

# Cahiers Papers

BEI EIB

International financial institutions  
in the 21st century



BANQUE EUROPEENNE D'INVESTISSEMENT  
EUROPEAN INVESTMENT BANK



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# Preface



Sir Brian Unwin  
President

*This year sees the 40th anniversary of the EIB, the European Union's financing institution. Over this period, the Bank has contributed substantially towards building an increasingly integrated and interdependent Europe. The anniversary is an occasion not only to look back on the achievements of the Bank during its existence, but also to take the opportunity to gaze into the future.*

*The Bank has always been at the service of the European Union and its member states. As the EU has evolved, so have we to meet the needs of its economies and its people. Two of the most prominent recent examples of the Bank's adaptability are the Amsterdam Special Action Programme in support of growth and employment in the Union, and the Pre-Accession Facility for the EU applicant countries of Central and Eastern Europe as well as Cyprus. The former has given us a new remit to invest in education and health projects, as well as indirectly into venture capital and technology-related companies. The latter will pave the way for the next enlargement of the Union.*

*But the occasion of the anniversary should also permit us to look into the future. Among the key changes that will affect the EIB in the next few years will be EMU and the renegotiation of EU regional assistance regimes in preparation for the enlargement of the Union.*

*EMU will promote further integration of European capital and financial markets, a restructuring of the banking industry, and increased competition for banks from the capital markets. This will obviously have major implications for the role of the Bank within EMU member countries.*

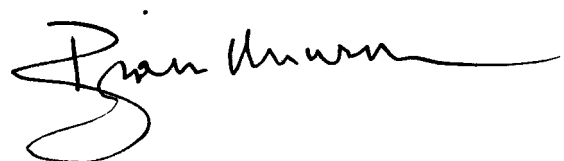
*At the same time, the need for EU support of regional development will continue, and become greater with further enlargement of the Union. In addition, budgetary constraints will limit fiscal transfers between countries. Continuing its historical regional policy role, the Bank will thus concentrate its efforts on peripheral economic areas and neighbouring regions. Continuing support will also be required for other key EU policies, including external co-operation. This last point brings us into the domain of other international financial institutions (IFIs).*

*These issues have been brought together in a strategy - approved by the Bank's Governors - for the next five to 10 years. Clearly, the Bank must continue to adapt to the changing economic and financial environment as it implements this strategy. However, some issues will always continue to be of great importance. These include, for example, the continuation and further development of the close collaboration with commercial banks and the European Commission.*

*In order to allow it to meet these challenges, the member states of the EU have decided to strengthen the Bank's capital foundation. The EIB's Statute sets an upper limit on the overall volume of lending operations as a proportion of subscribed capital: the total aggregate outstanding amount of loans and guarantees granted by the EIB must never exceed 250 percent of its subscribed capital. The EIB's 61 percent capital increase to ECU 100 billion, due to take effect on 1 January, 1999, will raise our ceiling for total outstanding loans to ECU 250 billion. This is one of the largest capital increases ever received by an IFI, and illustrates the very strong commitment of the shareholders to the institution.*

*However, we must also look further into the future. To do this we have invited eminent authors from a range of similar institutions across the world, as well as prominent commentators from outside such organisations, to give us their view of what the future will hold for IFIs in the next century. As no two IFIs share the same tasks, history and objectives, each one of them makes a valuable contribution to the debate.*

*The future is paved with important challenges. In the operations to come, the key challenge will be priority setting in order to maximise the additional contribution, or 'value-added', that IFIs can bring. However, just as during the last half-century, there is little reason to assume that such institutions will not be able to adapt to new situations, and to make a valuable contribution for many years to come.*

A handwritten signature in black ink, appearing to read 'Jean Monnet', with a long, sweeping horizontal line extending to the right.



# Introduction



Massimo Ponzellini  
Vice-President

*Thinking about the future is always a daunting task, especially when you can look back upon 40 successful years. It is natural to assume that things will go on as they are. But in an age of increasing globalisation, internationalisation and sophistication, this assumption is not only becoming more and more outdated, but may be a dangerous illusion. The future does hold out promises, but also pitfalls to be avoided. With that in mind, the EIB has over the last 18 months been engaged in its own attempt to chart a course that will take us into the next century. In June of this year, our Board of Governors, the Ministers of Finance of the EU, endorsed our medium-term strategy for the next five to 10 years, of which the capital increase (to ECU 100 billion of subscribed capital) is an important part.*

*Tackling difficult questions about the 'raison d'être' is not just the prerogative of the EIB, however. In order to place our strategy in a broad international context, we have invited contributions from similar international financial institutions (IFIs) as well as prominent outside commentators. Our aim was to collect their views of what the future will hold for IFIs in the next century. It should be said at the outset that we have asked the authors to speak in a personal capacity. The views expressed (presented later alphabetically by author) should thus not be taken to represent those of the institutions they work for, but they still offer an original outlook of people deeply involved in the matter.*

*The paper by **Jannik Lindbaek, Guy Pfeffermann and Neil Gregory** (Executive Vice-President, Chief Economist and Policy Analyst at the IFC, respectively) sets the scene with its detailed review of the development of the Bretton Woods institutions from their foundation to the present time. One of the particular areas they discuss is the support for private enterprise in developing countries. In fact, the early consensus on government-led policy has by now given way to the government playing a more passive role, i.e., setting the macroeconomic and regulatory framework for private enterprise to function. Overall, there is still a role for IFIs in their scenario, as these institutions have traditionally played the role of opening up new countries or sectors for private investment. In the parlance of the authors, IFIs will continue to push at the frontier. A requirement for development, though, is that there are adequate national 'institutions', be they legal or financial. Institution-building may thus prove to be one of the greatest challenges facing IFIs in the future.*

**Joseph Stiglitz** (Senior Vice-President, Development Economics and Chief Economist, World Bank) looks at IFIs from a more theoretical point of view. For him, one of their main 'raisons d'être' is the provision of international public goods such as peace, economic stability, the safekeeping of the environment and the provision of knowledge.

*This is not going to change, as only international public institutions are capable of providing these goods. For example, one area of special responsibility is knowledge about all issues relating to development. The World Bank has already referred to itself as the 'Knowledge Bank', and increasingly acts as a clearing-house of best practices for some of its poorer members. However, IFIs should act as a complement to private capital; they can never be a substitute.*

*A similar idea is picked-up by **Jean-François Rischard** (Vice-President for Europe, World Bank). He argues that the telecommunications and information technology revolution means that national boundaries will become progressively less important in many areas of economic policy. Global environmental issues will also come increasingly to the fore. The way to deal with this delinkage between national territory and the real world is to split 'governance' from 'government', with the rules for the former being jointly developed through global public policy networks. IFIs are well placed to assist in the development of these networks through their experience, knowledge and possible role as 'honest broker'. However, lending by IFIs would focus on only the most lagging countries, and even here they would intervene with the primary goal of developing local institutions. Financing would be together with the private sector, and would often involve risk-sharing instruments.*

*The paper by **Nicholas Stern** and **Hans Peter Lankes** (Chief Economist and Director of Transition Strategy of the EBRD, respectively) also considers relationships with the private market. They identify three principles which should govern the activities of IFIs both now and in the future: sound banking, additionality and a wider impact in terms of development or transition. Aside from providing finance when it is not available from other*

*sources on reasonable terms, additionality can also come about through expanding the frontiers of private sector development. This includes developing the institutions and policies that support markets, and more general contributions to market-based skills and innovation. Partnership with the private sector means that IFIs must themselves, in many important respects, act and think like the private sector. However, taking up a previous argument, IFIs must avoid crowding-out the private sector in activities it would have financed anyhow.*

*The 'rapprochement' of IFIs with the private sector is expanded upon by **Christopher Hurst** and **Eric Perée** (EIB). They note that the multilateral framework for IFIs has created a preferred creditor for sovereign lending that cannot be credibly duplicated by private sector lenders. However, the development agenda has shifted towards the private sector, and many IFIs are also progressively lending to private companies. This has many major implications for the management of IFIs, and for the potential for competition with private lenders. The solution to these pressures will depend upon the shareholders' views of the role of public sector banks (and hence IFIs).*

*Nonetheless, whatever strategy is followed, the need to demonstrate efficiency in a transparent way will be unavoidable. Following the logic of an earlier paper, this means that those IFIs with the strongest private sector orientation may come to look progressively like private sector institutions themselves.*

*Given the growing importance of efficiency and value-added, equally significant issues relate to the management structures of IFIs. **Pasquale Scandizzo** (University of Rome 'Tor Vergata') finds that governance is the major weakness of IFIs. Institutional and decision-making structures that were put into place when the institutions were created may no lon-*



ger be adequate to deal with a globalised capital market and the manifold economic problems faced by IFIs today. In general, they have a complex range of non-quantifiable objectives, and the various bodies involved in the institutions and the development process may have very different views of the appropriate role for IFIs. The ambiguous nature of these trade-offs and a lack of transparency in decision-making raise critical issues for accountability and effectiveness. These issues spill over into internal management.

In a provocative paper, **Michael Klein** (Chief Economist, Royal Dutch/Shell) looks back on the World Bank after 100 years of operations... in 2044, at which point the operating environment for IFIs has changed substantially. In fact, the World Bank as we know it will no longer exist. It has become the John Maynard Keynes Foundation with a staff of 500, while the IFC has been privatised. The JMK Foundation will still supply some of the international public goods discussed before, but the provision of such goods will have been completely 'un-bundled' from lending. Most of the other roles of IFIs, such as lender of last resort, will be provided by the private sector.

The last contribution is a discussion between **Jacques Attali** and **Alfred Steinherr** (Chief Economist, EIB). They sum up the volume by reflecting on a number of the key points raised in the papers.

What does all this mean for the EIB? While the Governors' decision has paved the way for the next five to 10 years, there is still the daunting challenge of the more distant future.

How best will we be able to play our part in the widening and deepening of the EU, and in the implementation of EU external co-operation policies?

Let me put three possible scenarios for the EIB on the table.

- In one scenario, our co-operation with the European Commission will intensify and the two institutions will fully integrate actions. Loans will be bound tightly together with Structural Fund interventions, and policies will be jointly developed. The two sister institutions will become twins.
- A second possibility is to take up Jacques Attali's idea of merging the EIB with the EBRD to create a European development bank operating through the entire continent. Of course, the EIB can also pursue a broader pan-European strategy without this marriage. The key point is that the focus of action would shift eastwards.
- Finally, the EIB can increasingly turn to the private sector, while lending on a non-concessional basis. Taking this to the logical extreme, the EIB itself could be privatised. This may seem farfetched, but even a short time ago, few would have foreseen the privatisation of national long-term credit institutions that has taken place in several European countries.

Only time will tell which of the three paths will be taken, or whether some other scenario evolves. Let me only conclude by recommending that you buy EIB shares, should they ever come onto the market.

*memorandum Poulletti*



**Christopher Hurst**

*Christopher Hurst is Head of Division in the Chief Economist's Department of the European Investment Bank. He has a doctorate from Harvard University, and previously held positions in economics and management science at the universities of London and Oxford.*

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**Eric Perée**

*Eric Perée is Senior Economist in the Chief Economist's Department, where he is responsible for financial research. He holds degrees from the Catholic University of Louvain and the University of Liège.*

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# Only a mid-life crisis? The future for IFIs in an integrated world

Christopher Hurst and Eric Perée

Will you still need me,  
Will you still feed me,  
When I'm 64?

**John Lennon  
and Paul McCartney**

## 1. Introduction

The European Investment Bank (EIB) differs from most other international financial institutions (IFIs) in that it lends in all of its member countries, not only in its poorer members. It does lend throughout the world, but most of its lending is within the European Union (EU). A significant share is within some of the world's wealthiest countries.

There is nothing new to this situation, and the EIB has survived as the oldest of the regional IFIs. What has changed is the speed of economic integration in Europe. The Single Market, eliminating barriers to intra-EU trade in financial services, has been put in place, and the end of this year will see the launch of EMU. The question of the appropriate role for the EIB in the next century would seem to be even more challenging than that of other IFIs, operating exclusively in countries where substantial poverty continues to exist (1).

Though this paper does not address the particular role of the EIB, this has nonetheless led us back to first principles and a consideration of how IFIs can add value in general. Certainly, this exercise runs the risk of existentialist angst, but when looking to the future we do have to face the possibility that euthanasia may be one of the best solutions to the problems of ageing.

Some basic justifications for IFI involvement seem to be the same everywhere. They are based upon changing the risk structure of projects for stakeholders. However, the contribution of the IFI becomes increasingly subjective and hard to quantify as lending shifts to the private sector and there is greater financial and economic integration.

In this paper we scan the logic for IFI intervention in a range of situations. The good news is that there do seem to be situations where IFIs will be able to generate value-added for some considerable time. In the most basic case, there will continue to be a role for multilateral wholesalers of funds between states. The bad news is that a globalised economy and the growing emphasis on the private sector as the vehicle for economic development will necessarily increase the competition between IFIs and commercial financial institutions. IFIs may find it difficult to carve out a niche in this evolving economic environment, and this need not be the same for all institutions.

We start the debate with a look at the traditional framework for IFI operations.

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*The views expressed here are those of the authors, and do not necessarily reflect those of the EIB. Thanks are due to Mireille Fischbach, Ole Rummel and Thomas Schröder for their assistance.*

1) The 1990s have seen a number of hostile views on IFIs. For example, the Bretton Woods institutions have been highly criticised by a number of outsiders, including members of the non-governmental organisation (NGO) community, under the banner: "Fifty years is enough".

## 2. The traditional model

### **A preferred creditor with sovereign borrowers**

*The special feature of IFIs is their multilateral nature, meaning that default would have repercussions on all other shareholders.*

What distinguishes international financial institutions from other financial institutions (2)? Perhaps the most obvious difference is that their shareholders are governments and that their Articles of Association are international treaties between sovereign states. This feature of IFIs makes them a very special intermediary for capital flows from savers in wealthier countries to investors in poorer ones.

If we start with the model of the World Bank (the oldest IFI, founded in 1944), the intention is that borrowers should be either governments or parastatal agencies that operate under government tutelage. Indeed, the requirement that borrowers obtain a government guarantee is included in the World Bank's Statutes. Thus, the traditional model of the IFI is one of raising funds on international capital markets and lending to governments (3).

The AAA credit rating for the World Bank, and its ability to borrow on the very best terms, comes from its financial strength. The total outstanding loan book can be no more than its subscribed capital plus reserves, so even in the extreme case of every borrower defaulting with no recovery of principal, the entire loss would be absorbed by shareholders - and creditors would be unaffected. Only a very small proportion (a few percent) of IFIs' subscribed capital is actually paid-in as cash. The rest is callable by the institutions in the event it is needed. This callable capital is a guarantee of IFI operations by the shareholders. The approach is essentially the same for most other IFIs (4).

Why should wealthy nations enter into this arrangement when they could just as well guarantee commercial lenders based in their own countries? Indeed, such guarantee schemes often exist for export credits and the like.

The special feature of IFIs is their multilateral nature, meaning that default would have repercussions on all other shareholders. This is a much more powerful deterrent than possible bilateral problems between a particular borrower and lender. The result is that borrowers default against an IFI in only the most extreme circumstances. This is illustrated in Table 1. The comparison between institutions is complicated by the fact that some also lend to the private sector and so they are also exposed to commercial risks. Indeed, the IFC lends only to the private sector. However, if we put the African Development Bank (AfDB) to one side, the general observation is that cases of sovereign default against IFIs are few.

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2) We use the term IFIs to mean the African Development Bank (AfDB), the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), the Inter-American Development Bank (IDB), the International Bank for Reconstruction and Development or, more commonly, the World Bank (IBRD), the International Finance Corporation (IFC) and the Nordic Investment Bank (NIB). Some summary statistics on these institutions are shown in the annex.

3) Some private companies did receive government guarantees in the early years of the World Bank - but this practice soon came to an end.

4) One could note some specific features of the EIB and the NIB. These two institutions can lend no more than 250 percent of their subscribed capital, so that the percentage of loans guaranteed by callable capital may drop to only 40 percent (1/2.5). However, they usually only lend outside their members (all at least BBB grade countries) when they receive a guarantee by some third party (e.g., by an individual member country or by a separate multilateral fund). The result is that all loans are of investment grade rating or higher.

**Table 1.** Non-accrual loans as a percentage of disbursed loans, 1996

ADB	AfDB	EBRD	EIB	IBRD	IDB	IFC	NIB
0.1	10.1	0.3	0.4	2.2	0.0	4.9	0.3

Source: Standard & Poor's.

**The key point is that the international framework has created a preferred creditor that cannot be credibly duplicated by private sector lenders.** The Paris Club of official creditors can be seen as a way of trying to put debt problems into a multilateral context once they have occurred. However, setting lending in a formal multilateral framework before loan contracts are signed is obviously a much more transparent and robust solution.

All this means that the cost of a state providing callable capital to an IFI is very low, since the likelihood that it will ever be called (the guarantee exercised) is small. It also means that there is a good reason why IFIs can price their sovereign loans on a non-discriminatory, cost-plus basis. While the market must consider individual sovereign risks, these do not exist in the same way for the IFI.

This also explains why debt relief, if funded by the IFIs themselves, must be approached with extreme caution. Such debt forgiveness schemes amount to default in all but name. To agree to debt write-off could undermine the preferred creditor framework unless there are the most carefully defined and controlled conditions (5). This may seem an easy way out for IFIs, and it is particularly galling for some observers who accuse IFIs of contributing to current difficulties through irresponsible lending practices in the past. However, someone must pay the costs of sovereign defaults. If this were to become a common phenomenon, IFIs would have no choice but to charge a risk premium or to stop this type of lending. In either case, the traditional model collapses.

### **3. The traditional model on a global capital market**

#### ***Rewarding inefficiency?***

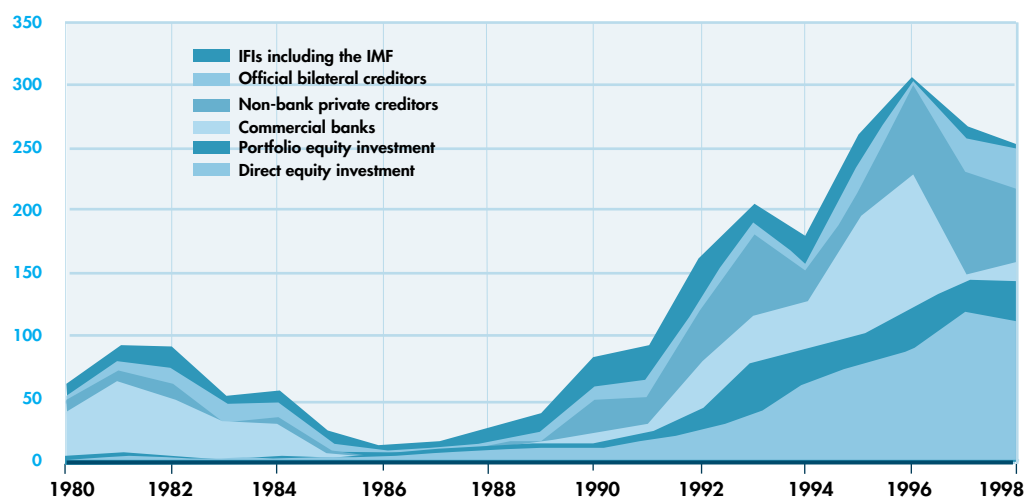
With the exception of the EBRD, IFIs were created when there were controls on international capital flows and private finance for less-developed countries was limited. Indeed, in some ways IFIs could simply be seen as institutions created by governments to circumvent, in a controlled way, the regulations and restrictions they had themselves imposed.

One remarkable feature of the last decade has been the globalisation of international capital markets. This is illustrated in Figure 1. An initial surge in private capital flows to emerging markets, largely associated with the recycling of oil revenues, occurred in the early 1980s. However, these flows (mainly syndicated bank loans) were brought to an abrupt halt by the Debt Crisis of 1982.

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5) The AfDB is the only IFI to have been downgraded to an AA credit rating. This was due to a combination of a highly politicised corporate governance, generally weaker shareholders (only one-third of callable share capital was held by investment grade countries) and the reduced number of regional members eligible for new loans. In other words, the credibility of the preferred creditor status and of shareholder support also depends upon how the institutions are run.

**Figure 1.** Capital flows to emerging markets, 1980-1998 (in USD billion)



Source: International Institute of Finance.

After a period of debt workouts and macroeconomic stabilisation, private capital flows boomed at the start of the 1990s. During this decade, foreign direct investment, portfolio investment and non-bank creditors have been the main source of funds for the developing world.

*It is hard to see over the long run what market imperfections could exist that IFIs can eliminate by their mere presence.*

By 1996, net lending from IFIs had dropped to only a few percent of total capital flows, down from over 40 percent in 1986 (a peak year for IFIs). As with the Debt Crisis before it, last year's Asian Crisis has led to a severe reduction in net bank lending. Importantly, other sources of private sector finance appear to have been much less affected.

Thus, the middle age of IFIs has been associated with a rapid slide in their overall importance. However, this is not equally true for all countries and the overall picture presented in Figure 1 is highly influenced by a few emerging markets. The fact that IFIs are preferred creditors, and can lend at below market rates, continues to exist even in an environment of global capital markets. Perhaps perversely, the largest financial gains (i.e., the largest difference with the market) occur in countries where sovereign risks are highest.

If there are no obvious failures of international capital markets, then sovereign risk premiums correctly reflect the uncertainties of lending to a particular country. This uncertainty in turn reflects the quality of economic management. The risk that governments will not be able to service debt denominated in foreign currencies would be very small if macroeconomic stability were pursued through appropriate monetary and fiscal policies, and capital inflows were wisely invested. Equally, the existence of sound democratic institutions would reduce the chances of political instability. It is true that only relatively short maturities may be available from private lenders, but this is a rational response to risk. Rolling over short-term credit is quite common in the corporate world as well. It allows a monitoring of the situation that is simply not possible with longer-term maturities.

There is, of course, a period when credibility must be gained by a state. However, it is hard to see over the long run what market imperfections could exist that IFIs can eliminate by their mere presence. In this case, IFIs could be accused of doing nothing more than releasing policy makers in recipient countries from the basically correct discipline of the market place. Under the worst scenario, this could allow greater military spending than would otherwise be the case - with obvious repercussions for peace and stability.

### **Defining the use of funds and loan conditionality**

One answer to the above question is that IFI lending is tied to a particular project (though this may be a 'policy' project as well as a physical investment) rather than just providing credit lines as a private lender might. This ensures that funds are used in a clearly specified, and hopefully sound, manner. The role of the IFI can range from simply checking project dossiers to offering technical assistance for project design and implementation.

Having cheaper finance available from IFIs distorts public investment towards those projects and sectors where this finance is available (5). Moreover, part of the policy package that comes with an IFI loan is likely to change the nature of the investment in a way that also benefits residents of other countries. This occurs even at a very focused project level, for example, through requiring competitive international tendering for suppliers and recognition of certain minimum environmental standards.

***There is a trade-off between expanding lending to broader and broader programmes, and the assurance that this is not simply providing credit lines to governments.***

The selection of projects is not without problems, however. IFIs are wholesalers of funds and they lack retail outlets. This means that they can only study relatively large investments. The task of originating smaller loans is prohibitively expensive. While some very large projects do have high economic returns, there may be investments at a small-scale that actually contribute more to economic development. The end result is that IFIs can distort investment towards excessively large, capital intensive, projects. One solution is to fund broad sectoral programmes, and many IFIs have supported this type of loan. The problem, as pointed out by some non-governmental organisations (NGOs), is that the staff of IFIs cannot have the local knowledge needed for the successful implementation of small community-based projects. This also applies to building institutional capabilities in recipient countries, an activity that requires close contact between trainers and trainees.

In funding these activities, IFIs must largely delegate project design and management to local counterparties or consultants. The final investment will only be as good as these counterparties. Thus, there is a trade-off between expanding lending to broader and broader programmes, and the assurance that this is not simply providing credit lines to governments.

If the IFI has no impact on the quality of investment, and hence on economic growth, the effect of its lending could be pernicious. Since the overall riskiness of the government would not change, one consequence of creating a preferred creditor would simply be that other loans from commercial lenders would get more risky.

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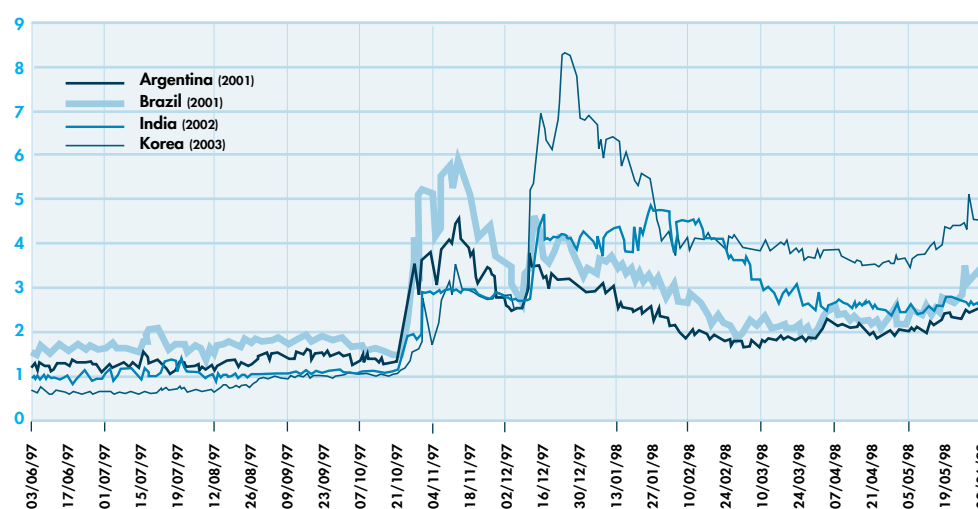
*5) It must be recognised that leakage of funds to non-productive activities remains possible, since some components of the IFI-defined projects may still have been done even if an IFI loan had not been forthcoming.*

## 4. Instability, over-reaction and IFIs

### *Herd instincts and volatility*

While the globalisation of finance should reduce market imperfections, a 'herd' tendency in international financial markets can still lead to volatile capital flows. Financial markets did a very poor job of anticipating the last two major crises - in Mexico in 1994 and last year in Asia. In these cases, lax foreign lending helped to support inefficient management (whether of government spending in the case of Mexico, or of risk control by banks in Asia). When the correction finally came a severe change was needed. With such dramatic swings in market sentiment, an over-shooting in the correction becomes likely.

**Figure 2.** Eurobond spreads, June 1997-June 1998 (in percent)



Note: The figure shows the spreads of USD-denominated eurobonds of Argentina, Brazil, India and Korea relative to US Treasury bonds with the same maturity.

Source: Datastream.

A further consequence of a herd mentality is that countries can be damaged by bad news from an unrelated economy. As an illustration, Figure 2 shows the large, but temporary, jump in government bond yields in a number of countries after the Asian crisis.

### *International crisis management*

Information on macroeconomic conditions is collected and analysed by independent rating agencies. Since this information also has its imperfections, the IMF's view on economic policies has become an important signal for future prospects. Some IFIs may also participate with the IMF in macroeconomic stabilisation packages. In Figure 1, the large increase of IFI and IMF lending in 1997 is due to the very substantial assistance provided to Asian economies after the crisis in October of that year.

If the IMF lacks sufficient resources to put emergency lines of credit in place, then there may be short-term gains from sharing the burden with other IFIs (typically the World Bank and the relevant



regional IFI). However, this 'fire-fighting' is a fundamentally different business from the long-term development-financing model we have discussed.

**The traditional role of IFIs can continue for some time. However, the risk of being left behind by the wayside of a rapidly globalising capital market may seem very high.**

In this case, IMF macroeconomic conditionality is the cornerstone of ensuring the funds are used for appropriate reform measures rather than simply bailing out inefficient governments (and hence, indirectly, other lenders). There could also be a case for IFI participation if the stabilisation package requires a number of longer-term structural measures, such as reform of the banking sector. However, it must be recognised that the time needed to prepare a sectoral loan may be very different from that available when international liquidity problems arise. Certainly, using IFI balance sheets as a conduit of funds because the IMF has funding problems is not a suitable role over the longer term.

### **Resource allocation under uncertainty**

The key issue for IFIs is that the risk of temporary shocks to interest rates could have a significant effect on the decision to implement capital intensive projects. At the government level, increased volatility in interest rates will lower the optimal level of external debt and so the availability of foreign currency to fund public investments. At the project level, the cash flow of capital intensive investments can be particularly sensitive to interest rate developments. This is a serious issue for project promoters facing liquidity constraints. Though most pertinent to the private sector (a subject discussed later in the paper), a number of parastatal agencies may also be expected to operate as autonomous financial entities and so face similar concerns (7). The ability of IFIs to put sovereign risks to one side and to take a long-term view of a project's viability can thus help ensure that key projects are actually implemented. The issue is not only one of international liquidity, but also concerns resource allocation in the face of uncertainty.

A general conclusion at this point is that, *since it does not depend upon any market imperfection*, the traditional role of IFIs in supporting public investment can continue for some considerable time. As economic growth and stability reduces spreads on sovereign debt, the financial benefits of IFI lending shrinks. However, IFIs can be a cheaper source of funding than international capital markets even for highly rated governments. With economic development, project selection can be increasingly delegated to national authorities. The obligation of IFIs to ensure that funds are only used for sound purposes remains, however.

One problem, at least for IFIs, is that this traditional core activity restricts their contribution to the development agenda to that of designing, building and managing public infrastructure. And even in this area IFIs are likely to be excluded from a number of new institutional structures involving the private sector. The risk of being left by the wayside of a rapidly globalising capital market may seem very high.

## **5. The risk structure of private sector projects**

### **The rise of the private sector borrower**

One feature of the last decade has been the recognition that many activities previously considered as the natural domain of the state can be readily, and perhaps more efficiently, provided by the pri-

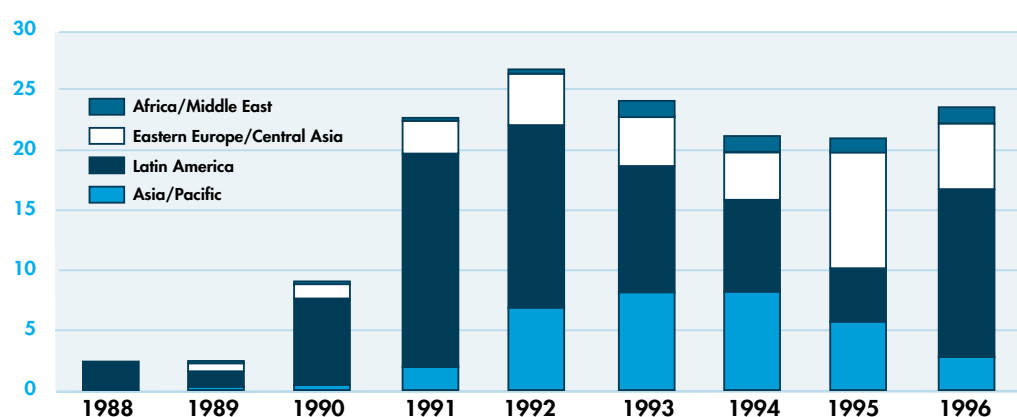
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7) Of course, such agencies are not fully autonomous since they benefit from government guarantees and often receive subsidies in one form or another.

vate sector. In addition, it is natural in today's environment of fiscal rectitude that governments should look increasingly to the sale of state enterprises to improve public debt levels. Figure 3 shows the jump in privatisation revenues in developing countries between the late 1980s and the 1990s, rising to an annual average of about USD 22 billion. Infrastructure accounts for more than 40 per cent of the total.

This trend also includes the close involvement of the private sector in the development of new infrastructure through public-private partnerships (PPPs). Such investment has averaged some USD 60 billion annually worldwide in the last decade, and is growing at a rapid pace.

**Figure 3.** Privatisation revenues in developing countries, 1988-1996 (in USD billion)



Source: World Bank.

While this emphasis on the private sector in the development process has emerged recently, the potential for IFI lending to the private sector was recognised long ago. The International Finance Corporation (IFC), the World Bank affiliate specialised in private sector operations, was set up as early as 1956. Other IFIs have also started private sector lending, though this is still very small for those IFIs most wedded to the traditional model (7).

### **Sovereign risks**

One dimension of the preferred creditor model outlined above still holds. Unless a company is producing offshore revenues that can be used to secure borrowings, the credit rating of all private sector entities is capped by that of the host state. The rationale is that no company can be in stronger position than its own government to convert domestic currency into foreign exchange in a timely fashion. This means that even if there are investments that are inherently better than the state, this cannot be reflected in the credit rating of private sector promoters.

7) For example, private sector lending by the ADB and IDB is only a few percent of turnover. The current policy guidelines are that private sector operations should be no more than five percent of annual lending at the IDB, two to three percent of portfolio at the AfDB and five to six percent at the ADB. The EBRD is in a particular position since its Statutes require that it do a minimum of 60 percent of turnover with the private sector. One of the most rapid transitions to the private sector has taken place with the EIB. Over the last decade EIB loans within the EU guaranteed by the public sector have dropped from some 80 percent of the total to under one-half.

The IFI can still ignore these sovereign risks since the host state would not limit access by project promoters to the foreign currency needed to service their debt. Equally, the project promoter would not be exposed to other political risks such as expropriation. This is most evident with the so-called 'B' loan of the IFC. When the IFC prepares a project, the planned loan may be split into an 'A' component and a 'B' component. The A loan is a normal loan from the IFC, while the B loan is refinanced with a syndicate of commercial banks. Normally, there is a single loan agreement between the IFC and the borrower for the full amount of the finance to be provided. The IFC then signs individual agreements with participating banks. Since the commercial bank syndicate comes under the IFC 'umbrella', the regulatory authorities of many countries have exempted IFC loan participation from country-risk provisioning. The IFC charges a fee for acting as lender of record and loan administrator, though this is much less than the level a normal valuation of sovereign risk would imply.

**The only solution is for IFIs to be managed so that there is a negligible probability of requiring callable capital.**

Along the same lines, a number of IFIs now offer sovereign risk insurance. For example, the World Bank - prohibited from lending directly to the private sector - has developed a programme of political risk coverage for loans from commercial banks. The Multilateral Investment Guarantee Agency (MIGA), another member of the World Bank Group, offers a similar service (9).

### **Commercial risks and regulatory risks**

However, lending to the private sector exposes IFIs to commercial risks and, unlike sovereign risks, these cannot be evaded. Indeed, in recognition of the different nature of this business, both the EBRD and IFC offer a range of equity-related products as well as loans.

When IFIs take commercial risks on their books, the logic for the original capital structure disappears. The IFC offers a clear example of this. While the IFC Statutes still define its maximum gearing (at up to four times its subscribed capital and reserves), in practice its approach is based on different principles. To start with, nearly all its subscribed capital is paid-in. This illustrates that when commercial risks are sufficiently large, it becomes impossible to maintain the concept of guaranteeing operations with callable capital that in principle will never be called. Of course, shareholders could assume commercial risks and let their callable capital be exposed to defaults, but it is not clear why they would ever wish to do this. Moreover, it would lay government budgets open to potentially large shocks, with the risk of severe disruption to national spending/borrowing plans.

What does this imply for institutions that have just a small share of subscribed capital that is paid-in? It would appear that the only solution is for these IFIs to be managed so that there is a negligible probability of requiring callable capital. Hence, the appropriate level of *paid-in capital and reserves* should be approached in much the same way that a private financial institution would look at the problem; i.e., to ensure that there are sufficient funds to absorb all risks of default at some relevant confidence level (10). In line with this, the IFC has adopted the rule that its capital base should be at least 30 percent of risk-weighted assets.

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9) By late 1997, the World Bank had provided such guarantees for a total of USD 1 billion of loans. At the end of the last fiscal year (June 1997) the maximum contingent liabilities of MIGA had reached USD 2.5 billion.

10) That is not to say that the targets for IFIs should be similar to commercial banks, since there may be very many specific issues. Rather it means that the technical approach to the problem would be similar.

The IFC was set up to deal *exclusively* with the private sector and its situation is unique among the IFIs (11). Nevertheless, most IFIs are keen to expand their operations with the private sector, and the issue of their adequate capitalisation (i.e., of paid-in capital plus reserves) will have to be addressed.

