The University of Michigan
CENTER FOR RESEARCH ON ECONOMIC DEVELOPMENT
Mailing Address: CRED, Lorch Hall, Ann Arbor, MI 48109-1220
Telephone: (313) 764-9490
Telex: 432-0815 Cable: CREDMICH

A Review of "Financing Development in the 1990's"

by

Percy Mistry

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Financing Development in the 1990's
By Percy Mistry

Overview

This article is worth reading. It is also schizophrenic: while the author's focus is almost exclusively on the role that international institutions can play in development, he is ultimately skeptical of their importance in financing development. Mistry spends much of the paper discussing the records of, and prospects for, the major international organizations (the World Bank and IMF in particular). He joins the call for a strengthening of these institutions. In the end, however, he criticizes "unrealistic navel-gazing about how to achieve increases in foreign aid". The initiative increasingly lies with the countries themselves, who must find ways of increasing the level and efficiency of internally-generated investment. This statement belongs to the section on "Private External Development Financing", the last and best section of the paper. Earlier sections deal more with institutional problems, and do less to distinguish Mistry from other observers of the development scene.

Sections I - III

I. Introduction The Introduction sets the stage for the most pressing task in development: dealing with the debt crisis. Mistry has two interesting things to say about the debt crisis. First, he argues that third world lending worked fairly well until the private sector got involved. He suggests that the commercial banks were amateurs in a game they didn't understand, and their frosty response to the Baker Plan is a welcome return to more sober and more familiar banking practice. New financing, to be realistic, must come from the multilateral development banks, through increases to their capital bases. They are currently overextended in highly indebted countries (HIC's), trapped into becoming even more overextended (the World Bank especially) as the private sector retreats from the

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Third World.

His second idea is less hard-headed. He calls for a debt restructuring facility, suggesting that it would facilitate the development of secondary markets. We are not told how it would help their development, nor why they need any help: with 100% growth over the last one or two years, and a current volume of between $10 and $15 billion per anum, they appear to be doing a good job of valuing and processing debt. (Discussion of a DRF is actually in section III of the paper, where Mistry outlines the establishment of such an institution.)

II. Bilateral Development Financing Mistry surveys the flows of official development assistance (oda) since 1945, and concludes that while the U.S. was both moral leader and major contributor for the first twenty odd years, it has since let its oda budget be guided mainly by geopolitics and short-run U.S. economic interests (and the U.S. is not alone in this regard). Much of what qualifies as aid is really export subsidization. Mistry calls for "truth-in-packaging": a removal from the aid budget of items that are really in the short term economic interests of the donor. This, he argues, will help quell public disapproval of current aid levels -- which are lower than they appear. Mistry also calls for a moral commitment to the poorest LDC's; the U.S. should pay less attention to Asia and more to sub-Saharan Africa, where aid has not been commensurate with need.

III. Multilateral Development Financing A survey of the major multilateral institutions (World Bank, IMF, regional development banks, regional club institutions, UN system) begins with an endorsement of the basic idea of a World Bank, and of MacNamara, who unleashed the "latent powers" of the Bank. Mistry is less favorable about the multilateral development banks today, which have raised roughly $25 billion each of the last four years while actually extracting net transfers from LDC clients. The capacity of multilateral institutions to swallow resources without transferring them is one of the overarching concerns of this section.

Mistry is an advocate of regionalization and specialization of aid portfolios of governments and multilateral institutions. He favors regional zones of influence in bilateral aid (U.S. and Canada focussing on Latin America, Europe on Africa, and Japan and Australia on East Asia). He also suggests that the regional development banks increase their share of total multilateral aid from 25% to 50%. (He suggests that while the IADB and the AsDB could best benefit from more capital, the AfDB really needs technical assitance.)

Section IV: Private External Development Financing

The message of this section is that funding for growth must increasingly be generated internally, except in the poorest LDC's where this is entirely unrealistic. Mistry is never sanguine about the prospects for capital markets in middle and high income LDC's, but is insistent that the alternatives are not much better. We clearly cannot expect much presence from the private banking community, and too much energy has been wasted in high-profile and counter-productive attempts to increase foreign direct investment. The only major external players left are the multilateral development banks. Ways must be found to help these institutions deal with the debt crisis, which has temporarily derailed development. He argues for general capital increases for all the development banks, and a DRF to help spread the current portfolio risk across capital markets. In the long run, however, the greatest potential lies with the LDC's themselves.

Investment funds must come more from within, and will require the nurturing of capital markets (and portfolio investment). His central point is that we must find ways of improving both the levels and uses of savings in LDC's. Already 95% of development financing is generated from internal savings (with multilateral institutions contributing roughly 5%, although we are not given a source for this

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number). But even though the share of domestic financing may be high, its absolute level lies well below its potential. Too much of this investment has been public; the nurturing of capital markets will expand the investment pool. The task differs by country. In Asia, where savings rates are generally high, attention must be paid to more efficient investment and the development of long-term savings institutions (such as insurance companies and pension funds). Elsewhere, the task is to increase the levels of savings.

Mistry's ideas are interesting. Unfortunately his list of ways to encourage private financing does not focus on the development of internal funds, apart from the idea of tieing aid to encourage better levels and uses of internal finance. We might infer that Mistry is less comfortable on this turf, or he would have more to say. He briefly lists problems facing capital market development, but does not tackle them. Moreover, he overlooks one key problem, namely the particular dependence that capital markets have on the general economic health of the country. Still, he is realistic about the alternatives for development financng, and this section in particular is worth reading.

(Note : For a good summary of the paper, Mistry provides one himself at the end.)

FINANCING DEVELOPMENT IN THE 1990s
Percy S Mistry

I. INTRODUCTION

A Historical Digression.

1. Economic development has been financed, one way or another, since time began. The requisite resources have, in the main, been *internally* generated with cross-border *external* financing assuming importance after the era of colonization and discovery by European empires in the sixteenth century. Since then, upto the early twentieth century virtually all such financing was private. Public support for private initiative was limited to grant of sanction by sovereigns whose imperial treasuries grew adept in exacting a share of the spoils. [Their successors now grapple with the opposite problem, attempting to rein in the "transfer of real resources" from rich to poor countries which Bretton Woods adopted as a more reasonable goal for global prosperity and development]. No demands were therefore made on public exchequers in developed countries to finance less developed ones outside until after the emergence of the Bretton Woods regime. Till then, such tax revenues as were used to finance development derived principally from levies in overseas dominions themselves and mainly from excise levies on trade. The massive disruption of the world economy and its financial system between the two world wars created an aberrant situation in which government-to-government financing played a significant interim role only to collapse in the aftermath of recession. That period saw the US displacing Europe as the primary source of capital.

2. The Bretton Woods Agreement brought with it an unprecedented period of imagination, intellectual leadership, and institutional innovation in financing global development. It successfully introduced enlightened public intervention in global affairs with extraordinary results in the form of an explosion in world trade and sustained expansion of the global economy for nearly three decades. Post Bretton Woods turbulence has culminated in confusion with a weary treadmill effect exerting itself. In an era of contrary ideology, it has gone unnoticed that "development" prospered when the official financial system worked well. It came apart when the private sector got too heavily involved. What has transpired during the current decade raises some fundamental issues about the future of development financing. These issues are related, perversely enough, to the larger issue of growing disillusionment with public intervention.

3. This brief historical excursion underlines an important point i.e. that the post-Bretton Woods development financing regime, relying extensively on "official institutions" supported by public revenues, constitutes a sharp departure from practices which had evolved over the preceding two and a half centuries. It is perhaps because contemporary development financing through "foreign aid" is relatively young, somewhat forced and quite different from previous patterns of "natural evolution" that it has been dogged by controversy. That phenomenon is not, as often thought, the product of reactionary forces which have ushered in a number of conservative governments. It has been evident even in the most benign and liberal of times.

4. The winds of disaffection with public interventionism (which swept simultaneously through several developed countries) brought changes which exacerbated a crisis which had already been in the making where development finance was concerned. The quality of recent debate about the value of external development financing, for instance in the US during the first Reagan Administration, was impoverished immeasurably with ideological fervour and innate prejudice, reinforced by anecdotal evidence, replacing thoughtful argument and intellectual honesty. Sweeping remedial actions were

consequently based on biases falsely invoking "taxpayer concerns" rather than upon a reasoned assessment of needs and priorities. With more experience, and some embarassment at the wreckage wrought, awkward attempts at damage containment have been made by the second Reagan Administration. Unfortunately, they do not go far enough. Squeezed in a budget vice of its own making the Administration is now severely limited in room for maneuver.

5. The last 40-odd years have seen gross flows of about $600-700 billion (1985 dollars) funnelled from developed into developing countries through public vehicles and over $500 billion through private ones. A large proportion of the latter figure does not represent a resource transfer in the common sense of the term. It reflects an accummulation of capitalized interest obligations. Impressive though these total figures seem, they are hardly a commendable reflection on global achievement looked at in annualized terms. An aggregated forty year perspective obcures the immense changes which occurred over that period, especially the roller-coaster movements in the rates of growth in development finance (discussed in the paragraphs below). After a promising start, the gap between rich and poor countries is not narrowing, as intended, but widening -- at a disconcerting rate. How much of the aggregate amounts provided to finance development have been recycled back into donor countries without any "real transfer" being effected is not clear. It is unlikely that real net flows could have exceeded more than 35% of gross amounts from official sources; moreover, the last five years have seen <u>reverse</u> net flows totalling about $120 billion in debt service and a further $200 billion or so by way of capital flight.

6. The results of government-to- government largesse as well as purely commercial lending to developing countries (too much of which is wrongly counted as "assistance") have been found lacking by increasingly skeptical publics. Regrettably public perspectives are often warped by exaggerated perceptions of the amount of external financing actually provided to the Third World and of waste. Continual emphasis on sensationalizing failure and downplaying success in development has resulted in conditioning popular opinion, especially in the US, to view development assistance through a distorted lens. The general public is largely unaware that expenditure of the <u>aid</u> dollar has been scrutinized and evaluated more thoroughly than any other form of public expendi[illegible], often to wasteful and self-defeating excess. The challenge of the 1990s will be to revive and restore a wider public mandate in support of development assistance in the US as has already happened in Europe and Japan.

7. In that connection, three observations are striking. The *first* is that, Africa apart, foreign aid has constituted a relatively small proportion (on average less than 5%) of total resources applied to development. *Second,* overall progress in developing countries reflects better performance in the utilisation of resources, over a greatly compressed time span, than was the case in developed countries at a similar point in their evolution. *Third,* in comparison with any other type of public expenditure program, whether social security, defence, infrastructure development, space exploration etc. aid programs have generally been more honestly managed, productive and effective than others.

8. Although predominant for nearly three decades after Bretton Woods, the role of official agencies in financing development was dwarfed between 1974-81 by the forceful entry of private commercial institutions in the development financing arena. That era ended abruptly in 1982 leaving in its wake a legacy of development unwound. Multilateral and bilateral agencies are again being called upon once again to assume a larger more appropriate role in financing development. But they are being asked to do so with a debilitating shortage of resources in a radically changed environment of political and financial risk. Development in two out of three continents has been derailed by debt.

In too many countries, some about to cross the development threshold, a lethal combination of reckless borrowing, loose lending and poor economic management has resulted in economic implosion. In Africa, nature intervened to abet these same factors at a particularly unpropitious time.

9. The abrupt reversals of the 1980s have resulted in two decades of growth, saving, investment and steady gains in per capita living standards ~~have been~~ lost in large parts of the South. What remains is an intractably large portfolio of relatively poor quality which the next phase of "development financing" inherits as a starting point. With the exception of the Philippines, Asia has so far escaped these traumatic vicissitudes. But, misplaced pressure to graduate very low-income Asian countries -- especially India and China -- from concessional funds, forcing them to rely more heavily on private borrowing indicates that even tough lessons are not easily learnt.

10. In an ideological climate which equates "private" with good and "public" with ineffective, it seems to have escaped notice that this disastrous consequence has resulted from *private* banks displacing *official* intermediaries in providing the bulk of development finance in the 1970s. The private sector (in this instance, commercial banks) engaged in an inherently risky activity on an unprecedented scale. Its analysis of risk was inadequate and the necessary experience/expertise to undertake this type of lending in large magnitudes was missing. Those shortcomings were abetted by a negligent policy posture on the part of governments which did not do enough to support and enlarge the "official system's" capacity to play a balanced role in petro-dollar recycling. Since 1982 the world of development finance has lurched along, flashing every warning sign that foundation-shoring and change are urgently needed. These signs are being ignored. Dangerous symptoms are confronted by trenchant reluctance to treat them seriously. The notion that crisis prevention is better than cure has not yet permeated the consciousness of policy-makers bent on repeating past mistakes. Changing that mind-set is the principal challenge of the decade ahead.

What Lessons have been Learned?

