United States Participation in the Multilateral Development Banks in the 1980s

Department of the Treasury
Washington, D.C.

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This assessment is dedicated

to the memory of Dr. Wilson E. Schmidt

EXECUTIVE SUMMARY

This assessment is intended to provide a comprehensive and dispassionate evaluation of the policies and operations of the multilateral development banks (MDBs) and, by applying the Administration's basic policy preferences and priorities to the findings, to establish a policy and budgetary framework for U.S. participation in these institutions in the 1980s. The study focuses on four institutions -- the World Bank Group, the Inter-American Development Bank (IDB), the Asian Development Bank (ADB), and the African Development Bank (AFDB).

The first part of the assessment discusses the role of the MDBs in the international economic system (Chapter I), criticisms which have been raised regarding the MDBs (Chapter II), the extent to which MDB operations contribute to U.S. interests (Chapter III), and the ability of the United States to exercise effective leadership within the institutions (Chapter IV). Attention is then directed to the development rationale which underlies our approach to improving MDB effectiveness (Chapter V). The second part of the assessment provides policy recommendations for future U.S. participation in the MDBs (Chapter VI), and illustrates the relationship between the budgetary implications of this policy direction and the lending operations of the institutions (Chapter VII).

The appendices, which are an important and integral component of the assessment, describe the structure and operations of the MDBs (Appendix I); assess the economic/financial situation of the developing countries over the next several years (Appendix II); and survey and evaluate in detail the criticisms, identified in Chapter II, which have been levelled against the MDBs (Appendix III).

Role of the MDBs in the International Economic System

In addition to providing project finance and technical assistance, the MDBs also act as financial catalyst, institution builder (including human capital formation), and policy advisor.

MDB flows account for a relatively small proportion (6-7 percent) of total flows to developing countries, but low income countries tend to be significantly more dependent on them. The catalytic role the MDBs can play in promoting the prudent economic policies necessary to facilitate private financial flows is expected to remain highly important for developing countries in the 1980s -- as will actual MDB financial support for the poorer countries.

The economic justification for the MDBs rests upon their capabilities to play an effective role in situations which require government intervention to provide economic benefits that private investors would not or could not generate. The most important aspects of MDB lending relate to correcting internal or external "market imperfections" hindering LDC development, and facilitating projects which yield positive externalities or benefits to the community at large. A look at the distribution of MDB lending by sector suggests that an overwhelming proportion of MDB lending has been directed into those sectors which tend to be in this desirable framework. The extent to which MDB activity is competitive with the private sector appears minimal.

While data are incomplete, an analysis of World Bank and ADB projects indicates that the economic rates of return on these projects are relatively high, 15-20 percent on average. This suggests that the institutions are making positive contributions to economic development. However, the effective implementation of a fairly high percentage of recent loans has been hindered by difficulties in a number of countries which could have been avoided had there been stronger efforts by the lending institutions to encourage appropriate economic policies in recipient countries. In their ability to influence economic policies in developing countries, the MDBs' record is mixed, with influence more easily exerted at the micro-level of policy and in countries willing to cooperate with the MDBs in identifying and implementing policy changes. This would suggest that the country allocation of lending should favor borowers willing to work constructively with the MDBs to insure projects are carried out in an efficient and rational economic framework.

Criticisms of the MDBs

A number of recent criticisms of the banks imply that policy and/or operational deficiencies have detracted from their institutional effectiveness. A total of nineteen criticisms were evaluated.

In some cases, such as independent audits and staff salaries, the situations which generated criticism have already been remedied or improved. While a significant number of other criticisms appear to have little validity, others focus on areas (such as evaluation systems, and the issue of absorptive capacity) where the evidence is not conclusive or the extent of the problem has not been quantified. These particular areas warrant additional follow-up. In addition, there are two specific criticisms which appear sufficiently serious so as to require the United States to seek corrective policy initiatives in the banks. These are: (1) the indication that in some instances there has been an overemphasis on loan quantity rather than loan quality, which

has served to erode MDB policy influence, and (2) the strong indication that a more effective maturation/graduation policy is required to make MDB lending more reflective of country need and the availability of alternative financing.

U.S. Objectives and MDB Performance

The United States has pursued three broad policy objectives through its participation in the MDBs. The first of these, political/ strategic, is based on the U.S. foreign policy role as leader of the non-Communist world. Fulfillment of this role has several specific dimensions as it relates to our participation in the MDBs. The long term dimension calls for the development of a more secure and stable world through the promotion of steady economic growth. The medium term dimension calls for effective development assistance programs in those countries which are of ongoing political/strategic importance. The short term dimension calls for rapid economic support for key countries which are in need of immediate assistance.

The second, and closely related, broad policy objective has to do with the preservation and growth of a free, open, and stable economic and financial system through the promotion of economic and social development. The MDBs work to achieve this objective by strengthening the ability of the LDCs to participate more fully in an international system based on liberalized trade and capital flows. The MDBs do this by acting as a catalyst for private investment and other private capital flows, as well as trade and technology flows; mobilizing and transfering government backed capital directly to developing countries; and encouraging rational LDC economic policies under free market concepts and global economic efficiency.

The third broad policy objective has to do with our humanitarian concern with alleviating poverty and improving the material well-being of the poor in developing countries. The MDBs are able to assist in the achievement of this objective by promoting overall economic growth and productivity in developing countries and by pursuing programs targeted directly on the poor. The banks can also provide emergency relief and/or reconstruction assistance.

