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Abbreviations and Acronyms

ARDE	Annual Review of Development Effectiveness
ARPP	Annual Report on Portfolio Performance
CAE	Country Assistance Evaluation
CAN	Country Assistance Note
CAR	Country Assistance Review
CAS	Country Assistance Strategy
CBO	Community-Based Organization
CGAP	Consultative Group for Assistance to the Poor
CSR	Civil Service Reform
DAC	Development Action Committee
DEI	Development Effectiveness Index
EAP	East Asia and Pacific Region
ECA	Europe and Central Asia Region
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
ICRG	International Country Risk Guide
ID	Institutional Development
IDA	International Development Association
IDF	Institutional Development Fund
IDS	Institute of Development Studies at Sussex University
IMF	International Monetary Fund
LCR	Latin America and the Caribbean Region
MNA	Middle East and North Africa Region
NGO	Nongovernmental Organization
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department
OEDCM	OED Corporate Evaluation and Methods
OEDCR	OED Country Evaluation and Regional Relations Group
PER	Public Expenditure Review
QAG	Quality Assurance Group
SAR	South Asia Region
WDI	World Development Indicators
WDR	World Development Report

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MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: 1998 Annual Review of Development Effectiveness

The ongoing financial crisis has raised questions about the underpinnings of development assistance and the role of international financial institutions. A new development assistance framework, grounded in partnership, is emerging. That is the backdrop for this year's *Annual Review of Development Effectiveness* by the Bank's Operations Evaluation Department (OED).

As in past years, the Review tracks the Bank's operational performance based on the findings of recent evaluations. The trends are highly encouraging, but when countries that have performed so well for so long suddenly stumble as dramatically as they did in the past year, the meaning of project level trends deserves careful consideration.

Accordingly, this Review draws on the work of scholars convened by the Institute of Development Studies of Sussex University to assess the implications of the crisis. It also relies on a relatively new OED instrument—country assistance evaluations—to place the lessons from the Bank's project experience in a broader context.

The Review complements the *Annual Report on Portfolio Performance*, which documents the Quality Assurance Group's findings about active operations, and the *Annual Report on Operations Evaluation*, which presents OED's assessment of the status and prospects of internal evaluation processes.

Robert Picciotto
Director-General, Operations Evaluation

Overview

This Review of development effectiveness comes at a time of crisis. In East Asia, about 20 million people have fallen back into poverty in the last year. Russia has been beset by political and economic upheaval. Japan is in recession with profound implications for the world economy. Economic problems have been compounded by natural disasters, such as floods in Bangladesh, in China, and in Central America. The prospects for achieving the OECD poverty reduction targets have dimmed.

The crisis is rich in lessons both for development practitioners and evaluators. Developing countries now confront a severe deterioration in the enabling environment, highlighting the impact of unregulated private flows and global interdependence and the growing influence of exogenous factors in determining development impacts.

A stable macro economy is not enough

Macroeconomic conditions are not enough to sustain equitable growth. Unlike the debt crisis of the 1980s, the ongoing financial crisis started in countries with relatively strong fiscal situations, sound monetary policies, and outward oriented trade regimes. When the crisis hit, government budgets in most crisis affected countries were balanced or moving into surplus, inflation was contained, interest rates were going down, and recorded unemployment was low.

Institutions matter

The crisis showed just how costly weaknesses in institutions—especially in the financial and social sectors—can be. Indeed, it is now clear that strong institutions are essential ingredients of economic and social stability. Poor institutions increase the vulnerability of developing and transition economies to shifts in private investor confidence. The importance of institutional development goes far beyond avoiding crises:

Strong institutions are essential ingredients of economic and social stability

- For Bank-supported projects, the quality of institutions can have important effects on development effectiveness. These effects are particularly pronounced in low-income countries.
- Where institutions are systematically weak, projects yield lower returns and higher risk.
- Better institutions strengthen a country's ability to adjust. They can more than double the likelihood that a country undergoing adjustment can stay the course.

An analysis of 41 low-income countries shows that only one was rated satisfactory on institutional quality. Only 40 percent of Bank-supported projects have substantial impact

on institutional development; civil service reforms undertaken as components of structural adjustment loans have mixed outcomes; public sector management projects, while improving, have historically performed below the Bank average. An OED evaluation showed that Bank-supported financial sector projects had satisfactory and sustained outcomes in just 50 percent of countries. Institutional development is slow and difficult to achieve, and requires stronger aid coordination and the development of capacity to absorb aid and reduce the risks of overload in a fragile institutional environment.

Poverty reduction and social safety nets

Social development should come center stage—both in assessing development effectiveness and in financing country assistance programs

A corollary lesson is that social development should come center stage—both in assessing development effectiveness and in financing country assistance programs.

Large reductions in employment of perhaps 10-15 percent are estimated for Indonesia and Thailand. With devaluations and the removal of subsidies, the newly unemployed will suffer from drastic losses in income and sharp rises in prices. The increasingly integrated global environment means that country susceptibility to shocks will not disappear. Much greater attention must be given to safety nets in helping to insulate the poor and the near-poor from disproportionately bearing the costs of shocks.

The crisis countries are not the only ones experiencing increasing inequality. Data for 74 countries shows that there has been an overwhelming increase in inequality within countries in the 1990s—49 countries experienced increasing inequality, while only 10 had decreasing inequality. This confirms the need to emphasize inclusion, social development, and safety nets in the design and implementation of reform strategies and development programs.

A country focus based on partnership

Financial, institutional and the social factors must be considered together. For growth to result in sustainable development requires country assistance strategies that give adequate weight to structural factors, capacity building and social equity, and that identify potential 'holes in the boat'—where structural faults might cause development gains to unravel.

A credible Bank's role begins with effective projects. This implies operations linked to the broader social, civil and economic environment. To scale up successes, the Bank must work in partnership with borrowers, donors, and other stakeholders to focus on maximizing development impact at the country level. To do so the Bank must consider the important side effects that interrelated activities can have on country policies and institutions. It also requires mutual recognition by all participants of their relative strengths and weaknesses, together with a willingness to define and share accountability. A partnership-based strategy is not only good policy from a development perspective, it is also good corporate finance.

Much remains to be done to enhance the quality of country assistance strategies. Where country assistance evaluations have been undertaken, OED estimates the assistance strategies have been satisfactory only 68 percent of the time. The analysis confirms that project

outcomes are highly dependent on the country strategy. For example, no country that had a satisfactory country strategy experienced weak project performance.

Project performance has improved

The performance of Bank-supported projects has improved substantially. The percentage of projects with a satisfactory outcome at the end of loan disbursement increased from an average of 65-70 percent in the 1990–96 period to an expected 75 percent or higher in 1997-98, including 7 percent with outstanding outcomes. This remarkable improvement demonstrates Bank and borrower commitment to improving development effectiveness.

There have been major quality improvements in two of the poorest-performing sectors (finance and public sector management) and in Africa, particularly in agriculture. Better borrower performance, more realistic project designs, and better portfolio management explain the improved outcomes. Nevertheless, sustainability and institutional development impact lag considerably.

A global perspective

Last year's Review concluded that "the challenge is to find the right fit between country policy and institutional factors and strategies to try to improve conditions favorable to improved growth and development." In a much more complex and hostile environment, this year's Review reaches a similar conclusion. It is now even clearer that improvements in project performance—important though they are—are not enough.

The architecture of the Bank's new approach to providing development assistance has passed a rather severe test. To be sure, adjustments and refinements in strategy must be made, and greater cognizance of the risks of the external environment must be internalized. Nevertheless, the Bank's new strategy for maximizing development effectiveness in a volatile global environment appears well conceived. The increased emphasis on partnership and poverty alleviation stressed in the Strategic Compact, and President Wolfensohn's call to move "beyond projects" in his 1998 Annual Meetings speech, are key to maintaining the performance improvements that have been realized in the past two years.

The Bank's new strategy for maximizing development effectiveness in a volatile global environment appears well conceived

Implications

The above diagnosis leads to the following conclusions for performance measurement and evaluation:

- Performance monitoring and assessment need greater transparency, with governance and institutional performance at center stage. More attention must be paid to monitoring structural, social, and poverty indicators.
- Evaluation has to move to a higher plane, focusing on the country, sector, and even global level.
- Evaluation rating systems have to give more explicit weight to the social impact of projects and programs and to the important effects that external shocks can have on the poor.

For the Bank's operations there is a need to:

- scale up successes, considering the important side effects that interrelated activities can have on country policies and institutions,
- strengthen support for institutional development, particularly for financial institutions and social protection, and
- shift from a project to a long term country focus both in design and implementation of operational strategies.

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Chapter 1

Development Effectiveness in a Volatile World

The current crisis confirms two main lessons for development effectiveness—and provides a new one. First, good macroeconomic fundamentals are necessary but insufficient for stable and sustainable growth. In today's global economy, sound institutions, especially in the financial and social sectors, are essential to economic and social stability. Second, projects are no longer the appropriate vehicles for development assistance unless they are connected to balanced country assistance strategies—focused on structural reform and capacity development, and owned by borrowers and other partners. An emerging lesson is that exogenous factors are far more influential in determining development impacts than had been previously thought.

1.1 The past year produced a severe deterioration in the economic conditions of the developing world. Russia's economic reform collapsed in a year when transition economies were finally growing after seven years of decline.[1] The sharp reversal for some of the world's fastest-growing economies and the greater caution of private investors have chilled global economic growth. The perceived risk of investing in emerging markets made a very large one-year jump.[2]

1.2 The crisis has induced concern about the ability of the global system to contain the contagion.* Given the economic turbulence and uncertainty, questions have arisen about the consensus reported in last year's *Annual Review of Development Effectiveness*. Is good macroeconomic policy* a sufficient foundation for development effectiveness?* Does the crisis invalidate the broadly based consensus in the development community about what constitutes sound economic policy?

Institutional weaknesses

1.3 With the crisis now over a year old, one fact has become clear: the costs of unregulated movements of private capital must be balanced against the risks. Indonesia, Korea, Malaysia, the Philippines, and Thailand received net private inflows worth almost 7 percent of their combined GDP in 1995–96. The reversal from 1996 to 1997 involved a swing of 11 percent of their combined GDP.[3] Changing risk perceptions by commercial banks and particularly portfolio investors (rather than foreign direct investors) explain the reversal. The sudden downgrading of country credit ratings sparked panic and flight among private investors.

1.4 Unlike the debt crisis of the 1980s, the current crisis started in countries with relatively strong fiscal situations, sound monetary policies, and outwardly oriented trade

regimes (table 1.1). Except in Thailand, government budgets were balanced or moving into surplus when the crisis hit. Inflation was contained, interest rates were going down, and recorded unemployment was low. Taking into account foreign direct investment, current account deficits were not excessive.

Table 1.1 Traditional crisis indicators

Indicator	*Indonesia*	*Korea, Rep. of*	*Malaysia*	*Philippines*	*Thailand*
Government budget deficit (percentage of GDP)					
Average, 1990–94	0.4	–0.4	–0.7	–1.4	3.2
Average, 1995–96	1.7	0.1	0.8	0.4	2.6
Inflation rate (change in the consumer price index)					
Average, 1990–94	8.8	5.3	4.1	11.1	4.6
Average, 1995–96	8.7	4.7	4.4	8.3	5.8
Current account (percentage of GDP)					
Average, 1990–94	–2.7	–1.5	–7.4	–4.5	–7.5
Average, 1995–96	–3.8	–3.4	–9.7	–5.5	–9.1

Source: Reisen (1998).

1.5 Weaknesses in economic management helped trigger the crisis. In all cases the capital account was the main vulnerability. Imbalances between short-term debt and official reserves—combined with premature financial liberalization and weak financial discipline in domestic banking systems—created situations vulnerable to speculative pressures.

The financial panic would not have spread without weaknesses in domestic institutions

1.6 Many fundamentals were sound in crisis-affected countries. The financial panic would not have spread without weaknesses in domestic institutions. As in the Southern Cone crisis 15 years earlier, banking discipline was weak and links between economic conglomerates, banks, and governments were too close. This led to excessive borrowing, disproportionate real estate booms, poor private investments and escalating levels of nonperforming loans. Why didn't policymakers and international financial institutions give these weaknesses appropriate weight? Because the lessons of the general debt crisis were guiding them, not the more relevant institutional lessons of Chile's 1982 crisis and Mexico's 1994–95 peso crisis. OED's (1990) audit report on Chile's structural adjustment loans* highlighted the lack of prudential supervision of financial institutions in increasing the economy's vulnerability to the point of collapse. A key lesson of that audit was: "prudential rules and surveillance are necessary safeguards for the operation of domestic financial markets, rather than unnecessary restrictions" (p. 12).

1.7 Microeconomic dysfunctions are harder to spot than macroeconomic weaknesses. From macroeconomic indicators, decisionmakers in the private sector and international financial institutions found it hard to argue with success. In East Asia, as in Chile and Mexico before, credible domestic reforms, low interest rates, and good growth prospects contributed to an explosion of private flows. Attracting those flows were exchange rate pegs, profitable interest rate spreads, and liberalizations of the capital account. Given the "halo effect" typical of investment booms, decisionmakers overlooked the failure of Asian

countries to comply with some basic tenets of the much-abused Washington consensus,* a listing of sound economic practices on which most analysts agree.

1.8 Using the benchmarks of this consensus, Rodrik (1996) notes that the policies of Korea and Taiwan (China) have long been well below par. We extend Rodrik's analysis to Indonesia and Thailand in light of OED's recent country assistance evaluations (table 1.2). Cumulatively, the analysis confirms that East Asian countries were following policies consistent with only 6 or 7 of the 10 tenets of the consensus. Caprio (1998) finds that banking sectors were extremely weak in Indonesia and Thailand. In contrast, according to Rodrik,

Table 1.2 The Washington consensus—not in East Asia

Elements of the Washington consensus	*Indonesia*	*Korea, Rep. of*	*Taiwan (China)*	*Thailand*
1. Fiscal discipline	Yes, partially	Yes, generally	Yes	Yes
2. Redirection of public expenditure priorities toward health, education and infrastructure	Yes	Yes	Yes	Yes, in the late 1980s
3. Tax reform, including broadening the tax base and cutting marginal tax rates	Unclear	Yes, generally	Yes	Yes, generally
4. Unified and competitive exchange rates	Yes, until 1996	Yes, except for brief periods	Yes	Yes, until 1991
5. Secure property rights	Limited	President Park started his rule in 1961 by imprisoning leading businessmen and threatening to confiscate their assets	Yes	Limited
6. Deregulation	Limited	Limited	Limited	Limited
7. Trade liberalization	Limited until the 1980s	Limited until the 1980s	Limited until the 1980s	Yes
8. Privatization	Limited, but not an issue	No. Government established many public enterprises during 1950s and 1960s	No. Government established many public enterprises during 1950s and 1960s	Limited, but not an issue
9. Elimination of barriers	Yes	Foreign direct investment heavily restricted	Foreign direct investment subject to government control	Limited to foreign direct investment
10. Financial liberalization	Yes	Limited until the 1980s	Limited until the 1980s	Yes, in the 1990s

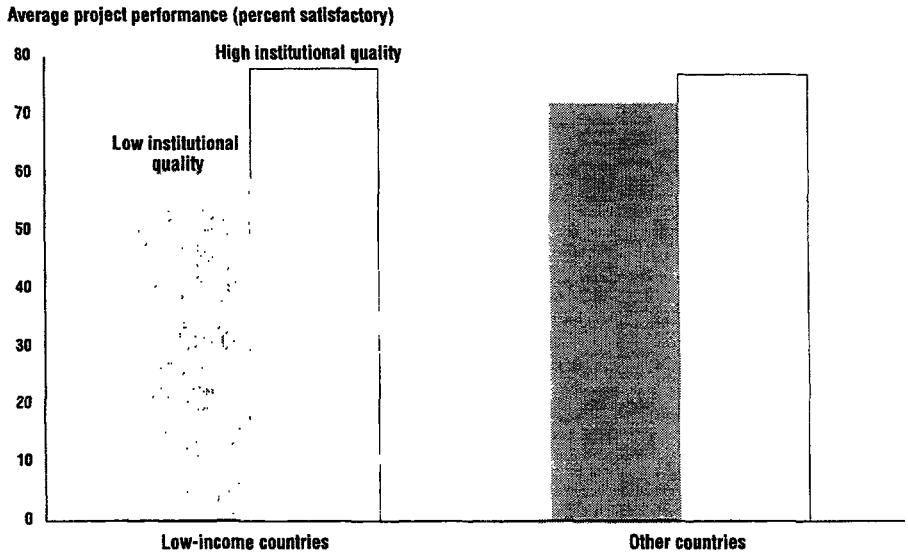
Source: Data on Korea and Taiwan are from Rodrik (1996); other data, OED, World Bank.

many Latin American economies—in particular, Argentina, Bolivia, and Mexico—fulfilled most of the consensus conditions. The conclusion: Washington consensus policies were neither the cause of high growth, nor the cause of the crisis.

1.9 Macroeconomic policy weaknesses were linked to competition policies and financial liberalization—the sequencing of which needed to be made coherent with prior institutional development* and structural policy reforms. It is significant that their neglect also featured heavily in the Chile and Mexico crises. In the words of Claessens and Glaessner (1997, p.8), "liberalization is inexpensive, fast, and easy to implement; building institutional capacity is expensive, slow, and complex." In sum, mistakes in macroeconomic policy played a part in the East Asian downturn and an even bigger part in Russia, but the more critical dysfunction was institutional. Financial sectors, governance standards, and corporate investment regimes (and in Russia, fiscal regimes) seemed adequate as long as the booms lasted.[4] But they proved fatally flawed once external conditions deteriorated. Given the unprecedented volume and reversibility of short-term capital flows, weak banking institutions and ineffective regulatory systems proved a lethal combination.