11. It is clear that the challenges of development financing in the next decade will be hostage to what has already transpired. How well the "system" responds to them depends on how well it applies the lessons of the past. What does experience suggest? Perhaps the following:

a. Global security and stability demand that poor countries advance, one way or another. Retrogression, even for short periods, is in no one's interests. The issue therefore is whether the rich ones help, hinder or do nothing at all. Domestic savings already account for over 95% of development finance on average across all developing countries. In the 1990s that proportion may be increased but not by much; improvements will occur only at the margin. External assistance will therefore remain a crucial component of development financing at the margin.

b. Debate about the relative merits of "public agencies" versus the "private sector" as the principal vehicle for development financing is sterile. The choice is not a simple binary one. The experience of four decades indicates clearly that both are complementary and indispensable. Neither can substitute for the other (except when each strays into areas where the other has comparative advantage). Both have weaknesses and strengths. Institutional capacities of individual agents in both public and private systems have serious flaws which need to be remedied. The real issue is one of defining the respective roles and achieving an appropriate balance between public and private agencies in financing development.

c. Public development financing through multilateral and bilateral agencies has lost its way. Too many of these agencies have become inward-looking; concerned more about self-perpetuation at the expense of other agencies and their collective clientele. These tendencies reflect signs of tired middle age. They do not require the official system to be weakened or scrapped. What they demand is re-direction, rationalisation and reinvigoration. On the *multilateral* front, agencies have multiplied much too rapidly with overlapping, confused mandates and unclear division of labour. They compete wastefully for administrative and lending resources from a shrinking tureen ladled by too few donor countries. *Bilateral* agencies have had their efforts distracted and diverted by pressures to meet a diversity of domestic political, military and commercial interests, all of which impinge on each other in a confused and often contradictory manner.

d. In the business of development financing the clock simply cannot be turned back. The economic, financial, industrial, trade and security regimes which exist today are global, not national. Their "global nature" might be partial and imperfect. Sovereign governments might resent the implied loss of control. Domestic political imperatives might, anachronistically, demand a contrary pretense. Nonetheless, the risks and costs of being guided by narrow nationalistic perspectives are now too great at every level. The Third Worlds is too large a part of the global system to be ignored or treated peripherally by the First. Development finance is both a crucial mechanism and lubricant for better articulation between them.

e. The "developing" world is not a monolithic but increasingly diverse. Despite important individual differences among countries in the developing world, attitudes, policies, institutions and programs aimed at financing development continue to be influenced by a generalized view of the Third World shaped in the 1950s and changed little since. The challenge of the 1990s will be to recognize crucial differences in external financing needs and to shape tailored programs of assistance along with suitably diverse financial facilities.

f. The globe is being sliced, orange-like, into geographically distinct North-South blocs with: Latin America (and the Caribbean) becoming largely a US-Canadian concern; Africa, an European concern; and East Asia, a Japanese/Australian concern. Segmentation into zones of influence might be useful in shaping bilateral policy. It is distinctly detrimental either in establishing the priorities of, or in managing, the multilateral system.

Implications for the Future.

12. Distilling from these lessons of experience, the directions which recommend themselves for the next decade include the following :

a. Donor governments urgently need to explicate more clearly focussed objectives in providing "foreign aid" (especially bilateral) taking into account political, security and economic relationships between a particular donor country (most importantly the US -- simply because its own approach and priorities provides a benchmark for others) and countries in the developing world. No donor country however large can have a serious or practical development financing policy toward the "Third World" at large or even toward a large portion of it. Any attempt in that direction can only result in resource dissipation.

b. The continued dissipation of the three major *international financial and trade institutions* (The World Bank, the IMF, and GATT) needs to be swiftly reversed by strong collective action. Their institutional capabilities need to be restored; their global mandates made more distinct and clear. It is essential that the next US Administration and Congress acknowledge the clear interests of the US and its partners to have these institutions functioning well. Commitments by the major donor governments to strengthen these institutions must be linked to their further rationalisation and operating effectiveness.
[Note: The recent reorganization of the World Bank has become an unfortunate example of how not to do things. It demonstrated the need for decisive, experienced leadership along with fundamental change in internal attitudes. Multilateral institutions have become sclerotic. Bureaucratic preoccupations and management ineptitude have resulted in a serious loss of credibility and cynicism — not least with their own staff! It would be a tragedy if, when vested with renewed support and faith, these institutions proved unable to rise to the occasion].

c. Greater synergy needs to be achieved between public and private resources in financing development in the 1990s. The involvement of the private sector in providing debt and equity financing needs to be approached on a different, more durable basis than in the 1970s.
[Note: Efforts, on the part of multilateral and bilateral aid agencies, towards achieving such leverage between their own resources and those of the private sector in the 1980s have proven desultory. An effective *modus vivendi* remains elusive. Vehicles such as cofinancing have not realized the potential earlier anticipated. Experience with investment guarantee mechanisms may fare worse. Even the efforts of established institutions such as the International Finance Corporation (the World Bank's private sector appendage) have not achieved desired breakthroughs. IFC seems to be permanently inhibited by design flaws in its structure which need to be re-examined. Unfortunately these same flaws are now being replicated in other similar appendages to the regional banks. Completely new and different approaches will therefore need to be tried with the public agencies attempting to address the concerns, and compensate for the limitations, of the private sector rather than the opposite].

d. The "portfolio risk" of development financing needs to be spread more broadly than it is now, across many more long-term financial institutions operating in global capital markets.
[Note: The most debilitating characteristic of the Third World debt crisis (one which has severely impeded its earlier resolution) is not that the debt burden is so large but that *the risk of default is so heavily concentrated* in a few large money-center banks. That concentration initially threatened the stability of the entire global banking system. Today the systemic threat has receded. Foresightedness, prudent regulation and more conducive banking legislation, along with fortuitous movements in exchange rates, have resulted in the banking systems of continental Europe and Japan being virtually immunized against prospects of default by developing countries. But, the domestic banking systems of the US and UK remain vulnerable to sudden loss of equity capital should default occur. The stock market collapse of October 1987 notwithstanding, considerable scope exists to restructure present LDC debt at more realistic market values, to securitize it and to spread it out in capital markets to meet different yield/risk preferences of different investors. It is interesting in this regard to note that while outstanding LDC debt on their balance sheet amounts to nearly 80% of the equity capital of the major US banks it amounts to less than 7% of the total pool of savings available in world capital markets].

13. With the benefit of lessons learnt in hindsight, and a glimpse of the principles that should guide action in the future, the following sections deal in much greater detail with specific observations and recommendations on what might be done to bolster: (a) the bilateral financing system; (b) the multilateral system; (c) the role of the private sector; and (d) the involvement of the East Bloc in providing finance for development.

II. BILATERAL DEVELOPMENT FINANCING

Trends in Bilateral ODA 1950-86.

14. Large-scale official development assistance (ODA) began with the most original and successful government-to-government program of foreign aid yet devised -- the Marshall Plan. Between 1948-53, the US provided $13.6 billion (nominal dollars probably equivalent to well over $100 billion in 1985 dollars) in commodity grants to facilitate European reconstruction. Counterpart funds from commodity sales financed investments which enabled Europe to register a 40% increase in industrial production over those five years. Despite the Marshall Plan's success in engendering European recovery, and the predominance of the U.S. as the world's largest (and only) creditor, the Point Four program designed in 1951 for developing countries provided only technical assistance. Capital flows to these countries were left primarily for private sources to finance until 1957 when the US set up the Development Loan Fund (USAID's predecessor). Several European countries (the U.K., France and Germany being foremost) followed suit with bilateral ODA programs of their own. These programs expanded rapidly at first, stabilized in the 1960's and were joined at periodic intervals by the entry of new donors. As a result, step increases in ODA occurred at 5-year intervals up to 1980. Japanese entry into the donors club was the major event of the 1960's. The late 60s and early 70s saw smaller European donors and Canada emerge as significant donors swiftly followed by Arab-OPEC countries in the latter part of the decade when generous proportions of windfall gains from oil revenues were provided as official aid. The 1980s saw real declines in ODA for the first time since Bretton Woods.

15. Between **1950-65** total ODA (bilateral and multilateral) grew by 3% annually in real terms. Virtually all of that growth was in bilateral aid on concessional terms. Since then ODA growth has been characterized by several sharp movements in: (a) the amount of official assistance provided; (b) the proportionate shares of different donors; (c) the shares channelled through bilateral and multilateral sources; and (d) the proportionate share of concessional official assistance in total official flows. By **1965** total annual ODA provided by the 17 members of the Development Assistance Committee (DAC) had reached a level of about $6.5 billion. Of that amount $4.0 billion (over 60%) was provided by the U.S alone. Bilateral aid accounted for $4.5 billion. In 1965 Japan provided less than $245 million and Germany about $445 million in total ODA while France and the UK provided $752 million and $472 million respectively. Canada accounted for less than $100 million in that year. In 1965 only two OPEC donors had bilateral programs of any significance (Kuwait and Saudi Arabia) with total official (concessional) aid from these countries amounting to less than $350 million of which most was bilateral.

16. The next five years saw little change in the total DAC- ODA. Between **1965-1970** it rose to just under $7 billion with the bilateral share accounting for about $5.1 billion. But major shifts in relative donor contributions began to show. The amount provided by the US dropped sharply between 1965-70 to less than $3.2 billion in 1970. Japan and Germany increased their contributions to $460 million and $600 million respectively; France's ODA increased significantly to $970 million (although DOM/TOM contributions have invariably plagued assessments of France's 'real' ODA) while the UK's increased only marginally to $500 million. In these five years the dramatic increases occurred on the part of smaller donors. Canada, The Netherlands and the Nordic countries registered three-fold increases in ODA during this period while Italy's ODA doubled. Libya joined the Arab donor club with Arab ODA rising to just under $400 million in that year.

17. The **1970-75** period was, in sharp contrast, characterized by dramatic change. Total DAC-ODA nearly doubled (in current/nominal dollars of course) to just under $14 billion while total OPEC-ODA increased by over 15 times to $6.3 billion. Bilateral channels remained dominant but slipped in share, accounting for $10 billion of the total DAC-ODA flow and for $5.1 billion of OPEC-ODA. Again, however, the US' position as dominant DAC donor continued to slide in share. In dollar amounts its 1975 aid climbed back to just over the 1965 level ($4.16 billion) while almost all the other donors registered spectacular increases. Japanese ODA increased nearly threefold in these five years to $1.15 billion; Germany by about the same multiple to nearly $1.7 billion. France more than doubled its ODA level to $2.1 billion in 1975 and the UK just less than doubled its contribution to over $900 million. The smaller donors continued to outperform their larger counterparts with the Dutch contribution more than tripling and the Nordics actually quintupling their 1970 levels while Canada's increased around 2.6 times. In OPEC almost all members became donors by 1975 with the UAE emerging as the second largest in that group and Iran taking a prominent place.

18. Galloping inflation ate heavily into real values between **1975-1980** when DAC-ODA again doubled in nominal terms over this five-year period to nearly $27.3 billion with OPEC-ODA registering a near 50% increase to $9.6 billion. In this period the US' share of DAC-ODA kept declining although the rate of decline slowed somewhat. In 1980, US-ODA was over $7.1 billion (due to extraordinary lumpiness caused by a delay in the previous year's appropriations; a properly adjusted figure for the year would have been closer to $6 billion had 1979 not resulted in an unusual downward interruption). Through this period Japan again tripled its ODA to $3.35 billion while Germany more than doubled it to nearly $3.6 billion; as did France ($4.16 billion) and the UK ($1.9 billion). Collectively, the smaller donors also doubled their ODA levels during this period marking the emergence of some stability in the overall pattern of DAC burden-sharing. In OPEC, changes in the Iranian regime resulted in a sharp reversal with Iran's ODA contribution becoming negative. Kuwait reasserted itself as OPEC's second largest ODA donor. In 1980 DAC channelled about $18 billion dollars of ODA bilaterally and OPEC about $8 billion.

19. The halcyon decade of the 1970's came to an abrupt end in the 1980's. Between **1980-85** total ODA has fluctuated around the 1980 level in nominal dollars and has declined in real terms. *Whereas between 1950-65 it increased at a rate of about 5% annually in real terms and between 1970-80 at a real rate of about 5%, it fell at a real rate of around 2.5% annually in the current decade until 1986, when it finally revived.* The principal cause of the decline has been in OPEC-ODA which, due to falling oil revenues, was $3.5 billion in 1985 (less than half its 1980 level). DAC-ODA grew marginally in nominal terms to about $30 billion in 1985 (but increased sharply to $37 billion in 1986). In the 1980-85 period of stagnation, US'-ODA grew to $9.4 billion in 1985 while, the ODA contributions of all other DAC donors stagnated or fell substantially. The reversal of exchange rate parities in the 1980's accounted largely for the dollar

declines in the ODA contributions of non-US donors; in local currencies their aid efforts still registered substantial percentage increases. This, however, can be seen as a restoration of balance lost in the 1970's when a large part of the dollar increase in other donors' ODA through the 1970's was also derived from exchange rate movements in their favor rather than by their aid effort. Exchange rates have again reversed since 1985 and significant increases in DAC-ODA recovery through much higher non-US contributions are becoming apparent -- despite being constrained, as they usually are, by increasingly arcane and irrelevant "burdensharing" concerns. Stagnation in total ODA between 1980-85 has been accompanied by a shift in favor of bilateral ODA. About $27 billion in DAC-ODA was channelled bilaterally in 1986. There was also a drastic cut-back by OPEC sources in their contributions to multilateral agencies in that year.

