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Rethinking the Role of the Multilateral Development Banks

What is the role of the multilateral development banks (MDBs) in the 1990s and beyond? Are the needs perceived at Bretton Woods still relevant today? Are the roles which the banks subsequently carved out for themselves still appropriate? Are there still gaps in development financing for the banks to fill, and do they serve a useful advisory role? The fiftieth anniversary of the World Bank in 1994 momentarily brought these issues to the fore, but media attention then moved elsewhere. The Group of Seven (G7) leading industrialised countries has now endorsed less radical proposals for strengthening the role of the MDBs. Will this mean business as usual? If not, how will the impetus for change be sustained?

The International Bank for Reconstruction and Development (IBRD usually called the World Bank) was created at the Bretton Woods conference in 1944 and it provided the model for the five other regional development banks which have evolved in similar ways. Box 1 outlines the features which distinguish them from other aid and development finance institutions, whilst Table 1 gives some basic numbers.

Box 1: What are the MDBs?

The World Bank based in Washington DC and the five regional development banks, the Inter-American Development Bank (IDB) also based in Washington DC, the African Development Bank (AfDB), based in Abidjan, the Asian Development Bank (AsDB) based in Manila, the Caribbean Development Bank (CDB) based in Barbados, and the European Bank for Reconstruction and Development (EBRD) based in London, are financial intermediaries owned by both developed and developing countries which provide long-term lending for development either globally or within a region. MDBs are distinguished by their intermediation on international capital markets. They all have at least some special funds available for lending at concessional rates (in `soft window' facilities) and also special facilities for private sector lending. In some cases these funds are managed by specially created agencies within the banks (see Table 1).

The World Bank

The Bank's original activity was reconstruction following the Second World War, especially in Europe. Physical resources were scarce; financial markets were fragmented and dominated by wartime needs. Output and domestic savings in many war-torn countries (mainly in Europe) were low, and the ability to expand export earnings was severely limited (and further constrained by high trade barriers). Currencies were non-convertible and exchange controls were widespread and stringent. Thus the need for large financial inflows was paramount, and the North American capital markets were initially the main source. Although the requirements of development in the poorer countries were already dimly perceived (India and the Latin American countries were major players at Bretton Woods), no-one foresaw the speed with which a large number of independent developing countries would emerge, or today's globalisation of capital markets. The new World Bank was therefore structured as a financial intermediary which would help its member governments raise money in existing markets which, at that time, they could not hope to access on their own. Its role was what later became known as `credit enhancement', using its large capital base partly subscribed in hard currencies but mostly in the form of members' promises to pay. This uncalled capital constituted a sort of guarantee fund on which the market lenders could rely, and provided much better security than most of the individual borrower nations could then offer.

It was soon found cheaper for the Bank to lend to borrowing countries directly from its funds than to issue guarantees. This in turn meant that it borrowed extensively in the main financial markets as these spread from North America to Europe, and later to Japan and the Middle East, in the process gradually building up a reputation which enabled it to obtain very favourable terms. The balance of its lending shifted, away from post-war reconstruction of mainly European members towards the newly independent developing countries, and with this shift came new developments in its structure.

The restriction of lending only to governments had become uncomfortable, and its affiliate the International Finance Corporation (IFC) was set up in 1956. The IFC also raises finance in the markets on its own credit at highly favourable rates but, unlike the IBRD, its function is to invest this money in private sector companies in developing countries. The Bank soon recognised that even its relatively cheap market-rate loans were inappropriate for the poorest developing countries, and the International Development Association (IDA) was created in 1960 as its `soft window'. The IDA is a fund largely dependent on grants from donor governments in the richer countries, and it on-lends at nominal interest and for up to 40 years. While this is much cheaper for borrowers, the IDA's inability to borrow from the markets itself means that it cannot use its donor resources to `lever' up much larger flows of borrowed funds. Most recently in 1988, as a way of encouraging the flow of direct foreign investment into developing countries, the Multilateral Investment Guarantee Agency (MIGA) was created to provide guarantees of investments in private ventures in these countries. All these agencies combine to make up the World Bank Group.