The United States has also pursued three operational or cost-effective objectives in the MDBs. The first relates to advancing U.S. commercial interests, and the benefits which accrue to such interests from MDB efforts to promote economic and social development. MDB projects can lead to increased supplies of raw materials and other products needed by the U.S. economy, as well as expanded U.S. earnings, both through MDB financed purchases of U.S. goods and services as well as by the expansion of developing country markets for U.S. exports. A second operational objective is budgetary, with the goal of minimizing direct U.S. budget outlays

for foreign assistance. This can be done in the MDBs through cost sharing arrangements with other donors and by leveraging U.S. paid-in contributions to the hard loan windows of the MDBs through MDB market borrowings backed by callable capital which does not require budget outlays. The third operational objective, institutional efficiency, has to do with the operational and administrative efficiency of the MDBs in carrying out their development programs. This involves having the MDBs design and implement high quality development loans so as to maximize the impact of scarce development resources.

Taking into account specific criticisms which have been directed at the MDBs with regard to each of these six objectives, the MDBs as a group were assessed in terms of their performance in promoting each objective. The conclusions are as follows:

-- the MDBs, by and large, have been most effective in contributing to the achievement of our global economic and financial objectives and thereby also helping us in our long term political/ strategic interests. However, there is room for improvement in terms of encouraging more effective economic policy reform in individual LDCs and implementing graduation policies more consistently;

-- the soft loan windows of the MDBs are particularly effective in advancing U.S. humanitarian interests;

-- the MDBs, particularly the hard loan windows, contribute significantly to the achievement of U.S. long and medium term political/strategic interests but are less effective with regard to the achievement of short term objectives, where identification of the assistance with the United States is important.

With regard to the operational objectives:

-- the MDBs have served U.S. commercial interests well;

-- the MDBs, particularly the hard loan windows, are particularly effective in serving the budgetary objective because of cost-sharing with other donors and the financial leverage derived from MDB borrowing against callable capital guarantees;

-- The MDBs have served the U.S. institutional efficiency objective reasonably well through operational and administrative efficiency and the generation of generally high quality loans.

U.S. Influence in the MDBs

A total of fourteen significant issues were identified for a detailed review of how effectively the United States was able to influence the MDBs over the last ten years. Of these fourteen -- which were generally representative of the success/failure composition of a much larger list -- the results were judged fully successful, in terms of the extent to which the eventual outcome matched the original objective, in nine instances. We were partially successful in three instances and failed in two of cases studied.

Analysis of the fourteen case studies reveals that U.S. leadership involved in each case the expenditure of political capital, with the United States drawing on its prestige as a world leader, its position as a major MDB shareholder, its capabilities as a primary actor in the banks, and on the confluence of interest among other bank members. The effort frequently required high level political involvement, up to and sometimes including the President.

The successful exercise of U.S. influence depended to a large degree on the United States Administration being fully and clearly committed to a well defined objective. Also important was the position and roles of other relevant actors such as bank management, other donors, the developing countries, and the U.S. Congress. Conversely, instances where the exercise of U.S. influence was not fully successful were characterized by inconsistency among objectives pursued, poorly defined objectives, and significant opposition from other parties.

In terms of the ability of the United States to exercise leadership in the future, certain key conditions will need to be met. The United States must be strongly and clearly committed at high levels to a well-defined policy objective which is not inconsistent with other objectives we are pursuing. The United States must also be prepared to expend political capital to succeed. Finally, one or more of the other significant actors -- MDB management, other major donors, or borrowers -- must support, or at least not oppose, the United States.

The extent of U.S. financial support for the MDBs and our willingness to play a positive, active role in the MDB decision making process are also relevant. If other significant actors perceive the United States is no longer willing or able to continue to play a major financial and leadership role in the MDBs, they may be less likely to be supportive of U.S. policy initiatives in the banks.

Improving MDB Effectiveness

Effective use of MDB resources requires a clear focus on increasing the quality rather than quantity of MDB lending, with country allocations of MDB lending directed on the basis of both policy performance and relative economic need.

MDB effectiveness in promoting LDC development in the 1980s will depend to a large extent on the banks' success in encouraging appropriate policies in recipient countries. The elimination of "targetry" (aggregate lending volume objectives) would permit more selectivity in the loan process and strengthen the relationship between loan programs and effective micro and/or macro policies. MDB efforts to catalyze domestic, particularly private, resources and to encourage individual incentives in a free market environment will also be very important.

The desirability of focusing scarce MDB resources on the most needy countries requires that renewed attention be focused on the adoption and equitable implementation of MDB maturation and graduation policies. Guidelines for the implementation of existing policy in the IBRD are somewhat vague and have resulted in the inconsistent application of the policy. A more sophisticated approach which incorporates a range of factors including debt servicing capacity, access to private capital, and others, appears warranted.

It is important to recognize that a more systematic implementation of maturation/graduation policies will over time change the country composition of MDB loan portfolios. Thus, in order to maintain the MDBs' international credit standing, particular care will have to be taken to ensure that the allocation of MDB resources continues to reward good economic management and performance and contributes to maintenance of a sound MDB loan portfolio.

Conclusions and Recommendations

Drawing on our analysis of MDB operations, we conclude that the value of the MDBs lies primarily in their cost effective contribution to LDC economic growth and stability. Continued U.S. participation in the MDBs is justified by a fundamental national interest in a more stable and secure world, which we believe can be best achieved in an open, market oriented international system. To the extent that the MDBs encourage the participation of developing countries in that international system on a permanent and self-sustaining basis, they are one of the major vehicles available for pursuing these U.S. economic and political/strategic interests.

U.S. support for the MDBs should be designed to encourage adherence to free and open markets, emphasis on the private sector as a vehicle for growth, minimal government involvement, and assistance to the needy who are willing to help themselves. Within this framework, the following specific policy recommendations are set out:

1. Market Forces. Lending policies and programs should increasingly emphasize attention to market signals and incentives, to private sector development and to greater financial participation by banks, private investors, and other sources of private financing (with particular emphasis on the IFC's approach and type of program).

