IDB's Ninth General Capital Increase: Implementation and Results

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BACKGROUND NOTE

SUPPORT TO SMALL AND VULNERABLE COUNTRIES

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IDB

TABLE OF CONTENTS

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ACRONYMS AND ABBREVIATIONS

C&D	Country Groups C and D
CPE	Country Program Evaluation
FSO	Fund for Special Operations
GCM	Grants and Co-Financing Management Unit
GNI	Gross national income
GNP	Gross national product
IDB	Inter-American Development Bank
LAC	Latin America and the Caribbean
OC	Ordinary capital
OVE	Office of Evaluation and Oversight
PBL	Policy-based loan
PBP	Programmatic PBL
PPMR	Project Performance Monitoring Report
SVC	Small and vulnerable countries
TC	Technical cooperation
VPC	Countries Vice-presidency

I. INTRODUCTION

1.1 **The IDB-9 Agreement was structured around two overarching objectives--reducing poverty and inequality and achieving sustainable growth—and two strategic goals--to address the special needs of the less developed and smaller countries and to foster development through the private sector.** This background note looks at the first strategic goal, support for less developed and smaller countries – or, as stated in the Agreement's lending target, support to "small and vulnerable countries." [1]

II. THE RATIONALE FOR SUPPORTING SMALL AND VULNERABLE COUNTRIES

2.1. **There is a literature that argues that small states—particularly small island states with populations below 1.5 million—have some specific development challenges.** A first argument is centered on the role of vulnerabilities. Small states are more vulnerable to economic shocks (particularly terms of trade shocks) and natural disasters.[2] Smaller economies also tend to have limited resilience, so that temporary shocks (e.g., to commodity prices) can have long-term effects. For instance, a temporary shock may drive the economy into an unsustainable macroeconomic path or a debt trap.

2.2. Another argument has to do with the fact that, because of their small scale, small economies may be unable to provide key public goods (e.g., effective government). Some countries—particularly the small island countries—may be so small that they have difficulty financing the provision of the basic public goods needed for an effective government. A related argument focuses on some increasing returns that favor mid-size economies.

2.3. **The evidence in support of the vulnerability of small states *per se* is limited.** Though it is generally a fact that smaller economies tend to have higher growth and income volatility, some authors have argued that the effect is totally driven by the degree of openness of their economy. In other words, it is not any intrinsic element of small economies that makes them more volatile, but rather the fact that they tend to be more open to the world.[3] This does not mean that small economies do not need help, but rather that the problem is economic vulnerability instead of size.

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1 OVE's midterm IDB-9 evaluation had reviewed progress on the lending targets as part of the analysis of the corporate results framework. Among other things, it found that the definition of small and vulnerable country was defined purely by economy size (absolute GDP below US$55 billion), without an operational definition of what a "vulnerable country" was. It also found deficiencies in the criteria to classify lending. See OVE, "Mid-Term Evaluation of IDB-9 Commitments," March 2013 and its annexes on Haiti and the Corporate Framework.

2 Small states tend to have small population and territory and, therefore, natural disasters tend to have a "national" impact. Also, on account of their small size, they have very limited opportunities for economic diversification. See, for instance, "Small States and the Commonwealth: Strengthen Resilience for Sustainable Development," Commonwealth Secretariat, 2014. See also Lino Briguglio (September 1995) "Small island developing states and their economic vulnerabilities," *World Development* 23(9): 1615-1632.

3 For a good survey on the theoretical literature on small states, see William Easterly and Aart Kraay, "Small States, Small Problems? Income, Growth, and Volatility in Small States," *World Development* 28(11): 2013-2027. For a seminal paper on the optimal size of countries, see Alberto Alesina and Enrico Spolaore (1997), "On the number and size of nations," *The Quarterly Journal of Economics* 112(4): 1027-1056. This paper defined the standard theoretical approach to the issue of optimal nation size as the trade-off between the increasing returns in the provision of public goods (which encourages larger countries) and cultural heterogeneity (a force in favor of smaller countries).

2.4. **These specific challenges of small economies may call for tailored intervention strategies.** One such strategy could be supporting economic integration, lowering the cost of the provision of certain public goods (government, justice, central bank). A good example in the region is the Organization of Eastern Caribbean States, which has a unique Central Bank in charge of the monetary policy of the seven member states. It is equally conceivable to have other regional government services through economic integration. However, shared regional institutions pose a significant coordination challenge.

2.5. **In addition, small states could benefit from some sort of insurance-like contingent instrument.** In the face of a negative shock, small economies could avoid falling into a negative poverty/debt trap if they were financially supported, say through a contingent credit line. The main challenge of providing credit lines is the fact that the risks tend to be concentrated. Natural disasters tend to be concentrated for the IDB because a significant number of its small states members are in the Caribbean. And since in our region economies remain mostly commodity producers and commodity prices are highly correlated, the Bank's ability to provide regional insurance for economic shocks is limited. Therefore, though small countries could benefit from an insurance mechanism, if the IDB were to carry that role, a proper risk diversification strategy (e.g., reinsurance) would have to be conceived.

2.6. **Even though the case can be made that small states need tailored support, most of it should probably be provided on nonconcessional terms**. The argument that small states could become credit-constrained in the face of a negative economic shock supports the idea of a contingent credit line. However, it does not necessarily support the idea that the credit line should be granted on concessional terms. Other forms of support to SVCs—such as support to regional integration, or technical assistance to increase the efficiency of government in the provision of public goods—probably should be provided on concessional terms.

2.7. **Many MDBs have specific programs to provide some concessional access to small countries.** For instance, the World Bank (IDA) and the IMF both provide access to their concessional loans to "small states" with population below 1.5 million people.[4]

III. IDB AND SMALL AND VULNERABLE COUNTRIES

A. The mandate to support small and vulnerable countries

3.1 **In the Bank's constitutive documents there is no mention of providing specific support to SVCs.** Centered in the economic planning tradition that was popular in the post-war period, the IDB Charter (1959) instructs the Bank to provide technical assistance to countries in the "preparation, financing, and implementation of development plans and projects."[5] Neither the Charter nor the successive strategic documents have any specific mention of the particular challenges of a subsample of countries in the region. The idea was that the Bank was to support each country in doing its own diagnosis and implementing its own development program. In that

4 See IDA, 2017, Towards 2030: Investing in Growth, Resilience and Opportunity, Replenishment Paper for IDA-18, Jan 2017 and IMF, The Poverty Reduction and Growth Facility (PRGF) – Factsheet, accessed online on January 2018.

5 See Agreement Establishing the Inter-American Development Bank, 1959. We will refer to it as "the Charter."

sense, these documents proposed an entirely country-specific approach to economic development.

3.2 **Complementing these individual development strategies, in the early years, the Bank stressed regional integration as a collective development strategy.** From the outset one thing that distinguished the IDB was its role in supporting regional integration schemes to achieve a collective development strategy. It comes as no surprise that the IDB was created at almost the same time as the Latin American Free Trade Association and the Central American Common Market[6]—although by the end of the 1960s the region was behind in its goal of achieving a common market.

3.3 **In view of the limited progress toward implementing the integration agreements signed in 1960, the presidents of the continent met at Punta Del Este in 1967 to revitalize the integration agenda.** As part of a more complex diagnosis, the presidents noted that regional integration had a heterogeneous effect, depending on a country's size and level of development. In a model of import-substitution industrialization, the region had to move toward intra-regional specialization and intra-regional trade. Less developed countries and countries with limited market access would then be at a disadvantage relative to larger and richer countries. To distribute the benefits of regional integration more evenly, the presidents of the continent agreed to provide "preferential treatment" to smaller and less developed countries to incentivize industries to move there.[7] For the first time, the Bank gets a specific instruction to provide preferential treatment to a subgroup of countries.

3.4 **The Bank operationalized the presidents' mandate in 1972 by approving new guidelines for the use of the concessional fund (the Fund for Special Operations).** As a direct consequence of the Declaration of Punta del Este, in 1968 and again in 1971 IDB Governors asked the Board of Executive Directors to give preferential treatment to "economically less developed countries and those with insufficient markets" (AG-7/68 and AG-7/71). In the meantime, the IDB-3 discussions had already noted the relative scarcity of concessional resources and had stressed the need to focus the less developed members (AB-626-1, 1.02,6). As a result, in 1972, a new policy for the use of the FSO was approved (AB-300-3, AG-11/72) to give preferential treatment to "less developed countries and countries with insufficient market." These rules distinguished between social projects and economic projects, broadly defined some areas of priority for FSO eligibility (e.g., transnational projects), and established priority for less developed countries.[8] Aside from these general considerations, the policy left it to Management to work out the exact operational implications in detailed guidelines.

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6 The Latin American Free Trade Association was signed in Montevideo in 1960 by Argentina, Brazil, Chile, Mexico, Paraguay, Peru, and Uruguay with the purpose of creating a common market in Latin America by 1970. The Central American Common Market was created in the context of the Organization of Central American States at the 1960 conference of Managua to create a common market in Central America.

7 See Declaration of Punta Del Este, 1967, Link.

8 "Social" projects were those assumed to need concessionality, while "economic" projects were those in which the rate of return was sufficiently high to allow borrowing from the OC. Because poor countries were eligible to borrow from FSO both for economic and social projects, a "two-step" procedure was conceived in the policy. The procedure was meant to ensure that the concessionality of the loan was captured by the government of country and not by the final beneficiary (private enterprise). See AB-300-3.

3.5 **With the operationalization of the concessional policy, the Bank's country group classification (A/B/C/D) first appeared.** In 1972 Management approved a new operational guideline (GN-870-4, June 1972)[9] that established differential economic conditions (interest rate, grace period, maturity) to access (convertible) FSO resources, depending on the type of country (see Figure 3.1).[10] It is from these guidelines that the country groups A, B, C, and D were first defined. Though initially the categories were meant simply to affect the allocation of concessional resources temporarily, with time they became both permanent and used to allocate lending envelopes in general. After the seven largest economies (Groups A and B) agreed to no longer borrow from the convertible FSO, Groups C and D became permanently equated with the smaller and less developed countries.