Over the past 20 years a parallel set of changes has affected the use of Bank money. The original aim was to support a series of discrete development projects, in infrastructure (irrigation, electrification, roads) or agriculture. With the debt crisis following the oil price shocks, the Bank moved into the area of policy reform and structural adjustment lending. It greatly increased its lending for macroeconomic and sectoral programmes rather than for specific projects, aiming to help governments through the painful process of adjustment to changes in the outside world as interest rates rose against them and markets for their exports fell away sharply. In concert with the International Monetary Fund (IMF) the Bank found itself involved in these more complex issues and rapidly increasing its store of knowledge about measures which did or did not help in stormy times. Both institutions began to insist that the lessons they had learned should be applied as a condition of their support. Such macro-economic policy conditionality has become the most severely criticised aspect of their work.

The Bank also became the main agent in marshalling the bilateral financial and technical support of donor governments, especially in sub-Saharan Africa. Donors, while insisting on pursuing their own aid policies, relied increasingly on the Bank's knowledge of their clients and its ability to drum up support for such operations as the Special Programme of Assistance to Africa. The sheer size of the Bank by comparisonwith other lenders and donors gave it an added advantage.

Table 1: Basic Numbers

	World Bank	**IDB**	**AfDB**	**AsDB**	**CDB**	**EBRD**
Year created	1945	1959	1964	1966	1969	1991
Membership	178	46	77	55	25	59
Soft window (where separate)	IDA	FSO	AfDF	AsDF		
Private sector window (where separate)	IFC	IIC				
Total loan portfolio* (US$ billion)	195.5	32.9	7.6	28.8	0.6	2.7
Total voting rights for:						
Borrowing countries**	43%	52%	65%	45%	61%	66%
Non-borrowing countries	57%	48%	35%	55%	39%	34%

* Measured as total loans outstanding and excluding private sector affiliates
** Countries eligible to borrow which except in Europe are all developing countries
Source: 1995 Annual Reports of the World Bank and the regional development banks

The 1990s have seen the Bank further increase its focus on the role of the private sector in development. Initially the pioneers of development economics had focused on the need for state intervention and direct government participation in the economy, especially during the earliest stages of development, and the Bank's original charter reflected this approach. The creation of the IFC was the first recognition of the need for change. In the late 1980s, the Bank came under considerable pressure to evolve new instruments of support for the private sector in borrowing countries. It is now accepted that it should do more to stimulate the growth of a healthy private sector in developing countries, though the publication in 1993 of the Bank report *The Asian Economic Miracle* restated some of the conventional case for limited state intervention.

For at least two decades, the Bank has also come under increasing political pressure, mostly from the industrial country shareholders, to consider the wider consequences of its actions and to broaden its agenda. Its earlier attack on poverty was based on projects such as in integrated rural development and small farmer agricultural extension. In the late 1980s the focus shifted towards the causes of poverty and the barriers to effective action against it. Also the environmental impact of some projects, especially dam construction and irrigation schemes, was severely criticised, and the Bank reappraised its methods in response. Shareholder pressure also encouraged it to add other objectives to its already formidable list: promotion of gender equality, help in creating conditions for `good governance' and the development of human resources. The original charter drew a distinction between Part One (non-borrowing) and Part Two (borrowing) countries. This distinction (with the industrial countries appearing to know what was best) came to dominate the Bank's internal politics. That experience influenced the creation and evolution of the regional development banks.

The Regional Development Banks

The constitutions and structures of the regional MDBs are comparable to those of the World Bank, with a core bank, like the IBRD, and a soft window analogous to the IDA. The World Bank remains the major source of funds, however, except in Latin America (see Figure 1). Each of them has built up a corpus of economic and technical expertise available to its members. However, unlike the World Bank, all the regional MDBs are able to lend directly to the private sector without government guarantee, although their implementation of this facility differs.

