Issues Concerning the Blend Country Regime and the Adoption of a Graduation Policy for ADF Countries

Background Paper

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Executive Summary

The ADB's Credit Policy, which follows the IBRD's Credit Policy, determines which countries are only eligible for ADF resources, which are only eligible for ADB resources, and which are eligible for a blend of the two (blend countries). Since the Bank adopted its current Credit Policy in 1995, three regional member countries have been blend countries: Egypt, which graduated to ADB-only status in 1999, and Nigeria and Zimbabwe, both of which are still blend countries. Blend countries receive financing under the same terms as ADF-only countries, but a 5 percent cap is applied to the aggregate amount of ADF Performance-Based Allocation resources available to them. This measure reflects the fact that blend countries have access to non-concessional resources (from ADB or elsewhere) and ensures that the bulk of ADF resources (95 percent) is allocated to ADF-only countries.

Cape Verde is expected to become eligible for ADB financing in 2009 and will be the first country to become a blend country since the Bank's current Credit Policy was approved. Angola might also graduate in the short term. The Bank Group does not have a graduation policy to define the adequate mix of ADF and ADB resources available to graduating countries during their transition to full creditworthiness. The objective of this paper is to review the current Bank Group blend regime and identify issues on which Deputies' preliminary guidance is solicited as input to the formulation of a graduation policy.

The first issue is that the 5 percent cap applicable to the aggregate amount of resources available to blend countries means that the amount of resources for which a given blend country is eligible in any one year is not a function of that country's needs and/or access to non-concessional financing but rather of the number of blend countries competing for those resources. Cape Verde would thus experience a decrease in its ADF allocation of approximately 50 percent upon becoming a blend country in 2009 because Nigeria is also a blend country. This paper discusses the removal of the aggregate cap on resources available to blend countries and replace it with country-specific caps, so as to allow a more tailored treatment of blend countries while ensuring that the bulk of concessional resources continues to go to ADF-only countries.

The second issue is whether harder lending terms (maturities) than those applied to ADF-only countries should be applied to blend countries and countries that are not creditworthy but are above the income cut-off point for eligibility to ADB resources, as a means of reflecting these countries' particular income levels and degrees of creditworthiness. This would increase the amount of reflows available to ADF-only countries over time.

Finally, the paper discusses broad issues for the elaboration of a graduation policy: anchoring individual country graduation strategies in each country's context; adapting economic and sector work, phasing-out periods and private sector development strategies to country circumstances; and harmonizing policies with those of the IBRD whenever relevant. Guidance from Deputies is also sought on whether and how certain small and/or vulnerable states should be allowed to continue enjoying full ADF allocation after graduating, in consideration of their special needs.

Detailed proposals will be submitted for the Deputies' approval as part of the ADF-12 consultations.

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Abbreviations

ADB	African Development Bank
ADF	African Development Fund
ADF-11	Eleventh General Replenishment of the African Development Fund
ADF-12	Twelfth General Replenishment of the African Development Fund
IDA	International Development Association
PBA	Performance-Based Allocation
UA	Units of Account

ISSUES CONCERNING THE BLEND COUNTRY REGIME AND THE ADOPTION OF A GRADUATION POLICY FOR ADF COUNTRIES

1. Introduction

1.1 The African Development Bank (ADB or the Bank)'s Credit Policy determines which countries are only eligible for African Development Fund (ADF or the Fund) resources, which are only eligible for ADB resources, and which are eligible for a blend of ADB and ADF resources (blend countries). Since the ADB adopted its Credit Policy in 1995, three regional member countries have been blend countries: Egypt, which graduated to ADB-only status in 1999, and Nigeria and Zimbabwe, both of which are still blend countries. The ADF's Performance-Based Allocation (PBA) system places a 5 percent cap on the aggregate amount of resources available to blend countries.

1.2 Cape Verde is expected to become eligible for ADB financing in 2009[1] and will be the first country to become a blend country since the current Credit Policy was approved in 1995. Angola may also graduate in the short term. However, the Bank Group currently does not have a formal graduation policy that defines the adequate mix of ADF and ADB resources available to graduating countries during their transition to full creditworthiness. These upcoming graduations therefore call for a review of the current blend country regime and the adoption of a graduation policy.