2. Promoting Policy Reform. Annual country and sector lending levels should be more flexible and less target oriented. The banks should be encouraged to introduce more selectivity and policy conditionality within projects and sector programs they support. The banks should concentrate their lending in those sectors where they have the most expertise and where they will have the most policy leverage. The IBRD structural adjustment lending program and the IDB sectoral lending program should be closely monitored to assess the potential for achieving policy reform.

3. Sector Allocation. The MDB sector allocation process should be based upon the economic or social priorities of the borrower government -- but only to the extent that their priorities are consistent with the basic economic principles of the MDBs. Increased emphasis should be given to the economic rate of return and policy improvements that can be obtained in the project selection process, and lending should increasingly be linked to specific policy reforms. Due consideration should also be given to the relation of the project to the overall development strategy, and to its overall economic impact.

4. Graduation. Existing IBRD graduation policy should be implemented more effectively and emulated in the regional banks. Countries above the agreed income threshold should be phased out over a reasonable period, with the Bank assisting the graduation candidate to remove the remaining constraints to self-sustaining growth during the phase-out period.

5. Maturation. The United States should encourage better allocation of soft lending funds through a more systematic "maturation" policy. This would require obtaining agreement to move countries into the hard loan windows as rapidly as their debt servicing capacity permits, also giving due consideration to the impact on the loan portfolios of the banks' hard-loan windows.

6. Paid-in Capital. The United States should develop and implement a plan to phase down and eventually phase out new paid-in capital for the hard loan windows on a schedule consistent with maintaining the financial integrity of the MDBs.

7. Soft Loan Window. The United States should begin to reduce its participation in real terms in the soft loan windows, especially IDA because of its large share of the budget, but at a pace consistent with U.S. economic and political objectives. This is consistent with our desire to realign the concessional windows more closely to assisting the poorest developing countries, and saves budgetary resources. We should also place increased emphasis on the adoption of effective policies by the remaining soft loan recipients.

8. U.S. Budget Priorities. The following factors should be carefully considered in determining U.S. allocations to the institutions:

-- to the extent needed, callable capital allocations to hard loan windows are preferable to concessional window replenishments;

-- the World Bank Group has been more successful than the regional banks in promoting appropriate economic policies; and

-- among the regional banks, the Inter-American Bank ranks particularly high in terms of our political/strategic interests. The Asian Bank ranks highest in institutional efficiency. The African Bank ranks high in terms of humanitarian concerns.

U.S. Budget Implications

The Administration remains committed to financing those MDB cost-sharing arrangements which have already been agreed to internationally. Based on the preceding conclusions and recommendations, the following points will also have a direct impact on future U.S. budgetary appropriations for the MDBs:

-- the United States should participate in upcoming MDB capital increases but seek agreement that no paid-in capital is required;

-- U.S. subscriptions to callable capital should continue to be made on the basis of program limitations rather than appropriations;

-- the United States should begin to reduce its participation, in real terms, in the soft loan windows, especially IDA; and

-- the United States should work to implement a more consistent "graduation" policy in the hard loan windows and a more systematic "maturation" program in the soft loan windows.

The principal U.S. budgetary issue relates to whether the United States should participate in future soft loan window replenishments and, if we do participate, at what levels. Given the importance attached to cost sharing traditions, any significant U.S. funding reductions probably would also reduce the overall availability of MDB resources and thereby to a large extent determine the speed with which our recommendations regarding graduation and maturation will need to be implemented. In general, the greater the U.S. contribution in future replenishments of the soft windows, the longer and more gradual could be the maturation of countries from the soft window to the hard windows. In effect, there is a trade-off between our desire to reduce budgetary outlays and mitigating the political costs and economic repercussions of accelerated graduation/maturation. The extent of China's access to IDA and/or IBRD financing will also have an impact on IDA/IBRD net funding availabilities for other borrowers and have important consequences for the speed and scope of maturation and graduation.

Therefore, deliberations on the level of future U.S. MDB contributions must carefully weigh their impact on MDB operations, on political relations with other developed country donors, and on the resulting consequences for individual developing countries. Such consequences include the debt service impact on borrowing countries and/or their access to alternative financing, the implications for the pace of growth and development, and the probable effect on U.S. bilateral relations with, and economic and strategic interests in, the "maturing" and "graduating" countries.

We have reviewed the implications of the following three illustrative ranges of U.S. MDB financing for the FY 1983-87 planning period.

(a) <u>No U.S. Participation in Soft Loan Replenishments</u>

This implies an annual U.S. appropriation for budget authority of $125 million after FY 1984. Given the importance attached to equitable cost-sharing, particularly with regard to IDA, most other key donors would either sharply reduce or cease contributions to soft window funds. Available soft window funds would be dependent on reflows, plus whatever small contributions were provided by other donors, and would only constitute a small fraction of current lending in nominal terms to "IDA only" recipients. There would be an increased demand by soft window recipients for hard window resources, hardening their debt profile and contributing

to debt service problems for some. In order to accommodate former soft window recipients, the IBRD would have to think seriously about speeding up the graduation of countries from hard window lending. To the extent that individual developing countries considered the soft windows important, relations with the United States could be affected adversely.

(b) A Major Reduction in U.S. Participation in Soft Loan Replenishments

This implies an annual U.S. appropriation for budget authority of $1.0 to $1.25 billion in the mid 1980s and focuses soft window lending almost entirely on the very poorest countries. It would represent a reduction from levels of current replenishments as originally negotiated of roughly 30 to 45 percent in real terms in U.S. contributions to the soft loan windows. While U.S. funding would be below international expectations, the United States would retain the flexibility to participate in either most (lower end of range) or all (upper end of range) soft window replenishments, but at reduced levels. There would also be moderate funds for encouraging the development of the private sector in recipient countries. Concessional lending to IDA only countries could grow at 9 percent per year in nominal terms from 1978-80 levels.