There are different ways to adjust to the changed circumstances. On the one hand, the IFI could outsource the bulk of commercial risk to other parties. This is what the EIB has done by requesting third-party guarantees on its private-sector lending. While this approach has worked in the European Union, where the local financial market is sufficiently developed and robust financial institutions are ready to assume the commercial risk, it is not obvious that such an approach can be easily replicated everywhere. On the other hand, a clear separation of sovereign and commercial risk could be obtained by transferring the latter to a dedicated affiliate dealing exclusively with the private sector (as with the World Bank - IFC model) (12). The capitalisation of the IFI affiliate would then be structured to fully cover commercial risks. However, it is not certain whether, in such a set-up, the privileged creditor statute of the traditional IFI can always be credibly transferred to the private sector arm.

The thorny issues of how individual loans are managed and priced will also have to be looked at. In a similar vein to the discussion of callable capital, it is unclear why IFIs' shareholders should allow their paid-in capital to bear commercial risks free of charge (13). If these risks cannot be transferred to third parties, they should be priced so as to maintain the IFI's return at the equivalent risk-free level. Obviously, in the case of structured finance there can be a complex combination of risk taking and risk mitigation, with some risks being carried on the bank's books and others being covered through credit enhancement schemes.

**When regulatory regimes are immature, an IFI involvement in a project may give comfort to other investors that regulatory decisions will be fair.**

Most IFIs do not have a large pool of expertise in the management of commercial risk, and there is little reason for these institutions to enjoy any comparative advantage in understanding these risks with respect to international commercial banks. However, IFIs can still play a very specific role in private sector projects. For example, one feature of the recent trend to privatisation and the emergence of private sector financed infrastructure has been the growth of regulated private monopolies and other public-private partnerships. When regulatory regimes are immature, there may be some doubt by investors over the way in which regulations will be interpreted in the future. If an IFI is involved in a project, this may give considerable comfort to other investors that regulatory decisions taken in the future will be fair and based upon sound criteria. While a more qualitative factor than the traditional preferred creditor status, the IFI presence still implies a different set of relationships with the state than may otherwise be the case.

In a similar spirit, many private infrastructure projects are capital intensive and have long payback periods. As IFIs have little difficulty to raise funds at competitive terms for long maturities, their intervention may serve as an important catalyst to get the project going (as discussed before, the avail-

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11) The IFC is also unique in that it has a long history of private sector activity and thus much better data on the default risks associated with its business.

12) The Inter-American Investment Corporation provides another example.

13) Some may think that there are positive externalities for shareholders from IFIs' private sector lending, and that this would militate in favour of them bearing part of the commercial risk. However, this is far from evident. As discussed later in the paper, the target return on equity of IFIs' shareholders is basically equal to the cost of their public debt. Any externality may already be captured in the gap between the return on equity generated by IFIs and that which private shareholders would normally require.

ability of long-term debt can have a major effect on the cash flow of such projects). The magnitude of these benefits is clearly a highly subjective matter, however.

## 6. A new role in the development of regional capital markets?

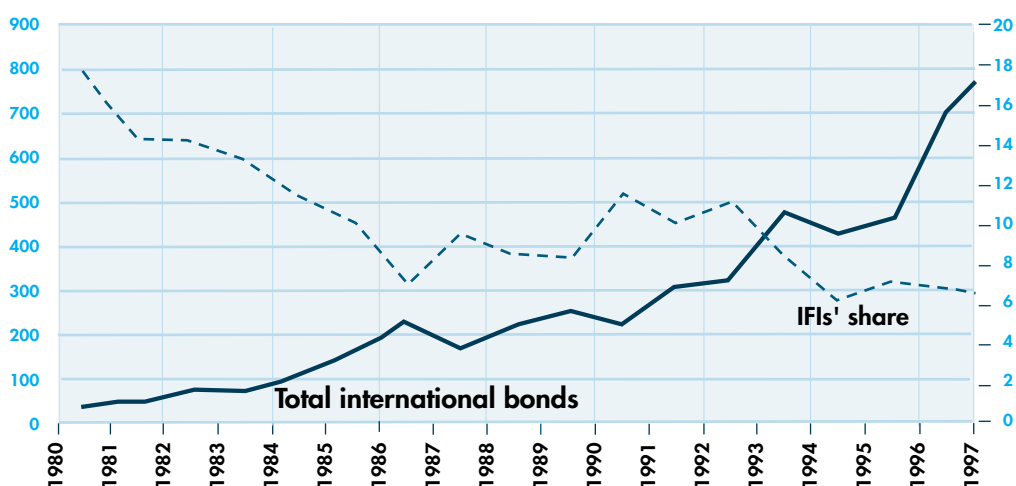
### *The widening scope of IFI borrowing activity*

*Within a global movement toward freer capital flows, IFIs have widened the set of currencies in which they borrow.*

It has recently been recognised that building sound domestic financial and banking markets is also a key factor in the development process. Numerous studies have demonstrated that financial development goes hand in hand with economic development. This means that the capital market and treasury operations of IFIs may play a development role if their action leads to the transfer of know-how to local financial institutions.

As shown in Figure 4, the (gross) volume of funds raised by IFIs on the international bond market is large, both in absolute value and in relative terms. Naturally, the sharp development of the international bond market since 1990 has meant that the relative market share of IFIs has trended downwards. By the mid-1990s, the annual borrowings of IFIs amounted to about USD 50 billion, or seven percent of the international bond market.

**Figure 4.** Size of the international bond market (in USD billion) and IFIs' market share (in percent), 1980-1997



Source: OECD Financial Statistics.

Within a global movement towards freer capital flows, and growing investors' appetite for investment in less traditional currencies, IFIs have widened the set of currencies in which they borrow. This is illustrated in Table 2. Does this trend to borrowing in emerging market currencies provide IFIs with a new development role, and so a new 'raison d'être' for the coming years?

A first observation is that the mere borrowing by an IFI in a particular currency does not automatically translate into a transfer of know-how to that country. The IFIs lending mainly to the public sector have little genuine demand for loans in other than the major international currencies. This is because governments are usually AAA-rated in their own currencies. Even if central banks are inde-

pendent, so governments cannot simply print money to service their debt, they usually still have sufficiently strong tax raising powers that the risk of the government coffers being empty is negligible.

*As the bulk of borrowings in non-traditional currencies adopt the euro-market format, the IFIs' contribution to the development of financial markets is likely to be modest.*

In these cases, borrowings in new currencies are usually exchanged *via* a swap with non-resident investors. International investors may find that the securities issued by IFIs in emerging market currencies are attractive, since there are no credit risks. Such investors are comfortable with bearing the interest rate and exchange rate risks involved, but do not wish to be concerned by the condition of the domestic financial market. Indeed, the bulk of borrowings in non-traditional currencies adopt the euro-market format. This eliminates a host of possible complications. The backbone infrastructure of the euro-market for listing, trading and clearing and settlement can be used, and most legal difficulties are also avoided. In such a context, the main result of IFIs' borrowings is the internationalisation of the currency. The contribution to the development of financial markets in the country of origin is likely to be very modest.

**Table 2.** IFIs' market share of international and eurobond issues, 1988-1998 (in percent)

Currency	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998*
Spanish pesetas	77	48	74	63	55	50	50	52	47	47	38
Portuguese escudos	100	0	69	77	86	65	52	32	18	18	9
Greek drachmas	—	—	—	—	—	—	69	100	100	35	60
Hungarian forints	—	—	—	—	—	—	—	—	—	—	100
Czech koruna	—	—	—	—	—	—	0	62	43	23	33
Polish zloty	—	—	—	—	—	—	—	—	50	68	70
South African rands	—	—	—	—	—	—	—	7	33	59	59
Korean won	—	—	—	—	—	—	—	100	—	100	—

\*First five months of 1998

Source: IFR Securities Data.

Irrespective of their final currency needs, it remains true that IFIs have usually been the first borrowers to open bond markets in the less traditional currencies. One reason may be that they have had an explicit privileged access to a market (because authorities do not permit other issuers to tap the market), or implicit advantages as their status and name recognition has allowed a clear separation of credit risk from other sources of financial risk. These arbitrage opportunities, together with the preferences of the day of international investors, are the driving forces for the bulk of IFI funding operations in non-traditional currencies. Nonetheless, there are still very good reasons for IFIs to broaden their base of funding currencies in this way. These operations provide attractive conditions, which in turn lead to cheaper lending rates through the usual cost-plus pricing approach.

### ***Intermediation within regional markets***

The story may be different for those IFIs which are more involved with the private sector, as they do face a natural demand for the domestic currency in question. Private sector borrowers are much less interested than sovereign borrowers in obtaining foreign currency loans unless it is good financial logic to do so. For example, the EIB has a stable demand for loans in non-traditional currencies, and it has had a vested interest in promoting and developing the domestic capital markets of less-advanced European countries. Such an approach does not necessarily provide the same short-term gains as the opportunistic deals mentioned above, as it requires a sustained effort to build up local skills. Some IFC operations provide another approach to fostering the development of local capital markets, by sponsoring the issue of domestic securities by resident issuers (14).

We can conclude that certain types of IFI operations, though only a small share of the current total, can have a beneficial impact. Once more, lending to the private sector appears to be the point of departure for any new role. However, this 'raison d'être' is likely to be ephemeral. Even if IFIs succeed in fostering the development of local capital markets in the early stages, their leading role is bound to be transitory - and much more so than the 'graduation' that will occur on the lending side.

### **7. Competition with commercial financial institutions**

This issue of whether an EU institution should be involved in a particular facet of public policy goes under the title of 'subsidiarity'. It has its parallels in the broader debate of 'additionality' and 'complementarity' for IFIs in general. The term subsidiarity was in fact first used by Pope Pius XII in 1931 when talking of the Catholic Church, and the debate over the role of IFIs also often has a strong ideological fervour.

#### ***Unfair advantages?***

***When IFIs lend to private sector borrowers, and start to offer a range of associated financial services, the scope for competition with commercial banks becomes apparent.***

When IFIs lend to private sector borrowers, and start to offer a range of associated financial services, the scope for competition with commercial banks becomes very apparent. Aside from the benefits that arise from the inter-governmental framework addressed before, IFIs have a number of other advantages including exemptions from taxation. They may also have an advantage due to their high capitalisation and the relatively low returns required by their shareholders.

Of course, the capital actually paid in to IFIs does have a cost. If these institutions were closed down and capital paid back to shareholders, then government debt could be reduced by an equivalent amount. At the same time, being non-profit seeking does not mean that there is no return on shareholders' equity. The usual approach is for an IFI to price its loans as though they were 100 percent financed through borrowing. Since there is also equity on the liability side of the balance

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*14) One further feature of intermediation on regional capital markets (between domestic investors and domestic project promoters) is that the ability of the IFI at assessing project risks may be better than that of local banks, particularly for complex structured finance. This means that the advisory skills of the IFI may continue to be helpful, even when they bring little additional knowledge to the international financial market place (assuming, of course, that the local subsidiaries of multinational commercial banks are not already well established). However, taking a very large share of the financing plan of any particular project could be counter-productive since it would crowd-out local financial companies.*

sheet, this implicitly prices equity at the same rate as the institutions borrowing costs. Thus, the return on equity is related to government benchmark interest rates (15).

However, this return is less than the profitability the shareholders of private banks would be looking for. Some comparisons of IFI returns and those of some large banks are illustrated in Table 3. Obviously, there may be considerable volatility to the figures, and the benchmark return depends upon the currencies in which assets are denominated. Moreover, the figures are not comparable, since the product mix may be quite different for the various institutions shown, but the overall picture is one of relatively cheap equity for IFIs (16).

**Table 3.** Real return on equity, 1992-1996 (in percent)

	ADB	AfDB	EBRD	EIB	IBRD	IDB	IFC	NIB
1992	4.9	3.4	-4.7	3.6	1.7	2.6	2.4	4.4
1993	5.2	1.3	-3.8	4.4	1.7	2.8	5.5	8.1
1994	4.1	0.6	-3.2	3.5	2.5	2.3	3.1	8.4
1995	4.9	0.8	2.7	4.3	2.0	3.3	5.8	8.8
1996	3.4	1.7	-2.4	3.5	2.3	1.3	6.2	8.3
Average 1992-1996	4.5	1.6	-3.3	3.8	2.1	2.5	4.6	7.6

	Deutsche Bank	Société Générale	Lloyds Bank	Istituto Mobiliare Italiano	Rabobank Nederland	Crédit Local de France	ING Bank	Abbey National
1992	14.6	9.4	22.2	5.7	7.9	12.5	10.5	12.4
1993	18.1	8.7	27.4	8.7	9.3	12.5	12.9	16.7
1994	12.6	7.8	30.7	7.1	8.9	14.0	11.6	22.1
1995	12.6	10.3	39.3	5.1	10.6	11.0	13.7	22.8
1996	14.7	10.9	46.4	8.3	9.8	13.3	12.4	23.5
Average 1992-1996	14.5	9.4	33.2	7.0	9.3	12.6	12.2	19.5

*Notes: Equity is defined as paid-in capital plus reserves for IFIs. The return for the private sector is calculated after provisions, but before taxes. All the private sector banks are AA rated or better. While shareholders' equity is exposed to more risk than that of an IFI shareholder, these remain sound financial institutions. The EBRD is in a specific position as it has just started operation. Its operating costs are yet to be covered by margin income from disbursed loans.*

Source: Bankscope.

15) The actual return earned depends upon the maturity composition of assets and liabilities, whether there are losses, and the extent to which administrative costs are covered through an additional mark-up.

16) The pressure on private institutions to get the most from their capital is clearly illustrated by the growth of securitisation, as banks package and sell low-earning loans to the market to free capital for more profitable purposes. This has become very widespread in the US, and is also growing rapidly in Europe. Worldwide, the market for asset-backed securities is of the order of USD 500 billion per year.



**IFI displacement of private sector lenders may be justifiable, if the cheaper finance causes economic activity to adapt in line with public policy objectives.**

If IFIs are cheaper than other sources of finance, it is normal that private sector investors would turn first to the IFI for finance. This is different from lending to governments. For the public sector, the overall package of project definition and loan conditionality clearly differentiates the IFI product from the lines of credit provided by private sector lenders. Project appraisal is obviously also needed with private sector borrowers, but commercial banks would often have to do a similar analysis to assess risks. Indeed, if the investment is made by private sector promoters in sectors that are competitive, and where there are no subsidies or other economic distortions, assessing the financial profitability of a project is essentially the same task as estimating the economic rate of return. Sound banking and development banking are one and the same (17).

The result of the possible competition between IFIs and commercial banks will be some crowding-out of private banks unless the IFI's involvement increases the demand for finance by an amount equal to its own lending. Except for the IFC B loan structure, or other guarantee schemes, it is likely that crowding-out will always happen to some degree.

### **IFIs as an instrument of public policy**

Even if the IFI does displace private sector lenders, this is still justifiable if the cheaper finance causes economic activity to adapt in line with public policy objectives.

One public policy goal could be to provide re-distributive transfers. An analogy can be drawn with government subsidies used within developed countries to relocate investment to lagging regions. Debt may be a better instrument than straightforward grant at achieving this goal, though not all of the problems associated with grant may be resolved. As with transfers, there may be substantial dead-weight losses (the projects would have been done anyway without the subsidy element) and the windfall profits from a cheap IFI loan may still encourage inefficiency by the recipients. Nonetheless, the obligation to repay debt is perhaps the best way of ensuring appropriate 'ownership' of the projects that are financed, and that funds are used for profitable purposes in a well-managed way. Of course, loans and grant can also be packaged together, and many IFIs are already involved in interest subsidy schemes with the subsidy element funded by aid donors (e.g., the International Development Association of the World Bank Group).

Public policy goals may also include measures to compensate for market failures in the real economy. Recent theories in economic geography have emphasised that growth may be concentrated in economic agglomerations (due to 'technical spillovers', concentrated labour markets, etc.). It is to offset the possibly widening gap between the most and the least advanced regions that public intervention may be required.

Such logic is perhaps most pertinent for IFIs that operate within relatively well integrated economic zones. At the international level, the environmental sector may provide a clearer example. Pollution does not respect national barriers, and there may be a global dimension to some environmental problems. Ideally, government regulation would mean that environmental costs are covered by

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17) There is one group of loans where the IFI could take a different view from a commercial lender - loans to banks for on-lending to small and medium-sized enterprises. A commercial lender would only be interested in the creditworthiness of the banking intermediary, while the IFI may also be concerned about the rules used to allocate loans to final beneficiaries. This is another of the ways in which IFIs can contribute to local financial sector development.

polluters (i.e., the 'polluter-pays-principle'), though this may not always be possible. In any case, there is a logic that subsidies should be used to help poorer countries to reach the minimum standards desired by wealthier countries since their own preferences could be to accept higher pollution levels. Each IFI has its own public policy goals that would justify action along these lines.

### **Two extreme views on IFI lending to the private sector**

While the displacement of commercial banks could be justified by these public policy considerations, the problem is that the 'value-added' of the IFI becomes progressively more subjective in these new settings, and the trade-off between the volume of activity and value-added becomes highly judgmental.

One could foresee two opposing views:

- IFIs should be given the benefit of the doubt, since added value is essentially non-quantifiable. Moreover, commercial banks offer a range of products while the IFI may focus on one or two key products (such as 'plain vanilla' long-term loans). Competition will only occur in a small market segment, and in a segment that it is not particularly profitable for commercial banks.
- The market should be relied upon to the maximum extent. IFIs should only intervene when there is no doubt over complementarity. This would mean developing the kinds of intervention that support the commercial banking sector. Examples would be guarantee schemes, B loans in appropriate settings, support in loan syndications, etc.

There is an important argument to support the first view. **When IFIs are operating efficiently**, there is no welfare loss if the public sector (e.g., an IFI) funds a project instead of a commercial bank. It is simply a question of commercial banks searching market share, and this is not in itself a goal for policy makers to be unduly concerned about (18). However, if the IFI cannot demonstrate that it adds value (e.g., through advancing investment, or changing investment patterns in a desirable way), and it becomes almost indistinguishable from other banks, it is legitimate for shareholders to ask: why bother?

**Where a particular IFI ends up, will depend upon local factors and the consensus between shareholders on the role of public banks in general.**

The second, more minimalist view, does not necessarily solve the problem of additionality in a clear-cut way. Indeed, with the growth of capital markets and securitisation of bank assets, it is exactly in the advisory sphere that some banks are looking for future profits. For example, a group of major banks (meeting under the auspices of the International Institute of Finance) have requested that the IFC should not compete for publicly tendered privatisation mandates, that it should rely to a greater extent on the ability of banks to appraise, arrange and manage project financing, and that it should limit underwriting of international securities to exceptional cases. Taking the logic to the extreme, everything an IFI does with a private sector project, including political risk insurance, can be done

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18) However, it would require a generous interpretation of the IFIs' Statutes to arrive at this conclusion. Most include a prohibition to financing investment where funds are available on 'reasonable terms' from other sources (e.g., the AfDB, EBRD, EIB, IDB, IBRD, IFC), though the language is slightly more nuanced for the ADB (it will pay 'due regard' to the availability of alternative finance), and the NIB, set up by Nordic countries in the 1970s, has no such limitation. What is 'reasonable' is, of course, in the eye of the beholder. Taking a legalistic view, it will usually be impossible to document and compare the terms of alternative sources of finance, meaning that the subjective judgement of the IFI must be relied on. Since there would be no demand for IFI finance if it were not less costly than other sources, one could argue that every IFI loan is more 'reasonable' than the market.

by private financial institutions - albeit at a different price. This means that where a particular IFI ends up between the two positions set out above will depend upon local factors and the consensus between shareholders on the role of public banks in general (there is by no means a uniform dogma on this issue). IFIs may evolve in quite different directions as a result.

**The key issue: the efficiency of IFIs and how to prove it?**

A further factor in deciding the final role for IFIs, and perhaps the determining factor, will be the reputation of the institutions. Are they indeed efficient in reaching their objectives? Or are their privileges and advantages simply supporting inefficient and wasteful bureaucracies?

**There will be growing pressure for IFIs to demonstrate their effectiveness.**

The bottom line for private companies is their profitability and the return on equity they generate for shareholders. Of course, it is not always straightforward to understand what is happening, and short-term profits can be boosted at the expense of sustained long-term returns. However, assessing performance is much simpler than for IFIs. These institutions are run on cost-plus principles, so the return on equity is determined more by interest rate developments than anything else, and they pursue a complex range of non-quantifiable objectives (19).

An additional complicating factor is the lack of transparency of decision making for groups outside the institutions. The IMF has most recently come under attack for this (20), but the same issue applies to IFIs in general. Though there may well be an unnecessary level of secrecy, it should be recognised that banking confidentiality does make openness difficult, particularly when private sector borrowers are involved.

The end result of these factors is a lack of information on the costs and benefits of IFIs. Aside from overall efficiency, this could also lead to undesired cross-subsidies from one activity to another, a further distortion of the playing field in the IFIs' favour. Such a situation will become increasingly unacceptable, and, as with all public sector activities, there will be growing pressure for IFIs to demonstrate their effectiveness.

This issue also raises an interesting question regarding the capitalisation of IFIs. In purely theoretical terms, there is not necessarily any inefficiency if these institutions have more paid-in capital and reserves than they actually need to support commercial risks. It is simply substituting IFI equity for greater borrowing, or private savings (from the people who buy the IFI bonds) by public savings (from taxpayers) (21).

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19) Other public institutions, e.g., hospitals and schools, also face a complex range of objectives. However, it may be relatively easier in some of these sectors to construct quantitative indicators of performance (e.g., waiting times for operations and success rates, and the percentage of pupils attaining certain educational standards).

20) For example, the G7 meeting in May 1998, encouraged the IMF to publish more information about its decision making.

21) Of course, this is not strictly true if raising taxes causes substantial distortions to the economy. To put the figures in some context, the paid-in capital and reserves of the institutions discussed in this paper is equal to some one-third of a percent of OECD GDP.

This theoretical argument does not hold if governments face constraints on gross government debt, since holding illiquid IFI assets does constrain the funds they have available for other purposes. This is certainly the case within the European Union due to the fiscal requirements of EMU, but it probably holds for many other governments as well. Indeed, the fiscal rectitude and move to the private sector mentioned in Section 5 are not restricted to developing countries. This means that it is very likely that one of the ways in which IFIs will be asked to demonstrate their efficiency is by using a minimum of shareholders funds to pursue their goals.

## 8. Conclusions

In this paper we have looked at the institutional framework for IFIs to see how this may adapt in the next century. The traditional model is of an institution ideally structured to fund large public infrastructure projects (or the state-owned industry that was also common in the post-war period). It is not that this model has lost any of its validity, but rather that the world has changed around it. Lending has shifted towards sectoral and programme finance, and IFIs have progressively delegated project design and implementation to counterparties.

***A consequence of significant private sector lending is that commercial logic must increasingly apply to the IFIs themselves.***

More fundamental, however, is the shift to the private sector as an agent for development, and the desire for IFIs to participate in this process. While small tentative steps can be taken in this direction with little impact, a consequence of significant private sector lending, and of the inevitable competition with commercial banks, is that commercial logic must increasingly apply to the IFIs themselves - and their accounts may look more and more like those of a private sector bank.

Taking this logic to its extreme and looking further into the future one could imagine that some IFIs will consolidate back to the traditional model, while others will become progressively private sector-oriented.

A middle ground could exist for those institutions that act as agents for grant donors, and package this together with loans. Even in highly developed regions there can remain market failures that justify public sector intervention in this way (perhaps the environment is the most obvious candidate).

For the group that is oriented most strongly towards non-commercial financing of the private sector, it may be a small step to explicitly unbundle sovereign and commercial risks, with sovereign risk insurance being provided by institutions operating along the lines of the traditional model. In this case, the private sector IFI may become a commercial entity in all but name.

This is crystal ball gazing far into the future. On balance, the near-term solution of euthanasia for IFIs seems a far too pessimistic view of their usefulness. However, the next few decades may be very much more aggressive and challenging for these institutions than it was for the first few decades of their existence. To quote the poet Philip Larkin: *"Life is first boredom, then fear"*.

# Annex

## Some statistics on IFI balance sheets, 1996

AfDB	ADB	EBRD	EIB	IDB	IBRD	IFC	NIB
<b>Maximum gearing</b>							
Loans outstanding, undischursed commitments and guarantees, cannot exceed 100 percent of subscribed capital, reserves and surplus.	Loans outstanding, undischursed commitments, equity investment and guarantees, cannot exceed 100 percent of subscribed capital and reserves.	Loans outstanding, equity investment and guarantees, cannot exceed 100 percent of subscribed capital, reserves and surplus.	Loans outstanding and guarantees cannot exceed 250 percent of subscribed capital.	Loans outstanding and guarantees cannot exceed 100 percent of subscribed capital and the general reserve. <i>In addition, policy to target reserves-to-loans ratio at 20 to 25 percent.</i>	Loans outstanding and guarantees cannot exceed 100 percent of subscribed capital, reserves and surplus. <i>In addition, policy to target reserves-to-loans ratio at 14 percent.</i>	Loans outstanding and guarantees cannot exceed 400 percent of subscribed capital. <i>In addition, policy that paid-in capital and reserves must be at least 30 percent of risk-weighted assets.</i>	The ordinary lending ceiling is set at 250 percent of subscribed capital.
<b>USD billion</b>							
<u>Total balance sheet assets</u>							
13.6	35.3	13.5	170.1	40.6	159.8	18.6	11.0
<u>Disbursed loans</u>							
9.5	16.1	3.8	132.0	25.2	102.6	6.0	7.3
<u>Subscribed capital</u>							
22.1	49.4	12.3	77.7	80.1	180.5	2.4	3.5
<u>Paid-in capital</u>							
2.1	2.7	3.6	5.5	3.0	9.1	2.2	0.4
<u>Reserves</u>							
1.3	6.6	0.0	16.1	6.1	16.3	2.5	0.7
<b>Percentages</b>							
<u>Paid-in capital/Subscribed capital</u>							
9.0	5.3	29.1	7.0	3.7	5.0	94.2	10.8
<u>Disbursed loans/Subscribed capital plus reserves</u>							
39	29	30	141	29	52	122	172
<u>Disbursed loans/AAA callable capital plus paid-in capital and reserves</u>							
123	55	43	202	63	103	126	432
<u>Disbursed loans/Paid-in capital plus reserves</u>							
282	173	103	613	277	403	126	670
<u>Non-accrual loans/disbursed loans</u>							
10.1	0.1	0.3	0.4	0.0	2.2	4.9	0.3
<u>Loans to rescheduling countries/disbursed loans</u>							
44.8	0.0	21.1	1.3	8.1	11.9	7.4	0.2

Notes: The subscribed capital of the EBRD was doubled on April 3, 1997, with the paid-in ratio set at 22.5 percent. The subscribed capital of the EIB will be increased on January 1, 1999, to ECU 100 billion. The paid-in ratio will be dropped to six percent at that time.

Source: Standard & Poor's, *Special Edition on Supranationals*, September 1997.

**Michael Klein**

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# One hundred years after Bretton Woods: A future history of the World Bank Group

Michael Klein

## 1. The World Bank Group

### 1.1 The first 50 years

*Reconstruction and development.* The Bretton Woods conference of 1944 gave rise to a set of global economic institutions - the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD or World Bank) and the General Agreement on Tariffs and Trade (GATT), precursor to the World Trade Organisation (WTO). Their rationale reflected the experience of the Great Depression of the 1930s, when world output collapsed amidst a contraction of trade and competitive devaluations. During the 1950s, in a world of fixed exchange rates with borders gradually opening up to trade and finance, the World Bank funded mostly infrastructure projects for economic development first in Europe, but soon in developing countries.

*Poverty and basic needs.* When the developed world recovered beyond expectations, attention turned to persistent poverty, particularly in Asia, one of the big battle grounds in the cold war. At the time, trust in public sector solutions to tackle development issues was still high. In addition to infrastructure lending, the 1970s saw rapid growth of World Bank projects in health and education, as well as rural and urban development to meet the basic needs of the world's poor via public sector solutions.

*Debt crisis and the end of communism.* The debt crisis of the 1980s shifted the focus towards policy-based adjustment lending, particularly in Latin America. Disillusioned with public sector solutions, attention shifted to private sector development, deregulation and open trade combined with orthodox fiscal and monetary discipline under the new "Washington Consensus". Latin America barely emerged from the debt crisis when the Soviet Union and other East European communist states collapsed, and the World Bank started on the uncharted task of helping the affected countries with the change towards a market economy.

*Global exchange, global concerns.* With the end of the cold war and increasing cross-border flows of trade, capital and information, a new global system started to emerge. The 1980s and 1990s saw an ever broadening scope of concerns for the World Bank in diverse areas such as protection of the environment, good governance including the fight against corruption, private sector development, gender equality combined with broader support for civic society, calls to consider the full spectrum of human rights, and moves towards advocacy of some form of democratic government.

By the 1990s, the World Bank Group had increased lending to over USD 20 billion per annum and grown from a few hundred staff in the 1950s to almost 11,000. Beyond the original IBRD, the World Bank group comprised its private sector arm, the International Finance Corporation (IFC) since 1956, the soft-loan window of the International Development Association (IDA) since 1960,

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*The views presented in this essay are the author's own and do not reflect positions of organisations that the author is or was affiliated with. The author would like to thank Constantijn Claessens, Pierre Guislain, Ignacio Mas, Doug McKay, Neil Roger, Jeffrey Shafer and Nemat Shafik for helpful comments.*

the International Center for the Settlement of Investment Disputes (ICSID) since 1966, and the Multilateral Investment Guarantee Agency (MIGA) since 1988. In parallel, a whole system of regional multilateral development banks had developed including the African Development Bank (AfDB), the Asian Development Bank (ADB), the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IDB), the Islamic Development Bank and a number of smaller ones.

Never were the development bureaucracies bigger, never were they asked to pursue more varied goals and never were they criticised more. Criticism reached a peak at the occasion of the 50th anniversary of Bretton Woods in 1994. Conservatives argued that the World Bank was just crowding out private firms and financial institutions and more generally wasting taxpayers' money. Left-leaning critics accused the institution of ruining the environment, hurting poor people and supporting corrupt elites. More mainstream observers found evidence of waste, an overemphasis on meeting lending targets over getting results on the ground, and a variety of other complaints about bureaucrats resisting needed change.

The fact that the Bank had systematically achieved very respectable real returns on projects where such returns could be measured, seemed to count for little (Table 1). The additional fact that the Bank was exposed to projects of a riskiness that looked more like venture capital than prudent lending did not make its critics pause. The decline of project quality following the worsening world environment in the 1980s was largely blamed on staff. Success ratios of 60 percent, a venture capitalist's dream, attracted only criticism, some of the sharpest from within the institution. It is not at all clear that the World Bank would have been invented at the turn of the 21st century had it not already existed.

*It is not at all clear that the World Bank would have been invented at the turn of the 21st century had it not already existed.*

**Table 1.** Average economic rates of return on World Bank-supported projects (in percent)

Sector	1974-1982	1983-1992
Irrigation and drainage	17	13
Telecommunications	20	19
Transport	18	21
Power	12	11
Water and sanitation	7	9
All World Bank operations	17	15

Source: World Bank (1994).

Yet, many argued that the World Bank Group was still in better shape than many other multilateral organisations. The World Bank, partly due to its exposed position, became a test case in the move to the new 'zero-tolerance' world, in which it was subject to increasing and competing demands from multiple constituencies including the about 180 shareholding governments, electorates in the various countries, non-governmental organisations (NGOs), firms, financial institutions, etc. In fact, in the absence of well-established global institutions for many concerns, it helped mediate, shape and implement conflicting demands, which were ultimately meant to affect policies in countries throughout the world.



## 1.2 Understanding the transformation

*Functions of the World Bank.* To understand the evolution of the World Bank Group it is helpful to decompose its basic product conceptually. In essence, the World Bank of the first 50 years produced a single product, the loan. Bundled up in the loan were five main functions - funding, guarantee, subsidy, policy advice and, to some extent, rating agency services. In addition, the World Bank participated to a degree in the lender of last resort system spearheaded by the IMF.

**The World Bank of the first 50 years produced a single product, the loan, but bundled up in this were five main functions.**

- The pure provision of *funding* was essential in the original Bretton Woods world of capital controls. The World Bank had *de facto* the privileged ability to move funds (loans) out of developed countries into developing ones - and back again (repayments). In principle, the Bank was to provide such funding only as a last resort, when private markets failed to do so.
- *Vis-à-vis* its bondholders the World Bank provided *guarantees* of repayment of the loans backed by callable capital from its shareholders. Normally this guarantee function was bundled with the loan, but for some time the World Bank tried to develop free-standing guarantee instruments to support direct private lending to developing nations.
- World Bank lending - often together with support by the IMF - was also seen by proponents as providing valuable *signals to private investors* about the creditworthiness of a country, thus coordinating investor expectations and preventing panicky and uninformed investor behaviour. In that sense, IMF and World Bank were *de facto* delegated to monitor countries' policy efforts on behalf of the private financial markets (Rodrik, 1995, and Gilbert *et al.*, 1996). The stamp of approval from the Bretton Woods institutions helped countries attract foreign capital, but might also have created a degree of moral hazard. The IMF, sometimes complemented by the World Bank and other international financial institutions (IFIs) also backed its signalling function with liquidity provision as a *lender of last resort*.
- The World Bank Group also passed on *subsidies* to developing countries either funded explicitly from resources provided by donor governments under the IDA scheme, or implicitly as shareholders renounced taxes and dividends and callable capital was not remunerated.
- Finally, World Bank staff and an army of consultants conducted research and provided *advice* on project design and management as well as on economic policies in the course of project work and in parallel.

*Synergies and conditionality.* Various analysts argued that the provision of all these functions under one umbrella was beneficial. Essentially it was argued that subsidised funds and the facilitation of private investment acted as an incentive for governments to pursue policy or project designs, which were thought to be suitable for economic development on the basis of research by the World Bank. The research was in turn facilitated by the access to data that lending enabled. The whole approach was often called policy conditionality.

*Unbundling and new roles.* With hindsight we can see how changes in the world at the turn of the century exerted major pressures on the World Bank to unbundle the different functions of the traditional loan. In the following, the essay analyses the emergence of a new set of separate, generally free-standing 'products'. In addition, an in-built tension underlay the role of the World Bank and also the IMF that drove to some extent the evolution of today's world governance mechanisms. Both

**Changes in the world at the turn of the century exerted major pressures to unbundle the different functions of the traditional loan.**

institutions, sometimes complemented by other IFIs, tried to set conditions for sovereign nations, thereby undermining aspects of sovereignty. This 'contradiction' was gradually resolved by the creation of standards and rules that were accepted world-wide. Once such rules were accepted the peculiar mechanisms of conditionality were no longer necessary. In retrospect, it is also clear that these changes were for the better, given the emergence of the world economy as we know it today, in 2044. In fact, out of the World Bank Group emerged a number of essential features of our current global governance mechanisms, even though few remember their origin.

*Outline of the essay.* The essay starts by providing a general sketch of the world in 2044 compared to that in the mid-1990s. Further features of the world of 2044 are later introduced topic by topic. The essay then argues that:

- First, the rise of both private financial markets and the private provision of most economic and social services rendered the *funding and guarantee functions* of the World Bank group largely superfluous.
- Second, most remaining *lender of last resort functions* are in 2044 exercised by pre-funded private standby liquidity schemes, because most lending is private-to-private and currency competition has rendered central banks unable to provide open-ended liquidity support.
- Third, the World Bank's involvement in structural surveillance and in various forms and aspects of public-private partnerships has given rise to a number of voluntary and mandatory *global standards and regulatory rules*, which embody policies that were previously promoted *via* World Bank loans. These rules form the essence of the global governance system of 2044. The World Bank has in particular facilitated better *governance for failed states*.
- Fourth, the *subsidy function* has by 2044 been integrated into the global component of the safety net for the poor. The World Bank helped design effective schemes and continues funding a number of them *via* loans or *via* straight subsidies.
- Fifth, much of the information and advisory work has been taken over by private firms as governments felt obliged to divulge more and more information and became increasingly transparent. The World Bank, in concert with other organisations, has more and more turned into an agency that helps governments diffuse *best practice in the area of economic policy*.
- Sixth, the World Bank is now run as a *foundation* living off an endowment funded from its original paid-in-capital and subsequent contributions. It continues to provide innovative contributions to the fledgling world governance system and particularly to the fight against poverty.

In essence, the World Bank's main over-arching role has been that of an *international catalyst for transition*. From being primarily a lender and guarantor it has evolved to promoter of best practice for policy-makers and better rules and standards for the global governance system. Its efforts remain focused around policies and schemes that help eradicate poverty and create the conditions for sustainable progress. Other multilateral organisations have been shaped by many of the same forces affecting the World Bank. Some, like the AfDB, took on increasing importance when Africa finally started growing. Others, like the EIB, are now largely private as the strong institutional framework of Europe, combined with highly sophisticated capital markets, enabled funding needs to be fulfilled that were previously covered by the EIB.

