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AFRICAN DEVELOPMENT FUND

ADF-VIII/CM.2/98/08

ADF-VIII OPERATIONAL PROGRAMME - SENSITIVITY ANALYSIS

ADF-VIII OPERATIONAL PROGRAMME – SENSITIVITY ANALYSIS

INTRODUCTION

1. At the first Consultative Meeting of the ADF-VIII replenishment held in Abidjan on 28 May 1998, the Deputies requested Management to prepare a sensitivity analysis of the ADF-VIII Operational Programme in response to possible lower resource replenishment levels. This note reviews the nature of the lending estimates, and outlines the possible implications of funding shortfalls.

PERFORMANCE AND SCOPE OF ADF-VII OPERATIONS

2. Over the ADF-VII period, the level of operations has increased from UA 199 million in 1996 to UA 745 million in 1997, and the lending objective for 1998 is UA 960 million. The implementation of ADF-VII had a slow start due to various reasons, some internal to the Bank (e.g. the restructuring of the Bank services with the resulting high vacancy ratio, especially at managerial level in the Operations Complex), and others attributable to the actions of borrowing member countries. Also, in keeping with the recommendations of the "*Action Plan for Improving the Quality of Bank Group Operations*" and the "*ADF-VII Lending Policy*", enhanced CSPs had to be prepared for borrowing member countries before any new lending operation. Moreover, the strict application of the Bank Group credit policy and ADF-VII operational guidelines required a critical review of all project proposals. These reassessments resulted in the cancellation of about 60 percent of projects/programmes and studies identified for the 1995/96 period.

3. It should also be noted that, because of the late completion of ADF-VII negotiations, the 1996 lending programme covered less than half a year. The year 1997 was, therefore, the first full year of operations under ADF-VII, although the implementation of the lending programme was (and is still) constrained by the lack of resources for multinational projects. The 1998 lending objective is UA 960 million, representing the balance of ADF-VII resources.

4. The progressive expansion in the ADF-VII lending programme has also been facilitated by the continued improvements in the economic performance of borrowing member countries. And, it has been achieved against the background of increased emphasis on project quality. The various measures taken with respect to project quality have been highlighted in the "*ADF-VII Mid-Term Report*", as well as in Section IV "*Enhancing Project/Programme Quality*" of the "*Proposal for the Eighth Replenishment of the African Development Fund (ADF-VIII)*". It should also be noted that ADF-VII resources have been allocated on the basis of country performance, as assessed in CSPs and in CSP Updates approved by the Board. As indicated in Table 1, about 92 percent of the ADF-VII resources allocated to countries had been earmarked for performing countries (i.e. 28 out of 41 ADF eligible countries) with normal and/or enhanced programmes.

Table 1
ADF-VII Resource Allocation

Performance-Based Allocation*	Number	Resources Allocated (UA million)	Percentage (%)
Enhanced	13	659.96	47.4
Normal	15	605.88	43.5
Reduced	3	47.50	3.4
Core	10	78.00	5.7
Total	**41****	**1,391.34**	**100.0**

** Under the enhanced programme, a strong performer country receives a 50 percent increase above the indicative country allocation; under the reduced programme, a weak performer receives up to 50 percent of the indicative allocation; a core performer receives no more than 20 percent of the indicative allocation.*

*** Nigeria, although eligible to ADF-VII resources, has opted not to borrow from multilateral sources at this time.*

5. ADF-VII guidelines stipulate that, up to 40 percent of project lending will be for agriculture and related activities, and 20 to 25 percent for the basic social sectors, and that, support to these sectors will account for the bulk of ADF-VII operations. The sectoral allocation during the 1996/1997 period has been in line with these sectoral targets. Cumulative commitments to the traditional agricultural sector alone amounted to about 20 percent of total commitments. However, when agricultural-related activities in public utilities and transport projects are taken into consideration, this percentage rises close to 44 percent. Similarly, the cumulative commitments to traditional social sectors accounted for 18.2 percent. This percentage rises to over 25 percent when stand-alone poverty alleviation projects are included. Thus, as summarized in Table 2 below, out of total ADF commitments of UA 944.34 million over the 1996/1997 period, UA 650.53 million, or about 69 percent were made on operations in agriculture and related activities, stand-alone poverty projects and the social sectors (see Annex I for details).