(c) A Modest Real Reduction in U.S. Participation in Soft Loan Replenishments

This implies an annual U.S. appropriation for budget authority of $1.5 to $1.75 billion in the mid 1980s, and is geared to a more gradual maturation/graduation process. It would represent some nominal increase from levels of current replenishments as originally negotiated, but a reduction of roughly 12 to 16 percent in real terms in U.S. contributions to the soft loan windows. The United States could participate in replenishments of all concessional windows and a private sector initiative. Soft window lending would focus not just on the very poorest countries (growth at 9 percent per year in nominal terms), but also on selective lending to blend countries linked to policy reform. These levels would imply a slower pace of maturation/graduation and slower movement toward increased reliance on market forces.

With regard to the hard loan windows, there is an economic rationale for reducing the budgetary impact of MDB capital increases arising from the paid-in element. While the key financial indicators of each MDB vary significantly, it appears that -- with the exception of the AFDB -- appropriate financial ratios during the 1980s could be achieved without further paid-in amounts.

The actual amount the Administration will request from Congress to fund U.S. participation in new replenishments in the

future will be dependent on the results of Congressional consultations, international negotiations, and on how successful the United States is in pursuing our new policy recommendations in each of the MDBs. With this caveat, however, the Administration has made some judgments for planning purposes on a range of appropriations requests for the MDBs through the mid 1980s. The Administration believes the middle budget range described above best meets international, institutional, and domestic requirements.

Although this middle budgetary range would represent a substantial real reduction in the appropriations for U.S. MDB funding of the soft loan windows, it is fully consistent with the conclusions we have reached and with the Administration's view of how development can be most efficiently promoted. This budgetary range would encourage a substantially greater degree of discipline in both the MDBs themselves and in borrowing countries. A reduced flow of financial resources in real terms would still provide adequate financing for the poorest countries who are willing to take appropriate measures to help themselves but are unable to obtain external resources from other sources. It would also necessitate more effective maturation/graduation, reinforce selectivity in lending linked to economic policy reform, and require the MDBs to step up their efforts as financial catalysts. Greater private sector involvement, including expanded co-financing, would now be seen as essential steps, not just potential improvements. The middle budgetary range is thus in keeping with the Administration's overall economic philosophy and our desire to improve the operational effectiveness of the MDBs.

In contrast, the budgetary numbers implied by the lower range would be unrealistic in terms of U.S. long term international economic and political interests, particularly in the developing world. On the other hand, the numbers implied by the upper range are inappropriate at home in the light of the Administration's basic economic philosophy and program of reduced government intervention, greater reliance on market forces and the need for stringent budgetary restraint over the next several years.

In sum, the Administration's policy preferences reflect an attempt to improve MDB operations, and thereby maximize their effective contribution to a more stable international environment, while at the same time take into account the real budgetary constraints upon the United States Government.

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GLOSSARY OF ACRONYMS

ADB	Asian Development Bank
ADF	Asian Development Fund
AFDB	African Development Bank
AFDF	African Development Fund
AID	Agency for International Development
BHN	Basic Human Needs
DA	Development Assistance
DAC	Development Assistance Committee of the OECD
DFCs	Development Finance Companies
EDs	Executive Directors
EFF	Extended Fund Facility
ESF	Economic Support Fund
ESW	Economic and Sector Work
FSO	Fund for Special Operations - IDB
FY	U.S. Fiscal Year or MDB Fiscal Year
GAO	Government Accounting Office
GCI	General Capital Increase
GDP	Gross Domestic Product
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development (World Bank)
IDA	International Development Association
IDB	Inter-American Development Bank
IDCA	International Development Cooperation Agency
IER	Internal Economic Rate of Return
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFIs	International Financial Institutions
IFR	Incremental Financial Rate of Return
IMF	International Monetary Fund
IRC	Inter-Regional Capital
LDCs	Less Developed Countries
LLDCs	Least Developed Countries
MDBs	Multilateral Development Banks
NAC	National Advisory Council on International Monetary and Financial Policies
NGOs	Non-Governmental Organizations
OC	Ordinary Capital
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department
OPEC	Organization of Petroleum Exporting Countries
PEO	Post Evaluation Office
PFIs	Private Financial Institutions
PL-480	Public Law 480
PLO	Palestine Liberation Organization
PPARs	Project Performance Audit Reports
SAL	Structural Adjustment Loan
SPTF	Social Progress Trust Fund
UN	United Nations
UNDP	United Nations Development Program
VTF	Venezuelan Trust Fund

INTRODUCTION

The Reagan Administration brought a fundamentally different view of both the need for and underlying economic philosophy of all government programs. This assessment of U.S. participation in the multilateral development banks (MDBs), undertaken along with a review of other major domestic and international programs, is timely and necessary for several reasons. In this context, the Administration believed U.S. participation in the MDBs should fully reflect its economic philosophy as to how economic development can be most efficiently promoted.

Along with extensive public commentary on the banks, the Legislative branch has raised serious issues with respect to the appropriate role of the banks and U.S. participation in the MDBs. During the FY 1982 budget deliberations, many valid concerns emerged. Strong Congressional interest in the banks has been reflected in studies undertaken by Congressional staff. Questions have been asked about the size of U.S. contributions; the influence of the United States in the banks; the size, growth and orientation of bank lending; and the banks' relationships with their borrowers. While the Administration decided to seek funding to meet previous MDB cost-sharing arrangements negotiated internationally, the Administration believed that the extent of U.S. participation in future MDB replenishments should be determined in light of an overall assessment of the institutions.

There are also more program specific reasons for this assessment. In both absolute and relative terms, the MDB component of the foreign aid budget has increased considerably. Over the last decade, budgetary requests for the MDBs have increased dramatically. The considerable growth in MDB resources and activities has generated greater interest in the effectiveness of their operations.