Figure 3.1. Conditions for Loans Originated from the FSO (GN-870-6, 1972)

	Group A	Group B	Group C	Group D
Countries	- Argentina - Brazil - Mexico - Venezuela	- Chile - Colombia - Peru	- Barbados - Costa Rica - Jamaica - Panama - Trinidad and Tobago - Uruguay	- Bolivia - Dominican Republic - Ecuador - El Salvador - Guatemala - Haiti - Honduras - Nicaragua - Paraguay
Grace period*	5 years	7 years	8 years	10 years
Amortization period	25 years	30 years	35 years	40 years
Interest rate	3% social 4% economic	2%	2%	1% (grace period) 2% (afterwards)
Commitment fee**	0.50%	0.50%	0.50%	0.50%

Belize, Bahamas, Suriname and Guyana were not members of the Bank at the moment the guidelines were issued. They were subsequently incorporated to group C (Bahamas and Suriname) and D (Belize and Guyana).

(*) Minimum, may be extendable to 10 years
(**) Charged over undisbursed balances

3.6 **Later capital increases emphasized, without further elaboration, the differences in the LAC countries' development levels and the need to have differential support.** IDB-4 (1975) first asked the Bank to "reinforce its policy of preferential attention to the needs of the less developed countries in the region, especially with the resources of the Fund for Special Operations" (AB-462, p.4.05). This capital increase first conceived the idea of specialization in borrowing, with richer developing countries having more access to ordinary capital (OC), while FSO specialized in less developed countries. With the differential impact of the oil shocks in LAC (where some nations were oil exporters and others oil importers), IDB-5 (1979) noted that "contemporary thinking tends to allow for the principle of diversity among developing nations" and thus "one can no longer speak in terms of development and underdevelopment but must instead distinguish in shades of

[9] Updated by GN-870-5 (January 1973), GN-870-6 (June 1974), and GN-870-7 (January 1975).

[10] The FSO had contributions in convertible currencies (non-borrowing member countries) and nonconvertible currencies (borrowing member countries). The latter were nonconvertible because they were meant to be used mostly in the territory of the member country so as not to affect the balance of payments. In the concessional lending discussions, the focus was the FSO's convertible funds.

difference." The result was the proposal for the "gradual concentration of financing on concessional terms and conditions in the relatively less developed countries" (AB-648, p.4.57-4.58). Approved during the LAC debt crisis, IDB-6 (1983) and IDB-7 (1989) abandoned the theoretical discussions about the special role of the IDB in supporting the less developed LAC countries. IDB-8 (1994) placed the focus on poverty eradication and the social sectors. This capital increase moved away from a country-based approach and, instead, placed the focus on supporting the poor in the region.

3.7 **IDB-9 reiterated the need to support SVCs but had no specific diagnostic or objective.** The document proposed supporting SVCs as a means of achieving "equity and sustainable development" in LAC (para 3.10, AB-2764). The implicit argument of the capital increase is that by supporting the poorer countries in the region, the Bank will contribute to closing the economic and social gaps in the region as a whole. The argument is hardly new and echoes the statements in favor of "balanced growth" made in IDB-3.[11] There is little else in the capital increase document about the rationale for supporting SVCs. In the discussion of the "preferential treatment to less developed LAC countries" (para 3.22-3.28, AB-2764), the document focuses more on the different instruments to support SVCs—FSO blend lending for D2 countries,[12] additional debt relief and grant-lending to Haiti,[13] support to small non-member island countries in the Caribbean,[14] and temporary measures to make the FSO sustainable until 2020[15]—than on what the problem is or what the Bank is supposed to achieve.

B. The Implementation of the Mandate: Lending Targets and Action Plan C&D

3.8 **Country groups were used for the allocation of scarce concessional resources** (see Table 3.1). In addition, the Bank's main way to implement the mandate to support SVCs was through lending targets. The first lending target, defined by IDB-6 in 1983, established that US$3 billion should be used for lending to Group A countries, US$9 billion should be lent to Groups B, C, and D, and the remaining US$1 billion should be left unallocated.

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11 "Since one of the Bank's fundamental objectives is to promote the balanced growth of its members, and taking account of the differences in the stage of development and economic potential existing between the various countries, the Board of Executive Directors intends to place strengthened emphasis in the granting of soft loans to the relatively less developed countries" (AB-626-1, para. 5.05).

12 In IDB-7 the Bank committed to allocate 55% of the resources to the 5 poorest countries in Group D. These became known as the D2 countries. With the concessional agreement of 2006, FSO liquidity was reduced significantly and loans from the concessional fund (FSO) had to be blended with OC.

13 The D2 countries benefited from the HIPC initiative and the MDRI initiatives, which wrote off all loans approved before 2004. In the Bank this was implemented through two concessional agreements in 1999 and 2006. As a result of the last concessional agreement, as of 2007 Haiti became eligible only for grants. In addition to the two debt reliefs of 1999 and 2006, Haiti received a third debt relief in 2010 in the context of IDB-9.

14 The Charter of the IDB grants the right to any OAS member to become a member of the Bank. In 1977 (AG-1/77) it was agreed, however, that small island states that were members of the OAS but not of the Bank would be supported through the Caribbean Development Bank. FSO funding has since been allowed for this purpose, with loans on the same terms as other FSO loans.

15 These measures, intended to increase retained earnings and liquidity, were to eliminate all transfers from the FSO net income (to the Grant Facility) and to stop funding technical assistance from the FSO. Also, the agreement reduced to 3% the part of the administrative expenses of the IDB that was charged to the FSO.

Table 3.1. Eligibility for Concessional (Convertible FSO) Resources and Lending Target (OC)

Replenishment	*Number of countries eligible for FSO*	*Country groups eligible for FSO*	*OC lending target*
Creation to IDB-3 (1959-1970)	All	A, B, C, D	
IDB-4 (1975)	21	B, C, D [a]	
IDB-5 (1979)	21	B, C, D	
IDB-6 (1983)	18	C, D	US$9 billion for B, C, and D
IDB-7 (1989)	10	D	35% for C&D
IDB-8 (1994)	5	D2	35% for C&D
IDB-9 (2010)	5[b]	D2	35% for SVCs

Sources: CA-474, AB-2764 and capital increase documents.

[a] Group A countries voluntarily agreed not to seek loans in convertible FSO.

[b] As per the concessional lending agreement of 2006 and the IDB-9 agreement, Haiti is temporarily a grant-only country.

3.9 **In addition, since IDB-7 (1989), there has been a lending target of 35% of overall lending for C&D/SVC countries.** In addition to being used in the process of allocating concessional funds, overall lending targets were also defined by country group. IDB-7 established, for the first time, a lending target in terms of the share of total lending rather than absolute amounts. Both IDB-7 and IDB-8 established that 35% of overall lending should be devoted to C&D countries. IDB-9 also defined a 35% lending target, but for "small and vulnerable countries." However, the definition of the SVCs contained in the Annex includes exactly the 19 countries of Groups C and D (AB-2764, Annex 1, para. 3.7-3.14).

3.10 **Neither the group classification nor the terms it established have been changed since the introduction of the FSO operational guidelines in 1972.** Although the guidelines were updated three times,[16] neither the group classification nor the financial conditions it established were changed.[17] The first price differentiation according to country group was approved in June 1972 (GN-870-4). Following the impact of the first oil shock (1975), the Group classification was revised and a methodology based on nine development indicators was introduced.[18] However, Management found "no grounds for amending the existing classification." The C&D classification has not been changed since, except for the addition of four countries that were not members of the Bank at the time the first guidelines were issued in 1972. Within the D classification there have been some minor changes, particularly in the definition of the D2 countries—also known as the FSO countries—which were the last subgroup of countries eligible for FSO lending.

3.11 **The Bank has missed the lending target for C&D/SVCs in every capital increase (IDB-6, IDB-7, IDB-8) that had such a target.** Under IDB-6 the Bank lent US$4.3 billion to Group A countries, but only US$6.6 billion to B, C, and D countries (AB-1378, p. 4.04). During IDB-7 only 31.4% of the lending went to C &D countries (Table III-1, AB-1704). Finally, the baseline for the SVC lending in IDB-9 was estimated at 27% of overall lending, below the goal set in IDB-8 (AB-2764, Annex).

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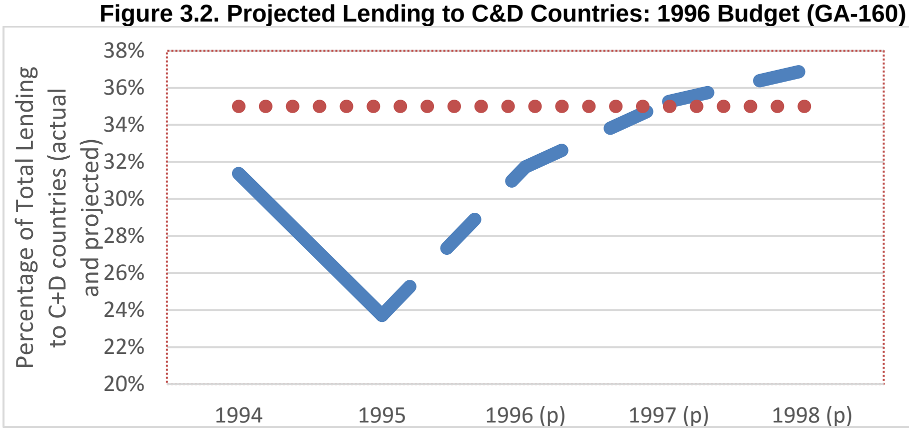
16 The original guidelines do not name the groups A, B, C, and D. However, the economic conditions for loans to Group A, B, C, and D countries are defined in paragraphs 2.a, 2.b., 2.c., and 2.d of that document. This probably explains why, with time, the letters A, B, C, and D became associated with each of the groups.