The Current Situation and Its Impact on Recipients

20. Real declines in bilateral ODA in the 1980's (despite the exchange rate induced rise in 1986) constituted double-jeopardy for the low-income countries in Africa and, because of the need to divert more scarce resources in their direction, a further blow fell indirectly on low-income Asia as well. Impressive increases in the 1970's notwithstanding, bilateral ODA grew at a much slower rate than other sources of external capital; in particular, private flows (associated with the commodity boom) and non-concessional official financing both through export credit and multilateral agencies. These other sources of external capital have virtually dried up for low-income African countries. Although they have increased somewhat for the two creditworthy low-income Asian "giants", other smaller Asian low-income countries suffer from the African syndrome.

21. ODA flows are critical for the small, low-income countries of Africa and Asia (as they are for Haiti, Bolivia, the Caribbean islands and Guyana in the Western Hemisphere). In 1981-82 they accounted for 82% of the total net capital receipts of low-income countries and (along with NGO flows) for nearly 95% of such receipts in 1985. Bilateral ODA flows despite increasing dramatically in the aggregate through the 1970's had actually declined very rapidly as a proportion of total inflows for the low-income countries. Although the falling share of bilateral ODA in the 1970s was offset by increases in multilateral ODA to low-income countries, the 1980s saw retrenchment in multilateral ODA flows to these countries as well. *1986, however, has seen a very sharp reversal of these trends although the durability of this shift is somewhat uncertain. and depends very heavily on the US fulfilling its multilateral commitments.*

22. What does this trajectory of ODA effort and particularly of bilateral assistance suggest? What are the pointers for the future? Broadly, the following observations come to mind:

a. The dollar based indicator for measuring the relative ODA efforts of various DAC donors is not useful in detecting marginal shifts; only in discerning major directional changes. Nor does the indicator adequately reflect the extent to which ODA efforts respond to the impact of exchange rate movements on recipients' financing needs. At times of major exchange rate movements the dollar indicator invariably exaggerates or understates the relative efforts of dollar vs non-dollar donors.

b. In the 1950-70 period bilateral assistance (and total ODA) substituted to a large extent for the relative absence of private and non-concessional capital flows to developing countries. In the 1970s, however, ODA flows grew rapidly but yet at a much slower pace than other external flows. Strangely enough they seemed to become more misdirected by the influence of extraneous concerns, i.e.

factors other than those which would govern the financing sound economic development per se. That is to say, increasingly scarce concessional resources actually flowed away from low to high income recipients even though the latter could avail of other forms of financial flow, while the former could only do so at great jeopardy to their fragile economic structures.

c. In the 1980's ODA stagnated at precisely the time that other flows also declined or reversed. This coincidence exacerbated rather than compensated for the financing shortfalls of ODA recipients, especially low-income ones. In 1986 this situation changed abruptly.

d. Large fiscal deficits (experienced by almost all OECD/OPEC governments in the 1980s), the dramatic fall in oil revenues and the reversal of exchange rate parities between 1980-85 have combined to increase, rather than decrease, "pork-barrel" political pressures in the deployment of shrinking bilateral aid budgets (despite the attempt to maintain bilaterally controlled flows through offsetting reductions in multilateral contributions). As a result the basic humanitarian, poverty alleviation, capital formation objectives of bilateral aid programs have become secondary and later tertiary to political, military, commercial and special interest concerns.

e. Private voluntary flows in donor countries -- most of all the US -- are picking up to fill the moral void left by misdirected public programs. These flows focus on precisely the humanitarian, people-to-people concerns which seem to have disappeared from the vision of governments.

f. A number of small increasingly wealthy countries (in particular the Asian NICs: Singapore, Hong Kong and Taiwan) are <u>not</u> participating in the ODA system as did Finland, New Zealand and most recently Korea when they reached a similar stage of development.

23. Taken together, these observations support the hypothesis that *in the 1980s, the basic motivation for donors' ODA efforts -- with a few notable exceptions -- has shifted from being "demand driven" (i.e. recipient need focussed) to being "supply-influenced"*. The bilateral aid budget is now much more a reflection of uneasy compromises made in ill-disguised efforts to reconcile the interests of various domestic constituencies in donor countries who have their own self-centered reasons for keeping bilateral aid programs going. When these motivations result in resource misuse, the economic failures of recipients are bewailed instead as the main reason for the continuing failure of pot-pourri programs - thus resulting in widespread public pressure to reduce them further. Ignorance of cause, coupled with disinformation about effect has been more responsible for withering public support for aid in the US than any actual antipathy toward helping the less fortunate. Worse still, in potential donor countries the view that ODA/aid is a worthless pursuit has taken hold even before they have developed any experience with it.

24. The time for fundamental change is long overdue. If bilateral assistance in financing development is to be restored to earlier levels of utility and promise then a clear cut sense of priorities, along with a rigorously imposed "truth in packaging" self-discipline is urgently needed. Perhaps nowhere is a change in commitment and strategic approach more needed than in the US. Despite sustained relative diminution over the last 20 years -- from over 60% of the total DAC-ODA effort to less than 30% in 1986 --the US remains the world's single largest donor. It would be no exaggeration to assert that the sense of drift and purposelessness (in actually helping recipients) which has come to characterise bilateral assistance, is due in no small measure to the absence of a rudder in

the US bilateral assistance vessel.

25. The rest of the OECD world, for good or bad, still takes its cue from the US no matter how hard other donors -- the smaller ones in particular -- try to emphasise other priorities and more useful alternatives. But even the voice of these donors (the aid "beacons" in a directionless environment) is diluted when their limited programs reflect their own political and commercial biases just as much as those of the larger donors. When the US goes adrift it is impossible to expect the bilateral programs of the UK, France and OPEC to adopt sensible allocation criteria outside of political considerations and historical or commercial ties. What is remarkable is that in spite of much bilateral misdirection the programs of countries like Japan and Italy are taking a turn for thebetter in their orientation and in a reduction of their traditional proclivity for directing their bilateral aid programs towards immediate, related commercial gain.

26. In restoring both honesty and direction in US bilateral assistance it is not necessary to invent anything new. It would suffice for starters to return to the values and vision of the old -- perhaps with a little less unbridled optimism, a few more realistic assumptions and expectations, a mellow understanding of lessons learnt (in other words wisdom) and considerably greater patience in waiting for the fruits of success to materialise. Development financing is not an instantly gratifying activity. If the experience of the last 40 years has taught donors that development is not achieved simply by throwing money at it (an argument which never seems to apply as rigorously when it comes to value for money in other areas of public expenditure) the same experience is instructive in revealing that an absence of money does not help to achieve development either.

US Bilateral Aid - What is Wrong?

27. Before suggesting (in a later chapter) how it might be put right, it is perhaps useful to flag a few characteristics of why the US bilateral aid program seems to be adrift:

- o Stripped of security/military assistance and of other political aid, less than $2 billion out of a visible US foreign aid budget of $13 billion can really be considered "development financing" in any meaningful sense. That the US share of total DAC bilateral (and multilateral) ODA should have diminished gradually reflecting the ascendancy of other major world economies (in particular Europe and Japan) was only proper. That the US share was as high as 62% as late as 1965 was remarkable; that it should be as low as 29% in 1986 is totally unjustifiable.

- o As a percentage of donor GNP the US has fallen from the top in 1965, when its aid accounted for 0.58% of GNP to near the bottom of the OECD league in 1985 when the percentage was less than 0.21%. By comparison the average DAC ratio for all members was 0.48% in 1965 and 0.35% in 1985. It is a sad reflection of present day reality that in total burden-sharing to maintain a "global order" the US preference is to take on the defense expenditure burden rather than the aid expenditure burden -- which is only one-twentieth of the size of the former. [It should not, however, go unremarked that in bearing a "trade" burden (by way of more open access to its market for developing countries) the US has played a disproportionately larger role as well — this particular burden however, is one which the US will find increasingly unable to shoulder with the same domestic political tolerance as in the past].

- To make matters worse, even within a smaller than appropriate US-ODA envelope, the allocation of its bilateral aid is horribly skewed. About 40% of bilateral US aid goes to Egypt and Israel. A further 47% goes to middle-income developing countries in Latin America and Asia. Only 11% is allocated to low-income countries. In this particular respect, the US presents itself as by far the worst of all donors with its net bilateral flows to low-income countries having dropped from 0.26% of GNP in 1965 (or 45% of all its aid) to less than 0.03% in 1985.

- US bilateral assistance to the two largest low-income countries - India and China is negligible. In net terms, capital flows on bilateral account with India are now negative, with China they hardly exist.

- Apart from the Middle East (which increasingly includes Pakistan) most of the remaining US aid is concentrated regionally in Central and Latin America and in the Philippines (and to a lesser extent), Indonesia and Thailand. It has no significant presence relative to other donors in low-income Africa - clearly the region most desperately in need of concessional bilateral assistance. In other words the US bilateral aid program almost gives credence to the popular canard about the US' alleged proclivity for dealing only with despots, dictators and military regimes with right wing biases. Its bilateral aid program has shown a distressing inability to foster the democratic and humanitarian values which the US stands for.

- Assistance to low-income countries is heavily concentrated in food aid which helps the US perhaps more than it does recipient countries. US leadership in areas such as population, nutrition, health, education and sanitation has been replaced by an ideological emphasis on private sector development.

28. In short, after 1965 the US went badly wrong in its perspectives on bilateral assistance. Before then it did almost everything right setting standards for the world to emulate. Since then, a peculiar political dynamic assumed primacy. Whether the Vietnam experience bent America's mind out of shape in aid policy, would be an interesting but not very useful speculation. The points adumbrated above suggest that present trends in US bilateral assistance are not sustainable. They need to be altered by the incoming Administration in 1989 if the US is to regain international respect and credibility as a leader in development assistance. Grudging dependence of its client states hardly fits the US' image of itself as an aid donor. USAID certainly has the institutional capability to accomplish far more, with far greater effect, than the continual political constraints on it permit. That those capacities are being wasted is a grave loss to the US and to developing countries increasingly convinced of the need to shift their policies in directions which the US has been advocating so hard for so long.

29. The Task Force on Concessional Flows (TFCF) established the relatively unambitious target of trying to achieve real growth rates of 2-3% in concessional ODA flows throughout the next decade. It also recommended a redirection of flows towards low-income countries and restoration of better balance between the proportions of multilateral and bilateral assistance provided by donor countries. Total <u>bilateral</u> DAC-ODA in 1987 was around $28 billion in grants and concessional loans of which the US share was about $7.5 billion. The *development* component of that amount was barely $ 1.5 billion -- about 20% -- the rest being military, security and political support. The US' serious budget constraints argue for urgent improvement in the quantitative and qualitative dimensions of US bilateral aid although political influences have worked in the opposite direction. What is urgently needed is a reorientation of priorities. The incoming Administration should aim to double the "development" component of the bilateral aid

budget to about $3 billion in 1989. It should continue increasing that component to around $5 billion within four years with an ultimate target of 75% of the total bilateral aid budget by the new millenium. The overall bilateral aid budget should be permitted to grow at rates recommended by TFCF (2-3% real or 6-7% nominal) from around $8 billion in 1988 to $12 billion by 1995 (in nominal dollars). With these levels of growth the US share of total DAC-ODA is unlikely to rise in the first half of the next decade and its ODA/GNP ratios will remain abysmally low.

Officially Supported Bilateral Export Credits

30. Elements in aid budgets which aim primarily at achieving immediate commercial advantage for the donor rather than the recipient ought not to be classified as aid. This criticism is not meant to imply that such elements are inherently inappropriate. They clearly are not. What is inappropriate is the effort at disguising and misrepresenting as "development assistance" what is in effect an "export subsidy" to manufacturers or providers of services in donor countries. Apart from confusing the issue, this practice can result in diminishing broad public support for budgetary appropriations which transparently serve the interests of particular business groups in the donors' own economies in the short-run. Export credits have now become an essential element in the global trading regime. Insofar as competition among industrial countries to subsidise export sales lowers the overall financial cost of capital imports for developing countries export credits are helpful. But, they are not "aid" and should not be dressed as such. More often than not the financial subsidy is overriden by much higher prices of goods being exported than would have obtained if the goods were purchased through international competitive bidding so that the "aid" element of such export subsidies is quite difficult to justify.

31. From an average of under $8 billion in 1970-72 gross disbursements of export credits from all DAC countries reached a peak of over $36 billion in 1981 declined thereafter to less than $27 billion in 1985. In net disbursement terms the picture was even more telling; rising from a $2.8 billion average in 1970- 72, net credits peaked at $18.4 billion in 1981 then declined to $7 billion in 1986. During this period the officially funded component of net export credits was relatively stable, fluctuating from a low 1970-72 average of $0.8 billion to a peak of $2.7 billion in 1982 (declining to under $2.0 billion in 1985). Since 1980, however, the amount has varied in the $2.0 - 2.7 billion range. Much greater votability has been apparent in the privately funded component of net export credits which rose from a 1970-72 base of $1.9 billion to a peak of $15.0 billion in 1981 and fell off sharply to around $4 billion by 1985 and less than $2 billion in 1986.