In light of these considerations, an interagency review of the MDBs, chaired by the Treasury Department, was initiated in the Spring of 1981. Our goal was to prepare a comprehensive and dispassionate examination of the MDBs, and then to apply the Administration's basic policy conclusions. Consultations with Members of Congress on the results of the review, and also in the development of the policy framework for ongoing U.S. participation in the MDBs, are an important part of this comprehensive assessment. Before the assessment was completed, informal consultations were also held with the managements of the MDBs and with other MDB member countries.

Staff from the Treasury Department, the State Department, AID/ICDA, and the Office of Management and Budget were primarily involved in the analysis and preparation of this study. It benefitted as well from the participation of the U.S. Executive Directors at the Inter-American and Asian Development Banks. In addition, the late Dr. Wilson E. Schmidt played a major role in shaping and directing the study, and many sections of the assessment reflect his insights and contributions.

CHAPTER I

THE ROLE OF THE MDBs IN THE INTERNATIONAL ECONOMIC SYSTEM

Many of the current issues surrounding the role of the MDBs in the international economy revolve around the question of whether there is any real need for MDB financing in coming years and, further, whether the banks may actually interfere with free market mechanisms in allocating capital resources so as to prevent maximizing the benefit to the international community from the most efficient employment of resources. It is essential, therefore, that we examine this issue in light of actual MDB performance. 1/

We approach this pivotal question first by examining the economic rationale for the existence of the MDBs and reviewing situations where the MDBs can contribute to a country's welfare by providing economic benefits that private investors would not or could not generate. We then examine actual MDB performance in assisting borrowers, on the basis of available evidence on the rate of return for MDB financed projects. This chapter also addresses the relevance of free market principles in MDB lending activities/operations, including the promotion of private enterprise, and reviews the sector allocation of recent MDB lending to determine how the banks are allocating their funds between the public and private sectors. Finally, this chapter looks at the extent to which the MDBs exert effective economic policy leverage.

Some preliminary observations are in order to put the subsequent discussion in perspective. Table 1.1 provides a summary of the voting positions of the 10 largest shareholders in the various multilateral development banks. The substantial dominance of the United States in the World Bank Group and the Inter-American Development Bank is readily apparent.

1/ Appendix I examines how each of the MDBs functions. It outlines the U.S. role in helping create the MDBs, describes how the MDBs mobilize resources, and reviews their financial structures, lending activities, and management framework, and Congressional attitudes toward the banks.

Table 1.1 Relative U.S. Voting Shares in the Multilateral Development Banks

IBRD (as of 6/30/81)

	Country	Percent of Total Votes
1	U.S.A.	20.84
2	U.K.	7.44
3	Germany	5.06
4	France	5.05
5	Japan	5.04
6	China	3.47
7	India	3.28
8	Canada	3.22
9	Italy	2.94
10	Netherlands	2.25

IDB (OC and FSO) (as of 12/31/80)

	Country	Percent of Total Votes
1	U.S.A.	34.55
2	Argentina	11.88
3	Brazil	11.88
4	Mexico	7.64
5	Venezuela	6.37
6	Canada	4.56
7	Chile	3.27
8	Colombia	3.27
9	Peru	1.60
10	Uruguay	1.28

Note: OC and FSO voting shares are the same.

IDA (as of 6/30/81)

	Country	Percent of Total Votes
1	U.S.A.	21.35
2	U.K.	7.32
3	Germany	6.57
4	Japan	5.59
5	France	3.85
6	Canada	3.80
7	India	3.31
8	Sweden	2.59
9	Italy	2.55
10	China	2.53

ADB and ADF (as of 12/31/80)

	Country	Percent of Total Votes
1	Japan	14.046
2	U.S.A.	11.190
3	India	6.780
4	Australia	6.237
5	Indonesia	5.897
6	Canada	5.683
7	Korea	5.490
8	Germany	4.780
9	Malaysia	3.181
10	Philippines	2.842

Note: ADB and ADF voting shares are the same.

IFC (as of 6/30/81)

	Country	Percent of Total Votes
1	U.S.A.	29.54
2	U.K.	9.04
3	Germany	6.53
4	Canada	4.20
5	Japan	3.95
6	Italy	3.77
7	India	3.29
8	Belgium	2.78
9	France	2.54
10	Netherlands	2.40

AFDF (as of 12/31/80)

	Country	Percent of Total Votes
1	Japan	9.17
2	Canada	6.98
3	Germany	5.42
4	U.S.A.	4.23
5	Italy	3.14
6	Sweden	2.57
7	Norway	2.56
8	Switzerland	2.39
9	U.K.	2.01
10	Denmark	1.59

Note: The African Devevelopment Bank holds exactly fifty percent of the voting power in the Fund.

Source: Treasury Department

During the last decade, the resources provided by the MDBs, as measured by net disbursements, have grown significantly. According to data from the Development Assistance Committee of the OECD, the net disbursements 2/ provided by the MDBs to the developing countries (as defined by the OECD) increased from $1.1 billion in 1970 to an estimated $5.58 billion in 1979. 3/

Nonetheless, MDB assistance represents only a relatively small proportion of the total external financial resources provided to LDCs (see Table 1.2). Net disbursements by the MDBs to LDCs typically represent about 6.7 percent of the total net external receipts of the developing countries. Even with the rapid growth in MDB lending, that proportion has remained relatively stable, reflecting, on the one hand, growing LDC financial needs in the face of higher oil prices and, on the other hand, greater access by them to private capital. In recent years, MDB assistance to the developing countries has been about one-fourth the level of the bilateral official development assistance provided by the OECD countries; and it has also run about one-fourth the level of the financial resources provided by private sources.

