



ADB



MEDIUM-TERM STRATEGY II  
2006–2008

May 2006



Asian Development Bank

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# Preface

The Asia and Pacific region is changing and growing at a breathtaking pace. Hundreds of millions of people now enjoy a better quality of life. Yet, in this region of growing prosperity, about 1.9 billion people live on less than \$2 a day, and over 620 million survive on less than even \$1 a day. One in five people do not have access to safe drinking water, and half the population is without proper sanitation. Over 4 million children below the age of five die every year. These conditions are unacceptable in today's Asia, and fighting poverty is our most urgent challenge.

An Asia and Pacific region free of poverty is our vision. It is also our mission and our passion. In 1999, the Asian Development Bank (ADB) adopted poverty reduction as its overarching goal. Pro-poor sustainable growth, social development and good governance were identified as the three pillars of our poverty reduction strategy. Following this, the long-term strategic framework (LTSF) 2001-2015 adopted these three pillars as its core areas of intervention. LTSF has also specified three crosscutting themes to reinforce these three pillars: promoting the role of the private sector, supporting regional cooperation and integration, and addressing environmental sustainability.

The medium-term strategy II (MTS II) 2006-2008 is the second in a series of medium-term strategies designed to flesh out the approach of the LTSF for shorter time periods, adjusting operational priorities in response to evolving conditions in each period. The pillars and themes of LTSF provide the basic frame of reference within which MTS II has been developed.

The main purpose of MTS II is to strengthen the poverty reduction impact of ADB's assistance programs in the context of the key challenges facing the region. To achieve this objective, MTS II has adopted five strategic priorities: catalyzing investment, strengthening inclusiveness, promoting regional cooperation and integration, managing the environment, and improving governance and preventing corruption. MTS II discusses how each of these strategic priorities will be pursued by ADB during the next few years. I should mention in this context that weakly performing countries face special circumstances that require a distinct strategic approach. We expect to have such an approach firmed up in a companion document to MTS II by the third quarter of this year.

MTS II also discusses several key adjustments in ADB's operational model that are necessary in order to make ADB a more responsive organization focused on results in the implementation of MTS II. The document also indicates a number of observable guideposts on how ADB's operational profile should evolve over the next few years. The strategic priorities of MTS II and proposed adjustments of the operational model will be incorporated in ADB's business plan, i.e., the Work Program and Budget Framework. The guideposts and the business plan will serve as milestones for Management to lead and monitor the implementation of MTS II.

MTS II has been developed through a consultative process that started long before the actual drafting of the document. In addition to the annual program consultations, the needs of developing member countries were comprehensively assessed during a review of ADB's poverty reduction strategy in 2004. These were reviewed in further consultations with developing member countries through 2004–2005. The actual drafting started with a Board and Management retreat in October 2005, followed by extensive internal consultations through a staff survey, focus group discussions, and several rounds of consultations with heads of departments and a panel of senior staff. A preliminary draft of MTS II was discussed in an informal Board session in February 2006, and the draft was also placed on ADB's website. The document has been finalized following Board discussions in March 2006, and taking into account the views of Governors expressed at the Hyderabad Annual Meeting. MTS II is thus the result of a truly collective effort.



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# Contents

	Page
<b>I. INTRODUCTION</b>	<b>1</b>
<b>II. BACKGROUND AND CONTEXT</b>	<b>2</b>
A. Major Development Trends and Challenges in the Region	2
B. The Corporate Planning Context	4
<b>III. THE STRATEGY</b>	<b>7</b>
A. The Approach	7
B. Catalyzing Investment	7
C. Strengthening Inclusiveness	10
D. Promoting Regional Cooperation and Integration	12
E. Managing the Environment	13
F. Improving Governance and Preventing Corruption	14
G. Assisting Weakly Performing Countries	15
<b>IV. THE OPERATIONAL MODEL</b>	<b>16</b>
A. Strengths and Limitations	16
B. Selectivity and Core Operational Sectors	17
C. Realigning the Organization	18
D. Use of Technical Assistance Resources	18
E. Use of Financing Partnerships and Cofinancing	19
F. Product and Process Innovations to Enhance Responsiveness, Flexibility and Efficiency	19
G. Portfolio Performance, Development Effectiveness, and Results	19
<b>V. CONCLUSION</b>	<b>21</b>
<b>APPENDIX</b>	
List of Medium-Term Strategy II Related Policy and Strategy Papers Recently Completed or Under Preparation	22

## ABBREVIATIONS

ADB	–	Asian Development Bank
ASEAN	–	Association of Southeast Asian Nations
CSP	–	country strategy and program
DMC	–	developing member country
FTA	–	free trade agreement
LTSF	–	long-term strategic framework
MDB	–	multilateral development bank
MDG	–	Millennium Development Goal
MIC	–	middle-income country
MTS	–	medium-term strategy
OCR	–	ordinary capital resources
PRC	–	People’s Republic of China
PRS	–	poverty reduction strategy
RCI	–	regional cooperation and integration
RD	–	regional department
TA	–	technical assistance

## NOTE

In this report, “\$” refers to US dollars.

# I. Introduction

1. The Asian Development Bank's (ADB) poverty reduction strategy (PRS) approved by the Board in 1999 adopted pro-poor sustainable economic growth, social development, and good governance as its three pillars. These were accordingly identified as the core areas of intervention in the long-term strategic framework (LTSF) for 2001–2015 which sets out a strategic framework for ADB's actions to pursue its vision of an Asia and Pacific region free of poverty. LTSF was laid out in broad terms to allow flexibility for adjustments in response to changing conditions. The role of the medium-term strategies starting with medium-term strategy I (MTS I) 2001–2005, is to translate the broad directions of the LTSF into more specific medium-term strategies.

2. MTS II was originally planned for 2006–2010. However, the region has been undergoing such rapid and far reaching changes that ADB's role and long-term strategy must be reviewed. Important choices have to be made under changing conditions. Some issues have already been identified as urgent. Accordingly, a two-track approach has been adopted. An independent panel of eminent persons will be requested to provide their assessment of key long term challenges facing the region and the role of ADB in that context. Following this, ADB will initiate a midterm review of the LTSF that will draw on wide ranging consultations with concerned stakeholders both within and outside the institution. Simultaneously, MTS II will introduce some strategic measures as the first steps of a more comprehensive longer-term ADB response. MTS II will be limited to 3 years (2006–2008), enabling the other elements of a more comprehensive longer-term strategy resulting from the midterm review of LTSF to be introduced by 2009 through MTS III.

3. MTS II aims to enhance ADB's **relevance** by meeting the key development challenges facing the region in reducing poverty. Five strategic priorities have been identified: (i) catalyzing investment, (ii) strengthening inclusiveness, (iii) promoting regional cooperation and integration (RCI), (iv) managing the environment, and

(v) improving governance and preventing corruption. Emphasizing ADB's catalytic role, MTS II proposes much greater recourse to financing partnerships and cofinancing along with its own financing resources, expertise and knowledge, in its efforts to help reduce poverty in the region.

4. An equally important question is how ADB will pursue these priorities. MTS II proposes adjustments in the operational model to address these "how" questions. To improve services to developing member countries (DMCs), MTS II identifies core operational sectors where ADB will focus its operations and for which it will build up a critical mass of expertise. The use of financing and technical assistance (TA) resources and the allocation of budgetary resources and staff skills mix will need to be adjusted accordingly. The organizational structure will have to be realigned. ADB will also build partnerships with other institutions, including financing partnerships and cofinancing, to leverage the poverty reduction impact of its own resources. Partnerships will be particularly important to meet the diverse needs of DMCs in fields outside ADB's core operational sectors. MTS II also calls for the systematic pilot testing of products recently introduced and further streamlining of business processes to make ADB more **responsive**, flexible and efficient. Finally, MTS II emphasizes the need for further adjustments in management priorities in response to the institutional **results** agenda that is being implemented in ADB to achieve greater development effectiveness. Such adjustments include a renewed emphasis on project implementation and portfolio performance, the application of quality-at-entry mechanisms and project readiness criteria, and the continuing development of results-based performance evaluation systems at all levels.

5. Section II discusses the background and context for MTS II. Section III presents the strategy. Section IV discusses adjustments in the operational model. Section V draws conclusions.

## II. Background and Context

### A. Major Development Trends and Challenges in the Region

6. The Asia and Pacific region has achieved significant reduction in income poverty in recent years. The proportion of the region's population surviving on \$1 or less a day came down from about 34% in 1990 to 19% in 2003,<sup>1</sup> and may have declined further by the end of 2005. The most significant factor underlying this achievement is the high level of economic growth. Growth is transforming Asia at a dramatic pace. The 1997 financial crisis marked a short interruption in a long period of sustained high growth in the Asia and Pacific region that is unparalleled in history. Not all the adverse effects of the crisis have been overcome, and growth varies significantly over time and across countries. Still, the region has grown at an average of about 6% per annum during the past 5 years. Now, middle-income countries<sup>2</sup> (MICs) of the region are increasingly diversifying and upgrading their work forces' skills as the region adjusts to new global supply chains, production structures, and firm behavior, triggered by advances in information and communication technologies.<sup>3</sup> This process is in its early stages, but has already had a major impact in many sectors. It is likely to profoundly change how the world does business and establish a new international division of labor. Its immediate implication is the progressive shift to a more skilled and productive workforce as the basis of competitiveness in MICs.