17 The financial conditions the document established were technically in force until 2007. However, soon after the guidelines were issued the Bank restricted concessional lending to the poorest 5 D countries (the D2 countries). So the financial terms of an FSO loan became de facto equated to 2% interest rate, 10-year grace period and 40 years of maturity. With the introduction of "blend" in 2007, the interest rate on the "FSO" part of the loan was reduced to 0.25%.

18 The Appendix lists the nine indicators and also explains how the classification was done.

3.12 **In response to the systematic failure to achieve the targets for C&D/SVC countries, the Bank created a special TC program to support the preparation and implementation of operations in C&D countries.** In the discussion of the Bank's 1996 Budget (GA-160) it was noted that during the first two years of IDB-8 (see Figure 3.2), lending to A and B countries had increased and the Bank was significantly departing from the IDB-8 goals for lending to C&D countries. The Board of Executive Directors asked Management to "outline possible ways of reconciling the Eighth Replenishment 65/35 percent funding-allocation target with constraints stemming from the shortage of concessional resources and limited absorption capacity of some Group C and D countries" (BFA/95/14). To address the main reasons for limited absorptive capacity in C and D countries (borrower institutional capacity, macroeconomic conditions, human and social capital endowments, limited bank financial resources, and Bank institutional constraints), an "Action Plan C and D" proposed seven areas of action based on detailed diagnoses of the 19 C&D countries (GN-1940-3).[19]

Figure 3.2. Projected Lending to C&D Countries: 1996 Budget (GA-160)



3.13 **The Bank then approved a budget of US$20 million for 1997-1998 to support three remedial actions (Action Plan C and D):** financing studies and project execution, with the aim of speeding up implementation; funding short-term consultancies to originate new lending; and establishing a training program to address the institutional bottlenecks in the countries. The Action Plan C and D was supposed to be financed by contributions from the Bank budget (US$8 million), the net income of the FSO (US$8 million), and donor countries (US$4 million). In practice, the contributions of donors never materialized (see Table 3.2).

19 The seven actions were as follows: (1) intensify efforts at portfolio management, (2) address procurement bottlenecks, (3) work to improve project "ownership," (4) emphasize an expansion of the human and social capital base, (5) support strengthening public policy institutions, (6) seek to expand concessional resource availability, and (7) increase and strengthen the Bank's human resources focused on the C&D countries and improve Bank processes and procedures to facilitate Bank operations in all countries, including C&D.

Table 3.2. Distribution of Resources: Action Plan C and D – Budget 1997-1998

Activity	*Goal*	*Total (US$ millons)*	*Administrative budget*	*FSO net income*
Identification and execution	These resources are intended to fund short-term consultant services to strengthen the identification of new operations and support the execution of projects already approved.	8	4	4
Training	These funds, drawn from the administrative budget, are intended to support project teams to finance consultant services for the preparation of new operations	4		4
Preparation	The objective of this program is to strengthen the capacity of executing agencies in C&D countries, by training staff involved in the preparation and implementation of projects financed by the Bank. The Board expressed interest in involving national institutions in these training activities.	4	4	
Total		16	8	8

Source: GN-1940-3 and RE-242.

3.14 **In parallel, the 1998 concessional agreement (AG-1/99, CS-3170-14) changed the way the target for C&D countries was to be measured during IDB-8,** establishing a different threshold (GNP per capita below US$3200 in 1997) to be used to compute the 35% lending target for C&D countries. The issue generated some controversy. In defending the proposal, President Iglesias noted that it "will help fulfill the Governors' wishes that access to loan resources be protected for low-income countries." Some Governors expressed reservations about the methodological change. The Governor for Canada noted that although he could "accept the flexibility that is being applied on the 65%/35% framework, […] in an ideal world, [he] would have liked to have seen a fuller analysis of all of the implications of that for the long-term program of the Bank." The Governor for Italy asked to understand "the rationale of using US$3,200 per capita GNP as a requirement for eligibility to the 35% portion." Finally, the Governor for the Caribbean constituency disagreed with the change and demanded "to receive some assurance from the Bank that it is not proposing to abandon its well-established principles of providing a commensurate level of assistance to the smaller members of our institution, even as other members of the multilateral community are coming to the realization that per capita income levels are unsatisfactory indicators of the capacity for socioeconomic transformation of small vulnerable economies, especially island state economies."[20]

3.15 **In practical terms, the change made it easier for the Bank to fulfill the lending target.** In 1997, 15 countries (instead of 19) in the region had a GNP per capita of US$3200 or less.[21] However, the list excludes a few small and rich Caribbean islands (Bahamas, Barbados, Trinidad and Tobago), as well as Costa Rica, Panama, and

[20] All quotes come from document CA-408. Committee of the Board of Governors, Summary of the Seventy-Eighth Meeting, Washington, DC, December 9, 1998.

[21] The proposal (CS-3170-14) does not contain the list of countries that would have counted toward meeting the 35% target. To estimate which countries would have been eligible, OVE used the World Bank data on GNI (USD) and population for 1997. (World Bank, World Development Indicators, 2017.) The World Bank reports only GNI, which is closely related to GNP.

Uruguay. In contrast, lending to two relatively large borrowers (Colombia and Peru) was to be counted against the 35%.

3.16 **IDB-9 provided no new guidance on the Action Plan C and D.** IDB-9 mandated the transfer of all TC funding from FSO to OC (para. 3.26, AB-2764) to make the FSO sustainable through 2020.[22] In fulfillment of this mandate, the Board of Directors approved an allocation of US$5 million to support C&D countries (DE-247/10) for 2011 and requested Management to develop a proposal for its use. In 2011, Management created the Small and Vulnerable Countries Special Program with two windows (one that replaced the old national TCs for FSO countries and the other that funded Action Plan C and D TCs). Action Plan C and D (Window II) TCs would be authorized up to US$5 million. Beyond the financial implications of these measures, there were no changes to the Action Plan C and D.

IV. THE RELEVANCE AND EFFECTIVENESS OF IDB SUPPORT TO SVCS

A. Country group classification

4.1 **The rationale for supporting "small and vulnerable" countries was never clarified.** The model of regional integration within an import-substitution strategy was the main argument behind the special support for small and insufficient market countries (1967). Even when regional integration and import-substitution industrialization strategies were phased out shortly afterwards, the successive Bank replenishments from the late 1970s on kept the targets for small countries. From IDB-6 on, however, the replenishment documents did not discuss the nature of the problems of SVCs. Instead, Governors increasingly focused on the lending target and the rule for the distribution of concessional resources and less on the rationale for supporting SVCs. IDB-9 was no exception.

4.2 **The only variable that consistently supports the country group classification is the overall size of the economy; C&D countries are all but the seven largest economies in the region.** After the original proposal, in 1975 Management developed a methodology to classify the countries into the four groups (see Appendix) using nine development indicators. OVE tried replicating the C&D classification using this methodology, and found that the only variable that explains the classification is the size of the economy. Using any other combination of indicators fails to replicate the country grouping. Indeed, the definition that Management proposed for "small and vulnerable country" in IDB-9 is also based exclusively on the size of the economy.

4.3 **IDB-9 *de facto* classification of SVC is significantly broader than that adopted by the literature and other institutions (e.g. WB-IDA).** *De facto* IDB-9 considers countries with nominal GDP below US$ 55 billion as "small and vulnerable".[23] This definition is significantly broader that the one used by the literature or by the World Bank in its operations (i.e. population below 1.5 million). Indeed, of 204 states and territories, 133 have a GDP below US$55 billion but only 56 have populations below 1.5 million (none of them having a GDP above US$55 billion).[24]

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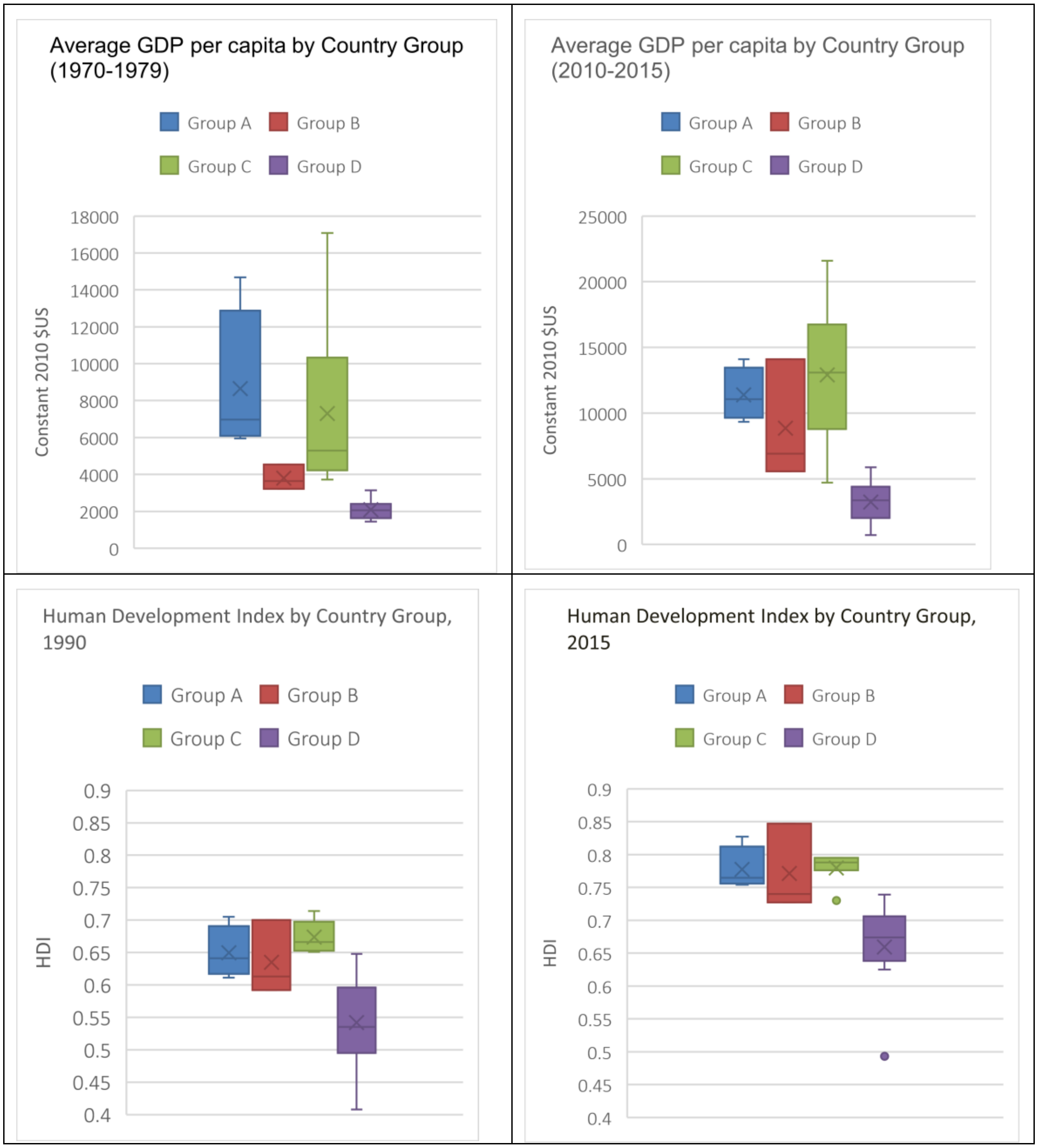
22 The FSO TC program was regulated by the concessional agreement of 2006 (CA-474).