However, the aggregate statistics conceal some significant variations in the importance of MDB financing for individual countries. Not surprisingly, lower income LDCs tend to be significantly more reliant on MDB (and bilateral) assistance than are the more advanced LDCs which have much greater access to private financial flows. Tables 1.3 and 1.4 describe the relative importance during the 1975-79 period of MDB financing, U.S. bilateral ODA, and private flows for the top 25 recipients of multilateral assistance in 1979. Multilateral flows as a percentage of total gross foreign flows are highest in relatively low income countries such as India (41 percent), Tanzania (33 percent), Bangladesh (29 percent), and Kenya (25 percent). On the other hand, private flows predominate in the more advanced LDCs such as Mexico (93 percent), Brazil (91 percent), Argentina (89 percent), and Malaysia (86 percent).

The developing countries with access to capital markets have also benefited from international trade: according to the estimates by the World Bank in its 1981 World Development Report, the export purchasing power of the oil importing developing countries increased by $121 billion in the 1970s. However, the increase was heavily concentrated in high and middle income countries and the share of the low income countries (with a 1979 per capita income of $370 and below) was only $3 billion.

2/ Disbursements less capital repayments on earlier loans.

3/ The nominal increase, however, must be deflated to measure the amount of additional real resources provided by the MDBs. Using the World Bank's disbursement deflator, the amount of real resources provided by the MDBs increased 70.4 percent between 1970 and 1979.

Table 1.2 Net Resource Receipts of Developing Countries
($ billions)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Total Receipts	19.08	20.76	22.39	30.61	33.92	53.35	57.06	63.39	79.60	80.98
Bilateral ODA	7.06	7.81	8.06	9.53	12.09	16.22	15.41	15.30	17.44	21.87
Multilateral ODA 1/	0.69	0.82	0.84	1.09	1.66	2.35	2.21	3.41	4.46	4.30
MDBs 2/	1.06	1.40	1.52	2.18	2.95	3.99	4.12	4.12	4.39	5.58
- concessional	0.38	0.51	0.55	0.91	1.19	1.49	1.66	1.56	1.54	1.80
- nonconcessional	0.68	0.89	0.97	1.27	1.76	2.50	2.46	2.56	2.85	3.78
Direct Investments	3.69	3.31	4.23	4.72	1.10	10.49	7.86	9.50	11.15	13.45
Private Borrowings 3/	3.30	3.60	5.32	10.28	10.28	12.42	16.22	18.70	25.54	19.67
Export Credits	2.71	3.42	2.19	2.36	3.25	5.61	8.60	10.63	12.93	10.92
- private	2.16	2.85	1.45	1.20	2.49	4.22	6.77	8.34	9.97	9.42
- official	0.55	0.57	0.74	1.16	0.76	1.39	1.83	2.29	2.96	1.50
Other	0.57	0.40	0.23	1.45	2.59	2.27	2.64	1.73	3.69	5.19

1/ Includes OPEC Special Funds, UN programs and excludes amounts provided by MDBs

2/ World Bank Group, IDB, ADB, and AFDB

3/ Excluding private export credits

Source: 1980 Development Assistance Committee Report

Table 1.3 Relative Importance of Annual Average MDB and U.S. Bilateral ODA Flows to the Top 25 Recipients (in 1979) of Multilateral Assistance, 1975-79

Country	MDB Flows as a % of Total Gross Foreign Flows (1975-1979)		U.S. Bilateral ODA Flows as a % of Total Gross Foreign Flows (1975-1979)	Total Private Flows as a % of Total Gross Foreign Flows (1975-1979)	Total MDB and U.S. Bilateral ODA Flows as a % of Total Gross Foreign Flows (1975-1979)
	Hard	Soft			
India	8.7	32.1	11.7	6.0	52.5
Korea	9.7	0.2	2.4	79.8	12.3
Brazil	4.6	0.1	0.3	90.9	4.9
Mexico	4.1	0.2	0.0	93.3	4.3
Philippines	8.1	0.3	3.2	82.2	11.6
Yugoslavia	12.3	0.0	0.0	69.5	12.3
Egypt	2.1	1.7	18.5	39.4	22.3
Indonesia	7.4	3.2	6.6	64.6	17.2
Turkey	11.0	3.6	1.7	64.7	16.3
Thailand	17.7	0.9	1.3	59.7	19.9
Morocco	7.7	0.2	2.4	64.1	10.3
Pakistan	9.2	8.4	16.3	15.0	33.9
Colombia	19.6	0.8	3.6	70.3	24.0
Bangladesh	0.1	28.5	29.6	3.8	58.2
Argentina	4.0	0.3	0.0	88.5	4.3
Tunisia	9.1	1.7	1.7	55.8	12.5
Malaysia	8.1	0.1	0.2	85.7	8.4
Guatemala	10.5	8.7	11.7	58.2	30.9
Tanzania	15.8	16.9	12.7	3.3	45.4
Kenya	17.8	7.4	4.9	48.3	30.1
Peru	3.3	0.4	2.6	59.6	6.3
Cameroon	9.0	7.1	2.0	48.5	18.1
Portugal	5.3	0.0	8.1	67.3	13.4
Burma	0.6	21.7	1.4	27.4	23.7
Bolivia	8.0	5.9	10.1	64.9	24.0

Source: See Table 1.4

Table 1.4 Annual Average MDB, U.S. Bilateral ODA, and Total Gross Foreign Flows to the Top 25 Recipients of Multilateral Assistance in 1979
(millions of current dollars)