7. The story is less sanguine, however, in other DMCs, and even in the less developed areas within MICs. Here, the old paradigm of low productivity and low wage

employment, backed by a large reserve army of the unemployed or underemployed persists, intensifying the dualistic structure of development.<sup>4</sup> Thus, despite the rapid decline in poverty incidence, large numbers of people remain poor. Over 620 million people still live on \$1 or less a day and about 1.9 billion people live on less than \$2 a day. The large absolute numbers of poor people reflects large-scale underemployment in many DMCs, especially in South Asia, and low wages in rural areas and the urban informal sector, though open unemployment rates have also been rising. While the rural workforce accounts for the bulk of the poor, the low wage informal sector accounts for half or more of urban employment in many DMCs (footnote 1). The International Labour Organization recently emphasized that poverty remains predominantly rural despite rapid urbanization, and that the "working poor" (employed but surviving on less than \$2 a day) account for 87% of the workforce in South Asia, 58% in Southeast Asia, and 47% in East Asia.<sup>5</sup> Unless growth and productivity both rise faster to productively absorb the rapidly growing workforce, this problem will worsen.

8. Sustained growth and rapid poverty reduction in Asia is critically dependent on improving the region's poor investment climate. This is despite the recent success of some countries in attracting considerable investment, particularly in manufacturing and services. The International Monetary Fund recently pointed out that while the investment rate is very high in some MICs such as the People's Republic of China (PRC), the region's overall investment rate of around 25% may not be enough to sustain a regional growth rate of 6%.<sup>6</sup> Some estimates, for instance, quote an investment need of \$200 billion

<sup>1</sup> ADB. 2005. *Key Indicators: Labor Markets in Asia: Promoting Full, Productive and Decent Employment*. Manila.

<sup>2</sup> For a discussion of the concept of "middle income countries" see ADB. 2006. *Enhancing Asian Development Bank Support to Middle Income Countries and Ordinary Capital Resources Borrowers*. Draft under Preparation. Manila. The term "country" as used in the context of ADB, refers to a member of ADB and does not imply any view on the part of ADB as to the member's sovereignty or independent status.

<sup>3</sup> Borrus, M, D. Ernst, and S. Haggard, eds. 2000. *International Production Networks in Asia: Rivalry or Riches?* London: Routledge Press.

<sup>4</sup> In a recent paper revisiting Arthur Lewis' celebrated theory of growth developed some 50 years ago, Gary Fields concludes that this dualistic model of growth remains very much valid today, both in Asia as well as the developing world at large (Fields, G. 2004. Dualism in the Labor Market: A Perspective on the Lewis Model After Half a Century. *The Manchester School*. December, 724-735). See also Felipe J., and R. Hasan, eds. 2006. *Labor Markets in Asia: Issues and Perspectives*. London: Palgrave and MacMillan.

<sup>5</sup> International Labour Office Regional Office for The Asia and Pacific. 2005. *Labour and Social Trends in Asia and the Pacific*. Bangkok: International Labour Organization.

<sup>6</sup> International Monetary Fund. 2005. *Regional Outlook September 2005: Asia and Pacific Department*. Washington, DC.

per year for infrastructure development and maintenance in East Asia alone.<sup>7</sup> Not only the PRC but several other developing countries have large savings surpluses that are invested outside the region. The average savings rate in DMCs in the region during the last 5 years has been around 27% (excluding the PRC), while the investment rate has averaged a little over 24%.<sup>8</sup> Clearly, private investors do not find the investment climate and opportunities attractive. This is particularly a challenge in those DMCs which are currently unable to attract much foreign investment. Besides policy uncertainties, weak governance, poor infrastructure, and immature financial markets compound the problem.

9. Furthermore, while the region is broadly on track for achieving the Millennium Development Goals (MDGs) for reducing “income poverty”, it is much less so for MDGs related to non-income dimensions of poverty. Many DMCs may fail to achieve the goals on children’s undernutrition, net primary enrollment rate, and reduction of infant and maternal mortality.<sup>9</sup> Success in reducing income poverty will not, by itself, lead to adequately improved living standards. Only a balanced attack on the income and non-income aspects of poverty can deliver a better quality of life for the poor. It is now well recognized in this context that under-achievement in these MDGs is closely linked to the situation of women in many DMCs (itself the focus of a separate MDG). In the absence of concerted action to improve the status of women and remove gender discrimination, therefore, the non-income dimensions of poverty will not be tackled effectively.

10. The growing momentum of RCI provides an opportunity to strengthen growth and reduce poverty. Several regional cooperation initiatives have been launched since the 1960s, including the Association for Southeast

Asian Nations (ASEAN, 1967), South Asia Association for Regional Cooperation (1985), and Greater Mekong Subregion initiative (1992). The end of the cold war gave a major push to RCI.<sup>10</sup> The trend was reinforced by the 1997 crisis that showed how much the region stood to gain through cooperation. The main force driving regional integration today is the growth of intra-regional trade, which now accounts for over 50% of total trade in the region.<sup>11</sup> Integration of the region has been led by market forces. However, it has major implications for public action if the benefits are to be sustainably and equitably shared, and the risks managed, as evidenced by several recent initiatives.<sup>12</sup> Many opportunities arising from RCI, in addition to trade and finance, are in the nature of regional public goods that will strengthen growth and reduce poverty. These include cross-border infrastructure projects, the coordination of cross-border movement of goods and people, containment of cross-border air and water pollution, prevention of communicable diseases and coping with natural disasters.

11. RCI is an important platform to reinforce individual DMC efforts on poverty reduction since greater trade and investment integration, and strengthened connectivity in the region, enhance the growth potential of DMCs. Furthermore, RCI is important for reducing intra-regional disparities through cross-country growth convergence. Closer trade integration, the formation of intra-regional supply chains, and stronger financial linkages will enable the smaller and slower-growing countries to align their growth rates to those of larger and faster-growing countries.<sup>13</sup>

12. High growth has environmental costs. Demographic pressure and growth are driving rapid urbanization, with 36% of Asians now living in urban areas,

<sup>7</sup> ADB, Japan Bank for International Cooperation, and World Bank. 2005. *Connecting East Asia: A New Framework for Infrastructure*. Washington, DC.

<sup>8</sup> There are also important inter-country variations. While savings rates are high in countries with a capital surplus, they fall short of investment rates—which are themselves inadequate—in most DMCs, many of which do not have access to the international capital market.

<sup>9</sup> ADB, United Nations Development Programme, and United Nations Economic and Social Commission for Asia and the Pacific. 2005. *A Future Within Reach: Reshaping Institutions in a Region of Disparities to Meet the Millennium Development Goals in Asia and the Pacific*. Bangkok.

<sup>10</sup> Ohno, K. 2002. The East Asian Experience of Economic Development and Cooperation. *National Graduate Institute for Policy Studies*. Background Paper for the RIETI/METI seminar at the World Summit on Sustainable Development in Johannesburg.

<sup>11</sup> Kawai, M. 2005. East Asian Economic Regionalism: Progress and Challenges. *Journal of Asian Economics*, 16, pp. 29-55. Tokyo.

<sup>12</sup> These include the ASEAN surveillance process, the Chiang Mai initiative on liquidity support through bilateral swap agreements, enlarged in Istanbul in May 2005, and the Asian Bond Market initiative to mobilize the region’s savings for investment within the region.

<sup>13</sup> Sauv , P. 2005. Economic Impact and Social Adjustment Costs of Accession to the World Trade Organization: Cambodia and Nepal. *Asia Pacific Trade and Investment Review*. April, 27-49. See also Ali, I. 2005. *A Tripolar Asia: Implications for ASEAN*. Paper presented at the 30<sup>th</sup> Annual Conference of the Federation of ASEAN Economic Associations. Makati: Asian Institute of Management, 24-25 November.

and as many as 11 megacities each supporting over 10 million people.<sup>14</sup> Urban infrastructure is collapsing in many of these cities, and water and air quality are deteriorating. The rapid depletion of energy and other mineral resources threatens the sustainability of high growth. There is growing evidence that the present paradigm of energy-intensive growth and consumption may be leading to climate change. Most countries are off track on the MDG for providing access to potable water in rural areas, and forest cover and biodiversity resources are declining in many DMCs. Annual tropical deforestation is among the highest in the world. The region remains one of the richest biological reserves, but population pressure and growth have led to destructive land use, fragmenting and destroying primary forests, wetlands, and grasslands, further triggering habitat changes and specie losses. Water supply has been affected by population growth and distributional changes (urban, industrial) while coastal erosion and degradation have taken their toll on the biodiversity of marine and coastal resources.<sup>15</sup> Using a single index “per person ecological footprint” (analogous to the human development index), the World Wide Fund for Nature estimates that the region now requires 1.3 global hectares (ha) of biologically productive area per person, but the region has only 0.7 global ha per person, resulting in damaged ecosystems and more and more people living in degraded environments.<sup>16</sup> Finally, ADB’s operations face the challenge of disasters. The World Disaster Report and technical analyses of specific disasters show the increasing frequency and magnitude of damage.<sup>17</sup>

13. Governance remains weak and there is a high incidence of corruption in many DMCs. Available indicators

of governance point to a governance deficit in the region.<sup>18</sup> Corruption, inefficiency, and poor capacity in public systems not only impede investment but also add large transaction costs to ongoing private economic activities, reduce the quality of life, and weaken public social and economic programs, sapping the energy from and eroding the effectiveness of DMCs’ development efforts. However, governance covers a wide range of activities. Its boundaries must be rigorously defined, and its components disentangled.<sup>19</sup> Efforts to improve governance must be distinguished from efforts to prevent corruption. Improving governance entails enhancing the efficiency and transparency of government processes for the common good, while curbing corruption is reducing the abuse of public office for private gain.<sup>20</sup> In both cases the toll on the poor is high.