1.3 The objectives of this paper are to review the current Bank Group blend regime (both its definition and its implementation) and discuss issues on which Deputies' preliminary guidance is sought, with a view to proposing a graduation policy and amendments to the blend country regime for the Twelfth General Replenishment of the African Development Fund (ADF-12). After this introduction in Part 1, Part 2 of this paper reviews the blend country regime currently in force in the Bank Group and places it in perspective to the World Bank's regime, before discussing proposals for adjustments to the blend country regime. Part 3 discusses the key issues associated with designing a graduation policy. Part 4 contains a list of issues on which Deputies' guidance is sought.

2. Reviewing the Blend Country Regime

Classification of Countries as Blend Countries

2.1 Under the Credit Policy approved by the ADB's Board of Directors,[2] the Bank Group uses the World Bank's country classification criteria to classify countries in three categories: countries only eligible for ADF resources, countries only eligible for ADB resources, and countries eligible for both ADF and ADB resources. This classification is based on two criteria: (i) per capita income that exceeds the International Development Association (IDA)'s operational cut-off[3] for 2 consecutive years, and (ii) creditworthiness that sustains International Bank for Reconstruction and Development (IBRD) financing.[4] The World Bank uses these criteria to

[1] Cape Verde was declared eligible for International Bank for Reconstruction and Development financing in 2009.

[2] This Credit Policy was adopted by the Board of Directors in Resolution B/BD/94/07/Rev1 on May 16, 1995, as an interim policy and was continued thereafter (see Document ADB/BD/WP/98/40, adopted by the Board of Directors in 1998).

[3] The operational cut-off for IDA eligibility for financial year 2010 (July 2009 to June 2010) is a 2008 per capita gross national income of US$1,135, using Atlas methodology.

[4] Individual country creditworthiness (risk) ratings are derived on the basis of both quantitative and qualitative analysis. The components considered by the World Bank are broadly grouped into eight categories: (i) political risk; (ii) external debt and liquidity; (iii) fiscal policy and public debt burden; (iv) balance of payments risks; (v) economic structure and growth prospects; (vi) monetary and exchange rate policy; (vii) financial sector risks; and (viii) corporate sector debt and vulnerabilities. Each of these categories is considered in turn, and the ratings for all categories determine the country's overall rating. However, no fixed weights are assigned to any one category and qualitative judgment is used to integrate the eight ratings into a single rating. The joint evaluation of the different categories for each country occurs against the background of a particular global

classify countries in one of four categories described here and summarized in Table 1:[5]

- Countries that are below the operational cut-off and are not creditworthy are IDA-only countries.
- Countries that are above the operational cut-off and are not creditworthy are also IDA-only countries but are called gap countries. They are not eligible for IBRD lending and are eligible for IDA resources on hardened terms (20 rather than 40 years maturity). These conditions take account of the fact that gap countries' per capita income is above the operational cut-off. The only African country currently in this category is Angola.
- Countries that are below the operational cut-off and are creditworthy are blend countries. Blend countries are eligible for both IDA resources (subject to a country-specific cap) on blend terms (i.e., 35-year maturities) and for IBRD resources. No African countries fall into this category at this time.

  A sub-category of this group consists of notional blend countries. Notional blend countries have the capacity for or a history of market-based borrowing and a per capita income below the IDA eligibility threshold, but are currently unable to borrow from the IBRD due to their marginal or deteriorating creditworthiness. When a blend country has not borrowed from the IBRD for an extended period, World Bank management may decide, after review, to keep its status as a blend country or to change its status to an IDA-only country. For example, in the early 1990s, Cameroon, the Republic of Congo, and Côte d'Ivoire, which were notional blend countries, were re-classified as IDA-only countries. Nigeria was a notional blend country until 2006, when it was reclassified as an IDA-only country. Zimbabwe is still a notional blend country but re-engagement with Zimbabwe is currently under consideration by the International Monetary Fund, the World Bank and the ADB. As part of this re-engagement, Zimbabwe's classification as a blend country will be reviewed to take account of its current creditworthiness and its per capita income.
- Countries that are above the operational cut-off and are creditworthy are IBRD-only countries unless they fall into either of the following categories:
  - Countries that have just met the two criteria (graduating countries) usually remain eligible for IDA resources on blend terms during a phasing-out period of 2 to 5 years.
  - Since 1985, small island states whose per capita income is above the cut-off level and are creditworthy remain eligible for IDA resources on blend terms. This exception recognizes that these economies typically have high transportation costs and, because of their small populations, fewer opportunities to pursue economies of scale. They also have severe human capital constraints. Cape Verde is the only African country in this category.