32. As a percentage of net developing country external capital receipts, export credits were a remarkably stable 12-15% of the total between 1970-81 but then fell sharply to below 7% in 1985 and below 2.5% in 1986. The post-1981 decline (a direct reflection of the debt crisis) was caused both by sharp cuts in developing country investment programs as well as an even greater withdrawal by the main export credit agencies as a result of sudden high operating losses. The fall-off was particularly sharp for the low income African countries when disbursements of new MLT export credits dropped to $250 million in 1985 less than a fifth of the 1980 level. Although export credits were concentrated mainly in the more advanced, middle-to-high income developing countries (which until 1981 got over 60% of the total net flow) a surprisingly large (net) share -90% - now goes to low-income countries, mainly for project finance. These net figures, however, obscure the pattern of gross flows (owing to much larger repayments from middle-income countries) which in 1985 still showed middle-income countries getting 70% of gross export credit disbursements. In the 1980-85 crisis period however there is considerable evidence that short term export credits have been

used in an undiscriminating fashion and have tended to exacerbate rather than improve external liability management.

33. The 1979-83 period of recession for the industrial world saw increasing resort to "mixed credits". Larger amounts of bilateral aid were used in connection with export financing, a practice previously resorted to on any significant scale mainly by France. Data are crude but mixed credits were roughly "guesstimated" to have risen from less than $250 million in 1975 (mainly France) to $10-12 billion for 1981-83 with the amount of bilateral ODA diverted amounting to about 25-30% of the total. France accounted for 45% of the total, with a mercantilist government in the UK pushing its share up to 23%; Italy and Japan followed with 9% each. ODA diversion for commercial purposes has diminished the development impact of bilateral programs. It has focused aid on inappropriate capital and import intensive projects, in countries least able to afford their operating costs. Mixed credits have also resulted in shifting bilateral ODA away from low-income to high and middle-income developing countries where export opportunities are highest and competition among industrial countries the keenest.

34. The US posture of frowning on diverting scarce bilateral concessional funds toward associated export financing is entirely correct and needs to be maintained. But, quite apart from its "aid" budget and connected with the flow of market sourced funding to finance development the US should, through a reorientation of its existing Commerce and Trade budgets, focus more on developing and regaining export markets in developing countries. Two problems need to be overcome. First US banks are probably the worst-positioned among banks from industrial countries as a whole to take on more developing country credit risk. Therefore their proclivity to expand lending to support US exports to LDCs is constrained. Second, their external indebtedness situation compels those developing countries with which the US has traditionally had the strongest trade links, to export more to the US than import from it and thus exacerbate its trade deficit.

35. Nevertheless, the US' own troubled trade circumstances call for action to redress the situation in ways that are mutually beneficial to developing countries as well. The first step may well be to expand substantially the capital base of the US Exim Bank and, along with the other bureaus of the Commerce Department, to mount an aggressive export drive focussing primarily on creditworthy developing countries and MIC's -- primarily in Asia. In developing this regional export market (left by default to Japan and Europe) the US should focus on having the Exim Bank utilize sophisticated financing techniques in international capital markets rather than relying on domestic US banking sources for funding. Note issuance facilities (NIF's) and revolving underwriting facilities (RUFs) aimed at financing US exports to countries such as India, China, ASEAN (sans Philippines for now), Korea, Turkey could be undertaken using the liquidity available in Asian and Euro capital markets. Initially, securing the most competitive terms on such facilities may require full or partial US guarantees as a sweetener to increase the quality and marketability of these financial instruments in global secondary markets. Apart from capital market sources, negotiated arrangements with Japanese banks may also be possible to facilitate the financing of US exports to developing countries.

36. This effort is only likely to be sustainable, and developmentally worthwhile, if the US exports being financed are internationally competitive, price-wise. In achieving that goal the US might consider targetting specific export industries (Japanese style) and providing direct assistance to sharpen their export capabilities. By international standards these are pretty woeful, paradoxically in a nation known for its marketing abilities. Possibilities would (in addition to aviation and computer equipment) include telecommunications, composite materials, sophisticated road transportation equipment - areas in which the US might benefit from longer term market footholds. This effort focussed on East and South Asia alone with public funding for expanded Exim Bank

operations of around $1 billion in equity capital up front could result in expanding US exports to those markets by $10-20 billion per year by 1995.

37. In its traditional export markets of Latin America, US export losses and its ability to recover them, are related directly to unwinding the excessive burdens of chronic indebtedness. If the current debt strategy is pursued to its illogical limit there is little that can be done for anyone's mutual benefit in trade terms. The export market potential of this region, along with an increasingly urgent need to revive the US' export engine calls for more imaginative structural solutions to the debt crisis which would restore the creditworthiness and external purchasing power of heavily indebted countries much faster than might otherwise be the case. This issue is developed much further in the next section on multilateral financing.

III. MULTILATERAL DEVELOPMENT FINANCING

A Perspective.

38. Perhaps the most significant contribution of the Bretton Woods era will prove to be the advent of successful official multilateral financing of global development. The foundations for this remarkable, unprecedented enterprise, which imaginatively combined official capital support with enormous leverage capacity in mobilising market resources were laid in 1947. But, it was not until 1968 -- when the McNamara Presidency began at the World Bank -- that the latent power of the vehicles available was unleashed. Multilateral development financing is very much, therefore, a phenomenon of the last two decades.

39. The US was largely responsible for building the extant multilateral edifice. In recent years, it has been equally responsible for undermining it. Its actions seem to be borne out of a reactionary reflex that multilateral institutions are too large and out of its direct, unilateral control. The first Reagan Administration repeated, with greater enthusiasm, all the errors of the first Nixon Administration in its crude efforts to bring these institutions to heel. The second Reagan Administration has fortunately attempted to reverse and limit the damage. Its efforts may yet be too little, too late. Nevertheless both outgoing and incoming Administrations have a special responsibility for leading the effort to revitalize and redirect them.

40. Hopefully, they will attempt to do so as partners in a collective enterprise rather than as the dominant owner of concerns who, despite having taken them public, finds it difficult to surrender the prerogatives of unilateral control. Mindless negativism toward multilaterals characterised the 1981-84 regime at the US Treasury. It has been succeeded by more thoughtfulness and responsible action in redirecting multilaterals to better serve US interests. It would be a unique further evolutionary step if in the next Administration the thought were to take hold that these institutions can best serve US interests by serving global interests first; not the other way around.

41. The multilateral development financing system now embraces the following distinct components:

a. The **International Monetary Fund and the World Bank** (with its various affiliates); these Bretton-Woods twins still remain the centerpieces of the "system" and account for by far the bulk (over 70%) of the gross resources flows multilaterally intermediated; both ODA (concessional) and market-based.

b. The **Regional Development Banks** which include primarily the three World Bank clones in the African, Asian and Latin American regions but also include smaller sub-regional institutions.

c. The **regional club institutions** in which donors are confined to particular regions but recipients are not. The largest and most influential of those are the EDF and the EIB but also include the Arab, Islamic and OPEC based institutions.

d. The **UN-system** with its plethora of specialized institutions catering to special sectoral demands in population, child care, health, agriculture, industry, development programs, educational, scientific and cultural and so on. Related to this sub-system but not part of it are organizations such as the ILO and new hybrids such as IFAD which to avoid creating a specious "miscellaneous" category are inserted in here!

42. With rapid growth and institutional proliferation this four-pillared multilateral system has become somewhat confused. It is characterised by increasing problems of role definition, unclear mandates, unnecessary duplication of effort and a collective burden of egregiously high, yet escalating, administrative expenditures. At the same time the net transfers of real resources to developing countries actually taking place through these agencies have declined precipitiously and are turning negative. As lending institutions mature and their portfolios stabilize the proportion of net transfers relative to gross and net disbursements diminishes rapidly and eventually becomes negative when its borrowers reach a stage of development which no longer necessitates continued borrowing. But it is disconcerting that these institutions - particularly the World Bank - are no longer making positive net transfers at a time when their developing country members have been transferring, in net terms, real resources equivalent to an average of $25 billion annually to the private financial system of the industrial world for the last four years!

Past Growth and Performance

43. Between 1948-68 the multilateral system and the largest driving force in it -- The World Bank -- developed quite slowly. Over a twenty-year period (the first five of which were devoted largely to European reconstruction financing) the World Bank's gross lending had barely reached a level of $1 billion annually with net disbursements being under $400 million in 1970. Very few of the IMF's larger financial operations till then had a developing country focus either -- net IMF purchases by developing countries were $0.3 billion in 1970. The three regional development banks were nascent operators at the time, having been established only in the 1959-66 period. IDA, the World Bank's concessional window was established in 1960, with the IFC -- its private sector arm -- having come into being five years earlier. Their individual annual operating (commitment) levels had barely reached $400 million and $100 million respectively by the late 1960s. Resources flowing through the UN system and the European and OPEC funding mechanisms were also relatively small -- in the range of $200 million (disbursements) annually.

44. These nominally diminutive flows from the official multilateral system -- concessional and non-concessional -- provided less than 5% of net resource flows to developing countries in 1960 and less than 9% in 1970. By comparison, <u>total</u> official flows (mainly from bilateral sources) accounted for 65% of all net external capital flows to developing countries, in 1970, diminishing to 50% by 1960 (for the low-income countries the proportion was a much higher 78% in 1970).

45. The 1970s saw an explosion in multilateral financing of development. Its relatively tranquil, almost somnambulistic, rate of growth began to seem like an aberration. Of total net external resource receipts by developing countries, multilateral flows grew from $1.8 billion in 1970 (of which $1.1 billion was concessional) to $12.7 billion in 1980 ($7.8 billion concessional) and nearly $16 billion in 1985 (of which $7.0 billion was concessional). Over the same period net IMF purchases by developing countries grew from $0.3 billion in 1970 to $2.6 billion in 1980, peaking at $14 billion in 1985. Multilateral flows thus accounted for under 9% of total developing country receipts in 1970, nearly 13% in 1980 and over 20% in 1985.

46. Despite these comparatively phenomenal rates of increase, even multilateral financing was dwarfed by private flows to developing countries, especially in long-term commercial bank lending which grew from $3.0 billion in 1970 to $23 billion in 1980 and $36 billion in 1983. Over the same period, direct investment flows increased from $3.7 billion in 1970 to peak at $17.2 billion in 1981 before collapsing to $7.6 billion in 1985. [There has been an apparent revival in 1986 although its durability remains uncertain until new trends are more clearly established] These figures have to be judged against the highly inflationary circumstances of the 1970s and early 1980s. Seemingly large nominal growth rates hide the fact that real growth rates in resource flows to developing countries, although quite substantial, were much lower.

47. Although virtually every source of multilateral finance expanded rapidly in the 1970s and early 1980s none did so quite as fast as the World Bank and its affiliates. Net disbursements of IBRD and IDA grew from about $500 million in 1970 to over $7.5 billion in 1983 (and over $10 billion in 1986). Net transfers, however, have tapered off from a peak of just under $6 billion (IBRD and IDA) in 1984 to about $3 billion in 1986/7 (almost all transfers being from IDA with IBRD net transfers approaching zero). Between 1970-83, net disbursements (concessional and non-concessional) of: (a) the three major regional banks' grew from $300 million to about $2.5 billion; (b) the EEC and EIB from $200 million to $1.7 billion; (c) the UN system from $300 million to $2.6 billion (largely due to growth in the UNDP and WFP); and finally (d) the OPEC multilateral sources from zero to $300 million.

48. Since 1983 growth in almost all sources of multilateral finance levelled off or has declined substantially (e.g. OPEC) especially in net resource transfer terms. What was particularly noteworthy in the 1970-83 period was the substantial growth in multilateral flow of ODA (concessional finance) which increased in share of DAC donors' total ODA from less than 6% in 1965 to 15% in 1970-71 and 32% in 1977-78 before falling back to 28% in 1982-83 around where its share has since remained (largely due to the IDA 7 debacle).

The World Bank.

49. The World Bank and its affiliates represent the core of the multilateral system and constitute its largest part. [Note: The role of the International Monetary Fund (IMF) is explored at length in a later chapter]. Entering the 1990s the multilateral system is insufficiently equipped to meet the various demands being placed upon it. This is as true of the World Bank as of the other multilaterals. Its ability to finance global development in the 1990s is perhaps more vulnerable now than ever before to: (a) the financial strength of its non-concesional (IBRD) component, which though substantially bolstered by its recent General Capital Increase remains vulnerable to deteriorating portfolio quality ; and (b) to the uninterrupted availability of concessional funds (IDA and an increasing amount of associated concessional cofinancing).

50. As before, the World Bank approached the limits of lending capacity, before shareholder agreement was finally reached, early this year, to augment the Bank's capital base by about $75 billion. The case for a third GCI was first mooted in 1984 with the US holding out. It took over three years for the US to finally agree with other shareholders that such an increase was critically needed if the Bank's role as the most effective public intermediary between private capital markets and developing countries was not to be irreparably damaged. Had exchange rate movements not suddenly restrained the Bank's "headroom" for further lending, and had the Bank not been the only remaining vehicle for funding the Baker strategy of muddling on without any clear sense of destination, the US would probably have prevaricated even further.