## 2. Lending and guarantees

### 2.1 The world in 2044 - Economic growth, income and poverty

*The World Bank has evolved to promoter of best practice for policy-makers and better rules and standards for the global governance system.*

*Growth at the frontier.* As in the 150 years preceding 1994, world productivity growth in the most advanced countries averaged about 1.5 percent per annum between 1994 and 2044. Japan overcame a major crisis at the turn of the century, deregulated its economy and has now reached US levels of labour productivity and a living standard of about USD 54,000 per capita (all figures in 1994 dollars adjusted for purchasing power differences). Labour and product market rigidities plagued the European Union during much of the early decades of the century with the result that Latin America has now caught up with European living standards at about USD 40,000 per capita on average (see Annex).

*Conditional convergence.* Most Latin American and Asian countries averaged productivity growth rates of about four percent as economies were prudently managed and suitably deregulated (Table 2) (1). Some countries were able to benefit from the ever-increasing potential for technological catch-up, achieving sustained growth rates above ten percent for two decades. But most countries and regions were plagued by recurring crises with the result that world output growth averaged a historically unexciting 3.3 percent (2.3 percent per capita).

**Table 2.** Per capita income growth in historical perspective (in percent)

	1950-1973	1973-1995	1995-2044
Western Europe	3.9	1.8	1.2
Southern Europe	4.9	1.7	1.2
North America and Oceania	2.4	1.4	1.6
Eastern Europe	3.5	-1.1	3.8
Asia (incl. Japan)	3.8	3.2	3.1
Latin America	2.5	0.5	3.7
Africa	2.0	-0.1	2.0
World	2.9	1.2	2.3

*Note: Income figures are in PPP-adjusted terms.*

Source: Maddison (1995) for historical numbers.

Africa is by now developing more broadly. Several countries have actually reached per capita incomes above USD 7,000. The greatest difficulties with economic growth have been experienced in the Middle East, where governments remained paralysed and unable to undertake necessary reform while the decline of conventional oil has reduced living standards. As a result of steady advance among the most developed countries on the one hand, and severe long standing disruptions in some economies on the other hand, inequality among countries has actually increased.

*Inequality and poverty.* While world output almost quintupled in real terms and average per capita output exceeds USD 18,000, about 15 percent of all people live on incomes below USD 3,500 (Indonesia's level in 1994). Serious poverty is still an issue in various pockets of the most advanced

1) Empirical analyses suggest that subject to sound policies backward countries tend to catch up with more advanced countries (Barro, 1991, and Fishlow, 1995).

regions and in parts of South and Central Asia, Africa and the Middle East. Yet, hope for an eventual victory over poverty has never been greater as a result of overall economic performance in the world. Successful global schemes for managing environmental stresses promise a future of sustainable decent living standards for most people still within the current century. By 2094, average African GDP per capita should have reached about USD 14,000 (Portugal's level in 1994), if reforms persist reasonably well and productivity growth increases to a moderate three percent on average - a rate achieved quickly by the early reformers in the late 20th century.

## 2.2 The evolution of private markets

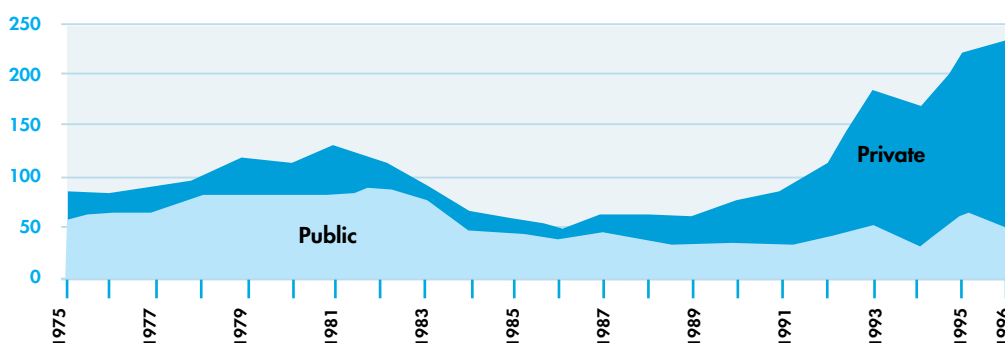
### *The rise of private capital flows*

*Diminishing capital controls.* Following World War II, global financial flows were limited by pervasive capital controls everywhere. Until 1960, about 80 percent of current account transactions from developed countries were still subject to controls (IMF, 1998a). Significant capital account liberalisation in major OECD economies such as Japan, France and Italy occurred only in the 1980s and to some degree throughout the 1990s. Japan's 'big bang' extended well into the first decade of this century. It took developing countries until almost 2010 to fully liberalise current account transactions. Capital account opening was delayed following the Asian crises of 1997. Yet, *de facto*, borders were becoming more and more permeable for financial flows. Following improvements in financial sector regulation and the unstoppable advance of cheaper and safer telecommunication technologies, capital account controls crumbled in most countries by the middle of the 2010s.

**It became apparent that private capital could be counted on to meet the investments needs of promising developing countries.**

*Private capital flows.* Already in the early years of liberalisation of financial flows it became apparent that private financial flows from domestic and foreign saving could be counted on to meet the investment needs of promising developing countries. Following the opening of developed financial markets, the 1970s saw massive private cross-border lending to developing governments (Figure 1). During the 1990s, developing countries had developed large private sectors able to borrow from private sources abroad. While some commentators complained that over 70 percent of such flows went to only 12 countries, on closer inspection it was clear that those 12 countries actually accounted for over 60 percent of world population and the number of countries with access to the capital markets kept increasing as governments improved economic policies (World Bank, 1997a). In particular, the IMF noted that countries in Africa with decent policies saw private capital flows recovering to levels "not much lower" relative to GDP than developing regions outside Africa (IMF, 1998a).

**Figure 1.** Public and private capital flows to developing countries, 1975-1996 (in 1996 USD billion)



Source: World Debt Tables.

### *Fiscal crises, privatisation and deregulation*

*Incentives in tax-funded transfer systems.* The capital markets were not the only area where private markets replaced government financing and provision of services. On the back of unexpected productivity growth, and therefore high taxation possibilities, many developed countries expanded the welfare state after World War II, particularly in Western Europe. The share of government expenditure in GDP rose from about nine percent of GDP in 1913 to 28 percent in 1960 and 46 percent by 1996 (Crook, 1997). Most of the increase was due to the ever-increasing cost of transfer payments from previously unfunded pension, social security and unemployment insurance systems. The very security provided by tax-funded schemes, combined with labour and product market rigidities, gradually undermined incentives to work and innovate. When productivity growth declined in the mid-1970s, government funding of the welfare state became increasingly problematic.

**Table 3.** Average government expenditure in advanced economies as a share of GDP (in percent)

Type of Expenditure	1981	2044
Traditional (military, civil, interest)	11.0	9.0
Economic services	4.4	2.0
Social services (health, education, housing)	14.0	8.0
Pensions and other transfers	12.8	6.0
<b>Total</b>	<b>42.2</b>	<b>25.0</b>

Source for 1981 data: Maddison (1991); unweighted average for 1981 calculated from data for France, Germany, Japan, the Netherlands, the United Kingdom and the United States.

*Reform of the welfare state.* While the break with the welfare state is often associated with the name of Margaret Thatcher, British Prime Minister between 1979 and 1990, the classic example that showed the way was Holland, where starting in 1983 the government slowly reduced benefits and taxes, such that the expenditure-to-GDP ratio dropped by 10 percentage points between 1983 and 1996. In the early 21st century the shift to the new systems started in earnest, albeit accompanied by acrimonious political fights, which in Europe led to the great unemployment and social crisis of 2010, which nearly broke the monetary union and dragged down growth for over a decade. Today government expenditure tends to vary between 20 and 33 percent in most developed countries (Table 3) (2). The accepted norm is that national welfare systems should largely rely on privately funded and defined contribution schemes. Society maintains a residual safety net with strong incentives to seek work.

*Privatisation and deregulation.* In both developing and developed countries the performance of state-owned firms in the manufacturing and service sectors remained disappointing. When fiscal constraints forced governments to act, a wave of privatisation and deregulation started to sweep all sectors of the economy throughout the world, much of it initiated by Chile, New Zealand, the United Kingdom and the United States in the 1970s and 1980s.

2) Given the assumptions about growth in this essay, the total amount of government expenditure is still higher by a quarter than in 1994. While roughly half of transfers remain in the public sector, half are handled via private insurance and pension schemes.

*Competition and innovation.* The biggest gains resulted from introducing real competition, which in particular increased incentives to innovate. One could already see that the benefits from innovation for infrastructure firms after the first serious episodes of deregulation swamped simple static efficiency gains (Winston, 1993). Education entered a revolutionary change in the early 21st century, driven on the one hand by demands for greater school choice (OECD, 1994), and by new options to design and deliver educational content as a result of the multimedia and telecommunications revolution, which is finally bearing full fruit. In the face of these pressures, old education systems were often unable to cope and gradually gave way to new entrants. Change was fastest in poor countries where on the one hand the potential return to education was enormous, while existing delivery systems were often dysfunctional. Likewise in health, where delivery has often been private, the new advances in medical know-how, such as a more complete understanding of the human genome, required new forms of delivery and funding for medical services of all kinds. Thus governments allowing experiments and free entry into these sectors have by now been widely imitated.

**Today, governments focus on setting basic policy frameworks governing entry into an industry, abuse of market power and regulation of quality.**

*The role of government.* Today, governments focus on setting basic policy frameworks governing entry into an industry, means to counter abuse of market power, and regulation of quality with mandatory standards in sensitive areas covering health, safety, environment and privacy. Basic services are delivered in health and education. In remaining natural monopoly areas such as some large transmission and distribution systems, mainly in water, road and rail transport, public agencies engage in price regulation. A number of road systems are still publicly owned, but more and more road utilities have emerged funded by electronically collected road user fees. As governments have contracted out a whole range of services, sometimes including tax and customs administration, security services, etc., the tasks of remaining civil servants have become more focused and demanding with a consequent rise in their pay and revival of status.

### **2.3 The vanishing rationale for World Bank funding and guarantees**

*The changing role of aid*

*Concerns about crowding out.* The liberalisation of financial flows and the privatisation of economic and social services fundamentally challenged the rationale for lending by the World Bank Group. Various observers noted that in the early days of free global capital markets in the late 19th century, private capital moved across borders without anything like the World Bank or any other international financial institution. Available evidence did not suggest that continued lending by the World Bank in the absence of capital controls would catalyse private capital flows beyond the level they would otherwise have reached (Rodrik, 1995). Private investors felt the Bank was taking away their legitimate business. Calls increased for the World Bank and the IFC to withdraw from traditional lending.

*The end of the foreign policy rationale.* At the same time, the end of the cold war in the late 1980s eroded the foreign policy rationale for supporting lending by the World Bank. When the cold war ended, official aid flows as a percentage of donor countries' GDP declined from 0.35 in 1986 to 0.25 by 1996 (World Bank, 1998). As part of a move towards greater regionalism, regional mul-

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3) Regional development banks comprise the African Development Bank, the Andean Development Bank, the Asian Development Bank, the Caribbean Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Inter-American Development Bank, the Islamic Development Bank and the Nordic Development Bank.

tilateral banks (3) grew in importance compared to the World Bank, as their objectives were more directly aligned with the foreign policy goals of their major shareholders.

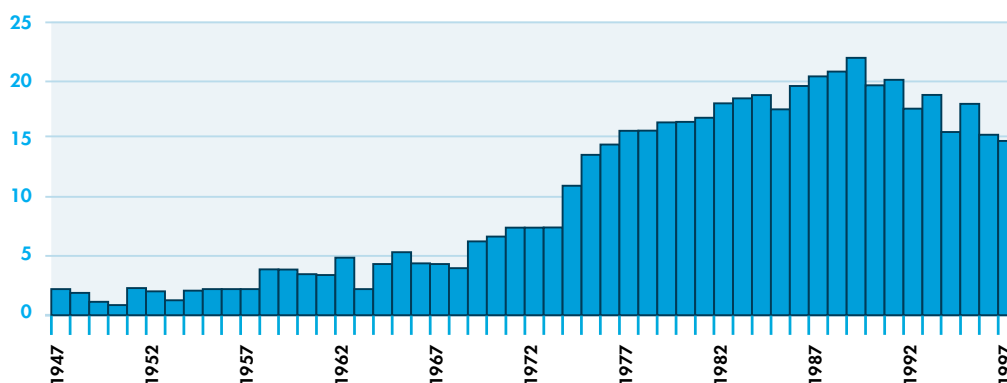
*The changing rationale for aid.* Finally, the basic justification for standard World Bank loans and development aid more generally was convincingly questioned (World Bank, 1998). Repeatedly, studies showed that good policies mattered most for economic development, not funding *per se*. In the context of good policies, aid could enhance their impact explaining, for example, the World Bank's successes in Japan and East Asia more generally. In the absence of good policy, aid actually often made matters worse as it reinforced and enhanced the command over resources by corrupt elites. Partly in response, late 20th century aid flows shifted from 'development' to humanitarian aid and support of policy reform in transition economies (World Bank, 1997a).

#### *The decline of traditional project lending*

*Sectoral shifts in lending.* With increasing privatisation, the portfolio of the World Bank began to shift to areas of residual public sector involvement. One of the first areas to go was lending to tourism, followed by a decline in industrial and energy lending in the 1980s. During the 1990s, the Bank started to withdraw from infrastructure lending, where private investment boomed, for example, telecommunications and power-generation. During the first two decades of the 21st century, the social sectors, health and education were similarly affected (4).

*Overall lending.* Aggregate World Bank project lending started declining in the late 1980s (Figure 2). At that time, many governments in developing countries made major efforts to reduce their fiscal deficits. As a result the total amount of public or publicly guaranteed debt fell slightly over the decade of the 1990s. This restricted the market for World Bank loans, which had to be guaranteed by governments. At the same time several other multilateral banks (ADB, IDB) received capital increases and took market share from the World Bank. More importantly, private players were able to lend funds to all creditworthy governments. If the World Bank wanted to follow its official philosophy of remaining a lender of last resort, it had to accept a declining lending volume.

**Figure 2.** World Bank lending, 1947-1997 (in 1997 USD billion)



Source: World Bank Annual Reports.

4) As early as the mid-1990s, Bank staff was faced with surprising proposals such as the one by the Nicaraguan government to privatise large parts of the primary education system of the country.

*Lending rate policy.* Already since the 1980s, the World Bank had a policy of not on-lending loans via financial intermediaries to private firms at below market interest rates so as not to crowd out private lenders. In 1998, the Bank set a precedent by charging South Korea a more market-based interest rate as part of special support following the Asian currency crises of 1997. In the first decade of the century this policy was broadened to encompass all lending. During the 2010s it was finally decided to make World Bank loans available at a penalty to the market (5). Consequently, World Bank loans are now only attractive to countries without adequate access to private capital markets, essentially a small and shrinking number of 'failed states'.

#### *Co-financing and guarantees - Supporting private enterprise*

*Co-financing and guarantees.* The World Bank responded to the vanishing rationale for loans with a number of schemes to complement rather than crowd out private financiers, e.g., co-financing and guarantees. The 1980s saw credit guarantees under 'B-loans' and 'ECO' (enhanced co-financing) schemes. However, all World Bank exposure had to be counter-guaranteed by governments thus effectively maintaining government risk exposure.

*Political risk insurance.* The 1990s saw a move towards targeting guarantees on special policy risks, which private lenders could not bear or manage as well as the World Bank. But private political risk insurance markets developed astonishingly fast. Already by 1998, political risk insurance of about USD one billion per project could be syndicated by half a dozen corporations such as AIG, Lloyds or CITI for maturities up to ten years. The coverages (convertibility, war and civil disturbance, expropriation and breach of contract) were no different from the World Bank's (Table 4). In fact, pricing for reasonable risk was not very different from the World Bank's (40 to 100 basis points for the beneficiary of the policy). That exposed the World Bank to a major adverse selection problem, leaving it with the worst risks.

**Table 4.** Offering of political risk insurance in 1997

Supplier	Private market	Bilateral risk insurers	MIGA	IBRD
Coverage	W-E-C-B	W-E-C-B	W-E-C	W-E-C-B
Maturity	up to ten years	about 15 years	about 15 years	15 to 20 years
Amount per project	> USD 1 billion	USD 250 million	< USD 50 million	n.a.
Price range in basis points	20 - 1,500	25 - 125	20 - 175	40 - 100

Notes: W = war risk; E = expropriation; C = currency convertibility; B = breach of contract.

Source: West (1998) and Irwin *et al.* (1997).

*The cost of risk-bearing to taxpayers.* The development of the private political risk insurance markets drove home the point that captive taxpayers are not necessarily better placed to absorb such risks than are global investors that can diversify over many countries. Taxpayer finance might have

**Private political risk insurance markets drove home the point that captive taxpayers are not necessarily better placed to absorb such risks than are global investors that can diversify over many countries.**

5) The example of US Treasury lending to Mexico in 1995 showed how effective such lending could be, providing the Mexican government with an incentive to regain access to the financial markets as early as possible so as to be able to repay the loan early. Furthermore, the US government made a profit thus validating the implicit trust of its taxpayers.



a rationale if the government truly had a lower cost of capital than private investors. But that is not clear at all. Governments borrow at lower apparent cost than private firms because they have recourse to taxpayers, not because they are better able to manage projects. The taxpayers provide unremunerated credit insurance. If such insurance was remunerated to compensate taxpayers for the risk imposed on them, it is *ex ante* no longer clear that public funding is advantageous (Brealey *et al.*, 1997, and Klein, 1997). The benefits to private parties that somehow participated in loans and/or projects under the World Bank Group umbrella, were ultimately based on the superior ability of the World Bank Group to extract taxpayers' money from defaulting nations *via* its preferred creditor status. In turn, this special position was backed by the taxpayers in the world's most developed countries. None of these taxpayers was ever remunerated for the *de facto* credit insurance they provided. Taking into account the risks borne by these taxpayers, it became doubtful whether policy risk cover of whatever type was actually adding value from a social cost-benefit perspective.

*Risk redistribution vs. risk reduction.* Of course, participation in lending operations alongside the World Bank Group was attractive to private investors, providing them with added security as they could hope for quiet diplomatic intervention, and in case of default they might find themselves higher up in the queue of claimants than otherwise (6). Today, this is determined by the new world bankruptcy system. In the case of the credit guarantee program, analysis suggested that the benefits from World Bank guarantees broadly equalled the cost of those guarantees to taxpayers, thus mostly shifting risk rather than reducing it (Huizinga, 1997).

*Moral hazard.* In fact, wherever there was an absence of sound policy, the risk cover provided actually created moral hazard problems. Both in Mexico's 1994 crisis and in the 1997 Asian crises, the culture of explicit or implicit off-balance sheet guarantees, particularly those provided to infrastructure projects, was a major contributing factor (Ruster, 1997). The IBRD had always been wary of these problems, and the amount of credit and policy guarantees it issued actually dropped in the late 1990s from about USD 500 million in 1995 to USD 100 million in 1997. Following the Asian crises of 1997, there was a period of revival. Yet, when convertibility insurance became tradable in the first decade of this century, the IBRD's program collapsed.

*Privatisation of MIGA and IFC.* MIGA and the IFC initially continued to be attractive to private parties, while in the case of the IBRD one of the investors' first question was "how long will the Bank delay us?". MIGA and the IFC were more focused and did not require government counter-guarantees and were thus easier to deal with. Yet, they too were forced to change. Under the pressure from competing financial institutions both MIGA and the IFC took on more and more risks in countries where investors did not yet dare to tread. Luckily, the relentless process of globalisation provided sufficient incentives for countries to perform. MIGA and the IFC were eventually privatised in the second decade of the century on the example of the Commonwealth Development Corporation, the IFC-equivalent of the UK government, which was already privatised before the end of the 20th century (7).

*Sound policy.* Throughout this period, World Bank policy work advocated private, competitive solutions more and more. Slowly, the simple basics emerged. Projects are eventually paid for either by

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6) Lending alongside the IFC could also provide some tax advantages such as exemption from withholding taxes.

7) Privatisation of the Commonwealth Development Corporation is being prepared for 1998.

taxpayers or consumers. When consumers pay the full cost of projects including the cost of capital, investors will invest. The 'shortage' of private financing for infrastructure finance in the late 20th century was essentially due to governments' unwillingness to raise tariffs to cost-covering levels (Dailami and Klein, 1997). The net effect of all efforts by the World Bank Group to support private sector development was to help in the politics of the transition to market solutions and adequate user fees, but it became more and more doubtful that the World Bank Group had any permanent rationale for financing the private sector. The only areas where public funding mechanisms are still used to support privately provided services in 2044 are those where governments have found it impossible to charge user fees, i.e., in the case of pure public goods, such as maintenance of the legal system.

### 3. Lender of last resort and rating agency functions

#### 3.1 Incentives behind currency crises

*Repeated currency crises.* In the process of financial liberalisation world-wide, the IMF, the World Bank Group and other IFIs were repeatedly called upon to fulfil their function as lenders of last resort (8). Following the private lending boom to governments during the 1970s, IFIs, led by the IMF, provided positive new flows to countries in crisis in the 1980s, particularly in Latin America as private net flows became negative. The Mexico crisis of 1994/1995 and again the Asian crises of 1997 briefly interrupted the increase in private flows and IFIs spearheaded efforts to ward off excessive economic and political distress. The biggest of all operations of last resort occurred in the first two decades of the 21st century, when Russia and China experienced severe currency crises just as they emerged on the world stage as new powerhouses.

*Moral hazard.* The repeated nature of currency crises, even in countries with the appearance of sensible macroeconomic policies, highlighted the importance of underlying incentive policies governing financial and currency systems. Foreign lenders in high-risk environments with high domestic interest rates were continuously tempted to lend to firms that were equally motivated to exploit interest rate arbitrage. The temptation to exploit such apparent arbitrage opportunities was vastly strengthened by the perception of borrowers, short-term lenders particularly, that somebody would ride to their rescue in case of distress, particularly in the case of large borrowers like Russia. Off-balance sheet government guarantees, for example for quasi-private infrastructure projects and widespread *de facto* liability insurance for financial institutions and principally politically powerful groups of companies with connected banks, underpinned the private sector's expectations about a bail-out, thus creating major moral hazard problems (9). These basic lessons had already been learned many years ago during the Chilean crisis of 1982, which in many ways resembled the Asian crises of 1997. The IMF and the various IFIs at times aggravated the problem by creating implicit government guarantees prior to a crisis, and then helping to bail out foreign lenders after the crisis hit. It took until the turn of the century for the first serious consequences to be drawn.

**Internationally agreed  
bankruptcy rules govern  
defaults, which are mostly  
private-to-private.**

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8) *Isolated attempts by private financial institutions to substitute for the monitoring and co-ordinating role of the IMF ended in failure, notably a monitoring experiment in Peru in 1976.*

9) *Once distress approaches, the incentives to gamble for financial institutions with barely any capital are tremendous. For the owners of a bank with a true capital-to-asset ratio of two percent, it pays to play roulette on single numbers because they have a one in 35 chance to win, but only a two in 100 chance to lose for a positive net present value, which explains share price appreciations for shaky banks that gamble for resurrection.*

**Lender of last resort functions are managed by a combination of fiscal and private schemes.**

*Weaknesses of surveillance.* The Chinese and Russian crises of the early 21st century also finally drove home the point that pre-emptive discipline was very hard to impose *via* government-owned institutions such as the IMF. Unfortunately, the conditionality of the market was often better than none at all, despite serious over-reactions (10). The Bretton Woods institutions had failed to anticipate the 1982 debt crises, the 1994 Mexico crisis and most of the Asian crises of 1997. Where they did anticipate, as in the case of Thailand in 1997, all their private warnings did nothing to prevent the crisis in the face of the political unwillingness of the Thai government. It became clear that public institutions have a hard time to initiate prompt corrective action of even blatant policy mistakes partly because of the fear to unleash problems, for which they would be blamed, partly because of what IMF-internal critics called “clientitis”.

### **3.2 Creditor co-ordination and market-based disciplines**

*Towards an international bankruptcy system.* In the early decades of the century, a system was put in place that imposed a significant cost on lenders who wanted to benefit from any form of support by a lender of last resort. Essentially, lenders would have to pay for their sins, for example by agreeing to roll over debt at or below original interest rates or accept a discount on the value of their loans. To some degree the new rules institutionalised principles applied under the Brady bond schemes for highly indebted countries in the late 1980s. The new system resembled a bit proposals for international standards for bankruptcy mechanisms as proposed, for example, by the late Jeffrey Sachs in the late 20th century. It was this new system that made the Russian and Chinese rescues just about manageable, because it reduced moral hazard by foreign lenders, while political moral hazard remained very large.

*Private-to-private capital market finance.* Today in 2044, internationally agreed bankruptcy rules elaborated under the auspices of the IMF, with participation of the World Bank and the Bank for International Settlements, govern defaults, which are mostly private-to-private. Sovereign lending hardly exists anymore and public debt policies tend to be quite conservative. In addition, deposit banking is no longer important. Securitised capital market transactions dominate. Private rating agencies provide market intelligence as governments and private borrowers in most countries have realised that increased transparency helps improve their access to capital markets and financial terms. Deposit insurance is restricted to well defined high-quality banks, so-called narrow banks, and is pre-funded.

*Pre-funded liquidity and deposit insurance schemes.* To the extent that governments maintain lender of last resort functions they are managed by a combination of fiscal and private schemes, such as the ones developed under Argentina’s currency board system in the 1990s. The fiscal authorities run conservative policies, thus maintaining room to borrow, and standby lines of credit with highly rated financial institutions are pre-arranged for the case of a panic. The IMF, in concert with international development banks, occasionally still provides lender of last resort functions to newly emerging economies, which make the transition from failed state to successful developing nation.

*Market-based rules and disciplines.* The key moral hazard issue of today arises from the reliance of basic pension and social security schemes on volatile investment in securities markets. Pre-funded portfolio insurance schemes go a certain way towards handling the issue. In addition, prudential

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10) Crook (1991) and Collier and Gunning (1997) discuss problems with applying conditionality.

regulations covering financial institutions benefiting from access to some type of lender (or subsidiser) of last resort were progressively tightened. Today, most financial institutions, particularly those directly supporting payment arrangements, often find it in their interest to maintain 15 to 25 per cent equity reflecting the capital structure that one used to find in banking systems without clear lenders of last resort, such as Hong Kong in the late 20th century. Investors of all types are providing a significant level of co-insurance, as it is now recognised that co-insurance by investors in financial institutions, and even depositors in narrow banks, improves monitoring incentives without enhancing the risk of systemic failure (Baer and Klingebiel, 1995). To some extent managers and shareholders of financial institutions are liable for failure with their personal wealth (11).

### 3.3 Currency competition

*Currency competition.* Central banks did not voluntarily decide to abandon their traditional lender of last resort role. Overtaken by events, they had no choice. Today, monetary authorities are simply small players in a very large world market. Uncontrollable, secure and low cost electronic transaction systems allow buyers and sellers anywhere to settle even micro-transactions in any currency under any jurisdiction. Many of the concerns about currency crises have been transformed by now. People are able to store value in numerous assets until close to the time of a purchase transaction. They can then choose from several hundred assets what they offer as means of payment, including some highly rated debt of private companies. At the time of transaction the current value of the 'money' offered as means of payment is electronically checked and the transaction concluded (12).

Such currency competition implies not only that issuers of money have lost their monopoly and their special power. It also means that political borders are no longer contiguous with transactions conducted in particular currencies. Investors in a particular country can thus hedge their position much better against 'currency' risk. The world has finally left behind the awkward currency system, where sudden changes in the value of a single asset (national currency) issued by a monopoly (central bank) can lead to the breakdown of whole economies. Lender of last resort services for borrowers in distress can be fulfilled by any issuer of means of payments who believes - based on an assessment of underlying solvency issues - that extra liquidity is good business. On the other hand, the expectation of excessive money issue by a money issuer trying to perform the function of lender of last resort can lead to pre-emptive 'capital flight' into another currency, a fate experienced already to some extent by several Asian countries during the crises of the late 20th century. Moral hazard is thus not much of a problem anymore.

*Structural surveillance.* In the transition to the new lender of last resort and bankruptcy regimes the World Bank played a subordinate role to the IMF. In addition to allowing its balance sheet to be used, relevant Bank staff was more and more seconded to support rescue operations. However, the World Bank benefited from its enhanced role in policy surveillance. In the late 20th century it became clear that macroeconomic monitoring by the IMF was not enough for effective surveillance. Structural policies and developments, particularly in the financial markets, also needed attention.

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11) New Zealand reintroduced aspects of unlimited liability for bank owners in the 1990s. The history of free banking in Scotland shows how uninsured banks advertised with the personal wealth of their owners (Caprio and Vittas, 1997).

12) In 19th century North America, clerks at shops had books providing guidance on what money issued by what bank they could accept and how to discount it.

Around the turn of the century, the World Bank became responsible for structural surveillance complementing the IMF's macroeconomic surveillance under its Articles IV and VIII. While originally seen mostly as part of the lender of last resort system, the new systematic attention by the World Bank to structural policies - as opposed to its otherwise often *ad hoc* attention in the context of loans - and its promotion of public-private partnerships paved the way for the Bank's major contributions to the establishment of a new world system of governance, a topic to which we now turn.

#### **4. Public-private relations: Emerging governance systems**

##### **4.1 Standards, property rights and enforcement mechanisms**

*Focus on policy framework.* As discussed above, intricate schemes to impose risks on taxpayers, even when there is no public good to be produced, do not matter much for progress. What does are policies that create appropriate market structures facilitating competition, and regulatory frameworks dealing with market power abuse and standards affecting health, safety, environment and privacy. The World Bank had for some time worked on improving such policies. As the connection of policy work with traditional project loans withered away, the Bank focused more on developing rules and standards in various emerging global fora.

*Environmental standards and policies.* One of the most prominent examples is provided by the World Bank Group's work on the environment. In a way environmental work started out as standard-setting before it was translated to some degree into lending activity. Today's World Environment Organisation owes much of its success to early World Bank work on standard setting, and, particularly, implementation of the 1997 Kyoto environment conference. The emission permit trading scheme that the Bank, together with the Environmental Defence Fund, helped promote is now seen as a key mechanism for creating a sustainable path to growth. Initially, there was a wide variety of economic instruments used to implement environmental goals, including command and control schemes, 'green' taxes and tradable permits. However, in time it became clear that all such systems required the same detailed monitoring and penalty features, but that tradable permits provided better incentives to minimise waste and to monitor obligations. A series of new types of tradable property rights has enabled the world to cope with a number of market failures, for example via fishery and water rights, trade in ecological sinks and markets for bio-diversity (13).

*Reputational mechanisms.* The transparency brought about by ubiquitous information technology has created many ways for voluntary standards to be monitored and gain wider acceptance. For example, labour standard SA 8000 is one of the early examples dating back to the previous century. It was devised in late 1997 by the New York-based Council on Economic Priorities covering areas such as trade union rights, child labour, health and safety and fair pay. It was initially subscribed to by multinationals such as Toys 'R' Us, Avon and Otto Versand, who hoped to gain competitive advantage by subscribing to it (Control Risks Group, 1998). Today, governments and corporations have no place to hide.

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13) By the mid-1990s, tradable water rights had been introduced, for example in the south-western United States, Chile and Peru. Fishery rights in countries such as Iceland and Canada, as well as emission trading for sulfur dioxide in the United States, were deemed a success. Schemes to 'harvest' bio-diversity instead of destroying it were promoted by coalitions of multinationals and NGOs (Lacasse, 1992, Hahn, 1993, and Thobani, 1997).

A host of accreditation and monitoring bodies, often private, certify behaviour to various constituencies, be they socially conscious consumers or relevant voters. Interest in maintaining reputation has often turned out to be an effective mechanism for upholding rules. The bond markets are now very effective at instilling fear in those governments that are seen to generate social problems, and thus trigger investor withdrawals. The World Bank Group has been instrumental in promoting better rules in a wide variety of areas including methods of popular participation, corporate governance, corruption and labour standards. While the World Bank has in various cases helped establish new rules and agencies to supervise them, it has itself not become a standard or regulatory agency, but continues to catalyse new approaches.

*Arbitration.* At the same time more formal enforcement mechanisms have been strengthened. The World Bank's ICSID has become part of the World Arbitration System, which in conjunction with the International Court of Justice has, *inter alia*, replaced the old system of over 1,200 bilateral investment treaties that existed at the turn of the century. Building on previous arbitration conventions, the new system provides an effective mechanism to obtain enforceable judgements, not only in cases of breach of private contracts, but also for complaints about non-adherence to environmental norms and human rights. Signatories, which include most countries of the world, tend to live up to their undertaking to enforce the system's judgements, as they perceive clear benefits from playing by the rules and creating a favourable investment climate. The new arbitration and monitoring systems have taken a major burden off the back of the WTO, which was in danger of being abused to enforce all sorts of norms by applying trade sanctions. New global norms and standards combined with agreed arbitration and enforcement principles instead have placed the spotlight on the real issue, i.e., the quality of local enforcement mechanisms.

**The real problem was to find ways to improve the governance system so that it would stop erratically taxing economic activity officially or via corruption.**

*Competition among jurisdictions.* The world is, of course, still a far cry from a single global government. But that is to the best. While it has been possible to tackle the key global problems such as climate change sufficiently to prevent disaster, competition among polities persists. Competition among jurisdictions has given us some of the most promising policy reforms, for example those of Chile in the 1970s and 1980s. Chile, like Vietnam, introduced key reforms precisely when the countries were abandoned by the world community and had to make necessity the mother of invention. The world today operates much in the spirit of the 1992 European Union project. Differing jurisdictions allow firms and financial organisations to conduct business on the basis of licenses issued in any other jurisdiction that subscribes to the new global standards and rules. Going back further in history to the origins of our fast-advancing world economy, it was competition among jurisdictions in medieval Europe that brought about the "European Miracle" (Jones, 1981), while the technologically more advanced China languished as mandarins suppressed merchants (Landes, 1998).

#### **4.2 Governance for failed states**

*Economic recipes.* While the global governance system has arguably improved, a number of states continue to languish in a Hobbesian state of affairs. Such 'failed states', mainly in Africa, became more of a pre-occupation of the Bank in the late 20th century. It had become reasonably clear by then that the basic economic policies to be recommended for such states were quite simple: peace, stable macroeconomic policy (low inflation and sensible, predictable taxation) and open borders

without policy distortions. Countries able to put such policies in place easily grew at three percent per capita. Uganda demonstrated the power of such simple measures when it grew at rates of about eight percent per annum in the 1990s (five percent per capita). Botswana and Mauritius had previously tied themselves to basic sound policies and quickly became middle income countries.

*The real issue: governance.* The real problem was not the basic technocratic policy prescription but ways to improve the governance system to the point that it would adopt the basic policies and stop erratically taxing economic activity officially or *via* corruption (Olson, 1996). Obviously, success had to do with the ability of governments to commit themselves to a basic set of sound policies. Commitment required that governments tie their hands credibly so as to resist the temptation by influential players to rip off the country.

*Commitment devices.* Very slowly the lesson began to sink in that tying one's hand behind one's back can help enormously as long as sensible minimal governance can be established. In many ways Hong Kong was the master example implementing economic policy making *via* institutions operating at arms-length from patronage and electoral processes that may undermine sound solutions (14). Argentina and Estonia successfully demonstrated the benefits of tying macroeconomic policy to simple rules under a currency board system.

Most of the troubled states in Africa, Central Asia, Indochina, the Middle East and parts of Latin America that have found a way out of their predicament proceeded along the Ugandan route by sticking to simple macroeconomic disciplines using cash-budget rules (15) that were so successful in reigning in Bolivia's fiscal deficit in 1985. Some adopted currency board schemes that became popular again after loopholes in the West-African CFA system were closed and tight constraints on policy-makers imposed. All opened their borders to trade and abolished price controls and entry restrictions.

*Concessions.* Citizens could recognise a good policy when they saw one. Old, simplistic notions of nationalism versus colonialism, private versus public ownership, etc., gradually became irrelevant to debate. The most dramatic policy experiments became possible as would-be-millionaires among government officials and warlords saw that they could actually live better by renouncing corruption and predation. The key obstacle proved to be the removal of the incumbents' fear of losing out to their various real and imagined opponents in the process of tying their own hands. It thus became essential to 'import' good government by delegating key policy-functions to agencies with no axe to grind in the country. Hong Kong, the world's first 99-year BOT (built-operate-transfer) country, provided the basic model, albeit complemented by a basic democratic mechanism to establish legitimacy. The World Bank Group became one of a group of agencies which provided technocratic insulation to policy-making processes that were judged to be better made at arms-length from the political process (see the Box on the next page).