23 See IDB-9 Replenishment document (AB-2764, Annex 1, para. 3.13).

24 Based on World Bank, WDI, series Population, Total and GDP (current US$) for 2010.

4.4 **The classification of country groups C&D did have some correlation with income per capita and human development early in the period, but that has waned with time.** Country group classification was closely correlated with per capita income in the early period, but, except for Group D, the classification does not correlate well with income in more recent times (see Figure 4.1). Also, there are significant heterogeneities within all groups, but particularly Group C. In terms of human development, the only group that stands out is Group D, with a significantly lower level of development.

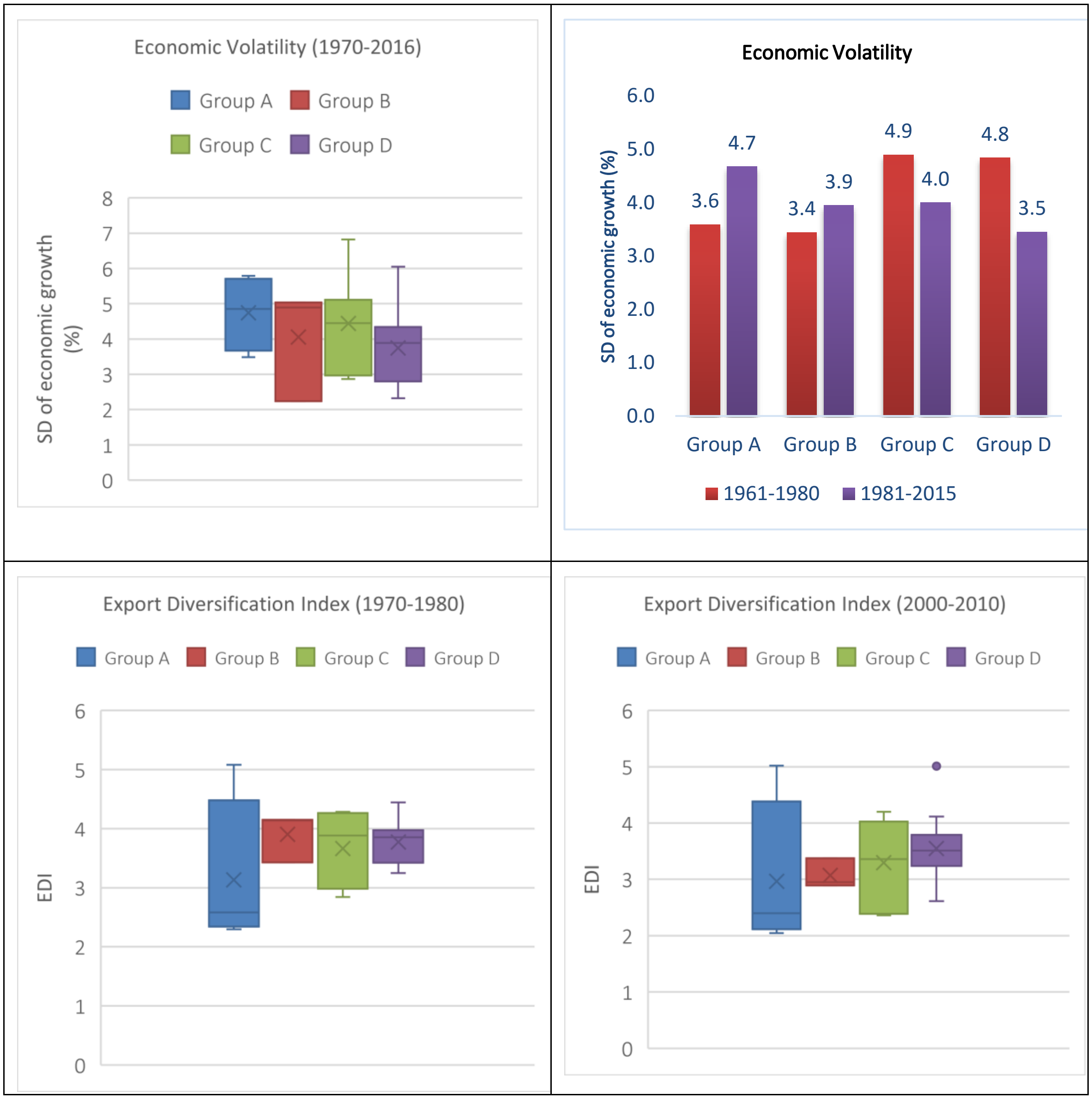
Figure 4.1. C&D Countries, GDP per capita, and Human Development



Source: Human Development Reports, United Nations Development Program - http://hdr.undp.org/en/.

4.5 **Overall, C&D countries do not differ significantly from A&B countries in other characteristics that are relevant for SVCs, such as export diversification or economic volatility** (Figure 4.2). Volatility seems to be more related to macroeconomic conditions than to the structural characteristics of small countries. Thus, larger countries with more macroeconomic instability have displayed a higher level of economic volatility. However, at least initially, Group D countries seem to have some level of economic volatility. As for export diversification, no group seems to stand out.

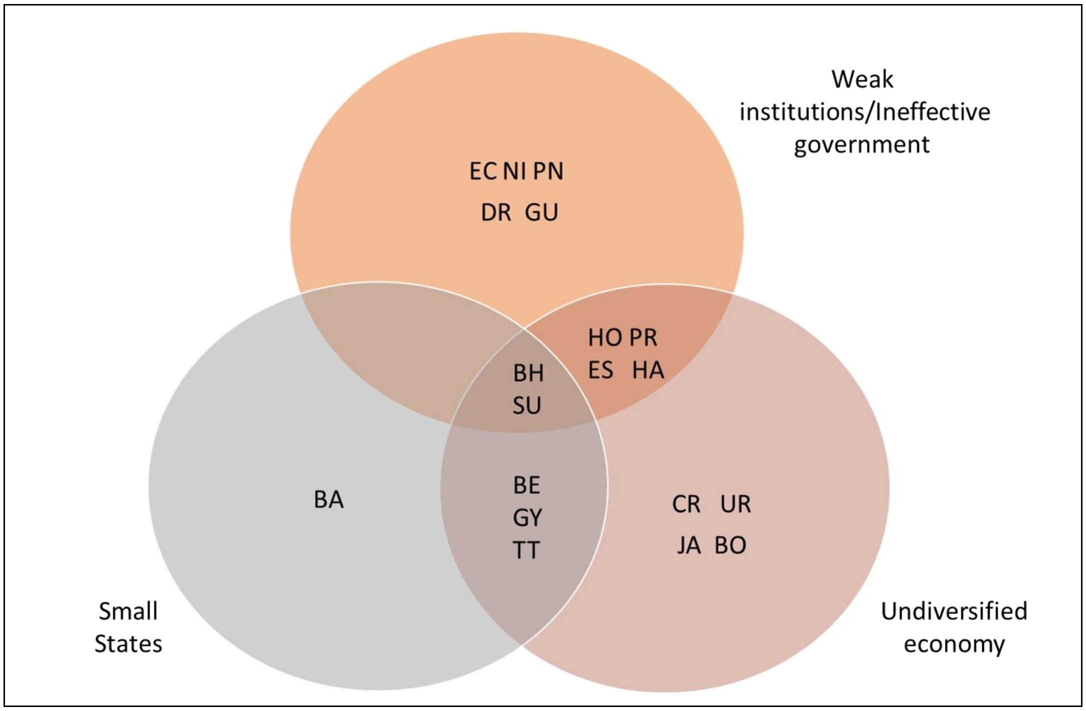
Figure 4.2. Economic Volatility and Export Diversification by Country Group



Note: Economic volatility is derived from the standard deviation of the annual GDP growth rate.
Export diversification: The lower the export diversification index, the less concentrated a country's exports are.
Source, export diversification: International Monetary Fund, 2017.
https://www.imf.org/external/np/res/dfidimf/diversification.htm
Source, economic volatility: World Development Indicators, World Bank, 2017.

4.6 **The 19 countries grouped in C&D category exhibit significant heterogeneity.** In general, the C&D countries can be separated into three groups according to their main development challenges (see Figure 4.3). First, a group of *small states* are challenged in providing public goods (including effective government) because of the overall size of their economies. For a second group of countries, the main vulnerability lies in their *undiversified economy*. There is obviously a correlation between size and undiversified economies; however, larger countries—particularly oil producers—can also have an undiversified export base. A third group is mostly characterized by their *weak institutions and ineffective governments*.