1.10 The reversal of capital flows was especially deep and disruptive where domestic interest rates were higher than in international markets. Financial supervision, corporate governance, and corruption—let alone social safety nets*—were too often given minimal emphasis in the "metrics" of performance monitoring and assessment. As stressed in last year's Review, institutional development lies at the core of development effectiveness. The

Figure 1.1 Institutions and project performance in low-income countries



Note: The institutional quality index is composed of three variables based on data from the *International Country Risk Guide* (ICRG) covering 1982–98. These variables are corruption, rule of law, and bureaucratic quality. Countries are assigned income groups based on classifications in *World Development Indicators 1998*. The average project performance for the country groups are based on project-level outcome data.
Source: ICRG; OED, World Bank.

"silent crisis" of poverty and destitution that affects low-income countries is deeply rooted in capacity constraints. How important is the quality of the institutional environment for Bank-supported projects in low-income countries? Very important indeed, because stronger institutions are associated with a 20 percentage point increase in the likelihood of a project's outcome* being rated satisfactory (figure 1.1). For the Bank's lending to low-income countries over the past two years, this improvement would translate into a more than $1 billion increase in effective Bank support.

Broadening the agenda to maximize development effectiveness

1.11 The need to scale up from a strictly project-specific focus to a broader, more inclusive orientation is now well recognized. It is a perspective that has been realized by hard-learned lessons from experience—for example, with large dams. As OED (*1996d*) shows, large dams were viewed as being synonymous with modernization and development in the 1950s and 1960s; but growing evidence of their adverse indirect and secondary impacts turned them into targets of public criticism in the 1970s and 1980s. As a result, new policies and standards emerged that scaled up the scope of the World Bank's intervention to include avoidance or mitigation of the adverse environmental and social consequences of large dams and, by extension, all projects with significant potential adverse side effects. To move beyond isolated success stories, the full array of factors affecting development results must be examined, and more inclusive, participatory approaches must be developed.

1.12 Such enhanced participation is essential if the complementarities across sectors and activities are to be fully exploited. However, besides developing broader, more inclusive approaches, the Bank and its partners must identify "holes in the boat." That is, donors cannot simply focus on projects or sectors that they know will perform well. They must also identify points of stress—such as financial weaknesses—that can cause gains to unravel. To achieve development effectiveness at the country level, Bank interventions must begin by designing effective projects. But they must also link individual operations to the broader social, civil, economic, and, where appropriate, international environment. They cannot neglect existing weaknesses that could more than offset the development effectiveness gains from a project. To be successful, the country assistance program must be firmly rooted in the borrower's ownership* of reform objectives.

1.13 Another lesson of the crisis is that social development should take center stage in the financing of recovery or development programs. The shocks of recent years have plunged millions into absolute poverty. The lack of formal social safety nets for the unemployed is being felt severely, partly because of the weakening of traditional systems that once supported the poor. Cuts in public spending for the social sectors and rises in prices associated with devaluations and the removal of subsidies may add to the burden on the middle class and the poor. If the global objectives for poverty alleviation of the OECD's Development Assistance Committee (DAC)* are to be attained, more attention must be paid to social development and social safety nets.

Social development should take center stage in the financing of recovery or development programs

The new primacy of the external environment

1.14 The emerging lesson of the crisis is that a risky external environment can strangle development prospects. Not only do developing countries face the prospects of continuing reductions in aid, they also confront a more uncertain environment—much more so than developed countries do (see chapter 5). Private investors will give even greater scrutiny to the country and institutional conditions that allow entry to global financial markets. That is why development effectiveness requires a perspective that goes beyond country-level concerns, especially for small countries.

1.15 Particularly important for the external environment are donor efforts to bolster financial systems and to help restore the confidence that is key to the capital flows needed to restart growth. The World Bank and the International Monetary Fund (IMF) have much to do in leading the provision of information on regional and global trends—certain to be an important global public good.* The Bank is especially well placed to assist in developing, processing, and understanding the often important fragments of information with broader implications.

1.16 A series of recent reports on international financial architecture laid out a range of actions to strengthen the international financial system.[5] The recommendations, which are relatively straightforward, call for enhanced transparency and greater discipline in balancing market incentives and public control. They also stress the need for improved vigilance by international organizations. The novelty of these reports lies not in the proposals themselves, but in their urging the practicing of what has long been preached.

1.17 The following chapters review recent evidence about the Bank's development effectiveness. Chapter 2 describes project and sector performance trends. Chapter 3 considers recent evaluation lessons at the country level. It draws on OED's country assistance evaluations to help draw out the lessons of the ongoing crisis. Chapter 4 draws lessons that can be inferred from OED's thematic studies. The final chapter discusses the implications for Bank operations and evaluation.

Notes

1 World Bank, *World Development Indicators 1998.*

2 Based on *Euromoney*'s ratings for country risk.

3 Institute of Development Studies at Sussex University, East Asia Crisis Workshop, 1998, chapter 1, page 1.

4 The glossary defines terms related to institutional development. In addition, box 3.1 illustrates the general perspective taken by analysts who focus on institutional issues.

5 In April 1998, finance ministers and central bank governors from a number of large economies formed three working groups—on transparency and accountability, on strengthening financial systems, and on international financial crises—to discuss the policy issues raised by the financial crisis. In October 1998, each working group presented its findings and recommendations in a separate report.

* See the glossary for definitions of words and phrases followed by an asterisk (*).

Chapter 2

Trends in Project Performance

Among evaluated projects exiting the Bank's portfolio in fiscal 1997 and 1998, more than 75 percent had satisfactory project outcomes. Thus the improvement in performance presaged by last year's Review has been sustained. There has also been a convergence in performance across regions and sectors, the result of major advances in Africa and in two of the poorest-performing sectors (finance and public sector management). Better borrower performance and more realistic project designs, as well as better portfolio management, explain most of the improvement. But sustainability and institutional development remain sorely neglected in project design and portfolio management.

2.1 OED evaluates all closed projects, assessing results likely to be achieved in each project's operational phase. Since last year's Review, OED has evaluated 298 operations across all regions and sectors.[1] Africa has the largest regional share of the evaluated cohort (28 percent), followed by Latin America and the Caribbean and East Asia and the Pacific, with shares of roughly 20 percent each. Nearly half the projects are in the finance, private sector, and infrastructure network, led by the transportation sector (30 projects). Agriculture projects make up an additional 21 percent.

Outcomes more than 75 percent satisfactory

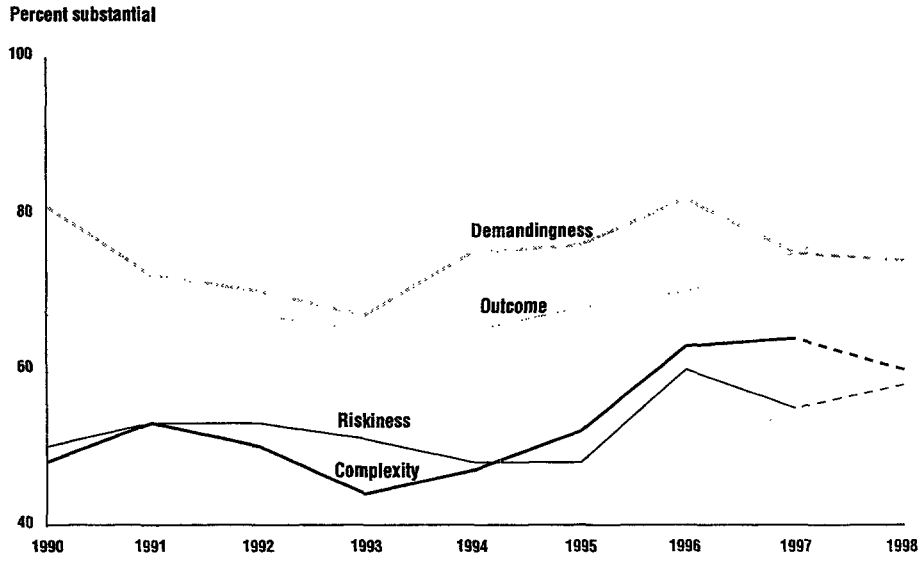
2.2 The percentage of satisfactory project outcomes has continued to improve in recent years. The proportion of satisfactory projects for fiscal 1997 exits—the latest year for which complete results are available—is 75 percent. The figure for exits in the first half of fiscal 1998 is 80 percent, exceeding the target of the Strategic Compact.[2] While this preliminary figure is likely to be biased upward, it represents a substantial improvement. We estimate the percentage of satisfactory projects for fiscal 1998 exits to be 76 percent, only slightly above the level for fiscal 1997.[3] But it is now clear that the Bank has moved in the past two years above the plateau in fiscal 1990–96, when the percentage satisfactory remained in the 65–70 percent range.

There has been a substantial improvement in project outcomes in the last two years

2.3 Some qualifications are in order. First, the unusually large risks in the international economy call for substantial discounts in the long term effects likely to be reaped from many completed projects. Second, more than 60 percent of the gains were in Africa, which has aggressively implemented a portfolio restructuring plan, but remains the region with the highest share of projects at risk of not achieving their development objectives.[4] But, a significant part of the improvement in Africa is in agriculture, which in 1993 developed an action plan emphasizing simpler models of delivery and greater sector coherence. So the recent gains may not be ephemeral.

2.4 A third reason for caution is that these buoyant outcome ratings are goal-sensitive—relating largely to planned project goals. Thus their significance is connected to the demand, complexity, and risk* of project objectives. In prior Reviews outcome trends were steady or only slowly improving as the portfolio became increasingly ambitious. But there has been a break in the upward sloping curves of demandingness, riskiness, and complexity from fiscal 1996 to fiscal 1997–98 (figure 2.1). This shift is admittedly modest. Still, it

Figure 2.1 Demandingness, complexity, riskiness, and outcome, by exit fiscal year



Note: Broken lines (exit fiscal year 1998) indicate preliminary results, with less than 50 percent coverage of exited operations.
Source: OED, World Bank.

could indicate that the improvement in outcome ratings was achieved, at least in part, through the achievement of more modest project goals.

2.5 Other notable characteristics of the performance trends include:

- Strong improvements among the previously poorest-performing groups, including finance and public sector management.
- Continued improvement in the outcome ratings of adjustment loans, with performance levels remaining above those of investment projects.
- Sustained progress in borrower performance, now at par with Bank performance.
- Recent improvements in Bank performance, especially in the quality of project supervision.

Improvements in development outcomes have been sustained and broadly based

2.6 In aggregate, this year's evaluation results confirm that improvements in development outcomes have been sustained and broadly based. But in the meantime, the overall development environment has shifted in dramatically challenging ways. This shift underscores the need for more reliable and timely evaluation measures and even greater use of

evaluation findings. With demand for lending boosted by the crisis, concessional resources declining, and Bank loans more costly to borrowers, concern with development effectiveness should not be allowed to flag.

Gains in development effectiveness

2.7 In search of a more comprehensive measure of project performance than the outcome rating, OED has piloted for this Review the development effectiveness index.* It integrates existing OED measures of outcomes, sustainability,* and institutional development impact. The measure ranges from 2 (for a project with a highly unsatisfactory outcome, which also has unlikely sustainability and negligible institutional development impact) to 10 (where high achievements on all three measures are realized).

2.8 The index improves the presentation of performance trends in three ways (box 2.1). First, it uses the spectrum of outcome assessments made by OED rather than the

Box 2.1: Institutional development and sustainability help capture project performance

Beyond the assessment of goal-oriented performance captured by the outcome rating, two examples show how explicit consideration of institutional development and sustainability can provide a richer description of the development impact of Bank-financed projects.

In 1995 an irrigation project in Pakistan was rated as having a marginally unsatisfactory outcome. The project sought to help farmers to invest in their own small wells in areas where there was fresh groundwater—directly useful for irrigation. Behind the outcome rating were two factors. First, the estimated economic return fell short of the 10 percent minimum threshold for satisfactory outcomes. Second, subsidies and free hook-ups to the power grid resulted in too many electric private wells being installed. But the project was rated as having substantial institutional development because it closed down the loss-making public institution formerly responsible for fresh groundwater pumping, replacing it with a market-based institution. Moreover, sustainability was rated as likely for two reasons. First, diesel pumps, which do not depend on the highly subsidized and unreliable electric distribution system, were emphasized. Second, the water users group worked well in coordinating the decisions of nearly 4,000 independent pump owners, with no depletion of water resources expected.

Contrast this with the outcome of the Rehabilitation Project of the port of Dar-es-Salaam in Tanzania, rated as marginally satisfactory. Although there were delays in implementation and part of the project was not undertaken, the port facilities were converted to containerized operations, the main project objective. As a result ship waiting times and berth times decreased. The institutional development component, however, was rated negligible because of poorly planned training arrangements for employees of the Tanzanian Harbours Authority. The sustainability of project benefits was also disappointing and rated unlikely. Given the size and complexity of the facilities installed, the lack of local basic skills was considered a critical shortcoming. Moreover, it appeared unlikely that the weak management of the Harbours Authority could remedy the problem without additional external support.

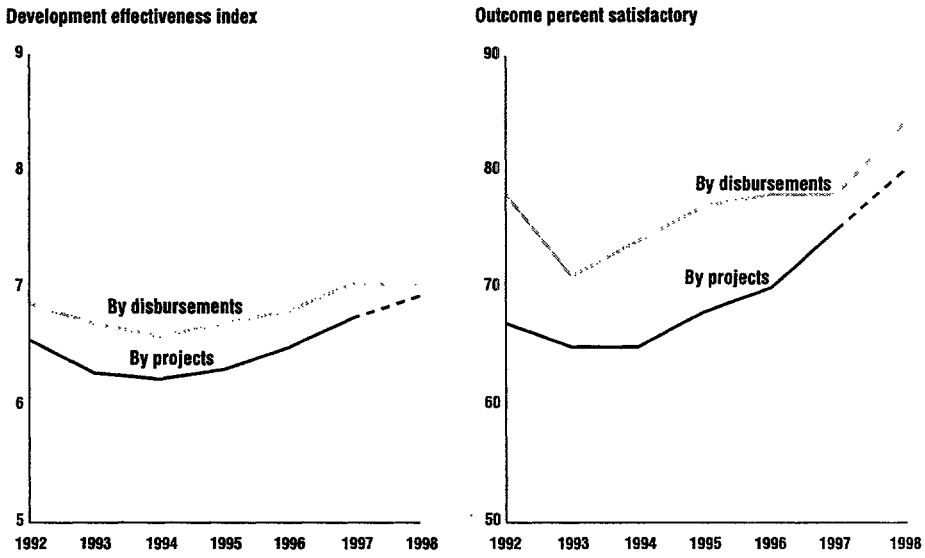
Now consider how the two projects would compare using an aggregate measure of performance that included sustainability and institutional development with one that considered only project outcome. Using the development effectiveness index, the project in Pakistan scores a 6.75, well above the Bank average of 6.38 for fiscal 1994–97. The project in Tanzania receives a 5.25. An analysis based solely on a binary classification of outcome does not take into account the contrasting performance of sustainability and institutional development. The descriptions of the two projects indicate that the first had better overall performance than the second, and that is the information the development effectiveness index conveys. A crude binary analysis based strictly on goal-based evaluation (outcome) would have reversed the ranking in favor of the project in Tanzania. These issues are discussed more fully in annex 1.

binary assignment to satisfactory or unsatisfactory outcome. Second, it qualifies a project's outcome judgment by rewarding the robustness of achievements into the future, in some cases recognizing the lasting benefits of significant achievements that fall short of expectations. Third, institutional development impact is given special emphasis. Together these aspects of the index provide a more complete picture of trends. The new index facilitates performance analysis of sectors and countries. Additional analysis is under way to confirm the robustness of the development effectiveness index, as well as its consistency and complementarity to measures used by the Networks and the Quality Assurance Group. Annex 1 summarizes the index's construction.

Outcome ratings gains have not been matched by gains in project sustainability or institutional development

2.9 While also showing improvement over the past two years, the development effectiveness index trend is less dramatic than the trend in outcomes (figure 2.2). Outcome ratings gains have not been matched by gains in project sustainability or institutional development.

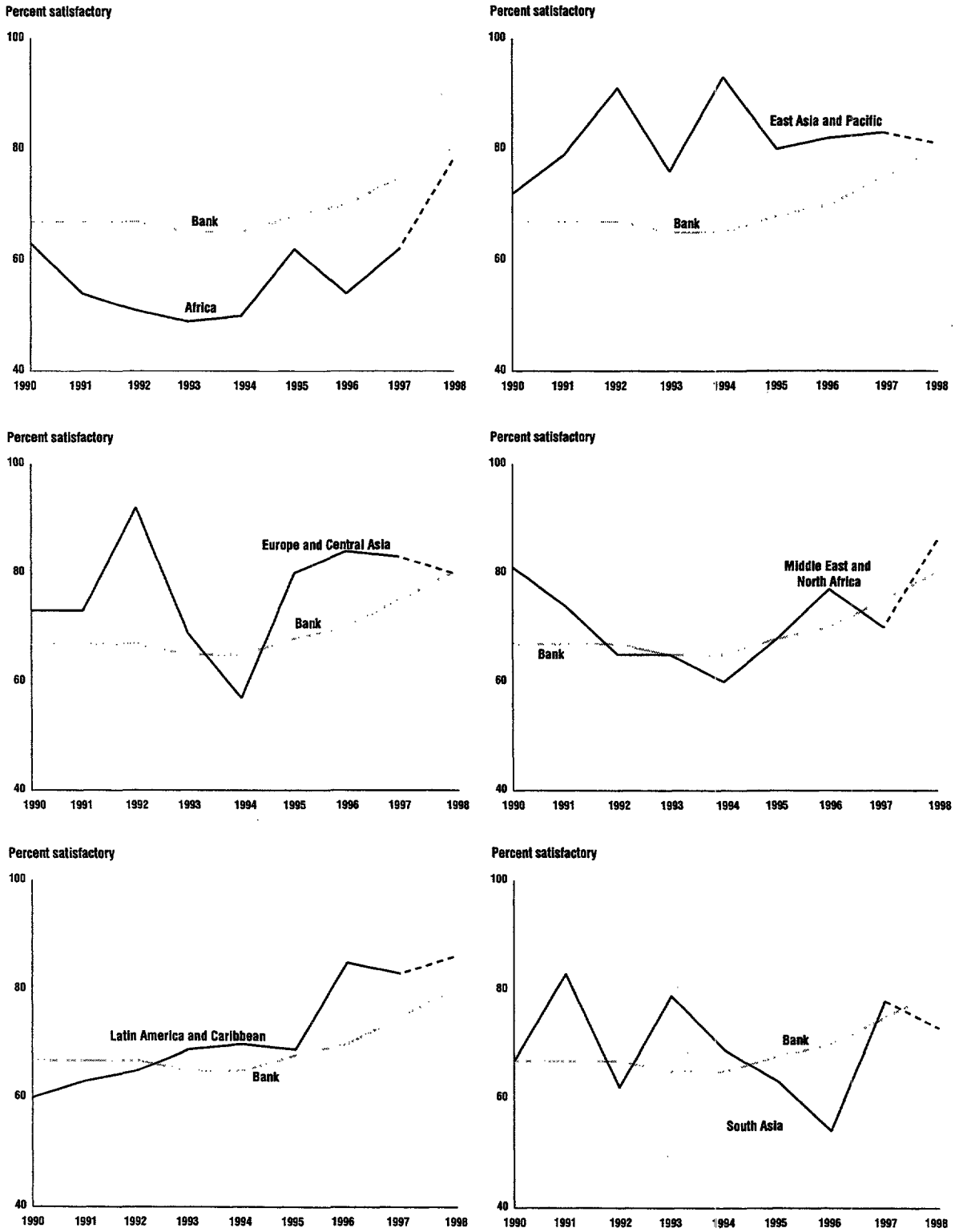
Figure 2.2 Two measures of project performance, by exit fiscal year



Note: Broken lines (exit fiscal year 1998) indicate preliminary results, with less than 50 percent coverage of exited operations.
Source: OED, World Bank.