Table 2
ADF-VII Operations in Agriculture, Agriculture-Related and Social Sectors, 1996-1997
(UA million)

	Amount	Percentage
Agriculture	185.14	19.61
Social Sectors	171.92	18.21
Poverty Reduction/Women's Economic Activities	64.15	6.79
Road Rehabilitation (mainly rural roads)	136.78	14.48
Water Supply, Sanitation and Rural Electrification	92.54	9.80
Sub-Total	**650.53**	**68.89**
Total ADF-VII Commitments	944.34	100.00

BASIS FOR THE PROPOSED ADF-VIII REPLENISHMENT

6. The paper entitled "*Proposed ADF-VIII Replenishment Level*" presented an operational programme amounting to UA 3,150 million. This amount was derived from the normalized[1] ADF-VII replenishment level adjusted for inflation (UA 2,770 million) plus resource requirements for proposed new activities to be carried out under ADF-VIII (UA 380 million). It does not, however, reflect the loss ensuing from currency transactions, which amounted to UA 23.7 million in 1997 alone.

Table 3
Proposed Level of ADF-VIII
(UA million)

	ADF Resources	
1. ADF-VII Normalized over 3 years	**2,618**	
2. Inflation Adjustment [5.79 %]*	**152**	
3. Sub-Total (1 + 2)	**2,770**	
4. Current Activities Not Originally Provided for Under ADF-VII	**180**	
HIPCs		180
5. New Activities Under ADF-VIII	**200**	
Multinational Projects		150
Private Sector Guarantees		50
6. Grand Total (3) + (4) + (5)	**3,150**	

* *Inflation rate as measured by changes in the Manufacturing Unit Value, obtained from the World Bank "Commodity Markets and Developing Countries", Washington D.C., November 1997.*

The Proposed ADF-VIII Replenishment

7. The proposed ADF-VIII replenishment (UA 3,150 million) is justified by the improved absorptive capacity of Regional Member Countries (RMCs), and the need to sustain the net resource transfers from the Bank Group. It is also attainable in light of the strengthened internal capacity of the Bank Group to effectively prepare, appraise and monitor the implementation of development projects and programmes.

8. Absorptive Capacity. With regard to the absorptive capacity of borrowing member countries, it should be noted that over the last few years, Africa's economic recovery both accelerated and spread to more countries. However, it has been noted that, this recovery is largely the result of the short-term pay-off to reforms that followed years of ill-designed policies. Africa has very low capital stock relative to its labour force, and the current growth rates, albeit supported by the implementation of good policy reforms, are unsustainable at current investment levels. Over the 1994-1997 period, the average investment ratio for

[1] It will be recalled that the May 1996 ADF-VII Resolution had clearly acknowledged that, the agreed replenishment will cover a period of only 30 months due to the late completion of the negotiations. Therefore, for comparison purposes, the normalized replenishment adjusts this ADF-VII replenishment level to the standard three-year replenishment cycle.

African countries was about 20 percent[2]. This ratio is well below the level necessary to sustain strong economic recovery. In several low-income countries, the investment ratio is even lower, at less than 15 percent of GDP. Given the RMCs low level of domestic savings and still weak propensity to attract private investment, much of the increased investment requirements will have to be funded by public concessionnary resources.