Figure 4.3. Countries Classified by Development Challenge



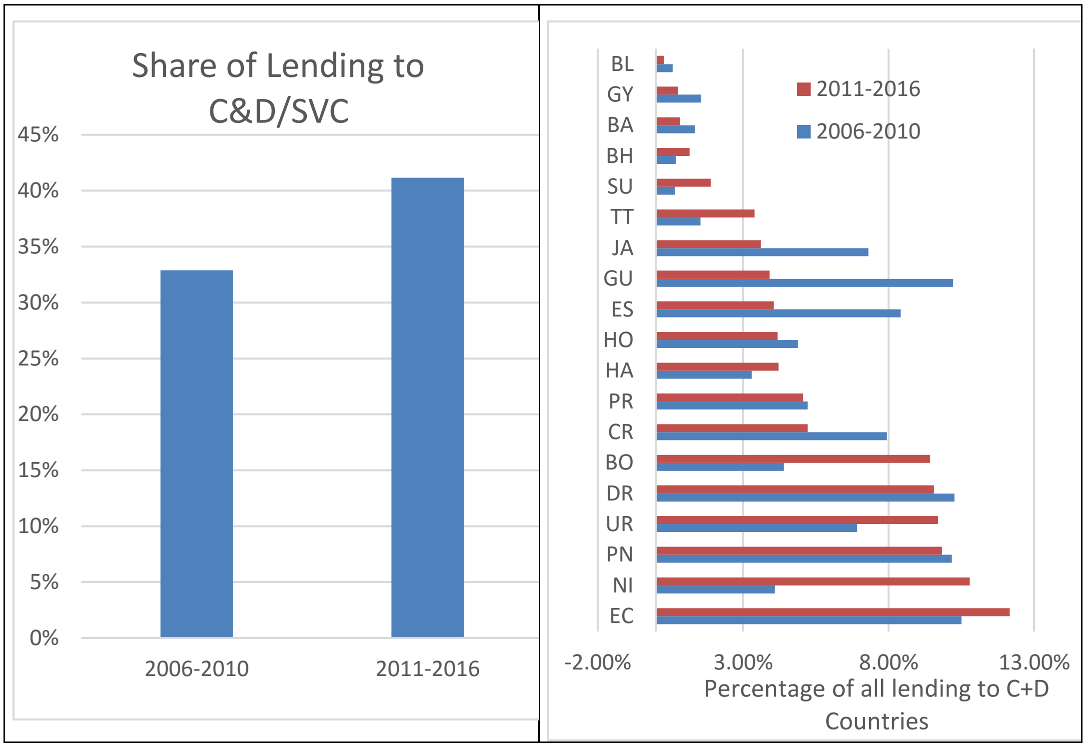
Notes: No information for Institutions index for Belize, Bahamas, Barbados, and Suriname. Institutions: tax burden as % of GDP; threshold: below median of sample. Economic vulnerability: the Economic Vulnerability Index is a composite of eight indicators: (1) population size, (2) remoteness, (3) merchandise export concentration, (4) share of agriculture, forestry, and fisheries in gross domestic product, (5) homelessness owing to natural disasters, (6) instability of agricultural production, (7) instability of exports of goods and services, and (8) the share of population living in low elevated coastal zone; index threshold: below median of sample. Small state threshold: < 1.5 million habitants.

Sources: Tax burden as % of GDP: Index of Economic Freedom, the Heritage Foundation, 2016. Economic Vulnerability Index: Fondation pour les études et recherches sur le développement international, 2013. Population: World Development Indicators, World Bank, 2016.

4.7 **The Bank has achieved the lending target for SVC/C&D, mostly thanks to large PBLs concentrated in a few of the largest SVCs (Figure 4.4).** Lending was however very concentrated and 5 countries represented about one-half of all lending to C&D countries. Moreover, a few large PBPs to these countries are mostly responsible for the attainment of the lending target.[25] In general, there is an increasing trend in both the concentration of lending to the largest 5 C&D countries (from 49% to 52%) and the share of PBLs (from 27% to 32%).

25 For instance, in 2015 lending to C&D countries reached 51% of total lending—a share that was fueled by a number of large PBLs to the largest C&D countries (US$500, US$300, and US$250 million PBPs to Ecuador, Dominican Republic, and Uruguay, respectively).

Figure 4.4. Evolution of the Lending Target during IDB-9



Source: IDB Data Warehouse.

B. Action plan C and D

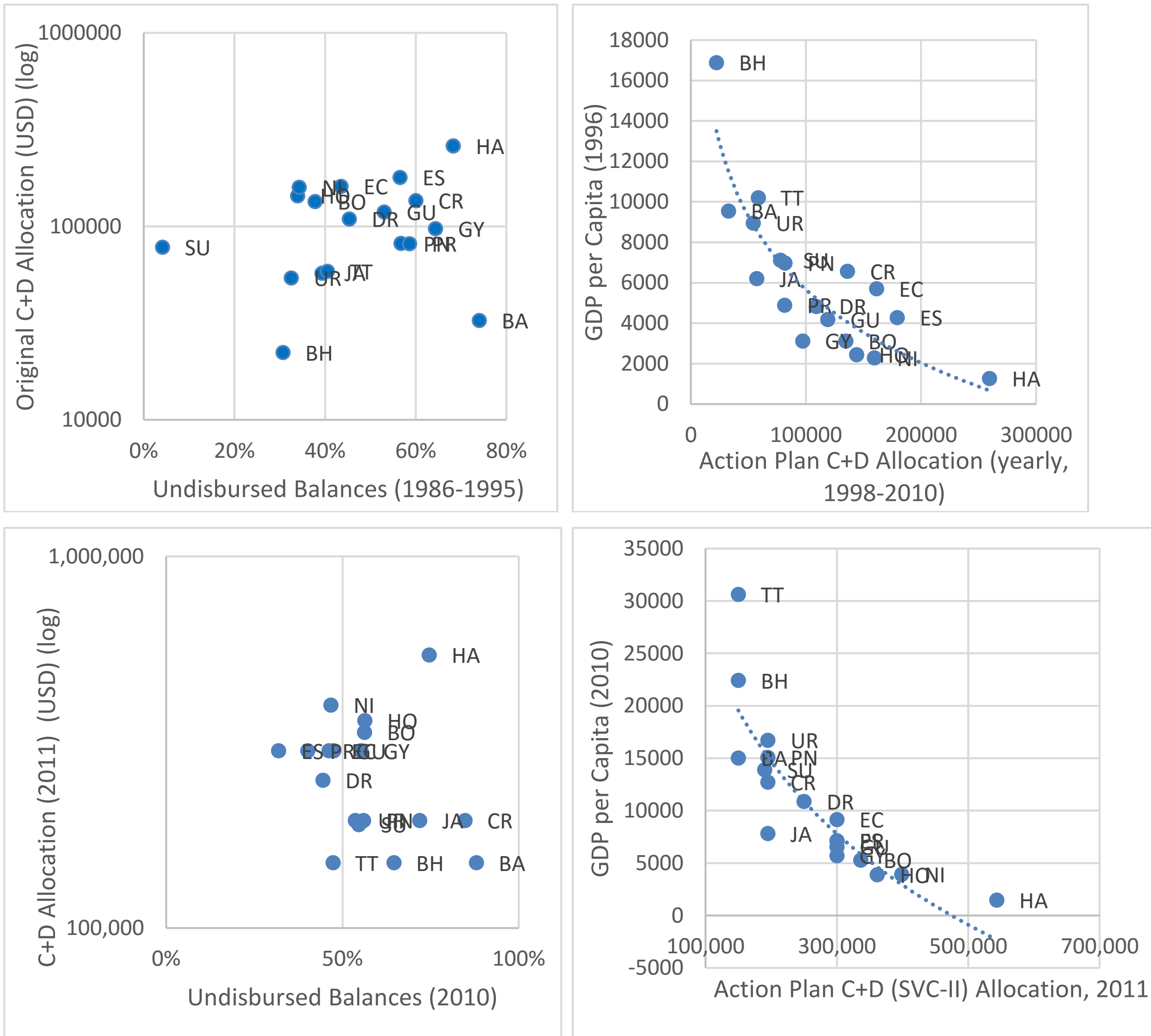
4.8 **The goal of the Action Plan C and D the C&D/SVC technical assistance program mutated over time.** Initially, the program had the objective of increasing disbursements and approvals in C&D countries. More recently, the SVC special program (2011) aims more generally at the "modernization and strengthening of the beneficiary countries' technical and managerial capacity." With this change, the direct link between the program and the achievement of the Bank's lending target has been weakened.

4.9 **After the initial distribution for 1997-1998, the amounts approved for Action Plan C and D remained constant until 2010.**[26] No new strategic guidance on the use of the TC was given, and only a reporting structure was set up through the Grant and Co-financing Management unit.