2.10 Weighted by disbursements, the data show a similar pattern of improvement, with the share of satisfactorily rated outcomes reaching 78 percent in fiscal 1997.[5] For fiscal 1998 exits, the preliminary satisfactory outcome achievement rate is 84 percent, though using the development effectiveness index the fiscal 1998 figure shows no gain over fiscal 1997, holding steady at 7.02. But regional analysis shows the disbursement-weighted index to have fallen in most regions, with the largest drop in East Asia and the Pacific (1 point, for 27 percent of Bankwide disbursements). This was offset by a large increase in Latin America and the Caribbean (1.15 points, for 23 percent of Bankwide disbursements). The drop in East Asia reflects movement in China and especially Indonesia, which together account for roughly 80 percent of the region's disbursements.

Figure 2.3 Operations with satisfactory outcome, by region and exit fiscal year



Note: Broken lines (exit fiscal year 1998) indicate preliminary results, with less than 50 percent coverage of exited operations.
Source: OED, World Bank.

2.11 All regions except East Asia and the Pacific show improvement in fiscal 1997–98 compared with long-term averages for fiscal 1990–96 (figure 2.3). Improvements in project outcomes were largest in Africa (box 2.2) and Latin America and the Caribbean, with 14 and 15 percentage point gains in the share of satisfactory outcomes, respectively. These improvements—particularly in Africa, where performance has historically lagged behind other regions—have raised the global average and reduced regional disparities (figure 2.4).[6]

Improvements in project performance were noticeable in most sectors, especially in previously poor performing groups

2.12 Improvements in project performance were noticeable in most sectors (figure 2.5). The most notable decline, among sectors with significant numbers of recently evaluated projects, was in industry. In that sector there was a fall from 54 percent satisfactory performance in fiscal 1990–96 to a dismal 36 percent satisfactory in fiscal 1997–98, as well as a 7 percent drop in the average development effectiveness index. This represents the continuation of a downward trend in a sector with declining emphasis in the Bank.

2.13 The fastest-improving sectors were concentrated in the previously poorest-performing groups. Public sector management, finance, and industry were the worst-performing sectors in fiscal 1990–96 (by projects), with development effectiveness and project outcomes well below the Bank average. Public sector management and finance show more than a 10 percentage point increase in the share of projects with satisfactory outcomes and a significant increase in the average development effectiveness index in fiscal 1997–98. Significant improvements (by projects) were also evident in agriculture, urban, transportation, and population, health and nutrition.

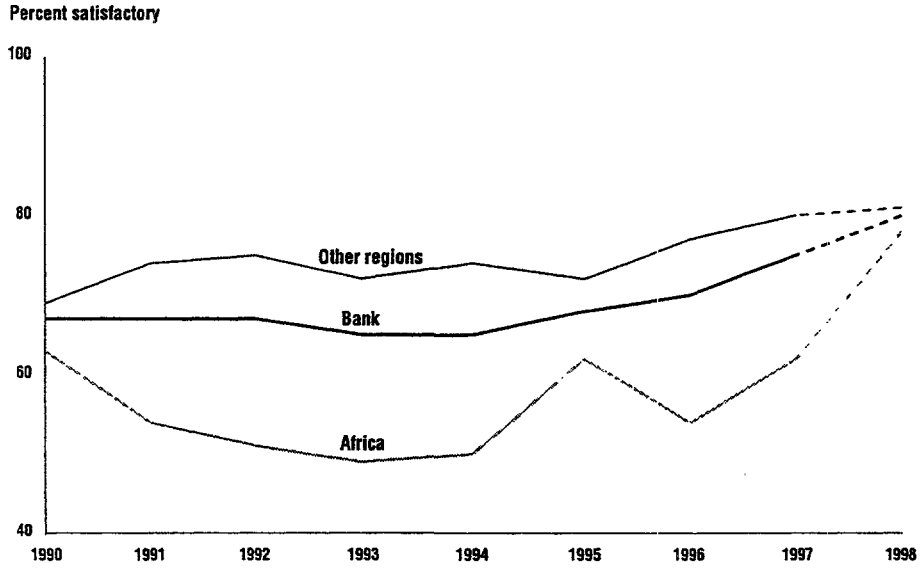
Box 2.2 Areas of improvements in Africa

Performance gains in Africa have been driven by improvements in agriculture, public sector management, and finance. Of the projects exiting in fiscal 1997–98, agriculture dominates the Africa portfolio (26 percent share). Satisfactory outcome ratings for agriculture projects increased from 54 percent in fiscal 1993–96 to 76 percent in fiscal 1997–98.

One explanation of this extraordinary improvement is the success of capacity building work. There has been a 16 percentage point improvement in the number of projects having substantial institutional development impact in Africa. For example, the National Agricultural Services project in Côte d'Ivoire strengthened the monitoring, evaluation, and cooperative support activities of the Ministry of Agriculture. Another example is the Technical Assistance project in Mozambique. It supported the country's transition from a centrally planned to a market-oriented economy, and is a good illustration of the improvement in African public sector management projects. The pace of institutional development in Mozambique was rapid, with key economic institutions like the Ministry of Finance and the central bank significantly strengthened while progress was steady in improving the quality of financial reporting in both the public and private sectors.

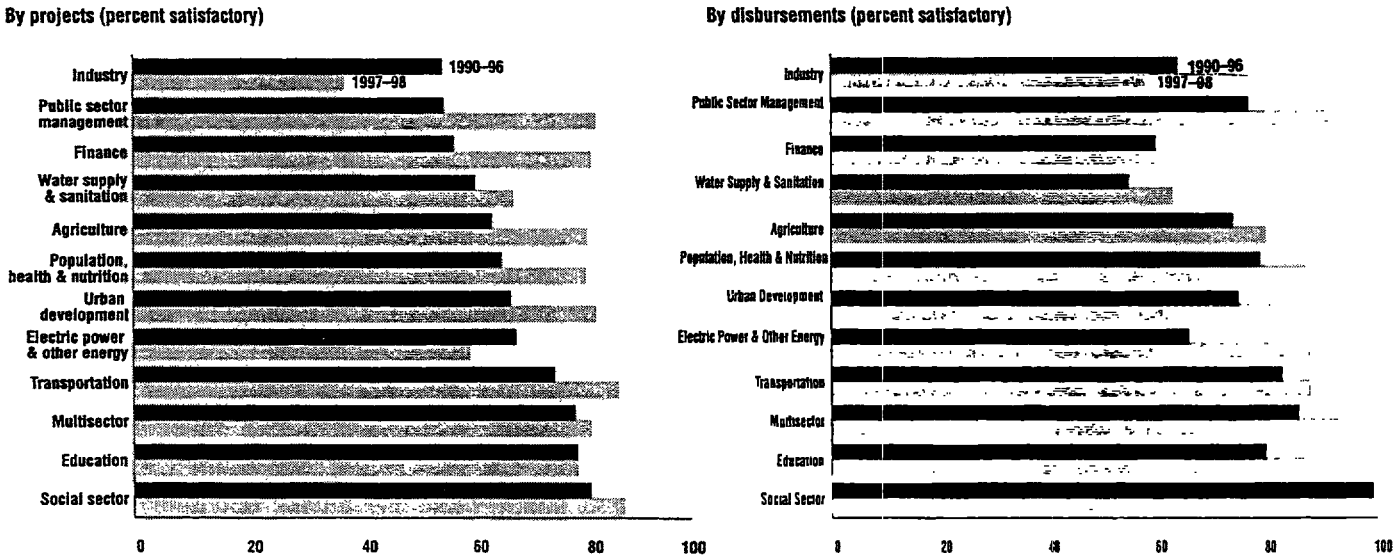
Also in Mozambique, a financial sector project more than achieved its objectives through better fiscal and monetary management and privatization of the banking and industrial sector. This result contributed to a sharp drop in inflation, and increased private investment and higher economic growth. Expansion of social spending also resulted in a noticeable improvement in health and education.

Figure 2.4 Africa region—relative performance trend, operations with satisfactory outcome, by exit fiscal year



Note: Broken lines (exit fiscal year 1998) indicate preliminary results, with less than 50 percent coverage of exited operations.
Source: OED, World Bank.

Figure 2.5 Operations with satisfactory outcome, by sector and exit fiscal year group



Note: Only sectors with at least 10 exiting projects in fiscal 1997–98 are included.
Source: OED, World Bank.

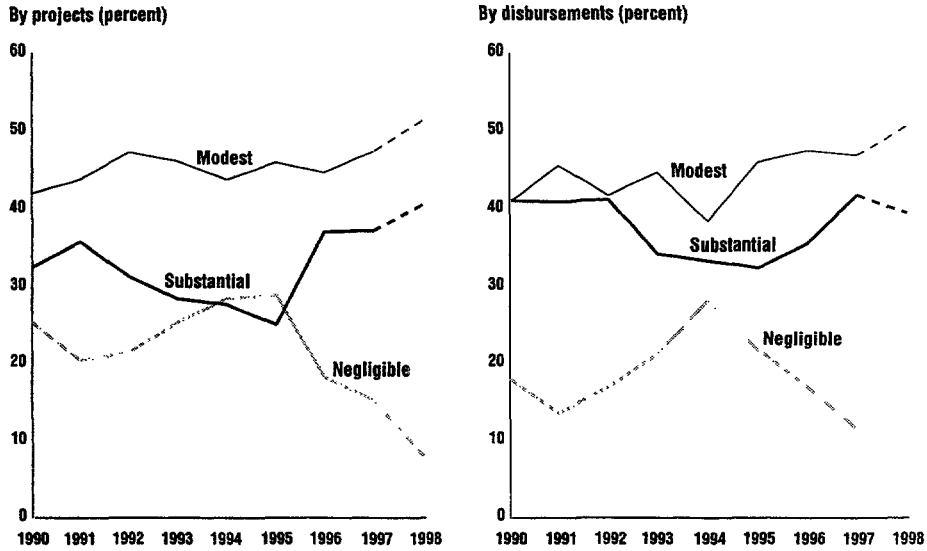
2.14 Care should be taken in interpreting these sector changes as potentially lasting shifts in performance trends. A comparison with performance assessments of the active portfolio currently under supervision provides a complementary gauge.[7] They provide modest support for the view that sector improvements are likely to be sustained. For example, active agriculture projects have improved to above-average performance in fiscal 1998, with lending scheduled to increase in the near future as the Rural Action Plan is implemented. Similarly, they indicate declining performance for the shrinking number of industry projects. The current portfolio data do not, however, support sustained gains in the finance sector.

Adjustment loans continue to have higher average outcomes and sustainability than investment loans

2.15 Adjustment loans continue to have higher average outcomes and sustainability than investment loans, though the gap has narrowed. The share of satisfactory outcomes for adjustment loans rose from 74 percent in fiscal 1990–96 to 82 percent in fiscal 1997–98, compared with a rise from 66 to 76 percent for investment loans. Institutional development performance has evened to roughly 38 percent substantial for both types of loans.

2.16 Last year's performance results suggested only minor progress in IDA and blend-financed projects. This year's results display much stronger improvement—with IDA and blend projects among the fiscal 1997–98 exits performing at par with IBRD-financed projects when considering outcome, sustainability, and institutional development impact. Considering outcomes alone, the share of satisfactory projects among IDA loans and blends was actually above that for IBRD-financed projects: 79 percent were judged satisfactory in fiscal 1997–98 compared with 74 percent for IBRD loans.

Figure 2.6 Institutional development impact, by exit fiscal year



Note: Broken lines (exit fiscal year 1998) indicate preliminary results, with less than 50 percent coverage of exited operations.
Source: OED, World Bank.

Institutional development impact—improving but still weak

2.17 The first two objectives of a five-point development framework offered by President Wolfensohn in his address at the 1998 Annual Meetings relate to institutional development.[8] Institutional development is particularly important in low-income countries, where the potential gains are the greatest and, as chapter 3 illustrates, the quality of institutions the lowest.

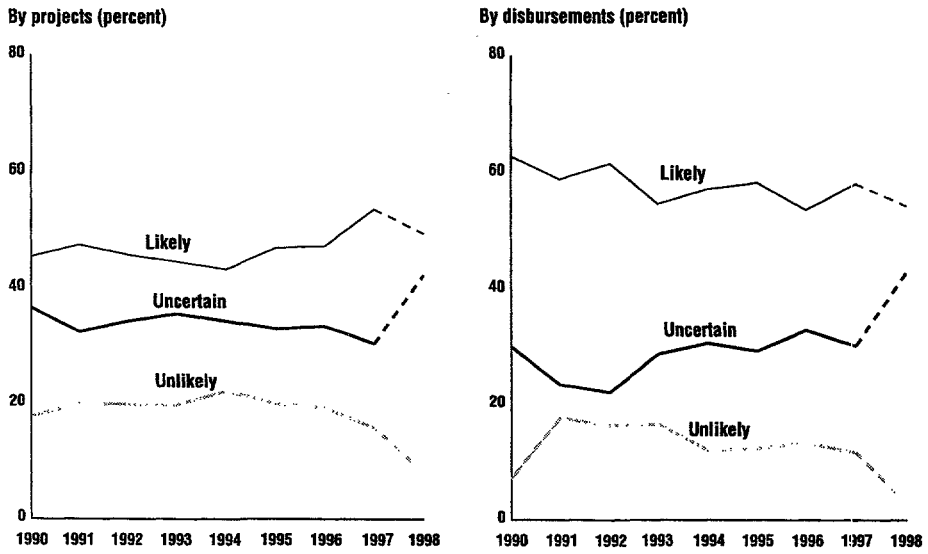
2.18 Recent evaluations show that the institutional development impacts of Bank projects are improving but there is enormous scope for further improvement (figure 2.6).[9] Current exits show historical highs of only 40 percent of operations with substantial institutional development. Between fiscal 1991 and 1995 the share of projects with negligible institutional development rose from roughly 20 percent to nearly 30 percent. That share dropped to the lowest on record of just 15 percent in fiscal 1997. By disbursements, however, the historical trend of larger projects having greater institutional development impacts shows signs of weakening. The share of disbursements with substantial impact was below the project-weighted average in two of the past three years. In chapters 3 and 4 we show the fundamental importance of institutional development in development effectiveness. The main finding: the spillover effects from better monitoring and closer attention to institutional development have been neglected, and need much greater emphasis in Bank operations.

> The institutional development impacts of Bank projects are improving but there is enormous scope for further improvement

Sustainability—low and weakening?

2.19 The fiscal 1997–98 data send a mixed signal on sustainability[10] that may well be a precursor of future declines in performance caused by a deteriorating external climate (figure 2.7). The proportion of projects judged as having likely sustainability that exited in

Figure 2.7 Sustainability, by exit fiscal year



Note: Broken lines (exit fiscal year 1998) indicate preliminary results, with less than 50 percent coverage of exited operations.
Source: OED, World Bank.

fiscal 1997 maintained an upward trend, increasing to 54 percent from 46 percent in fiscal 1990–96. But these projects closed at the latest in June 1997, well before the East Asian crisis. The partial results for fiscal 1998 projects, exiting in the unfolding of the Asian crisis, show a decline to 50 percent of projects judged to have likely sustainability. This decrease is largely because of the drop in East Asia and the Pacific projects—those most directly affected by the crisis—from 66 percent likely sustainability in fiscal 1997 to 43 percent in fiscal 1998. Similarly, there has been an almost doubling of the share of active projects in the Region at risk of not achieving their development objectives.