9. The improved economic performance notwithstanding, Africa remains the poorest region as evidenced by the standard economic and social indicators. Despite significant improvements, a number of challenges remain. In the health sector, infant mortality rate, life expectancy at birth, maternal morbidity and mortality rates are among the highest in the world. Primary school enrolment has declined in the past decade, and Africa remains the only continent where average gross enrolment ratios for primary education have remained lower than 100 per cent; secondary school enrolment is only 24 percent, compared to 50 percent in other developing regions. In a continent where about 45 per cent of the population live below the poverty line, and where 70 per cent of the poor are rural, the challenge is to pursue rural development, including provision of basic rural economic and social infrastructure. The continent still lacks a transport system that can foster rural-urban links, the effective functioning of markets, and regional cooperation and integration.

10. In response to the above, the Fund is expected to continue to play a key role in supporting projects and programmes that provide basic social services to enhance human capital and foster income-earning opportunities for the poor. It is also expected to promote the incentive structure (policy and infrastructure) necessary for private sector, and sustainable development.

11. Net transfers. It is worth noting that net transfers by the Bank Group to ADF-only countries amounted to only UA 106 million in 1997, or UA 2.7 million per country on average. This is due to the fact that, ADF net transfers were largely offset by the negative ADB net transfers, on account of past ADB loans to these countries under the previous credit policy. ADB net transfers are negative and will remain so throughout the ADF-VIII period, worsening from UA 253 million in 1997 to UA 302 million in 2001. It is, therefore, important to set the ADF-VIII replenishment at a level which would ensure continued net positive transfers to ADF-only countries.

12. Project Quality. The issues pertaining to the strengthened internal capacity have been discussed in previous reports to the Deputies ("*ADF-VII Mid-Term Report*" and "*Proposal for the Eighth Replenishment of the African Development Fund)*". In summary, an Action Plan for Improving the Quality of Operations has been implemented since 1995. Measures under the Action Plan focus on issues relating to programming strategies, lending policies and practices, monitoring and post-evaluation and operational reporting through the various stages of the project cycle. The Action Plan aims at ensuring systematic application of existing guidelines, particularly with regard to country operational strategies, and scheduling of more effective project implementation, and supervision reporting. The Plan also provides for the preparation of Annual Portfolio Performance Reviews. The Action Plan has been incorporated into the regular operational system and the project cycle, to enhance the capacity to design, implement and monitor operational activities.

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[2] See "African Development Report 1998", African Development Bank, 1998.

SENSITIVITY ANALYSIS

ADF-VII and ADF-VIII Resources

13. Over the ADF-VIII period, projected cancellations are estimated at UA 75 million, and reflows at UA 180 million. These resources have been included in the alternative scenarios presented in Table 4 below on the sources of ADF-VII and ADF-VIII resources.

Table 4
Sources of ADF-VII & ADF-VIII Resources
(UA Million)

SOURCES	ADF-VII	ADF-VIII SCENARIOS				Proposed Replenishment Level
		I	II	III*	IV	
ADF Pledges	1,059	-	-	-	-	-
Supplementary Pledges	268	-	-	-	-	-
Botswana's Contribution	2	-	-	-	-	-
South Africa's Contribution	4	-	-	-	-	-
Total New Pledges	**1,333**	**1,333**	**1,927**	**2,363**	**2,515**	**2,895**
Italian ADF-VI Pledges	267	-	-	-	-	-
Reflows	114	180	180	180	180	180
Cancellations	468	75	75	75	75	75
Total ADF Resources	**2,182**	**1,588**	**2,182**	**2,618**	**2,770**	**3,150**
ADF-VII Normalized over 3 years	2,618	-	-	-	-	-
Inflation Adjustment	152	-	-	-	-	-
Total	**2,770**	**1,588**	**2,182**	**2,618**	**2,770**	**3,150**
Annual Average	**923**	**529**	**727**	**873**	**923**	**1,050**

* *Corresponds to normalized ADF-VII.*

Alternative Scenarios

14. Scenario I assumes total resources amounting to UA 1,588 million, equivalent to core ADF-VII pledges and projected reflows and cancellations over the ADF-VIII period. It would translate into a yearly average of UA 529 million, compared to an average of UA 873 million under the normalized ADF-VII. This would represent a decrease of 39.4 percent in nominal terms.