14. The key development challenges facing the region stem from the main regional development trends discussed above. These include (i) improving the investment climate, (ii) making development more inclusive, (iii) consolidating the trend of RCI, (iv) better managing the environment, and (v) strengthening governance and preventing corruption. Their relative importance will vary across countries, and for some countries, certain country-specific challenges may be more important than these issues. In weakly performing countries for instance, their circumstances and predominant challenges are quite different from those listed here.

#### B. The Corporate Planning Context

15. The PRS identified pro-poor sustainable economic growth, social development, and good governance as its

<sup>14</sup> Lohani, B. 2005. Financing the City: ADB’s Perspective. Paper presented at the ADB Annual Meeting Seminar on Financing the City. Istanbul, Turkey. 3 May.

<sup>15</sup> United Nations Environment Programme. 2002. *Asia Pacific Environment Outlook 2*. Thailand.

<sup>16</sup> Global Footprint Network and World Wide Fund for Nature. 2005. *Asia-Pacific 2005: The Ecological Footprint and Natural Wealth*. Cambridge.

<sup>17</sup> Between 1994-1998 and 1999-2003, the average number of disasters increased from 428 per year to 707, with the greatest increase (124%) in developing countries. The annual frequency of floods has doubled in the last 30 years, and Asia accounts for 40% of the increase. (Dutta, D. and S. Herath. 2004. Trend of Floods in Asia and Flood Risk Management with Integrated Risk Basin Approach. *Proceedings of the Second International Conference of Asia-Pacific: Hydrology and Water Resources Association*. Singapore; Integrated Regional Information Networks. 2005. Disaster Reduction and the Human Cost of Disaster. *IRIN Web Special*. UN Office for the Coordination of Humanitarian Affairs).

<sup>18</sup> Kaufmann, D., A. Kraay, and P. Zoido-Lobaton. 2002. *Governance Matters II: Updated Governance Indicators for 2000-01*. Working Paper No. 2772, World Bank Policy Research Department, Washington, DC.

<sup>19</sup> Quibria, M.G. 2005. Does Governance Matter? Yes, No or Maybe: Some Evidence from Developing Asia. OED Working Paper, ADB. Manila.

<sup>20</sup> Kaufmann, D. 2005. Back to Basics—10 Myths About Governance and Corruption. *IMF Finance and Development*, 42 (3).

three pillars.<sup>21</sup> The LTSF specified three crosscutting strategic themes to reinforce these pillars: (i) promoting the role of the private sector in development, (ii) supporting RCI, and (iii) addressing environmental sustainability. MTS I covering the years 2001–2005 emphasized the importance of the private sector in mobilizing resources, and ADB’s catalytic role. MTS I also underlined the importance of country ownership and leadership of the development agenda, a long-term approach to development assistance, improvement of strategic alliances and partnerships, measurement of development impacts, the strategic role of learning and expertise, and the importance of flexibility to allow ADB to be more responsive. These themes and operating principles remain valid, and need to be pursued further where the agenda remains incomplete.<sup>22</sup> During the MTS I period ADB’s own scale of operations stagnated, despite the huge development needs of the region. This raises concerns about ADB’s relevance and responsiveness. These concerns provide the basis for determining ADB’s strategic and operational priorities in response to the key regional challenges outlined above.

16. ADB’s priorities also need to reflect the international consensus on development assistance embodied in the Paris Declaration on Aid Effectiveness and the United Nations Millennium+5 Summit in 2005. ADB and its bilateral and multilateral development partners are committed to aligning assistance more closely with DMC development priorities and country systems, greater harmonization of assistance programs among the development partners themselves, and an increasing emphasis on managing for development results. As a key regional institution in the architecture of international development assistance, ADB needs to show leadership in applying these principles in its operational strategy.

17. Finally, in applying these principles and drawing on the lessons of MTS I, MTS II needs to adopt a clear set of priorities and changes in its operational model, where appropriate, to implement the core areas of intervention and crosscutting themes of the LTSF more effectively in pursuit of the goal of poverty reduction.

<sup>21</sup> The PRS was reviewed in 2004, and has been enhanced (ADB. 2004. *Review of the Asian Development Bank’s Poverty Reduction Strategy*. Manila). Poverty reduction has been reinterpreted as the MDGs which the international development community is committed to achieve by 2015. For a detailed assessment of the degree to which the region is achieving the goals see footnote 9. The major changes in the enhanced PRS include: (i) refinement in strategic direction including greater country focus and alignment of ADB operations with a country’s own PRS; (ii) increased attention to results, monitoring, and evaluation; (iii) greater emphasis on capacity development, adopting this as a thematic priority in addition to the original PRS thematic priorities of private sector development, gender, environment, and regional cooperation; (iv) revision of ADB’s project classification to introduce the category of targeted intervention; and (v) removal of project category lending targets.

<sup>22</sup> ADB. 2005. *A Report on the Implementation of Medium-Term Strategy (2001-2005)*. Manila. The main findings are summarized in Box 1.

### Box 1: Report on the Implementation of Medium-Term Strategy I (2001–2005)

#### Overview

The first medium-term strategy (MTS I, 2001–2005) set priorities for Asian Development Bank (ADB) operations based on the strategic agenda laid out in the long-term strategic framework 2001–2015. It was agreed at that time that MTS I would be reviewed after 5 years to summarize progress in implementation, as well as to provide a context for formulating the second medium-term strategy (MTS II).

#### Main Themes of MTS I

- **Country Ownership and Long-Term Approach.** MTS I advocated measures for ADB to ensure country ownership and adopt a long-term approach in its involvement with developing member countries (DMCs), including committing to greater focus and selectivity within countries, more in-depth sector and country analyses, and responsive and flexible approaches to changes in country circumstances.
- **Strategic Alliances and Partnerships.** MTS I called for ADB to define and realize opportunities for partner collaboration in all phases of operations and to better align institutional policies and procedures to achieve development results. MTS I also recognized the importance of regional and subregional initiatives and the need for ADB to collaborate with its DMCs in addressing cross-border issues.
- **Development Effectiveness.** To help DMCs achieve the Millennium Development Goals, ADB must become more relevant, responsive, and results-focused. This must include improving operational policies, strategies, and approaches; mainstreaming management for development results; refining business processes and organizational structure; improving systems for managing knowledge; and enhancing human resource management systems and procedures.
- **Organizational Alignment.** MTS I emphasized the need to better align the organization to increase the effectiveness of operations, including developing more flexible and responsive business processes, offering new and innovative assistance modalities, and integrating resource management.

#### Main Findings

- **Achieving Development Effectiveness.** ADB has taken important steps toward development effectiveness, including formulating a new results-based work program and budget framework (2006–2008) and introducing results-based country strategy and programs (CSPs). However, ADB's evolving mandate, instruments, and resources make selectivity essential for achieving results. ADB must now deepen its commitment to manage all of its operations and activities for results.
- **Ongoing Initiatives to Enhance Organizational Performance.** During MTS I, ADB implemented a number of initiatives to improve organizational efficacy. The most important of these include a major reorganization and implementation of streamlined business processes, which included making the Operations Evaluation Department independent; review of the poverty reduction strategy; a revised performance-based allocation policy; a unified public communications policy and upgrading of the Office of External Relations to a department; creation of a new accountability mechanism; introduction of a new human resources strategy; establishment of the Office of Regional Economic Integration; establishment of the Risk Management Unit; and establishment of the Special Initiatives Group in the Regional and Sustainable Development Department. ADB also adopted a comprehensive reform agenda in 2004.
- **Context for MTS II.** During the MTS I period, ADB's annual loan approvals and disbursements stagnated. This requires ADB to examine its relevance and responsiveness to DMC needs. The review of MTS I identified a number of important issues for which implementation of the MTS I agenda remains incomplete. Efforts need to be intensified during MTS II to complete these tasks. These include the need to become more selective, remain relevant to ordinary capital resources borrowers, mainstream results orientation, increase effectiveness of private sector development, be more proactive in regional cooperation and integration, improve CSPs, and improve knowledge products and services and technical assistance.

# III. The Strategy

## A. The Approach

18. MTS II aims to strengthen the effectiveness of the PRS in addressing the goal of poverty reduction in the context of the key regional challenges identified above. It has adopted the following five strategic priorities: (i) catalyzing investment, (ii) strengthening inclusiveness, (iii) promoting RCI, (iv) managing the environment, and (v) improving governance and preventing corruption. Each of these strategic priorities is further discussed below.<sup>23</sup> In many respects these priorities reflect themes that were already identified in MTS I, and carry forward its unfinished agenda. The difference is that MTS II is focused on the specific means of operationalizing and implementing the strategic agenda.

19. How the strategic priorities are operationalized and blended in different DMCs will vary greatly given the DMCs' enormous diversity. There are large, densely populated MICs, which are rapidly emerging as global economic powers. At the same time, there are the tiny island economies and small landlocked mountain economies. Some DMCs have access to international capital markets while others do not. Some have reasonably well-developed financial markets and other institutions of a market economy, while others do not. Governance capacity of public institutions, physical infrastructure development, and social development as reflected in the education and health MDGs vary greatly among countries. Clearly, a "one size fits all" approach would be inappropriate in this context. Accordingly, the five strategic priorities, while selective, are sufficiently broad to accommodate the wide diversity of country conditions and assistance needs of ADB's DMCs.