- **The IDB**, the oldest regional MDB, now lends more each year in Latin America than the World Bank. Initially created to focus on economic and social development, the IDB charter included the Fund for Special Operations (FSO) as an in-built soft window. The IDB also chose to create a distinctive private sector affiliate, the Inter-American Investment Corporation (IIC), in 1986. Following criticism of operational inefficiency in the 1980s, the IDB has undergone two reorganisations, in 1988 and again in 1994. In 1995 a private sector `window' was opened, although lending is limited to 5% of its ordinary capital resources.
- **The AfDB**, until recently largely controlled by its borrowers in a region which has suffered much economic as well as political turmoil, is the only regional bank with serious financial problems and a level of bad debt which threatens its future operations. For this reason, in the mid-1990s it has been obliged to reorganise both its lending portfolio and management, and it has cancelled a number of previously agreed but undisbursed loans. It has disqualified 39 African countries from borrowing in the future from the Bank itself, restricting them to access to the `soft window' African Development Fund (AfDF). It has introduced a series of far- reaching

changes in its internal management, and is currently debating a still larger role for its non-regional members in exchange for contributions to the AfDF; but its future role remains unclear.

- **The AsDB**. The lack of wider regional co-operation explains the relatively slow formation of the AsDB. Japan was its main promoter and continues to have the largest voting share. Like the World Bank, the AsDB is dominated by developed countries which have 55% of the voting rights. The Asian Development Fund was created in 1974 as the bank's soft window. In 1994, the AsDB embarked on a new policy to ensure that 40% of its total loan volume and 50% of all projects focus on social and environmental sectors.
- **The CDB**, despite its narrower coverage, is structured along the same lines as the other MDBs, with 20 regional and 5 non-regional members, and much of its lending is done in close co-ordination with the World Bank and the IDB. The CDB was created to focus on the urgent social and economic needs of its less developed members: the small, poor economies. It manages its soft loans internally through a range of special funds, and these amount to about a third of annual loan approvals.
- **The EBRD**, as the newest MDB, is different in several ways. It has a more overt political rationale, designed to help the former communist countries through the transition to a market economy; and it is obliged (not merely empowered) to concentrate more than 60% of its lending in the private sector, which it does directly without the need for a private sector affiliate.

This multiplication of lending agencies has not been without problems. The case for separate regional banks was always more political than economic. There is obvious risk that overlap will turn into duplication, and even into conflict. Formal machinery for co-ordination exists between headquarters. Yet collaboration flourishes in some borrowing countries, and fails to work in others. For example, it is not yet clear how the EBRD role in Eastern Europe differs from the closely related work of the World Bank Group in the region.

The Changing Context

This story of institutional evolution shows how the MDBs have built up many advantages in the last fifty years. They have attained a certain `critical mass' which gives them important features. First, they command highly favourable borrowing terms in the markets, which can still be used to the benefit of their borrowers. Collectively, they are still the largest source of public development finance (in terms of gross flows, if not of net transfers); moreover, this finance is untied and free from most political strings. Secondly, the World Bank plays a key `facilitator' role in resource mobilisation, not only by its own operations but also within the donor community as a whole; no other body has the same power of persuasion. Its regular consultative groups for the poorer developing countries provide a framework for aid co-ordination which would need to be replaced if the MDBs disappeared. Thirdly, the MDBs, and in particular the World Bank, possess a store of knowledge and analytical capacity, based on experience and research, unequalled anywhere else. These three advantages in combination give the World Bank and its peers (including the IMF) some considerable authority in talking to the donor community and to the developing countries.

The MDBs have changed a lot over the last half century, but the world in which they operate has changed even more. The emergence of over a hundred newly independent developing countries has altered both the size and the composition of the banks' governing bodies, and shifted the balance of power within them. Many of the formerly poor developing countries have now emerged as significant global players, some with strong current account surpluses and high domestic savings ratios. They are graduating from borrower status, and some are exporters of capital and contributors to the MDBs' soft window funds. Instead of a single `North-South' dichotomy, there is now a wide spectrum of economic strength.