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14) Blinder (1997) argues the case for independent economic institutions even for advanced democratic economies.

15) Under the simple cash-budget rule, a government can only spend money when it has cash. Borrowing is forbidden.

### **The Easy Mining Concession**

The first experiment in 2005 began with the attempt by the ruler of a war-torn African state to attract business to the country. Parts of the country were not under government control and dominated by warlords, but the ruler tried to bring business to these areas too. He was able to find some interest in the Easy Mining company, a far flung mining and services conglomerate.

In thinking through the practicalities, it became clear that the mining operation required protection by a private security firm. At the same time, in the territory of the warlords several NGOs continued to participate in humanitarian relief operations. On the one hand, Easy Mining feared that the NGOs might monitor its operations and potentially create problems to its reputation. On the other hand, it started seeing an opportunity in working constructively with NGOs to demonstrate credibly that it was implementing acceptable business principles.

Easy Mining approached a well-known IFI with a reputation as a keen promoter of partnership ideas with business and civic organisations. After many meetings, an entirely new solution emerged. The whole operation would not be restricted to mining, but aim at economic development for the whole region in which Easy Mining was planning to operate.

To establish the legitimacy of the arrangements, the principle of the concession was put to a vote among the affected inhabitants. The vote supported the establishment of a 69-year concession of a vast track of territory to a venture between a special subsidiary of the IFI and a coalition of local and foreign NGOs currently operating in the territory. The warlords were provided with a royalty-type interest in the success of the concession. Concession administration was contracted out to a multinational service company, which was to run the concession as a country with the ability to raise taxes. A private security company was hired to ensure protection. It was to operate under rules of engagement similar to those that had been developed by Shell Nigeria in consultation with Pax Christi and Amnesty International in the 1990s. A complex revenue-sharing agreement existed between all the parties involved.

By now we know the result. While not as spectacular as Hong Kong's rise, the concession territory soon became the envy of its neighbours. Peace and stable property rights allowed a variety of businesses to flourish. With success came immigration pressure from other countries. After some incidents, when security personnel expelled illegal immigrants with dubious methods, agreements with neighbouring countries were negotiated, which either expanded the concession territory in exchange for a share of extra royalties, or introduced tighter and better regulated border controls. Several concessions have since been formed. Many delivered their promise, only a few failed. At the same time several governments saw the wisdom of introducing simple standard policies and Africa's turnaround began in earnest.

This story is, of course, fiction. Yet, the elements are mostly real. Africa has experienced a mining boom in recent years, with companies often using security firms or mercenaries to protect people and sites. While Easy Mining is a figment of the imagination, the World Bank does promote innovative public-private partnerships, including ones that would promote community development in the area of operation of foreign investors (World Bank, 1997b).



## 5. Safety nets for the poor

### 5.1 Incentive issues

*Shame brought by success.* Economic growth remains a necessary means to eradicate poverty on a large scale and was essential to success in the Asian miracle of the late 20th century, which overturned many dire predictions made in the 1950s and 1960s about widespread misery among the masses of Asia. During the last three decades of the 20th century, and for the first time in 300 years, the income of the average person in developing countries grew faster than those in developed ones (Maddison, 1995). Yet, as most of the world found its way towards decent living standards, the inadequacies and injustices of trickle-down solutions became ever more intolerable (16).

**Aid became like export credit, with multilateral institutions wooing politicians with examples of how many contracts went to firms in their states.**

*Hidden interests behind aid.* Much of aid, particularly at the bilateral level, was originally given on the background of foreign policy interests. As foreign policy concerns subsided after the end of the cold war, a key constituency for aid were firms in relatively well-developed countries that sought funding for projects in developing ones. Aid became relatively more like export credit, with international institutions such as the World Bank, for example, wooing members of the US Congress with examples of how many contracts went to firms in their states. Much of aid was thus given to fund the construction of projects. Whether projects delivered services after completion was *de facto* of lesser concern. Furthermore, much aid flowed through governments with the result that corruption and inefficiency raised costs and lowered performance.

Africa of the late 20th century provides the clearest examples. Aid-funded telephone lines in Africa cost much more than double their cost in developed countries. Donor-supported utilities in many countries performed miserably. Port charges in Abidjan (USD 200 per container) were higher than those in Antwerp (USD 120 per container). Only 37 percent of non-salary funds released in Uganda for primary schools actually reached them (Collier and Gunning, 1997).

*Incentives to perform.* Proponents of aid could point out that aid-funded projects did still better than many unsupervised government programs. However, evidence became more compelling that it should be possible to do better by providing sound incentives to private providers of services, and by keeping funds out of the hands of rapacious officials. In Ghana, for example, “the average public clinic had 2.2 times the number of staff and a 25 percent lower probability of having drugs than a private facility. In Kenya public clinics had 10 times more staff and 20 times the number of days without antibiotics as the private facilities. In both the resulting lower quality of public facilities reduced their usage (Collier and Gunning, 1997, p. 25)”.

### 5.2 Performance-based subsidies

The key to the beginning of a solution lay in recognising that under traditional aid projects subsidies went to inputs rather than being based on ultimate performance. By the late 20th century, World Bank social sector projects shifted their emphasis from brick-and-mortar projects to sound policy and service performance. Programs such as education for girls received prominence. Some moderate success was achieved with using NGOs as more effective delivery channels for aid. By

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16) Already, in the mid-1990s, the UN estimated that the basic needs of the poor for water, food and healthcare could be met with only USD 40 billion annually, i.e., only about 0.13 percent of world output (United Nations Development Program, 1997).

**World Bank social sector projects shifted their emphasis from brick-and-mortar projects to sound policy and service performance.**

now it has become common to provide performance-based subsidies. Essentially there are two main types, both of which were explored in World Bank projects around the turn of the century.

*Performance contracts.* For some services like basic health and education, performance contracts have been granted to private firms including NGOs. Under these contracts the private provider undertakes to deliver services and is paid as a function of agreed performance measures - often directly by the donors. Such measures range from the number of vaccinations performed to the quality of test results for elementary school students. Monitoring of results has always been imperfect and, as always, what gets mostly monitored is what gets done to the detriment of unforeseen or non-measurable side effects. Yet, advances in measurement techniques prompted by the performance contracts have reduced such concerns. Many measurement improvements were actually proposed by competing bidders when trying to obtain performance contracts. In any case, there was never much choice. Under any approach to poverty alleviation donors needed to assess the effectiveness of their interventions.

Reputational interests by major contractors have also limited reckless neglect of undesirable side effects, particularly after some early scandals. The payments to the contractors are sometimes grants, but sometimes also loans obtained by the government. Competitive bidding of the contracts has resulted in major cost reductions as evidenced, for example, early on in the case of competitively bid contracts to provide remote areas of Chile with telecommunications services.

*Targeted income subsidies.* The second type of performance-based subsidy is applied wherever user fees can sensibly be levied, be it in water and power systems, more specialised healthcare and much of education. Essentially, subsidies are targeted to poor individuals. For example, they may take the form of vouchers for healthcare and education or subsidies to the bills of customers of monopoly utilities, such as water distribution systems. An early example is found in the Chilean water subsidy system of the 1980s. Here the municipality maintained lists of poor citizens and paid up to 85 percent of their bill once they had paid their portion. This provided firms with proper incentives to provide services without distorting prices and relying on cross-subsidies.

*Policy improvements.* In essence, the now widespread performance-based subsidy schemes enhance the purchasing power of the poor to levels that allow provision of a targeted service. In a number of cases even generous amounts of subsidy have not been able to motivate private investors to initially provide services. This was due to inadequate policy environments that prevented the private party from operating and/or actually obtaining revenues and keeping profits. Such policy barriers to provision for the poor became much more obvious with the introduction of the performance-based schemes. Policy conditionality was then established as a condition for obtaining funds for subsidy schemes (17).

### **5.3 Economics and politics of targeting**

*Rationing and segmentation.* Initially, there was a certain amount of apprehension about introducing means tested subsidy schemes.

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17) A key policy issue is the supply response from businesses benefiting from some form of subsidy scheme. When supply is fixed, subsidies simply raise the price to producers and possibly redistribute the supply towards those previously too poor to afford much. The poor benefit most when increased demand is translated into increased supply rather than increased rents for producers.

- First, some critics argued that distinguishing between the deserving and undeserving poor smacked of paternalism. While this kind of criticism has always been raised in the history of charity, it remains unavoidable to ration the limited supply of gifts by something other than price.
- Second, it was feared that the administrative costs of targeting might offset the benefits. Indeed, in areas where poverty was endemic, basic services were provided free to all under the first type of performance contract. However, with the advent of smart cards, monitoring of beneficiaries has by now become relatively cheap in many cases.
- Third, some felt that more choice in competitive markets like health and education might increase social segmentation. Yet, effects have been limited. Segmentation has always happened anyway, as people move to areas they feel comfortable in, and, more importantly, the quality of service seems to have had the determining influence on the choice of school and hospital.

*Constituencies for subsidies.* Extensive targeting of funds to the truly poor has obvious ethical attractions, yet it has consistently been difficult to raise funds for subsidies without appeal to other motives of the donor community such as the export support mentioned above. Yet, three factors in particular have helped sustain and even increase support for subsidies:

- The new performance-based subsidies have maintained the export support motive as companies in developed countries have been prominent providers of services that have been rendered profitable by the new form of subsidies. The policy dialogue tied to the provision of performance-based subsidies has actually opened new fields for private enterprise.
- Improvements in targeting have spurred charitable giving and support for tax-funded aid, while a general improvement in living standards in rich countries has gradually raised the amount of donations to combat poverty. Today, private charitable donations to developing countries exceed USD 30 billion, enough to fund basic needs projects for all the world's poor (18). There is thus an adequate constituency for widespread targeting, particularly as more and more people see themselves as citizens of earth and not only of their home nation.
- Finally, innovative matching grant schemes pioneered by the World Bank have also contributed to alleviate free rider issues, and the decline in tax levels has nudged levels of charitable giving up in most countries.

**Competition among donor agencies has increased. This is just as normal and healthy as competition among firms.**

*The donor market.* Competition among donor agencies has increased. It has become clearer that competition among donors is just as normal and healthy as competition among firms. Donors simply deliver a service to somebody else than the person who pays. In a way, competition among donors is like competition among flower-by-wire agencies who, for payment, deliver a service to somebody other than the person paying. Efforts at donor co-ordination have focused on the one area where there is a natural monopoly of sorts, namely in systems that identify deserving beneficiaries and, more importantly, in systems that establish whether beneficiaries have already received

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18) Output in the advanced countries with incomes above USD 20,000 exceeds USD 125 trillion in 2044. The absolute number of truly poor has shrunk by at least 25 percent over the last 50 years. As a result, in terms of 1995 purchasing power, it is now possible to meet the poor's basic needs with just about USD 30 billion, or about 0.024 percent of rich countries' output. Traditionally, people in rich countries have given between one-half and two percent of GDP to charity (Kaplan, 1996, and Klein, 1986). Of this up to five percent has gone to 'remote' causes such as humanitarian aid abroad. By 2044, five percent of 0.5 percent amounts to over USD 30 billion.

help by some other donor. Again, smart-card technology that became widespread even in remote areas of Africa in the early 21st century in the form of pre-paid cards for electricity meters, has made possible a cost-effective solution for identifying the beneficiaries of aid.

All in all, there is reason to hope that poverty may largely be wiped out by the end of the century. World-wide inequality is not likely to decline much, while growth rates continue to diverge strongly within and among countries. But, yet again like in the case of Chile in the 1980s and 1990s, it seems possible to reduce poverty drastically through targeted performance-based subsidy schemes (Ferreira and Litchfield, 1997).

## 6. Learning

### 6.1 Information, research, advisory and training services

*Towards transparency.* The original synergy between the World Bank's lending activities, the access to information it obtained, and the ability to give relatively apolitical advice provided some rationale for its mode of operation. By now governments and other institutions alike have realised the benefit of transparency and make more and more detailed information available. Advisory relationships consequently rely less on political acceptability than professional competence.

*Private solutions.* As in the case of loans, pressure from private providers not to crowd them out of good business has reduced the Bank's role in information provision, monitoring and advice. Rating agencies, consulting companies, research institutes and training and education companies have taken the place of World Bank activity to a large degree. The Bank's special information and advisory advantage mainly persists in 'failed states'.

### 6.2 Learning systems

*Government failure.* Yet, even today governments find it hard to learn as well as firms do from best practice in other countries. Civil servants grow up within a particular government and do not naturally find exposure to other countries and environments as happens in multinational firms that rotate staff. The eternal incentives of unavoidable bureaucratic budgeting processes make sensible, discretionary *ad hoc* decisions about study trips, seminar attendance and other learning activities, etc., problematic. Some bureaucrats do not want to fund such 'unnecessary' luxuries, while others are all too keen to go on low-pressure 'boondoggles'.

*Market test.* There remained, therefore, a role for the World Bank to create learning opportunities for public officials. At the same time more and more governments recognised the importance of ideas and good advice as opposed to 'simply money'. Chile, Malaysia and also Peru were early World Bank customers that were willing to pay a share of the cost of advice (19). In 1997, the World Bank also introduced the first training courses that were heavily funded from participants' contributions and thus for the first time subject to a reasonable market test.

*The global public sector learning system.* By now we have a system of international learning and benchmarking for public officials, which combines automaticity to cope with bad bureaucratic incen-

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19) Early fee-based advisory services of this type were provided more and more by the mid-1990s under special memoranda of understanding with individual countries.

**Governments find it hard to learn from best practice in other countries. There remains, therefore, a role for the World Bank to create learning opportunities for public officials.**

tives and a measure of market test to maintain the providers' incentives for quality products, including those of World Bank officials involved in the process. Today's institutions also retain elements of the old OECD, which *de facto* provided relatively low cost standardisation of cross-country information and learning, and a type of mid-career academy for officials, who either worked at the OECD for some years, or in the embassies that countries maintained there. As a result, a small core of staff with pay dependent on course attendance and other measures of results works with a large rotating complement of country officials from all over the world to digest experience and spread best practice information. Core staff is located in a few centres in the major time zones of the world. Learning events may take place at these centres or through video conferences of various types.

*Policy games.* As incentives to provide more intuitive and useful learning events improved, the World Bank, partly under the auspices of its training arm, EDI, developed the powerful games that today are essential support for policy-makers. Much learning was previously text-bookish, dry, overly diplomatic and often not forward looking. In fact, many meetings and conferences did little justice to the quality of participants, materials and speakers available. Policy games, however, became intuitive and fun ways of exploring possible courses of action based on serious analysis fed into the process (20). By now it is clear that it is worth making as many mistakes as possible in policy games before trying out strategies in real life - an obvious point among US military strategists and tacticians, but not yet among economic policy-makers by the end of the 20th century.

## **7. Foundation**

*Tool for change.* While the World Bank tackled a large variety of topics, it ultimately maintained a focus on improving policies, whether by using conditionality as provider of funds or by providing intellectual and organisational support for new policy or learning initiatives. Sometimes the focus slipped and the World Bank started to compete unnecessarily with private firms or other organisations. Yet, usually, external pressures brought back the essential focus on policy. The World Bank turned out to be a useful tool or forum to help bring about a new global governance system. Given that the system was - and still is - evolving, it was at times not easy, or even sensible, to ascribe a particular role to the World Bank, because there was no fixed system within which such roles could be defined for any length of time.

*Disorderly bureaucrats.* What made the World Bank effective in this endeavour, paradoxically, was its lack of bureaucracy. While often accused of bureaucratic behaviour, it was in fact a rather free-wheeling and at times undisciplined organisation, the "most under-managed he had ever seen" in the words of its President Lewis Preston (1991-1995) (Wolf, 1994). The IMF was a true bureaucracy marching effectively to the tune of its management. The Bank, although it had its share of bureaucratic rigidities, in a sense resembled more a science park full of policy entrepreneurs.

*Sources of funds.* In the late 1990s the Bank was led by James Wolfensohn, a policy-entrepreneur rather than a conservative guardian of focused basic rules (Stevenson, 1997). He managed to set the Bank on a course that made it the *Thermo-electron* of public agencies. *Thermo-electron* was an exceptionally successful company in the 1990s that acquired notoriety for its ability to spin off a multitude of successful subsidiaries. Wolfensohn started looking at the Bank as a foundation. From

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20) By 1998, several large corporations were experimenting with games as methods for exploring strategic issues. Consulting companies, such as Booz, Allen & Hamilton, who had closely worked with the US military provided assistance.

that perspective the Bank had an endowment, its paid-in capital and retained earnings, on which it earned money that could be used for a variety of purposes. Today, the Bank no longer invests its capital in highly liquid and safe government paper. Rather it behaves like a foundation or pension fund investing in a variety of instruments including bonds and equities. This has allowed it to earn funds to maintain the real value of its capital and still earn about six percent in real terms, about one percent higher than the average real returns of a diversified portfolio in the financial markets due to its exemption from today's corporate tax rates of about 20 percent. As it has not had a capital increase for 50 years it earns today roughly USD 1.8 billion per year in 1995 prices after increasing reserves to maintain the real value of its capital.

**The World Bank no longer invests its capital in highly liquid and safe government paper. Rather, it behaves like a foundation or pension fund investing in a variety of instruments.**

*Uses of funds.* Its income is spent on a variety of initiatives. Usually funds are allocated either as seed capital or as matching funds. For example, standard-setting bodies supported by the World Bank may obtain fees from certification activities. World Bank supported learning activities are usually 90 percent funded by user fees or annual appropriations (as in the case of the OECD today). World Bank contributions to performance-based subsidies are generally made on a matching basis complementing both public and private contributions via multiple specialised windows. When governments borrow from the World Bank, because they lack access to the private financial markets, the World Bank uses its considerable scope for borrowing in addition to its paid-in capital. It earns good money on the loans, which are now routinely priced at a penalty to the market. By the same token the subsidies are thus completely unbundled from the loan product and deployed in a targeted fashion.

*Staff and offshoots.* The World Bank maintains only a small core staff, although it also pays for key staff seconded more permanently to its offshoots. Including the latter it maintains a payroll of about 500 regular staff compared to almost 11,000 staff and long-term consultants at the end of the last century. It achieved reductions in staff via natural attrition, by drastically restricting indefinite employment contracts, and by encouraging entrepreneurial staff to form spin-offs where they had some upside earnings potential as long as they could attract matching funds in agreed proportions. In addition, many staff joined the organisations that became ever more important in the emerging new world governance system (21).

*JMK-Foundation.* One of the enduring legacies of the Bretton Woods system is the Annual Meeting of the IMF and World Bank, which continues to be a preferred event for economic policy-makers to exchange views and to mingle with private companies and NGOs. In Abidjan, this year's venue, a motion is on the table in honour of the 100th anniversary of Bretton Woods to rename the World Bank in the spirit of the father of Bretton Woods, John Maynard Keynes. As he said the "Fund (IMF) is a bank and the Bank is a fund". The World Bank is to be named the John Maynard Keynes Foundation, a more modest and becoming name in view of its role, its achievements, and the changing role it plays in a world that has changed the World Bank's very nature almost beyond recognition - a rare case of an international bureaucracy that was able to adjust dynamically, actively help shape the emerging global system, and work itself largely out of business in line with its mandate.

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21) An example of this were the staff members who left the World Bank to head up regulatory agencies when many countries privatised infrastructure services in the 1990s.

# Annex

## World output and population in 1995 and 2044

Area	GDP (as a percentage of world total)		Growth of GDP/capita (in percent)	Population (as a percentage of world total)		GDP/ capita (in USD)	
	1995	2044		1995-2044	1995	2044	1995
North America	22.9	10.5	1.5	5.1	3.5	26,436	54,831
Europe	21.5	7.9	1.2	5.4	3.5	23,114	41,469
Japan	8.1	3.6	1.8	2.2	1.3	21,677	51,956
Oceania	1.1	1.2	2.8	0.5	0.4	12,804	49,545
East Asia	18.5	34.8	4.0	31.1	26.6	3,479	23,773
South Asia	5.3	8.2	3.0	23.0	25.8	1,351	5,751
Latin America	9.0	16.7	3.7	8.4	8.2	6,255	37,102
Sub-Saharan Africa	2.4	3.5	2.0	10.3	17.9	1,365	3,602
Middle East and North Africa	5.7	6.6	2.0	5.5	7.4	6,124	16,160
Eastern Europe and FSU	5.5	7.0	3.0	8.5	5.4	3,791	23,575
World	USD 33.6 trillion	USD 170.8 trillion	2.3 percent per annum	5,744 million	9,388 million	USD 5,857	USD 18,195

Notes: Regional GDP is given as a percentage of total world GDP, GDPs are in PPP-adjusted dollars, and regional population is given as a percentage of total world population. FSU is the former Soviet Union.

Source: Bulato *et al.* (1990) for population growth estimates, and IMF (1998b) for baseline GDP growth.

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# The evolving role of multilateral development banks: History and prospects

Jannik Lindbaek, Guy Pfeffermann and Neil Gregory

## 1. Introduction

Like all institutions, international financial institutions (IFIs) (1) are creatures of their past. Their organisation and orientation reflect the economic and political contexts in which they were born and evolved. So, too, will their future be shaped by global trends and the ways they respond to them. In this paper, we trace some of the salient themes from the evolution of the role of IFIs, and identify emerging challenges and future directions as they move into the 21st century. Reflecting our background, we give particular emphasis to their support for private enterprise in developing countries, and to the experience of the International Finance Corporation (IFC) and the World Bank Group.

## 2. The origins of the species - Before and after Bretton Woods

The notion that the governments of the more affluent nations should help poorer nations improve their standards of living is relatively novel. Until World War II, most of what came to be known as 'developing countries' were colonies. Colonial powers invested to varying degrees in infrastructure, institution-building and relief programs. In the 1930s, the League of Nations had initiated one of the earliest multilateral 'development assistance programs', notably in China (2). Ragnar Nurkse (1953) articulated the League of Nations' intellectual framework as it related to development (3). Thinking focused on publicly directed capital formation as the mainspring of economic advances. The League of Nations never spawned an institution capable of mobilising financial resources for investment in developing countries, but the emphasis on the public sector and physical investment was to dominate thinking about development for a generation.

The creation of the World Bank (International Bank for Reconstruction and Development or IBRD) alongside the International Monetary Fund (IMF) at Bretton Woods in the summer of 1944 - when Paris was still occupied - created the institutional means to translate multilateral financial aid into reality. However, the original draft proposal for an international bank, written in early 1942, made no mention of development. The proposal referred only to a Bank for Reconstruction. When Ed Bernstein of the US Treasury asked what they would do with the bank once reconstruction was over, Harry White threw the question back: "What would you suggest?" "Let's have it [development] there for after", Bernstein said. Out of this afterthought the International Bank for Reconstruction and Development was born (4).

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*We are grateful to Jonas Haralz, Ram Mahidhara, Enrique Rueda-Sabater, Robert Picciotto and John Soladay for comments on earlier drafts. The findings, interpretations and conclusions expressed in this paper are entirely those of the authors and should not be attributed in any manner to the IFC or to members of the Board of Executive Directors or the countries they represent.*

1) This paper discusses those institutions responsible for long-term development finance, also referred to as multilateral development banks. In order to be consistent with other papers in this volume, we use the abbreviation "IFIs" throughout to describe this group.

2) For example, the League of Nations offered Chinese customs officials technical assistance.

3) In one of the most famous passages he stated that "Capital is made at home", meaning that investment is financed primarily out of domestic savings; foreign savings in the form of development aid or private foreign investment only accounts for a small share of financing.

4) See Kapur et al. (1977). The authors also mention that Paul Samuelson's first edition of his classic textbook, published in 1948, "contained less than three sentences on development (vol. 1, p. 67)".

Not only were the developing countries virtually off the World Bank and Fund's original maps, but the IFIs soon were sidelined by massive Marshall Plan aid. Churchill gave his 'Iron Curtain' speech at Fulton, Missouri, and in early 1947 President Truman pledged US support to anti-Communist forces in Greece, inaugurating the era of containment. The Cold War had begun. Soon thereafter the European Recovery Program, later called 'the Marshall Plan', the 'mother of all economic assistance programs' was initiated. Bilateral US assistance to Europe took off in a spectacular manner, while the World Bank only began to lend substantial sums for development a decade later.

The architecture of the current international financial system has not entirely shaken off the marks of its origins. To say that it was designed for a Keynesian world is not to overplay the role of Lord Keynes in its creation, but rather to draw attention to the economic worldview that underlay it. This worldview was essentially based on a mixed economy, where private enterprise coexists with large, active governments, who take responsibility for aggregate economic outcomes. Governments - central, national governments, to be precise - were expected to regulate and direct economic activity to achieve social goals, such as stable prices and low unemployment.

Insofar as the private sector was considered at all, it was seen as a passive partner, responding to varying government stimuli. It was inherently unstable and short-term, and could not be relied upon for growth and development without heavy government intervention and guidance. Industries such as steel making, coal mining, electricity generation, railways and healthcare were widely perceived as being too important to be left to the private sector, and were generally brought under direct government ownership.

***The international financial institutions created at the end of World War II were, and remain, intrinsically intergovernmental.***

Hence, the international financial institutions created at the end of World War II were, and remain, intrinsically intergovernmental. The IMF, World Bank, regional development banks, UN, WTO and so on are directed by Boards or Assemblies of government officials. Their equity is wholly provided from government funds, and their goals are determined by public policy. Profitability was not a goal, nor were the interests of the private sector explicitly considered. Development banks could only lend to private enterprises with government sanction and with government guarantees of repayment. Equity financing was unheard of. In practice, they soon concentrated on lending to governments in a cosy symbiotic relationship.

In the early post-war years, this bias towards government-to-government relations seemed immaterial. Communism and socialism were at their zenith, particularly in the post-colonial states of Africa and Asia. Many industrial economies were heavily influenced by socialist movements. Even those, like the USA, which remained firmly wedded to capitalist principles, gave a larger role to the government than ever before - partly as a legacy of the Depression, partly as a legacy of the wartime economy. In most countries, the role of the private sector in the economy was at best neglected, at worst actively disregarded.

The Marshall Plan also influenced development assistance in at least three lasting ways. First, Europe's economic recovery suggested that the Marshall Plan had been effective. Indeed, while it is not possible to say how much credit was due to Marshall Plan assistance, Western Europe's economies recovered at spectacular rates. This perception of success infused development assistance to developing nations when it began in earnest with a 'can-do' spirit. Second, many Marshall Plan

officials later brought their experience to the World Bank. Former British and Dutch colonial officials who became senior officers of the early Bank may have been even more important carriers of development experience to the World Bank. Third, the Marshall Plan aided relatively developed countries, with strong institutional capacity, leading to a neglect of institution building, which proved to be an important barrier to development in less developed countries.

It did not take long for the World Bank and its shareholders to realise that its structure was not suitable for all the needs of its members. This led to the creation of two siblings explicitly designed to be different. First, the Bank's structure was not proving suitable for lending to the private sector. While Keynes' vision for the World Bank had been for it to be more entrepreneurial than other international institutions (5), in practice it had become another part of the international bureaucracy - its capital base subscribed by governments, its borrowing underpinned by additional capital callable from member governments, its directors mostly civil service appointees, its loans all guaranteed by host country governments.

Hence, in 1956, the IFC was formed with the express objective of financing private enterprises. While still wholly-owned by member governments (and hence with virtually the same board of directors as the World Bank), all the IFC's capital was paid in, rather than callable. This enabled it to make equity as well as loan investments (6), and to carry investment risks without sovereign guarantees. To avoid duplication with the World Bank, the IFC was explicitly prohibited from taking government guarantees, and was required to finance productive commercial enterprises, privately managed if not wholly privately owned. To prevent IFC bureaucrats substituting for host government bureaucrats, the IFC was also prohibited from sponsoring projects itself, or being more than a passive minority shareholder. For a long time the IFC remained unique amongst IFIs in this structure and role.

Second, the World Bank's lending terms, while finer than available commercially, were still at near market levels. These terms were determined by the rate at which IBRD could borrow in international finance markets, plus a mark-up (7), to cover the World Bank's administrative costs. This was beyond the capacity of many poor countries to afford. Thus, the Bank's role in poor countries was heavily constrained by limited repayment capacity. The UN floated the idea of a multilateral trust fund to provide finance on highly concessional terms to the poorest countries, funded by the rich countries. While the World Bank was initially reluctant to consider lending at concessional (i.e., subsidised) rates, international pressure to do something for poor countries grew, until the Bank decided that if an international agency was going to do this, "it would be better for it to be done under the work habits and style of the Bank than of some New York-based UN agency" (8). The main donor countries agreed. Hence, the International Development Association (IDA) was born, as a trust fund replenished periodically by donor governments, administered by IBRD. Armed with this new financing 'window', the Bank expanded its lending to poor countries.

Between 1958 and 1966, the World Bank was joined in its mission by a set of regional IFIs, including the Inter-American Development Bank (IDB), the Asian Development Bank (ADB) and the African Development Bank (AfDB). The newly formed European Community launched a multilateral development

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5) "I should like to see the Board of the Fund composed of cautious bankers, and the Board of the Bank of imaginative expansionists (Keynes, 1980)".

6) Although the IFC was only permitted to take equity stakes after an amendment to the Articles in 1961.

7) Currently a 0.5 percent spread plus a 0.75 percent commitment fee.

8) See Kapur et al. (1977, vol. 1, p. 12).

program in 1958, and established the European Investment Bank with a mandate which extended to developing countries. At the same time, large bilateral aid programs were directed at the developing countries in the wake of the transition from colonial to independent states. Development assistance had become a large-scale activity, sustained in part by Cold War rivalry.

### **3. Glory days - The era of investment projects**

World Bank activities increased progressively during the 1950s and 1960s. Under the leadership of George Woods (1963-1968) the portfolio of projects branched out into new areas such as agriculture, water supply and education, all the time working through, and lending to, public agencies. A 'big push' occurred during the McNamara years (1968-1981).

As in the case of Marshall aid, this big push in development assistance was accompanied by impressive improvements. Between 1950 and 1975, most developing countries experienced rapid growth. Sub-Saharan Africa was growing at the respectable rate of 2.4 percent per capita per year, and among the developing regions only South Asia was lagging behind. Not only did the developing countries' per capita growth match that in the industrial countries, but social indicators improved markedly. These trends are documented in Morawetz (1977).

**During the 1960s and 1970s, the IFIs emphasised the financing of basic public sector infrastructure.**

During these decades IFIs emphasised the financing of basic public sector infrastructure 'projects' such as hydroelectric dams, roads and irrigation, some of which played an important role in removing strategic obstacles to economic growth (9). During the McNamara years the World Bank moved into new areas, notably education, health, rural and urban development, and so did the regional IFIs.

### **4. Years of malaise - The rise of policy-based lending**

This 'idyllic' era came to an end in the late 1970s. Inflationary financing of the Vietnam War and of the 'Great Society' followed by two consecutive oil price shocks changed the world economic environment profoundly for the worse. Many industrialised economies, including the United States, experienced slow growth as well as inflation (a combination known as stagflation). With the exception of Japan, the East Asian 'Tigers' and a few oil-exporting countries, most countries went through painful years of slow economic growth. Indeed, growth in most developing countries was not to pick up before the early 1990s (10).

Economic malaise affected development assistance in a number of ways. First, the serious economic problems of most industrial countries (and of the US in particular) (11) overshadowed what interest the public had shown for overseas development issues. Putting one's own house in order came first (12). Second, the damaging oil price hikes of 1973 and 1979, as well as increasingly vocal demands for

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9) Focus on public agencies and enterprises is a direct result of the IBRD's Articles of Agreement, which require loans to be guaranteed by borrowing governments.

10) Interestingly (and most importantly), social indicators of development, and first and foremost average life expectancy at birth, continued to improve in spite of adverse economic circumstances. Among the reasons for continued social progress were increased availability of inexpensive medical devices (e.g., rehydration kits), and the fact that knowledge (e.g., boiling drinking water, contraceptive methods, etc.) once acquired is not eroded by economic downturns.

11) European and Japanese support for development assistance was less negatively affected.

12) Perhaps the most dramatic illustration was the decision by the US government to hike interest rates sharply in 1979. This broke the back of double-digit inflation and laid the foundation of US economic recovery, but also led to the 'debt crisis' and a 'lost decade' for Latin America.

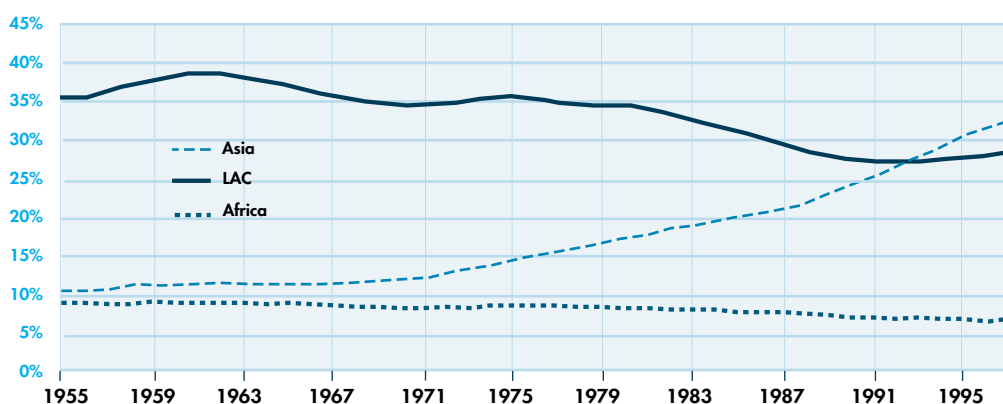


**Inflationary financing of the Vietnam War followed by two consecutive oil price shocks changed the world economic environment profoundly for the worse.**

a 'New International Economic Order' on the part of developing nations (including members of OPEC) (13), polarised opinion and, on balance, eroded political support for development assistance. Third, poor economic performance in many developing countries (as well as civil unrest and armed conflicts) led to increased scepticism about the efficacy of development assistance IFIs.

Figure 1 shows trends in GDP per capita of developing countries measured in purchasing power parity terms as a proportion of that in the United States. It suggests that of the major developing regions only East Asia managed to reduce the gap with the United States. In other regions slower economic growth and rapid population increases combined to keep the 'development gap' with the industrialised countries widening. Of course, IFIs played only a secondary role in the ups and downs of developing country growth and could not by themselves have prevented the widening of the gap (as noted, "capital is made at home", not by IFIs, and so are economic policies). Still, living conditions in the poorer countries would have been worse in the absence of IFI-supported projects and programs.

**Figure 1.** GDP per capita, 1955-1996 (as a percentage of the US)



Note: LAC is Latin America and the Caribbean.

Source: Maddison (1995).

The oil price shocks played havoc with the development plans of the majority of oil-importing developing countries. The share of export earnings needed for oil imports suddenly shot up, often leaving little left for capital goods imports, let alone for servicing foreign debts. The international financial institutions responded vigorously. The IMF took the lead. A special oil facility was created under its aegis and IMF programs were extended to a large number of oil-importing developing countries. The World Bank (IBRD and IDA) followed suit, extending an increasing number of 'structural adjustment loans' and 'sectoral adjustment loans' (14). Investment loans typically were disbursed over many years as dams, irrigation districts and other infrastructure projects were built. Much of the aid flows so extended were used for capital goods imports related to the projects, and hence did not

13) For example, the Brundt Commission report recommended a 'development tax' to be levied in OECD countries and to be transferred to developing countries.

14) Structural adjustment loans harked back to the late 1960s when US AID and the World Bank (the latter in the case of Colombia) extended 'program loans'. The essence of such loans was a quid pro quo: foreign exchange and budgetary resources were provided by aid donors while the government of the borrowing country committed itself to carrying out an agreed economic program. As a rule these loans supplemented IMF programs. Sectoral adjustment loans involve similar balance of payments support in exchange for understandings about development programs in particular sectors, e.g., agriculture.

help much in increasing import capacity for oil, food, and other immediate necessities as well as for debt service. The objective of adjustment lending was to restore sustained economic growth as soon as possible, given limited amounts of external financing.