4.10 **The allocation of funds in C&D countries does not seem to respond to the countries' implementation needs.** Instead, the FSO part of the Action Plan C and D funds was allocated among the countries with a formula that mirrored the formula for sharing convertible FSO resources. Thus, the allocation of C&D funds is very closely correlated with the relative poverty of the country (Figure 4.5, top 2 panels). This distribution is at odds with the stated objective of the program—to support the preparation and implementation of the Bank program. The revision of the amounts allocated for the C&D action plan in 2011 (SVC-Window II) did not change this. Allocations continue to be related to income per capita and unrelated to implementation needs and challenges (bottom 2 panels in Figure 4.5)

26 The concessional agreement of 2006 maintained the budget of US$2 million for the Action Plan C and D (CA-474, para. 4.22),

Figure 4.5. Action Plan C and D Allocations (for 1994-2010 at the top, for 2011 at the bottom), Implementation bottlenecks (left), and GDP per capita (right)



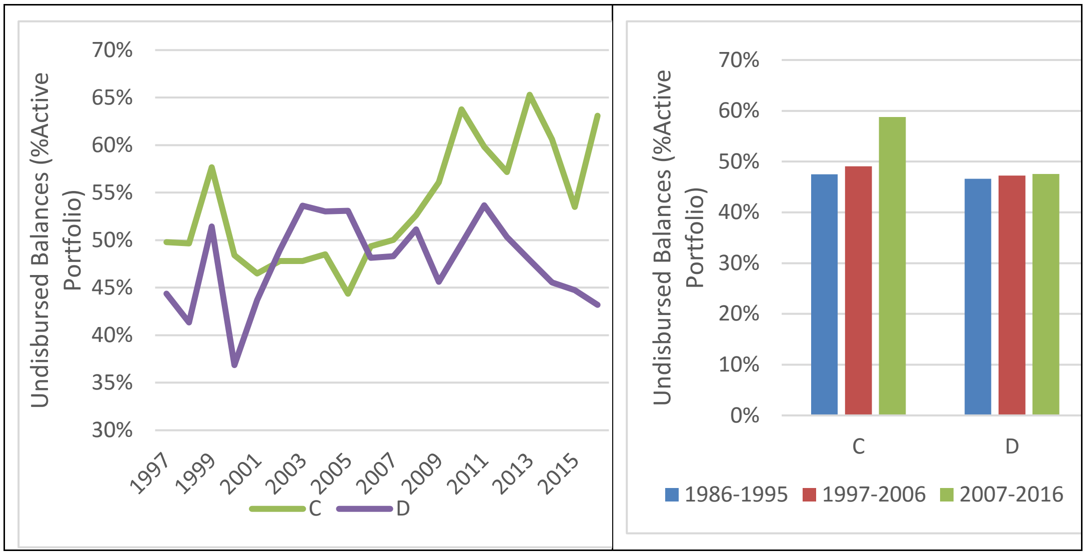
Source: IDB Data Warehouse and World Bank, World Development Indicators for GDP per capita.
Note: The figure corresponds to the original allocation (1997-2010). The results are similar if the updated allocation is used.

4.11 **In terms of the outputs of the Action Plan C and D program, OVE found that in the initial stages (1997-2000), it increased the amount of resources spent in project preparation (Fig. 3.1, RE-242) and execution.** However, OVE found that in many instances, the counterfactual of whether C&D countries received more resources as a result of the plan was difficult to establish since FSO countries received also national TCs funded from the FSO. Except for countries that were ineligible for FSO TC funding but eligible for Action Plan C&D funds, it is not obvious that C&D countries received more resources for project preparation and implementation as a consequence of the program.[27]

27 Bahamas, Barbados, Costa Rica, Panama, Suriname, Trinidad & Tobago, Uruguay, and Belize had a GDP per capita of over US$1600, which made them ineligible for FSO convertible TC funding (see RE-242, 4.10 citing OP-402).

4.12 **Action Plan C and D does not seem to have had an impact on the level of undisbursed balances in C&D countries.** If anything, undisbursed balances tended to increase, although this may also be reflecting the increase in approvals (Figure 4.6).

Figure 4.6. Undisbursed Balance and C&D Action Plan

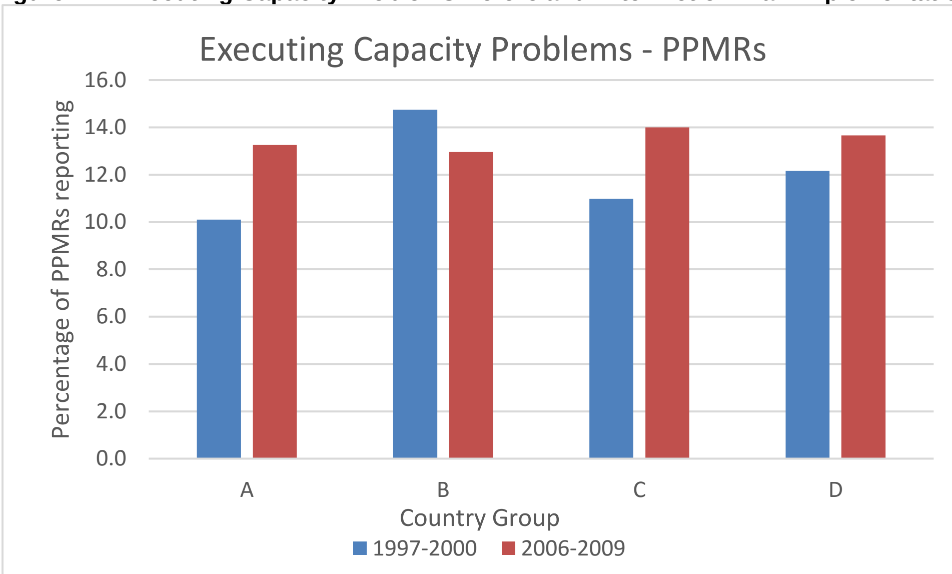


Source: IDB Data Warehouse.

4.13 **Moreover, there were no major changes in the types of problems C&D countries reported after the implementation of the Action Plan.** OVE looked at the portfolio problems reflected by the old monitoring reports (Project Performance Monitoring Reports, or PPMRs) before and after the implementation of the Action Plan C and D,[28] and found that the incidence of execution problems ex-ante was relatively similar in all four country groups. Moreover, the incidence of some problems, such as those with the executing agency's capacity (see Figure 4.7), increased between 1997-2000 and 2006-2009, even relative to A and B countries.

[28] The PPMRs recorded 19 possible reasons for projects to have execution problems (legislative ratification, executing capacity commitment, lack of counterpart, etc.). The PPMR was discontinued in 2009. The new PMR system does not contain a taxonomy of problems, so no analysis is possible after 2009.

Figure 4.7. Executing Capacity Problems Before and After Action Plan implementation

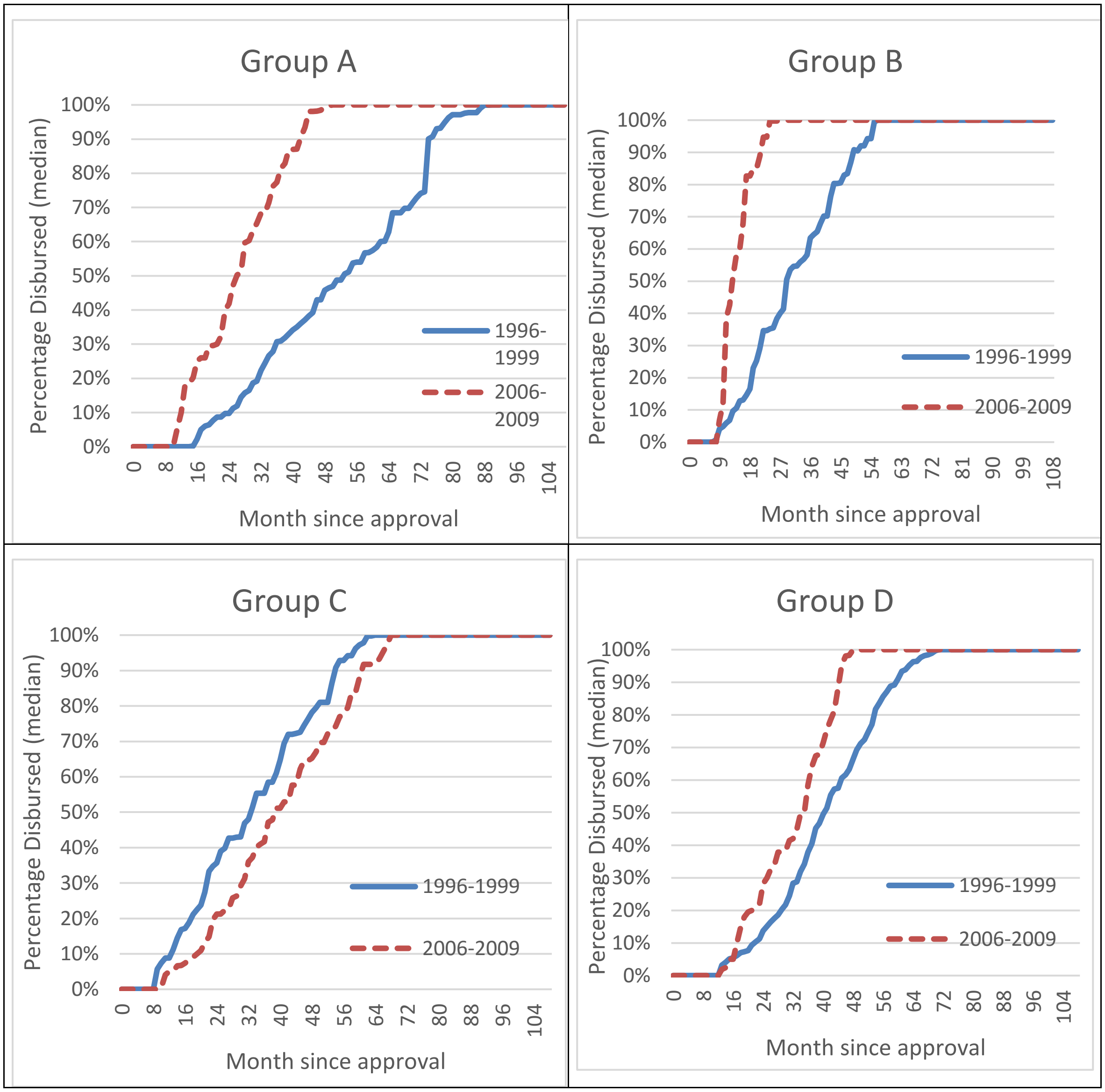


Source: PPMR system (IDB Data Warehouse).

4.14 **Disbursement curves reveal some positive progress in countries in Group D, but not C.** OVE computed the disbursement curves of all loans approved between 1996-1999 and 2006-2009.[29] Three country groups (A, B, and D) exhibit a major improvement (see Figure 4.8). It is possible that the performance profile of Groups A and B was negatively affected at baseline by the financial crises many countries experienced around that time; in fact, this is consistent with the PPMR data (problems with the national counterpart were rampant in A countries). As for Group C, 5 of the 8 countries had lower disbursements in 2006-2009 when compared to 1996-2009.