51. The GCI solves only part of the problem that the Bank faces financially. The last four years have witnessed the Bank putting an increasing share of its portfolio at greater risk in the heavily indebted countries (HICs). As of March 31, 1988 over 55% of its total loans (disbursed and undisbursed) were accounted for by the HICs; these countries also accounted for just under 50% of its disbursed and outstanding portfolio. At the same time, both the number of countries and amounts in serious (even if not yet protracted) arrears to the Bank are growing at a worrying rate. This latter phenomenon was, till recently, unknown. With continued weakening of the net disbursement/net transfer role played by the Bank protracted arrears are likely to get worse in the near term before they get better.

52. Yet, with deteriorating portfolio quality and growing arrears (fortunately the problem of diminishing capital ratios is now past) the Bank is under pressure from the US Treasury to put out a larger quantity of funds to HICs at a faster rate each time a critical rescheduling is being negotiated or due payment date arrives. The amounts of money the Bank has put into these countries (particularly the big five debtors -- Argentina, Brazil, Mexico, Nigeria and the Philippines), places it on an increasingly untenable treadmill. Like commercial banks in previous years, the World Bank must now either keep lending larger and larger amounts to the HICs to pay itself back, or risk default along with permanent damage to its preferred creditor status and triple-A credit rating. When the Bank must keep lending to protect its own financial integrity, and indebted borrowers are increasingly aware that it must, there is little cause for borrowers to deliver on policy reform or anything else for that matter.

53. Expanded multilateral bank financing was one of the three crucial components in the Baker Plan with the World Bank assigned the largest role. It was provided unreservedly while the other two components did not materialize. As a result the Bank now finds itself alone trying to bridge the annual external financing shortfalls of debtor countries -- but in doing so it is building financial bridges to nowhere. The commercial banks are on a firm, unshakeable path toward reducing their outstanding portfolios in the HICs. The IMF too is being repaid more in principal and interest than it is recycling. Both these outcomes are possible largely because the Bank is still pumping money in. The question is -- how will the World Bank eventually be bailed out? Certainly not with the GCI -- which unfortunately is being seen even by the Bank's management as a panacea to a series of pressing financial problems. If a larger capital base is used as a springboard from which to increase financing to HICs further, without reductions in their other debt burdens, the GCI could prove detrimental, rather than advantageous, to the Bank in the long run.

The Need for a Debt Restructuring Facility.

54. The capital increase has improved the Bank's capital ratios and enables it to lend more. But, it will not serve to improve the quality of its loan portfolio unless an associated facility permits the Bank to engineer the restructuring and write-down of clearly impaired, non-performing commercial loans owed by its borrowers, thus improving their creditworthiness. It would have made more sense to split the $75 billion increase between incremental capital for the Bank (of about $50 billion) and used the remaining $25 billion to capitalize a highly geared Debt Restructuring Facility. Unless commercial debt can be wound down to tractable levels over the next 5-10 years, the Bank should definitely not be providing additional loans to HICs on its own balance sheet. It should instead provide restructuring facilities which permit the release of an equivalent (or greater) amount of usable resources for development through carefully engineered reductions in debt service and in outstanding debt. Without this approach not only will the Bank's ability to help HICs be impaired; it may not be able to do much for other borrowers either because of capital pre-emption and loss of credit-standing.

55. Calls for a solution to the Third World debt problem are converging on the creation of a Debt Restructuring Facility. Ideas along these lines have been put forward since 1983. They have been refined considerably along the way and have been presented recently, in sophisticated form by a major international bank. The urgency of moving beyond the Baker Plan is accepted almost universally, except by the US Treasury. It is clear that previous debt strategies have failed in one critical respect. While they have bought time for creditors to shore up their balance sheets, they have debilitated the economic capacity of debtor countries to a point where sustaining present approaches is no longer viable. The time bought for the financial system has not been as well used by the US banking community as it has by other banking systems. One key element in the Baker strategy, requiring commercial banks to keep lending funds to countries demonstrably unable to repay, has been missing from the outset. Consequently the second element i.e. swift adjustment in borrowing countries, has not materialized either primarily because programs have been grossly underfunded but also because after six years of debt fatigue the political will to keep inflicting pain on domestic populuations has withered.

56. Contrary to the views of US policy-makers, the reticence shown by commercial banks to get further enmired is entirely right and proper. No bank management can justify such an absurd course of action to its shareholders. Nor should it be asked to by any authority; particularly after three years of involuntary lending have only served to worsen the situation. The Administration's belated response is to acknowledge that debt reduction must now be an important consideration in future action on the debt front. Yet its prescriptions for achieving that goal are woefully weak and inadequate. Options and menus left entirely up to the private banks to experiment with are no substitute for a publicly funded special initiative to bolster the system where the market has clearly failed. The present state of paralysis seems unlikely to be resolved without a change in Administration and in the leadership of the US Treasury.

57. Nevertheless, it is not too soon to consider what needs to be done. The detailed outlines of a Debt Restructuring (DRF) and how it would work are provide in the accompanying Annex. Its essential features would comprise the following:

a. The DRF would employ the same concepts of "callable" leverage as are used in the capital bases of the MDBs.

b. It would in addition provide for much greater "statutory" leverage with a 10:1 gearing ratio for authorized capital to outstanding loans.

c. The DRF would not need to raise cash resources from the marketplace in the same way the MDBs do. Its operations would be confined to a "paper-exchange"; with the DRF "buying" a large portion of the syndicated loan claims of commercial banks against LDCs and "selling" to them instead its own DRF bonds -- long-term (20 years) with a bullet maturity and priced at a premium over the respective equivalent Treasury issues of countries in which the banks were domiciled.

d. The "purchase" of commercial bank loans would be at a negotiated market-based discount. This discount would be passed on to the borrowers by the DRF in its entirety.

e. In purchasing the claims of commercial creditors the DRF would, in turn, convert these claims into long-term (20-30 years) bonds, issued by indebted governments yielding a coupon rate sufficient to provide the DRF with an operating spread over the interest it had to pay on its own paper.

f. The DRF would clearly not attempt to take over all LDC debt presently held by commercial banks. It would offer to take up no more than 25-40% (a higher proportion in smaller debtors) of the total outstanding private debt of any one debtor. In doing so it would operate with (hopefully) improved policy reform/conditionality approaches and objectives adopted by the Bank (and Fund) to encourage adherence by borrowers to fiscal and monetary discipline in reducing their internal and external imbalances.

57. Reactions to this proposal (and its several recent variants) have ranged from the cautiously supportive (especially on the part of LDC authorities and European/Japanese bankers) to the strongly opposed, if not derisive (from the US). Objections range from the difficulty of adopting "grandiose" and "global" solutions using taxpayers' money in a constrained political environment to excessively belabored (and false) claims of difficulty with technical aspects. In fact the DRF is not any more "grandiose" a solution to the debt problem than a GCI -- it can easily be dealt with as part of a World Bank capitalization package. Nor is it a commercial bank bail-out. The banks are likely to take heavy write-downs which will need to be charged-off over time. Nor will a DRF prevent case-by-case problem solving; it will enhance it.

58. In that connection it should be noted that the present painful rescheduling negotiations are hardly unique to each situation as is often alleged; features negotiated in one deal invariably spill over to the next one. Moreover a properly functioning DRF is likely to support the development of wider, more efficient secondary markets in LDC paper. DRF bonds themselves, partially credit-enhanced as they are, will be marketable instruments. Depending on interest rate movements and improved growth prospects in HICs (resulting from a more durable solution to the debt drag), DRF bondholders may even realize capital gains on these instruments which could offset their initial discounted write-downs. Moreover the LDC bonds held by the DRF are more than likely, in many cases, to be attractive to investors at some point before maturity unless one simply writes-off any prospect of the more advanced HICs improving their circumstances over the next 20 years. If that were the case, additional lending in large amounts by the World Bank is hardly advisable!

59. Oppositon to the DRF proposal suggests that the real obstacle to a DRF is not disagreement about whether it is the appropriate solution but the absence of political will. There persists a dogged unwillingness to move away from a debt strategy to which the US Administration has committed itself -- even though the evidence is overwhelming that it

is not working, matters are getting worse and time is running out. A new Administration without the encumbrance of previous baggage may need to act on creating a DRF swiftly, before: (a) the onset of an increasingly likely global recession tips the debt crisis totally out of the control of extant abilities to contain it; and (b) such an eventuality seriously impairs the financial foundations of the World Bank and consequently of the official multilateral system.

Concessional Multilateral Finance (IDA).

60. In addition to expanding the capital base of IBRD, there remains continual doubt and concern about the flow of regular funding for IDA -- the Bank's concessional window. IDA remains the central pillar of multilateral ODA, accounting for nearly 40-50% of such flows. From a peak commitment level of over US$3.8 billion in 1980, IDA's commitments dropped sharply to $2.7 billion in 1982 and have averaged about $3.2 billion between 1983-87. Net IDA disbursements in the meantime have leveled off at just under $3 billion in the last 3 years. Since IDA6 was negotiated, the institution has been bedevilled by complex pro-rata burden sharing arrangements governing release of donor resources. Those arrangements have resulted in linking the commitment (not disbursement) capability of IDA to the vicissitudes of appropriations sanctioned by the US Congress. In doing so it has made IDA operations singularly vulnerable to domestic political influences which are of little relevance to its primary business.

61. The uncertainties and administrative difficulties caused by this linkage are, however, trivial when compared with the damage it has done, indirectly, to the integrity of IDA. Efforts to work around it have resulted in compromising the multilateral essence of IDA by necessitating successive "special arrangements" (first the Special Fund, then the FY84 Account, then the Special Facility for Africa). Such arrangements have undoubtedly helped in loosening the purse-strings of other donors and capturing budgetary resources which were available but which other donors were unwilling to provide directly to IDA because of anachronistic preoccupation with arcane, irrelevant principles of burdensharing, whose application has been invariably vitiated by movements in exchange rates. Unfortunately, such "special" arrangements have become a feature of every replenishment since IDA5.

62. It was perhaps in dealing with the legislative schedule for obtaining IDA6 appropriations that the most damage was inflicted on multilateralism by the first Reagan Administration. The devastating impact of its lack of concern for honoring IDA6 obligations on the schedule negotiated by the previous US Administration was compounded by its obdurate stance in negotiating an IDA-7 replenishment which was far too low (from any vantage point one chooses to take). Appeals to the White House from the State Department and the National Security Council, not to mention European and major Third World Heads of State, urging reconsideration of the Treasury's indefensible hard-line were unthinkingly disregarded.

63. The second Reagan Administration has attempted to undo some of the earlier damage with support for a much larger IDA8 replenishment -- $12.4 billion instead of the $9 billion for IDA-7. The irony is that exchange rate reversals have resulted in <u>annual SDR commitments</u> for IDA-8 (SDRs are IDA's unit of account) below those for IDA-7. Fortunately, despite the US' present budgetary constraints, Congress has appropriated nearly the full amount of appropriations for IDA8 in the current fiscal year. It must continue to do so. If it does not, appropriations wrangles over IDA8 could again result in derailing IDA with the same problems as occurred for IDA6.

64. A new Administration must grapple immediately with putting in place a framework for negotiating the next (IDA9) replenishment. Its basic policy commitment should be toward increasing (by 3%) annual IDA flows in real terms, which would imply supporting an annual average level of around SDR 4 billion per annum. Moreover the Administration should insist on a replenishment period for its entire tenure to avoid continual replenishment appropriation battles during its life. This would imply an IDA9 replenishment of SDR 16 billion for the *four-year* period between 1989-92. Instead of equal annual commitment levels, these should be tapered upwards (from say a level of SDR 3.5 billion in 1989 rising to SDR 5 billion in 1992). Such a commitment profile would avoid sharp increases in appropriation levels (as occurred between IDA5 and IDA6 and again between IDA7 and IDA8) of the kind which fostered earlier Congressional resistance.

The Regional Development Banks

65. Comprising mainly the African, Asian and Inter-American Development Banks, the Regionals also include smaller sub-regional institutions such as the Caribbean and South Pacific development banking institutions. While the former (large regionals) have grown in (relative rather than absolute) competence and strength, the latter (sub-regionals) have been weakened and brought to the verge of insolvency. Modeled as World Bank clones these institutions -- especially the big three -- have developed distinct personalities and characteristics. Their growing financial capacity and relative operational competence (especially in the case of IADB and ASDB) raises a fundamental question for the future *i.e. what is the appropriate division of labor between these banks and the World Bank in their respective regions through the 1990s and beyond?* To the extent that they differ significantly from the World Bank, it is mainly in the politics of internal decision-making. Those politics, in recent times, have certainly impeded the course of smooth institutional growth and development, nowhere more so than in the case of the Inter-American Development Bank. In this instance, a critical needed Capital Increase has been long-delayed because of the unwillingness of borrowing regionals to concede de facto veto powers the the US on the Bank's lending decisions.