In this changing environment the MDBs' importance as a source of development finance has declined. By the late 1970s, bilateral aid programmes had overtaken them as the main external source of development finance to the poorer countries, although large amounts of commercial bank lending (much of it recycled OPEC surpluses) went to the middle-income countries. Private sector flows dropped sharply after the 1982 debt crisis, but recovered rapidly in the 1990s. Since 1994 bilateral aid flows have stagnated and begun to turn down, both in absolute and proportional terms; both they and multilateral flows have been overtaken by private sector flows.

These flows take four main forms: direct investment by foreign firms; purchase of equities in domestic stock markets by foreign private investors (greatly boosted by recent privatisation issues); commercial bank lending (now recovering a little after the debt crisis); and bond issues by borrowers in developing countries. Yet private flows remain concentrated on only 25 30 countries, twelve of which have absorbed around 80% of the flows since 1990. They include some poor but rapidly growing economies like those of China and India. For the remaining developing countries, especially the poorest ones, which are mainly in Africa, access to the market is still almost impossible, and dependence on bilateral and multilateral sources continues to be essential.

A snapshot view of the overall position in 1994 taken from the OECD DAC Tables shows total net resource inflows of about $184 billion into the developing countries. Of the total, the MDBs provided 6%, including $3.9 billion from hard and $7.4 billion from soft windows. Another 22% was bilateral aid, mostly grants and soft loans. Over 70% came from the various private market sources. The contribution of the MDBs is therefore small and shrinking.

In addition to the MDBs' decline as a source of finance, their loan portfolios (apart from the EBRD) are maturing, resulting in transfers out of developing countries as repayments are made. For many countries, the MDBs as a group now receive more money by way of interest and repayments than they advance in new loans: their contribution to individual country cash flow is negative. Like any bank, they reach a `steady state' unless their lending continues to grow quite rapidly. There are, however, upper limits to their rate of expansion, set by the size of their capital bases and by the availability of suitable projects against which to lend. Partly as a result, most of them, apart from the AfDB, are building up substantial reserves relative to their lending needs, and transferring part of their remaining surpluses to their soft windows. In aggregate (but not necessarily for individual countries) they still contribute positively to cash flow in most years, especially to the poorest countries. One by-product of past lending from `hard windows' has been a build-up of debt by a group of very poor (mostly African) countries which is now unsustainable (see ODI Briefing Paper 1995 (1) *Poor Country Debt: a Never-ending Story?)*. By contrast, some middle-income countries are now paying back much more than they receive, while a few non-borrowers are still repaying old loans.

Is There Still a Role for the MDBs?

In a changing world, where capital flows much more freely than in 1945, many critics argue that there is now a case for closing down the MDBs' lending operations (which could be done by selling the existing loan portfolios) and turning them into purely aid-giving and advisory agencies, using only their soft windows. Should their lending operations increasingly give way to guarantee or credit-enhancement operations? Could the disengagement process be speeded up by `graduating' from borrower status those countries which can now stand on their own feet? Should the private-sector affiliates such as the IFC also be privatised? Another argument is that the profits from the conventional banking operations should be returned to the shareholders by way of `dividend' instead of being ploughed back into reserves or allocated to soft-window operations.

The conventional wisdom is that all this would be premature. Part of the case for retaining the banks consists of a `middle tier' of countries for which access to private capital markets is at best precarious, so that they need the MDBs as a fallback. There is a second group of countries like India and China which, despite their high credit standing, have a majority of their population which is still desperately poor, and for which a mixture of MDB lending and soft-window money continues to be appropriate. Many middle-income countries continue to receive MDB policy and technical advice and the presence of the MDBs in such countries may also reassure private investors. The poorest countries, which receive money only through the soft window, might argue that they also need continued access to this accumulated expertise, which would be dissipated if the present institutions were cut back sharply. Nor is it clear that the World Bank could continue to play its `facilitator' role so forcefully if it no longer provided so much of the cash itself. The regional development banks are also seen by borrowers as providing a margin for manoeuve in lending negotiations. The MDBs' private sector lending may also attract additional private financial flows. The IFC argues that small amounts of multilateral loan or equity capital frequently gear up much larger sums from private investors who welcome the `comfort' provided by an IFC stake backed by careful IFC scrutiny of an investment project (or by MIGA or World Bank involvement). Such gearing ratios are usually estimated at around 7:1, so if this argument is valid IFC withdrawal would be a serious mistake. But this `additionality' argument is unproven in the absence of counterfactual evidence.