While the World Bank shifted towards adjustment lending, the other IFIs continued to focus on project financing. The essence of adjustment lending (which came to be known as 'policy-based lending') is conditionality; i.e., agreements between IFIs and the borrowing countries that funds will be released only as specific policies are being implemented. Macroeconomic policy changes are typically the most politically sensitive of all. Conditionality requires strong economic staffs as well as the ability to withhold disbursements unless conditions are met. The Bretton Woods institutions are better equipped than the regional IFIs in both respects. Hence, regional IFIs have generally only extended adjustment loans in close co-ordination with the Bretton Woods institutions.

**Investment projects were unlikely to yield the expected benefits amidst high inflation, low savings and frequent balance of payments crises.**

IFI shareholders, and many in the development community, came to realise increasingly that investment projects were unlikely to yield the expected benefits amidst high inflation, low savings and frequent balance of payments crises. Indeed, sluggish economic growth itself often undermined economic benefits (for example, because expected demand for electric power did not materialise). As attention turned increasingly from project issues to the macro-policy environment (15), engineers, financial analysts and sector economists, who had played a dominant role in shaping development projects, yielded influence to macroeconomists (16). Because of its much greater involvement in macro-policy loans, this shift was more pronounced in the World Bank than in the other development banks. The difference in skill mixes between the World Bank and the other IFIs persists to this day; it has serious implications for the future role of IFIs, which are mentioned below.

With the shift to policy lending the question arose of what policies were to be supported. The World Bank's structural adjustment operations reflect, in the main, economic orthodoxy, which has come

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15) Some parts of the World Bank, in particular those dealing with Latin America, had focused on policy conditionality long before 'structural adjustment' appeared on the scene. It had become common practice in the late 1960s to relate large projects as well as - sometimes - the entire lending program in a particular country to economic policy. Hence a tradition of policy conditionality existed in Latin America, which made the shift to structural adjustment lending much easier in that region after 1979.

16) Economists did not always enjoy such prominence. When in the late 1940s Hans Singer, one of the 'pioneers of development', told Joseph Schumpeter that his work in the UN was to be on the problems of underdeveloped countries, his surprised response was: "... but I thought you were an economist". This, in retrospect, may have been a most perceptive reaction. As we note later on, the quality of institutions and of organisations is being recognised as one of the foundations of prosperity; the economics profession may yield to institutional specialists.

17) Consensus policies were summarised by Williamson (1994) as follows:

- Fiscal discipline
- Public expenditure prioritisation, e.g., killing 'white elephants' (uneconomic investment projects), reducing or eliminating subsidies
- Tax reform
- Financial liberalisation
- Unified and competitive exchange rate
- Trade liberalisation
- Liberal foreign direct investment regime
- Privatisation
- Weeding out regulations which do not serve the public interest, and strengthening those that do, such as banking supervision
- Secure property rights without excessive transaction cost.

to be known as the “Washington Consensus” (17). This consensus is built on the new economic paradigm, with governments playing a supporting role to private enterprise-led growth. Empirical evidence shows that towing the consensus line has paid off in more rapid and more sustained growth. In turn, better economic performance enhances aid effectiveness (18). Recognition that aid effectiveness is to no small extent dependent on the quality of policies poses a difficult challenge to aid agencies including IFIs. We mention some of the implications below.

Aid agencies have come a long way from the ‘can-do’ resource transfer days of the Marshall Plan. As large volumes of financing have yielded limited impact, unfulfilled expectations have multiplied, and more challenging questions have been raised about the effectiveness of economic assistance programs. The end of Cold War competition has increased the donors’ willingness to take issues of aid effectiveness seriously.

### **5. The balance shifts - IFIs and the private sector**

The disappointing performance of state-led economic policies throughout the world in the 1950s and 1960s, which was thrown into sharp relief by the crises of the 1970s, led to a gradual disenchantment with the ability of governments to generate growth and development through direct control of the economy. The failure of post-war attempts at government-led growth and development were particularly marked in the less developed countries. Soviet/Chinese-style central planning led to disastrous inefficiencies and shortages; African socialism created dualistic economies where an uncompetitive modern state lived a parasitic existence on the backs of a primitive informal sector; and Latin American protectionism fostered large but weak state enterprises which destroyed value.

These outcomes stood in strong contrast to the rapid progress that took place concurrently in those few countries which let the private sector play more of a leading role in the economy. It is not entirely coincidental that these included countries such as West Germany and Japan where government powers had been deliberately limited following World War II, and capitalist processes transferred from the USA. They also included post-colonial countries which had chosen to build on their colonial legacies as freeports, e.g., Hong Kong and Singapore, and countries which opposed communism for political reasons, and hence rejected its economic approach too, e.g., Taiwan. For a long time, the special circumstances which led these countries to adopt a different approach to economic development disguised the general applicability of their growth experience, but by the 1980s it became clear to most observers that the larger role played by private enterprises in these economies was an important contribution to rapid economic growth.

By the late 1970s, the spread of economic stagnation from communist and socialist economies to mixed economies led to an economic paradigm shift from the post-war consensus of state-led growth to the current consensus of private enterprise-led growth. Roles were to be reversed, with governments now in the passive role, simply providing a stable macroeconomic environment and a liberal regulatory framework, with private enterprises providing the dynamic for growth.

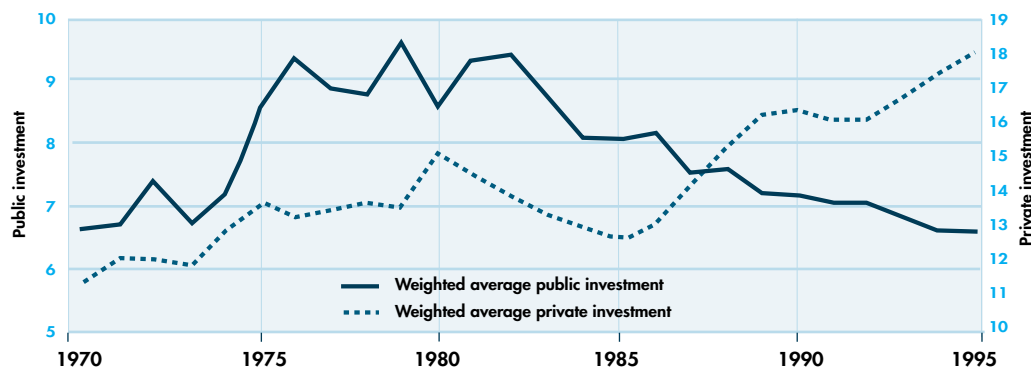
**Governments were to be in a passive role, with private enterprises providing the dynamic for growth.**

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18) See, in particular, Burnside and Dollar (1997). The abstract reads: “Foreign aid to developing countries has been criticised as wasteful and even counterproductive. Careful examination of the recent experience with foreign aid shows, however, that it can be an effective investment when a recipient country’s economic policies are sound before aid is provided”.

The results are striking. Figure 2 shows trends in public and private fixed capital formation (note the two different scales) (19).

**Figure 2.** Annual public vs. private investment growth rates in 30 developing countries, 1970-1995 (in percent)



Source: Bouton and Sumlinski (1996).

Until the mid-1980s, private and public investment tended to move together. In prosperous years both went up as public spending stimulated private demand and private growth increased public revenues, and vice versa. This pattern changed after 1985. Fiscal penury caused in part by high debt service payments forced governments to pare their spending. Typically, current spending (in particular public salaries) were cut less than investment. Consequently, public investment declined by over one-fifth. IFIs have not compensated for this decline by stepping up project lending, in part because borrowers cannot afford the share of project costs, or do not have the institutional capacity to manage the investments (20). Furthermore, the construction of large-scale infrastructure projects has become more problematic and more costly owing to environmental and social concerns. At the same time, the level of private investment has risen, as industries have been transferred to the private sector, deregulation and economic stabilisation have increased growth opportunities, and new sectors such as infrastructure have opened to private investment.

From the beginning, the World Bank and IMF had argued for a larger role for private enterprise than many of its borrowing countries allowed. In its early work in reconstruction, World Bank loans to private enterprises were not uncommon (e.g., Toyota Motors of Japan), but were always guaranteed by the host country government. However, beyond reconstruction needs, governments were reluctant to guarantee loans to private enterprises, preferring to guarantee loans for public enterprises. Once the IFC was created, the World Bank turned its back on financing private enterprises directly. However, it maintained an indirect interest by financing financial intermediaries (development banks and the like) which made loans to private enterprises. Typically, these were structured as lines of credit, with

19) Figure 2 does not capture privatisation, i.e., sales of existing public assets. The focus is on gross fixed capital formation, or new investment. Note, however, the quantitative importance of privatisation: during the period from 1990 to 1996, government revenues from sales of assets totalled nearly USD 160 billion, of which USD 70 billion came from foreign investors, not including the value of assets privatised by way of vouchers (which yielded no direct government revenue). Among the privatised companies are many of the IFIs' traditional public sector borrowers.

20) Not only the poorest countries but most developing countries are showing increasing reluctance to add to public sector debt or to incur guarantees or to take commercial risk, all of which create contingent payment obligations.

government guarantees of repayment from the intermediary. How could the intermediary bear the risk? Often, by being government-owned itself. Implicit government underwriting of losses, lack of profit motive and inability to take credit risks undermined these intermediaries' business judgement. This type of intermediary lending fell into discredit, due to high levels of political interference in the allocation of credit and low repayment rates. The institutions themselves mostly ended up insolvent.

**Reflecting the paradigm shift of the early 1980s, recently established IFIs have been more consciously oriented towards financing private investment.**

Underlying these lines of credit was the mixed economy philosophy, which legitimised government direction of the allocation of credit. Unfortunately, this provided a cloak for illegitimate diversion of funds to enterprises favoured by politicians or civil servants, for both noble and base reasons. Legitimate direction of credit was based on the mistaken notion that cheap credit, along with protection from imports, would promote faster growth in domestic industries. This growth rarely occurred in a sustained fashion.

Over time, the imperative to lend to developing countries with heavy state dominance of the economy led the World Bank to accept a larger role for public enterprises and financial institutions, all the while arguing for commercial disciplines. When it became apparent that these disciplines were unlikely to emerge, the World Bank became a leading proponent of privatisation, and 'rolling back the frontiers of the state'.

Reflecting the paradigm shift of the early 1980s, recently established IFIs have been more consciously oriented towards financing private investment. The European Bank for Reconstruction and Development's (EBRD) Articles require that 60 percent of its financing be private, non-guaranteed. In recent years, it has consistently exceeded these requirements. In 1989, the IDB spawned an IFC-like affiliate, the Inter-American Investment Corporation. In addition, in the mid-1990s the IDB, ADB and AfDB obtained authorisation to lend for non-guaranteed private investments. At the same time, bilateral support has increased through export credit and guarantee agencies. In total, private sector financing by IFIs and export credit agencies has grown from USD 9.5 billion in 1991 to USD 26.5 billion in 1997.

Direct IFI financial support for the private sector in developing countries has played a key role in facilitating the shift in economic structure towards private investment. Because of their mandate to invest in developing countries even where country risk is high, and their willingness to pioneer new instruments and new sectors, IFI support has opened up a number of new countries and sectors for private investment. Advisory work has focused on improving the environment for foreign direct investment (FDI) (21). A key part of this process has been support for privatisation, which has transformed the economic landscape of the transition economies in particular (22).

IFIs also helped establish the framework for private investment in infrastructure, by working through the difficulties in pioneering transactions. In many countries, the first private power generation plant, or the first cellular telecom franchise, has been supported by an IFI, most often the IFC or EBRD. But very quickly, follow-on transactions are able to proceed without the support of the IFIs (23).

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21) See Weigel et al., (1997).

22) For example, from 1992 to 1994, the IFC assisted with the first mass privatisation program in Russia, which sold 14,000 enterprises employing 10.5 million people and created 40 million new shareholders. See Donaldson and Wagle (1995).

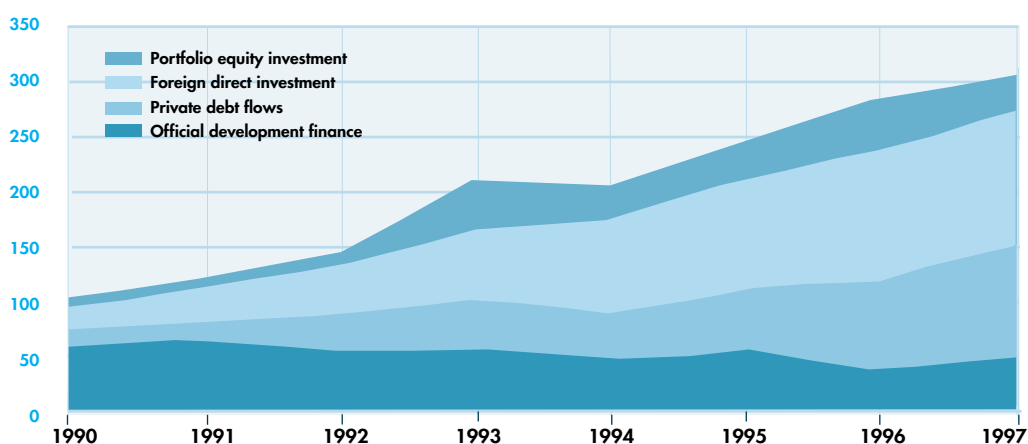
23) See Carter and Bond (1996).

In capital markets, IFIs have promoted new financial instruments, such as leasing (24). IFIs have also encouraged portfolio investment through development of local capital markets, investment funds and the sharing of investment information. The IFC first used the term emerging markets and invented the leading indexes tracking their performance, which have been vital for the development of the fund management industry in this area (25).

The private sector has been a vehicle for capital flows from developed to developing countries from before the beginning of official aid flows. From the oil fields of the Persian Gulf to India's tea plantations to Argentine railroads, foreign investment underpinned the development of industries and supporting infrastructure. During the post-war period, the role of foreign private capital shifted from direct investment to lending to governments. This reflected government antipathy to private enterprise, and particularly to foreign enterprises, which were feared as 'back-door colonisers' or thieves of national wealth. Sovereign lending dried up in the 1980s following the Latin American debt crisis, resulting in an effective disengagement between private investors in developed and developing countries.

In the 1990s, there has been renewed engagement, driven by the new market-friendly paradigm in many developing countries, the lowering of global trade and investment barriers, and the fall in communications and transport costs. These forces have led to the growing integration of world markets for goods, services and capital, a process that has become known as globalisation. As a result, private capital has displaced official development finance as the main source of external financing for developing countries, accounting for 85 percent of the total in 1997, compared to only 41 percent in 1990 (see Figure 3).

**Figure 3.** Foreign capital flows to developing countries, 1990-1997 (in USD billion)



Source: World Bank (1998).

Also, private investors in industrial countries are looking to diversify their risks internationally and are becoming more sophisticated in their treatment of emerging markets. Whereas ten years ago a mutual fund investor might have selected an emerging market fund, now he or she can select a regional fund, or a sector fund. As a result, the surge in FDI has been accompanied by a surge in portfolio invest-

24) See Carter (1996).

25) About USD 7.5 billion of passively managed funds currently track the IFC Investable and IFC Global Index.

ment. This offers domestic investors scope for raising capital on domestic capital markets, since foreign investors, where allowed in, dramatically increase the size and liquidity of these markets.

As the private sector becomes more experienced in working in emerging markets, this trend is likely to intensify. Private capital flows are increasingly long-term in nature, and are being made available to more private borrowers on increasingly competitive terms. Spreads on emerging markets corporate debt have fallen, while maturities available to borrowers in a number of developing countries have lengthened to over five years (26). Whereas a few years ago most privatisation transactions or private infrastructure concessions drew on IFI advice, now the majority proceeds with private advisors and investors.

**Since IFIs generally aim not to displace private investment, they are being forced to push on into new sectors and countries.**

This has generated something of a virtuous circle: greater IFI attention to private sector development has brought with it greater private investment. Since IFIs generally aim not to displace private investment, they are being forced to push on into new sectors and countries. Whereas ten years ago the IFC could claim a pioneering role by investing in infrastructure in Argentina, this is now mainstream private business. Today, the IFC's pioneering role involves financing health facilities in Kenya. Once private investors become comfortable with this, the IFC will need to move on again.

The shift in economic structure and the resurgence of private capital flows have challenged the work habits of IFIs in a number of ways. First, it has led to a reallocation of financing from the public project to private project windows, e.g., infrastructure financing. This has left some IFIs with an imbalance of capital and human resources, with the finance and staff still heavily weighted towards the public sector window. IFIs have not been as agile as they might have been in responding to this shift. A particular obstacle has been the constitutional difficulties in shifting capital between uses. For example, the IBRD, IDA and IFC are all legally distinct institutions, and capital transfers require the approval of their shareholders.

Second, private investment banks and venture capital companies have brought new work practices and standards of client service to developing countries. Whereas IFIs could once treat many clients as supplicants, who had no choice but to borrow from them, there is now a wider choice of options. IFIs have discovered that there is a limit to the premium (whether in loan spread, restrictive covenants or processing time) that the market will bear, before borrowers seek private alternatives. Even where there is no private financing available for the particular investment in question, expectations of client responsiveness, speed and quality of service have been raised by greater exposure to private banks.

## **6. The missing foundation - Institutions, and how to build them**

More recently, the limitations of the market paradigm have become evident in many country settings, with weak private sector responses to change in the economic policy environment. The share of private fixed investment in GDP, for example, ranges from 25 percent in some countries to only five percent in others. Even where countries adopt similar, market-friendly policies, differences in private sector responsiveness remain. A key question for IFIs has been to understand why private enterprise

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26) This trend appears to have only been temporarily interrupted by the 1997 financial crisis in some Southeast Asian countries.

**One of the greatest unsolved challenges for IFIs is how to become more effective in supporting institution-building.**

response varies so much. The answer seems to lie to a large extent in the quality of institutions (27). Recent research shows, for example, that two institutional factors are strongly related to investment levels, i.e., the rule of law and corruption (28).

This has helped draw attention to the importance of supporting institutions in fostering private sector growth, drawing on the work of economists such as Douglass North (29). Marshall aid to Europe was successful in large measure because recipient economies had been damaged by war but their institutional capacity remained intact. Post-war reconstruction in Germany and Japan succeeded because of a heavy emphasis on creating stable, effective institutions. Developing countries, especially the poorest ones, and some of the post-communist economies lack much of this institutional capital. These two institutional dimensions are by no means abstract: indexes are compiled routinely which make it possible to rank countries in these respects.

The quality of the institutional framework affects the performance of all forms of financial flows. The World Bank's self-evaluation department identified the quality of 'governance' as a major impact on aid effectiveness. It has become clear that the degree of success, whether in investment projects, adjustment loans or technical assistance, hinges largely on institutional factors. Most recently, the vulnerability of the economies of Southeast Asia have been linked to weak institutions, such as banking regulators, bankruptcy laws and commercial accounting.

Thus, IFIs have moved on from adjustment lending and policy dialogue to give renewed emphasis to building the capacity of domestic institutions (legal systems, customs services, etc.). In the light of the current Asian financial crisis, particular attention is now being given to the importance of strong financial institutions.

However, the performance so far of IFIs in institution-building has been modest. Large sums have been spent on 'technical assistance' with little lasting impact. Much of this money has been spent on expensive expatriate advisers and consultancy studies. Their advice, however technically strong, could not in itself create institutions, which is an inherently endogenous process. Nor can external advisers make much impact where (unlike in post-war Europe and Japan) existing institutions, however weak or dysfunctional, are well entrenched and protected by vested interests.

One of the greatest unsolved challenges for IFIs is how to become more effective in supporting institution-building. Their traditional structures, with an international staff based in one location, visiting clients for short missions, is not conducive to the context-sensitive, high intensity, long gestation work of institution-building. As of today most of them lack the capacity to deliver effective institution-building loans and advice. Even the World Bank, which spearheaded institution-building, first through its investment projects, then by means of policy lending and technical assistance, has only a limited capacity

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27) The term 'institutions' refers to the 'rules of the game' - laws, regulations and how they are made and enforced (or not enforced). This includes such important aspects of economic life as enforcement of private contracts by the state, the judiciary, commercial dispute settlement, utilities and banking regulations, and of course, first and foremost the protection of life and property.

28) The rule of law is defined as the degree to which citizens are willing to accept established institutions to make and implement laws and adjudicate disputes, and the presence of 'sound political institutions', a strong court system and provisions for orderly succession of power. See Brunetti and Weder (1997).

29) See North (1990).



in this area. This was brought home when, in the wake of the crisis in East Asia, the World Bank was asked to field more banking and banking supervision experts than it commanded at the time. The same is true to an even greater extent when it comes to help reform judiciary systems, not to mention the broader legal environment. The challenge is greatest for the less broad-based IFIs.

Some, such as the World Bank, are responding by decentralising, changing their skill mix, and developing longer-term, more flexible lending instruments. Some are seeking partnership with local organisations, foundations and bilateral agencies that seem better equipped for this work. Other approaches may emerge.

## **7. Intellectual leadership - Analysis and advice**

One aspect of limited institutional capacity within borrower governments has been the ability to analyse development policy problems, and formulate investment projects. When the World Bank was established, it was expected that borrowers would come forward with well-prepared proposals for appraisal by the Bank. Within a year or two, it became apparent that this was not happening, and the Bank took the fateful decision to take on the role of project preparation itself. This created the modern World Bank in two important senses.

First, project preparation is vastly more staff-intensive than project appraisal. It led the World Bank to build up large technical cadres, initially of engineers and agronomists, then latterly of economists. From there, the Bank worked upstream to develop its own capacity to do sector and country analyses, basic economic research and even data gathering. By the zenith of its staffing in the early 1990s, the Bank's research department had a staff whose quality, quantity and output outshone most university economics' departments. The Bank had become the intellectual leader in the analysis of developing countries. This emphasis on project preparation and economic analysis was emulated, on a narrower basis, by the other IFIs.

Second, it combined the functions of project preparation and appraisal in the same staff and management, without any effective separation. Thus, the Bank became both promoter and investor, or, to put it another way, it was both prosecutor and judge (30). Insofar as borrowing governments were liable for the loan repayments, they retained an independent review function, but even this discipline was weakened in countries receiving IDA finance on near-grant terms. This undermined project quality, due to the lack of disinterested critical review of project design (31). Equally importantly, it led to lack of borrower 'ownership' of project objectives and activities. Eventually, dissatisfaction with the quality of the resulting portfolio led to reviews of project cycles in IFIs, starting with the 1992 Portfolio Management Task Force at the World Bank, led by ex-World Bank Vice-President Willie Wapenhans. This reviewed the quality of the World Bank project portfolio, and found that many projects

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30) "Weaker borrowers called for a greater degree of Bank involvement, and in more extreme cases the projects literally were 'Bank' projects. The institution's direct involvement in project identification and preparation was particularly marked in Africa, where, more often than not, the project ideas governments advanced were only peripherally represented in their official public investment programs. The formulation of a full project concept was in most cases the product of Bank identification and preparation missions and was done by Bank-financed or Bank-supervised consultants (Kapoor et al., 1977, vol. 1, p. 36)".

31) This does not mean projects were not subject to extensive scrutiny; on the contrary, the World Bank developed an extensive system of internal review as a substitute for effective external review. However, these reviews have limited influence over the final decision on whether to finance a project.

languished unwanted, unloved and undisbursed, once the Bank had finished its work of designing them and committing the funds.

**The World Bank is moving to being a global clearing house of knowledge on development. It may come to separate its roles as supplier of expertise and of finance.**

Following the Wapenhans report, the World Bank made explicit efforts to increase borrower ownership of projects, and to strengthen internal review functions to improve 'quality at entry' into the portfolio. At the same time, the Bank has been encouraged by its shareholders to impose more rigorous design standards on loans, particularly in the area of environmental and social impact, and to include a broader range of stakeholders in project design. These trends have tended to counter the aim of increasing borrower responsibility for, and ownership of, project designs.

The world has changed massively since the World Bank was established in the 1940s, such that there are now many universities with excellent development economics departments, and many consultancies offering expertise in the same fields as the Bank. Thus, borrowers and lenders alike are now able to look more outside themselves for expertise. However, they have been slow to do so, since IFIs have established large cadres of experts, whose services are offered free at the point of use by being packaged together with financial services. Thus, when you ask for a loan, you get a package of analytical work and advice with it, which you pay for in the fixed loan charges, whether you use it or not.

The growth in other sources of expertise on development offers scope for a greater plurality of thought and analysis on development, and greater interchange between IFIs and others working in the field. In response to this, the World Bank is moving from a position of being a universal provider of data and analysis to being a global clearing house of knowledge on development, both disseminating its own analytical work, and acting as a broker for the expertise of others. It is also moving towards 'unbundling' its loan and advisory services, allowing countries who do not want to borrow to pay directly for analytical work.

This parallels changes in the structure of private financial institutions, which are increasingly specialising either as arrangers of finance (e.g., investment banks), suppliers of finance (e.g., pension funds, mutual funds, securities markets) or suppliers of information and analysis (rating agencies, research services). Over time, the World Bank may come to separate its roles as a supplier of expertise and a supplier of finance, instead of bundling the two into a single product called a project.

The IFC has always kept a clearer distinction between these roles. Its Articles preclude it from acting as a project sponsor, so it has largely relied on others to develop investment proposals, which it then appraises. In its advisory work, such as on privatisation, it has kept a strict separation from its investment role. Thus, the IFC acts as an adviser on privatisation, or as an investor in the privatised company, but not both at the same time. This has helped it avoid some problems of poor project quality which have afflicted the World Bank. However, in areas like Sub-Saharan Africa, it has limited its ability to find bankable projects. Various schemes have been attempted to help sponsors with project development and implementation (32), but these have been kept at arm's length from the IFC.

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32) Including the Africa Project Development Facility, African Management Services Company and Enterprise Support Services for Africa (co-financed with the United Nations Development Program, the AfDB and others).

## 8. To boldly go ... - IFIs in the 21st century

A report, *Serving a Changing World - Report of the Task Force on Multilateral Development Banks*, was written at the request of the Development Committee in 1996. It contains a useful reminder of the IFIs' role. The role is articulated as follows: "Official development finance - including that of the IFIs - needs to remain an important part of external resource flows to a majority of developing countries. The IFIs must support the policies, the institutions, and the infrastructure necessary to promote broad-based economic growth and efficiency, improve the prospects of the poor, protect the environment, and encourage the development of the private sector. As countries achieve development success, their demands for IFI services are likely to change, and where they gain adequate and reliable access to international capital markets, the IFIs' financial role can be expected to decline" (33). This characterisation of the IFIs' role echoes many of the themes which we have touched upon. It provides a springboard for discussing the future of IFIs in the 21st century.

### 8.1 Financing development

Between 1990 and 1997, disbursements by official aid agencies have declined from nearly 60 per cent of net long-term resource flows to developing countries to 15 per cent, as well as in absolute terms (34). The decline reflects better access to capital markets by an increasing number of developing countries as well as lesser demand for official assistance in financing public sector investment, such as infrastructure projects.

However, private flows are heavily concentrated on a narrow range of countries, sectors and borrowers: 75 per cent of net private capital flows go to a dozen countries, albeit including the largest developing countries - this leaves over 100 developing countries with little access to private financing. Even in those countries which do receive private capital, borrowing is limited to a small set of 'top tier' countries, and is mainly for extractive industries, infrastructure and financial sector activities. Private flows would be unlikely to meet all the basic needs for better education, health, rural roads and other investments characterised by long gestation periods and low profitability. Thus, while many of the traditional destinations of IFI resources now have access to private finance, there remains a large set of companies, sectors and countries which continue to need IFI involvement to mobilise financing.

This suggests that IFIs will play a more selective role in financing development in the 21st century, focusing on areas not adequately financed from other sources. This poses a dilemma for IFIs, since the findings on aid effectiveness suggest that to achieve greater impact they concentrate assistance on countries where policies and institutions are reasonably supportive of development. These are likely to be the ones that are most attractive to private investors, too. Thus, IFIs will be pushed towards countries where the conditions for investment are more difficult, but at the same time will be more selective about investing in these countries where the prospects of success are poor. The outcome is likely to be a more selective and more limited range of lending opportunities.

This raises the question of whether developing countries with good access to private finance should 'graduate' from IFI borrowing. The tension here is between universality and selectivity. IFIs function best and

**IFIs will play a more selective role in financing development in the 21st century.**

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33) *Summary and Recommendations*, par. 23.

34) See *World Bank (1998)*. *Official flows increased somewhat in the wake of the crisis in East Asia*.

enjoy the broadest political support with a broad set of borrowers. Shareholders like this, because it means IFIs are serving the countries of interest to them; borrowers like this because it means they are well placed to share best practice from a wide range of operational experience. The World Bank, with the widest borrowing membership, is widely regarded as the leading IFI source of knowledge on development.

The graduation point is likely to become more difficult to define, as disparities in the level of development and access to financing can be as great within countries as between countries. There is a huge gulf in living standards between coastal China and the interior, between Sao Paulo and Manaus. Blue chip companies in emerging markets can now access international financial markets, and sometimes obtain even finer terms than governments, while second-tier companies may still need IFI backing. Thus, graduation decisions will need to become more nuanced to reflect finer distinctions than simply whether a country should be eligible to borrow, and on what terms.

Demand for policy-based lending, which remains one of the World Bank's major capabilities, is likely to continue to fluctuate. The size of 'rescue packages' has increased in recent years with each major crisis (Mexico, East Asia). With further liberalisation might come even greater volatility. Some of the regional IFIs contributed to recent 'rescue packages', even though they lack the breadth and depth of the Bretton Woods institutions in this domain and are not in as strong a position to enforce policy conditions. The need for such financing has been felt as much, if not more, among graduates (e.g., Korea), since they are larger economies, and more integrated into the global economy. Thus, IFIs may retain a role as a lender of last resort to countries even where their role in financing investment is past.

## **8.2 Financing governments**

The world of unitary nation states is breaking up under the centrifugal forces of regional blocs and the centripetal forces of decentralisation to subsovereign authorities. At the same time, the centrality of governments in directing economic development is being eroded in many countries by a more assertive civil society, which both seeks to participate in economic decision-making, and offer alternative channels through which financial resources can flow.

IFIs were based on an inter-governmental and international structure. They will have to adapt to work with governmental organisations at both supra-national and sub-national levels. For example, the IMF currently has no mechanism to give the European Central Bank a voice on its Board, yet it will become the most important monetary authority in the world. Only individual European countries have seats. Another example is the increased decentralisation of responsibility to municipal and local authorities. Traditionally, IFIs have only lent to these authorities with central government guarantees. As central governments grant greater fiscal autonomy to local government, this is no longer appropriate.

Already, they are struggling to adapt to the growing role of civil society. With the introduction of an independent inspection mechanism in 1993, the World Bank was the first to allow civil society a direct voice in its investment decisions, albeit only as a channel for complaints by affected parties. At the same time, IFIs have moved towards much greater disclosure of information to the public about their operations. In parallel with this formal approach, the World Bank also engaged more intensively with civil society in its analytical and project preparation work (e.g., poverty assessments with greater participation by the poor themselves), and began to intensify the use of non-governmental

organisations (NGOs) as participants in World Bank projects. However, the tension remains, with such collaboration subject to the host government's endorsement, not least because of the need for government guarantees of any loans. Hybrid multilateral organisations are beginning to bring together NGOs and IFIs in new ways, e.g., the Consultative Group for Assistance to the Poorest, which acts as a co-ordinating mechanism for microfinance schemes managed by NGOs.

### 8.3 Financing private enterprises

While it is difficult to disentangle cyclical and secular changes, the rise in private financing seems to be driven by fundamental changes in the global economy. For now, there is still a role for IFIs in investing alongside private investors, to provide expertise in appraising and structuring transactions, and a degree of 'comfort', or even formal guarantees, against country risks. There also remains a need to help structure and execute deals - even creditworthy infrastructure projects can prove difficult to close without IFI support. However, as financial markets are becoming more sophisticated about assessing and handling risk, these roles are also likely to diminish.

*The roles of assessing and handling risk are also likely to diminish as financial markets become more sophisticated.*

Since instability in Southeast Asia continues to emerge, it is too soon to draw conclusions on its impact. However, some initial trends are clear. First, IFIs have been drawn more than ever into supporting reform of institutional frameworks, from banking supervision to provision of government financial information. Second, the private sector has shown increased ability to discriminate between risks, so that the contagion effect on other countries has been limited, and investors are starting to bargain hunt for strong assets within classes of highly distressed assets.

Demographic trends in rich countries - the imperative to save for retirement since taxation-funded schemes will be unable to provide adequate cover - will continue to drive savings rates up and investment returns down in industrial countries, hence encouraging investors to seek higher returns in emerging markets. Hence, IFIs are unlikely to be needed to do 'plain vanilla' investment transactions, but will have a continuing role in helping push the envelope wider, by sector, country and product.

### 8.4 Advice on development

Reduced demand for IFI services, the unbundling of advisory, transactional and financial services, and the increased selectivity in operations pose questions for the IFIs' future role as advisers to developing countries. In the past, the large scope of operations has enhanced their effectiveness in spreading best practice, i.e., the transfer of useful knowledge from one country to another (35). IFIs will find it more difficult to maintain and develop their knowledge base, which springs in large part from their own transactions experience, if demand for loans declines; likewise, for recipients, technical advice is usually most convincing when it is part of a real-world project. Disembodied or self-standing advice is less likely to convince. IFIs may therefore lose their pre-eminence as sources of expertise on development, and become more facilitators than generators of analysis.

### 8.5 Building institutions

Institution-building will be a central task in the development process in the 21st century. This poses an immense challenge to IFIs. On one hand, they could develop the structure and expertise to

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35) The first question government officials usually ask IFI staff who recommend certain policies or institutional changes is: How did it work elsewhere? This is when real-life examples can be very persuasive.

support this effort. This would require unprecedented change in terms of staffing, organisational structure and financial instruments (36). On the other hand, they could learn to work in partnership with other agents of change, including bilateral agencies and NGOs. This too requires changes in the ways IFIs work, with greater openness and willingness to work as a partner, and more flexible means of financing collaborative work. Either way, IFIs will need to refine their understanding of the institutional context of their work, and improve their ability to assess institutional risk.

### **8.6 Standard setting**

A new role for IFIs has emerged as a result of greater global economic integration, which has created a need for international standards of financial regulation, information and transparency. Since IFIs are already involved in financial market reform, they have been a natural choice for promoting better standards, through analysis and technical assistance.

Likewise, increased awareness of global environmental and social issues has led to the promotion of international standards in these areas, too. Here, IFIs have been targeted for attention due to the environmental and social impact of their own lending activities. Adoption of higher standards in their operations may promote better practice in these areas. It is also having the effect of deterring borrowing from IFIs for projects with significant impacts in these areas.

### **8.7 Reconstruction**

Lastly, IFIs are being called back to their roots to help with reconstruction. In Rwanda, Bosnia, the Democratic Republic of Congo, the West Bank and Gaza, there is a renewed need for financial and institutional support for post-conflict economies. Rapid infusion of resources can play a critical role in creating the conditions for lasting peace, but is difficult to do when the most rudimentary institutions may be lacking. Since low-income countries have been particularly heavily affected by conflict (37), reconstruction will be an important element in achieving poverty reduction. Again, this will challenge the current structure and work processes of IFIs.

### **8.8 Financing the IFIs**

In the light of the various directions in which IFIs might evolve, it is important to recognise the internal financial constraints they face. The IFIs' ability to grow and adapt over the past 50 years has been largely due to their robust financial structure. Endowed by their government shareholders with an equity base and shareholder guarantees (callable capital), they have been able to raise bond finance in large volumes at the finest rates. By charging borrowers a modest spread over these loan costs, they have been able to generate ample budgetary resources to support not only loan processing, but a range of ancillary services. This model does not extend to the concessional funds such as IDA, which remain subject to periodic replenishment. As a result, the room for manoeuvre and innovation in the use of concessional funds has been much more constrained.

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36) *Perhaps the League of Nations had it right in the first place when they extended technical assistance to the Chinese customs administration in the 1930s?*

37) *Virtually every low-income country has had a major conflict or borders a country which has had one; 15 of the world's 20 poorest countries have had major conflicts in the past decade.*

The trends outlined above pose a number of threats to the financial structure of IFIs. As noted above, demand for large volumes of non-concessional project financing has declined in those countries with ready access to capital markets, while IFIs may become more selective in the projects they will support, and the countries in which they will operate. This has been partly masked by a temporary demand for policy-based lending. Over the longer term, we are likely to see a secular decline in demand for IFI financing in pure volume terms.