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outlook. Underpinning individual country assessments is a set of macroeconomic projections covering a 2-year period.

[5] See International Development Association. September 1997. *IDA's Performance-Based Allocation System: Simplification of the Formula and Other Outstanding Issues.*

Table 1: Snapshot of the IDA's Country Classification System

<table>
<tr><td></td><td colspan="3">Creditworthiness to Sustain IBRD Financing</td></tr>
<tr><td rowspan="3">Per Capita Income above IDA's Operational Cut-off for more than 2 Consecutive Years</td><td></td><td>No</td><td>Yes (blend countries)</td></tr>
<tr><td>No</td><td>Countries below cut-off and not creditworthy: IDA-only countries on IDA terms</td><td>Countries below cut-off and creditworthy: Eligible for IBRD resources and for IDA resources subject to a cap and blend terms (India and Pakistan)
Also notional blends[6]</td></tr>
<tr><td>Yes</td><td>Countries above cut-off but not creditworthy (e.g. Angola): Gap countries not eligible for IBRD resources and eligible for IDA resources on hardened terms</td><td>Countries above cut-off and creditworthy:
Eligible for IBRD resources. Exceptions:
• Graduating countries are eligible for IDA resources during a phasing-out period (2-5 years) on blend terms
• Small island economies are eligible for IDA resources on blend terms despite being above cut-off and creditworthy</td></tr>
</table>

2.2 Blend countries at the World Bank are therefore either (i) middle-income countries that have just graduated from IDA and are classified as blend countries during the phasing-out period; (ii) middle-income countries that qualify under the small island economy exception; and (iii) low-income countries that are creditworthy (including notional blends which in practice do not borrow from the IBRD).

2.3 Since the adoption of its Credit Policy in 1995, the Bank Group has strictly followed the World Bank's country classification for African countries. The only exception was Nigeria, which the World Bank reclassified as an IDA-only country in 2006 (largely as an essential prerequisite for Paris Club debt relief and because Nigeria was not borrowing from the IBRD). The Bank Group, in contrast, maintained Nigeria as a blend country, largely to avoid crowding out resources otherwise available to smaller, less endowed ADF-only countries. The Bank also makes no exceptions for small island economies graduating to the ADB window.

Volume, Terms and Conditions

a. Volume aspects: The cap applicable to blend countries

2.4 The aggregate volume of ADF financing available to blend countries is capped under each replenishment framework to take account of the fact that blend countries have access to non-concessional resources from ADB or elsewhere. By capping the ADF resources for which blend countries are eligible, the Fund makes more resources available to ADF-only countries. Since the adoption of the current Credit Policy in 1995, the aggregate resources available to blend countries have been capped at 5 percent of total PBA funds. This ensures that at least 95 percent of ADF resources are allocated to ADF-only countries.[7] This ceiling was carried over into the Eleventh General Replenishment of the African Development Fund (ADF-11) period, with Nigeria and Zimbabwe the only countries classified as blend countries during this time.[8] Should the aggregate allocations received by blend countries under the PBA system exceed the 5 percent ceiling, they are reduced pro-rata.

2.5 The fact that this cap applies to the aggregate amount of resources available to blend countries raises several issues. First, the cap has the same pro-rata reduction effect on all blend countries irrespective of their needs and/or their access to non-concessional financing. Second, the amount of resources received by blend countries varies according to the number of blend countries competing for the capped resources from year to year. For instance, Cape Verde will experience a decrease of its ADF allocation by approximately 50 percent upon

[6] See definition of notional blends in section 2.1.