66. Together the three large regionals account for a larger volume of net nonconcessional transfers than the World Bank (IBRD) at the present time (about $1.4 billion vs zero) although their combined concessional transfers are at about half the level of IDA's (i.e. $1.5 billion vs $3.0 billion). They are significant sources of net funding for developing countries at the present time. However, they too are likely to provide diminishing net transfers or, as in the case of IADB, negative net transfers because artifical constraints on their capital have reduced levels of commitment well below levels which reflect genuine borrower demand for long-term development financing. At the present they are also considerably cheaper sources of finance than the World Bank. They enjoy the same credit standing as the World Bank on capital markets but are likely to suffer a downgrading if the World Bank's credit standing is affected, regardless of differences in their individual financial circumstances.

67. In that sense (despite strenuous attempts on their part to develop distinct, separate identities) these institutions constitute a linked MDB network as far as both borrowers and financial markets are concerned. That they remain separate identities is helpful both in raising private capital from global markets and in sharing portfolio risk. With increasingly shaky management capabilities being exhibited throughout the system, it is wise to continue spreading decision-making responsibilities across separate MDB managements rather than concentrate it monolithically. Moreover, opportunities must continue to be provided for different institutions to be receptive to and experiment with different ideas and approaches to development financing -- especially in regions with

substantially different characteristics and needs. From the borrowers' viewpoints, the regional banks, while generally considered less technically proficient in an all-round sense than the World Bank, are regarded as being easier to deal with and far more sympathetically attuned to borrower needs.

68. In the 1990s the regionals should be encouraged by the donor community -- and particularly by the U.S. which plays perhaps the single most significant role in shaping the policies and directions of all these institutions -- to develop a larger role relative to the World Bank (i.e. their commitment levels should be permited to expand at a faster rate) and a more distinct flavor in their operational orientation. Instead of operating at levels of around 25% of World Bank lending levels the Asian and Inter-American banks should be lending at about half the levels of the World Bank by the mid-1990s; the African bank's pace of growth will continue to be restricted by the pace of development of its internal lending and management capabilities.

69. The first order of business for the US -- to shore up the foundations for multilateral financing -- is to secure Congressional authorization for the IBRD's next GCI and, concomitantly, to establish a Debt Restructuring Facility. When that is done (and it may well fall upon the next Administration to steer these two difficult issues through Congress) the agenda for the donor community and the US in the 1990s should turn toward strengthening the regional institutions. That agenda should be focused on the following:

a. For the IADB: Revive and complete negotiations for a capital increase with a substantially augmented FSO component to finance development in the Caribbean, Central America and Bolivia; expand IADB's role in regional capital markets; foster a more symbiotic relationship with the Carribbean Development Bank; and, finally, abolish the separate private sector affiliate of the IADB, creating instead a third window within the institution which would enable it to make equity investments and commercially oriented loans.

b. For the AsDB: Increase the capital base of the Asian Development Bank again in the mid-1990s and negotiate the next AsDF replenishment at a level of about $6-8 billion to enlarge and shift the focus of concessional financing for low-income Asia through AsDF rather than IDA; encourage the AsDB to play a more aggressive role in mobilizing resources from regional capital markets in Asia and Australia and to bring about greater linkage between these markets and the domestic markets of the larger, more advanced Asian countries; at the same time, permit Japan to overtake the US in assuming the single largest shareholding of AsDB and to provide a substantially larger share of AsDF and AsDB capital funding; finally, thought might also be given to relocating AsDB in a less vulnerable environment, possibly in a non-borrowing member country with a developed capital market in order to attract and retain high caliber staff.

c. For the AfDB: Concentrate on building up, with help from IBRD and EIB, the technical and broader institutional capacities of the AfDB before considering further expansion of its resources. Focus on key sectors in which AfDB might develop a comparative advantage in project lending over the next 5-10 years.

d. Aim to double, in real terms, present levels of net disbursements (concessional and non-concessional) to borrowing countries from the three regional institutions by the end of the next decade

Other Regional Institutions

70. In addition to the major regional MDBs, in all which the US has a vital and constructive role, there are a number of "regionals" defined by the composition of the donors rather than by the location of borrowers. The largest and most influential of those is the European regional system (in which the US plays no part) whose financial capacity and contribution -- especially in Africa -- far outstrip its institutional strength. The main pillars of the European system comprise the (concessional) European Development Fund (EDF) -- which is now a large provider of concessional funds to Africa than IDA -- and the European Investment Bank (nonconcessional) whose development financing activities remain peripheral to its main task of financing industrial and infrastructural investment within the European Community.

71. Both these institutions could (and should) be encouraged to play a more closely interlinked role with the multilateral system especially with the World Bank and the African Development Bank. The EDF could significantly augment its own effectiveness and leverage in Africa and other Lome convention countries by such association as could the EIB in North Africa, the Middle East and Eastern Europe. It should be a matter of priority for the US to leverage its own scarce bilateral and multilateral contributions to the maximum extent possible by having the multilaterals it supports engage these European institutions in a much closer working relationship in these three specific regions. The nexus of relationships, however, requires the US to experiment with adopting a posture with which it has little familiarity i.e. that of a junior partner, with the Europeans and the multilaterals taking the lead -- a relationship which might gradually evolve in Asia as well with Japan being encouraged to assume a more appropriate leadership posture. If the US is to tailor its role in keeping with its reduced resource circumstances it has little choice but to adapt its political profile (especially in institutions and regions where other OECD partners have greater financial capability and commitment) in commensurate fashion.

72. The other significant source of regional funding comprises Arab OPEC states which are principal shareholders of several sub-regional development financing institutions in the Middle East and North Africa (e.g. the Arab Fund for Economic Development, the Islamic Development Bank, BADEA, etc.) These institutions have waned somewhat in the 1980s as petrodollar revenues have declined and their sponsors have correspondingly reduced levels of capital support. That unfortunate (and unnecessary) eventuality has imperiled institutions which have developed considerable potential and whose participation in development financing -- especially in a troubled region -- can make a crucial difference. These institutions need to be refueled and their capacities strengthened gradually instead of being totally vulnerable to movements in spot oil prices. As with the US, the issue for Arab donors is less one of affordability than of priority. Even in their significantly reduced circumstances they can easily afford to maintain capital support for these institutions without the precipitous declines witnessed over the last five years.

73. The US agenda as far as these particular institutions and their sponsors (over whom it retains significant leverage) are concerned should be to convince them to maintain past levels of capital support as part of the contribution which oil (and by now liquid asset) rich Gulf states make toward the maintenance of a secure, prosperous global system. These states benefit greatly from the existence of such a system. It is in their interest to help defray the various costs of maintaining and strengthening it in whatever way they can. Protestations of Arab donors that their aid programs are pure generosity (and cannot therefore be taken for granted) because unlike other donors they derive no procurement benefits from their ODA need to be rebutted and put to rest permanently.

These "holier than thou" invocations have litle justification in fact given the significant amounts of financing needed by developing countries to pay for oil imports and the egeregious overall imbalances in payments between oil-rich states and the developing world, even with reduced oil prices!

74. If politically-driven OPEC aid to countries in the Middle Eastern region -- which, as observed earlier, in the view of Arab donors is an essential response to misdirection of a large part of US ODA -- is excluded, the ODA contributions of Arab donors flowing to developing countries outside the Middle East are relatively low. US and OECD policy should be aimed at exerting political leverage in restoring OPEC-ODA levels to somewhere between the peak levels of 1980-81 and the current desultory ones. It should also aim at redirecting a greater proportion of OPEC-ODA through multilateral channels and toward lower-income countries. Clearly none of this can be done credibly without: (a) significant changes in the US' own foreign assistance policies and priorities; and (b) its voice being supported by other major donors -- European and Japanese.

The UN System

75. A substantial number of UN and independent specialized agencies are engaged peripherally or directly in the business of providing external finance for development or emergency relief -- almost always on grant terms. The more easily recognizable ones play a large and extremely useful role in their respective sectors of specialization; these include UNDP, UNFPA, UNICEF, UNESCO, ILO, WFP, WHO, FAO, UNIDO, UNCTAD to name but a few. From a net disbursement level of less than $400 million in 1970, UN agency-channelled assistance rose to nearly $2.7 billion in 1983 and $ 3.3 billion in 1987.

76. The vast array of agencies in the UN system leads to neither efficiency nor effectiveness in providing external development finance. Institutional proliferation imposes a serious budgetary burden on donors, too much of which goes into defraying unnecessarily duplicated administrative costs. It imposes an equally onerous burden on the overstretched administrative capabilities of recipient governments in dealing with so many agencies as well. At the risk of oversimplification one possibility that should be considered in the 1990s is for institutions within the UN system dealing with development assistance to be rationalized into three specialized organizations with separate, streamlined administrative structures. The detailed specifications for such reform are spelt out in a later chapter. If a successful program of rationalization and administrative reform were undertaken, budget support should be maintained by the US and other contributors at current levels in real terms resulting in net levels of assistance flowing from the UN system should increasing in the 1990s from around $4 billion at the beginning of the decade to around $6 billion (in constant dollars) by its end.

77. Once institutional rationalization and better directed focus is achieved UN agencies should consider ways in which the more advanced developing countries, while remaining recipients of higher level technology and assistance can become significant contributors in providing development assistance (primarily technical) to poorer countries especially in Sub-Saharan Africa and low-income Asia. Providing the US and other OECD countries are willing to exert sufficient muscle to overcome the initial hostility and resistance of other blocs there is no good reason why such an outcome should remain elusive for too long.

78. Finally, outside the UN-system but not slotting neatly into any other categories, the future of newly created institutions such as IFAD -- intended to provide a model for cooperation between OECD and OPEC donors -- which have run into serious

funding needs to be urgently reconsidered. In the circumstances of the 1990s it is difficult to see the raison d'etre for separate institutions such as these being perpetuated. A model experimented with in good faith has not worked out very well. It is time, therefore, to ask whether IFAD should not be unwound as a separate institution and its financial obligations/claims folded into either IDA or into the FAO structure.

IV. PRIVATE EXTERNAL DEVELOPMENT FINANCING

External Financing from Market Sources:

79. From a relatively low-profile in the 1950s and 1960s external development financing from private market sources took a quantum leap in the 1970s. The entry of global commercial banks as major financiers of development especially in the middle-income developing countries, whose creditowrthiness and prospects seemed at the time to be almost unlimited. It has since collapsed in the 1980s with the onset of the debt crisis. Significant shifts have also occurred in the nature of financing provided by private sources over the last four decades. The emphasis was almost exclusively on direct foreign (equity) investment (DFI) between 1950-69. In those two formative decades there was relatively little commercial debt financing (except for short-term trade financing or privately funded export credits) at the time. In the 1970s the "syndicated Eurocurrency loan" dominated as the primary vehicle for development financing from commercial sources. DFI increased substantially in nominal dollar terms during the same decade, but its value in real terms, and its proportionate share in financing development, declined dramatically. In the 1980's private flows from all sources (except voluntary sources, discussed later) have declined very sharply. The signs now emerging suggest clearly that capital markets are likely to play a much larger role than commercial banks in providing both debt and equity (i.e. portfolio rather than direct) flows to developing countries in the 1990s. In short, one full cycle has been turned in the last forty years with capital markets reemerging as the dominant force in development financing.

80. The foregoing chronology is a bit misleading in one important respect. It obscures the crucial *indirect financing* role that private capital markets have played throughout the last four decades (and the last two in particular). It is often overlooked that private capital markets have providing the <u>liquidity</u> (i.e. the actual money) for financing development under cover of the <u>security</u> provided by the major multilateral development banks. These institutions raise between 80-95% of their non-concessional lendable resources from private capital markets (in 1986-87 gross borrowings of the four MDBs amounted to over $25 billion in global capital markets although net borrowings probably amounted to less than $12 billion) against the guarantee of their paid-in and callable capital. Between 1960-87, a crude estimate of *gross amounts* provided by private bond markets to the MDBs would be about $100 billion current dollars. This would amount to nearly $200 billion in 1985 equivalent dollars. [Note: These and other developments have been cogently described and carefully analysed in the World Bank's 1985 World Development Report entitled "International Capital and Economic Development"].