20. Thus, while MTS II will move ADB toward the set of identified institutional priorities, the profile of ADB's assistance will vary considerably between different groups of DMCs. The country strategy and programs (CSPs) are the key documents to ensure country focus and selectivity

at the country level within the framework of MTS II. The CSPs will reflect DMCs' specific needs, demarcating the intersection of ADB's institutional priorities and the country's development priorities. The same institution may play a very different role in, say, countries that are eligible for mainly or only ordinary capital resources (OCR) as compared to countries that are eligible for mainly or only Asian Development Fund resources under ADB's country classification. The possibility of reflecting this country classification in ADB's policies and procedures also needs to be explored, as suggested in the recent dialogue with MICs and countries eligible for OCR funding (footnote 2). Finally, the group of weakly performing countries has needs that are so different—and so difficult to address—that in addition to an overall ADB strategy, a distinct strategic approach will have to be developed for these countries.

## B. Catalyzing Investment

21. Asia's transformation is being led by the private sector. In this environment, rapid poverty reduction in most DMCs is critically dependent on a higher level of private investment that will create employment and improve productivity. This in turn requires improvement of the poor investment climate. As a recent World Economic Forum report points out, huge resources can be tapped from the private sector, provided the investment climate is suitable and the appropriate risk mitigation products and instruments can be deployed to mobilize these resources.<sup>24</sup> ADB's own scale of operations is small compared with the region's size, and the direct impact of its investment is at best marginal. However, ADB can leverage more and better investment from other sources within and outside the region; especially from the private sector which accounts for over 70% of total investment. Clearly, ADB has to engage in private sector development and catalyzing private investment as part of its core business for accomplishing the mission of poverty reduction. To this end, ADB must use the whole range of its products and services, including sovereign and nonsovereign loans,

<sup>23</sup> The logical framework linking the strategic priorities to interventions, implementation modality, and the monitoring mechanism is presented in Figure 1.

<sup>24</sup> World Economic Forum. 2005. *Building on the Monterrey Consensus: The Untapped Potential of Development Finance to Catalyze Private Investment*. Geneva.

**Figure 1: MTS II Strategy, Interventions, Implementation and Monitoring**



grants and investments; guarantees, complementary financing scheme, syndications, and loan and grant administration services; expertise and TA. Its good relationship with DMC governments and its good standing with investors are also valuable assets that it can use to help improve the investment climate and generate attractive investment opportunities.

22. The greatest impediment to private investment is the high level of risk arising from policy uncertainty, market distortions, and legal and regulatory weaknesses. All these raise transaction costs, and the uncertainty about expected rates of return on investment.<sup>25</sup> Hence, assistance for policy and institutional reform in DMCs would be one of the main planks of ADB support. Program and sector development loans will be important tools for such assistance together with economic, thematic and sector work, TA, and policy advice. Reform elements can also be built into project loans, as is increasingly the case in recent years.

23. Another major constraint to higher investment is the lack of good infrastructure in urban and rural areas. In most DMCs, inadequate and unstable power supply, inefficient transport systems, poor quality roads, weak and ageing railroad networks, badly equipped and congested ports and airports, unreliable communications systems, and grossly inadequate urban infrastructure raise transaction costs, curtail productivity, and often render investments unviable. In some cases, the transaction costs include health costs because of higher pollution, e.g., poor urban transport systems leading to deteriorating air quality. A concerted push to infrastructure development will thus help step up the pace of poverty reduction through higher investment and growth. It will also contribute more directly to poverty reduction since improved connectivity immediately enhances livelihood opportunities and access to basic health and education services which are integral to reducing the non-income dimensions of poverty.

24. Over the past three decades, ADB has directed a significant share of its loans toward infrastructure development, averaging about 50% for energy, transport and water supply and sanitation. However, its interventions have evolved into more complex policy and operational structures to complement the progress of initiatives by DMCs. The investment in physical facilities that

characterized earlier projects is now accompanied by an array of sector and institutional reform measures to improve efficiency in resource management and service provision, and ensure strict compliance with safeguards. This trend has to be reinforced. Private investors have generally been reluctant to enter the infrastructure field because of the high risks involved and infrastructure has largely remained in the public sector. A major recent thrust for ADB has thus been to develop public–private partnerships, which should be a priority in those DMCs where this is feasible. Particularly important will be ADB’s nonsovereign lending operations, and use of its guarantee and credit enhancement products to mitigate risk.

25. The third major impediment to private investment is the narrow skill base of human resources. Development of quality human resources and investment in education and health will be important to sharpen the region’s competitive edge, and a major factor in catalyzing more private investment. Apart from their instrumental value (upgrading human resources), such investments have the intrinsic merit of enhancing capabilities and the quality of life. This is especially relevant in the case of public investment in basic education and health services for poor people, who would not have access to these services in the absence of such investments. This will be the third plank of ADB’s catalytic role in improving the investment climate.

26. Apart from assistance to improve the overall investment climate, ADB can also use its loan, investment and credit enhancement instruments to leverage cofinancing with public and private sector partners. For example, in one recent project (Nam Theun 2 Power Project in the Lao People’s Democratic Republic) ADB’s \$70 million investment (including a \$20 million public sector loan and a \$50 million private sector loan), and a \$50 million political risk guarantee leveraged, along with the World Bank and other partners, a total investment of \$1.45 billion. This illustrates that ADB can use its own investments to actively promote good projects and catalyze additional private investment. This is particularly important in the poor and less developed DMCs where domestic private enterprise is still limited and foreign investors are reluctant to invest on their own. Products of particular interest from the leveraging angle are ADB’s political risk and credit risk guarantees. ADB’s contribution is the offer to absorb, for

<sup>25</sup> See footnote 6 and Kuroda, H. 2005. The Conundrums of Global Bond Markets—An Asian Perspective. Speech at the Global Bond Summit, Hong Kong, China, 16 November.

a fee, the whole or a part of the risk of debt servicing default for political or commercial reasons. The leveraging impact and incentive to apply these guarantees would be much stronger if headroom commitment practices were adjusted to reflect the actuarially computed contingent liability of guarantees.<sup>26</sup>

27. Projections using ADB's financial model indicate that with some adjustments in loan loss provisioning and capital adequacy norms, to account for the higher risk of its private sector operations compared to public sector lending, ADB could significantly raise the share of its private sector operations while still preserving its AAA credit rating. How far ADB should scale up either its overall operations or the share of its private sector operations over the next 10 years is a question with long-term implications. It will have to be addressed in the context of the review of the LTSF. MTS II only calls for a concerted effort toward more private sector operations. This will entail a significant enhancement of ADB's risk management capability and associated adjustments in the skills mix of staff. Systems will also have to be put in place for the recently established Risk Management Unit to work in close coordination with the regional departments (RDs), the Private Sector Operations Department, and the Office of Cofinancing Operations. Synergy and teamwork cutting across these departments/offices are key for ADB's success in catalyzing private investment.

28. Private sector operations are integral to private sector development, a thematic priority under the LTSF. While commercial viability is undoubtedly important in selecting projects for leveraging private investment, such selection has to be guided by the projects' development impact. In this regard, MTS II endorses the recommendation of the internal task force on private sector development strategy that ADB should prioritize transactions that

- (i) have a strong demonstration effect (i.e., those that test markets and create confidence);

- (ii) are innovative and pioneering (i.e., those in frontier countries, sectors, and financing structures); and
- (iii) are replicable by ADB and others in the country and elsewhere.

The task force has also identified a number of key challenges that need to be met if ADB is to play a more effective role in private sector development, and specified actions to implement the revised strategy.<sup>27</sup> These are summarized in Box 2. As recommended by the task force, relevant sector road maps in CSPs will henceforth form the basis of all ADB interventions to support private sector development in a country, including private sector operations.

### C. Strengthening Inclusiveness

29. Inclusive patterns of growth and social development enable disadvantaged groups to benefit equitably from the opportunities that development provides. The main operational implication of this strategic priority is to selectively focus on operations that promote productivity enhancing reforms, employment intensive rural development and social development. The rationale for each of these elements is discussed below.

30. High growth is the most powerful vehicle to rapidly reduce income poverty.<sup>28</sup> It generates the jobs and income needed to lift people out of poverty. However, in many DMCs there is a growing pool of the "working poor" who are employed but have such low productivity and earn so little that they remain impoverished. Inclusiveness requires ADB's assistance to be directed not only to promote higher growth, increasing employment, but also to promote higher productivity which would raise wages. The policy and institutional reforms to improve the investment climate, which will help establish efficient and competitive markets that drive growth and productivity, are therefore equally important to strengthen inclusive growth.

<sup>26</sup> A review of ADB's guarantee and credit enhancement policies is planned for 2006 to ensure that ADB's products are better aligned with best market practices and meet client demands in this area.

<sup>27</sup> ADB. 2006. *Private Sector Development: A Revised Strategic Framework*. Manila.