Bank and borrower performance improving—but greater gains from borrowers

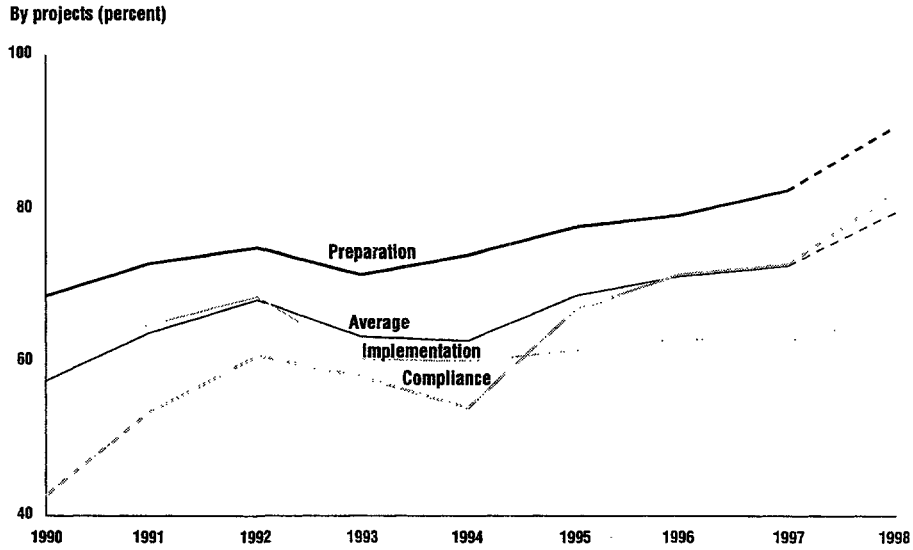
2.20 Analysis in past Reviews on the determinants of successful project outcomes found project-specific borrower performance to be the most important determinant of project success. Bank performance and country macroeconomic policy environment were also found to be less significant.[11]

In fiscal 1997–98 borrower performance improved to 75 percent satisfactory

2.21 In fiscal 1997–98 borrower performance improved to 75 percent satisfactory from 66 percent satisfactory in fiscal 1990–96 (figure 2.8).[12] This increase is pronounced in IDA countries, particularly in Africa and Latin America and the Caribbean. Borrower inputs have improved dramatically in finance and public sector management projects—rising from satisfactory performance in 57 percent of operations exiting in fiscal 1990–96 to 84 percent exiting in fiscal 1997–98. These sectors enjoyed large gains in outcomes over the same period, confirming the importance of borrower inputs in project performance. Improvements of more than 10 percentage points were found in urban and transport operations.

2.22 The increase in borrower performance reflects improvements in project preparation and in compliance with legal covenants. Implementation performance remains the

Figure 2.8 Borrower performance, by exit fiscal year

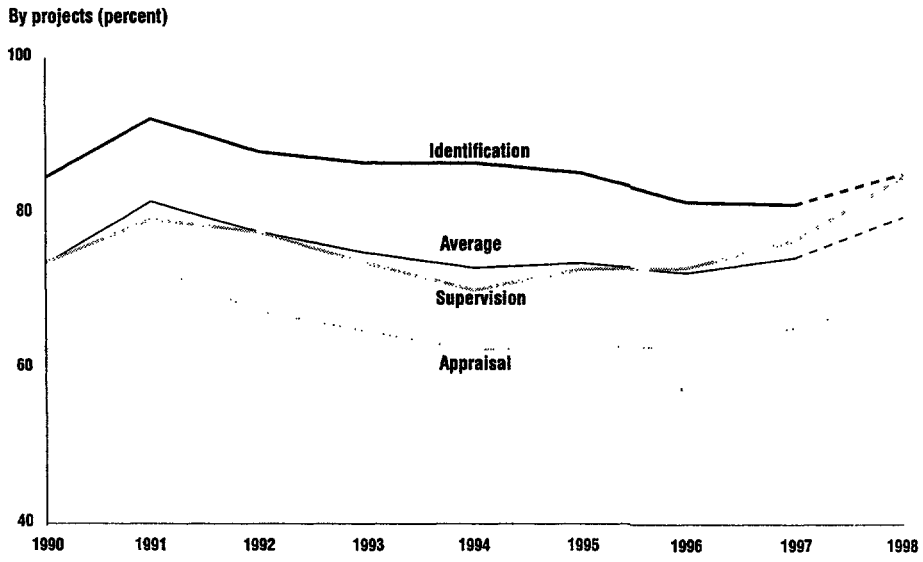


Note: Broken lines (exit fiscal year 1998) indicate preliminary results, with less than 50 percent coverage of exited operations.
Source: OED, World Bank.

poorest-performing dimension, with an unsatisfactory assessment in more than a third of evaluated projects. The overall increase in performance puts the overall quality of borrower inputs at par with Bank inputs. Three of every four evaluated projects now show satisfactory Bank and borrower inputs.

2.23 Bank performance, by contrast, improved modestly for fiscal 1997–98 exits, with only a one percent increase in the overall average over the 75 percent satisfactory average for fiscal 1990–96 (figure 2.9).[13] Lower-quality project identification has been offset by better supervision, while project appraisal improved slightly.[14] These results conceal some areas of particular improvement. Regionally, Latin America and the Caribbean showed improvement in both appraisal and supervision, raising the overall Bank performance average to 80 percent. Conversely, borrower performance in East Asia and the Pacific projects dropped in all three dimensions in fiscal 1997–98, with appraisal performance showing the largest decrease. Finance and public sector management, population, health, and nutrition projects also show improvements in Bank performance.

Figure 2.9 Bank performance, by exit fiscal year



Note: Broken lines (exit fiscal year 1998) indicate preliminary results, with less than 50 percent coverage of exited operations.
Source: OED, World Bank.

Outstanding projects—7 percent of the total

2.24 Of the 298 operations evaluated in the past year, OED assessed 20 (7 percent) as outstanding and 4 (1 percent) as exceptionally poor (table 2.1). The 20 outstanding operations all had highly satisfactory outcomes, likely sustainability, and substantial institutional development impact. In addition, these projects met or exceeded their main goals, had highly innovative designs, and are replicable in other countries or sectors. They featured strong borrower ownership, enjoyed highly satisfactory or satisfactory quality at entry, and were well supervised.

Of recent evaluations, OED assessed 7 percent as outstanding and 1 percent as exceptionally poor

Table 2.1 Outstanding performers and poor performers among recently evaluated projects

Country	*Project name*	*Loan/credit number*
Outstanding performers		
Benin	Urban Rehabilitation and Management	C2338
Brazil	Land Management I - Parana	L3018
Brazil	Parana Municipal Development	L3100
Chile	Second Public Sector Management	L3411
China	Ertan Hydroelectric	L3387
China	Integrated Regional Health Development	C2009
China	National Afforestation	C2145
China	Northern Irrigation - Part A	C1885
China	Ship Waste Disposal	C2391
Dominican Republic	Primary Education Development	L3351
Estonia	Highway Maintenance	L3731
Hungary	Human Resources Development	L3313
Lao PDR	Second Telecommunications	C2101
Latvia	Agricultural Development	L3695
Mexico	Contractual Savings Development Program	L4123
Morocco	Telecommunications Sector	L3557
Mozambique	Second Economic Recovery	C2628
Peru	Debt and Debt Service Reduction	L4133
Tunisia	Population and Family Health	L3307
Vietnam	Structural Adjustment	C2657
Poor performers		
Ecuador	Second Water Supply	L2774
Morocco	Rural Primary Education	L3026
Papua New Guinea	Land Mobilization	L3051
Rwanda	Sectoral and Pre-Investment Studies	C1796

Note: Covers the 298 projects evaluated since the last ARDE. *Source:* OED, World Bank.

The characteristic feature of poor performers is a general lack of supervision and low borrower ownership

2.25 The success of the outstanding projects can be traced to flexibility in responding to changing conditions—the result of consistent monitoring, good supervision, and partnership building. Even projects with complex designs succeeded because of extensive and effective Bank staff involvement and judicious technical assistance (box 2.3). In contrast, only one poor performer had satisfactory quality at entry. The characteristic feature of poor performers is a general lack of supervision and low borrower ownership.

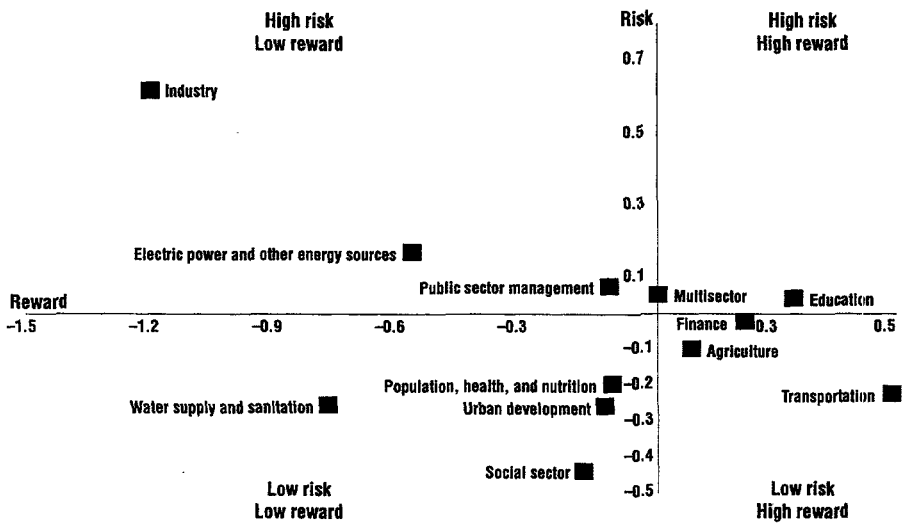
Sector analysis

2.26 For a successful development strategy, assessing risk (as measured by the variability of rewards) is as critical as assessing the expected development impact. Risks and rewards in the 12 sectors with more than 10 projects exiting in fiscal 1997–98 are shown in

figure 2.10. The origin of the axes corresponds to a reward equal to the average development effectiveness index in the 1997-98 portfolio, and risk is equal to the standard deviation of the index in that portfolio. The axes measure differences for specific sectors relative to the Bankwide average and the standard deviation of the development effectiveness index. Thus each quadrant, starting from the upper left and moving clockwise, corresponds

For a successful development strategy, assessing risk is as critical as assessing the expected development impact

Figure 2.10 Relative risk and reward by sector, exit fiscal years 1997–98



Note: Only sectors with at least 10 exiting projects in fiscal years 1997–98 are included. While the development effectiveness index has desirable mathematical properties for this kind of analysis, a similar performance distribution occurs when measurement relies on project outcome measures.
Source: OED, World Bank.

Box 2.3 Two outstanding projects

The importance of borrower ownership, commitment of Bank staff, and good supervision is illustrated by Chile's Public Sector Management Loan. The loan's main objectives were to increase the efficiency and effectiveness of key public management agencies, remedy the government's inadequate economic analysis and coordination capabilities, and improve policymaking in the legislature. These myriad objectives were more than exceeded due to the dedicated, competent action of the borrower, supported by an excellent Bank team. Capacity improvements and the beginning of cultural change were achieved in several key policymaking agencies and in the Library of Congress—above-average achievements for a freestanding technical assistance loan.

The crucial role of borrower commitment and strong Bank leadership is similarly illustrated by Latvia's Agricultural Development Project. This highly successful project was the first Bank-financed investment project in Latvia. Its overall development objectives were to enhance the privatization of agriculture, agroprocessing, and forest industries through financial and technical assistance. Well-focused objectives, a simple design, and such innovative features as the mobile credit officers of the new Agricultural Finance Company were important ingredients of project success. Clearly underpinning these successes was the government's commitment to the project, in turn strongly influenced by the effectiveness and staffing continuity of the project management unit and by Bank supervision.

to one of the four classes: high risk-low reward, high risk-high reward, low risk-high reward, and low risk-low reward. The coordinates corresponding to each sector measure the sector's risk-reward combination relative to the average project.

2.27 Figure 2.10 allows a comparison of average project results for each sector and the dispersion of these results around the corresponding Bankwide values. However, these comparisons are not meant to rank sectors. Instead they suggest that the relative risk-reward framework may be useful for the Bank Networks in considering potential weaknesses and strengths of Bank interventions in specific sectors, and external challenges that the sectors may face. Take the industry sector, where the average development effectiveness index is far below the Bankwide average and volatility is much higher. This raises questions: Does the Bank have comparative advantages in supporting industrial projects relative to the private sector? Or can the below-par results for this sector be attributed to a concentration of these projects in countries lacking good infrastructure? How much of the volatility in industry projects is the result of poor selectivity by the Bank? How much can be explained by exogenous shocks (such as contagion effects in regional crises), which are likely to affect industry projects more than less market-oriented interventions?

2.28 Similarly, the relatively low rewards of water and sanitation projects—and the relatively high confidence that performance in this sector will be weak—raises several questions. Why do this sector's results stand in such contrast to the rest of the Bank's portfolio? Do measurement problems drive the results? Or is a sector with such important potential effects on health and poverty really a relatively weak performer? We do not try to answer these questions here. The point is to present a framework that the Bank Networks can use to compare and contrast their sector performance with the results in other sectors. The framework itself should be scrutinized and tested for robustness over time.

Notes

1 The terms "operation" and "project" refer to both IDA and IBRD lending and are used interchangeably. Unless otherwise stated, all time period references relate to the fiscal year in which evaluated operations exited the portfolio.

2 The results for fiscal 1998 are based on a sample of 114 evaluated operations—40 percent of the 283 exiting operations—for which Regional staff have prepared completion reports. A complete set of data by region and sector will be provided on OED's Web site for reference and follow-up.

3 The likely bias arises from problems of sample representation for the preliminary fiscal 1998 results. According to project data from the Quality Assurance Group (QAG) at exit, the cohort evaluated so far includes far fewer problem projects (16 percent) than the projects remaining to be evaluated (26 percent). Of the evaluated cohort, those rated as problem projects by QAG at exit were only 18 percent satisfactory while the rest were more than 90 percent satisfactory. Assuming the same relationship between QAG and OED assessments for those fiscal 1998 exits yet to be reviewed by OED yields an estimate of 73 percent satisfactory for the part of the cohort not reviewed here. Combining this group with the exits reviewed implies an overall 76 percent satisfactory rating for the entire group of fiscal 1998 exits.

4 Data from the *Annual Report on Portfolio Performance Fiscal Year 1998 (ARPP)*, prepared by the Quality Assurance Group.

5 Disbursements are measured in real terms, deflated to fiscal 1996 US dollars.

6 The standard deviation of the regional shares of satisfactory projects has dropped 40 percent, from 10 percentage points for fiscal 1990–96 to 6 percentage points for fiscal 1997–98.

7 Data on the active portfolio under supervision is taken from the *Annual Report on Portfolio Performance Fiscal Year 1998 (ARPP)*, prepared by the Quality Assurance Group. The basic measure of performance used in the ARPP is the number of projects at risk of not achieving their development objectives. Projects at risk consist of actual and potential problem projects. Actual problem projects are those for which implementation progress is unsatisfactory or development objectives are not likely to be achieved. Potential problem projects are those rated satisfactory on implementation progress/development objectives but have other risk factors historically associated with unsatisfactory outcomes.

8 "The Other Crisis," delivered in Washington, D.C., on October 6, 1998, emphasized the essentials of good governance and the need to specify the regulatory and institutional fundamentals essential to a workable market economy.

9 Institutional development impact measures the extent to which a project has improved an agency's or country's ability to make effective use of its human and financial resources. This impact, possible even in the absence of explicit institutional development objectives, includes both traditional impacts, through new or improved organizations, and the impact projects have on the rules of the game governing public and private sector behavior.

10 Sustainability is defined as the likelihood, at the time of evaluation, that a project will maintain its results in future. To judge the sustainability of an operation, evaluators take into account country conditions, government policies, and other conditions specific to the operation such as availability of funds for operation and maintenance. Basic factors behind the original project appraisal are also considered—such as technical, financial, and economic viability, susceptibility to external shocks, and the social, environmental, and governance environment.

11 Looking at shifts in country macroeconomic environments, the fiscal 1997–98 evaluated exits have slightly more projects in the poorly performing country group than do those exiting in fiscal 1990–96 (12 percent compared with 9 percent), with a slight decrease in projects in the lower-performing group (from 17 percent to 14 percent). The three other groupings of high, lower-medium, and upper-medium performing countries show even less variation when analyzed for fiscal 1990–96 and fiscal 1997–98. While slight, the movement toward poorer-performing economic environments makes it unlikely that country selectivity played a role in the improved performance results of fiscal 1997–98.

12 Borrower performance is assessed for three project processes—preparation, implementation, and compliance. Implementation is the broadest of these three project measures, with dimensions under the government's control—such as broad project commitment, appointment of key staff, and counterpart funding—as well as implementing agency factors such as management, staffing, cost changes, and beneficiary participation.

13 Bank performance is assessed for three project processes—identification, appraisal, and supervision. Assessments of the Bank's performance during project identification include looking at the involvement of the government and beneficiary whether the project is consistent with the Bank's country assistance strategy and whether there is a grounding in economic and sector work. The quality of appraisal includes the following dimensions: technical and financial analysis, cost benefit analysis, institutional capacity analysis, and environmental and social analysis. Dimensions taken into account for assessing project supervision include progress reporting, identification/assessment

of problems, use of performance indicators, advice to the implementing agency, and flexibility in suggesting/approving modifications.

14 Findings that supervision improved are consistent with the latest Quality Assurance Group self-evaluation assessments of supervision in *Supervision Quality in FY98: A QAG Assessment (RSA2).*

* See the glossary for definitions of words and phrases followed by an asterisk (*).

Chapter 3

Development Effectiveness at the Country Level

Country evaluations confirm that weak institutional development has been a key problem in improving development effectiveness. Risk-bearing institutions—particularly the financial system and social safety nets—have been neglected by the development process. In many low-income countries, channeling aid through isolated, uncoordinated enclave projects has left capacity inadequate. Where the enabling environment is weak, projects should be justified largely for their policy reform and for their capacity development impacts, with the attendant risks reduced through judicious testing of borrower ownership. Country evaluations also show that institution building is needed to ensure that a country's outward orientation can safely reap the benefits of globalization—and shield the poor from its shocks.

Where the enabling environment is weak, projects should be justified largely for their policy reform and for their capacity development impacts

3.1 In 1995 OED inaugurated country assistance to assist the Board deliberations on country assistance strategies.* By now,[1] 17 such country assistance evaluations (CAEs) have been produced. They assess the relevance, efficacy, efficiency, sustainability, and institutional development of assistance strategies. Using the insights of independent professionals, they are case studies of aid effectiveness in the tradition of Cassen (1994) and Mosley, Harrigan, and Toye (1991). They identify lessons of experience and draw the implications for future strategies. More than 90 percent of operational staff preparing country assistance strategies found them helpful. The following findings emerge from an overview of CAEs:

- When graded the same way projects have traditionally been evaluated by OED, CAEs rate the overall outcome of the Bank's country strategy as satisfactory 68 percent of the time.[2]
- The rating of the Bank's country strategy from the CAEs is a relatively strong predictor of the average performance of Bank-supported projects.
- The most important development issues identified by CAEs are consistent with those that would be inferred from other empirical analyses of growth and poverty alleviation.[3]

The country as the unit of account

3.2 For this review OED undertook a pilot analysis of the linkages between country strategy and project performance. As a first step, all completed CAEs were subjected to a formal rating process consistent in structure with OED project ratings which are based on evaluative conclusions about the design, outcome, and impact of the Bank's assistance strategy in a country.[4] OED staff preparing CAEs were asked to summarize their views on

the outcome, sustainability, and institutional development of Bank country strategies as they would on projects (table 3.1).