At the same time, there is increasing demand for IFI loans in areas which cost proportionately more to prepare and supervise, such as technical assistance for institution-building, and environmentally and socially sensitive activities. But the decline in private lending margins to developing country borrowers will limit the spread which IFIs can charge on loans. Moreover, there is continued demand for services which have traditionally been financed from the spread on lending: analytical and advisory services, knowledge broking services and data. IFIs are only now experimenting with ways to charge for these services in order to reflect ability to pay.

The net result is that the profitability of IFIs is likely to come under increasing strain, thereby constraining their ability to take on additional roles. Price pressures will encourage further unbundling of services, and direct charging for a greater proportion of services. This will reveal areas where willingness to pay is weak, and which may therefore decline (e.g., basic research, which as a public good is difficult to sell). Insofar as governments want IFIs to continue to provide global public goods such as research, new funding mechanisms may need to be found which share the financing burden amongst all member countries.

*Insofar as IFIs continue to provide global public goods such as research, new funding mechanisms may be needed from member countries.*

## **9. Conclusions**

Despite enormous progress in many countries over the past half-century, many challenges remain. A growing and migrating population, environmental degradation and growing international integration have created new interdependencies between rich and poor countries. Thus, the imperative for international co-operation is likely to get stronger, rather than weaker. IFIs have proven themselves able to respond to shifting economic paradigms and global trends, and will need to do so again as the new century unfolds.

The business of development assistance has always been complex, even if its full complexity was not well understood at the beginning, and the institutions in existence have rarely been a perfect match for the roles they are required to play. This has led to a continuing process of creating new institutions and reinventing existing ones. It has also led to a continuing temptation for IFIs to take on new roles, without relinquishing old ones.

To some extent, they have been victims of their success: due to their relative efficiency compared to other vehicles of international co-operation, governments have tended to load new tasks onto them, whether or not they are inherently suited to them, while seldom relieving them of existing tasks. But this contains the seeds of their own downfall - an expanding mandate risks a loss of management focus, and clarity of purpose. At the time of the World Bank's 50th anniversary, this dilemma was widely discussed. One analogy offered was that the Bank could be the world's aircraft carrier - large and well-equipped, ready to rise to whatever international challenge its owners put before it. The discussants that mattered - the Governors and Executive Directors - rejected this model, and by pressing budgetary constraints, have encouraged a refocusing on core tasks.

***IFIs will need to pursue selectivity and unbundle their services, while becoming more responsive to a changing world.***

Looking ahead, IFIs will come under increasing pressure as alternative sources of finance, analysis and advice develop and their profitability declines. This will mitigate against temptations to over-expansion. To fulfil their mandates in the next century, IFIs will need to continue to pursue selectivity and unbundle their services, while becoming more responsive to a rapidly changing, pluralistic and integrated world. Adaptability will be as much a *sine qua non* for the 21st century as it has been until now.



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### **Jean-François Rischard**

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*He joined the World Bank in 1975, serving as a Project Officer until 1982, when he moved into the financial policy and asset/liability management areas, becoming Division Chief in 1984. After spending three years as Senior Vice-President of the Wall Street investment bank Drexel Burnham Lambert, he returned to the World Bank in 1989 as the Director of the Investment Department, taking responsibility for the USD 25 billion liquid assets portfolio of the World Bank Group. In 1993, Mr. Rischard was promoted to Vice-President, Finance and Private Sector Development, and built up this new vice-presidency to serve the Bank and its clients through its specialised expertise in these areas. In 1997, he became Head of the Finance, Private Sector and Infrastructure Network, which regroups, besides the staff of his original vice-presidency, all of the staff who operate in those areas within the Bank's geographical vice-presidencies.*

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# Multilateral development banks and global public policy networks: Speculations for the next century

Jean-François Rischard

## 1. Introduction

The next 20 to 30 years will be a period of unprecedented and accelerating change as a result of two powerful forces - the advent of a radically different world economy, and the explosion of the world's population. As these forces are unleashed, the world's nation-states - weakened by their increasingly unhelpful territorial and hierarchical constructs - will struggle hard to keep up with changes. Sooner rather than later, new trans-national governance solutions will have to be implemented. One among several solutions is the adaptation, or even re-invention, of multilateral institutions to support global public policy in the 21st century.

## 2. Forces for change

Virtually all countries now embrace market-oriented policies. More than five billion people live in market economies today, as against only one billion a decade ago. Entrepreneurship and the private sector are widely recognised as *the* dynamic factors of growth.

What this means for developing countries is now clear: year after year, the IMF's *World Economic Outlook* shows that developing countries as a group grow two to three percentage points faster than the OECD economies. This means that there is a massive shift of growth and business opportunities towards the South and East. The group of new players with high growth rates is expanding beyond the original group of China and a few East Asian and Latin American countries. For example, Uganda scored a growth of nearly six percent last year.

The distribution of world markets is about to undergo a massive shift as well. To pick one example, in 2010, the Asian middle class - crudely defined as people matching Portugal's GDP per capita today - will embrace 750 million individuals. The current East Asian crisis, hard-hitting as it is, will not affect this trend.

The global economy is also being propelled by a powerful cluster of innovations - centred on low-cost telecommunications and information technology. These innovations cover every possible area of human activity, including biotechnology, robotics, high-performance materials and, of course, software. Even mundane transport has been revolutionised through containers, hub airports and overnight shipping systems.

Much is yet to come:

- Over the next 20 years, the cost of telecommunications may well drop to a point where we have a free commodity. In a study the World Bank recently sponsored, it was estimated that the cost of a one-hour transatlantic call would be three US cents by 2010.

- New data compression techniques, smart combinations of fibre and wireless communications and the global satellite schemes in the making will eliminate bandwidth constraints and knock connection costs down to a few US dollars per station in about a decade - with a dramatic increase in connectivity everywhere, even in the most remote areas.

Unlike earlier industrial revolutions, this information revolution is not about the transformation of energy and matter. It is about the transformation of *time and distance*. It is about information flowing faster and more generously throughout the planet, with the result that *knowledge* has become a more important production factor than labour, raw materials and capital. These powerful forces are leading to a major revolution in business practices and even in society itself.

As these forces combine, a *new world economy* is emerging at a breathtaking pace. It brings unbelievable opportunities for new markets, new products and new ways of doing things, and unprecedented catch-up opportunities to developing countries.

But this new world economy will also be stressful. All firms, all sectors, all countries - rich and poor - will have to compete. The traditional distinction between rich and poor countries will be overtaken by new distinctions: between fast and slow, and learning and static countries.

And as the new world economy develops, the world's population will move in three to four short decades from six billion people today toward an eventual peak of about 10 billion people. The urbanisation rate will shoot up to over one-half. Almost everywhere, globally, regionally and even locally, there will be environmental problems. Congestion will multiply. Food production will have to triple just as agricultural land frontiers disappear.

The challenge of the 21st century will be foremost one of growing complexity.

### 3. Struggling nation-states

***Nation-states will be increasingly overwhelmed by the new world economy and will have no choice but to devolve power to others.***

While complexity increases, nation-states and their central governmental systems will remain by and large organised like a pyramid, with information flowing up the hierarchy to increasingly overwhelmed leaders at the summit. Moreover, the civil service culture, little changed over the past hundred years, will continue to promote the best process managers up the hierarchy, rather than the best leaders.

These structures worked well in periods of slow change, but will come under stress as the rate of change accelerates. For example, it is increasingly hard to see how nation-state governments will be able to cope with the complex governance, taxation and regulatory issues posed by electronic commerce.

In other words, nation-states and their central government apparatus are and will be increasingly overwhelmed by the challenges posed by the new world economy and population growth. Adding to this stress, ageing populations and exploding pension fund liabilities will build up budget pressures to ominous levels for many central governments.

The beleaguered central government core of nation-states will have no choice but to devolve power to others: vertically, to supranational bodies and subnational entities such as provinces, states and municipalities; and horizontally to other players empowered by the information technology revolution, including the private sector, non-governmental organisations (NGOs) and other parts of civil society.

Under the traditional territorial construct of modern nation-states, the political system, the economic system and the environment are all superimposed. Powerful forces are now dragging these three factors apart. The new world economy is pulling the economic system outside the territorial boundary of the nation-state. Global and regional environmental problems are increasingly shifting control of the environment outside territorial boundaries. The result: an erosion of the sovereignty of the nation-state. This is one cause for malaise in the now *disconnected* political systems - with distrust almost everywhere of the capacity of the political leadership to cope with the great changes ahead.

#### 4. Global public policy networks

**A promising strategy differentiates between governance and government.**

If public policy is to sustain the new world economy, preserve the environment and manage major risks rather than merely react to them, it must avoid the pitfalls of territoriality. Forming a world government would be one response, but such a solution is clearly unrealistic. And while it may transcend territorial boundaries, there is little reason to believe that a global government would be better equipped to deal with the technical complexities of public policy than its national counterparts.

A more promising strategy differentiates between *governance* and *government*. Elements of governance would be de-linked from their formal territorial foundation (the nation-state) and hierarchical structures (the government); global public policy issues could then be tackled more along functional lines and more proactively. Pursuing this idea, one could think of several complementary trans-national governance solutions. The following discusses four such tracks.

A first track is to replace the weak, reactive G-7/8 type of consultations with *Bretton Woods-style brainstorming sessions*. Through such venues, world leaders would identify and formulate strategy on issues of global concern.

But regular brainstorming venues alone cannot provide the continuous technical consultations needed to address global public policy issues. In addition to Bretton Woods-style sessions of top leadership, there is therefore a need for a second, complementary track: *trans-governmental networks*, that is, permanent channels of communication linking national bureaucracies to facilitate the open exchange of information. There are quite a few examples of such networks, but they are still in embryonic form. The financial crisis in Asia has alerted policy makers that such links are long overdue. But there should be no doubt that functional trans-governmental networking has to go far beyond global capital markets to cover a broad range of policy issues - among them, intellectual property rights, environmental degradation and taxation in the age of information.

Establishing trans-governmental networks would help nation-states to catch up with a private sector which is not territorially-bound. However, these networks will not be able to fully eliminate such

asymmetry. If these networks include only government players, they will continue to lack the dynamism, agility and knowledge base that characterise global economic networks. Such adaptive and intelligent systems can be achieved only if they seek the active participation of non-state actors, thus turning these trans-governmental networks into our third track: true *global public policy networks* - of government departments, the corporate community, non-governmental organisations and other interested civil society participants, such as foundations.

All these actors have a direct stake in the outcome of public policy. Equally important, their range of activity is not trapped by political boundaries. On the contrary, their legitimacy and success often come from their ability to cross territorial boundaries with ease.

To garner credibility, trust and eventually success, these networks must be grounded in an international legal context. The World Trade Organisation's dispute resolution mechanism comes to mind. However, here too change is under way, as the international community has begun to opt for non-binding international legal agreements. Not only are these agreements more flexible, they are also open to non-state parties, reflecting the mixed composition of actors in global public policy. Although these agreements are characterised as 'soft' international law, the empirical evidence suggests that compliance is quite high.

## 5. Re-inventing multilaterals

**Multilateral institutions could play a leading role in nurturing global public policy networks.**

The vision laid out above implies a considerable change in our understanding of multilateralism and leads to the fourth, highly complementary track: *re-inventing multilaterals*. The idea: multilateral institutions could play a leading role in nurturing the much-needed global public policy networks alluded to above. Let us illustrate this here with respect to one type of international financial institution (IFI): those involved in multilateral development finance.

First, these institutions could be charged with supporting the participation of developing countries in global public policy networks. This includes a focus on institution-building, the promotion of good governance, the widespread dissemination of information and the establishment of a knowledge base that permits all interested parties to contribute to the debate over a particular public policy issue.

Second, IFIs are in an ideal position to kick-start such policy networks. Unlike countries, private players and NGOs, these institutions do not represent particular interests. Instead, their mandate is to promote the deeper integration of the world economy and to ensure that this can be achieved on socially and environmentally sustainable terms. Thus, IFIs could well take the lead in identifying those public policy issues that require a global commitment. They could then provide an institutional umbrella for policy formulation by mediating between the various stakeholders involved. Lastly, they could assist in monitoring the application of global public policy and, if mandated, support its enforcement.

Based on these two roles, IFIs would need to evolve well beyond their original role as we enter into the next century. Think of IFIs as part of the fabric of the global public policy networks of the future. In that role, they would provide not just finance but three sets of essential services:

- **Global knowledge services.** The World Bank, like all the multilateral development banks, has vast experience and knowledge of a full range of development policies from fiscal stabilisation to the design of handpumps, from civil service reform to traffic management. It also has a reputation for providing high-quality, disinterested policy advice.

However, IFIs could improve knowledge dissemination, replacing the traditional, voluminous economic and sector reports (which are often outdated by the time they go to press) with short, timely, accessible articles on best practice or targeted topics of immediate interest and rapid referral to the relevant internal or external experts. The internet is a logical vehicle for this (1).

In addition to disseminating best practices, IFIs can do more to help individual governments implement country-tailored programs for institutional development. Light on reports and long on results, this involves helping countries obtain the help they need to reform their civil service, update legal/commercial frameworks (e.g., concessions for public-service provision, mechanisms for corporate governance and regulations) and improve such social services as education. The key is to establish governance mechanisms that are flexible enough to respond to shifts in the new world economy, and to equip developing countries to become active participants in global public policy networks.

- **Global partnership services.** Through their experience, multilateral development banks have developed credibility as 'honest brokers'. Simultaneously, they have developed strong working relationships with clients, NGOs and other stakeholders in public policy issues. These qualities position them to assume the role of convenors of partnerships and dispassionate trustees for the formulation and implementation of global public policy reforms beyond the purview of individual governments.

IFIs are already convening professional organisations and others to develop global technical standards or to pursue the resolution of key issues. The World Bank, for example, has partnered with the World Conservation Union to establish the Global Commission on Dams to set standards on the planning, design and operation of dams world-wide. It has developed an alliance with the World Wildlife Fund to promote the conservation and sustainable use of forests. It also manages the *infoDev* program to help developing countries realise the urgency of addressing the Year 2000 computer problem.

The role of trustee and partnership facilitator could be broadened to tackle the critical issues of world energy, food security and environmental degradation as well as specific initiatives such as improving corporate governance and banking supervision, controlling money laundering and other forms of corruption and stemming trade in nuclear and other dual-purpose technologies. By providing these platforms for debating, developing and implementing global public policy, IFIs are in a privileged position to kick-start and sustain individual global public policy networks.

- **Global financial services.** Multilateral development banks still have an important role to play in financing investment in developing and transition countries, or even in backward regions or sectors of more advanced countries. This role has been transformed in the past decade as foreign

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1) See, for example, **Viewpoints** at <http://www.worldbank.org/html/fpd/notes/notelist.html>.

direct investment has risen eightfold, eclipsing official development assistance. But since this foreign investment has generally been concentrated in the wealthier developing and transition countries, these institutions' role as lender in the weaker countries remains. In re-invented multilateral development banks, loans and credits would focus on support for macroeconomic stabilisation, assistance with privatisation and handling post-privatisation issues, improving legal and commercial frameworks and direct investment as minority shareholders alongside private partners. These institutions' modified financing role is therefore linked closely to their role as policy advisers.

***IFIs are limited in their ability to embark on ambitious reforms on their own. Their shareholders must take the lead.***

However, as inter-governmental organisations, IFIs are limited in their ability to embark on such ambitious reforms on their own. Their shareholders - the member countries - must take the lead in proposing an international architecture that can respond to the demands of the new world economy and embrace the vision of global public policy networks. They should also reconsider the current division of labour among global and regional multilateral development banks, make their operations dovetail and re-think their links to other multilaterals and global players. One of the first Bretton Woods-style sessions alluded to above should be devoted to this.

## **6. Conclusion**

Some are likely to reject an agenda as ambitious as the one laid out here. They might argue that the formation of global public policy networks transfers too much power to IFIs and undermines the sovereignty of nation-states. However, one must realise that nation-states have *already* lost sovereignty and that the establishment of global public policy networks is *a collective way to regain it*. This does not mean that local actors may not play an important role in enforcing and monitoring globally-agreed rules and standards. By ensuring that these networks are based on partnerships with civil society and the private sector, they provide practical meaning and guidance to the oft-quoted line: *Think globally, act locally*.

The basic role of these institutions in this agenda would change, but not their ultimate goal - reducing poverty. To the contrary, it is a recognition of the fact that despite all their efforts, this task remains a formidable one. But if IFIs join forces with others and focus on their comparative advantages, the new world economy offers a unique opportunity to bring us all closer together.







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# The purpose, management and governance of IFIs: A case study of ambiguity

Pasquale Lucio Scandizzo

## 1. Introduction

The international economic order pursued by the Bretton Woods 'founding fathers' was based on the idea that a combination of different international institutions would be needed to keep the world financial system from degenerating into periodic and destructive crises (Mikesell, 1994).

Following the creation of the World Bank, a number of international financial institutions (IFIs) were established, sharing the Bretton Woods model as a means of achieving co-operation among lenders and borrowers and, at the same time, differing in regional orientation and modes of behaviour. The three regional development institutes - the Inter-American Development Bank, the Asian Development Bank and the African Development Bank - followed more closely the World Bank course. The European Investment Bank (EIB) and, much later on, the European Bank for Reconstruction and Development (EBRD), on the other hand, developed their own approach to international co-operation and development finance.

In all cases, IFIs seem to share a common core in terms of goals, business procedures and organisational culture. They have also increasingly become a network reflecting a broader consensus on 'proper' country policies. These include fiscal restraint, trade liberalisation, and autonomy of central banks.

While it may be argued that their present scope goes much beyond what was originally envisaged as their mission, investment financing remains the primary, explicit focus of their operations. Thus, it seems reasonable to ask how they have performed in this specific field and whether their presence as international lenders of last resort has been and will still be useful. The question, however, is not as simple as it sounds: IFIs possess a number of characteristics, from their quasi-public nature to the non-profit status, that make it rather difficult to establish performance standards. They have also come to behave as if they were given a mandate to supervise and discipline borrowers, be they countries or private parties. The resulting scenario is complex and needs to be explored with some care to avoid that the many, and potentially conflicting goals of these institutions pre-empt any serious evaluation of their capacity to match objectives and means.

## 2. IFIs as non-profit institutions

The non-profit status of IFIs can be partly traced to their inter-governmental nature and partly to the need to assume a posture of moral agents in pursuit of the public good of reconstruction, development and stability. Most of the early chronicles of the World Bank (e.g., Galambos and Milobsky, 1995), however, register a hard-nose, business-like attitude reflecting the weight of the Wall Street establishment on the organisation as well as the financing strategies of the institution. Indeed, all IFIs seem to be ambiguous about their non-profit status and their public nature, two characteristics that actually weaken their claim of being promoters of market freedom against the interference and, allegedly, the ineptitude of the public sector.

**Market failures, such as asymmetric information and the fact that lenders might have incentives to shirk, could justify the existence of international non-profit institutions.**

But what is the economic basis that might justify the existence of international 'non-profit' institutions and to what extent can it be utilised to understand the creation of IFIs as self-promoting, autonomous agencies? The main economic theory to this effect applies to the institutional sectors: last resort financing for current and capital account adjustment (Schwartz, 1992), investment for economic development (Gurley and Shaw, 1992), basic needs and social and economic reforms (Killick, 1995). In all these sectors, markets may fail because of asymmetric information (Anayiotos, 1994), and because lenders find that profit gives a powerful incentive to shirk. Shirking may consist of forcing conditions upon borrowers, and of lowering the quality of services provided by financial intermediaries (such as project preparation and supervision tasks). These activities, in fact, may be carried out in the interest of the borrower because the intermediary is individually sheltered from default by government guarantees.

Profit maximisation may also be construed to be inefficient because it may lead, in imperfect credit markets, to a failure to select projects with positive net present values as a consequence of agency costs, adverse selection and the redistributive nature of credit contracts under risk (Jensen and Meckling, 1986, Förster, 1995, and Horn, 1995). Senior lenders who maximise profits tend to capture the rents arising from the fact that the financing of new and less risky projects lowers the risks of all previously issued debts, while raising the cost of total debt to the borrowers. Financing of riskier projects, on the other hand, and its adverse redistributive effects on senior lenders, is generally prevented by the fact that most banks in developing countries reserve the right of recalling all loans if the creditworthiness of the borrower falls below what they consider a minimum acceptable standard.

The monitoring difficulties of development credit both from the point of view of the borrowers and of the lenders thus appear to justify the setting up of major non-profit agents acting as lenders of last resort and to monitor borrowers and other lenders' 'quality'. In this respect IFI loans can be considered a 'trust signal', as they indicate that the borrowers involved are creditworthy and that the possible co-financing lenders do not engage in arm-twisting with the borrowers; nor are they exposing the funds of their creditors to unsustainable risks.

The monitoring function can be enhanced by commitment mechanisms, which also act to increase the creditworthiness of the borrowers in the financial markets. Such mechanisms, envisaged since the very beginning of IFI operations, were pioneered by the IMF, and led to a form of extended conditionality, requiring the country on the borrowing side to commit itself to productive investment (Claessens and Diwan, 1990) and approved policy changes. This demanded in turn the development of policy prescriptions reflecting a broad agreement on 'good' government behaviour. The so-called "Washington Consensus" grew progressively from a broad and somewhat loose macro-economic framework to include standards of market freedom, the importance of the private sector, trade liberalisation, credible exchange rates, sector policies, welfare systems, governance rules and, ultimately, the very functions of the government. Commitment to 'market friendly' policies was difficult to extract at first, in part because the totalitarian governments that dominated the development scene in the post-war period could not credibly commit themselves to actions which denied their nature. A combination of economic factors and political evolution, however, made it increasingly possible for governments to send their own 'trust signals' to the markets, thus validating, but ultimately also voiding some of the certifying tasks that the IFIs had usefully undertaken.

An additional reason that is sometimes cited as a major justification for the existence of IFIs and, indirectly, their non-profit status, is the provision of public goods. Among these, one can certainly put the trust-generating signals cited above, but also, at least in the intention of the founding fathers, a contribution to international liquidity and the efficiency of international financial markets. Compared to private transactions, the financial flows controlled by IFIs appear minuscule both in terms of money collected from the financial markets and money lent to countries and/or private borrowers. Nevertheless, a convincing case may be constructed that liquidity creation is not possible without a sufficient supply of information (see, for example, Drabek, 1995, and Zecchini, 1995, for a favourable account of the role of IFIs in mobilising resources for the development of transition economies) and, indeed, without trying to understand the very process of development (Stern and Ferreira, 1993). IFIs, therefore, through their advisory and consultative role, informed by their monitoring activities and backed up by extended conditionality, may be seen as the key providers of reliable information on world economic and financial conditions and, as a consequence, as major contributors to international liquidity (James, 1995, 1996).

More controversial public goods provided by IFIs are related to their functioning as a network for professional best practices and control on the quality of the projects financed. Since their inception, project evaluation techniques were indeed sponsored as a professional field and extensively used in practical work by IFIs, with special emphasis and enthusiasm by the World Bank. This had enormous effects on the popularity of project evaluation as a field of economic analysis as well as a professional tool. But IFIs themselves seemed to be ambiguous and somewhat unreliable about its use. Reviews by external bodies of IFIs concluded that guidelines for project evaluation were often ignored or misused. In several cases, projects were selected for political reasons and technical and economic evaluations were utilised ex-post only for cosmetic or bureaucratic purposes.

### **3. Accountability and governance**

As non-profit institutions, IFIs enjoy widespread tax exemptions and are subsidised by member countries. Exemptions range from non-liability from capital taxation to limited liability from income taxation for officers and employees. Subsidies include those in kind, such as real estate, machinery and free personnel, but also financial subsidies such as the provision of capital from the shareholders without the expectation of dividends or capital gains. Member states grant further diplomatic privileges to IFI officers, immunities of various kinds, and housing and educational subsidies.

Against this background of exemptions, prerogatives and franchises of stakeholders (IFI managers, employees and bond subscribers), it appears natural to ask what rights are vested in the shareholders, as well as to whom and how the IFIs are accountable. The question is important, but by no means trivial to answer, for three main reasons. First, non-profit institutions, by their very nature, tend to be self-referential, in the sense that the absence of profits and the non-definition of residual rights practically voids ownership (Peters, 1993). Second, conflicts of interest and moral hazard may develop among member countries if borrowers behave opportunistically and count on being ultimately bailed out by the IFIs themselves from any massive debt crisis. Adverse selection and a fall of trust may also arise from lender behaviour, if IFIs let themselves be unduly influenced by the political preoccupations of major shareholders. Third, perks and empire building, the major source of conflicts between managers and shareholders in the modern corporation, may be especially insi-

dious. In fact, monitoring by IFI shareholders is generally lax, national bureaucracies tend to be subservient and some governments are known to try to use managers to pursue their own strategies.

Governance rules of IFIs are indeed difficult to pinpoint, because they were treated since the beginning as international bureaucracies in the UN-style, rather than as corporate entities. Boards are variously composed of central bank and treasury representatives, but they often appear to be themselves a mere extension of national bureaucracies. Annual meetings congregate central bank governors and ministers of member countries in largely ritual exchanges, whose main scope is often to look outside the institutions, to the world order and the international markets, rather than to IFIs' capabilities and performance. Debate on efficiency and effectiveness is discouraged and only sparingly taken up by legislators when the time comes to vote on appropriation bills for new capital injections. A combination of good personnel policies, sincere as well as strategic displays of goodwill, enlightened network building, public relations and straightforward lobbying keeps the IFIs' reputation sufficiently high in the right circles to ensure political support when it is needed. Decision-making procedures, technicalities and professionalism are sufficiently complex to appear to justify the lack of transparency, and the essentially unaccountable nature of much of the institutions' operations and managers.

***Governance appears to be one of the major weaknesses of IFIs.***

In sum, governance appears to be one of the major weaknesses of international financial institutions. To be sure, lack of definition of shareholders' rights on one side, and covert vesting of rights onto management and 'key' shareholders on the other, may have helped to free the organisation from the encumbrance of multilateral controls and costly active monitoring. At the same time, lower monitoring costs may be more than counterbalanced by higher costs of lobbying, public relations and the management of periodic re-organisations and related bureaucratic crises. They may also have resulted in lack of substantial support in the IFIs natural constituencies and possible allies such as NGOs and liberal groups of various kinds.

#### **4. Hard noses and bleeding hearts**

While similar to UN organisations as non-profit, co-operative enterprises among member states, IFIs have always eagerly emphasised their different nature of 'concrete' operators and market actors. This difference is reflected in their pragmatic approach to finance and development, as well as in their tough stance on the need to discipline borrowers. According to this view, the language as well as the operations of IFIs should be such as to ensure shareholders/creditors that their surveillance on the borrowers will make sure that the loans go to a good end. As a consequence, IFIs should be tough-looking and keep their distance from charities, NGOs and other 'do gooders'.

This has far-reaching consequences in shaping the behaviour of IFIs. On one hand, they do not do a good service to the UN organisations, which are seen as 'bleeding hearts' or the epitome of incompetence. On the other hand, a 'hard nose' posture may work well with weak governments who need help and legitimacy, but is an easily defused threat for governments under normal political and economic conditions. Imposing tough conditions on lending, ignoring the consequences of projects on income distribution, on the poor, on the environment and on other 'soft' components of society, has been widely practised by IFIs, but by their own account, this has proven to be highly counterproductive. Of course, 'talking tough' may be more effective and justified when it reflects the more recent "Washington Consensus", however, on the predominance of the markets tempered

by social sensitivity. Even in the best circumstances, however, it may risk to overstate its own case and lose the audience by an excess of confidence.

Yet one can find some merit in the presence of financial agents that act as advocates for the market, while at the same time take an interest in developing projects that the market would probably not consider for financing. 'Hard nosing' in this case can be seen as a strategy to gain reputation in the eyes of the other market players. Thus, IFIs can afford to finance riskier loans which venture into 'soft' areas such as institution-building, poverty alleviation and environmental protection, and at the same time, keep their high credit-rating and their market reputation. Because the combination of tough stance and soft operations corresponds to a basic ambiguity in their mission of suppliers of public goods, they can afford to appeal to the right and the left of the political spectrum. They may indeed make politically and economically palatable for the 'hard noses' the policies that the 'bleeding hearts' would fail to deliver for lack of resources and political support. The down-side of these considerations, of course, is that, as they strive to achieve market credibility, 'hard nosing' can fall in the trap of pursuing hard policies that hit the poor and worsen income distribution. At the same time, it may fail to do anything of substance for the more vulnerable segments of society (Sinha, 1995).

## 5. Targets and instruments

IFIs pursue a variety of objectives ranging from development (e.g., the World Bank) to promoting integration, social cohesion and balanced development in Europe (e.g., the EIB). The interpretation of these objectives changes with time, as does the specific formulation of the targets that are indicated as having priority. Interest groups of various kinds interfere with target setting and often make the implementation of the institutions' objectives complex and unpredictable. While virtually all project IFIs can be denoted as long-term lending institutions with stated purposes and clearly identifiable constituencies, their short-term targets and instruments are dictated by the interaction of many interest groups, bureaucracies and governments. Indeed, the stated targets are often unrealistic. A case in point is the group of IFIs that is concerned with development aid, a field blessed by a multitude of interests ranging from legislative committees to commodity groups, industrial groups, and the various elements of the voluntary and intellectual community. The set of targets that results is often internally incoherent, and incompatible with the limited instruments available (Ruttan, 1996).

Yet, IFIs have proven to be quite effective, even though perhaps too much in "à la guerre comme à la guerre" fashion, to deal with the problem of finding a workable compromise between a conflicting set of goals and the set of feasible instruments. This is in part the consequence of the pragmatic approach that most of them have found inevitable to follow, and in part of the technical capabilities of staff and management. The lags involved in long-term projects, by making it difficult to recognise success and failure, have also made it easier for the pragmatists to constantly change course in response to the prevalence of this or that interest group. It is hard to say whether this flexibility is good or bad. It denotes a particular type of time inconsistency but, at the same time, a certain capacity to deal with the inherent imperfection of state contingent implicit contracts with multiple constituencies. In their role as policy advisers, for example, IFIs have maintained an overall balance between economic and political targets, thus favouring more democratic as well as more pragmatic approaches to government by consensus (Haggard and Webb, 1993).

*While all IFIs have stated purposes and clearly identifiable constituencies, their short-term targets are dictated by the interaction of very many interest groups.*

***IFIs may be too simple to operate in global security markets. More complex forms of financial institutions are called for.***

In any event, the complexity of goals and instruments characterising the present status of IFIs does not appear by itself a sufficient reason to call for a simplification in their scope, structure and mode of functioning. The concentration on infrastructure or agriculture that was typical of the early stages of development finance, for example, can hardly be reproduced today. In fact, second generation development finance appears such a rich and intriguing phenomenon that IFIs may be too simple to cope with it through the limited array of debt instruments that can be mustered. More complex forms of financial institution are called for to operate in global security markets and to use to a fuller extent the capabilities of the new information technology (Geisst, 1988).

The re-organisation that is taking place in the banking sector, for example, shows that banking is becoming more diversified both at the industry and at the firm level, and it is augmenting both the scale of its operations and the variety of its products. Effectiveness in pooling resources from a multitude of savers is increasing and so is the capacity to finance projects on the basis of their merits rather than their guarantees. In this rapidly changing scenario, IFIs may seem ill at ease, because of their ambiguous nature as non-profit making financial institutions. Yet they have proven able to innovate, even within the narrow limits of their mandate as inter-governmental organisations (Diwan and Kletzer, 1992). In the case of project financing, for example, IFIs have been leaders in experimenting with a variety of forms and structures, and are being recognised as authoritative and competent in the field of financial engineering. A similar position has been gained in currency packaging to reduce foreign exchange risks to borrowers and lenders, and in the capacity to manage with success, a diversified portfolio of securities.

The many accomplishments in innovating, however, are not enough to show that IFIs are effectively able to cope with the increasing complexity of world financial markets. Risk management and securitisation, for example, appear to be two areas where such conservative institutions, predominantly staffed with bureaucrats, economists and engineers, can hardly be expected to perform. The loan process, which has been traditionally the field of emphasis of IFIs, tends to crowd out the potentially creative activities of liability management. It also has the consequence of focusing the attention of the stakeholders on the more political side of the activities of the organisations. This only generates the lopsided need for the IFIs to keep 'moving the money' to satisfy the political constituencies and the need to deliver in the eyes of the shareholders, the commodity and industrial lobbies and the competitors in the development field.

A major negative allegation in this respect has come from the so-called North-South debate (Vos, 1996). IFIs have been accused to be instrumental in a 'loan-bunching' problem. This is a cyclical model where developing countries are alternatively treated with massive credit pushing and credit rationing. According to this model, IFIs would lead periods of credit pushing. Under the pressure of the oligopolistic financial markets where they operate, these institutions would easily find their 'money moving' urge leads to incentives to open the road to private international financing of an excessive amount of loans. In turn, this would cause an unsustainable build-up of foreign debt in Southern countries with an ensuing financial crisis followed by a period of credit tightening (Suter, 1992) and a reverse flow of resources between the South and the North. No special leadership would be provided by IFIs in this more difficult phase of the cycle. Some empirical support of this view can be found in the endorsement of the World Bank for large scale borrowing as late as 1981, and its subsequent lagging role in the debt-reduction process (Armendariz de Aghion and Ferreira, 1993).



*The long lags in recognising successes and failures have made a mockery of the claim of encouraging innovative behaviour and rewarding independent thought.*

## 6. The people and the work

Compared to all other financial institutions operating in the international markets, IFIs stand out for the quality and diversity of their staff. Highly educated, relatively youthful, culturally and ethnically diverse, the IFIs' personnel appear to strike standards unequalled by most comparable institutions, including the UN and the central banks. Against this background of capability and potential excellence, however, the IFIs' staff has shown a rather mixed performance. Many studies and staff reviews have recognised that the quality and the rich background of those attracted to IFIs has been under-utilised or misused. Management practices designed to pursue abstract goals rather than responsibility have stifled creativity and encouraged careerism and opportunism rather than personal and professional growth. Creativity has also been low, while the long lags in recognising successes and failures have made a mockery of the claim of the institutions to encourage innovative behaviour and reward independent thought.

The non-profit nature of IFIs and the ensuing ambiguity on goals leads to confusion among explicit and implicit objectives. The political context is played down as a framework for generating explicit goals, but, at the same time, it looms large in the unspoken explanation of the underlying motives to almost everything that goes on from loans to staff careers. In turn, this engenders cynicism, passivity and self-doubt. The resulting working environment is one where there is a tremendous fear of those innovative actions that may result into leaks, errors, or simply political fallout of one type or another. In this context, cautious behaviour is at a premium. Many people are pushed to focus on their career rather than on their work in spite of the widespread practice of politically appointing top-level managers and executives and ladder-climbing by affiliation. In sum, the IFIs' work environment is a case study of ambiguities and stress, where professional excellence often goes hand in hand with alienation, and idealism with lack of purpose.

## 7. Conclusions

In many ways the IFIs of today are very different creatures from the institutions created or envisaged at Bretton Woods. From a model of restrictive intervention, active monitoring and government financing, IFIs have evolved towards a diversified set of organisations by and large market-friendly, private-oriented, liberal and independent. The economic model of the IMF has been vindicated by events (Polak, 1997), and has been embraced by virtually all other IFIs. However, in spite of their influence and the success of this model of economic policy, IFIs are not much liked by the general public, by their development constituencies, or even by their staff. Governance rules are opaque and objectionable. Political and ideological standing appears to be ambiguous and often opportunistic. Given their nature, which at best can be characterised as an unanticipated good effect of a bad idea, what should be their future?

First, one should recognise that IFIs have given good proof as instruments of co-ordination in imperfect capital markets. There is really no reason why these functions should not continue to be performed in the future by IFIs, displaying the prudence and the competence that they have shown in the past.

Second, some evidence suggests that IFIs may have used their position to administer questionable principles and to dispense equally questionable advice. The extent to which these practices may

have caused a real damage to the countries is unclear. However, this highlights the question of responsibility and governance. To whom should these institutions be accountable? And what should be the criteria to judge success and failures, establish responsibilities, and discriminate between legitimate beliefs and manipulative ideologies? Here, a better, more skilful and clearer institutional design is in order. The new design should give greater consideration to the need to align ownership and control, and to balance the rights of all stake-holders (managers, staff, lenders and borrowers) in making decisions about the broad strategies of the institutions. This applies equally to the choice of operations, information and external relations.