<sup>28</sup> On the strong linkage between growth and poverty reduction, especially in Asia, see among others, (i) Ahluwalia, M. S. 2002. *Poverty, Growth and Globalization: Facts, Myths and Misconceptions*. Lecture delivered under the Distinguished Speakers Program. ADB, Manila, 30 January; (ii) DFID. 2002. *Making Connections: Infrastructure for Poverty Reduction*. Government of United Kingdom. Department for International Development. London; (iii) Leather, W. 2002. *A Review of Ten Poverty Reduction Strategy Papers*. Overseas Development Institute PRSP; (iv) Quibria, M. G. 2002. *Growth and Poverty Lessons from the East Asian Miracle*. Tokyo: ADB Institute; (v) Ali, I. and E. M. Pernia. 2003. *Infrastructure and Poverty Reduction – What is the Connection?* ERD Policy Brief Series No. 13. Manila; and (vi) Islam, R. 2004. *The Nexus of Economic Growth, Employment and Poverty: An Empirical Analysis*. *Issues in Employment and Poverty Discussion Paper 14*. Geneva: International Labour Office Recovery and Reconstruction Department.

## Box 2: MTS II and the Strategic Framework for Private Sector Development Actions Toward Successful Execution

The report identifies actions toward the successful execution of the strategic framework for private sector development (PSD). It recommends that PSD be recognized as a core business theme in MTS II. This has been done with catalyzing investment as a major priority of MTS II.

The report also suggests a number of other actions:

- **Establish best practice policies and processes.** Systematically screen and monitor PSD transactions, review existing restrictions on private sector operations, and clarify reporting. **(IIQ 2006)**
- **Clarify accountabilities and improve teamwork.** Define accountabilities for activities within the business cycle and processes for enforcement, including responsibilities of operational support departments, and introduce systems to ensure inter-departmental teamwork. **(IIQ 2006)**
- **Promote cofinancing.** Reconfirm the mobilization of funds from others as a major priority. Update policies on credit enhancements and the cofinancing strategy. **(IIQ 2006)**
- **Provide market-oriented products and services.** Continue to implement innovation and efficiency initiative proposals with pilot-testing and explore the need to design more instruments. **(Ongoing through 2006-2008)**
- **Ensure that skills and human resources are adequate.** Develop a skills development program and create incentives structures that reward teamwork. **(IIQ 2006)**
- **Strengthen risk management capacity.** Establish and enforce clear policies and procedures for independent risk assessment and management. **(IIQ 2006)**
- **Improve client relationship management.** Manage client relationships more systematically guided by “one ADB, one voice” principle. **(Ongoing through 2006-2008)**

31. More importantly, rapid urbanization notwithstanding, poverty remains a mainly rural phenomenon, with over 70% of Asia’s poor living in rural areas.<sup>29</sup> In the medium term, any credible program of attacking poverty through inclusive growth has to focus on the rural sector. However, the rural sector should not be equated with agriculture; there are limits to the labor absorption capacity of agriculture. A poverty reduction strategy for rural areas has to focus on diversifying the rural economy and expanding off-farm employment in rural industries and services alongside developing agriculture. Developing rural finance and rural infrastructure such as rural roads and rural power, which are essential to expand both farm and off-farm employment, are as important as agriculture specific investments in irrigation and water management, improvement of production technologies and farming practices, etc. Rural roads in particular have

been shown to be one of the most effective forms of investment for reducing rural poverty (see para 23 above). Thus, in its strategy to alleviate rural poverty, ADB should focus on rural roads, power, and finance; and irrigation and water management; where it has a good track record and can maintain the necessary critical mass of expertise. This approach can be further strengthened by targeting operations for less developed areas within DMCs where poverty is concentrated.<sup>30</sup>

32. Market-driven processes such as high growth and rising productivity are important for rapid and sustained poverty reduction. However, these market driven processes are not sufficient to reduce poverty. The market system responds to economic incentives, not society’s socio-political goals. Its inability to ensure equity is one of its greatest failures. Supporting inclusive social development,

<sup>29</sup> Estimated from ADB. 2005. *Key Indicators: Labor Markets in Asia: Promoting Full, Productive and Decent Employment*. Manila; and World Bank. 2005. *World Development Indicators Online*. Available: <http://devdata.worldbank.org>.

<sup>30</sup> Reducing poverty through growth and productivity increase still leaves the problem of vulnerable groups such as the aged and the disabled, and safety nets for those who remain unemployed despite the tightening of the labor market. In the main, providing safety nets is best left to specialized institutions such as the International Labour Organization, acting in partnership with national governments and nongovernment organizations. However, some of ADB’s capital market interventions, such as pension reforms for the formal and informal sectors can be useful.

the main pillar for reducing the non-income dimensions of poverty, is equally important. As mentioned earlier, investment in education and health has great intrinsic value as an end in itself.<sup>31</sup> It also has great instrumental value in raising productivity. ADB will prioritize education sector interventions, and selective interventions in the health sector supported by cross-sectoral investments.<sup>32</sup>

33. Growth and rising productivity also do not necessarily reduce gender disparities, but gender equality and women's empowerment are essential aspects of inclusiveness. Without specific attention to improving women's economic, social, and political status, poverty reduction and social inclusiveness will remain largely unrealized in the region. ADB's strategic commitment to gender equality cannot be reduced to one or another individual project, since this is a thematic commitment cutting across interventions in all sectors. However, some interventions in microfinance, education and health have special strategic significance for gender equality. Examples include education of girls, maternal health care, and proactive measures to protect women's equal entitlement to education and health services. These are arguably the most effective interventions that ADB can offer to support gender equality and the empowerment of women. Thus, loan projects, especially in health, education, and microfinance, will be developed with a gender theme, while efforts will be made in other sectors to address gender as a cross-cutting issue.

#### **D. Promoting Regional Cooperation and Integration**

34. Another strategic priority of MTS II is to mainstream support for RCI as a regional level platform to reinforce country level efforts to reduce poverty and cross-country disparities. RCI, mainly driven by the market forces of trade and investment, enhance the growth potential of individual countries, thereby strengthening their capacity to reduce poverty. Integration also helps to link and better align the slower growing countries of the region with the faster growing economies, thereby helping to reduce inter-country disparities in the region. RCI also serves as a platform for regional level initiatives to manage cross-

border environmental and health risks. It is appropriate for ADB to respond to the growing momentum of RCI among DMCs, because of its mandate and strong reputation in this field. ADB's success here will depend critically on effective cooperation between the recently established Office of Regional Economic Integration and related departments including RDs.

35. Traditionally, cross-border infrastructure projects—and national projects with significant cross-border implications—have been the backbone of subregional cooperation programs such as the Greater Mekong Subregion. Their key characteristic is support for the coordinated development of both physical as well as institutional elements of connectivity infrastructure such as cross-border networks for transportation, power, and communications and systems harmonization. Such subregional cooperation programs strengthen connectivity and integrate the region by linking markets and people. The subregional programs will remain the first pillar of ADB's RCI strategy. However, responding to the region's emerging need for monetary and financial cooperation, trade and investment integration and regional responses to cross-border environment and health hazards, MTS II calls for an extension of the RCI program to include three additional pillars that address these challenges.

36. The 1997 financial crisis led to a sharp increase in poverty in the affected countries. Since then, ADB has supported monetary and financial cooperation in East Asia to help improve their resilience and support growth. First, ADB has assisted efforts to improve surveillance measures to prevent the recurrence of a crisis through the ASEAN surveillance process. Second, ADB has provided support for establishing cooperative mechanisms for liquidity arrangements in the form of the Chiang Mai initiative, which is a network of bilateral swap agreements providing recourse to foreign currency for countries experiencing exchange rate difficulties. Third, ADB has assisted the Asian Bond Market initiative to deepen and strengthen the region's resilience to financial shocks by building deeper markets for local currency-denominated bonds. These initiatives, involving ASEAN and ASEAN+3 finance ministers, have demonstrated a commitment by the

<sup>31</sup> For an authoritative exposition of the development philosophy which emphasizes the importance of these social outcomes, and which eventually led to the adoption of the MDGs at the United Nations Development Assembly of 2000, see Sen, A. 1999. *Development as Freedom*. New York: Anchor Books.

<sup>32</sup> Health outcomes very often depend on investments outside the health sector, such as the provision of potable water supply systems; sanitation, sewerage and solid waste management; reduction of air and water pollution, etc.

region's leaders to seek cooperative regional solutions. Going forward, the second pillar of RCI is to help create an economic zone in which coordinated approaches are developed for financial, monetary, and currency issues.

37. The third pillar is to facilitate trade and investment cooperation and integration in the region. Over the medium term, such an effort will require a greater focus on issues related to regulatory coordination and harmonization on border and "beyond border" issues, covering not only trade in goods but also trade in services, investment, competition, and other areas. A related set of challenges emanates from free trade agreements (FTAs), many of which are implemented or pursued at the bilateral and/or subregional levels. FTAs are thus important additional instruments to promote RCI. However, they raise several challenging questions. Expanding and re-prioritizing RCI will include advice and capacity building on policy and technical issues relating to FTAs, maximizing the benefits of regional free trade and investment, and ensuring compatibility with multilateral rules and disciplines.<sup>33</sup>

38. ADB will take on a larger role in providing a range of other regional public goods. These involve programs and projects that contribute to the shared management of public goods such as natural resources, watersheds, and common approaches to human trafficking; public health issues such as HIV/AIDS, severe acute respiratory syndrome (SARS), avian influenza; and regional safety and security. This will be the fourth pillar of RCI.