Project performance is strongly correlated with the quality of the country assistance strategy

3.3 Project performance is strongly correlated with the quality of the country assistance strategy. None of the countries that had a satisfactory country strategy experienced weak project performance. In only 2 of 25 periods rated did an unsatisfactory Bank country strategy result in satisfactory performance on projects.

Table 3.1 Performance of Bank-supported country strategies and projects

Country assistance strategy rating	*Average project outcome performance*	
	Satisfactory	*Unsatisfactory*
Satisfactory	Albania (1992–97)	
	Argentina (1991–96)	
	Bangladesh (1980–96)	
	Bolivia (1986-97)	
	Côte d'Ivoire (1960–79)	
	Côte d'Ivoire (1994–98)	
	Ghana (1982–96)	
	Jamaica (1987–96)	
	Malawi (1995–97)	
	Morocco (1983–88)	
	Mozambique (1984–96)	
	Philippines (1986–97)	
	Poland (1986–96)	
	Thailand (1987–96)	
	Zambia (1994–96)	
Unsatisfactory	Côte d'Ivoire (1980–86)	Argentina (1985–90)
	Morocco (1989–94)	Côte d'Ivoire (1987–93)
		Jamaica (1980–86)
		Kenya (1990s)
		Malawi (1990–94)
		Togo (1985–90)
		Togo (1991–96)
		Zambia (1980–93)

Note: Average Bank-supported project outcomes over 50 percent are categorized as "satisfactory." Country strategy ratings of 4 and above are rated "satisfactory." Other approaches to categorizing relatively strong and weak performance, using central tendencies such as mean and median, produce similar results. *Source*: OED, World Bank.

3.4 CAEs' judgments about key strategic issues are similar to those that would be suggested by empirical studies of growth and poverty.[5] However, the relatively low aggregate outcome measure, 68 percent satisfactory, suggests room for considerable improvement in Bank country assistance strategies. In what follows we consider some of the common lessons from CAEs.

Institutions, aid, and growth

3.5 Development assistance has achieved much (table 3.2). For low-income countries the rate of improvement on most measures of deprivation is considerably better than that for high-income countries. But improvements in growth have been less propitious (Ingram 1992). For example, the weighted average per capita growth rate for low-income countries for 1980–96 (outside China and India) has been negative. So, low-income countries do not—as economic convergence models predict—catch up with high-income economies. Instead they fall farther behind.

3.6 Poor policies have a lot to do with disappointing income growth. Yet even the low-income African countries described as sustained policy reformers (IMF 1995) have had average growth of only 0.5 percent a year. The growth rate among this group is only slightly higher than that realized by Europe over the 400-year pre-capitalist period before 1820 (Maddison 1997). So something other than weak macroeconomic policies is impeding growth.

3.7 There is no simple explanation for such weak performance. But one factor, which recurs in OED's country evaluations, is the weakness of institutions. For instance, only 30 percent of low-income countries enjoy an institutional environment rated as marginally satisfactory, less than half the level for middle-income countries (box 3.1). Only 1 of 41 low-income countries scores a satisfactory rating on institutional quality, while more than 30 percent of middle-income countries do.[6] By contrast, OECD countries (except Korea) boast satisfactory institutional quality ratings. Among low-income countries a low institutional rating is more common than a weak policy environment: 40 percent of low-income countries and 77 percent of middle-income countries have good policy regimes.[7]

3.8 Policies and institutions are weaker than they might otherwise be because of inadequate donor coordination. Zambia's country assistance strategy provides a stark example. In 1987 the Bank concluded that Zambia's policy regime was not appropriate for the Bank to provide further lending. The Bank maintained this position for almost four years until 1991, when it resumed lending. In the 12 years before the Bank's withdrawal of assistance, aid averaged more than 9 percent of GDP a year. During the hiatus in Bank lending, donor assistance as a share of GDP rose to more than 15 percent of GDP a year. So, during a period when the Bank found the policy environment such that aid was unlikely to promote

Policies and institutions are weaker than they might otherwise be because of inadequate donor coordination

Table 3.2 Trends in socioeconomic indicators and income, 1970–96 (percentage change)

Country group	*Crude death rate (per 1,000 people)*	*Infant mortality rate (per 1,000 live births)*	*Life expectancy (years at birth)*	*Access to safe water (percentage of population)*	*GNP per capita (1987 constant U.S. dollars)*
High-income	10	72	9	n.a.	66
Low-income	33	40	17	260	44
Low-income excluding China and India	37	37	21	55	-4

Source: World Development Indicators 1998, World Bank.

Box 3.1 Institutions and developing economies

Since the 1980s a new development perspective has emerged. It holds that institutions and economic organizations are the key determinants of economic, social, and political progress. Six Nobel prizes have been awarded to scholars who made pioneering contributions to neoinstitutional economics. In parallel, development evaluators have established the crucial role of capacity building in ensuring the sustainability of development programs. Yet the links between development practice and academics are not strong. In addition, the evaluation profession has been slow to adapt its methods and processes to the new development consensus.

The papers presented at a recent OED conference (1998) illustrate that institutions matter. The papers explore not only how to get the institutions right but also how to assess the fit between institutions and development challenges through evaluative techniques. The papers show that:

- Variable combinations of competition, cooperation, and hierarchy are needed to achieve positive societal outcomes in specific country circumstances.
- Getting the incentives right is crucial to overcoming the restrictions that arise from the neoclassical model.

The papers argue that if institutional analysis is to become operational, it will have to provide greater clarity in the area of incentives. Institutions matter because incentives trigger motivation and action in both the public and private sectors. Incentives are thus the first building block for policy design, implementation, and evaluation of results. The difficulty lies in aligning the incentives structure with the collective interest.

Source: Picciotto and Wiesner (1998).

development effectiveness, donor assistance increased—and exceeded total investment. This pattern of donor support was motivated by donors' humanitarian concerns with the problems of a very poor country. But it did little to increase borrower ownership, to strengthen institutions, or ultimately to reduce poverty.

A central problem has been countries' lack of capacity to absorb the volumes of aid provided

3.9 CAEs of low-income countries—Albania, Ghana, Malawi, Mozambique, Zambia—as well as recent work by African policymakers on the African Capacity Building Study (World Bank, 1996a), argue that a central problem has been countries' lack of capacity to absorb the volumes of aid provided. Rather than directly addressing this, however, many development agencies, including the Bank, have established parallel methods to channel financial assistance, ignoring the adverse effects on capacity creation. This finding is not new, but it bears repeating. For example, Johnston and Van De Walle (1996, p. 66) argue that "aid has rarely contributed to effective institution building as it has bypassed local institutions in project implementation and design. The preference for enclave projects and parallel management structures to ministerial administrations has been particularly destructive."

3.10 A recent Danish government report on development cooperation issues in Tanzania (Helleiner and others 1995) reaches similar conclusions on how donor practices often undermine ownership. For example, in primary education the study finds that agencies frequently manipulate the choice of government departments they work with in order to achieve their objectives. The report also argues that where the government is reluctant to

agree to a donor's project, there have been implicit threats of a reduction in general donor support. Finally, it suggests that a common practice for donors is to pay "incentives" to government officials working on their projects.

3.11 Berg (1993) points out that, in such situations, "technical cooperation takes on a role different than its traditional one: it substitutes for and subsidizes government operating budgets. It does this directly by payments to government staff on projects, and indirectly by financing experts to do operational work normally done by government employees. This is disadvantageous in two ways. It misuses the technical assistance personnel resource, reducing its effectiveness for institution building. And it is extremely costly; high-cost expatriates are hired in posts that nationals could fill more cheaply" (p. 213-14).

3.12 The effects of lack of donor coordination on institutional development can be particularly acute in small countries, where the sheer volume of external assistance (and the associated absorptive capacity constraints) can hinder development effectiveness. Albania's country assistance review found that despite supporting and helping to design highly innovative projects overall, "IDA's strategy...did not fully appreciate the risks of overload inherent in a rapidly growing and diverse portfolio and a fragile institutional framework" (p. 12). Donor assistance in Albania reached more than 50 percent of GDP!

The lack of donor coordination on institutional development can be particularly acute in small countries

3.13 In contrast, in middle-income countries external assistance flows tend to be too small to have much impact. For instance, shortly after the 1994 devaluation in the 13 West African countries belonging to the Communauté Financière Africaine, the Bank lent the largest borrower in the zone (Côte d'Ivoire, a low-income economy) an amount equivalent to 1.5 percent of its GDP, or less than 2 percent of Bank commitments that year. But to provide similar support to the three East Asian economies—Indonesia, Korea and Thailand—that ran into difficulties in 1997 would have required lending more than three times the scale of net transfers that actually took place, equivalent to more than 60 percent of total Bank lending for 1997.

Adjusting to the external environment

3.14 The quality of lending and the support for institution building are only part of the equation. Equally important for development effectiveness is how well a country adjusts to the external environment, so that opportunities for growth can be exploited and the poor can be insulated from adverse shocks. CAEs provide interesting examples of how countries adjust or fail to do so.

Outward orientation and growth

3.15 Reform is a complex business requiring a clear understanding of borrower interests in the light of political economy considerations in order to nurture sustained ownership. Where the seeds of borrower ownership are in place, lending can be a useful instrument of reform. But as CAEs show, development assistance is not science—it is art. In unstable policy environments, there is no substitute for case-by-case assessments, framed to distinguish risks worth taking (Côte d'Ivoire and the Philippines) from risks that are inappropriate (Kenya).

3.16 The expected gain from assistance is the product of the probability of success times the rewards of adjusting. The enormous gains that can be realized from adjusting are often overlooked (box 3.2). Many studies focus only on whether adjustment took place—not on the payoff. A perspective that considers only the risk of failure and not the gains from success can be misleading. It is the type of perspective that might be used by a lender facing roughly the same level of loss with each failure, and a payoff that does not increase with the gains from success. This kind of decisionmaking is inappropriate for an equity investor—or for the kind of development partner described in the Strategic Compact.

3.17 What happens if a high standard is set for what is judged to be a permanent, lasting improvement in the policy environment? In the cases considered, only about 12 percent of adjuster countries realized a permanent and major improvement in their macro-

Box 3.2 The long-run expected benefits of adjustment

Can a country with a weak policy environment adjust? Can it shift from a bad to a good regime and sustain it over a decade or more? Or, as a number of analysts have observed, do countries that attempt to adjust not make it—and adjust over and over again? Finally, if durable adjustment is possible, do adjusters grow more rapidly?

To consider some of these questions, we use the Burnside and Dollar (1997) measure of macropolicy, based on the financial deficit, inflation, and openness for 1975–96. We considered 43 countries for which data were available. The Burnside and Dollar policy index was constructed annually, and the changes in it were used to categorize countries:

- Durable adjusters are those that maintained a good index for at least nine years. Not yet durable adjusters are those that have adjusted for at least the past four years but have not maintained adjustment long enough (nine years) to be classified as durable adjusters.
- Oscillators are those that do not tend to adjust but continue to oscillate between weak and strong policy environments. Their policy index remains volatile over time.

The sample has 12 durable adjusters, 20 not yet durable adjusters, and 11 oscillators. Durable adjusters are further divided into countries that adjusted and maintained it at the first attempt, and countries where the policy index oscillated between good and bad before the adjustment to good policy environment was sustained. Eleven of the 12 countries successful at maintaining a good policy index, according to Burnside and Dollar measures, did so on the first attempt.

The oscillators have had a weak policy index on average for about 13 years and for more than 60 percent of the period for which data were available. They also perform badly on Bank adjustment loans—with only 49 percent satisfactory outcomes. The average number of oscillations between strong and weak policy regimes for this group is four. If we add up the times all three categories of countries have attempted to adjust, the probability for a country to adjust durably is about 12 percent. Of course, this measure depends fundamentally, and arbitrarily, on the period chosen to qualify as a successful adjuster. It also depends on the quality of the country's institutional environment. If, for example, we consider the probability of successfully adjusting in countries that have satisfactory institutional environments, the likelihood of successful adjustment increases to 30 percent.

The threshold of nine years is arbitrary—and very conservative. If we reduce it to seven years, the odds of success increase to 16 percent—one in six. And as measured by OED, the outcome of adjustment loans in not yet durable adjusters would be strong and very similar (if slightly higher, 85 percent satisfactory) to that of durable adjusters.

Regardless of the threshold, it is clear that the probability of success is not high. So, for adjustment to have a lasting high payoff requires that the gains from adjustment be substantial. Are they? Does this turnaround to good policy make a difference? The payoff associated with successful adjustment can be illustrated in terms of the differences in average growth, per capita income, inflation, and volatility of these variables in the different country classes. In successful adjusters, per capita GNP grew at almost three times the rate of countries that have not yet achieved durable adjustment, and six times faster than oscillators. The adjusters also increased their growth rates more than sixfold.

economic policy environment. But for them, per capita income growth rates have been almost three times those for unsuccessful countries, and more than six times higher than their pre-adjustment growth rates.

3.18 Thus a review of the broader adjustment experience supports a key lesson of CAEs: the realization of high-payoff successes requires careful analysis and cooperation, rather than the use of simple rules to determine whether support should be provided. Nevertheless, this complexity does not mean that indicators are not available. For instance, information on seeming intangibles, such as concepts like borrower ownership, can be made operational, and obvious tests can be used to sort out the likely sustainability of investments in policy change (box 3.3).

Borrower ownership together with a greater concern for institutional quality could improve performance even more

3.19 By relying on such characteristics to guide Bank support for adjustment lending, the probability of success can be improved. Indeed, the probability of success in Bank-supported adjustment lending has increased significantly in recent years—because the Bank has become more conscious of the importance of borrower ownership. Combining this insistence on ownership with a greater concern for institutional quality could improve performance even more. It could also increase the legitimacy of subsequent reform efforts.

Outward orientation and poverty alleviation

3.20 In low-income countries capacity weaknesses are pervasive. In middle-income countries they tend to be specific. The country evaluation of Poland (OED, 1997e) suggests that reform of the social safety net remains one of the most important areas in the unfinished policy agenda. Recent reports on Thailand and Indonesia (World Bank, 1998) and a growing body of empirical work summarized in Levine (1997) show that in middle-income countries the institutions that specialize in bearing risk—financial intermediaries and social safety nets—have been neglected by the development process. Such oversight has had serious economic and social consequences, as recently demonstrated in Indonesia, the Republic of Korea, Russia, and Thailand.

Box 3.3 Measuring borrower ownership and its relation to adjustment outcomes

Borrower ownership of adjustment programs is often cited as vital for making policies credible, safeguarding against policy reversals, and ensuring the sustainability of benefits. An OED evaluation of nearly 100 adjustment programs in 42 countries by Johnson and Wasty (1993) highlights the symbiotic relationship between program outcomes and borrower ownership. It delineates the following performance measurement criteria for ownership:

- Is the initiative for formulating and implementing the adjustment plan the borrower's?
- Is there observable consensus among key ministries and decisionmakers on the nature of the crisis and the necessary actions?
- Have specific up-front actions been initiated before the program?
- Has participation taken place within the society?

The evaluation shows that measures of ownership are strong predictors of outcomes. And through selected country case studies, it ascertains the important factors that account for differences in the intensity of borrower ownership.

3.21 Over the long term, openness helps poor countries grow faster, and assists in reducing inequalities (Edwards 1997). But openness also makes it more important to put in place well-functioning risk-bearing institutions. To estimate the effects of shocks on income distribution, OED updated data from Deininger and Squire (1996) and added estimates for other countries. The data indicate an overwhelming increase in inequality within countries.[8] In fact, increases in inequality were five times more frequent than decreases: 49 countries experienced increasing inequality, 15 appear to have no trend, and 10 had decreasing inequality. Inequality is particularly acute in transition economies (box 3.4). But it is also increasing in countries that previously had no trend or a decreasing trend.

For sustainable progress, better safety nets and better-targeted expenditures on those aspects of poverty for which markets do not work are essential

3.22 To sum up, growth and an outward orientation are keys to reducing poverty. But alone they are not enough. For sustainable progress, better safety nets and better-targeted expenditures on those aspects of poverty for which markets do not work are essential. As Sala-i-Martin (1997) documents, such expenditures can have strong positive effects on growth. Similarly, OED's *Social Dimensions of Adjustment* (1996e) found that no country has achieved sustainable poverty reduction without growth. It also showed that the quality of growth is critical to the distribution of benefits. Much greater emphasis on safety nets—and expenditures on sectors not adequately funded by market processes—are needed if poverty is to be alleviated.

Box 3.4 Greater poverty and income inequality in transition economies

According to available information, poverty has increased across Eastern Europe and Central Asia. Take life expectancy at birth. It has declined precipitously in several economies, most notably Russia, where the average life expectancy for men in 1995 (58.3 years) was three years below that in India and a stunning six years below than at the start of transition. The drop in life expectancy in other countries, such as Ukraine and the Baltics, is similarly concentrated among men, and there were declines in 14 of 17 countries for which there are data. The income and health dimensions of poverty have also deteriorated. Nine of the 17 countries with data experienced increases in infant mortality, and 10 of 16 countries with data experienced a deterioration in secondary school enrollment.

The close relationship between poverty and income inequality distinguishes three groups of countries. In the first group—the Czech Republic, Hungary, the Slovak Republic, and Slovenia—inequality was historically low and has risen moderately. In the second group—Poland, Romania, and the Baltics—inequality was slightly higher than in the first group at the start of the transition and has since increased to levels at or above the OECD average. In the third group—primarily Russia and Bulgaria, and perhaps including other Commonwealth of Independent States countries—inequality has shot up dramatically from moderate levels to reach levels typical of more unequal developing countries.