***Second generation IFIs should monitor borrower performance across a broad variety of projects rather than lending for projects that they have chosen and designed themselves.***

Third, whether IFIs have been successful in project lending appears doubtful. Reviews of projects financed by IFIs have not revealed marked differences from other projects financed by governments or private banks. Also, many studies of IFIs' operations have shown that decisions to lend were often loaded in favour of ruling elites and bureaucratic counterparts. Decisions also tended to be taken under the pressure of short-term motivations rather than dictated by long-term needs or by sound allocative criteria. Second generation IFIs should thus direct their resources to monitor borrower performance across a broad variety of projects essentially chosen by governments and/or private parties. They should not engage primarily in lending for projects that they have chosen and designed, or try to impose lending plans to member countries.

Finally, in spite of their professional quality and the excitement and prestige of their jobs, IFIs' staff have often been operating under difficult and unyielding conditions. They have felt alienated by a too sterile and hierarchical organisation, by their lack of real responsibilities and, often, by the antagonism of non-governmental organisations and other interest groups. A new wave of international financial institutions can only be successful if they are able to offer to a sufficiently large number of dedicated people the unique professional opportunity to work effectively for development and the improvement of the international community.

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# Making the most of markets: The role of IFIs

Nicholas H. Stern and Hans Peter Lankes

## 1. Introduction

Since the World Bank and the International Monetary Fund were launched at Bretton Woods more than 50 years ago, and the regional development banks in subsequent decades, the world economy has changed in important respects. In considering the role of international financial institutions (IFIs), two changes are of particular significance. First, 'globalisation' implies that foreign trade and private capital now play a far greater role in economic development than before. Partly as a result, world real interest rates have increased markedly. Second, the poor performance of statist models of development has led to a re-examination of the role of the state and motivated a strong shift towards private, market-based approaches. As a result of these changes, the private sector and private, international finance have become prime agents of economic development.

In this article, we discuss how IFIs can pursue their mandates by creating the conditions for the right kind of market-oriented growth and by forming partnerships with the private sector. We argue that partnership with the private sector calls for significant adjustments in the modus operandi of IFIs, as well as for clear principles of engagement. IFIs must complement and catalyse private finance, they must not displace it. A clearly defined approach to supporting private sector development will carry IFIs well into the 21st century.

## 2. A world of private capital flows

World financial markets have witnessed profound changes over the last few decades. This has included the strong growth of private capital flows to developing countries. Net long-term private flows rose from USD 38 billion in 1980 (46 percent of total flows) to an estimated USD 256 billion in 1997 (85 percent of total flows) (1). The share of net official flows has correspondingly declined.

It is important to recognise that total private capital flows remain focused on a small number of developing countries. For example, foreign direct investment (FDI) flows to the top 10 recipient developing countries constituted 74 percent of the total in 1997, although these countries account for only about half of the total population of the developing countries (2). On the other hand, Africa in particular stands out as one region that relies almost entirely on official flows for external finance. Many countries in the Commonwealth of Independent States are in a similar position.

The composition of these private flows has seen a marked change over the last two decades. While earlier flows were composed largely of commercial bank debt flowing to the public sector, recent years have witnessed a sharp increase in the level of private sector portfolio flows and direct investment, both of which had contributed little during the 1980s. For example, in 1980, debt flows con-

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*Vanessa Glasmacher provided valuable research and editorial assistance in the preparation of this paper.*

1) See World Bank (1998). For simplicity, we adopt that publication's definition of developing countries here, which encompasses the transition economies of Eastern Europe and the former Soviet Union.

2) These countries are China, Brazil, Mexico, Indonesia, Poland, Malaysia, Argentina, Chile, India and Venezuela.

stituted 89 percent of private capital flows, whereas FDI constituted 11 percent and portfolio equity was almost non-existent. In 1997, the largest share of net private flows into developing and transition economies was in the form of FDI (47 percent of total private flows), followed by bonds (21 percent), commercial bank lending (16 percent) and portfolio equity (13 percent). The characteristics of these different types of financing vary on a number of important dimensions, including maturity, risk-sharing, managerial involvement, technology as well as volatility.

***In a distinct sequence, official funding, FDI, non-guaranteed debt, dedicated equity funds, and, finally, direct local stocks and money-market investments have entered the market successively.***

The flow of private capital to the transition economies of Eastern Europe and the former Soviet Union has reflected the same broad trends. In a distinct sequence, official funding, FDI, non-guaranteed debt, dedicated equity funds and, finally, direct local stock and money market investments entered the market successively at one to two year intervals (Lankes and Stern, 1997). At the start of transition, official capital flows increased sharply, while private flows were negligible. Net official flows to transition economies peaked in 1991 at USD 21 billion. After 1993, they declined both as a share of the total and in absolute terms. Private flows began to exceed net official flows in 1993, and by 1997 they accounted for USD 45 billion in the seven largest recipient countries (3). This represented 18 percent of aggregate net private flows into developing countries, slightly more than their share in developing country GDP (a little under one-sixth) and almost twice their population share (about one-tenth) (4). In addition to these flows of equity, bond and bank debt, several countries also recorded large inflows of short-term funds into the local money markets in recent years, mostly into treasury bills.

The level and quality of private capital flows depends crucially on perceptions of risks and returns. These, in turn, depend not only on basic endowments and opportunities, but also on the ability to respond to opportunities in an effective, market-oriented fashion, or, more generally, the 'investment climate' in recipient countries. The investment climate includes macroeconomic stability, structural reforms and the institutional infrastructure which underpins the market economy (financial institutions, reliable business practices, legal and regulatory framework, tax system, etc.). It also includes political stability and consistent, transparent, responsible and 'market friendly' behaviour from the authorities. Equally important is the development of human capital and of physical infrastructure, both of which are vital ingredients for the success of enterprise investments.

One reflection of the importance of the investment climate is that the level, location and motive of FDI into the transition economies are all strongly associated with progress in transition. For instance, leaving out the three oil and gas economies of Central Asia (Azerbaijan, Kazakhstan and Turkmenistan), the rank correlation coefficient for 22 countries between the European Bank for Reconstruction and Development's (EBRD) average indicator of transition in 1997 and cumulative FDI per capita over the period from 1989 to 1997 is 0.89 (5). This provides strong support for the conclusion that it is the reform process which opens opportunities for profitable investment and

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3) These countries are Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and the Slovak Republic. Data is provided by the Institute for International Finance.

4) See World Bank (1998).

5) See EBRD (1997) for the EBRD's indicators of transition. The measure referred to here is the average of scores, on a scale from 1 to 4, along eight dimensions of transition, including large and small enterprise privatisation, enterprise restructuring, price liberalisation, trade and foreign exchange regime, competition policy, banking reform and development of securities markets and non-bank financial institutions. For an empirical analysis of the relation between motives for FDI and progress in transition, see Lankes and Venables (1996) and EBRD (1996).



which, through its impact on risks and returns, motivates investors to take advantage of them. It also suggests that direct equity investors have carefully evaluated the economic environment and made informed choices (6).

### 3. The role of IFIs in the changing market place

In general terms the objectives of IFIs have always been poverty alleviation, economic growth and protection of the environment (7). Traditionally, IFIs have promoted these objectives by working with governments and government agencies. This reflects the ideas and the capital structures which prevailed at the time of their creation. Broadly speaking, IFIs have pursued these objectives with loans for public sector projects or programmes, technical assistance and policy-based lending. IFI loans have generally been made to, or guaranteed by, the borrowing states.

The EBRD is somewhat different. Its later foundation and the special circumstances of this foundation pointed to a rather specific objective, namely to foster the transition of its countries of operations to open-market economies. The founders took it that the transition would indeed raise living standards over time as well as expanding basic choices and rights of the population.

*In the new economic environment, the importance of IFIs and bilateral aid as sources of funds has decreased.*

In the new economic environment, the importance of IFIs and bilateral aid as sources of funds has decreased. While private flows are rising, official flows are constrained by tight budgets following two decades of fiscal laxity. As budgets get squeezed, official aid, both bilateral and multilateral, has been a vulnerable target. Furthermore, the collapse of centrally planned economies and the poor performance of heavily distorted economies in Africa, Latin America and the Middle East have led to a re-examination of the role of the state in economic development. As a result, there is a growing understanding among developing countries that to achieve market-oriented economic growth, they must create the conditions in which a strong private sector can flourish.

Since the importance of IFIs as a source of funds has decreased while the potential role of the private sector has increased, a central challenge for IFIs is to find ways of fostering development through expanding opportunities for the dynamism of the private sector. They should view the private sector as a prime vehicle for the achievement of development goals. In so doing they must seek to ensure that the poor participate and benefit from the growth process and that growth is environmentally sustainable. There are two complementary ways in which IFIs can pursue these objectives:

- i) they can help governments create the conditions for the right kind of market-oriented growth;
- ii) they can become participant investors, working with the private sector to expand and improve private capital flows.

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6) Causality also runs the opposite way, from FDI to progress in transition. FDI can have a variety of benefits for the transition process, in particular for successful restructuring and improvements in corporate governance, but also more broadly by educating officials, managers and workers in the recipient countries. At this stage in the transition process it seems reasonable to suppose that the dominant effect is from transition to FDI.

7) See de Larosière (1996) on the topics raised in this section. The Task Force on Multilateral Development Banks (MDBs) (1996), identified that the role of MDBs should involve reducing poverty, promoting effective government and a strong civil society, protecting the environment, investing in infrastructure and utilities and encouraging private sector development.

The first of these embodies some of the more traditional IFI roles. This involves promoting macro-economic stability and ensuring the provision of the necessary physical, institutional, legal and regulatory infrastructure. While these basics are crucial to investment and growth, participation in growth requires adequate provision for health and education, which in turn enhance growth itself. Poverty alleviation, however, calls for more than fostering participation. It also involves protecting those who are not in a position to provide for themselves by establishing a social safety net. In the past, the IMF, the World Bank and regional IFIs have played a major role in the establishment of macroeconomic stability, in the assistance with tax, legal and sectoral reform and in the creation of a social safety net through policy-based lending (8). These are all areas that continue to be important for market-oriented growth.

**Partnership with the private sector implies that IFIs must act and think like the private sector.**

The second approach represents territory that has been less well explored by IFIs, and they must ask how they can assist more directly in establishing the conditions for the expansion of the private sector. In doing so, they must recognise the increasing - and understandable - reluctance of governments to provide sovereign guarantees; a reluctance that stems from the pressures on public finances and the requirement for hard budget constraints if market-based incentives are to function effectively. While recognising that there will be important projects (particularly environmental and some infrastructure) for which sovereign guarantees will be necessary, IFIs should support this resolve and avoid sovereign guarantees wherever possible. This means that IFIs must find new ways of operating; ways that harness private sector finance for broader development goals. The way to do this is for IFIs to work in partnership with the private sector and to become participants in the investment process.

#### **4. IFIs as participants in the process of private sector development**

Partnership with the private sector implies that IFIs must, in important respects, act and think like the private sector and subject themselves to the shifting opportunities and constraints of the market. The challenge, which we discuss in the next section, is to combine such an approach with the active pursuit of IFIs public policy objectives. But it is clear that creativity and flexibility are of the essence in responding to market needs and IFIs will have to develop their expertise in a number of aspects of banking which have, so far, been less familiar to them.

There are also a host of other practical implications of partnerships between IFIs and the private sector that will need to be considered. It is likely, for instance, that procedures of most IFIs would have to adapt to the flexibility and confidentiality required of private sector operations. This does not always sit easily with public sector accountability. A move away from sovereign guaranteed lending will also call for a new risk culture and the know-how required for the analysis of commercial risk.

Despite the constraints under which IFIs inevitably operate, there are nevertheless good reasons why the private sector would often have an interest in teaming up with them. IFIs bring a number of strengths to such partnerships. First, they are endowed with a capital structure that helps them to absorb many of the risks associated with taking a lead in high-risk environments (9). Second is the

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8) It should be remembered that, while the IMF has always been directly concerned with macroeconomic stability, the World Bank transformed itself from an infrastructure bank to a development bank in the years of the Presidency of Robert McNamara (1969-1982), with structural adjustment loans appearing only at the end of that period.

9) This includes their preferred creditor status (which mitigates rescheduling or default risk), their conservative gearing ratio and their strong shareholder support in both industrialised and recipient countries.

relationship they have with governments in developing countries that enables them to reduce political risks for a project in a way which commercial banks cannot. This relationship also means that a government will often have more confidence in a project if an IFI - which has a duty to protect its members' interests - is acting with a private partner. A third strength which IFIs have, is their knowledge of, and experience in, these regions. Finally, this experience and their access to technical assistance mean they can mitigate the risks involved in project development. Without the project development support of IFIs, many projects would never get off the ground.

## 5. Operational principles guiding partnerships with the private sector

***IFIs must build on their strengths to expand the frontiers of private sector development.***

Recognising their resource limitations IFIs must be selective in their approach. They must build on their strengths to expand the frontiers of private sector development and not simply displace the private sector in activities it is well-prepared to undertake on its own. And they can be effective in this task only if they themselves set an example of sound and well-run institutions. Thus they require clear operational principles.

We see three principles which should govern the activities of IFIs in this area. At the EBRD we call them sound banking, additionality and transition impact. Any project we select must meet all three criteria. They ensure that our activities make a broad contribution to the transition process. Closely related to the transition criteria is the promotion of sound environmental practices, a principle strongly grounded in the EBRD's mandate. Of course, flexibility - both in terms of attitudes and instruments - is also crucial. This means that the activities of IFIs change as countries develop and finance becomes more widely available to different segments of the market. This process of constant change should be key to IFI participation in the investment process. They must, in a sense, lead the way and open opportunities for private investment flows to follow and not prolong their involvement once sufficient private capital is available. We have seen this very clearly at the EBRD where we graduate our activities from one market segment to another as alternative sources of finance develop in some areas, and new, as yet unexplored opportunities, become practical possibilities.

*First, sound banking.* The financial return to the IFI should be commensurate with the risk. Sound market-oriented development cannot be promoted by investments which are commercially unsound. By ensuring their projects are financially sound and viable, IFIs set an example and establish important standards in accounting, disclosure and corporate governance. The rigorous application of this principle also ensures the financial health of the institution itself. This is crucial for credibility. IFIs must show their shareholders that they are running a tight ship and using resources effectively if the continued support of shareholders is to be justified.

*A second key principle of IFI involvement is additionality.* The privileges enjoyed by IFIs - including, above all, their capital base - would often allow them to displace private funding or provide an unfair competitive advantage to their private partners. This cannot be the objective of IFI support. Instead they should stimulate the private sector into operating in areas or in manners in which it would not otherwise be ready to operate. IFI additionality can arise in two ways: the IFI contributes financing which is not available on reasonable terms elsewhere; and its involvement exerts a profound influence on the generation, design and implementation of a project. Good project design will help achieve both sound banking principles and development or transition impact. Additionality

should be assessed on a project by project basis. Also, IFIs must have clear policies on how additivity is to be assessed.

At the EBRD we have established a two-part 'additionality test' which is carefully applied in our project selection process.

- i) EBRD *pricing* is pressed upwards relative to the 'market'. Relevant evidence on the market includes interaction with the client, knowledge of funding requests from commercial banks and reactions from competing funding sources.
- ii) *Other terms* are pressed that influence a project's design or functioning in ways that are crucial for wider transition or development impact. Depending on circumstances, the EBRD adopts a strong stance regarding issues which include governance, procurement, the environment and the regulatory framework.

Clear negotiating positions along these lines help ensure that IFIs do not compete with the private sector, but complement and catalyse it.

*Last and most importantly, IFI projects should have a wider development or transition impact.* This is in fact more than an operating principle, it is the basic purpose of IFIs. If the investment projects supported by IFIs are to facilitate private sector development, they should be appraised in relation to their influence both on the investment climate - discussed above - and on the ability of enterprises and financial institutions to respond to it (10). Each IFI has to develop methods which focus on its own mandate. For the EBRD, this is the promotion of the transition process, but analogous methods can be developed for other objectives.

The public and private sector projects supported by IFIs can have a number of qualitative characteristics that serve to advance private sector development, or in the language of the EBRD, that have a transition impact. The key foundations of a market economy are the markets themselves, institutions and policies that support and promote markets and market-based conduct, skills and innovation. Project selection and design should embody an assessment of project impact along these qualitative dimensions, in addition to traditional economic rate of return criteria and an analysis of environmental impacts.

While in principle these impacts of projects could be appraised with the help of sufficiently sophisticated cost-benefit analysis (CBA), in practice conventional CBA is ill-suited to capture the diffuse benefits of structural and institutional change and learning. However, the impacts embodied in these qualitative characteristics are intertwined with those captured in the analysis of economic rates of return and environmental benefits and the three analyses should be taken together in assessing projects (and in practice, it is fairly straightforward to avoid double-counting) (11).

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10) *The dividing line between the 'climate' in which private agents act and the ability to respond is not always clear-cut (i.e., some issues could be placed on either side of the divide), but it is nevertheless a helpful distinction for some purposes. The analysis of transition impact which follows focuses primarily on the ability to respond, but also covers some aspects of the investment climate.*

11) *The importance of IFIs operating at the frontiers of private activity is developed further in de Larosière (1996).*

The possible contributions to competitive market structures, the institutions and policies that support markets, and to skill transfer and innovation are discussed in more detail below.

*The projects supported by IFIs can have a number of qualitative characteristics that serve to advance private sector development.*

### **Contributions to competitive market structures**

- A project or series of projects can promote greater competition in its sector of activity by creating a market or by altering the structure of an existing market. Increased competitive pressure is likely to improve the efficiency with which resources are used, demands are satisfied and innovations are stimulated.
- A project can also help to increase competition in other markets. There are two important ways in which markets can be extended and their functioning improved by projects: through interactions of the project entity with suppliers and clients and through project contributions to the integration of economic activities into the national or international economy, in particular by lowering the cost of transactions.
- To be effective, the contributions to the structure and extent of markets must be sustained. This can be achieved through projects which have a strong demonstration effect and, if necessary, through IFI support for more than one project in a particular sector of a country.

### **Contributions to institutions and policies that support markets**

- A project may result in increased private ownership through privatisation or new private provision of goods and services (including financial services). This can generally be expected to strengthen market-oriented behaviour, innovation and entrepreneurship. Private ownership is also complementary to, and often a condition for, competitive markets.
- The process of investing in a project can contribute to the reform of policies, governmental institutions and practices that serve to enhance the investment climate through a project-related policy dialogue and the ability of IFIs to mitigate certain types of political risks. Examples include improvements in the functioning of regulatory institutions and practices and contributions to laws and practices that protect or strengthen private ownership and the open economy. This is particularly relevant where not only the project entity benefits, but also other economic activities.

### **Contributions to market-based conduct, skills and innovation**

- A project can contribute directly to providing and improving commercial skills and technological know-how. Commercial skills can include accounting, banking and finance, management, marketing and procurement. Skill transfers are often complementary to other project impacts such as institution building and expanding market competition.
- The transfer of skills and technology can have a particularly strong impact on development or transition by showing other enterprises what is both feasible and profitable and thereby inviting replication. Examples of demonstration effects relevant to development or transition are: (i) products and processes which are new to an economy, (ii) ways of successfully restructuring companies and institutions, and (iii) new methods and instruments to finance activities.

*A challenge for IFIs is to strengthen the feedback from private sector experience to government policies, institutions and behaviour.*

- By strengthening corporate governance, a project can foster more effective private ownership of enterprises, and thereby enhance the legitimacy and functioning of the market economy and of private property. Demonstrating effective approaches to corporate governance can be particularly important in transition economies, where there is little recent experience with private ownership. Measures to strengthen private domestic financial institutions can be complementary to more effective corporate governance.

While the selection and design of projects with one or more of the above characteristics should be a fundamental principle guiding IFI support of investment projects, the potential impact does not end at this point. Rather, the experience of investing and operating investment projects can and should inform the policy dialogue with governments. A challenge for IFIs is to strengthen the mechanisms through which this feedback from private sector experience to government policies, institutions and behaviour takes place.

## **6. Partnership profiles and sectoral considerations**

IFI collaboration with the private sector can take a wide variety of forms. There is no obvious limitation on the financial structure of interventions, which can range from straight equity to mezzanine instruments and debt, underwriting and guarantees. Intervention can also take the form of introducing financial instruments to capital markets, for instance through IFI treasury departments. We cannot discuss these different forms of intervention in detail here, but it is useful to consider particular sectoral challenges and possible IFI responses.

Development or transition impact can be achieved in most sectors of economic activity. In each case, the strength and value of impacts is determined by context. It is obvious, for instance, that a demonstration effect is particularly valuable where the technique, behaviour or product to be demonstrated is relatively new to the 'audience' and there is scope for replication. In many cases, it is immaterial whether the vehicle for IFI impact is a candy factory or the national power grid. In fact, the EBRD's experience has shown that co-operation with foreign and local investors in the general industrial and services sectors can have far-reaching benefits in terms of the functioning of markets, market-oriented behaviours and institutions. Nevertheless, because of the strategic role played in any economy by the financial system and infrastructure, these sectors can offer particularly interesting challenges for IFI involvement.

### **6.1 Partnerships in the financial sector**

IFIs can help build financial institutions by putting in place the funding needed to implement projects or strengthen their capital base by investing in them. This is a vital task in the transition but also in a broader development perspective. A market economy requires a well-functioning financial sector. It fulfils the crucial task of financial intermediation, i.e., collecting savings and allocating them to fruitful investment. But it also takes steps to ensure that borrowers recognise the obligation to pay and will be in a position to repay, thus imposing hard budget constraints in the economy at large. Strengthening local financial institutions is therefore a priority in any developing country.

At the EBRD the collaboration with banks, which has taken the form of co-financing, credit lines, equity and mezzanine finance or syndications, has proved extremely fruitful. We are working

directly with 184 local banks in our countries of operations (43 of them on an equity basis), and we have worked with more than 100 international banks through our syndications programme in the past seven years. While we bring capital to all these investments, our involvement provides different benefits for different partners. To international banks we provide an umbrella of political comfort derived from our long-term relationships with governments and our preferred creditor status. To local banks we provide much needed medium-term capital and we can assist in their institutional development.

An area that is receiving increasing attention is the reform of social security systems, and in particular the involvement of the private sector in providing for old-age income security. Pension reforms that introduce privately managed individual retirement accounts will have a broad impact on how economies operate. Successful reform depends on the existence of a solid private pension fund management sector, on capital markets that fulfil some basic conditions (regarding liquidity, depth and diversity of instruments), and on reliable regulation. In working with the private sector (in addition to providing advice at the policy level), IFIs can support such reforms by strengthening the institutional basis for their implementation and thus increasing public confidence in them. Both the EBRD and the International Finance Corporation (IFC) have invested in pension fund management companies to ensure that funds are professionally managed, prudent investment guidelines are followed, a level playing field is maintained, acceptable service levels are offered and accounts are transparent. A similar role can be played by IFIs in other non-bank financial institutions, such as insurance and mutual funds.

A further area where IFIs can play an important role is in promoting the availability of equity and especially venture capital. Equity is widely sought after in developing economies, particularly by small and medium-sized enterprises. IFIs are well placed to participate in funds and help attract institutional investors, such as pension funds and mutual funds, into these countries. In this way they can also help to strengthen nascent capital markets. By being early in the game and showing good management and professionalism, they can provide a strong demonstration effect (12).

## **6.2 Partnerships in the infrastructure sector**

The financing of infrastructure has been a traditional focus of IFI activity. An efficient infrastructure is of crucial importance to private sector development. However, the financing needs here are particularly large. Given that most countries are today facing severe budgetary constraints, this funding has become difficult to raise from traditional methods. Infrastructure is becoming more commercially oriented, an approach that can lead not only to the strengthening of operations and improvements in efficiency, but also opens up access to private finance. Private funding with no recourse to the sovereign introduces important market disciplines which control costs, provide revenues and allocate risks. At the same time, private involvement calls for a strong and reliable regulatory framework, which remains a key challenge in many developing countries. While the potential for private involvement varies across sectors (being greater, for example, in telecommunications

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*12) Capital markets development can also be supported by a variety of other means. At the EBRD, for example, we are working to improve the legal basis for share ownership; by participating we help launch share privatisations; we are improving accounting and registry procedures, and we are ourselves issuing benchmark bonds in the local currencies of some of our countries.*

and power than in roads), there is significant scope for expansion in all sectors. Despite a rapid increase in recent years, private funding for infrastructure still represents only around 10 percent of the total in developing countries.

When looking at private sector involvement in infrastructure, the starting point in most countries and sectors is a public monopoly which is either national or local in scope. Keeping this in mind, one can distinguish three levels at which infrastructure can become commercially oriented. At the very basic level, authorities can begin to operate the public sector in a manner which reflects more closely the ways the private sector operates. This means paying close attention to revenues, costs and market demands. It also involves creating a governance structure which provides clear goals, makes management responsible for performance and allows them independence to carry out their tasks. This may involve bringing in a private sector partner on an advisory basis. Alternatively, governments can seek the limited entry of new private providers through various forms of public/private partnerships. This approach involves more active private sector participation, usually as an operator. Potential areas include independent power plants, cellular telephone networks, toll roads, municipal services, ports and airports. The basis for this involvement is usually some type of concession. The third alternative is for governments to opt for full privatisation of some public services.

Both the IFC's and the EBRD's experiences show that IFIs are well placed to develop financing structures which encourage such private sector participation: structures which are simple, cost-efficient and can be easily replicated. Careful design and innovative use of the wide variety of IFI instruments are key to succeeding in this area. Risk allocation is also key. IFIs should not only share the general project risk with private partners (through equity or non-recourse debt), they should also assume those risks that they are well placed to mitigate. These tend to include general economic and political risks and risks arising from shifts in regulatory regimes.

*IFIs should not only share general project risk with private partners, but they should also assume those risks that they are well placed to mitigate.*

The difficulties involved in structuring and implementing such projects must not be underestimated. Not only do they require strong political backing from countries, they often require the enactment of specific legislation or the introduction of the necessary regulatory environment to support them. Furthermore, these are often complex projects to develop, and certain costs tend to be front-loaded. Nevertheless, it is precisely this complexity, in which political, regulatory and commercial elements are interwoven, which creates the scope for valuable contributions by IFIs.

## **7. Concluding remarks**

The new focus on market-oriented economic development is here to stay. So too are the private capital flows. The task of IFIs must be to facilitate these processes. IFIs have the potential to further expand the frontiers of private sector development. To do this they must continue to adapt. They must build on their strengths. In this article we have tried to explain how. IFIs must continue to work with governments, but they must also go beyond this and participate directly in the private investment process.

Private markets and private flows are powerful forces. The availability of a strong and dynamic partner in the development effort represents a great opportunity for IFIs, which can help harness these forces. In so doing, it is crucial that they subject projects to clear principles of selection and design.



***The new focus on market-oriented development is here to stay. So, too, are private capital flows. The task of the IFIs must be to facilitate these processes.***

It is also crucial that they work together. The tasks are immense and each IFI has its own strengths. They must exploit their comparative advantages to the benefit of the countries in which they work. While competition among IFIs can yield benefits (such as innovations in operations), it is important that this competition is constructive. Where competition does take place, it is important that all IFIs should work to achieve the same high standards in terms of project impacts on development or transition, additionality and conformity with sound banking principles. Competition by dropping standards not only results in departures from an IFI's mandate, but it also prevents other IFIs from fulfilling their role.

Ultimately, IFIs may not be needed. The fact that they are no longer necessary will be a clear sign of their success. That time has not yet come: IFIs still have important goals and the means to achieve them.

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# International financial institutions and the provision of international public goods

Joseph E. Stiglitz

## 1. Introduction

Changes in the role of collective action at the international level, in the international economic environment, and, most importantly, our better understanding of economics in general require that we rethink the role of international financial institutions (IFIs). For multilateral development banks like the World Bank, their central mission, the promotion of growth and the reduction of poverty, is clear. The steps toward fulfilling this mission in a changing world are also relatively clear, and many of these institutions have already begun processes of renewal. But all of the IFIs have, in one way or another, also been involved in crisis management, especially in recent years. Here, future roles are less clear because they depend on the redefinition of the international financial architecture - a redefinition that has been hotly debated, but has not yet crystallised into a shared vision. The theoretical underpinnings - as well as the practical implementation - of alternative visions will require far more development before clarity on a future role will be attained.

In this essay, I will address these questions from the perspective of the theory of international public goods, which is a powerful way to organise our thinking both on why we have IFIs in the first place, and the role that they should play in a changing world.

## 2. The theory of international public goods

The Bretton Woods institutions were created in response to the perception that the international economic order had somehow failed, and that this failure had not only contributed to the economic collapse of the Great Depression, but also to the World War that followed. Beggar-thy-neighbour policies of trade restrictions and competitive devaluations had exacerbated, if not contributed directly, to the propagation and generation of a worldwide downturn. Several institutions were created at the time, among them a new international trade regime (GATT) to reduce trade restrictions, and a new international monetary regime - fixed exchange rates supported by an International Monetary Fund - to reduce the scope for competitive exchange rate devaluations.

In addition, war-torn Europe required extensive reconstruction, on a scale that seemed beyond the ability of the private sector's funding ability. The longer-term challenge of development - billions of people living in economies whose per capita incomes were but a fraction of those in pre-war Europe and America - also seemed to be a crucial problem that could be ameliorated by an international development bank. In spite of the scarcity of capital, private capital simply did not seem to be flowing there, at least not at the pace that would be required to ameliorate poverty.

The task of constructing a new international economic order that would provide for economic stability, promote economic growth and facilitate the development of the poorest countries was an international problem that required *international* collective action. GATT and the Bretton Woods institutions helped facilitate this action.

**The Bretton Woods institutions were created in response to the perception that the international economic order had somehow failed.**

**International public goods such as peace, international economic stability, the global environment and knowledge extend well beyond national frontiers.**

At the time that these institutions were developed, there was no general theory of collective action and no well-developed theory of public goods (1). Subsequently, it became clear that the geographic boundary (2) over which collective action was required may differ among different goods and services. In some cases - referred to as local public goods (Stiglitz, 1997) - the boundaries may be far more limited than national boundaries; while in other cases - international public goods (3) - the boundaries may extend well beyond national frontiers, possibly encompassing the entire world. Peace, international economic stability and overall international economic management, the global environment and knowledge (especially basic knowledge) are among the more important international public goods. There are many interrelations among these various international public goods, a point to which I shall return later in this essay.

The development of the nation-state during the 19th and 20th century required that a variety of collective actions be undertaken at the international level. The importance of these co-operative measures - in interstate rather than international relations - can be seen in the development of the United States. Many believe that part of the US economy's strength came from the vast national market that was created as the country expanded and transportation and communication costs were reduced. But it is more important to note the ways in which this market was created: the federal government took actions which ensured that artificial barriers to trade among the states were not created, either explicitly through tariffs and quotas or else in less transparent ways, like different regulatory practices in different states. At the same time, it actively promoted those institutions that would facilitate the creation of a strong national economy. While it did not go so far as to create a national banking system (restrictions on interstate banking were dismantled over the last decade), as early as 1863 it set up the Office of the Controller of the Currency to supervise 'national' banks, which were viewed as an essential complement to a national economy. For more than a century after this landmark legislation, banking continued to be confined to the state level. Even today some people continue to be hostile toward national banking.

Recent decades have seen a parallel set of changes at the global level. Communication and transport costs have continued to plunge, and many of the barriers to trade, such as tariffs and quotas, have been falling markedly (although there is a danger that these gains will be offset by the rise of non-tariff barriers, including dumping and countervailing duties). There is the potential for a parallel set of gains as opportunities to take advantage of economies of scale and scope increase (4). And again, the creation of an *international* economic framework, fulfilling many of the functions currently undertaken at the level of the nation-state, is an essential factor in realising these potential gains.

We have made only limited progress in doing so. While the World Trade Organisation and its predecessor, the GATT, have been highly successful in reducing formal trade barriers (tariffs and quotas), progress in other arenas - such as regulatory barriers - has been far more difficult. There is no

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1) Samuelson's formalisation of the concept of pure public goods (1954, 1958) was to occur almost a decade later. But it would be wrong to suggest that there was no overall approach to collective economic action. Pigou's "The Economics of Welfare" (1920) provided a comprehensive rationale for government action, including the existence of externalities.

2) In some cases, the boundaries may be defined on bases other than geography.

3) See Stiglitz (1995) and Economic Report of the President (1997).

4) For some countries, such as the United States, the magnitude of these potential gains may be limited, given that economies of scale have been virtually fully exploited. For these countries, the gains from globalisation are then more of the classic comparative advantage - taking advantage of the relatively cheap labour elsewhere in the world.

international framework, including contracts, disclosure, fraud, bankruptcy and competition corresponding to the best functioning national economic frameworks. There are no international regulatory authorities corresponding to those with oversight of financial, securities and telecommunications matters within national boundaries.

One might argue that *international* action in these areas is not required; that, at least in the realm of economics, market forces will ensure that standards will emerge spontaneously where they are required. Along the same lines, one can assert that if governments give firms a choice of legal frameworks, then firms will choose the legal framework that is most efficient (in some sense); and that this competition among communities will ensure that most governmental entities will either provide such choice, or will provide itself the legal framework which is most conducive to enterprise.

There is some merit in this set of arguments. Differences in regulation do create competition: countries that have provided sound supervision of financial institutions have found that deposits gravitate there, as depositors value the supervisory services provided. The United States has claimed that the gains from standardisation of competition policy are sufficiently weak, as the likely standard would be weaker than that already employed in the United States.

Yet, as a general proposition, there is little theoretical and empirical basis for the conclusion that international action would be superfluous: Nash equilibria are not, in general, Pareto efficient. The theoretical literature on standard setting has shown convincingly that the market may converge on an inefficient standard, and the empirical literature is replete with examples (including the famous QWERTY typewriter example (5) and the VHS/Betamax video-recorder example). Similarly, the proposition that competition among communities results in Pareto efficiency (the Tiebout (1956) hypothesis) has been shown to hold only under highly restrictive conditions (Stiglitz, 1983).

Still, without an international government, the political obstacles to implementing an effective international economic framework in most areas are sufficiently great that such a framework will only evolve in a decentralised way. In the decentralised process, a common set of standards, or at least a framework which is similar enough to make the difficulties of moving to a uniform standard seem very low, may well evolve.

***The absence of an international framework has proved troublesome in recent years – particularly in the areas relating to financial markets and bankruptcy.***

But there are some areas where the absence of an international framework has proved troublesome in recent years - particularly in areas relating to financial markets and bankruptcy. In these and other areas, multiple frameworks may impose huge costs to international transactions, where there may be ambiguity about which laws will govern. Although the contract may itself specify the jurisdiction under which disputes are to be adjudicated, the legal framework may override such contract stipulations. In any case, economic arrangements often involve interrelated contracts that may specify alternative legal frameworks. (Ultimately, the laws of the country where the disputed assets reside will dominate, although countries may cede their rights to others.) Moreover, the multiplicity of interactions means that there are inevitably externalities, with the legal framework in one governing authority having implications for the consequences of others.

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5) See David (1985).

My purpose here, however, is not to set forth a detailed international economic framework, but to focus first broadly on the need for international collective action, and then more narrowly, on the role of IFIs in the international financial architecture. In this discussion I will work under the hypothesis that strong international institutions addressing many other aspects of international public goods, such as an international legal and regulatory framework, are unlikely to arise in the early part of the next century.

### 3. The role of multilateral development banks

#### 3.1 Capital markets

*The original limited rationale for development banks - filling a market gap - must be reconsidered.*

*Filling gaps.* The increase in capital flows to the less developed countries has had an important effect on the IFIs, including the World Bank. Long-term flows of private capital have increased six-fold to USD 256 billion between 1990 and 1997. Today, these private flows dominate official flows, which amounted to only in USD 44 billion in 1997. Clearly, the original limited rationale for development banks - filling a market 'gap' associated with the failure of capital to flow to developing countries - must be reconsidered. The broader rationale for multilateral development banks - facilitating, in any way possible, the process of economic development and poverty alleviation in less developed countries - has maintained its salience. Even as 'gaps' in the market close, the task of redistributing resources remains.

In the more circumscribed area of capital flows, these IFIs still have an important role, but one which may be significantly modified from that of a half-century ago. This is partly because the private capital flows are targeted - they go disproportionately to a few countries and into selected areas. Although in 1996 low-income countries, excluding China, represented 42 percent of the developing world's population, and 12 percent of its output, they received only six percent of the capital flows (World Bank, 1997). By contrast, twelve countries receive more than three-fourths of the total flows. The flows go disproportionately to certain sectors, with almost none of the money paying for health or education.

Moreover, the form of the flows is also circumscribed, though less so than in earlier years. Development banks were originally established because commercial banks failed to provide the long-term finance that industrial firms needed for their projects. Although matters today are far better than they were at the time of the first development banks 150 years ago, or even at the time of the establishment of the International Bank for Reconstruction and Development a little more than a half-century ago, the flow of long-term capital, especially long-term capital willing to engage in a significant amount of risk sharing, is still constrained.