39. As the LTSF suggested, the rationale for RCI is premised on significant externalities, benefits that transcend national borders. This requires innovative funding arrangement because the distribution of benefits and costs among the partner countries is not always balanced. In the absence of an honest broker/facilitator, individual countries would not bear the cost of providing public goods from which the benefits would primarily flow to other countries. Because it has a strong reputation in RCI, ADB can be the coordinator and facilitator. As the LTSF suggested, this would require new funding arrangements, including the establishment of a regional cooperation

funding facility. Such a facility would be useful for both lending and non-lending, i.e., TA activities.

## E. Managing the Environment

40. The region is experiencing considerable environmental stress as a consequence of demographic pressure, combined with high growth. MTS II, therefore, emphasizes not just growth but environmentally sustainable growth. If the environment is not protected, the region will continue to experience many forms of environmental degradation, ranging from the loss of forest cover and biodiversity resources to deteriorating air quality, water pollution and the exhaustion of nonrenewable natural resources. The growing imbalance between energy demand and supply is threatening the sustainability of Asia's high growth. Thus, securing the poverty reducing benefits of growth, while at the same time minimizing its adverse impact on the environment is a major challenge. A "green growth" course must be pursued, i.e., protect the environment and at the same time maintain high growth.<sup>34</sup> However, the environment agenda is massive and broad. MTS II proposes that ADB be selective in this field, based on its comparative advantage, and focus mainly on environment issues specific to the sectors where ADB is actively engaged and has the knowledge to be effective.

41. A significant change in energy-use patterns is essential to steer away from the specter of per capita energy use rising to levels now seen in the developed economies. Asia's current energy development path, which focuses mainly on increasing the supply of low-cost, fossil fuel-based energy, is unsustainable. Asia's share of greenhouse gas emissions increased from less than 9% in 1973 to 24% in 2003, and is projected to increase to 29% by 2030. ADB should more directly help DMCs acquire low-carbon technologies and implement energy efficiency and renewable energy projects on a "no regrets" basis to enable Asia's technology leap.<sup>35</sup> A plan comprising of assistance for such projects with concomitant support for their financing is being drawn up under ADB's new energy efficiency initiative.

<sup>33</sup> Srinivasan, T.N. 2005. Nondiscrimination in GATT/WTO: Was there anything to begin with and is there anything left? *World Trade Review* 4 (1).

<sup>34</sup> Chung, R.K. and H. Lee. 2005. Towards Environmentally Sustainable Economic Growth (Green Growth) in Asia and the Pacific. *Asia Pacific Economics Association Meeting 2005*. Tokyo: Hitotsubashi University.

<sup>35</sup> The concept means implementing energy efficiency and renewable energy projects that are economically viable now even without including their long term environmental benefits; these will create "no regrets" if predicted climate change impacts do not occur.

42. Another area needing urgent attention in the wake of rapid urbanization is urban water supply, sanitation and waste management. Access to safe water is still an urgent problem. The water MDG will not be met in large parts of Asia. ADB must support investments in water supply in partnership with the private sector. However, increased levels of investment alone are not sustainable unless they significantly improve key performance indicators of the utilities, i.e., improved cost recovery, increased coverage, and better conservation. More than half of the region's population does not have access to proper sanitation facilities. The wastewater management facilities in DMCs do not correspond with volumes of water supply, and investments in wastewater management have lagged. Investment in urban sanitation and wastewater management are priorities. Here again, there are opportunities for public-private partnerships. Finally, proper solid waste management lags behind water supply and wastewater management in urban Asia. It is a key area of work given its lack of development and underlying link to health and the environment. ADB needs to catalyze private sector initiatives in solid waste management to rapidly accelerate investments in cleaning up urban centers. Reference was also made earlier to environmental and health costs of poor infrastructure. Investments in efficient urban transport systems, for instance, is emerging as an urgent priority to contain air pollution in the region's burgeoning towns and cities.

43. Turning to "green" environment issues, investments to create new, or to enhance existing, forest capital have consistently been much lower than disinvestments (caused by deforestation and forest degradation). Forestry faces net negative investment year after year. Accelerated economic growth and increasing demand for forest goods and services are undermining forest ecosystems. The performance of key sectors such as agriculture, energy (hydropower), and water will be seriously undermined and put at risk without sound forest and biodiversity management. ADB should help contain the loss of forest cover, using a river basin/landscape approach, and ensure that ADB-supported projects do not adversely affect forest capital and biodiversity resources.

44. After recent natural disasters, ADB was called upon to provide emergency assistance for rehabilitation

and reconstruction. Projects to rebuild infrastructure destroyed by the December 2004 tsunami had barely got under way, when Pakistan was struck by the catastrophic earthquake of October 2005. Even when disasters result in no physical damage (for instance an outbreak of an epidemic like the 2004 SARS or current fears about an avian influenza pandemic), ADB will be expected to respond rapidly. Given the increasing frequency and magnitude of damage from disasters, provisions for post-disaster rehabilitation and reconstruction must be revisited and, if considered necessary, a standing facility established to deal with such requests.

#### **F. Improving Governance and Preventing Corruption**

45. Last, but by no means least, there are the twin tasks of improving governance and preventing corruption that are key to poverty reduction. It is the poor who suffer the most from the consequences of weak governance and corruption. The development and poverty reduction impact of ADB actions for addressing all the priorities discussed above will depend critically on ADB's ability to effectively assist DMC governments in improving governance and preventing corruption. Improving governance and preventing corruption have therefore been identified as strategic priorities for MTS II.

46. In 1995, ADB became the first multilateral development bank (MDB) to adopt a governance policy that applied to all its operations. Three years later, ADB adopted an anticorruption policy. In 2005 ADB carried out a combined review of the implementation of ADB's governance and anticorruption policies. The review concluded that while ADB has raised the profile of governance in the region, there is still a long way to go towards embedding implementation of the governance and anticorruption policies in the main stream of ADB operations. The review found that the sheer scope of the governance policy has resulted in too many small projects of short duration and thinly spread staff resources. As a result, the review called for more focused governance activities. It also called for ADB's renewed commitment to fighting corruption.<sup>36</sup>

<sup>36</sup> ADB. 2006. *Improving Governance and Fighting Corruption – Implementing the Governance and Anticorruption Policies of the Asian Development Bank*. A working paper. Manila.

47. To keep ADB's assistance in this area focused, and in line with the review's recommendations, MTS II proposes that ADB's governance interventions give priority to public financial management, including procurement, public expenditure management, as well as the legal and regulatory framework and capacity development in sectors/subsectors where ADB is active. ADB will also work closely with other MDBs to develop a uniform framework for preventing and combating fraud and corruption by participating in the dedicated task force established at the meeting of MDB heads in February 2006. Under this framework, MDBs will harmonize their definitions of corruption, improve the consistency of their investigative rules and procedures, improve information sharing, and ensure that compliance and enforcement actions taken by one MDB are supported by all others. Based on the above mentioned review of the implementation of the governance and anticorruption policies, a second governance and anticorruption action plan is under preparation.<sup>37</sup> The action plan will focus on themes which are critical to implementing these policies.

48. Applications of such a bankwide action plan at the level of individual DMCs will be spelt out through country-specific CSPs. Support for the themes will be channeled through ADB's operationally relevant sectors/subsectors in each DMC. In addition, ADB will support national and subnational government initiatives for these themes where there is a demand and ADB has significant operations in national or subnational governments. The nature and scope of specific interventions will be country and context specific.

## G. Assisting Weakly Performing Countries

49. As reflected in a recent review of aid policies,<sup>38</sup> the detrimental consequences of neglecting weakly performing countries or limiting support solely to humanitarian assistance can be substantial. The absence of badly needed development assistance can contribute to such countries becoming more unstable. Over time, lack of engagement may threaten the stability of neighboring countries, create opportunities for international terrorism, and displace people and create refugees. Although humanitarian aid is necessary to save lives in the immediate aftermath of disasters and conflicts, it is insufficient to meet the rehabilitation and reconstruction requirements and the long-term development needs of weakly performing countries.

50. The main elements of MTS II are relevant for countries with legitimate and orderly governance, generally peaceful conditions, and governments committed to improving public policy and delivery of public goods and services. They are less relevant in developing countries that experience natural or man-made crises or whose government's ability to govern, implement development programs, and deliver basic services has critically deteriorated. A more flexible approach is required to meet the needs of such weakly performing countries. This will include not only special fields and modalities of intervention and allocation of resources, but also special forms of partnership with the government and development partners, flexibility in the application of policies and procedures, and staff with appropriate skills to tackle the unique problems of these DMCs and suitable incentives. To address these issues, a distinct strategic approach for weakly performing countries is now being developed in a companion paper to MTS II.

<sup>37</sup> The first action plan covered the period 2002-2004.

<sup>38</sup> DFID. 2005. *Why We Need to Work More Effectively in Fragile States*. Government of United Kingdom. London: Department for International Development.

# IV. The Operational Model

51. For the strategic priorities discussed in section III, the deliverable products include financing and provision of different types of expertise. An assessment of how ADB is positioned today to deliver these products will point to the steps required to establish an operational model that is well aligned to implement MTS II. It should also be noted that changes in the operational model will have resource implications, both human and financial. Further efforts for resource efficiency will be strongly pursued, and resource requirements of MTS II will be secured through the annual budget process.