Country	MDB Flows (1975 - 1979)		U.S. Bilateral ODA Flows (1975-1979)	Total MDB and U.S. Bilateral ODA Flows	Total Gross Foreign Flows (1975-1979)
	Hard	Soft			
India	120.1	446.2	162.5	728.8	1388.4
Korea	369.6	8.1	90.8	468.5	3821.7
Brazil	380.5	12.2	22.8	415.5	8387.5
Mexico	312.7	15.7	2.5	330.9	7712.2
Philippines	179.7	5.9	71.3	256.9	2208.8
Yugoslavia	182.7	0.0	0.0	182.7	1486.5
Egypt	55.6	46.4	497.0	599.0	2686.7
Indonesia	171.9	75.7	154.8	402.4	2328.4
Turkey	166.1	54.0	25.3	245.4	1507.1
Thailand	120.6	6.6	9.0	136.2	683.2
Morocco	92.7	1.9	29.3	123.9	1198.3
Pakistan	81.7	75.2	145.0	301.9	888.6
Colombia	122.6	5.1	22.3	150.0	626.2
Bangladesh	0.5	135.9	141.3	277.7	476.7
Argentina	90.9	7.6	0.0	98.5	2297.5
Tunisia	50.7	9.3	9.5	69.5	558.0
Malaysia	98.6	0.3	2.8	101.7	1210.8
Guatemala	20.5	16.9	22.8	60.2	194.5
Tanzania	28.8	31.0	23.3	83.1	183.1
Kenya	50.6	21.0	14.0	85.6	283.9
Peru	38.4	5.3	30.3	74.0	1176.6
Cameroon	28.2	22.0	6.3	56.5	312.0
Portugal	43.1	0.0	66.8	109.9	819.9
Burma	1.2	44.7	2.8	48.7	205.9
Bolivia	29.1	21.3	36.5	86.9	362.9

Notes:

1) Figures for annual average MDB flows during the 1975-1979 period are from the World Bank, but include all MDB disbursements.

2) Figures for annual average U.S. bilateral official development assistance during the 1976-1979 period are from the DAC's Geographical Distribution of Financial Flows to Developing countries.

3) Figures for annual average total gross foreign flows are built up from the IMF's Balance of Payments Yearbook, Euromoney, and World Bank components.

An assessment of the economic and financial prospects of the developing countries illustrates the international economic framework within which the MDBs will be operating over the next several years. 4/

For many LDCs, particularly low income LDCs, higher energy prices and the adverse impact of sluggish industrial country growth on LDC exports are likely to make the period through the mid-1980s one of even more difficult adjustment than was faced in 1974-78. While inflation has eroded the real value of past fixed term external debt, the debt situation of the LDCs has been aggravated by high real interest rates on other borrowed funds. As a result, the debt situation for a number of countries is probably more precarious than in the 1970s. Balance of payments deficits will remain high and large additional financial inflows would be necessary to sustain current rates of LDC growth. Financial requirements are, however, sensitive to growth rates, and relatively small changes in growth can imply significantly greater changes in financial requirements.

The international capital markets should be capable of providing much of the required finance. While private bank lending to the LDCs is expected to grow in absolute terms, it is not, however, expected to duplicate the exceptionally rapid growth of the 1970s. Given the concern over country exposure, global economic uncertainties, and the short term liquidity problems now facing a number of LDCs, the extent to which the private banking system, especially the U.S. system, can accommodate another major increase in LDC lending is not all that clear. The perceived adherence of prospective recipient countries to prudent economic policies will be an increasingly important determinant of such flows. As a result of efforts to diversify lending portfolios, private bank lending may also be less geographically concentrated than in the past. Asian and oil exporting countries are the likely beneficiaries of such a trend, with African countries continuing to have very limited access to these private flows. 5/ The flow of official bilateral finance will be contained by the economic and budgetary problems facing many donor countries.

4/ Appendix II provides an assessment of the economic and financial prospects of the developing countries over the next few years.

5/ It should be noted that economic growth prospects for the 1980s are bleakest for the least developed countries in Africa, where a chronic shortage of skilled people and formidable structural problems are likely to result in only minimal economic growth even if all goes well for the overall world economy.

It is likely, therefore, that the middle income LDCs in general will continue to rely heavily on private capital financing, historically the most important source of LDC financing in aggregate (See Table 1.2). The catalytic role the MDBs can play in promoting the prudent economic policies that are necessary to facilitate private financial flows is of substantial importance. Actual MDB financing support will be more important for the lower income countries for whom multilateral flows as a percentage of total gross foreign flows have traditionally been high.

A. Economic Rationale

With these preliminary observations in mind, we turn first to the economic rationale for the existence of the MDBs.

The Theoretical Role of MDB Lending

According to economic theory, welfare is maximized in a free market environment where factors of production move freely in response to opportunities to maximize their marginal product guided by a system of prices determined by supply and demand. Government intervention may tend to reduce efficiency and welfare by misallocating resources. However, economic theory has identified certain situations of "market failure" in which government intervention can serve to increase welfare and is therefore justified. As governmental institutions, the MDBs can be viewed as instruments designed to provide economic benefits that private investors would not or could not generate.

"Public" Goods and "Quasi-Public" Goods. Public goods are those goods and services which, if produced, are available to the community at large, since it is not feasible to provide them for one subgroup in the population without providing them for all. Non-payers cannot be excluded from consumption, and the extension of benefits to additional users involves no additional costs.

There are relatively few examples of "pure" public goods. The classic example is a lighthouse. Another example is national defense. Examples of MDB projects with a large public good element include a regional IBRD mosquito abatement project in West Africa, and elimination of the tsetse fly as part of an IBRD agricultural project in the Cameroons. In such projects, benefits are available to payers and non-payers alike. Thus a private investor would not find enough clients willing to pay for his services to justify his undertaking the activity. Nevertheless, the activity may provide economic benefits to the population that greatly exceed its economic costs to society.

While there are few examples of pure public goods, there are many examples of goods that include some benefits to the public beyond those that are paid for, and these are referred to as "quasi public" goods. Flood control dams and urban roads are examples of quasi public goods that come close to being pure public goods. While quasi public goods may be supplied by the private sector, generally they will not be provided in socially optimal amounts.

Externalities 6/. An "external economy" is present if an economic activity by a producer or consumer confers as a by-product a benefit on others without imposing an appropriate cost. When external economies are present there are divergences between the private profitability of an investment activity and its net benefit to society, and between the interests of the private producer and society at large.