81. A quick reprise of the relative and absolute role played by private sources in financing development is captured in numbers below:

a. **1950-69**: External financing for development was dominated by official aid flow channeled bilaterally by larger donors -- primarily the U.S. Official ODA grew at a real rate of around 3% from less than $500 million in the early 1950s to $6.5 billion in 1965. It accounted for nearly 60% of total net flows. In that period, commercial lending was confined exclusively to short-term trade credits averaging perhaps less than $300 million in outstandings at any time up to 1965. In net terms such lending accounted for about 2% of total flows to developing countries in 1960 with that share increasing to 15% by 1969 when bank lending amounted to nearly $3 billion. Total DFI in all developing countries averaged around $500 million annually in the late 1950s and about $800 million in the early 1960s, rising to $1.2 billion annually in 1965-69. It accounted for 23% of total net flows to developing countries in 1960 but less than 17% in 1970.

b. **1970-79**: The share of ODA in total net flows to LDCs declined to about 45% in 1970 and to 40% in 1979 although the dollar volume rose from $7 billion to $32 billion. Non-concessional ODF however increased to 5% in 1970 and 11% of the total in 1979 ($11 billion). In this period commercial bank (long-term) lending expanded dramatically in volume (from $3 billion to $23 billion) and share (from 15% to 22% in 1980) in net flows. Gross flows of commercial bank lending, however, showed an even more remarkable rise with annual syndicated Eurocurrency credits to developing countries rising for instance, from less than $1 billion in 1970 to $49 billion in 1979/80. In this decade DFI diminished, in proportionate terms, even further from 17% of net flows in 1970 to barely 8% in 1980 despite the fact that it averaged $2.8 billion annually between 1970-74 and $6.6 billion between 1975-79. This increase in nominal values notwithstanding DFI hardly grew in real terms at all; more than 50% of the incremental DFI was in the form of reinvested earnings rather than new cross-border flows. As noted earlier, in tandem with commercial bank lending, export credits grew from less than $3.0 billion annually in 1970 (net) to $17 billion in 1980 with the share of such credits in total net flows rising from 5% to over 13% in the decade. Total net resource flows to developing countries during this decade grew five-fold from less than $20 billion in 1970 to over $100 billion in 1979, $128 billion in 1980 (and $140 billion in 1981).

c. **1980-86**: 1981 saw the end of the financial flow boom for developing countries. Since then there has been a dramatic and sustained decline in all financial flows to developing countries. In nominal dollars, total net flows to developing countries recovered marginally from a 1985 nadir to $84.7 billion in 1986. In real terms, however, this increase was illusory. Adjusted (to 1985 dollars) for prices and exchange rates, OECD estimates suggest that total flows to developing countries continued to decline from $82.3 billion in 1985 to an equivalent $69.7 billion in 1986. DAC-ODA flows showed a sharp nominal increase but only a marginal improvement in real, exchange-adjusted terms. *Total* ODA continued to suffer a real decline. Whether the DAC-ODA figures portends a sustainable change in trend remains to be seen. From a level of $37.2 billion in 1981 (under 27% of total net flows) ODA, after declining to $33.4 billion in 1983 (when it accounted for 34% of net flows) has risen to $44.1 billion in 1986 (or over 52% of total net flows to developing countries). In the same period long-term and short-term commercial bank lending has declined from a peak of $52 billion in 1981 (over a 37% share) to barely $5 billion (long and short term) in 1986 (or under 6% of total net flows). Export credits too have collapsed in net terms as indicated earlier while DFI has stagnated and later declined from an average of $13 billion in 1981-83 to $10 billion in 1984-86. International bond lending, however, has recovered somewhat. From negligible levels developing countries issued bonds for $1.5 billion in 1980/81 rising to $5 billion in 1982, collapsing completely thereafter to below an average of $1 billion for 1983/84 before recovering to an average $3.7 billion for 1985/86.

82. These overall changes need to be viewed carefully in the context of five key factors: (a) the uncertain financial conditions which prevail in global equity markets after the crash of October 1987; (b) the persistent fragility of the US banking system's aggregate balance sheet despite massively increased loan loss provisions on LDC debt portfolios; (c) the growing and urgent problem of the US' own indebtedness (both internal and external) with accompanying uncertainty about exchange and interest rates; and (d) the pressures on multinational direct investors in an increasingly uncertain environment where attention is focussed on acquisition and merger activity within the developed world. Under these circumstances, it is dangerous and irresponsible to gamble on maintaining minimum desired levels of net external resource flows to developing countries largely through private market sources in the immediate future; especially if such reliance is in the absence of public underpinning for the security of such flows.

83. Present capital market conditions are likely to persist into the early 1990s. The US private financial sector at large is neither financially inclined nor sufficiently motivated to assume the risks either of net additional lending to, or large incremental equity investments in, the Third World. Particularly so when domestic economic circumstances and confidence are uncertain and the US' own demands on its own and other capital markets are straining their capacities.

Implications for Private Solutions to the Debt Problem.

84. These realities have profound implications which argue for a change in the debt strategy being adhered to by the US Treasury. One of the key design flaws in constructing the Baker Plan was ill-considered reliance on further lending by the commercial banking system. Already at grave risk, it was still expected to "do its part" in reversing negative net transfers through substantially enlarged relending. From a banking point of view that would have been neither wise nor desirable in protecting the interests of shareholders, depositors or indeed developing country borrowers. That commercial banks did not respond with money or enthusiasm was a much belated sign of good sense returning in the wake of prudence abandoned. Bankers saw clearly what policy-makers refused to acknowledge -- i.e. that this was no longer a problem of liquidity but of more fundamental structural proportions.

85. Furthermore, it makes little sense to keep LDC portfolio risk concentrated in the banking system. Indeed the extant risks of residual LDC debt balances held by commercial banks need to be diffused more widely through the financial system i.e. in capital markets at large, through a process of discounting and securitization in the form of more amenable and tractable financial instruments. The task of shifting the risk of 30-50% of the outstanding stock of LDC debt on to capital markets (about the proportion which should be shifted over the next five years) is likely to pre-empt and dampen the enthusiasm of the market place to add significantly to present LDC indebtedness with new flows. At the margin, there will always be some appetite for taking on the risk of new LDC credits which are not considered overborrowed. But a wounded marketplace is showing signs of wariness; even for Indian, Chinese and Korean paper at the present time. Institutions willing to take on more creditworthy LDC paper will most likely do so after unloading their less creditworthy LDC loan assets.

86. The dilemma confronting the international community is to reconcile the conflicting objectives of: (a) private creditors intent on receiving interest payments whilst reducing extant exposure; and (b) debtor countries striving to stem and reverse massive outward transfer of resources from their own economies so that internal investment and growth can be revived. *After five years of negative net transfers it is painfully clear that the key objective for the development financing community must now be to again achieve positive net transfers of resources to developing countries through the next decade.* This can no longer be achieved prudently through additional lending to highly indebted countries -- either from the commercial or official multilateral banking systems. The only choice open, as observed earlier, is to restructure outstanding levels of debt in a manner which enables positive net transfers to be achieved through significant reductions of debt service and of outstanding levels of debt.

87. Reducing presently unmanageable levels of Third World Debt will involve both: (a) the financial engineering approaches being tried out in converting debt into equity with a view to recapturing lost asset value as some future date; and (b) more structured approaches to reducing contractual obligations to reflect more realistic market determined values of these risky assets. The former approach alone (e.g. an expanded "menu" of options and exit bonds) is unlikely to make more than an insignificant dent in the overall problem; especially when the "problem" keeps growing at the inexorable rate of $80-100 billion each year (as the difference between "contractually obligated" and "actually paid" debt service is added relentlessly to the outstanding amount).

88. Therefore, the first conclusion emerging from a quick analysis of trends is that some form of debt restructuring is a sine qua non for stabilizing the regime of private external financing for development. Second, at least through the first half of the 1990s, privately sourced capital must be backstopped by the callable capital guarantees of the larger multilateral institutions. Their capital ratios need to be strengthened and their activities carefully redirected to avert a sudden escalation of portfolio risk in countries caused by lending for purposes which these institutions are not presently well equipped to handle. Substantial capital increases for the World Bank, and in quick succession for the other MDBs, need to be negotiated to expand their ability to intermediate market resources and to avert these institutions getting themselves into significant negative net disbursements and net transfer situations with their borrowers collectively. Third, the strident emphasis on restoring DFI (i.e. equity investment) to levels of the 1960s and beyond needs to be muted because it is achieving an effect opposite to intent.

89. There is clearly much greater scope for expanded DFI through debt conversion than is presently being exploited. However, that process is unlikely to bring <u>additional</u> foreign investment flows. In fact, it may even detract from additionality. Nonetheless, structured properly, such conversions will release resources currently devoted to debt service. The scope for such conversion is limited in the case of <u>direct</u> foreign investment. There is definitely much more scope for applying debt-equity conversions to <u>portfolio</u> foreign investment in developing countries. But even in this respect there are limiting constraints which cannot be overlooked or wished away.

90. These include, inter alia: (a) the relative backwardness, inefficiency and small size of local capital markets (at least compared to what the international investor is accustomed to trading in global market centers); (b) the ease with which these markets can be manipulated by a few large individual or institutional players; (c) the paucity of good, well-run publicly listed companies which would warrant capital market listing; and (d) the adjustment pressures being exerted on indebted countries, by official agencies, to keep devaluing their currencies.

91. More concentrated effort in capital market development and more efficient linkage to regional markets will alleviate these constraints but, not in the short term. For instance, the behavior of authorities in regulating the Hong Kong market during the recent crash as well as market collapses in Mexico and Korea has cast a pall on what seemed to be looming as a promising opportunity to lure more portfolio investors into developing country markets. Moreover, the underlying problems which influence the attitudes of foreign investors on the one hand, and developing country governments on the other, are not likely to evaporate simply because wishful words are thrown at them.

92. The process is likely to be long and slow despite arduous attempts to "buy" policy reforms in the direction of greater openness. To the extent that developing country governments feel compelled by external agents to act in ways they are not convinced will yield fruitful results, progress toward significant expansion in DFI or PFI flows is likely to be hesitant and non-durable. Meaningful change in attitudes is likely to be achieved more through direct exchanges between private sector entities in developed and developing countries than through the offices of governments, multilateral agencies or multilateral insurance mechanisms. It is doubtful that the recently launched Mulitilateral Investment Guarantee Agency (MIGA) will achieve very much in unblocking DFI flows. Even with the more innovative GRIP facility invented by IFC over a year ago there have been virtually no takers!

Reliance on Domestic Finance.

93. In the final analysis, developing countries face two unpalatable realities. First, budget constraints in developed countries will limit the expansion of official financial flows, whether concessional or otherwise. Second, the current set of circumstances are as likely to retard as accelerate private financial flows in an environment of perceived higher risk. The combination of these two considerations must lead developing countries -- except the poorest -- to lessen reliance on external finance and increase both the quantum and use-efficiency of domestic savings.

94. Achieving this outcome depends on:

a. the rate of institutional development and policy change in *domestic financial sectors* which are the principal determinants of efficiency both in resource mobilization and allocation; and

b. changing, perhaps radically, the balance between public and private investment and expenditure in developing countries. This is especially urgent in the face of clear evidence that the public sector has generally failed to perform satisfactorily in the business of running productive enterprises and equally persuasive evidence that a rich reservoir of private energies and resources in developing countries is not yet being fully tapped.

95. The focus of intellectual effort in laying the groundwork for the 1990s needs to be shifted from: (i) unrealistic navel-gazing focussed on how to achieve increases in "foreign aid" to (ii) more careful consideration of how to improve upon the mobilization of internal resources coupled with more intelligent use of ALL resources used to finance development. There is an equally urgent need to focus on how external assistance can be redirected to helping with increased mobilization and better use of domestic savings, in particular private savings, in Africa and Latin America. In Asia, domestic savings rates are already high. There is little scope for increasing them much further without unproductively stifling growth in consumption. Effort on this continent, therefore needs to be focussed on better use of savings than on increasing the quantum per se. Apart from

reliance on general policy change, much more could be done in the areas of institutional development (particularly in developing the long-term savings institutions such as insurance companies and pension funds) and in increasing the efficiency of financial intermediation through the application of better financial controls and techniques in extant domestic banking systems. Service infrastructure in the accounting, auditing and legal areas needs to be substantially and swiftly improved as well. *The "hardware" focus of development financing in earlier decades and the "policy reform" focus of the 1980s need to be augmented in the 1990s with increased emphasis on services, "orgware" and management.*

96. The US' policy priorities for encouraging private flows in the 1990s should include:

a. backing off from futile emphasis on massive relending by commercial banks;

b. a more forthright supportive approach for officially underpinned debt restructuring;

c. shifting a part of the burden of commercial bank-held LDC debt on to capital markets through securitized financial instruments;

d. significant expansion of export credit guaranteed lending to LDCs on longer maturities than are traditionally provided;

e. expanding the role of MDBs in intermediating larger flows of private finance from capital markets; this would include specific measures such as (i) doubling the extant capital base of the system; (ii) encouraging MDBs to concentrate on lending for projects and sector investments in the more creditworthy countries; (iii) supporting commitment levels which would result in achieving and maintaining positive net transfers to HICs through their own balance sheets; (iv) encouraging them to "manage" the restructuring of external commercial debt in HICs;

f. promoting wider application of debt-equity swaps; putting more emphasis on capital market development; and encouraging portfolio foreign investment in developing countries;

g. abandoning high-pressure tactics for public divestiture and privatization; encouraging and supporting such programs through agencies such as the World Bank when government themselves are convinced of their fiscal and economic benefits are likely to prove far more durable than ideological rhetoric, which has proven counterproductive;

h. encouraging expansion of foreign private sector involvement in utility and infrastructural investments through greater use of "build-own-operate" (BOO) and "build-own-transfer" (BOT) financing techniques now being tested by the more innovative European merchant bankers; in this connection the US should require MDBs and export credit agencies to review and revise those operating policies and procedures which might impede wider use of these techniques;

j. reorienting bilateral aid programs to focus more clearly on assisting recipient governments to mobilize and use domestic resources more effectively.