In sum, poverty and income inequality have increased in all transition economies since the late 1980s. Some increase in income inequality in the region, even in the long run, is probably an unavoidable consequence of the introduction of market-based rewards. Nevertheless, the scope of structural change and economic dislocation have introduced additional inequality and poverty.

Source: Based on EBRD (1997), annex 2.2.

Notes

1 Up until August 1998.

2 OEDCR staff were asked to rate country assistance strategies (quality at entry, implementation, outcome, sustainability, and institutional development) from their evaluations in CAEs. Where the evaluator thought appropriate, the country strategy was rated separately for different periods. For the 17 countries reviewed, CAEs identify 25 time slices—that is, different and distinct strategies for the country within the time period covered by the evaluations. Project ratings corresponding to the same countries and periods show project outcome was satisfactory 68 percent of the time. The latter figure is similar to the average project performance during the period of the CAE analysis.

3 Derived from background work on country assistance strategies, available electronically at http://www.worldbank.org/html/oed.

4 The evaluation form follows the style of OED's project information form, and the methodology is that of OED's methodology for evaluating completed lending operations. See OED Lessons and Practices 10, "Evaluating Development Operations: Methods for Judging Outcomes and Impacts," 1997.

5 In addition to comparing the perspectives on growth and poverty reduction in CAEs with those of empirical models, we compared how well these judgments on country strategy performance performed as a predictor of subsequent Bank project performance. While 25 observations limited the degrees of freedom, these judgments nevertheless serve as a stronger predictor of subsequent project performance than do macroeconomic policy measures.

6 The data on institutional quality refer to country ratings on bureaucratic quality, rule of law, and corruption as defined by the International Country Risk Guide. An average of the three ratings of greater than 4 on a 1–6 scale is considered satisfactory. A rating of greater than 3.33 and less than 4.0 is considered marginally satisfactory.

7 This rating is based on a more limited sample of low- and middle-income countries. The policy index has been calculated on an annual basis for 1995 as in Burnside and Dollar (1996).

8 Using comparable data on income distribution for 45 countries, Deininger and Squire (1996) show that over the 30-year period up to the early 1990s there was no trend in within-country income inequality. In 29 countries the Gini coefficient—a measure of income distribution—remained virtually constant, in 8 it increased, and in another 8 it decreased. In the 16 countries with an increasing or decreasing trend, in 12 the change was small. Our shorter-term perspective, focusing on changes over five or more years, suggests that in recent years a very different pattern has emerged. The trends in transition economies are an important aspect of the changing pattern. But even in the 45 countries considered by Deininger and Squire, an updating of their data and a more-short term focus shows that about five times as many countries (24) have an increasing trend as do those with a decreasing trend (5 countries). Of course, given the limited amount of observations, our classification necessarily based on a heuristic approach.

Chapter 4

Thematic Evaluations and Institutional Development

The current financial crisis has far-reaching implications for development practitioners, and for evaluators. A higher priority must go to monitoring financial sector performance—and to the wide range of institutions involved in improving governance. Emphasis must also be given to the institutions—such as nongovernmental organizations and civil society—that help those not served by formal institutions. And to improve the effectiveness of public expenditures, practitioners and evaluators should help to introduce results-based management in the administration of development programs.

4.1 Structural and social constraints to development need far more scrutiny. OED's *Process Review of World Bank Grant Programs* (1998) shows that progress has been made on broadening the Bank's agenda and developing instruments to nurture the many kinds of institutions that can address these constraints. For example, the Institutional Development Fund (IDF) and the Consultative Group to Assist the Poorest (CGAP) promote institutional capacity-building and donor coordination. Similarly, the mainstreaming of new lending instruments—such as Learning and Innovation Loans and Adaptable Program Lending—represent tangible progress in the development of stronger, more sustainable institutions. But much more needs to be done.

4.2 Although it is well known that institutional factors are essential ingredients of economic growth and social stability, these factors remain neglected. This chapter considers the lessons of OED thematic evaluations for the wide range of institutional development issues involved in improving governance.

Financial sector

4.3 The financial institutions in crisis countries violated virtually all the institutional norms recommended by a recent OED study on *Financial Sector Reform: A Review of World Bank Assistance* (1998f). The OED analysis of financial sector interventions focused on analyzing how the elements of the Bank's evolving financial sector policy were reflected in Bank-supported projects. Examining 23 countries, the study found a satisfactory and sustainable outcome in only 12. The recommendations of the study—especially on the timing, sequencing, and scope of regulatory intervention—are more relevant than ever in light of the past year's events. According to Reisen (1998), careful monitoring of financial institution conditions in the crisis countries would have revealed serious weaknesses in financial systems. Consider how four key indicators of financial system strength developed in the OED study behaved in the crisis countries.

The financial institutions in crisis countries violated virtually all the institutional norms recommended by a recent OED study

Capitalization and bad loan exposure

4.4 At the outbreak of the crisis, nonperforming loans were the highest in the Republic of Korea (16 percent of total assets) but similarly high in Thailand (15 percent) and Indonesia (11 percent; table 4.1). These figures are much higher than the 9 percent in Mexico in early 1995, where the cost of rescuing banks has been estimated at about 15 percent of GDP (Caprio and Klingebeil 1996). In Indonesia, Korea, and Thailand capital-asset ratios were 6–10 percent. So even before the crisis, nonperforming loans far outweighed (on average) bank equity capital.

Government interventions

4.5 Banks in crisis countries may have been affected by certain kinds of government interventions in bank lending and corporate finance. The governments often directed lending towards particular sectors, both formally and often informally. In addition to explicit guarantees, there were implicit guarantees that lead to presumptions of government bailout for non-performing loans in favored sectors. This lead to excessive investment and risky lending. Once the bubble burst, investor confidence was further undermined by the uncertain fiscal implications of honoring government explicit and implicit guarantees.

Accounting and prudential standards

4.6 The weaknesses of accounting standards in crisis countries are common in many emerging markets: inconsistent financial reporting, limited power of auditors to examine

Table 4.1 Bank system risk exposure in East Asia

Indicator	*Indonesia*	*Korea, Rep. of*	*Malaysia*	*Philippines*	*Thailand*
Bank system exposure to risk (percentage of assets, end 1997)					
Nonperforming loans	11	16	8	6	15
Capital ratio	8–10	6–10	8–14	15–18	6–10
Real estate exposure	25–30	15–25	30–40	15–20	30–40
Collateral valuation	80–100	80–100	80–100	70–80	80–100
Regulatory features during the 1990s					
Bank lending to connected firms	High	High			
Government-directed bank lending	Yes	Yes	Yes	Yes	Yes
Bank deposit insurance	No	No	No	Yes	No
Importance of state-owned banks	High			High	
Accounting standards	Weak	Weak		Weak	Weak
Enforcement of regulations	Weak	Weak	Weak	Weak	Weak
Incentives for capital flows					
Short-term inflows	Limited	Limited (promoted)			Promoted
Long-term inflows	Limited	Limited			Promoted
Outflows	Free	Limited			Limited

Source: Reisen (1998).

company records, lax auditing and accounting standards out of line with international good practice, lack of penalties for incorrect reporting of information, and tolerance of multiple accounts. In such environments, detailed examinations by supervisors and regulators may not reveal the information needed to regulate properly or to ensure prudential soundness.

Enforcement capabilities

4.7 Even though some of the crisis countries had strengthened their supervisory and regulatory infrastructure during the 1980s and 1990s, partly in response to costly banking crises in Indonesia and Malaysia a decade earlier, enforcement capabilities remained weak (Fischer and Reisen 1993). Bank regulators had also imposed limits on bank lending, including liquidity requirements, exposure limits, and risk-based capital requirements. But according to Reisen (1998), these standards and ratios were poorly enforced.

4.8 The crisis reinforces the need to adopt a central recommendation of the OED study on financial sector reform: "more resources should be allocated to monitor and evaluate countries' financial sector programs, with performance indicators" (p.83). The crisis also underpins Bank management's seeking special budget authority from the Board to support financial sector work. But above all, it confirms the large adverse effects from neglecting institutional development.

Governance issues

4.9 The crisis has reinforced the already-strong evidence that growth in per capita income is enhanced by strong property rights, sound legal foundations, and capable civil servants—all operating in an effectively managed institutional system. There is also evidence that corruption in these institutions hampers growth.[1] Does better governance and lower corruption improve the development effectiveness of projects? Unambiguously, yes. As measured by the development effectiveness index, Bank-supported projects in countries with an inadequate bureaucracy are on average the weakest performers.[2] In countries with a well-functioning bureaucracy, projects perform much better, with significantly lower risks than average.

Does better governance and lower corruption improve the development effectiveness of projects? Unambiguously, yes.

4.10 Similarly, Bank-supported projects in high-corruption economies have had significantly lower returns with significantly higher risk. Corruption is almost always associated with low bureaucratic quality, so that public sector management projects in corrupt countries are particularly likely to be low-return/high-risk projects. Only education projects have a high return and a low risk in countries with high corruption. Projects in low-corruption economies nearly always have a higher return and a lower risk than comparable projects in other countries.

4.11 Perhaps the most difficult governance issues arise where the state has collapsed or failed, particularly in countries that have recently emerged from conflict. In general, projects in these countries tend to have lower rewards and higher risks, reflecting the turbulence that conflict engenders. Still, risk-reward performance varies significantly across sectors, and as might be expected, many types of infrastructure projects perform well in societies that have experienced destruction and civil conflict.

4.12 Another message of OED's (1998k) study of the Bank's experience with post-conflict countries is that the Bank can assist best if it avoids the overzealous pursuit of unrealistic fiscal rectitude. The circumstances of these countries require that the first emphasis be on support for rebuilding the institutions of government and civil society.

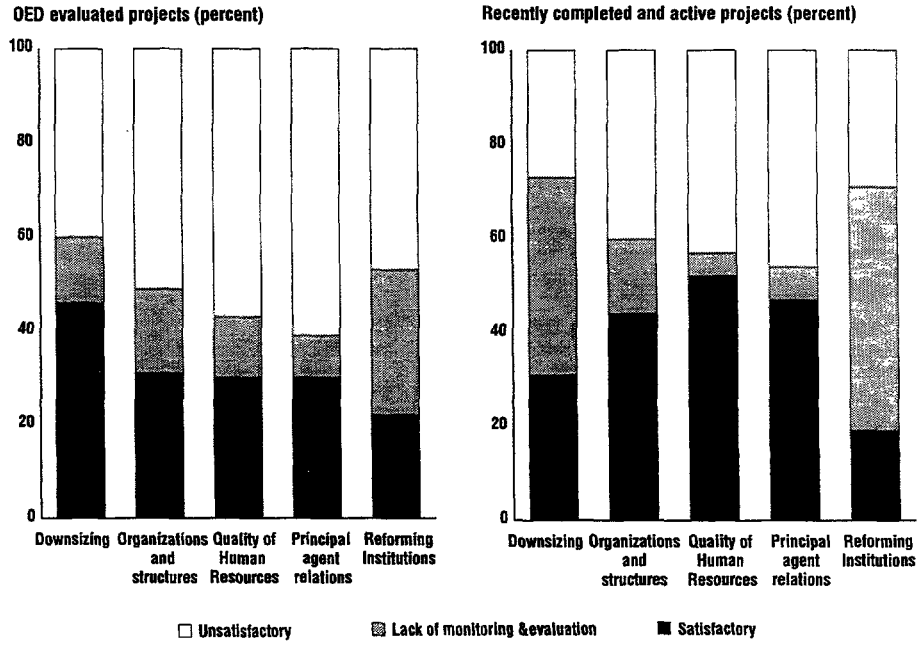
Governance institutions

Civil service interventions—only 33 percent...achieved satisfactory outcomes

4.13 The Bank has long supported efforts to improve the workings of the state. In the 1980s, Bank assistance primarily sought to make governments "leaner" through downsizing. In the 1990s the Bank sought a "clean state" for its clients by strengthening the credibility of governance institutions through institutional reforms—that is, intra-public sector regulatory reform and establishment of checks on arbitrary action. Regardless of the approach, the results have been meager. OED recently evaluated more than 300 civil service reform interventions supported by 124 lending operations approved during 1980–97. A significant percentage of completed and ongoing operations lacked adequate monitoring and evaluation information to make meaningful assessments of performance. Only 33 percent of those interventions that could be evaluated achieved satisfactory outcomes (figure 4.1). Institutional development impact was rated as substantial in only 16 percent of completed operations—and in only 10 percent of completed stand-alone projects.

4.14 Overall project performance in the public sector management sector is improving, but civil service reform components remain among the weakest-performing interventions in the Bank's portfolio. As with financial institutions, a central recommendation of the

Figure 4.1 Performance of civil service reform interventions



Note: The data reflects OED evaluations through July 1998.
Source: Civil Service Reform Study, forthcoming, OED, World Bank.

OED analysis is that far greater priority should be devoted to integrating the use of performance indicators to monitor and support more effective public administration efforts. Results-based management systems can be an effective way to focus public sector performance on outcome measures (box 4.1).

4.15 Public expenditure analysis is central to the Bank's policy dialogue with member countries. It is also an evolving and rapidly growing field within the Bank's economic and sector work, having grown from 3 reviews before 1979 to 39 in fiscal 1998. Public expenditure reviews are a means for the external evaluation of a borrower's fiscal policies and sector reform efforts. They also provide a framework for coordinating external assistance and assessing its effectiveness, and they can provide a micro foundation for the IMF's macroeconomic framework. IDA's deputies have underscored the importance of public ex-

Box 4.1 Public sector performance review: Integrating public sector performance with a results-based management system

A recent OED study of Public Expenditure Reviews (1998) discusses how this analysis might give greater emphasis to output measures rather than traditional input measures. It says that to provide relevant analysis of public expenditures, a public sector performance review must begin by developing an understanding of three contextual dimensions of the country's public sector.

Public sector mission and values. Societal values and norms—as embodied in the constitution or in annual budget policy statements—may be useful points of reference for public sector mandates and the values inherent in those mandates. In industrial countries the mission and values of the public sector are spelled out in a medium-term policy framework. For example, there is a formal requirement in New Zealand that a policy statement of this type be tabled in parliament two to three months before the budget statement. In contrast, public sector values are rarely addressed in developing countries, because the orientation is to "command and control" rather than to serve the citizenry.

Authorizing environment. The authorizing environment includes formal (budget processes and institutions) and informal institutions of participation and accountability. Do these institutions and processes work as intended in providing an enabling environment for the public sector to meet its goals? Do various levels of government act in the spirit of the constitution in exercising their responsibilities? What are the checks and balances against deviant behavior? Are there formal rules to ensure fiscal discipline? Is public sector borrowing subject to financial market discipline? How is government performance measured? Are output and outcome indicators for public services monitored by anyone? In industrial countries institutional norms are strictly adhered to, and there are severe moral, legal, voter, and market sanctions against noncompliance. In developing countries noncompliance often is neither monitored nor subject to sanctions.

Operational capacity and constraints. What is authorized is not necessarily what will get done because available operational capacity may not be consistent with the task at hand. Further, even the operational capacity that is available may be circumvented by the bureaucratic culture or incentives that reward command and control—and corruption. Some key questions: Do the agencies responsible for various tasks have the capacity to undertake them? Are there binding contracts on public managers for output performance? Does participation by civil society help alleviate some of these constraints? Whereas in industrial countries answers to most of these questions are expected to be yes, this is not true in developing countries.

The analysis and recommendations in such a review must be consistent with and recognize any inconsistencies between a country's mission and values, its authorizing environment, and its operational capacity. If they are, the review will enable the client and external partners, including the World Bank, to understand better how to improve public sector performance. It will further serve as a catalyst to introduce results-based management in developing countries. Such an approach to public sector management would help change bureaucratic culture from its emphasis on command and control, with arbitrary and oppressive rules, to one focused on serving its citizens, earning their trust, achieving results, and working better for less money.

penditure reviews as instruments for client capacity development as well as for enhancing development effectiveness by integrating review results with country assistance strategies.

4.16 OED's (1998g) study of *The Impact of Public Expenditure Reviews* found that quality has improved in recent years. But it also found that public expenditure reviews provided good (but often dated) analyses of spending policies with little concern for cost efficiency or the quality of public services. They had only a modest effect on Bank lending strategies, client expenditure policies, and aid coordination. The study argued that such reviews could become significantly more effective if they were more demand-responsive, if better synchronized with authorities' budget cycles, and if they gave due recognition to institutional constraints.

NGOs and CBOs can play a particularly important role in projects targeted at improving gender equality, the environment, and poverty alleviation

4.17 In many societies, nongovernmental organizations (NGOs) and community-based organizations (CBOs) provide a closer link to the poor than public sector institutions. According to an OED (1998h) study of *NGOs in Bank-supported Projects*, 38 percent of Bank-supported projects include NGOs or CBOs in their plans. This involvement increased to 46 percent of projects in 1997, more than doubling from 20 percent in 1989. The study found that these institutions can be particularly important in projects targeted at improving gender equality (80 percent), the environment (54 percent), and poverty alleviation (48 percent). But their capacity is often limited by erratic funding and a lack of financial independence.

4.18 The lack of government capacity to work effectively with NGOs and CBOs is also important. While there are some outstanding examples of government agencies with a strong ability to work with NGOs, these are exceptions. Similarly, the Bank's capacity to encourage NGO and CBO involvement in projects remains limited. And as for financial institutions and public sector institutions, the Bank's database and statistics on NGOs and CBOs do not provide a reliable picture of their involvement in Bank-supported projects. Nor do they describe results. The database mainly records whether provision was made for NGO or CBO involvement, not the actual involvement.

4.19 In sum, much remains to be done to develop a better understanding of the role of institutions in assessing and encouraging development effectiveness. As measured by the performance of Bank projects, there are significant and broad gains to be realized from developing and maintaining well-run and effectively managed public institutions. Similarly, increased vigilance on corruption—and increased reliance on new public sector management techniques, such as results-based management—could have positive spillover effects on the overall quality of Bank assistance. Finally, the Bank could more systematically engage the institutions of civil society in addressing issues of gender equality and poverty alleviation. The Institutional Development Fund, the Consultative Group to Assist the Poorest, and the new lending instruments are promising vehicles for doing this.