[29] The samples were chosen to reflect, to the extent possible, the pre-Action Plan situation (disbursement data are not available before 1996). Projects in this first batch correspond to projects approved between 1996 and 1999 and probably entered execution in late 1990s/early 2000s when Action Plan C and D was starting to be implemented. The comparison group (2006-2009) was chosen to allow a complete implementation period (approved at least 8 years ago).

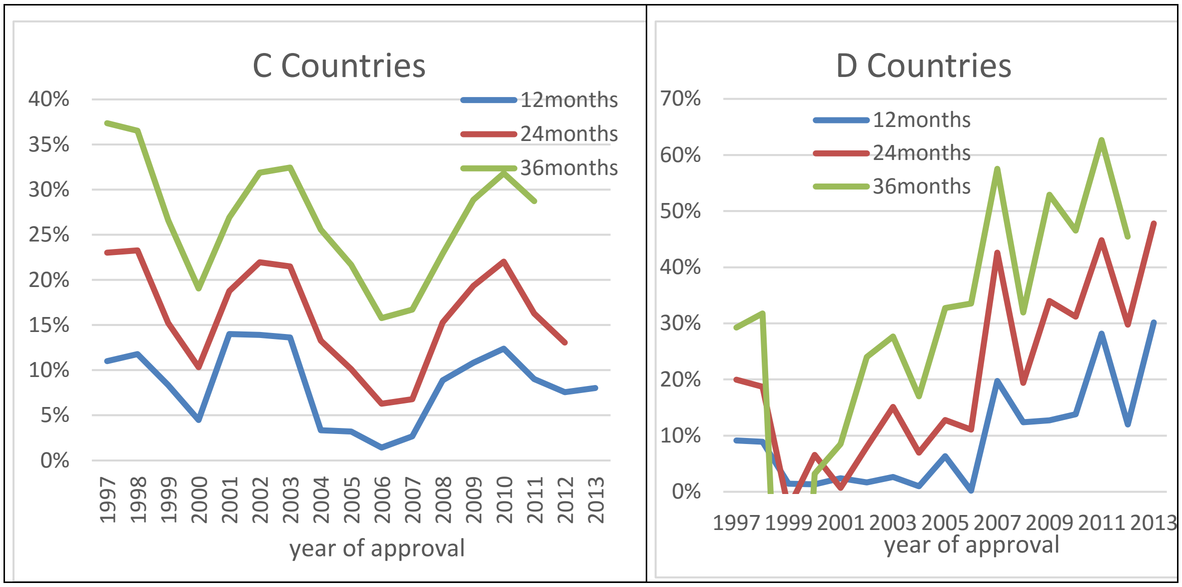
Figure 4.8. Disbursement Curves by Country Groups



Source: LMS, IDB Data Warehouse.

4.15 **Looking in detail at the disbursement profile at 12, 24, and 36 months since approval confirms previous findings.** Group D countries seem to have consistently improved their performance, particularly since 2007, although without further study it is difficult to determine the causes. Debt relief—and the cancellation of old portfolio—might have played a role in improving D countries' performance. For C countries, loans approved during crisis periods (2000-2002, 2008-2010) seem to coincide with periods in which the portfolio disbursement improves. This seems to point to an improvement of the disbursement profiles during the recovery from the crises (1, 2, and 3 years after the crises) (see Figure 4.9).

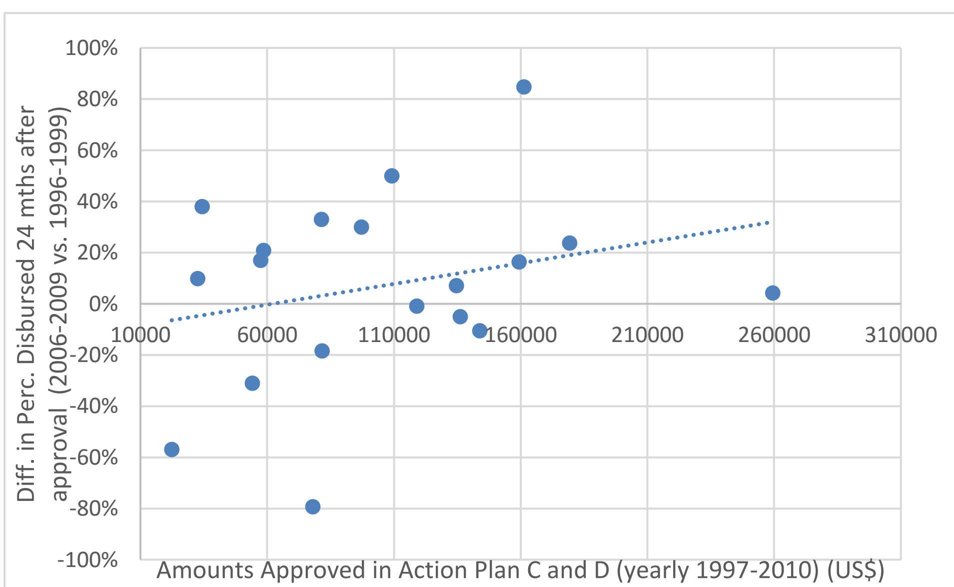
Figure 4.9. Cumulative Disbursements (% total) at 12, 24, and 36 months (3-year moving average)



Note: Only investment loans. *Source:* LMS.

4.16 **The evidence suggests that there is, at most, a weak connection between change in disbursements and Action Plan C and D.** The correlation between disbursement change and Action Plan C and D funds received is positive but statistically insignificant at all 12, 24, 36, 48, and 60 months from approval, although there seems to be a stronger relationship (still marginally insignificant) at 24 months. All of this suggests that there could be some relationship between the Action Plan C and D funds and disbursement speeds and that any such effect is stronger earlier in the execution of the project (12 and 24 months after approval) (see Figure 4.10). To get a sense of magnitude, an increase of 10% in the amounts approved in Action Plan C and D TCs (if interpreted causally) would imply an increase in the overall disbursements of about 1.75 percentage points (at 24 months).

Figure 4.10. Action Plan C and D and Disbursement Changes between Projects Approved in 1996-1999 and 2006-2009

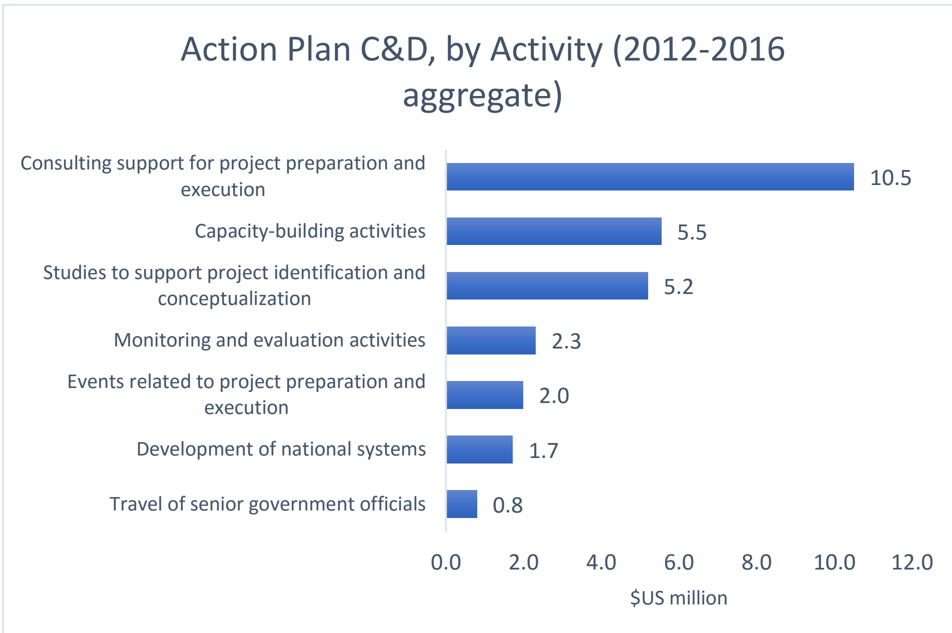


Source: LMS, IDB Data Warehouse.

4.17 **Bank staff—particularly at country offices—have repeatedly stressed the importance of C&D funds as a flexible source of funds to facilitate project implementation.** Evidence from interviews, mostly carried out in the context of CPEs, has confirmed this. In contrast, all the other funding available for project preparation and implementation is assigned on a sector basis, and is based on the current projects in preparation and execution.

4.18 **Since the implementation of the new SVC (Window II), most of the resources have financed consultancies and studies for project preparation and implementation** (see Figure 4.11). GCM has produced annual detailed reports with the classification of the activities financed by SVC-II (Action Plan C and D) funds.

Figure 4.11. Uses of Action Plan C and D Funds



Source: GCM reports, Action Plan C and D.

V. CONCLUSIONS

5.1 **Except for some early resolutions by the Governors, there is no clear strategic guidance as to what the IDB's preferential support to C&D countries is supposed to achieve.** Even IDB-9, which changed the name of "C&D countries" to "small and vulnerable countries," did not attempt to define either what a small and vulnerable country was or what was the nature of the support such a country needed. From a theoretical point of view, at least three arguments could be made: some countries are simply too small to sustain an effective government, others have weak institutions and small governments, and still others have an undiversified economic base that makes them more vulnerable to economic shocks. The possible solutions depend on the type of problem. For instance, small states would benefit from regional integration to reduce the burden of financing government. Although some problems (economic vulnerability) may call for increased lending, not all the problems involve a solution that calls for lending.

5.2 **As for the original classification of C&D countries, OVE found that the only variable that consistently reproduces the ranking is the overall size of the economy.** The grouping bears little relation to economic vulnerability, development level, or even the strength of the institutions. In consequence, a wide variety of countries with distinctly different development challenges are pooled under the Group C&D classification. Moreover, the definition was first proposed in 1972 and revised only once in 1975. Despite the differential evolution of countries in the last 40 years, the list of Group C&D countries continues to be the same that was agreed in the concessional fund allocation agreement of 1972.