[7] The cap was 15 percent in ADF-3 (1982-1984) and 10 percent in ADF-4 to ADF-6 (1985 to 1993) but the cap did not apply to policy-based operations. The number of blend countries varied between nine and 13 during these cycles.

[8] Egypt graduated from a blend country to an ADB-only country in ADF-8.

becoming a blend country because Nigeria is also a blend country and Nigeria's PBA allocation exceeds the total resources available for all blend countries.[9] Were Nigeria not a blend country, Cape Verde's ADF allocation would not be impacted by the cap but rather would remain at its full level.

2.6 For reference, IDA does not have an aggregate cap on the resources available to blend countries. To take account of the particular circumstances of each country, including its capacity to borrow on non-concessional terms, IDA applies country-specific caps and phasing-out periods for graduating countries instead. Thus, access to concessional resources is gradually phased out for graduating countries, while for large countries that are below the cut-off mark but are creditworthy (India and Pakistan), caps are applied but are eased when alternative resources become temporarily unavailable. This makes these countries notional blend countries for a certain time.[10] As discussed in section 2.1, no caps or phasing-out processes are imposed on small island economies such as Cape Verde. Under IDA's classification, no African blend country is currently subject to a cap.[11]

b. Terms and conditions applicable to blend countries

2.7 ADF applies identical loan terms and conditions to ADF-only and blend countries: a 50-year maturity, a 10-year grace period, a service charge of 0.75 percent per annum and a commitment charge of 0.5 percent per annum on the undisbursed portion.

2.8 For reference, IDA applies different terms to IDA-only, blend and gap countries to reflect their different creditworthiness and income-per-capita levels: 40-year maturities for IDA-only countries, 35-year maturities for blend countries, and 20-year maturities for gap countries. All IDA credits have a 10-year grace period and a 0.75 percent service charge. IDA credits do not carry a commitment fee.

Key Issues for Adjusting the Blend Country Regime

2.9 The above discussion raises two key issues in relation to the blend country regime:

- Should there be country-specific caps for blend countries instead of an aggregate cap?
- Should different loan terms (maturities) apply to different country categories?

a. Moving from an aggregate cap to country-specific caps

2.10 As indicated in section 2.6 above, the fact that the cap on resources available to blend countries is not country-specific raises several issues. Moving to a country-specific approach based on objective criteria would allow the volume of resources available to specific blend countries to be determined and their eligibility for concessional resources to be phased out in consideration of their circumstances, while ensuring that the bulk of concessional resources continues to go to ADF-only countries. Thus, countries with limited or deteriorating creditworthiness could be eligible for a higher share of ADF resources than countries with real access to financial markets or other borrowing on non-concessional terms. Meanwhile, countries in their graduation period would see their eligibility for concessional resources phased out to reflect their creditworthiness and increasing access to ADB resources. A detailed proposal discussing a set of criteria to determine individual country caps will be developed for discussion during the ADF-12 replenishment consultations.

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[9] According to 2009 PBA results, Cape Verde's ADF allocation would be reduced from about UA 10.9 million to UA 5.9 million. However, Cape Verde would also become eligible to borrow approximately UA 30 to 40 million per annum from the ADB upon graduation.

[10] See International Development Association. November 2001. *IDA Allocation to Blend Countries.*

[11] Nigeria was capped until its reclassification as an IDA-only country.

b. Applying different lending terms to different country categories

2.11 Different lending terms (maturities) could be applied to different country categories to better take into account the very different needs and creditworthiness of ADF countries in each category. These terms would be tailored to the countries' creditworthiness and their access to other sources of financing. For instance, blend countries could have shorter maturities (e.g. 40-45 years) than ADF-only countries (50 years) while gap countries, like Angola, could have even shorter maturities (e.g. 25-30 years).