Notes

1 See Clague (1997) and Knack and Keefer (1995). For literature on corruption, see Bardhan (1997), World Bank (1997b, Mauro (1995, and Rose-Ackerman (1998).

2 To consider the effects that country characteristics might have on Bank performance, we examined performance in a wide range of countries. For example, we grouped countries by whether they were post-conflict societies, transition economies, Sub-Saharan Africa economies, had high or low levels of corruption, good or weak bureaucracies, persistently poor policy environments, and so on. Annex 2 describes data sources and country classifications.

Chapter 5

Implications for the Bank and for Evaluation

The implications of the current financial crisis are sobering for the Bank and for the evaluation profession. It has become amply clear that the value added by development assistance programs and by evaluations would be substantially enhanced by more explicit attention to exogenous factors and long-term structural constraints. There should also be a sharper focus on the measurement of poverty reduction as the acid test of development and better methods of assessing institutional development both at project and country levels.

5.1 Last year's *Annual Review of Development Effectiveness* concluded that "the challenge is to find the right fit between country policy and institutional factors and strategies to try to improve conditions favorable to improved growth and development" (p. 51). In a much more complex—and hostile—external environment, this year's Review reaches similar conclusions. It is now even clearer that improvements in project performance are not enough. Broader structural and social constraints impede project effectiveness, but so too does the riskiness of the global environment for developing countries.

In a much more complex—and hostile—external environment improvements in project performance are not enough

5.2 Before considering what these constraints mean for Bank operations and their evaluation, an evaluation of longer-term trends in Bank performance and development effectiveness needs to be placed in the context of the unprecedented events of the past year. It is particularly important to consider the implications that these events pose for the prospects of sustainable growth and poverty reduction.

Global risks

5.2 Some evidence of just how hostile the current environment is for developing countries is shown by *Euromoney's* country risk ratings.[1] For this Review, OED calculated a GDP-weighted measure of country risk for developing and industrial countries. The measure for developing countries shows a deterioration in the past year to the riskiest level since the Latin American debt crisis—and one of the biggest adverse shifts since World War II. The measure also shows that in the aftermath of the crisis, the external environment for developing countries remains, unlike that for industrial countries, at a high level of uncertainty—again the highest since the debt crisis. For industrial countries, the aggregate trend is the opposite: toward less volatility. Developing countries are now perceived as very risky investment environments. Does this matter?

5.3 Perhaps a great deal. While the relationship between such aggregate measures of country risk, investment flows, and project performance is not simple, the broad dimen-

sions of the relationship are clear. As the debt crisis took hold in the mid-1980s, risk measures increased and Bank performance deteriorated to below 70 percent satisfactory outcomes. Then, as the crisis was resolved and the environment improved, private capital flows increased sharply and project performance improved, particularly in the past few years. These relationships are hardly precise. But they cannot be ascribed to coincidence. To disentangle some of the possible effects for development effectiveness, examining the relationship to Bank performance is instructive.

5.4 Measures of country risk are expectations about likely performance—expectations often not realized. The measures can change after investments have taken place and been evaluated, either to reflect the changes that took place or to correct expectations. Countries can do much better than was expected—as many did in the years before the East Asian crisis—and much worse than expected—as in East Asia and Russia over the past year. How did changes in country risk affect the performance of Bank projects exiting in fiscal 1997 and 1998? Consider three types of economies: those where country risk during the implementation of Bank project was stable, those where the country risk rating improved significantly during project implementation, and those where it deteriorated (table 5.1).

Table 5.1 Average performance of projects implemented in three country-risk environments, projects exiting in fiscal 1997-98

	Improvers	*Stable*	*Deteriorators*
Share satisfactory (percent)	85	74	73

Note: The change in risk rating between the year of approval and the year of exit has been used to classify countries. Improvers refer to countries whose risk rating improved by more than five percentage points; stable refers to countries whose rating changed by less than five percentage points; deteriorators refer to countries whose risk increased between the year of approval and the year of exit.

Performance improved because it was being swept along by a rising tide

5.5 Countries whose circumstances improved account for more than 60 percent of the exiting projects. In these countries, risk perceptions improved considerably during implementation, as the world moved to one of the highest-ever growth rates for developing countries. Not surprisingly, project performance in these economies was good—the likelihood of a project's having a satisfactory outcome in those countries was 85 percent. This is 11 percent higher than in economies that performed as expected when the project was initiated. Fortunately, outcomes appear to be more robust with respect to the unanticipated deterioration in country risk. Countries that experienced an increase in risk, even those that had a substantial increase, did not experience a large reduction in project performance. So at least from a preliminary analysis of past performance, the deterioration in conditions should not be devastating for the existing portfolio. But the effects on future projects may be more serious.

5.6 In some respects the recent improvement in overall performance on Bank-supported projects has been the result of projects being implemented in economies undergoing

improvements in broad fundamentals. In this light, performance improved because it was being swept along by a rising tide. But what will happen if this tide has crested, and future performance is no longer buoyed by a continually improving external environment? If current forecasts of country risk are accurate, and a large portion of Bank borrowers do not experience an improving external environment during implementation, overall satisfactory performance of future projects could be reduced by as much as 5 percentage points.[2] Evaluation must give greater prominence to the effects of the external environment, particularly for sustainability.

Box 5.1 What do we know about the extent of poverty?

The Bank is considered the largest repository of information on poverty. But it has systematically focused on data collection only since 1991, when it issued a directive mandating poverty assessments in borrowing countries. So far, 94 assessments have been done (83 countries and 11 updates) covering about 90 percent of the world's poor. Twenty-two poverty assessments were completed in fiscal 1996 (17 countries and 5 updates) and 10 (8 countries and 2 updates) in fiscal 1997. By 2000 the plan is to complete the remaining 22 assessments and 9 scheduled updates.

When the Bank's *World Development Report* on poverty was published in 1990, poverty measures could be calculated for only 11 countries. These surveys covered the 10 years leading to 1990 and together accounted for 40 percent of the total population of the developing world and 50 percent of its poor. The quality and availability of household survey data for developing countries have improved considerably since then. Today 138 surveys are available for 69 countries. The timeliness of data has also improved from an average lag of 11 years in the mid-1980s to about 5 years now. Even so, *World Development Indicators 1997* reports estimates of the population living below $1 a day per person for only 60 countries.

The most commonly used measure—the head count index—counts people below the poverty line but ignores what is happening to them and whether they are becoming poorer. In the extreme, the measure actually improves if the poor die from poverty (Sen 1976). *World Development Report 1990* recognized that for any given increase in the incomes of the poor, the reduction in poverty depended on where the poor were relative to the poverty line. If they were concentrated just below the line, the increase in their incomes would have a bigger effect on poverty than if they were spread more evenly.[3]

It remains difficult to compare rates of poverty in different countries. There are, in fact, conceptual and practical problems.[4] The surveys from which the poverty data are drawn are:

- Taken at different points in time.
- Based on different sample designs that may or may not be nationally representative.
- Conducted under methodologies that are often dissimilar.
- Designed to yield a wide variety of often different types of information.

Some obtain information only on incomes, while others obtain information only on consumption. Most differ in the depth and detail about consumption. Methods of valuation vary considerably, with some surveys using prices at the nearest market while others use farmgate prices.

The money-metric measure of welfare involves setting poverty lines and denoting the household cost of the level of welfare needed to escape poverty. Best practice involves adjusting for differences over time or space and household demographics. But the data needed to do this consistently are inadequate and generally variable. The problems of making purchasing power parity currency adjustments for international comparisons adds to the lack of comparability. Setting the poverty lines too high to include, say, countries in Eastern Europe in the comparison raises the estimates of poverty for other countries.

If this vast heterogeneity in the underlying data is not carefully controlled for, aggregation to obtain regional or global estimates is not valid, and comparisons across countries and time are at best spurious.

Prospects for poverty reduction

The assessment of development effectiveness should give pride of place to poverty alleviation

5.7 The events of the past year confirm that the assessment of development effectiveness should give pride of place to poverty alleviation. Chapter 3 reviewed the effects that the recent financial crisis and the ongoing transition from socialism have had on income distribution. What these shocks mean for poverty alleviation can be seen by considering what they mean for the OECD's Development Action Committee's (DAC) goals on poverty alleviation. The DAC goals call for a reduction in the number of people in absolute poverty of 1 billion by 2015. These goals require that about 50 million people be raised from poverty each year for the next 20 years.[5] The East Asian crisis has, in effect, already put the DAC program nearly a year behind schedule. But this was not the only poverty-increasing shock. The increase in poverty due to the collapse of safety nets in transition economies is larger than the East Asian effect, and to offset these increases will require perhaps another three to four years of successful effort on poverty reduction for the DAC goals to be realized.

5.8 Together these two shocks have moved the goal posts four to five years farther away than when the targets were established only two years ago. Much more must be done in improving poverty measures if the Bank and the donor community are to come to grips with the full dimensions of global poverty (box 5.1). While the goals may be a useful structure, greater detail is needed to flesh out all the important dimensions of poverty reduction. Better data are needed so that the poor truly become visible in our evaluations and goals. Finally, more than safety nets and income growth are needed to achieve DAC's poverty goals (box 5.2).

Box 5.2 Poverty alleviation and income growth

In assessing human welfare, advocates of human development would, at a minimum, place indicators of social conditions—notably life expectancy and educational achievement—on equal footing with such traditional economic measures as GDP per capita and a poverty index. Some would go further and include indicators of political and civil liberties. To the broader measure of human development, a common reaction among economists and economic historians is skepticism, because improved life expectancy is typically viewed as a byproduct of economic development.

Not always. New techniques of disease control, based on new knowledge of disease, have been sources of improved life expectancy. And public intervention has been crucial for implementing them. The free market institutions commonly considered to be behind economic growth have not been responsible for adopting the new techniques of disease control. Nor do free market institutions appear to have generated the new technology of disease control. But perhaps economic growth has been necessary for increasing life expectancy—by providing the resources needed to fund public spending on the new technology, either directly or through international aid, or to fund the research responsible for the advance in knowledge. At most, however, economic growth may have been helpful, but it was not required to finance the advance in knowledge that brought infectious disease under control.

So higher life expectancy cannot be taken as simply a byproduct of economic growth or the free market conditions that foster it. Indeed, public policy initiatives have been essential to the improvement of life expectancy, and these can be—and have been—undertaken in the absence of economic growth. Life expectancy is an objective to be pursued in its own right by the institutions and policies it requires.

Source: Easterlin (1998).

Implications for the Bank

5.9 What does all this mean for Bank operations and evaluations? Three issues require greater emphasis: poverty alleviation, country strategies, and institutional development.

Poverty alleviation

5.10 In recent years poverty alleviation and social concerns have been afforded more attention in Bank strategies, as mandated by the Strategic Compact. This year's Review finds that much greater donor coordination is essential, particularly in low-income countries. In these countries, declining volumes of external assistance must be better coordinated and more sharply focused on poverty reduction.

5.11 OED evaluation efforts should emphasize social aspects more. Rating systems should give more weight to the social impact of projects and programs. Recent shocks have had a profound negative effect on poverty, and it is difficult to exaggerate the importance of the need for measures to address these concerns systematically. Safety nets are the vehicle for addressing shocks and should be at the forefront of poverty alleviation concerns, rather than being comfortably assumed away as they have been in many analyses of world poverty.

Country strategies

5.12 The Bank has made considerable progress on broadening the development effectiveness spectrum—for example, it has already moved beyond projects in its strategic perspective. But as the discussion of the external environment showed, continual improvements in Bank and borrower performance may not be enough to maintain the performance of recent years, much less continue the steady improvements. In such a context, even the best-designed project will not contribute to development effectiveness without a greater understanding of how it fits into the broader country and international environment.

5.13 For evaluation, OED will reemphasize and intensify its shift in focus on the country as the appropriate unit for evaluation. It will also give more attention to sector performance. These new emphases will build on, not substitute for, OED's traditional concern with project performance.

Institutional development

5.14 The events of the past year have revealed how costly weak institutions can be. The importance of sound institutions has long been known. Not known was how costly a systemic institutional failure can be. Bank operations have made significant progress on focusing resources on this important issue. And as discussed in chapter 1, a major dimension of this work will be on financial institutions—but recent events underscore that much more needs to be done.

The events of the past year have revealed how costly weak institutions can be

5.15 For evaluation, greater emphasis should be placed on the metrics of institutional development. The development effectiveness index is but a first step on this journey, and further work should be done in considering how institutional development can be given more emphasis in evaluation measures. Simpler, concrete steps are needed. For example,

today's project supervision and completion reports do not require a rating of institutional development impact. This shortcoming should be rectified. For its part, OED should make sure that its new country evaluation instrument gives adequate attention to institutional development issues.

5.16 The past year has tested the Bank's new framework for providing development assistance. While this test is far from complete, the past year's results appear promising. The broad dimensions of the Bank's strategy appear to be well conceived. With continued adjustment and refinement, they should permit the Bank to help developing countries confront a much tougher external environment.

Evaluation is central to adjusting the Bank's approach

5.18 Evaluation is central to adjusting the Bank's approach. For example, systematically addressing poverty alleviation requires making the poor visible through better data and monitoring systems. Output targets must be linked much more tangibly to policy inputs and must recognize the increased risks of the external environment. With the help of evaluators, those targets must be embedded in the scorecards of country and sector assistance strategies.

Notes

1 *Euromoney's* semiannual country risk ratings range from 0 (most risky) to 100 (least risky). Each rating is calculated as a weighted average of nine categories of indicators representing analytical credit and market indicators. The categories are economic data (25 percent weighting), political risk (25 percent), debt indicators (10 percent), rescheduled debt or debt in default (10 percent), sovereign credit ratings (10 percent), access to bank finance (5 percent), access to short-term finance (5 percent), access to international bond and syndicated loan markets (5 percent), and access to and discount on forfeiting (5 percent).

2 The estimated relationship between country risk and portfolio performance during 1997–98 is used to forecast ratings for projects exiting in 1999. The forecast of a 5 percentage point deterioration in fiscal 1998 satisfactory projects is used as a baseline scenario, assuming that country risk ratings in 1999 would be the same as in 1998. In a more pessimistic scenario, country risk ratings would deteriorate by 6 percentage points.

3 *World Development Report 1990*, box 3.3, page 47.

4 See Ravillion (1994a, 1994b, 1996) and Pollak (1991).

5 The estimated number of poor people in 2015, given the expected increase in population and assuming a 50 percent reduction in poverty, is 900 million. This would call for lifting almost 1 billion people out of poverty over the next 20 years, or about 50 million people a year.

Annex 1

A New Approach to Evaluating Bank Projects—The Development Effectiveness Index

The current Bank evaluation system assesses project results through a set of three ordinal ratings—on project outcome, sustainability, and institutional development impact:

- *Outcome* boils down to answering the following question: Did the project achieve satisfactory development results considering the relevance of its main stated objectives, and the associated costs and benefits? The outcome rating takes into account relevance (to check whether the project's objectives were consistent with the country's development strategy), efficacy (to examine whether the operation achieved its stated goals); and efficiency (to assess results relative to inputs in terms of costs, implementation times, and economic and financial returns). Outcome is rated on a six-point ordinal scale: highly satisfactory, satisfactory, marginally satisfactory, marginally unsatisfactory, unsatisfactory, and highly unsatisfactory.
- *Sustainability* is defined as the likelihood, at the time of evaluation, that the project will maintain its results in future. In assessing sustainability, evaluators focus on features (country conditions, government and economic policies, political situation, and conditions specific to the operations, such as availability of funds for maintenance) that determine whether the operation will last over its intended useful life. Sustainability is rated on a three-point ordinal scale: likely, uncertain, and unlikely.
- *Institutional development impact* is defined as the extent to which a project has improved an agency's or country's ability to use its human and financial resources effectively and to efficiently organize economic and social activities. Institutional development impact is rated on a three-point ordinal scale: substantial, modest, and negligible.

As in previous years, we report trends on each evaluation dimension separately (see chapter 2). In this year's review, however, we have introduced a new measure of overall project results—the development effectiveness index—based on the three ratings. This instrument allows us to take the analysis of portfolio trends a step forward, making it possible to compare overall average results—and their variability—across different groups of projects.

The development effectiveness index is defined by assigning cardinal weights to the ratings of each of the three result-oriented counts, then combining them in a simple way. The index formula is:

development effectiveness index = outcome weight + sustainability weight + institutional development weight

where

Outcome weight		Sustainability weight		Institutional development impact weight	
Highly satisfactory	7.75	Likely	0.75	Substantial	1.5
Satisfactory	6.0	Uncertain	0.25	Modest	0.5
Marginally satisfactory	5.25	Unlikely	0	Negligible	0
Marginally unsatisfactory.	4.5				
Unsatisfactory	3.75				
Highly unsatisfactory	2.0				

Thus the development effectiveness index ranges from 2—for a project with highly unsatisfactory outcome, unlikely sustainability, and negligible institutional development impact—to 10—for a project with highly satisfactory outcome, likely sustainability, and substantial institutional development impact. Looking at the weights, it is easy to see that outcome is the main force behind the index. Note also how the index separates between satisfactory and unsatisfactory outcomes, where an index measure of 6 represents such a "divide." In fact, a project with unsatisfactory outcome will never score higher than 6, no matter what ratings it receives on the other two dimensions.

The average development effectiveness index in the fiscal 1990–98 portfolio is 6.47. The standard deviation is 1.85. The contribution of outcome to the average index in the portfolio is about 80 percent; the remaining 20 percent is almost evenly split between the other two evaluation components.

A similar cardinal measure of overall project performance was put forth in last year's Review. The thinking used in building that index was to establish, using subjective assessment, the relative importance of the three results-oriented counts, and then combine them in an intuitively appealing way. One of the main drawbacks of this approach was that, by ignoring the information embedded in the historically observed portfolio, it tended to excessively penalize underperforming projects and over reward overperforming ones. It induced a double-counting effect that, rather than conveying the extra information contained in the six-point classification of outcome results and the data about institutional development impact and sustainability, duplicated a satisfactory-unsatisfactory dichotomy.