5.3 **Given the lack of clarity of the objectives of the support to C&D countries, it is difficult to assess the effectiveness of Bank support.** The Bank failed to meet the lending targets for IDB-6, IDB-7, and IDB-8, but met the 2015 target for IDB-9. However, this is mostly driven by a few operations in the largest C&D countries. Also, given that SVCs face several different challenges and the link between them and a lending program is unclear, it is difficult to interpret the meaning of achieving the lending target in terms of development outcomes.

5.4 **Regarding the Action Plan C and D technical assistance program, several findings emerge.** First, the funds were allocated according to countries' per capita income rather than the extent to which there were disbursement difficulties. As for results, C&D countries do not seem to have improved significantly relative to A or B countries (either in terms of the problems reported in the project monitoring system or in the evolution of the disbursement curves). Yet there is some weak correlation between the changes in the disbursement speeds of projects and the amounts of Action Plan C and D funds they received. Finally, VPC staff have consistently pointed out to OVE the importance of Action Plan C and D TC funds for project preparation and implementation—particularly given the rules for the allocation of the Bank's transactional budget.

5.5 **Looking forward, two broad suggestions emerge.** First, despite the persistent emphasis on working with SVCs, in the last 40 years the Bank has made limited progress toward defining the nature and scope of the support these "small and vulnerable" countries need. In that regard, it would be useful for the Bank to reconsider the nature of the problem(s) these and other LAC countries face and the types of support they would need. Only then would it make sense to determine the appropriate way to group countries and the instruments needed for their support—lending, reimbursable and non-reimbursable technical assistance, or increased budget allocation for the country offices. Second, regarding the Action Plan C and D (SVC-II) non-reimbursable technical assistance program, again it would be useful for the Bank to analyze what the objectives of the program are, how the non-reimbursable resources can help achieve those results, and whether current country groupings remain relevant to those objectives. It is advisable that the Bank's costs related to the implementation of its operations be included as an administrative cost in the institutional budget rather than as a separate technical assistance operation, as has been customary.

APPENDIX I. ANALYSIS OF THE METHODOLOGY FOR GROUPING COUNTRIES C&D/SVC

In 1972 the Bank established new policy guidelines for the loans it provides to its country members, with the aim of giving preferential treatment to economically less developed countries and countries of insufficient market. For this, it classified borrowing countries into four groups, each of which would be subject to different terms and conditions on their loans: different grace and amortization periods, interest rates, and commitment fees. The original document (GN-870-4) did not establish a methodology to classify countries.

In a revision of the classification in 1974 (GN-870-7), a two-stage methodology for classifying groups was developed. In the first stage, the countries were ranked on the basis of nine indicators (the exact methodology or weight given to each indicator is not disclosed):

- Total GDP per capita
- Total GDP
- Total population
- Average rate of population growth (percentage)
- Ratio of gross investment to GDP
- Growth of GDP per capita
- Years of life expectancy at birth
- Infant mortality per 1,000 births
- Literacy rate (percentage)

The second stage of the classification consisted of adjustments based on informal consultations of the Executive Directors.

The GN-870-7 document indicates that this classification is designed to reflect the borrowing countries' development levels. It also states that, because of the difficulty and limitations of performing international comparisons, this classification cannot be the only instrument for determining loan conditions, but instead should be used as an indicative guide.

In addition, the document points out that if there were to be any persisting changes in a country's development levels, the country's relative position and classification would change accordingly. However, despite the many changes the region has gone through in the last 30 years, these groups have remained the same.

Benchmarking

We performed the country's benchmark for five different years, starting in 1975 (when the Bank did the original grouping) and ending in 2015. The purpose of this exercise was to try to replicate the original groups of 1975 and observe how economic and development changes might have altered the groups if they had been established at other times.

First, we based the group classification on the arithmetic mean of the scores countries received for each of the indicators, using data for the World Bank's, World Economic Indicators.[1] To establish the scores, we ranked each country per the value of each indicator, giving them a score from 1 to 26 (1 being the best, 26 the worst). Next, these scores were added and divided by the number of indicators (arithmetic mean), which provided the country's final score—a number from 1 to 26. The top four scores were put into Group A,

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[1] Data for literacy rates were very limited, so that indicator was left out of the analysis. There were no data for any indicators in Venezuela in 2015, so we took the last available data. When a country had missing data at a given point in time, it was considered to be a 0, so countries were "penalized" for not having data; however, this did not happen repeatedly, except for Haiti.

the following three into Group B, and all the rest into the Group C & D category. Figure I.1 shows the results of this exercise.

Figure I.1. Borrower Classification According to Development Indicators

	Group A	Group B	Group C &D
1975	- Argentina - Uruguay - Brazil - Venezuela	- Mexico - Jamaica - Trinidad and Tobago	-Bahamas -Barbados -Belize -Bolivia -Chile -Colombia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala - Guyana -Haiti -Honduras -Nicaragua -Panama -Peru -Paraguay -Suriname
1985	- Argentina - Chile - Mexico - Venezuela	- Brazil - Uruguay - Bahamas	-Barbados -Belize -Bolivia -Colombia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala -Guyana -Haiti -Honduras -Jamaica -Nicaragua -Panama -Paraguay -Peru -Suriname -Trinidad and T.
1995	- Argentina - Chile - Colombia - Brazil	- Bahamas - Jamaica - Venezuela	-Barbados -Belize -Bolivia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala -Guyana -Haiti -Honduras -Mexico -Nicaragua -Panama -Paraguay -Peru -Suriname -Trinidad and T. -Uruguay
2005	- Argentina - Chile - Mexico - Venezuela	- Uruguay - Brazil - Colombia	-Bahamas -Barbados -Belize -Bolivia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala -Guyana -Haiti -Honduras -Jamaica -Nicaragua -Panama -Paraguay -Peru -Suriname -Trinidad and T.
2015	- Argentina - Chile - Colombia - Mexico	- Costa Rica - Uruguay - Panama	-Bahamas -Barbados -Belize -Brazil -Bolivia --Dominican R. -Ecuador -El Salvador -Guatemala -Guyana -Haiti -Honduras -Jamaica -Nicaragua -Paraguay -Peru -Suriname -Trinidad and T. -Venezuela

Next, we classified countries solely on the basis of the size of their economy according to their, GDP, provided in the World Development Indicators (see Figure I.2). Interestingly, Groups A and B are an exact match to the actual classification of 1975, although Groups C and D are not. The groups have remained the same over time—that is, the seven biggest economies in 1975 are still the region's biggest economies.

Figure I.2. Borrower Classification According to GDP (constant 2010 US$)

	Group A	Group B	Groups C &D
1975	- Argentina - Brazil - Mexico - Venezuela	- Chile - Colombia - Peru	-Bahamas -Barbados -Belize -Bolivia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala - Guyana -Haiti -Honduras -Jamaica -Nicaragua -Panama -Paraguay -Suriname - Trinidad and T. -Uruguay
1985	- Argentina - Brazil - Mexico - Venezuela	- Chile - Colombia - Peru	-Bahamas -Barbados -Belize -Bolivia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala - Guyana -Haiti -Honduras -Jamaica -Nicaragua -Panama -Paraguay -Suriname - Trinidad and T. -Uruguay
1995	- Argentina - Brazil - Mexico - Venezuela	- Chile - Colombia - Peru	-Bahamas -Barbados -Belize -Bolivia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala - Guyana -Haiti -Honduras -Jamaica -Nicaragua -Panama -Paraguay -Suriname - Trinidad and T. -Uruguay
2005	- Argentina - Brazil - Mexico - Venezuela	- Chile - Colombia - Peru	-Bahamas -Barbados -Belize -Bolivia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala -Guyana -Haiti -Honduras -Jamaica -Nicaragua -Panama -Paraguay -Peru -Suriname -Trinidad and T.
2015	- Argentina - Brazil - Mexico - Venezuela*	- Chile - Colombia - Peru	-Bahamas -Barbados -Belize -Bolivia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala -Guyana -Haiti -Honduras -Jamaica -Nicaragua -Panama -Paraguay -Peru -Suriname -Trinidad and T.

Finally, we classified countries according to their GDP per capita, shown in the World Development Indicators. using the official data. With this ranking we see more variation over the years from group to group, and interestingly we see many Caribbean economies in the top spots (see Figure I.3).

Figure I.3. Borrower Classification According to GDP per Capita (Constant 2010 US$)

	Group A	Group B	Groups C &D
1975	- Bahamas - Suriname - Trinidad and T. - Venezuela	- Argentina - Brazil - Uruguay	-Barbados -Belize -Bolivia -Chile -Colombia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala - Guyana -Haiti -Honduras -Jamaica -Nicaragua -Mexico -Panama -Paraguay -Peru
1985	- Bahamas - Barbados - Brazil - Venezuela	- Mexico - Suriname - Trinidad and T.	-Argentina -Belize -Bolivia -Chile -Colombia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala - Guyana -Haiti -Honduras -Jamaica -Nicaragua -Panama -Paraguay -Peru -Uruguay
1995	- Bahamas - Barbados - Brazil - Venezuela	- Argentina - Chile - Uruguay	-Belize -Bolivia -Colombia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala - Guyana -Haiti -Honduras -Jamaica -Mexico -Nicaragua -Panama -Paraguay -Peru -Suriname -Trinidad and T.
2005	- Bahamas - Barbados - Trinidad and T. - Venezuela	- Brazil - Chile - Uruguay	-Argentina -Belize -Bolivia -Colombia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala - Guyana -Haiti -Honduras -Jamaica -Mexico -Nicaragua -Panama -Paraguay -Peru -Suriname
2015	- Bahamas - Barbados - Trinidad and T. - Venezuela*	- Brazil - Chile - Uruguay	-Argentina -Belize -Bolivia -Colombia -Costa Rica -Dominican R. -Ecuador -El Salvador -Guatemala - Guyana -Haiti -Honduras -Jamaica -Mexico -Nicaragua -Panama -Paraguay -Peru -Suriname