2.12 Besides improving the match between ADF financing terms and a country's per capita income and creditworthiness, the application of shorter maturities (lower concessionality) to blend and gap countries would result in an increase in ADF reflows over time. Since the Advance Commitment Capacity is mainly based on reflows, this would make more internal resources available for allocation during each ADF cycle. A detailed proposal discussing differentiated financing terms with simulations of their impact will be developed for discussion during the ADF-12 consultations.

3. Designing a Graduation Policy

3.1 The Bank Group does not have a detailed graduation policy, partly because of the fact that no country has graduated from ADF-only status to blend country status since the Bank adopted its Credit Policy in 1995.[12] With the upcoming graduation of Cape Verde, it has become imperative for the Bank to decide whether and how to phase out eligibility for ADF resources for graduating countries.

The IDA's Graduation Policy

3.2 For reference, the IDA/IBRD graduation policy requires phasing out countries' access to IDA financing as their creditworthiness increases and they are able to take on more IBRD financing. Over time, this results in a gradual hardening of the blend ratio, preparing the country for full graduation from IDA.[13]

3.3 When IDA determines that a country should graduate, a graduation program is formulated, usually in the Country Assistance Strategy. This program comprises the following elements:[14]

- (i) A phasing-out of IDA lending (usually over a 2-5 year period);
- (ii) A phasing-in of IBRD lending (over the same period);
- (iii) Special economic and sector work and technical assistance to help address transition issues, such as improving access to commercial sources of lending; and
- (iv) An increased role for the Multilateral Investment Guarantee Agency and the International Finance Corporation to improve private sector capital inflows.

Each of these measures is tailored to the country's particular circumstances.

[12] The only countries to have graduated were Egypt, which graduated from blend country status to ADB-only country status, and Equatorial Guinea, which graduated directly from ADF-only country status to ADB-only country status (without going through blend status) following the World Bank's accelerated graduation of these countries in 1999.

[13] However, some countries have in the past graduated on an accelerated basis due either to improvements in the availability of country data, showing that the country's income was substantially higher than previously thought (Egypt in 1999), or to the development of a large amount of natural resources within the country (Equatorial Guinea in 1999).

[14] See International Development Association. January 2001. *IDA Eligibility Terms and Graduation Policies.* IDA's graduation policy also provides for the acceleration (doubling) of the repayment of IDA credits when a country is creditworthy for World Bank borrowing and its per capita gross national product reaches or exceeds the operational cut-off for IDA eligibility for 3 consecutive years. All IDA credits include an acceleration clause to that effect. However, acceleration has not been applied in practice and IDA's policy has instead been to reach out to these countries to become donors.

Designing a Graduation Policy that takes Individual Country Circumstances into Account

3.4 The Bank's graduation policy should anchor its policy recommendations in the country context and country-specific conditions: sustained, policy-induced graduations (e.g., Cape Verde) should be treated differently from graduations due to the discovery and development of a large amount of natural resources (e.g., Equatorial Guinea in 1999).[15] The Bank's strategy to support these countries in their transition to middle-income country status will differ in each case. Policy dialogue, economic and sector work, the phasing-out of ADF resources and a strategy for private sector development will need to be tailored to individual country circumstances. The Bank Group is also exploring the possibility of offering products that blend concessional and non-concessional financing to these countries. To the extent possible, the Bank's graduation policy should also be harmonized with the graduation policy of the World Bank.

3.5 One of the key issues of a possible graduation policy is whether to allow certain states to continue enjoying their full ADF allocation (in addition to access to ADB resources) after graduating in consideration of their special vulnerability and needs, as is done in the World Bank's small island economy exception. Given the large number of small and/or vulnerable states on the African continent and their diverse situations, however, it would be particularly challenging to single out a sub-group of African countries whose special needs are more deserving of an exception to the graduation policy than are the special needs of others.

3.6 Different categories used by existing Bank Group or IDA policies to determine country vulnerability are discussed briefly below:

- The current "fragility" criteria used in the Bank's strategy for enhanced engagement in fragile states (post-conflict or transition countries whose gross domestic product has contracted by more than 10 percent since 1990 and which rank in the bottom quintile of the United Nations Human Development Index) are not particularly relevant because they were selected to identify countries that require supplemental assistance at the time they come out of and transition from conflict. By the time these countries reach the applicable per capita cut-off level and/or become creditworthy, it is unlikely that these criteria will continue to be met. Accordingly it is unclear why these countries (originally numbering nine under ADF-11), which will have had to achieve significant recovery and economic growth in order to graduate, should be favored over other graduating countries or more needy ADF-only countries.