15. Scenario II assumes the availability of resources equivalent, in nominal terms, to that of ADF-VII (UA 2,182 million). This scenario would translate into a yearly average of UA 727 million, and it would imply a decrease of 16.7 percent compared to the normalized ADF-VII.

16. Scenario III would maintain the ADF-VIII replenishment at the same level in nominal terms as the normalized ADF-VII. Total resources would, therefore, amount to UA 2,618 million, averaging UA 873 million per year.

17. Scenario IV would maintain the ADF-VIII replenishment at the same level as the normalized ADF-VII level adjusted for inflation. Total resources would amount to UA 2,770 million, averaging UA 923 million per year. This would imply an increase of 5.8 percent over the normalized ADF-VII, corresponding to the inflation adjustment factor.

18. The proposed ADF-VIII replenishment level of UA 3,150 million would average UA 1,050 million per year, representing a 20.3 percent increase in nominal terms over the normalized ADF-VII. The proposed replenishment level provides limited resources for the new initiatives for HIPCs, multinational projects, and private sector guarantees. Without these initiatives, this scenario would correspond the normalized ADF-VII adjusted inflation (i.e. Scenario IV).

Sensitivity Analysis

Table 5
Alternative Scenarios for the Use of ADF-VIII Resources
(UA million)

	Normalized ADF-VII	Alternative Scenarios ADF-VIII				Proposed ADF-VIII Replenishment Level
		I	II	III	IV	
Total Resources	**2,618**	**1,588**	**2,182**	**2,618**	**2,770**	**3,150**
Less HIPCs	131	180	180	180	180	180
Less SFM*	133	90	90	90	90	90
Resources available for Operations	**2,354**	**1,318**	**1,912**	**2,348**	**2,500**	**2,880**
Project Lending (up to 70 %)	1,648	923	1,338	1644	1,750	2,016
PBL Operations (up to 22.5 %)	530	297	430	528	563	648
TAF Operations (up to 7.5 %)	176	98	144	176	187	216
Sectoral Allocations **						
Agriculture and Related Activities (Up to 40 % of Project Lending)	659	369	535	658	700	806
Average per Country	16.9	9.5	13.7	16.9	18.0	20.7
Social Sectors (up to 25 % of Project Lending)	412	231	335	411	438	504
Average per Country	10.6	5.9	8.6	10.5	11.2	12.9
Average Annual Lending Programme	785	439	637	783	833	960
Average Annual Lending per Country	20	11	16	20	21	23
Average Annual Lending per Performing Country ***	25	14	21	25	27	31

* *Total reflows during the ADF-VIII period are estimated to be UA 180 million, of which UA 90 million would be used for SFM.*
** *Sectoral allocations under ADF-VIII are shown for illustrative purposes only.*
*** *Assuming that the presently performing countries continue to receive 90% of resources available for operations.*

19. ADF as a Development Partner. Scenarios I and II imply a drastic reduction in both sector allocations and average annual lending per country. Such reductions would be in sharp contrast with the improved economic performance, as well as the increased absorptive capacity of borrowing member countries. Moreover, with such low average lending volumes, the ADF would become a marginal contributor to the development effort of its borrowing member countries at a time when their investment requirements are looming large. In this context, it should be noted that, the ADF would also play a secondary role to other development finance institutions operating in Africa.

20. A replenishment level lower than UA 3,150 million would also have major implications for the Fund's ability to pursue its poverty alleviation effort. As indicated in Table 5 above, under Scenarios I and II, resources allocated for the priority areas of agriculture and social sectors would allow for one project per country over the 3-year period, given the average ADF loan size of UA 9 million achieved during 1996-1997 period. Similarly, under Scenarios I and II, the average lending per country implies that, even for the performing countries, ADF involvement would be restricted to 1 to 2 projects per year. Such levels and frequency of ADF involvement would undermine its credibility with RMCs as a major development partner.