The new measure improves on the index described, making the inferences based on such an instrument more robust. It does so by explicitly taking into account the information coming from the historically evaluated portfolio, and by keeping to a minimum—and transparently stating— the set of subjective judgments needed to choose a specific index among the many ways of defining one.

Weights are assigned using the historical evaluated portfolio as a benchmark, and taking into account the strong positive association among evaluation dimensions, to avoid double-counting effects and to extract the most information from the empirical observations.

The fact that good (bad) ratings on one dimension are associated with good (bad) ratings on the other dimensions allows us to unambiguously rank more than 70 percent of the

projects in the observed portfolio using only the ordinal information conveyed by the three sets of ratings. Using only two clear assumptions—premised on the Bankwide consensus about the importance of outcome ratings and on the most efficient way to use information embedded in the observed portfolio—we are able to increase the fraction of projects that can be ranked to more than 81 percent.

Such rankings are then used to assign scores to each dimension separately. Choosing a formula that defines the index as the sum of three scores makes it easy to understand and calculate within the Bank, as well as outside, and allows us to easily calculate changes in the overall index associated with given changes in the distribution of ratings in a given group of projects (by sector, region, and so on).

Caution should be exercised in interpreting the scores on each separate dimension, since they are derived by looking at the additional informational content that each result-based count contained relative to the other two in the historically evaluated portfolio. The fact that the ratings on outcome appear to be the driving force behind the index is the result of two forces. First, in establishing the ranking of observed projects on which the index is built, we used (although parsimoniously) outcome as a tie-breaking rule. Second, the fact that outcome was rated on a six-point basis, as opposed to the three-point bases used for the other two counts, resulted in outcome ratings conveying more information, and thus receiving more weight. The fact that outcome evaluation is based on a finer scale is a testimony to its prominence among the ratings, and we welcome this asymmetry because we did not have to impose any subjective mechanism to give outcome more weight in the determination of the index.

In conclusion, although we report the percentage each result-based count contributed to the index, this was done only for completeness. After all, the index's purpose is to summarize information as far as possible: researchers interested in examining performance on each count will find it optimal to look only at the ratings in the chosen dimension (rather than look at the components of the weights which are intimately connected to one another).

Another point worth stressing about the index is the nature of its cardinality. The cardinality should be understood as interval-scale cardinality: because it is impossible to locate an absolute, nonarbitrary, zero point for the scale, distances between index values are meaningful, but not ratios. We choose a 2–10 range because this makes the index readily comparable with other indexes used within the Bank while allowing us to space index values in a way that may be appealing for practitioners and nonpractitioners alike.

Although it is not of the ratio-scale nature (ratios of indexes are not meaningful, given the arbitrary range), the cardinality of the development effectiveness index makes it a valuable instrument for analyzing Bank project performance. For a start, it makes it possible to compare overall performance across, for instance, Sectors, Networks, and Regions using the information contained in the project ratings. This represents a step forward with respect to standard comparisons based simply on binary classification (satisfactory or unsatisfactory) of outcome, which not only leave out the sustainability and institutional development components of projects results, but also ignore the nuances embedded in the six-point scale on outcome. This is the use of the index we are mainly concerned with in this report (see chapter 2).

The usefulness of the development effectiveness index is not limited to the use suggested here. Using the index, means and variances for different groups of projects—representing different types of investment—can be calculated, and the portfolio evaluated using the standard tools of portfolio theory.

The richer information embedded in the index can be used as an alternative dependent variable in regression studies that try to explain the factors behind the Bank's intervention successes and failures (see Burnside and Dollar 1997). The index could also serve as an explanatory variable in the right-hand side of regression analyses linking Bank efforts to development results (reduced poverty or inequality, increased growth, and so on).

It is worth stressing that the guiding rationale in translating into a cardinal measure an ordinal system of performance ratings is to come up with an evaluation instrument with desirable properties, to be used to trace out the major trends, factors, and effects of Bank investments. The development effectiveness index is not meant to substitute for direct cardinal measures of project performance, like the rate of return approach to project evaluation. But given the shift of development economics toward greater attention to policy and institutions, the rate of return methods are ill-fitted to capture the policy reform and institution-building components of Bank projects. This motivated the adoption of an evaluation system applicable to all projects (for about a third of Bank projects rate of return can still be—and is—calculated) that sacrifices the advantages of cardinality to capture the many facets of project results. Thus the development effectiveness index represents an attempt to solve the tradeoff between these two conflicting factors, and should not be construed as an attempt to "faithfully and precisely" measure in a cardinal way the underlying reality.

Annex 2

Glossary

Adjustment loans: Financing aimed at promoting policy reform. Disbursement of these funds, directed at alleviating the costs of the transition to a different policy and institutional environment, is contingent on the fulfillment of a set of conditions by the recipient country (usually based on macroeconomic indicators).

Borrower ownership: The extent to which the recipient country is involved in and committed to a project's strategy and goals. Ownership is greater when the borrower initiates the formulation and implementation of a project, there is clear consensus among government officials and other decisionmakers on the course of action, and there is broad public support for the initiative.

Contagion: Transmission of destabilizing conditions from one open economy to others closely connected to it, resulting in regional crisis.

Country assistance strategy: The main vehicle for Board review of the Bank Group's assistance to IDA and IBRD borrowers. The strategy document describes the Bank Group's strategy based on an assessment of country priorities and indicates the level and composition of assistance to be provided based on the strategy and the country's portfolio performance. The heart of the country assistance strategy is the ongoing Bank-country dialogue and joint efforts in preparing and implementing the strategy. Strong country ownership and consultation with key stakeholders—pursued with sensitivity and prior general agreement of the government—are crucial features of a successful country assistance strategy.

DAC goals: A set of six internationally accepted development goals for the 21st century in the areas of poverty, gender, education, environment, and health. The goals were published by the OECD's Development Assistance Committee in 1996 in a policy paper known as *Strategy 21*.

Demandingness, complexity, and riskiness: These are three important project design characteristics. Demandingness refers to the extent to which the project could be expected to strain the economic, institutional, and human resources of the government/implementing agency. Complexity refers to such factors as the range of policy and institutional improvements contemplated, the number of institutions involved, the number of project components and their geographic dispersion, the number of cofinanciers, etc. Riskiness refers to the likelihood that the project as designed, would be expected to fail to meet relevant project objectives efficiently. In determining project riskiness, evaluators consider the extent to which the project could reasonably have been expected *at the time of project prepa-*

ration and appraisal to face known risk factors, such as lack of borrower commitment, inadequate counterpart funding, and war or civil disorder.

Development effectiveness: A demonstrable contribution to economically sound, socially equitable, and environmentally sustainable growth.

Development effectiveness index: A measure of overall project-specific results based on the index aggregation of three OED project ratings on outcome, sustainability, and institutional development.

Global public goods: Goods that are available for the benefit of all countries, and for which one country's use does not reduce another's consumption. Yet no single country could or would invest in these goods because the costs generally outweigh the aggregate benefits.

Institutional development: Improvement in an agency's or country's ability to make effective use of their human and financial resources and to efficiently organize economic and social activities.

Macroeconomic policy: Government actions designed to affect the entire economy rather than specific sectors or markets, especially with respect to the general level of income, employment, prices, interest rates, and balance of payments. Policy measures are usually categorized as fiscal or monetary, depending on which instruments—taxes, public spending and debt, control of money supply and central bank discount rates—are used.

Outcome: In terms of project ratings, outcome refers to the extent to which a project achieved its major relevant objectives in a cost-efficient way. Under the results-based management framework, this is to be distinguished from outputs, which measure what is produced or done (for example, using fewer resources compared with plans, previous performance, or the performance of other organizations). The outcome of a health publicity campaign might be a 5 percent increase in awareness among those targeted.

Risk-bearing institutions: Organizations designed to share the risks and costs of unpredictable events among large groups. Examples include unemployment support programs, health programs, and life insurance.

Safety nets: Mechanisms that aim to alleviate the burden on the vulnerable of an unfavorable economic situation (e.g., unemployment insurance).

Strategic Compact: The Strategic Compact between the Bank's management and executive board provides a long-term framework for guiding the Bank's renewal and calculating the associated resource needs. The Compact, approved in March 1997, adds $250 million to the Bank's $1.2 billion administrative budget to be used over 30 months to improve how the Bank does business. The Compact is complemented by substantial redeployments and

savings throughout the Bank, identified through an ongoing review of cost-effectiveness. The Compact focuses on refueling current business activities, refocusing the development agenda, retooling the Bank's knowledge base, and revamping institutional capacities.

Sustainability: The likelihood, at the time of evaluation, that a project will maintain its results in future.

Washington consensus: An internationally agreed set of measures that are typically implemented during policy reform, including fiscal discipline, financial and trade liberalization, deregulation, taxation and public expenditure adjustments, and privatization.

Annex 3

Data on Outcome Sustainability and Institutional Development Impact

Table 1: Outcome, sustainability, and institutional development (ID) impact for exit fiscal years 1990–96, 1997, and 1998, by sector, network, lending type and source, region and income group (by projects)

	Exit fiscal years 1990-96					Exit fiscal year 1997					Exit fiscal year 1998				
			Outcome	Sust.	ID Impact			Outcome	Sust.	ID Impact			Outcome	Sust.	ID Impact
	# of proj.	Share	% sat.	% likely	% sub.	# of proj.	Share	% sat.	% likely	% sub.	# of proj.	Share	% sat.	% likely	% sub.
Sector															
Agriculture	431	27	63	36	31	51	24	76	55	39	26	23	85	54	62
Education	128	8	78	54	33	19	9	74	63	47	9	8	88	38	38
Electric Power & Other Energy	148	9	67	59	32	11	5	55	45	18	7	6	67	50	33
Environment	2	0	100	50	0	7	3	71	57	29	1	1	100	100	0
Finance	83	5	56	43	29	14	6	77	69	46	7	6	86	57	29
Industry	85	5	54	41	26	7	3	57	57	57	4	4	0	0	0
Mining	18	1	65	61	50	3	1	67	67	100	2	2	50	50	100
Multisector	138	9	77	57	32	21	10	81	43	25	9	8	78	33	0
Oil & Gas	49	3	80	53	57	4	2	75	75	25	2	2	100	50	50
Population, Health & Nutrition	51	3	65	47	20	12	6	83	67	25	12	11	75	67	25
Public Sector Management	80	5	54	39	28	12	6	67	67	8	9	8	100	56	56
Social Sector	10	1	80	40	50	7	3	100	14	71	7	6	71	0	0
Telecommunications	30	2	77	70	37	3	1	67	100	33	2	2	100	100	100
Transportation	183	12	74	52	29	21	10	81	48	67	5	4	100	80	80
Urban Development	77	5	66	36	21	16	7	75	44	25	6	5	100	60	40
Water Supply & Sanitation	66	4	60	33	31	9	4	67	33	0	6	5	67	50	50

Table 1: Outcome, sustainability, and institutional development (ID) impact for exit fiscal years 1990–96, 1997, and 1998, by sector, network, lending type and source, region and income group (by projects) continued

	Exit fiscal years 1990-96					Exit fiscal year 1997					Exit fiscal year 1998				
			Outcome	Sust.	ID Impact			Outcome	Sust.	ID Impact			Outcome	Sust.	ID Impact
	# of proj.	Share	% sat.	% likely	% sub.	# of proj.	Share	% sat.	% likely	% sub.	# of proj.	Share	% sat.	% likely	% sub.
Network															
Environmentally & Socially Sustainable Development	433	27	63	36	31	58	27	76	55	38	27	24	85	56	59
Finance, Private Sector & Infrastructure	739	47	67	49	31	88	41	71	53	40	41	36	74	54	46
Human Development	189	12	74	51	30	38	18	82	55	45	28	25	7	41	22
Poverty Reduction & Economic Management	218	14	69	50	30	33	15	76	52	19	18	16	89	44	28
Lending type															
Adjustment	225	14	74	57	35	33	15	79	58	33	12	11	92	50	50
Investment	1,354	86	66	44	30	184	85	74	53	38	102	89	79	49	39
Lending source															
IBRD only	821	52	71	56	35	105	48	74	61	36	47	41	75	48	43
IDA/blend	758	48	62	34	27	112	52	76	47	39	67	59	84	51	39
Region															
Africa	533	34	54	28	21	63	29	62	30	42	37	32	78	46	32
East Asia and Pacific	278	18	83	71	42	41	19	83	66	44	22	19	81	43	52
Europe and Central Asia	111	7	76	59	43	18	8	83	78	50	11	10	80	60	40
Latin America & Caribbean	283	18	69	53	36	47	22	85	57	35	21	18	85	65	40
Middle East & North Africa	161	10	69	47	28	20	9	70	65	25	7	6	86	43	57
South Asia	213	13	68	40	29	27	12	78	63	22	15	13	73	47	33
Other						1	0	0	0	0	1	1	100	0	100
Income Group															
Lower	862	55	61	35	26	119	55	72	47	38	66	58	77	48	35
Lower middle	458	29	71	52	32	63	29	75	56	33	32	28	84	42	42
Upper middle	219	14	79	69	44	31	14	87	70	47	14	12	85	85	54
High	40	3	82	77	44	4	2	75	100	0	2	2	100	0	100
Total/average	1,579	100	67	46	31	217	100	75	54	37	114	100	80	50	40

Note: Sust.= sustainability, proj.= projects, sat.= satisfactory, sub.= substantial. Income group categories are derived from the *World Development Indicators 1998*. A full set of supplemental statistical tables providing further project evaluation results are available electronically at http://www.worldbank.org/html/oed.

Table 2: Outcome, sustainability, and institutional development (ID) impact for exit fiscal years 1990–96, 1997, and 1998, by sector, network, lending type and source, region and income group (by disbursements)

	Exit fiscal years 1990-96				Exit fiscal year 1997				Exit fiscal year 1998			
	Disburse. *$millions*	Outcome *% sat.*	Sust. *% likely*	ID impact *% sub.*	Disburse. *$millions*	Outcome *% sat.*	Sust. *% likely*	ID impact *% sub.*	Disburse. *$millions*	Outcome *% sat.*	Sust. *% likely*	ID impact *% sub.*
Sector												
Agriculture	26,669	74	47	37	3,096	77	66	42	1,056	87	71	77
Education	5,993	80	61	46	1,438	85	71	53	362	95	20	25
Electric Power & Other Energy	19,350	66	67	35	1,528	87	76	40	572	90	59	48
Environment	75	100	29	0	232	78	76	40	34	100	100	0
Finance	9,767	60	53	38	2,336	50	45	33	847	85	74	68
Industry	11,890	64	55	29	1,338	75	75	81	407	0	0	0
Mining	1,273	69	80	41	106	79	79	100	270	97	97	100
Multisector	21,903	86	65	44	1,488	90	57	25	760	99	34	0
Oil & Gas	3,683	83	89	42	246	99	99	38	347	100	96	4
Population, Health & Nutrition	1,625	79	65	36	800	94	71	22	741	80	70	16
Public Sector Management	3,974	77	58	53	505	89	51	10	273	100	29	83
Social Sector	674	99	89	18	435	100	6	83	181	67	0	0
Telecommunications	1,306	78	79	44	382	90	100	88	91	100	100	100
Transportation	16,198	83	59	32	2,047	84	44	60	675	100	58	60
Urban Development	6,857	75	50	26	670	76	58	16	544	100	62	7
Water Supply & Sanitation	4,574	55	29	26	1,187	65	17	0	564	59	21	24
Network												
Environmentally & Socially Sustainable Development	26,744	74	47	37	3,328	77	67	41	1,090	87	71	74
Finance, Private Sector & Infrastructure	74,898	70	59	33	9,840	73	55	44	4,318	81	58	42
Human Development	8,292	81	64	42	2,673	90	60	49	1,285	82	46	16
Poverty Reduction & Economic Management	25,877	84	64	46	1,993	90	55	21	1,033	99	32	22

Table 2: Outcome, sustainability, and institutional development (ID) impact for exit fiscal years 1990–96, 1997, and 1998, by sector, network, lending type and source, region and income group (by disbursements) continued

	Exit fiscal years 1990-96				Exit fiscal year 1997				Exit fiscal year 1998			
	Disburse. *$millions*	Outcome *% sat.*	Sust. *% likely*	ID impact *% sub.*	Disburse. *$millions*	Outcome *% sat.*	Sust. *% likely*	ID impact *% sub.*	Disburse. *$millions*	Outcome *% sat.*	Sust. *% likely*	ID impact *% sub.*
Lending type												
Adjustment	41,619	78	64	43	3,717	66	52	33	1,742	97	57	65
Investment	94,191	72	55	34	14,118	81	60	44	5,984	81	53	32
Lending source												
IBRD only	98,619	75	64	40	11,034	75	55	43	4,979	84	52	40
IDA/blend	37,192	72	43	29	6,800	83	63	40	2,747	85	60	38
Region												
Africa	22,440	63	29	24	2,678	72	45	43	1,361	73	37	30
East Asia and Pacific	28,468	88	81	48	4,467	88	70	55	2,089	76	31	37
Europe & Central Asia	14,244	76	62	44	1,735	88	80	53	1,074	100	87	30
Latin America & Caribbean	36,653	72	65	38	4,441	71	38	37	1,746	94	74	66
Middle East & North Africa	10,119	71	44	29	1,618	70	52	34	519	96	34	37
South Asia	23,887	70	51	32	2,894	78	73	25	936	79	69	20
Income Group												
Lower	56,864	71	47	31	8,646	80	66	42	3,191	76	54	36
Lower middle	42,938	73	58	37	4,944	81	51	41	3,099	88	37	38
Upper middle	33,208	79	74	46	4,061	71	48	43	1,353	96	98	47
High	2,801	81	79	46	184	81	100	0	83	100	0	100
Total/average	**135,811**	**74**	**58**	**37**	**17,834**	**78**	**58**	**42**	**7,726**	**84**	**54**	**39**

Note: Disburse.= disbursements, sust.= sustainability, sat.= satisfactory, sub.= substantial. Disbursements are measured in real terms, deflated to fiscal 1996 US dollars. Income group categories are derived from the *World Development indicators, 1998*. A full set of supplemental statistical tables providing further project evaluation results are available electronically at http://www.worldbank.org/html/oed.

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