Some Recent Re-thinking

With increasing doubt about the continued relevance of the MDBs, many attempts have been made to redefine their mission. From the early 1970s a number of outside studies have posed these questions and the banks themselves have recently mounted a series of quite radical internal reviews. The process began within the World Bank, where a former Vice-President was recruited to re-appraise the Bank's portfolio of projects in an attempt to increase its overall effectiveness. The resulting Wapenhans Report (unpublished but widely publicised in 1992) was frank about the failure rate of Bank projects, which it attributed in part to a `culture of commitment' in which staff were judged more by the new projects for which they won approval (and had funds `committed') than by projects' ultimate success. Another probable factor was the multiplicity of objectives set by the shareholders and management; as the targets multiplied, the success rate of projects (measured by evaluation audits) fell. The report advocated a rigorous thinning-out of the portfolio (with an inevitable effect on the level of lending), followed by much more careful evaluation of completed projects and better feedback of lessons learned. It also endorsed some changes already in hand, in the way shareholders exercise their control: away from detailed scrutiny of individual projects (never very effective when conducted at Board level) towards a greater concentration on the Bank's policies in differing areas and for differing activities. The three older regional banks then carried out rather similar reviews and reached similar conclusions; the much newer EBRD had re-thought its role a year earlier as the result of an internal crisis.

The fiftieth anniversary of the Bretton Woods institutions was another occasion for re-examination. Some outsiders, for example in the NGO community under the banner of `Fifty Years is Enough', argued for radical change because lending remained persistently insensitive to issues of poverty, social development and environmental sustainability, and policy advice and conditionalities, particularly on structural adjustment and economic reform, were exacerbating these problems. Past or present insiders also raised many specific concerns. These events attracted much publicity, but heralded no dramatic changes. The latest high-level review was commissioned by the Development Committee (a group of Ministerial Governors of the World Bank) and carried out by a special Task Force under a veteran of development banking, Abdlatif Al-Hamad, head of the Arab Development Fund. Its report in early 1996 took the present roles of the MDBs essentially as given, but it subtly redefined those roles in several respects.

A major question concerns the large increase in private flows to developing countries. The report acknowledges the changing economic environment but restates the need for MDB support of the majority of developing countries which do not benefit from these flows. Similarly, it stresses that direct private sector loans should only be made if they are additional (e.g. there are insufficient private flows) and they serve a development need. In the context of a wider donor initiative re-emphasising the primacy of poverty in the aid agenda, several proposals are made for sharpening the MDBs' focus on poverty. The report suggests progressive withdrawal from countries which can look after poverty for themselves. Despite the current emphasis on privatisation, it also restates the role of governments, especially in dealing with poverty. Furthermore, it reiterates the need for sustainable development policies. Overall it argues that `the MDBs' contribution is more than the sum of their parts'; and that they are still needed in broadly their present roles. It recommends a more sharply defined role for their Executive Boards, which should focus more on guiding strategy than on day-to-day management.

This incremental approach seems to represent the present governmental consensus on the future of the MDBs. The Development Committee broadly endorsed the Task Force report, and asked the five heads of the MDBs to report on progress in two years' time. The G7 summit at Lyon in June 1996 also supported the Task Force conclusions. The responsibility is thus placed firmly upon the member governments to ensure that these changes, and other desirable reforms, are carried through. If there are to be no dramatic reforms, this also constitutes a continuing challenge for those in civil society (including politicians, the academic community, trade unions, small business organisations, others representing the poor, marginal and disadvantaged, and of course the media) who have sought to enhance the accountability of the MDBs for the effects of their actions. How will critical attention be sustained on whether the declared changes in policy are substantive and not merely cosmetic?

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