## A. Strengths and Limitations

52. ADB's main strengths include the following:

- (i) a unique capacity to deliver integrated solutions, through a combination of technical sector and thematic experts, economic/market reform experts, financing/risk mitigation experts, and legal experts, i.e., the complete package of expertise required to deliver the relevant products and solutions, all under one roof;
- (ii) ADB's AAA credit rating, its preferred creditor status, and a capital base backed by all member countries, including developed countries;
- (iii) an inherent risk-mitigating and problem-solving capacity through privileged client-cum-shareholder relationships with DMC governments, and recognition of ADB as a trusted development partner and "honest broker"; and
- (iv) long and rich experience in preparing public sector investment projects in key investment sectors/subsectors.

53. The major aspects of ADB's capacity that need strengthening are as follows:

- (i) While ADB has a wide range of required expertise, the stock of such expertise in any field is limited, with staff members thinly spread across some 50 subsectors and additional

thematic areas. A critical mass of expertise needs to be built in key sectors.

- (ii) There is excessive use of consultants of mixed quality, who do not contribute sufficiently to mitigating ADB's expertise deficit.
- (iii) Internal incentive and performance systems are geared toward project approval rather than project quality and project implementation, and do not sufficiently reward financing partnerships that leverage additional investments into ADB operations.
- (iv) Feedback from clients—the borrowing member countries—indicates that ADB's rigid and cumbersome procedures significantly raise the transaction costs of borrowing, thereby considerably eroding the attractiveness of the relatively soft terms of ADB's loans (footnote 2).
- (v) Feedback from clients also indicates that inadequate staff resources are being allocated to project implementation, a point validated by ADB's recent record in disbursements.

54. Based on the above assessment of strengths and weaknesses, several adjustments are proposed in ADB's operational model to better align it for implementing MTS II:

- (i) identification of core operational sectors for building the required critical mass of expertise in ADB operations;
- (ii) realignment of the organization;
- (iii) more focused use of ADB's TA resources;
- (iv) strategic use of financing partnerships and cofinancing;
- (v) product and process innovations to enhance ADB's responsiveness, flexibility, and efficiency; and
- (vi) focus on portfolio performance, development effectiveness, and results.

Each component is discussed below.

## B. Selectivity and Core Operational Sectors

55. ADB cannot do everything everywhere, and do it well. To deliver high-quality services to its DMCs, ADB needs to be focused and build up a critical mass of expertise in a few selected sectors where it can become a leading provider of assistance to the DMCs. Expertise is defined here to include capacity for world-class economic, thematic and sector work; policy advice; and safeguard advice; in addition to technical (scientific and engineering) expertise in the selected sectors/subsectors and financial expertise. However, there is a tension between the identification of a few priority sectors for ADB and the diverse conditions and corresponding diversity of needs among different DMCs. The approach adopted is to define ADB's strategic priorities relatively broadly in MTS II to accommodate the diversity of needs, and within this broad strategic framework use the CSPs as the key strategic documents to provide the required country focus and customize country assistance programs to meet the specific needs and priorities of individual DMCs. The CSPs will demarcate the intersection of ADB's institutional priorities and the country priorities of a particular DMC. ADB needs to maintain the capacity to assist DMCs across a wide range of sectors/subsectors. However, it is not possible for ADB to build up a critical mass in all these fields.

56. A few sectors have been identified as ADB's core operational sectors (group I) where ADB will build up a critical mass of expertise to act as a leading provider of assistance (financing and expertise). The identification of these sectors is based on: (i) relevance of the sector for the strategy; (ii) demand for ADB assistance in the sector as reflected in external and internal consultations<sup>39</sup> and the sector composition of ADB's portfolio and pipeline; and (iii) ADB's track record and capability to deliver quality projects in the sector, as reflected in Operations Evaluation Department reports. The core operational sectors are road transport, energy, urban infrastructure, rural infrastructure, education and the financial sector (Table 1). Each sector has been identified as being key for several strategic priorities. Each sector has a large demand for ADB assistance in many DMCs. ADB has a strong record of good performance in each sector. While playing a leading role in providing assistance in these core operational sectors, ADB will strengthen its partnerships with other development partners in the sectors. Partnerships can range from financing partnerships and cofinancing (section IV E) to sector-wide approaches (SWAPs), sharing of sector knowledge, and coordination of assistance and policy dialogue.

Table 1: Priority Classification of Sectors/Subsectors

Group I	Group II	Group III
<ul style="list-style-type: none"> <li>• Road transport</li> <li>• Energy</li> <li>• Urban infrastructure (water supply, sanitation, waste management, and urban transport)</li> <li>• Rural infrastructure (roads, power, irrigation, and water management)</li> <li>• Education</li> <li>• Financial sector</li> </ul>	<ul style="list-style-type: none"> <li>• Agriculture and natural resources (except fishery, livestock, irrigation and water management)</li> <li>• Railways</li> <li>• Health</li> <li>• Trade (RCI related)</li> <li>• Law and the judiciary</li> <li>• Public finance and economic management</li> </ul>	<ul style="list-style-type: none"> <li>• Fishery</li> <li>• Livestock</li> <li>• Civil aviation</li> <li>• Water transport</li> <li>• Communications</li> <li>• Development finance institutions</li> <li>• Housing construction</li> <li>• Industry</li> <li>• General government administration</li> </ul>

<sup>39</sup> DMCs needs and expectations from ADB are routinely assessed during annual programming discussions, and were reviewed in the context of ADB's PRS review in 2004. This needs assessment was reexamined through consultation with OCR borrowers in 2004/05, and a separate follow-up consultation with countries eligible for Asian Development Fund resources through ADB's resident missions in late 2005. Internally, there has been detailed discussion among the Board, Management, and staff, including an ADB-wide staff survey and several focus group discussions.

57. Group II consists of sectors that are not selected as core operational sectors. Building ADB's expertise or capacity in group II sectors is not a priority. They are nevertheless important in enabling ADB to meet the diversity of needs across different countries, and to ensure country focus in ADB operations. The demand for assistance in group-II sectors is typically more limited than for those belonging to group I. ADB's performance record in group-II sectors is also mixed. But all the sectors included in group II are relevant for one or more of the five strategic priorities of MTS II. ADB will maintain adequate capacity in these sectors to provide the range of options needed to enable country focus in ADB's operations. The group-II sectors include agriculture and natural resources, railways, health, trade related to RCI activities, law and the judiciary, and public finance and economic management (Table 1). Since ADB's capacity in group-II sectors will be more selective and limited than for group-I sectors, partnerships will play a particularly important role for leveraging the impact of ADB operations in these sectors.

58. Finally, while building up capacity and a critical mass of expertise in the core operational sectors, selectivity also implies that ADB should exit from some sectors. It is not possible to vacate whole sectors, but a number of subsectors have been identified as belonging to group III (Table 1). Subsectors in group III may at best have limited demand for ADB services, and ADB's performance has been patchy in these subsectors. MTS II proposes that operations in these subsectors be gradually wound up. However, under some special circumstances, if there is a specific demand for assistance in any of these subsectors, Management and the Board of Directors can consider such a request.

### C. Realigning the Organization

59. Effective implementation of MTS II requires realignment of RDs to remove the structural constraints identified by the independent assessment of the 2002 reorganization. These are (i) imbalance in the geographic span of control of the RDs, (ii) consequent imbalances in the workload across RDs, and (iii) associated erosion of skills mix and lack of critical mass of sector specialists at the RD level. Realignment of country coverage by RDs will create a more supportive and conducive organizational framework that enables the following:

- (i) enhanced synergy between country and regional operations, by re-grouping countries within RDs more in line with existing regional and subregional initiatives and entities;
- (ii) better country focus as a result of equitable and balanced work load between the two operations groups and across RDs and optimal use of staff resources and their skills; and
- (iii) enhanced skills mix in each RD through operational synergy and focus by grouping countries with congruent development challenges and priorities.

60. The realignment will do the following:

- (i) Merge the Mekong and Southeast Asia Departments into a single department to optimize economies of scale in resource use, and to align the country coverage with that of ASEAN, a major subregional cooperation entity.
- (ii) Establish a new Central and West Asia Department to cover the Caucasus and Central Asian countries together with Pakistan and Afghanistan, to enhance country focus and synergy between country and regional operations.

61. This realignment of RDs will strengthen and enhance effectiveness of ADB operations and the implementation of MTS II. The realignment itself will be carried out within the 2006 budget framework in terms of staffing and budgetary resources.<sup>40</sup>

### D. Use of Technical Assistance Resources

62. The TA program will need to be reformed, to make it more responsive to DMCs' needs, more focused, and better integrated into the gamut of ADB's operations in DMCs. ADB's TA program serves many purposes including preparing projects, providing advice on policy reform and capacity building, and promoting regional cooperation and knowledge management. ADB has already started to reform the TA program. The objectives of this reform are to: (i) make more strategic and efficient use of TA resources, including focusing on priority sectors and themes; (ii) reduce the number of TA projects to ensure quality and

<sup>40</sup> The realignment took effect on 1 May 2006 with the following new configuration of regional departments: Central and West Asia, East Asia, Pacific, South Asia, and Southeast Asia.

manageability; and (iii) increase effectiveness by linking TA to lending/grant operations.

63. For increased effectiveness, lending and non-lending operations will need to be further integrated to ensure that various ADB interventions reinforce each other. MTS II is envisaged to streamline not only TA program and lending but also economic, thematic and sector work. One of the main objectives of the non-lending operations is to establish the preconditions for improving the investment climate. An equally important objective is ensuring more equitable and inclusive development in DMCs. Enhanced focus on institutional and organizational capacity in all non-lending operations will be key in further increasing the capacity of DMCs to prepare and manage their own strategies, policies or projects in the near future. The non-lending operations will be anchored in the CSP process and will be classified in the same priority groups as the lending operations.