Private Voluntary Sources

97. One of the "constants" in net external resource flows to developing countries is the contribution of private voluntary and non-governmental organizations (PVOs/NGOs) -- such as Oxfam, Red Cross, CARE, World Vision, Live-Aid -- which raise the bulk of their funding from voluntary charitable contributions. The total contribution of these entities is significantly understated because the statistics available usually exclude the value of services provided by the volunteers who work for these organizations both in donating and receiving countries. From a level of just under $1 billion in 1970 (excluding the matching contributions often provided by official bilateral agencies to PVOs/NGOs -- these are counted as part of official ODA), private voluntary contributions (in money alone) have grown steadily to levels of $1.3 billion in 1975, $2.3 billion in 1980, and nearly $3 billion in 1986. Concentrating initially on relief and emergency operations the private voluntary sector has been putting increasing emphasis on tackling grass-roots development problems and programs. These agencies, their functions and potential are discussed in greater detail elsewhere

V. INVOLVING THE SECOND WORLD

98. No prospective glimpse into the next decade is well-served by excluding peripheral vision. OECD statistics provide regular vignettes of East Bloc (CMEA) financed ODA tinged with skepticism about what the "aid" content of these ODA contributions actually is. More recent evidence indicates a creeping increase in CMEA-ODA coupled with a genuine interest on the part of CMEA -- and the Soviet Union in particular -- to join the world community in managing both its own and global economic affairs. The present Soviet regime appears, prima facie, to offer an unprecedented opportunity for the world community. The question is whether the world community -- and, most importantly, the US -- is willing to take the large risk of calling the USSR's hand -- if indeed, as the more hardened skeptics suspect, it is playing one. There is a clear danger that premature and ill-prepared entry by the East Bloc into the world monetary, trading and financial regime might result in constipating the global system. It could, were entry permitted, also render the troika of key multilateral institutions (GATT, the IMF and the World Bank) ineffectual and impotent -- i.e. much the same thing that large quarters of US and Western opinion believe has happened to the UN system with the voting combination of the Second and Third Worlds.

99. Whether that danger is greater than perpetuation of the status quo is the question that US policy must address as one of the key issues of the 1990s. Are the US and other members of OECD so weak, so divided, so threatened by prospective collusion by the Second and Third Worlds against their economic and security interests as to shun the opportunity of expanding global membership in multilateral institutions to accommodate the "prodigals"? Or are conditions such that, with painstaking effort and considerable future frustration, CMEA entry into the global regime can actually be made to result in reducing tensions and anxieties by capitalizing on the interest of CMEA to put their economies in shape rather than indulge in continued global adventurism?

100. These questions have no easy answers. After forty years of living with the alternative, however, the attractiveness of a step toward a more promising future has its own compelling dynamic. Serious questions were raised about the implications of China's entry into the membership of global economic institutions. The experience so far has been mutually rewarding and satisfactory. Moreover Hungary, Poland and Romania are already members of the IMF and World Bank. But Soviet entry raises issues quite different from those of China's or the smaller East Bloc countries. The USSR is not a poor, underdeveloped economy which requires concessional lending and across-the-board

development assistance. Its entry into the global system will require a major change in the size and composition of the quota of the IMF, the capital of IBRD and the size of IDA. It will probably seek to displace Japan as the second ranking power in the World Bank (and Japan is anxious to seek the same rank in the IMF) -- a position which Japan has achieved with considerable effort and after overcoming considerable (totally unnecessary) resistance. As a donor member the USSR may still need (perhaps more so than did Saudi Arabia) continuing technical assistance from the World Bank and possible stand-by assistance from the IMF. The sheer number of technical difficulties in negotiating its entry have not even begun to be identified.

101. None of these considerations, however, pose insuperable obstacles. The main impediment is the willingness of G-7 nations to take a political decision welcoming Soviet entry into the global monetary system. That decision would be of equal, if not greater, historical significance than the Nixonian era decision to establish relationships with China. Soviet overtures have, so far, been hastily but decisively rebuffed. US policy-making on such a crucial issue requires a more thoughtful, deliberative response. The unfolding of events along their present trajectory may well require the next President of the United States to consider Soviet and enlarged East Bloc entry into the world economic and monetary institutions on appropriate terms to be worked out soon after approval of the next General Capital Increase.

102. The costs and benefits of Soviet entry into the multilateral system need to be urgently thought through in strategic terms from the viewpoint of the US; that of Europe and Japan as well as that of the developing world, inparticular the littoral giants - China and India. In terms of benefits to the institutions concerned, Soviet entry in the near term could be a substantial boon. Assuming for instance, in the case of the World Bank, that Soviet entry was negotiated immediately after the next GCI (when the World Bank's capital base would have been expanded by the present membership to nearly $180 billion) it would result in additional capital of $18 billion of which nearly $2 billion would be in cash (but a much smaller proportion in convertible currency). These figures exclude the effects on entry of the three other members of CMEA who are not yet members of the Bank or Fund. Similarly, if the Soviet Union were to attempt securing number two status in IDA on a cumulative basis, (an expensive proposition) the addition to IDA's resources would be quite substantial. With total replenishments from IDA1-8 amounting to over $55 billion, a Soviet share of say 20% would result in additional resources of well over $11 billion. Even on a marginal basis, assuming it were to participate from IDA-9 onwards, the cost to the Soviet Union would be in the range of $2-3 billion, were it to take on a higher share than Japan. Hence, entry to these institutions is likely to involve a fairly substantial cash cost in gold and convertible currency. Willingness to meet those obligations would pose an interesting test of Soviet intent.

VI. CONCLUSIONS

103. This chapter has attempted to review extant sources of external financing for development, extrapolating from experience pointers and prospects for the future. In doing so it focusses on changes in US policies -- bilateral, multilateral and vis-a-vis the private sector -- which are necessary to avoid paralysis and achieve greater effectiveness without necessarily increasing the budgetary burden. The position taken by the US is critical, not just for the US but because US policy drives the entire system -- however hard other participants strive to avoid being hostage to the shifts in the US' posture with quadrennial changes in Administration. The conclusions drawn are summarised below:

General Conclusions.

(1) External development financing in the 1990s must carry with it the baggage of unwinding a large amount of outstanding debt -- mostly private but also public (in Africa) -- which imposes a severe drag on development. Both the amounts of financing needed in the 1990s and institutional re-engineering must be considered in the context of that unfortunate legacy.

(2) Bilateral development financing programs are now confused compromises, among vested interests in donor countries, with conflicting and incompatible objectives. They need to be straightened out especially in times when shortages in the quantity of resources must be compensated for by improvements in the quality of aid programs. Bilateral aid has shifted from being driven by recipient needs to being a hostage of the donor's "supply-interests". This situation must be reversed.

(3) Multilateral institutions have proliferated extensively. Their collective administrative costs now exceed the (net) transfer of real resources which these institutions were set up to achieve. This state-of-affairs calls into question their raison d'etre and begs urgent selective rationalization accompanied by an expansion of the capital and operations of core institutions. GATT, the IMF and the World Bank, in particular, need to be strengthened.

(4) Public resources need to be used to "leverage" private financing in an imaginative manner; especially at a time when budgetary resources are tight in the public sector and private proclivities are to reduce rather than expand profiles in development financing.

Specific Conclusions.

On the Bilateral Front.

(5) The US bilateral aid program is grossly misdirected. As a possible consequence it has also resulted in the skewed distribution of the bilateral programs of other donors, most notably OPEC. The following five-point program could restore credibility to US bilateral aid. First, "truth in packaging" i.e. include only genuine development assistance expenditures in the aid budget and put other items elsewhere. Second, the Egypt/Israel components in the aid budget absorbing 40% of the US' bilateral ODA, have become entitlement programs -- their share should be reduced over 5 years to 20%. Third, the US should increase its share of bilateral aid to LLDCs from 15% to 40% by 1995; concentrating primarily on humanitarian and social sector lending. Fourth, the US aid program should incorporate a suitably tailored component for India and China building up to 20% of the program by 1995. Fifth, "political" aid to Latin America should be reduced and targeted at the interface of achieving greater leverage with private capital. Such a program would enable the US to live within a "genuine" aid budget of $10 billion in 1990, (less than 1% of the total budget and considerably less than the UN target of 0.7% of GNP) rising nominally by 5-6% each year.

(6) Budgetary resources should be applied (but not from aid allocations) to expand the capital base and operating capacity of the US Exim Bank.

On the Multilateral Front.

(7) The IMF has, after dealing with the effects of successive oil shocks, the debt crisis and a collapse of commodity prices, gone (through the back door) into the business of development financing. Both the Fund and the World Bank are focusing on structural adjustment lending and the Fund is competing with IDA for contributions to its SAF. The wisdom of the Fund's becoming permanently involved in development financing is questionable. The US should reverse itself on support for SAF and get the Fund to focus more on establishing the framework of a more durable post-Bretton Woods monetary regime.

(8) The World Bank is suffering from an identity crisis, caught between the Fund on the one hand and increasingly capable regional MDBs on the other. Its role in the 1990s needs to be more clearly defined with better conceptualized division of labor. The Bank is today a hesitant, unsure institution focusing increasingly on activities it has demonstrated no particular competence in handling i.e. structural adjustment lending (SAL). It shows no signs of developing the same disciplined approach to SAL operations which it has developed in the context of its project lending. Part of the Bank's problem lies in earlier US hostility towards fast-disbursing lending followed later by a US policy *volte face* requiring the Bank to play an unduly aggressive "money-spraying" role in debtor countries, as part of a flawed debt strategy. This measure has coincided with ill-concealed proclivity to exercise unilateral control over the affairs of the institution at a time when the US must depend increasingly on other donors to provide the financial support the Bank needs. With excessive attention on Latin America and Africa the Bank is becoming less and less relevant to other quality borrowers, especially in Asia, which represent the its more "natural" market.

(9) Present US policy is leading the Bank into loading much more risk on its financial structure than circumstances warrant. Two actions need to be taken swiftly to present further deterioration in the Bank's financial standing and its creditworthiness. First, a Debt Restructuring Facility needs to be established which would permit the Bank to assist heavily-indebted countries through reductions in their outstanding debt and debt service rather than through additional lending on its own balance sheet . Second, the US needs to support and swiftly negotiate a General Capital Increase of at least $60 billion for the Bank proper (allowing about $30 billion for capitalizing the proposed DRF at the same time).

(10) On the concessional side the Bank (IDA) has taken bold initiatives in Sub-Saharan Africa based on expectations of IDA availabilities in the amounts negotiated under IDA-8 (i.e. $12.4 billion between 1988-90). Congress has acted on the first instalment under IDA-8 appropriating nearly the full amount. The same wisdom needs to be exercised for the next two instalments (catching up on the first instalment's small shortfall) so as not to compromise further the Bank's credibility and effectiveness thus diminishing prospects for achieving key US policy objectives in Africa. .

(11) The US needs to act swiftly in defining more clearly the roles it expects the regional MDBs to play, especially vis-a-vis the World Bank, and to bolster their capital bases. Regional MDBs should not be encouraged to engage in policy based lending, for which their decision-making processes are not well suited. The US should consider permitting Japan to assume a clear position as the largest shareholder in AsDB provided it offers commensurate financial support.

(12) As a matter of policy the US should encourage the World Bank and the African Development Bank to develop much closer operational linkages with European multilateral institutions especially in the context of their activities in the African, Middle Eastern and Eastern European regions. In the same vein the US should exert some political leverage over OPEC donors in bolstering their levels of ODA support and the quality of their assistance -- it can hardly do so before making radical changes in its own policies and programs.

Encouraging Private Finance

(13) Private sources are unlikely to be aggressive financiers of development in the early 1990s especially in the face of unfolding circumstances in international banking and capital markets. US policy focus should be placed on using private markets to restructure and securitize the extent overhang of LDC debt rather than look to markets to provide significant amounts of additional development capital at their own risk. This argues in support of earlier suggestions for establishing a DRF and enlarging the capital base of the MDBs in efforts to leverage private capital with public resources.

(14) Exhortation in favor of expanding direct foreign investment might be in danger of achieving a counterproductive outcome. DFI may well increase if the use of debt-equity swaps expands. However, such transactions are not likely to account for very large amounts of equity. Equally, progress toward public sector rationalization and privatization in developing countries is more likely to be achieved through quiet diplomacy than through overt US pressure.

(15) Constraints on official resources and dampened proclivities on the part of the external private sector to finance development will compel greater reliance on the more efficient mobilization and use of domestic resources (a problem the US now shares with the developing world). External assistance needs to be focused more sharply on achieving this objective by focussing US assistance on financial sector/capital market development in the Third World.

(16) Gradually rising flows of private voluntary organizations pose a challenge and an opportunity for reorientation of US' official aid and for the construction of a more effective interface between "people-to-people" and "government-to-government" assistance. US policy should focus on achieving greater symbiosis between private voluntary and official aid efforts playing on the comparative strengths of each.

Involving The Second World in Development Financing.

(17) Finally a unique historic opportunity seems to be presenting itself to bring the Soviet Union and other East Bloc countries not yet members of the international financial institutions within the ambit of the free world's monetary, trading and financial regime. US policy for the 1990s must answer the question as to whether the time has not now come to engage these economies within a single global regime.