- Making an exception to the graduation policy according to the size of the country is also challenging in Africa because of the difficulty in adopting a cut-off point and because of the diversity of the economic situations of small countries under any given cut-off. According to the World Bank small state classification (i.e. states with a population of less than 1.5 million)[16], there are only four ADF small states. If the cut-off point was to be raised to 4.5 million, the number of ADF small states would increase to 11 (Table 2). Under any of the thresholds shown in Table 2, Cape Verde would be the only country to which the exception would currently apply, as it would be the only blend country.

[15] There is also the potential case of reverse graduation for countries that are ADB or blend and are being reclassified as blend or ADF only.

[16] The World Bank does not have a formal "small states" category for resource allocation purposes but largely refers to countries with a population of 1.5 million or less as small sates. Botswana, Jamaica, Lesotho, and Namibia also participated in the work of the Small States Task Force between 1998 and 2000 although their populations were above 1.5 million (see International Development Association. September 2007. *IDA's Performance-Based Allocation System: Simplification of the Formula and Other Outstanding Issues*; and International Development Association. 2004. *Supporting Small and Vulnerable States)*.

Table 2: Number of ADF Small States by Population

Population (million)[17]	Countries
1,5	Cape Verde, Comoros, Djibouti and Sao Tome & Principe
2,5	Countries above + the Gambia, Guinea Bissau and Lesotho
3.5	Countries above + Mauritania
4.5	Countries above + Central African Republic, Republic of Congo, and Liberia

- The small island economy category used by the World Bank to determine continued eligibility for IDA resources is based on the grounds that small island economies typically have high transportation costs and, because of their small populations, fewer opportunities to pursue economies of scale and severe human capital constraints. In Africa, this category includes only Cape Verde.[18]

3.7 If one rules out the fragility criteria used for the Fragile States Facility, the use of either of the other two categories described above (the small state category and small island economy category) would lead to Cape Verde's continued eligibility for full ADF allocation after graduation. Adopting the World Bank's small island economy category would mean harmonization of treatment with the World Bank on this issue, but this category would de facto be limited to one country.

3.8 This is only a preliminary discussion and fuller review of vulnerability criteria is required before deciding if a particular group of countries deserves an exception to ADF graduation rules. Additional work will be carried out to identify an adequate mix of criteria that are appropriate and applicable for the Bank and its clients and detailed proposals will be developed for discussion during the ADF-12 replenishment consultations.

4. Conclusion

4.1 Deputies are invited to take note of this report and provide preliminary views on the following issues, to inform Management's preparation of changes to the blend regime and its development of a graduation policy for ADF-12:

- The elimination of the 5 percent cap on the aggregate amount of resources available to blend countries and its replacement by country-specific caps;
- The application of shorter maturities to blend and gap countries in order to better adapt the terms of ADF financing to the different situations of ADF countries, thereby increasing the amount of reflows to the ADF over the long term; and
- Maintenance of full eligibility to ADF resources after graduation for a limited subset of particularly vulnerable countries.

4.2 Finally, Management is considering proposing to the ADF's Board of Directors that pending the adoption of a graduation policy for ADF-12, Cape Verde should exceptionally continue to be eligible for its full ADF allocation rather than for a reduced allocation if the cap were applied (i.e. UA 10.93 million instead of UA 5.9 million[19]). This exception would result in the aggregate amount of resources allocated to blend countries under ADF-11 totaling approximately 5.13 percent, i.e. slightly exceeding the 5 percent cap. Do Deputies support this approach until the Bank adopts a graduation policy?

[17] Using the 2007 United Nations population data series.
[18] Other countries are Dominica, Grenada, Kiribati, Maldives, Samoa, St. Lucia, St. Vincent and Grenadines, Tonga, and Vanuatu.
[19] Using 2009 PBA results.