#### **E. Use of Financing Partnerships and Cofinancing**

64. The fourth important adjustment in the operational model relates to leveraging additional investment through financial intermediation services provided by ADB, beyond the lending from its own account. ADB's relevance is not only defined by the level of financing that it provides from its own balance sheet but also the benefits it creates by forging partnerships with official and commercial financing partners in support of sustainable development impact. In particular, beyond generating project and deal flows for financing partners, ADB can provide—against a fee—a range of intermediation products and services, including the financial administration of grants and loans, credit enhancement, loan and guarantee syndications, and other related risk-sharing arrangements. Successful intermediation and consolidation of these services will depend substantially on ADB's corporate plans, incentives and parameters giving recognition to ADB's leveraging role in mobilizing resources for DMCs. The review of ADB's cofinancing strategy and a new financing partnership strategy, planned for 2006, will elaborate on how to increase the financing partnerships that are required to catalyze investment in Asia.

#### **F. Product and Process Innovations to Enhance Responsiveness, Flexibility and Efficiency**

65. The fifth important adjustment required in the operational model is the introduction of new products and processes to enable ADB to more flexibly and innovatively meet DMCs' ever more complex development needs and improve the achievement of real development outcomes on the ground. Greater efficiency in this regard is also required to reduce the transaction costs that DMCs incur by doing business with ADB, including measures to accelerate loan processing. Some initiatives are already under way in the pilot phase under the innovation and efficiency initiative,<sup>41</sup> including new provisions on cost sharing and expenditures eligible for ADB financing, the multi-tranche financing facility, the subsovereign and nonsovereign public sector financing, the refinancing and restructuring modality, and the local currency financing for the public sector. These pilots will be accorded high priority during the MTS II period, and followed up as appropriate. The Special Initiatives Group has recently been established in the Regional and Sustainable Development Department to sustain the pace of innovation. Together these new pilot products offer DMCs a greater range of choice of modern, adaptable and competitive financing options, well placed to cater to DMCs' specific development needs in a tailored manner. With this expanded palette of products, ADB will also be in an improved position to bring the benefits of ADB financing to a greater range of clients than is currently the case. Other agenda items introduced or envisaged under the innovation and efficiency initiative include: (i) reform of CSP and business processes, (ii) reform of consultancy services, (iii) reform of procurement procedures, and (iv) consolidation of safeguard policies for greater effectiveness and efficiency.

#### **G. Portfolio Performance, Development Effectiveness and Results**

66. Another adjustment in the operational model relates to the enhanced emphasis on project implementation and portfolio performance in the framework of ADB's institutional results agenda. In assessing the effectiveness of development efforts, attention is increasingly focused on country outcomes, and

<sup>41</sup> ADB. 2005. *Innovation and Efficiency Initiative: Pilot Financing Instruments and Modalities*. Manila.

more particularly progress in achieving the MDGs. Through the delivery of its products and services—such as projects, financial and technical support to policy reforms, knowledge products, etc.—ADB contributes to these outcomes. Enhancing ADB's contribution to country outcomes requires a shift in corporate priorities from an institutional culture that prioritizes loan approval and lending volumes, to a culture where portfolio performance and contribution to country outcomes become predominant. This shift must be supported by changes in the incentives systems, including staff rewards. It also entails the refinement and application of quality-at-entry mechanisms and project readiness criteria for all operations, both of which play critical roles in subsequent project implementation and ultimately overall portfolio performance. Linked to this is also a required change in the overall institutional performance assessment parameters, away from "Board approvals" to "financial commitments" (i.e., loan/grant documents signing and effectiveness), and portfolio performance (project implementation).

67. Finally, the mainstreaming of results-based CSPs aims to support programming processes that ensure alignment with country priorities and, at the same time, provide concrete tools (such as a results framework) for reporting and monitoring ADB's contributions to country outcomes. Enhanced quality at entry of projects and improved analytical work at the "upstream" stage of country planning and programming are prerequisites for successful and timely delivery of ADB assistance. The implementation of MTS II will have to be monitored in relation to development effectiveness, based on existing institutional control mechanisms. Substantial progress has been made to introduce results-based performance evaluation systems at all levels, including corporate (work program and budget framework), departmental and individual work plans (performance and development plan), project design and implementation (project performance management system), country operations (CSP results framework), etc. These mechanisms will be refined and complemented as necessary to enhance their suitability and reliability for implementation of MTS II.

# V. Conclusion

68. MTS II has been prepared to guide operations for 2006–2008. This is a transitional period during which the LTSF will be reviewed, and a new long-term strategic direction established to respond to emerging development challenges in the region. These will be reflected in MTS III, to be launched in 2009. As a strategy for this transitional period, MTS II combines continuity and change. Poverty reduction is its overarching goal, and it is developed around the three pillars of pro-poor sustainable economic growth, inclusive social development, and good governance as in the LTSF. Within the broad framework of the LTSF, which was also the framework of MTS I, and based on an assessment of recent important developments in the region, MTS II has adopted five strategic priorities to further strengthen the poverty reduction impact of ADB's operations: catalyzing investment, strengthening inclusiveness, promoting RCI, managing the environment, and improving governance and preventing corruption.

69. MTS II is a strategy document, laying out the broad directions in which ADB operations should evolve within the medium term. It is not an action plan. Nevertheless, it has also specified several adjustments in the operational model, specific measures that will facilitate implementation of its strategic priorities. These specifications are or will be elaborated in more specific policy and strategy papers recently completed or now under preparation or review. The list of these papers along with their expected Board submission date is provided in the Appendix.

70. Finally, some observable milestones must be reached by the end of 2008, which will serve as markers for tracking whether MTS II is on course.

71. At the strategic level, the five priorities entail that by the end of MTS II, the following should be observable compared to the present:<sup>42</sup>

- (i) a higher share of projects that improve the investment climate in DMCs and a significantly higher volume of private sector operations;
- (ii) a visible shift in the profile of assistance programs in favor of operations that promote inclusiveness;
- (iii) a rise in the volume of assistance provided for protecting the environment, particularly in the energy and urban infrastructure sectors;
- (iv) an increase in the coverage and scale of RCI activities; and
- (v) embedding of elements to strengthen governance and prevent corruption in CSPs.

72. These strategic adjustments in the assistance profile should be supported and complemented by other visible adjustments in the operational model:

- (i) growth in the critical mass of expertise in the core operational sectors, together with evidence of exit from group-III subsectors;
- (ii) a more rational use of TA resources in line with MTS II priorities and CSPs;
- (iii) a visible increase in the cofinancing and financing partnership operations;
- (iv) advance in the introduction of new products and processes that are successfully pilot-tested;
- (v) clear and sustained improvement in project implementation and portfolio performance; and
- (vi) mainstreaming of results-based approaches, including results-based CSPs.

73. The strategic priorities and adjustments of the operational model proposed in MTS II will be incorporated in ADB's business plan, i.e., the Work Program and Budget Framework. This framework and the guideposts listed above will serve as milestones for Management to lead and monitor the implementation of MTS II.

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<sup>42</sup> See also the MTS II implementation and monitoring mechanism in Figure 1.

# Appendix

## List of Medium-Term Strategy II Related Policy and Strategy Papers Recently Completed or Under Preparation

Paper	Expected Board Submission
Private Sector Development: A Revised Strategic Framework	Submitted IQ 2006
Revising the Procurement Guidelines	Submitted IQ 2006
Use of Consultants by ADB and its Borrowers	Submitted IQ 2006
ADB's Strategy for Regional Cooperation and Integration	IIQ 2006 <sup>a</sup>
Enhancing ADB Support to Middle Income Countries and Ordinary Capital Resources Borrowers	IIQ 2006 <sup>a</sup>
Managing for Development Results in ADB – Revised Action Plan	IIQ 2006 <sup>a</sup>
Review of ADB's Credit Enhancement and Guarantee Policy	IIQ 2006
Comprehensive Review of ADB's Water Policy Implementation	IIQ 2006 <sup>a</sup>
Report on the Energy Efficiency Initiative	IIQ 2006
Review of Implementation of the Gender and Development Policy	IIQ 2006
Review of the Implementation of the Urban Sector Strategy	IIQ 2006
Transport Strategy 2006-2008	IIQ 2006
Achieving Development Effectiveness in Weakly Performing Countries	IIIQ 2006
ADB's Financing Partnership Strategy	IIIQ 2006
Enhancing Effectiveness of Technical Assistance Management	IIIQ 2006
Review of Implementation of Governance and Anticorruption Policies and Development of Action Plan	IIIQ 2006 <sup>a</sup>
Energy Sector Strategy	IIQ 2007
ADB's Policy Statement on Environment and Social Safeguards	IIIQ 2007
Revised Urban Sector Strategy	IVQ 2007

IQ = first quarter; IIQ = second quarter; IIIQ = third quarter; IVQ = fourth quarter

<sup>a</sup> Informal Board seminar has been conducted.

# Acknowledgements

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## About the Asian Development Bank

The work of the Asian Development Bank (ADB) is aimed at improving the welfare of the people in Asia and the Pacific, particularly the 1.9 billion who live on less than \$2 a day. Despite many success stories, Asia and the Pacific remains home to two thirds of the world's poor. ADB is a multilateral development finance institution owned by 65 members, 47 from the region and 18 from other parts of the globe. ADB's vision is a region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their citizens.

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