21. Net Transfers. As noted in the document entitled "Proposed ADF-VIII Replenishment Level", and in paragraph 11 above, net Bank Group transfers to ADF-only countries remain positive only on account of the sizeable net ADF transfers. This favourable position would deteriorate rapidly under any reduced replenishment level, particularly Scenarios I and II under which the average lending programme would represent respectively less than a half and two thirds of the proposed replenishment level. Under these conditions, there is a risk that the borrowing member countries would have little incentive to service their debt to the Bank Group, with a potential detrimental effect on the improved arrears situation experienced over the last two to three years.

22. Impact on PBL Operations. A lower replenishment level would also lead to reduced PBL allocations. Notwithstanding the problems encountered in past PBLs, which are currently being addressed by Management, cutbacks in PBL lending would limit the ADF activities in this area at a time when there is a growing consensus that, African countries must take greater responsibility for and ownership of their adjustment programmes, and when, there is an increasing recognition by RMCs and the donor community that, the Bank can play a constructive role in policy dialogue and reform. Furthermore, the Bank Group is increasingly invited by both the RMCs and the donor community to take the lead in the area of governance, especially the establishment of a macroeconomic and judiciary framework suitable for private sector promotion and sustainable development. Progress in these areas is dependent on the Fund's ability to provide a meaningful contribution and participate actively in the design and implementation of PBL operations. It should also be noted that a reduction in PBL would undermine the ADF's effort in poverty reduction. Various studies have shown that, increased public spending on health and education would need to be complemented by institutional and policy reforms that increase the effectiveness and access to these services.

23. Impact on TAF Operations. As regards TAF allocations, the proposed cutbacks would restrict the ADF capacity to provide much-needed assistance in developing a strong pipeline of national and multinational projects, and for institutional capacity building activities. Prevailing constraints in human, institutional and financial capacities of most RMCs, however, point to a continued and urgent need for more – not less – assistance in institution building and support to project cycle activities and economic management. The review of TAF operations has highlighted areas where improvement is needed for TAF to achieve its long-term objectives. Lessons have been drawn from this exercise, and necessary steps are being taken to redress this situation and make TAF the effective complement to the Bank's project lending that RMCs need.

CONCLUSION AND RECOMMENDATIONS

24. As noted above as well as in the previous paper submitted to the Deputies, the proposed replenishment level is essentially a renewal of the normalized ADF-VII adjusted for inflation. It provides limited additional resources only for the new initiatives and for the continuation of the HIPCs programme. However, it is a conservative estimate which does not take into account the possible resumption of ADF lending to the presently inactive countries, nor does it take into account the continued improvement in the economic performance of some countries. These developments would translate into additional investment requirements.

25. The above analysis and summarized information in Table 5 clearly show that a lower level of replenishment would drastically reduce the resources available for operations. Such reduction in Bank lending, particularly under Scenario I and II, would diminish the Bank Group's role in the development effort of its RMCs. Scenarios I and II are, thus, not viable options.

26. Any possible reduction along the line of Scenarios III and IV will have to take into account the need to protect the allocation for project lending. The allocation for project lending under the proposed replenishment level (UA 2016 million) represents the minimum level of resources required to allow the ADF to pursue effectively its poverty alleviation activities, and to contribute in a substantive way to the financing of the considerable investment requirements of RMCs. Accordingly, the possible reduction in ADF funding will have to be effected by eliminating the ADF contribution to the international HIPCs initiative. However, the exclusion of HIPCs would undermine the credibility of the Bank's effort in its collaboration with the Bretton Woods Institutions and its policy dialogue with RMCs on the debt issue.

27. In summary, only the proposed ADF-VIII replenishment level of UA 3,150 million would allow the Bank to make a meaningful contribution in propelling ADF countries towards such investment and growth rates that would assist in reducing poverty and promoting sustainable development.