In addition, these shorter-term private capital flows are highly volatile. An estimated USD 100 billion left East Asia last year - one-seventh of their gross domestic product. These outflows can occur for reasons beyond the control of a country: the East Asian crisis, for instance, may have slowed capital flows to Latin America as investors became more cautious about 'emerging markets' in general. IFIs can be a force for economic stability. They should stand ready to engage in countercyclical lending - which is when the country most needs money but is often least able to obtain it.



I have identified several distinct roles of multilateral development banks that are associated with filling 'gaps' in order to improve capital flows: assisting flows to those countries and those sectors and in those forms where the private sector seems reluctant to go, and counterbalancing the market's often irrational and highly destabilising gyrations.

*Improving the economic environment.* There is perhaps a more fundamental role: improving the economic environment in order to facilitate the flow of private capital, domestic investment, growth and development more broadly. There are many dimensions to an effective development strategy, including investments in human capital, stable macroeconomic policies and growth-enhancing microeconomic policies, which include trade liberalisation, sound legal frameworks providing for competition, bankruptcy, contract enforcement and corporate governance. IFIs can play a role not only in providing information about the consequences of alternative policies, but also in certifying that countries are engaged in meaningful policy reforms. Such policy frameworks have been shown to be an effective complement to capital flows (World Bank, forthcoming).

*Strengthening the democratic processes.* There is a concern that the IFI method of building the economic environment - namely conditionality - may not be an effective influence on political decision-making and may undermine democratic processes. There is little evidence that conditionality is effective, and especially that it can provide the basis of durable, sustainable reforms in circumstances where such reforms would not otherwise have been undertaken (6). Indeed, in many cases, conditions have been agreed to that not only do not represent a consensus, but were not even widely discussed by Parliament or the media. Worse still, there are cases where conditions have been imposed which have not been even publicly disclosed at the time of the agreement! I suspect that such practices will not be sustained as IFIs move into the next century, and their modes of operation will be more supportive of democratic processes, with dialogues based more on mutual respect than on neo-colonial attitudes and authority relationships.

Indeed, it has become increasingly recognised that an effective state - a transparent state, eschewing secrecy and corruption, but committed to democracy and development - increases the effectiveness of both private and public capital flows (7). Reflecting these findings, multilateral development banks are pursuing strategies to enhance the effectiveness of the state (rather than, as some have suggested was the case in the 1980s, creating a minimalist state). This broader strategy will, I think, constitute a cornerstone of the approach pursued by IFIs into the next century.

**IFIs will take an increasingly important role in providing complements to private capital as opposed to capital itself. How they do this will depend on the evolving nature of the capital market.**

IFIs will thus take an increasingly important role in providing complements to private capital (as opposed to capital itself). What they do and how they do it will depend on the evolving nature of the capital market itself. As new financial instruments are created, multilateral development banks will have to continue to respond to the new financial realities. At the same time, our enhanced understanding of the failings of the market will reveal new roles. The debt crises of the 1980s revealed some of these failures: the standard economic theory prediction that the wealthier, lending countries should have developed instruments that led them, not the borrowing countries, to absorb most of the risk associated with changes in real interest rates, did not occur. Developing countries were left with the unfortunate position of having to absorb the huge shock of higher real

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6) See Dollar and Svensson (forthcoming), Ranis (1995) and Mosely et al. (1995).

7) See the World Bank's 1998 World Development Report.

interest rates of the 1980s (though subsequent adjustments led to some risk absorption by the lenders). Today, IFIs provide a broader variety of financial lending instruments than they did a quarter century ago, and I expect this pattern to evolve further.

*Partnerships with the private sector.* That having been said, some proposals of new forms of partnership between IFIs and the private sector must be looked at with some scepticism. There is a role for guarantees for items like sovereign risk, and these are already widely provided. But many of the proposals extend to commercial risks where the potential for problems of adverse selection and moral hazard are substantially greater. Given the inventiveness that the private sector has shown in inventing instruments to pool, share and transfer risk, one must look askance at the extent to which IFIs might improve the risk-sharing potential - as opposed to what the private sector may really want, which is a hidden subsidy. Many of these proposals entail the multilateral development banks absorbing the risk and the private sector absorbing the profits: these institutions would provide guarantees to absorb the downside risks, and the private sector would receive all of the upside potential.

In the 21st century, however, I suspect that we will increasingly face the fuzzy boundaries between political and commercial risks that have already begun to absorb our attention - how, for instance, should we treat changes in regulatory regimes, or regulatory practices? In a developed country these are typically treated as another form of commercial risk, although changes in regulatory regimes can also be used as a way to confiscate wealth in a manner that differs little from more direct expropriations.

### **3.2 Beyond capital markets: The provision of knowledge**

In my discussion of the role of multilateral development banks in capital markets, I emphasised the increasing importance of the policy framework, and that one of the distinctive contributions of these institutions was to provide information, knowledge, about the consequences of alternative policies. This is an example of a broader role that IFIs have increasingly undertaken, namely providing knowledge, a role which is perfectly consistent with their mandate to provide international public goods. Indeed, so important is this role that the World Bank is increasingly referring to itself as the Knowledge Bank, and in its 1997 Strategic Compact, setting out new directions which would define its role at least early into the next century, these knowledge activities were front and central.

These changes were based in part on the recognition that what separated more developed countries from less developed countries was not only the gap in objects, in physical and human capital, but gaps in knowledge. The success of the East Asian economies was attributable as much to the closing of the knowledge gap as it was by the closing of the objects gap. By one reckoning, for instance, Korea's GDP would have been one-half of what it was in 1990 if it had only accumulated physical and human capital with no improvements in knowledge, organisation and entrepreneurship after 1955 (World Bank, forthcoming).

Recognising that knowledge, and especially knowledge about and relevant to development, is an international public good provides a special role for IFIs, which will attain increasing prominence in the coming century.

***Knowledge about development is an international public good and provides a special role for the IFIs.***

**Other international public goods, such as the special responsibility for looking at the global environment, take on increasing prominence within the mandates of IFIs.**

### **3.3 Links with other international public goods**

The provision of knowledge is just one of the international public goods that will figure in the mission of multilateral development banks in coming decades. Given the strong linkages which exist between all of the various international public goods outlined earlier, the core mission of these institutions in promoting growth and poverty alleviation among the less-developed countries, and the absence of strong international institutions addressing these other international public goods, it is natural that these other international public goods take on increasing prominence within the mandates of IFIs.

The World Bank already plays an increasing role in the environment. We recognise that promoting growth is not just a matter of increasing GDP, but improving living standards more broadly, and the quality of the environment is an important ingredient of these broader gauges of living standards. As multilateral institutions, we have a special responsibility for looking at the *global environment*, at issues such as global warming, biodiversity, desertification, water management and hydrofluorocarbons, and the ways in which these global environmental goods are affected by and affect the developing world. The interactions are multi-dimensional and complex. Poverty and lack of access to alternative energy sources may induce poor peasants in Nepal to deplete their natural forests, contributing further to their future impoverishment and environmental degradation. A switch to hydroelectric power would substitute 'clean' energy for energy which leads to carbon emissions, and, by reducing deforestation, to more carbon sequestration. It might greatly enhance living standards (among other benefits, reducing the time spent gathering wood), open up new economic opportunities, and prevent further deforestation. At the same time, however, a transfer to hydroelectric power generation may lead to the destruction of some valleys and the dislocation of some workers. This is but one example of the complicated interlinkages between the environment and development, which will be an increasing focus of concern for the multilateral development banks in the coming century.

The great lessons of the latter half of the 20th century is that *development is possible* but that *development is not inevitable*. Good policies, accompanied by transfers of knowledge and resources, and the development of durable institutions that enhance the likelihood that good policies will be adopted and that the resources and knowledge can be effectively absorbed, are essential ingredients in successful development strategies. These will be the central commitment of the multilateral development banks in the coming century.

### **4. The structure of international financial markets**

There is an emerging consensus - within academia, within government, and within the broader citizenry - on the set of issues just described, that are at the core of the redefinition of the role of IFIs. What was at best a one-time consensus on the role of international institutions in the area of international financial markets is, to say the least, fraying. It is not that there are not well-recognised problems - if anything, the dissatisfaction with the way the current system is working and may work in the future is increasing - but there are no agreed upon remedies. In part, this is due to a lack of intellectual coherence or a set of theories, supported by empirical evidence that can clearly define the role for IFIs in enhancing the effectiveness of international financial markets.

**The intellectual coherence needed to define the role of IFIs in enhancing the effectiveness of international financial markets is lacking.**

There have been marked changes in international financial markets, which have brought with them innumerable benefits. The huge increase in cross-border flows of capital, including flows of capital to developing countries, is but one example. Since typically capital flows to areas where (at least private) returns are highest, such flows increase world output. The improvements in financial markets, including international financial markets, have facilitated the transfer of huge amounts of risk as well as the diversification of risk; and this in turn should facilitate the ability of enterprises to engage in high risk - but high return - activities.

But these huge benefits have come with a cost. There is evidence that financial crises have become more frequent, with larger costs, both in terms of the government's expense in restructuring the financial sector (to meet the obligations under deposit insurance, or to bail out failing banks), and in the more general effect of slower economic growth that follows such crises (Caprio and Klingebiel, 1996, and Caprio, 1997). The challenge of the coming century for IFIs is to see if they can define roles which enhance the growth and efficiency enhancing aspects of international financial markets, while reducing the costly destabilising properties. Doing so may require marked changes in the ideology and practices of IFIs over the past half-century.

#### **4.1 The role of government in financial markets**

A basic tenet of market economies is that free trade in goods is desirable. It brings with it enormous gains in productive potential. Though there are a few isolated instances, associated with imperfect risk markets (8) or imperfections in competition (where strategic considerations may dominate) (9), in which it is not in the interest of a country to pursue trade liberalisation on its own, these are the exception, not the rule. In that sense, one might argue that for small developing countries, there is little need for international institutions: each one on its own would be, in its own self interest, led to complete trade liberalisation.

But such an interpretation is oversimplified on at least two counts. First, it ignores the internal political dynamics within a country: policies do not necessarily maximise the welfare of the country as a whole, but of the ruling political elites. International agreements may help reign in these elites, and ensure that policies that advance the interests of the economy more broadly are pursued.

Second, it ignores the possibility of collusion, tacit or explicit. The developed countries may devise rules of trade which enhance them, at the disadvantage of the developing countries. They may piously talk about economic liberalisation in those areas in which they have a comparative advantage - manufacturing - but steadfastly resist liberalisation in those areas in which the developing countries have a comparative advantage - agriculture. They may knowingly refer to their own political realities - the difficulties they face in eliminating the distortions in agriculture, but have little tolerance for the symmetric political problems in developing countries. Their political and economic muscle is the rationale for the seeming asymmetry.

But on the economic rationale for trade liberalisation, the arguments - the theoretical analyses buttressed by empirical studies - are compelling. Thus, while there may be disputes about the pacing

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8) See Newbery and Stiglitz (1984).

9) See Krugman (1979).

and sequencing of reforms, or the necessity and nature of the safety net required to protect those who are hurt by liberalisation, there is a common acceptance of the goals.

Matters are far more complicated in the area of financial markets. To see this most forcefully, let me spend a moment on the principles applying to the financial markets within a single country. There is, again, a consensus that government should not only not be running, say, a steel company, but its interventions should be highly limited, e.g., to ensuring that the company faces the true social costs of its actions, including its contribution to environmental degradation. Not so with financial markets. Here, by contrast, there is a consensus that there is, for instance, a large role for government in ensuring the safety and soundness of the financial institutions, in maintaining competition, in protecting consumers, and in ensuring that underserved groups have some access to capital. It is not the place here to review the literature in support of this broad-based role of government (Stiglitz, 1994). Suffice it to say that financial markets are concerned with gathering and using information; that markets in which information is imperfect and in which information acquisition plays an important role typically exhibit significant deviations from perfect competition; and that even if they were structured in ways in which all markets were perfectly competitive, the outcomes would not, in general, be Pareto efficient (Greenwald and Stiglitz, 1986).

There may, in addition, be complicated trade-offs: enhanced competition may erode franchise value (the present discounted value of future profits), reducing a financial institution's incentives to engage in prudent behaviour; and the losses from such behaviour (or the increased costs of monitoring to increase the likelihood that safe and sound practices are followed) may more than offset the gains from a slight increase in competition (Caprio and Summers, 1996, and Hellman *et al.*, 1997). Moreover, because of the intimate relationships between financial and real markets, a failure in financial markets may have enormous real consequences, contributing, for instance, to a marked downturn in aggregate output. These systemic risks not only mean that there may be a disparity between social and private costs and benefits, but they lead to government actions, such as bail-outs, which, while they reduce the short-run impacts, exacerbate the discrepancies between social and private risk.

Although the circumstances in which unfettered free markets in goods are welfare enhancing are relatively broad, the circumstances in which unfettered free markets in financial institutions lead to efficient solutions are highly restrictive. Thus, while there is a presumption for a very limited role of government in product markets, there is a presumption for a far more extensive role of government in capital markets.

Recent experiences have bolstered these long-standing presumptions - not only the innumerable banking crises, but also the scandals in the under-regulated Czech capital markets, the consequence of which has been not only that a few have gained at the expense of the many, but that the capital markets have failed to perform their functions of improving economic performance by raising capital and monitoring (Nikitin and Weiss, 1997).

#### **4.2 From fixed to flexible exchange rates**

IFIs are concerned with *international* financial markets in which all of the issues that arise in domestic markets occur, plus one new element: the issue of exchange rates and exchange rate risk. In the simplest version of the competitive paradigm which underlies so much of economic analysis,

exchange rates make no difference. Just as the classical dichotomy in a closed economy held that the determination of real variables could be separated from that of nominal variables - with the sole function of the money supply being to determine the price level - so too would the exchange rate follow directly from the respective price levels in an open economy in the expanded classical dichotomy. The conditions under which money is neutral have been shown to be somewhat more general than those under which the classical dichotomy was established, but still highly restricted: *in general, money matters, at least in the short run*, though there is perhaps more disagreement about the reason for this than over the validity of this conclusion. Under almost any of these explanations, *exchange rate regimes* also matter. There is less of a consensus about what the best exchange rate regime is, but there is a growing belief that fixed exchange systems do not work: they cannot be sustained and when they finally 'break' the dislocations are large which, because of the concavity of adjustment costs, is more costly than a series of smaller adjustments (10).

But most governments have remained uncomfortable with truly market-determined exchange rates. (Governments talk about wanting a 'strong currency', not an equilibrium value.) Even market ideologues routinely argue for intervention in the exchange rate market (witness the *Wall Street Journal* editorial page which has consistently berated the East Asian countries for 'allowing' their exchange rates to depreciate.) The rationale for these interventions is often hard to reconcile with their devotion to the market: they sometimes suggest, for instance, that they are stabilising the market. But unless they have information that is not at the disposal of market participants, why would the market not do just as good a job at stabilisation? And if they have information that is not at the disposal of market participants (such as the course of future monetary policy), why do they not just disclose that information, rather than trying to take advantage of the asymmetry of information? (In general, asymmetries of information hinder the operation of markets; the distortions associated with the exploitation of monopoly power, including monopoly over information, can be just as great when exercised by government as by the private sector.)

### **4.3 Developing an intellectually consistent framework**

There are three broad approaches in thinking about these interventions. One can be traced back to Keynes, one of the founders of the Bretton Woods institutions. He himself had little of the ideological faith in markets that has seemed to come to be an important, if not dominant, strand. He saw markets as animated by animal spirits; expectations were far from rational; investors were engaged in judging beauty contests in which the object was not to choose the most beautiful person, but the one the others would so judge. He saw markets, especially labour markets, as often not clearing, and a strong role for government in such situations to stimulate the economy. In this view, in which the economy is replete with market failures, interventions in international markets may well be required. The systemic consequences, for instance, of the volatility of short-term capital flows may well make interventions that dampen these flows and stabilise them desirable.

The second approach begins with the presumption that markets are efficient, and if there are inefficiencies - for example, misaligned exchange rates - there is no confidence that the government would

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10) But even here, there is no general rule: modern macroeconomics has stressed the role of expectations. It has been argued that a fixed exchange rate may provide a 'nominal anchor' which stabilises inflationary expectations, and thus inflation itself. The problem has been that, having stabilised inflation, countries have found it difficult to find a smooth way of exiting from the fixed exchange rate regime, and the crises which result from the resulting misalignment of exchange rates often have enormous real costs.

have a better judgement about the appropriate exchange rates than the market. In this view, government should not intervene, even in the event of a marked change in exchange rates. To be sure, such large changes may lead some individuals to go bankrupt, but this is simply the working out of the laws of the market. Why should the government be more inclined to intervene when the relative price of two currencies changes, than when the relative price of oil or cabbage changes dramatically?

In fact, however, much of the international community has been taking a third approach, one in which it is normally assumed that markets work perfectly, or at least well enough that government should not intervene; but occasionally, there are disasters - exchange rate crises - requiring strong governmental interventions. To my knowledge, no intellectually consistent framework underlying this peculiar hybrid has been developed. Indeed, since the interventions typically entail bail-outs (the magnitude of which may in fact have been increasing over time, in spite of the increasing lip service paid to the dangers of 'moral hazard'), the interventions themselves would give rise to a discrepancy between social and private risks - and thus a misallocation of resources, *even when there is no crisis*.

The rationale for the interventions lies not in any compelling evidence that there would be disastrous contagion effects, or that the interventions themselves would reduce the magnitude of the contagion. Indeed, most of the contagion is hard to reconcile with models of investor behaviour which assume rational, informed investors (a belief of those who have strong confidence in market solutions); and many models of rational, informed investors suggest that contagion effects might be exacerbated by the typical interventions (Stiglitz, 1998). Rather, the rationale for the interventions is that governments find it difficult to sit idly by when there is any significant perceived probability of a disaster - better to be seen to be acting, even if the action has little if any effect, than to do nothing.

There is, perhaps, a way which might reconcile a seeming faith that markets work well - except when they work so disastrously that there is a crisis. For this is exactly the same quandary that many neo-classical economists faced after the Great Depression. That Depression convinced most reasonable people that markets do not always work perfectly, and the macroeconomic theories developed at the time and subsequently provided an explanation for why this might be so. But the standard microeconomic theories, and in particular the Fundamental Theorems of Welfare Economics, argued that the economy was, in general, Pareto efficient. One of Samuelson's great achievements was to reconcile these seemingly inconsistent strands, through the so-called neo-classical synthesis. *This was simply an assertion - based neither on a consistent set of assumptions nor a well-articulated theory - that 'normally' the economy was efficient, when it was operating at full employment; but occasionally, it faced macroeconomic maladies, in which the key issue was not the allocation of resources among competing uses, but rather the full utilisation of the available resources*. It seems equally, if not more, plausible, that the periods of massive underutilisation are but the most obvious manifestations of market inefficiencies; they are the tip of the iceberg, but even in the absence of such massive misallocation of resources, there may be a myriad of smaller, but significant, misallocations (Greenwald and Stiglitz, 1986). More recent theories have attempted to derive macroeconomic consequences from a consistent microeconomic analysis, and in these models this is precisely the case: markets are in general not Pareto efficient, and the structure of the economy is such as to amplify shocks and make them more persistent, so that with a large enough initial negative shock, the economy may experience an extended period of unemployment (Greenwald and Stiglitz, 1993).

**Capital account liberalisation may be accompanied by actions intended to discourage volatile short-term flows at the same time that long-term capital is encouraged.**

Volatile, short-term capital markets can be an important source of shocks to the economy. The fact that the economy's ability to absorb these shocks is limited means that there are gains from trying to reduce the shocks that it faces - in short, to dampen the fluctuations in short-term capital movements. To be sure, the growth-enhancing effects of short-term capital movements must be set against these negative, destabilising effects. But there are empirical and theoretical reasons to believe that these growth benefits may be limited. First, cross-country regressions find little support for significant effects of capital account liberalisation on either growth or investment (Rodrik, 1998), a finding that is in contrast to the standard result that there are significant effects from trade liberalisation. Second, this should not come as too much of a surprise, given that growth benefits are typically related to long-term investments, and it is extremely risky to fund long-term projects with short-term capital, and doubly so when the short-term capital is denominated in a different unit than at least some of the sales and costs. Third, speculators have increasingly focused attention on the ratio of reserves to short-term debt, forcing countries that wish to avoid a crisis to increase their reserves in tandem with short-term borrowing. In effect, poor developing countries are borrowing at high interest rates from American and European banks, and then re-lending the proceeds to the treasuries of those countries at low rates: a peculiar exercise, indeed. Although the whole round-trip may lead to some productive investment, it would be far preferable if the country lent money directly to the borrower; the country is, in effect, paying a high price for the foreign bank's screening and monitoring services. It would be far better to develop those capacities itself.

In the 20th century, one of the main goals of IFIs has been to oversee the liberalisation of countries' exchange rate convertibility for trade purposes, an important part of the overall process of trade liberalisation. Some have seen one of their main goals in the next century as overseeing capital account liberalisation. This may be the case, but the oversight will, especially after the East Asian crises, take on a quite different form than what was anticipated only a short while ago. For that liberalisation may well be accompanied by actions, such as the Chilean reserve scheme, intended to discourage volatile flows of short-term capital at the same time that long-term capital is encouraged. *There may well be a role for IFIs to help implement such precautionary policies on a collective basis.* Some of the proposals, such as the Tobin Tax (a modest tax on foreign exchange transactions), can most effectively be implemented on a global scale. Even if IFIs do not play an active role in implementing such policies, they may play an important role in the evolution of standard policies; such standards will go a long way to ensuring investors that such policies should not be interpreted as reflecting hostility towards foreign capital; moreover, such standards may lower the transactions costs involved in operating in capital markets in different countries.

Recent discussions have focused on the importance of improved data (though at the same time noting that such data will never be sufficient to eliminate crises, and in some cases may actually lead to greater economic volatility) (11). Much of the data that will help monitor the financial position of various countries can most effectively be collected if there is international co-operation, so that data from lending and borrowing countries and institutions can be reconciled. It should, however, be noted that there is a question about whether such data should be collected by an independent inter-

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11) Earlier, we noted the possible intellectual inconsistency between those who take a strong market position, but at the same time believe that there is a role for government intervention at the time of a crisis. Note that in the standard competitive model, all relevant information is conveyed by prices; the additional quantity data (e.g., concerning levels of debt) are not required. Indeed, the virtue of decentralised allocative processes is that (when they work) such centralised data is not required; by the same token, decentralised market processes make the accurate collection of such data difficult.



national statistical agency, rather than an 'operating' agency, to avoid actual and perceived conflicts of interests (12).

#### **4.4 Lender of last resort**

There are some who have toyed with a somewhat grander role for IFIs - a role at the international level analogous to that played by central banks within a country. It is now widely recognised that a lender of last resort cannot stave off crises, and may actually lead to actions (moral hazard) making such crises more likely. Stable financial systems require not only a lender of last resort, but also strong supervision and deposit insurance (to prevent runs). It does not seem likely that in the immediate future countries will delegate the supervisory functions to an international body, partly because the standards entail elements of political as well as economic judgement. There have been several instances in which governments have deliberately temporarily weakened standards as part of the process of promoting an economic recovery; in doing so, they not only mitigated the magnitude of the economic downturn, but may actually have reduced the magnitude of the financial crisis which could have been exacerbated by a more extensive credit crunch. Unless countries have greater confidence in the ability of IFIs to make those judgements in ways which are consonant with their own economic and political welfare, it is unlikely that, unless forced to do so by circumstances, countries will willingly turn over these important levers of the economy to an international body.

#### **5. Concluding comments**

A few years ago, there was a small but vocal movement against the Bretton Woods institutions: Fifty Years is Enough. The extent to which the debate has changed so quickly is remarkable. There is now widespread agreement on the need for international collective action in a wide range of areas, as suggested by the theory of international public goods.

*Critics claim that there is little guarantee that collective actions will be welfare enhancing. Yet, public institutions have developed in ways which respond effectively, even if not perfectly.*

All collective action - at the local, national and international level - faces serious governance problems. Critics claim that without the kind of discipline provided by the market, there is little guarantee that collective actions will be welfare enhancing, and there are numerous instances where these actions have indeed been counterproductive. Yet, in many instances, the need for collective action is great, and public institutions have developed in ways which respond to those needs effectively, even if not perfectly.

I believe that this is the case for IFIs: if they were not here today, we would not be inventing them; and they have been successfully reinventing themselves to respond to the new conditions of the international environment. The task of promoting economic development and alleviating poverty has just begun. As I said earlier, the great lesson of the last 50 years is that development is possible, but not inevitable. The multilateral development banks can be an important force for making such development both more possible and more likely.

But the other major challenge facing the IFIs when they were first established more than 50 years ago remains more elusive: today, financial crises are more frequent, with deeper and more profound effects, though to be sure, we have, so far, avoided a world-wide depression even approaching the scale and scope of the Great Depression. It seems clear that collective action is required,

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12) These are similar to the arguments within a country.

but there is of yet no consensus on the nature of the required action, partly because there is no consensus on the nature of the desirable international financial architecture. And the lack of consensus in that arena in turn may in part be attributable to the difficulties of finding, let alone agreeing to, a consistent and coherent intellectual framework.

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### **Jacques Attali**

*A well-known author, Mr. Attali has written more than 20 books on matters spanning economics, politics, current affairs, sociology and history.*

*From 1981 to 1991, Mr. Attali served as Special Advisor to the President of the French Republic, a post he relinquished after founding the European Bank for Reconstruction and Development (EBRD) and becoming its first President in 1991. In 1993, Mr. Attali returned to France as Conseiller d'Etat, where he now heads a consultancy firm.*

*He obtained his doctorate in economics from the University of Paris IX Dauphine, after attending the Ecole Polytechnique, the Institut d'Etudes Politiques, the Ecole des Mines and the Ecole Nationale d'Administration. In addition, he holds honorary doctorate degrees from the Universities of Kent and Haifa. His achievements have been recognised by his selection as a Chevalier of the French Legion of Honour. He is also a member of the International Academy of Cultures.*

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### **Alfred Steinherr**

*Alfred Steinherr is Head of the Directorate for Economics and Information and Chief Economist of the EIB. Previously, he was professor at the Université Catholique de Louvain, and has held positions at the IMF and the European Commission. He has a doctorate from Cornell University.*

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# A discussion between Alfred Steinherr and Jacques Attali

**Alfred Steinherr:** As you know, we have received a number of interesting papers for our volume on “International Financial Institutions (IFIs) in the 21st Century”. The articles have raised several important questions, and we are glad to have the opportunity to conclude the volume with this discussion. Let me start by asking you a question about the entry for international institutions in your recently published “*Dictionary of the 21st Century*” (1). In your entry you set out a future agenda for such institutions, but the points raised deal mainly with organisations like the United Nations. IFIs are only dealt with implicitly. Was this intentional?

**Jacques Attali:** IFIs are more complex than organisations like the UN since their future is directly linked to the development of the world market. Depending on whether we are moving towards an integrated global market, or returning to a more fractured system, the future of IFIs will be markedly different.

If this emerging global market is going to be a pure and perfect one for the first time in the history of mankind, IFIs may well turn into private organisations and disappear. On the other hand, we may find that, especially in the light of the global effects of the Asian crisis, the market is not in equilibrium without state or public support. I believe this to be more the case. This calls for international financial resources to stabilise both markets and demand. Finally, we will need IFIs to establish and verify a growing number of standards, especially standards of transparency, taxation, and regulation. I envisage a whole new range of IFIs charged with controlling and enforcing financial standards. One such institution could be in charge of managing a global Tobin tax (2). We may even one day see institutions like the *Tennessee Valley Authority* (TVA) spring up on a regional or global scale (3).

**How does development enter all of this? Assuming that we are going to have an almost perfectly functioning global market, will certain countries not still be left behind and thus in need of continued support from the richer countries?**

There can be no global market without global market institutions. One interesting example is the World Trade Organisation. Its dispute settlement mechanisms will bit by bit lead to the elaboration of a global trading law. I believe that we need more standard-setting institutions like that. In addition, there is a continuing need for institutions in charge of financing development. Certain

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1) Jacques Attali (1998). *Dictionnaire du XXIe siècle*. Paris: Fayard.

2) The Tobin tax is a modest tax on foreign-exchange transactions. The small levy on each transaction penalises short-term flows relatively more than long-term ones, thereby affecting long-term investment much less than short-term speculation. However, to be effective, it has to be applied globally, since otherwise markets would move offshore to where the tax is not applied (The Editor).

3) The Tennessee Valley Authority is a federal corporation set up by President Franklin Roosevelt in 1933 to develop the Tennessee river basin (covering Tennessee and parts of Alabama, Virginia, Georgia, Kentucky, North Carolina, and Mississippi). It has built and operates 50 dams for flood control, 29 hydroelectric generators, eleven coal-burning power stations, and two nuclear power plants. It also manages a number of research programmes in agriculture, economics, environment, and industry. While the power system is self-supporting through the sale of electricity, other programmes are financed through the federal budget. It is run as an independent agency of the US executive department, with Board members being appointed by the President with ratification by the Senate (The Editor).

supranational organisations already have trouble funding their respective areas of concern. For example, we will need more and more development resources to finance those health problems that the World Health Organisation cannot do by itself. Equally, financing all the global educational problems is beyond the means of UNESCO. Even if an integrated global market exists 50 years from now, the continued needs of two to three billion people in poverty sets out the arena for IFIs quite clearly. The future emergence of micro-credits, that is, very small credits for individuals to buy tools, etc., will not happen all by itself in this global market-place. It will require institutions and public financing bodies that may very well be IFIs.

**We see strong regional concentrations in the global market today. In terms of institutional development, how do you see the division between regional and inter-continental organisations?**

Continental markets are a prerequisite before attaining a global market, and we will have the former first. I firmly believe in continental integration as a starting-point for global integration. We are witnessing a strong growth in regional trade today, as a result of which there will be strong regional organisations for planning and financing investment on all continents one day (the TVA again comes to mind). For this reason I believe that the EIB and the EBRD should merge. There is no reason for the two to stay apart.

**Was not the EBRD born out of the conviction that a global organisation is not sufficiently targeted towards very specific regional problems?**

Indeed it was. It was important to create a regional organisation in which all the interested countries are shareholders. As the Central and Eastern Europe countries were not going to participate directly in the financial decisions of the EIB until European Union (EU) membership, regional financial integration under the auspices of the EBRD was going to be the first step towards political integration. Incidentally, this concept would have worked better if the EBRD had been restricted to European members only. Non-European shareholders in a fundamentally European institution can lead to a lack of clear focus.

**What will IFIs do in a capital market that is much more efficient than it is today? We can already identify problems of differentiation with the private sector. Where is the intervention of a public bank justified? Can you recommend guidelines to follow?**

Yes, there will be a growing pressure for the abolition or privatisation of institutions like the EIB or the EBRD. Given the fact that they lend to the private sector, it would be true to say that they are in competition with private banks. However, there is no reason why IFIs must be in competition with the private sector. One possible resolution of this problem is continued specialisation. IFIs can find niches, and the list of possible areas is long. One avenue could be standard setting, which cannot be done by the private sector. Another possibility outside the reach of the private sector is the organisation of dispute settlement mechanisms. Then again, there are sectors that will always rest in the public domain. As such, financing the environment, health, education, law, social security and credit to the poorest is not up to the private financial system. While it is absolutely necessary to learn about competition in schools, it would be disastrous to transform schools into competing enterprises.



In essence, everything that is worth the participation of IFIs is a first step towards the creation of a continental government.

**One part of the IFIs' vocation is to follow objectives that cannot be measured in terms of profitability. Risk-taking is strenuously avoided by organisation like the EIB and the World Bank. The latter, for example, passes its risks to the government of the country that receives funding. In very few cases does the EIB take risks. Is it not true to say that in today's financial market, which has gained quite considerably in efficiency, the market for risk remains the most imperfect? This puts a special emphasis not on the allocation of funds, which are aplenty, but on the choice of projects. Where do you see the advantages of inherently risk-averse institutions like the EIB? Wouldn't the EBRD's way, which does involve risk-taking, be more the way of the future and lead to a better allocation of resources?**

I firmly believe that risk-taking is an essential element of acquiring legitimacy. The basis of sovereignty involves the sovereign taking risks. This gives him real power. An institution which takes risks increases its sovereignty and so plays a much more important role. Rather than a supranational institution, the EIB is a purely multilateral one. It has so far refused to take any risks, in other words, to take sovereignty in its decision-making. It seems to me that this prudence, which was necessary to attain its authority, acts today as a real brake on its development. The Europe of today may as a result suffer from the bias of this institution against using its almost unlimited risk-management reserves.

**This leads us to the question of governance. As with other IFIs, the EIB's decisions are taken by our Board of Directors, which represents our shareholders, i.e. the EU member states. In general, the Board consists of representatives of ministries with objectives and agendas that are not necessarily aligned. Do you approve of this controlling structure, or do you think that we ought to have a broader democratic oversight; say, more responsibility to the European Parliament?**

Over time, we have to convert from multilateralism to supranationalism. While the former has always been compatible with the Treaty of Rome, which was above all a multilateral treaty of integration, Europe has moved on since 1957 and has become increasingly supranational. This also means that the institutions of the EU cannot stay multilateral, but must become supranational. It involves moving away from the authority of each member state and towards that of the EU. For that reason, the EIB still represents a conception of Europe as simply a common market without any political integration. The creation of the single currency, on the other hand, shows that political integration is already happening today. In that respect, the EIB should really assume its independence in a supranational spirit, and open up its accounts to the European Parliament.

In terms of general transparency, I believe that IFIs can make particular use of the internet. Being able to log onto the web-sites of IFIs will greatly enhance their accessibility and proximity to the general public. In future, everyone will be able to see where lending goes. New technologies should also much reduce operating costs. In fact, I sincerely hope that IFIs will steal a march on private-sector institutions when it comes to the usage of the new technological possibilities and capabilities.

**Which would in fact be an additional contribution to the creation of a federal structure?**

Much more than that, it would in fact be the best proof that the EU is serious about tackling employment. If the EIB turns itself into a supranational institution, it could use its enormous financial reserves for risk-taking in order to support investments that create growth and employment.

**In one of the contributions to this volume, the Chief Economist of the Royal Dutch/Shell Group writes a provocative essay from the point of view of the World Bank's centenary in 2044. On this occasion, the World Bank is being turned into a foundation with a co-ordinating staff of 500, which is in stark contrast to the more than 10,000 staff it has today. This is perhaps a logical extension of the argument of the Chief Economist of the World Bank, who maintains that the main goal of IFIs is to provide international public goods. However, many of these goods, such as knowledge on development, do not have to be bundled together with lending. Is the John Maynard Keynes Foundation something that you find plausible?**

It is very plausible to imagine that the World Bank loses some of its operational competencies. While these will be transferred to private organisations, the Bank remains a centre for initiative and support. In the EU, this is already happening with the European Commission, which is slowly transferring its logistical activities to private organisations or non-governmental organisations. I can foresee this happening with the World Bank, too. However, activities on a global scale will continue to be necessary. In that respect, one of the organisations that will become extremely powerful in 50 years' time is the Bank for International Settlements (BIS). It will expand upon its present-day standard-setting functions, and I cannot see how the BIS, the IMF, and the World Bank can all remain independent of one another indefinitely. I foresee a reconciliation in which one primary function will be to finance the work of non-governmental organisations in terms of micro-credits for the assistance of the poorest, or the financing of other sectors that will remain in the public domain, and also special innovative projects. But a new function of international organisations will also appear, which is the issuance of standards. This will entail a new power for international organisations, since when you set standards, you also have to verify them. Examples of this exist even today. The World Bank issues standards for "group practice" with respect to micro-credits, standards for tenders, standards for customs and duties, as well as standards for the fight against corruption. In the future, the World Bank will be a standard-setter with an apparatus geared towards their verification; say, for the evaluation and co-ordination of financial standards.

**Thank you very much for wrapping up this volume of the EIB Papers. You have emphasised that the market will continue to need international public institutions for it to operate correctly. Then, you have stressed the need for IFIs in the areas of standard-setting and their co-ordination. Interestingly, you have outlined a particular future role for the EIB. It would be a supranational body, and answerable to the European Parliament. It would be directly involved in planning regional activities in the same way as the Tennessee Valley Authority, and it would operate on a continental scale through a merger with the EBRD. Thank you once more for giving us food for thought with this proposal.**

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