Physical infrastructure projects, particularly improvements in internal transportation and communications systems, often yield high external economies in the form of lower costs of production, distribution, and/or marketing in a wide range of industries. MDB projects in the transportation sector, for example, can make economically attractive the cultivation of more fertile but formerly isolated land, increase the mobility and efficiency of the labor force, and often induce a shift from subsistence to commercial farming leading to a higher volume of output. Improvements in infrastructure can also lead to the formation and expansion of new private investment opportunities by increasing the size of markets and allowing domestic producers to take advantage of latent economies of scale. Electric power projects and water supply and sewerage projects also tend to yield high positive externalities.

In FY 1980, about 37 percent of all MDB lending was for transportation, communications, power, water supply and sewerage projects which generally can be classified as physical infrastructure projects. Another 28 percent of the lending in 1980 was for agricultural loans. Inspection of these loans reveals that about 40 percent of the project costs in these loans was for physical infrastructure investment in the agricultural sector of the economy. Hence about 48 percent of MDB loans have been directed to physical infrastructure projects in which external economies feature prominently.

6/ Externalities can be positive or negative. The discussion which follows is limited to the case of positive externalities -- external economies -- which is the kind of externality that is relevant to MDB lending.

Lending for education and public health also entails unique externalities. By value, 4.3 percent of MDB lending in FY 1980 went to finance education projects in the LDCs. Expenditure for education can be treated as an investment in human capital, which is in principle similar to an investment in physical capital. One of the most important reasons for official intervention in education is the alleged existence of external economies which accrue to the students' associates, employers, and community. Part of the increased productivity due to the education of the employee will be captured by the student in the form of higher wages, but part of the increased productivity of the employee will result in increased returns to the employer and theoretically to society as a whole. 7/

Improvements in public health also yield large externalities because they provide benefits not only to the consumer but also to the community as a whole. About 2 percent of the value of MDB lending in FY 1980 was directed toward public health projects.

Internal Market Imperfections. One of the most important aspects of MDB lending relates to correcting internal market imperfections in borrowing countries. MDB efforts to foster efficient resource mobilization and allocation within recipient countries help establish the type of environment needed for more efficient and sustained growth. Conditions relating to the pricing and efficiency of services -- which work to reduce government subsidies and encourage commercial practices -- have been, for example, a frequent feature of MDB advice to borrowing countries. In the balance of payments area, the MDBs, particularly the World Bank, encourage countries to adopt open trading policies involving the promotion of export industries and the reduction of tariff barriers which foster uncompetitive import substitution. MDB success in the policy advice arena will be assessed in subsequent chapters.

In some LDCs the productive factors that must cooperate with capital are extremely scarce, and, in view of limited project identification and implementation capacity, the marginal productivity of capital and number of investment opportunities in these countries is quite low. This can be viewed as an extreme case of "market imperfection" in the sense that it reflects a combination of international factor immobility, imperfect information, and institutional inadequacy. Since MDB project loans typically make provision for technical and managerial assistance, they serve

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7/ The most compelling case for official intervention in education, however, is not the externality argument, but rather has to do with imperfections in capital markets and the long gestation and payback periods typically associated with educational investment, which in the absence of official intervention would lead to under-investment in human capital.

to raise the marginal product of capital and help recipient countries economize on these important but scarce resources. MDB efforts related to the identification, preparation and implementation of projects can also serve as a means of developing the institutional, human, technical, and physical capacity central to the long term development process.

This is particularly relevant for the low income LDCs where the underdeveloped resource base often poses a special constraint on the establishment of an efficient free market environment. The agricultural sector -- on which most of such countries still depend heavily -- is particularly vulnerable given the relative immobility of labor, the predominance of the smallholder farmers, and the limited use of off-farm inputs. Selective MDB lending -- accompanied by the provision of technical expertise and managerial capacity -- can often raise the level of such activity to the stage where it begins to integrate with the private market oriented forces which exist elsewhere in the economy. With this catalytic effort, the dynamics of the development process itself may over time reduce or correct a number of the market imperfections which were present at the outset.

External Market Imperfections. International financial markets by and large are efficient. Since there are many transactors (absence of monopoly), transaction costs tend to be quite low, and information tends to be widely disseminated. Nevertheless, international capital markets are far from perfect. The imperfections of these markets can limit the access of some LDCs to international financial flows, thus reducing economic growth in the LDCs. Consequently, such imperfections provide another reason for MDB investment financing.

1. Imperfect Information as a Barrier to Access. Private investors need accurate information in order to make economically efficient decisions. The private banks need to know about a borrower's ability to service and ultimately repay its loans in a timely manner. The expense of obtaining all the relevant information firsthand about small countries, particularly those without well established repayment records, often exceeds the potential profit. Given the competitiveness of commercial bank lending, what actually happens in such cases is that a bank relies on second hand sources of information, or it "gambles", often leading to a wrong decision because the bank's subjective risk estimate was either higher or lower than the objective risk. The frequency of private debt rescheduling provides some evidence of inadequate knowledge or foresight. Imperfect information undoubtedly limits access of some LDCs, and enterprises operating within the LDCs, to private financial flows and as a result some productive investment opportunities are foregone.

The MDBs, particularly the World Bank, play an important role in correcting the market imperfection described above. They help disseminate the knowledge and information that is required to make international capital markets work efficiently and, in so doing, act as a catalyst for private investment. Seldom do the MDBs provide all the financing for their projects and when a project has an MDB "stamp of approval", the fact that the private investors know that the project has been carefully appraised by the banks often is influential in the private sector decision to participate in the project through co-financing.

The benefits to commercial banks of participating through co-financing with the MDBs include: greater familiarity with LDC conditions and procedures, controlled exposure, low cost access to MDB project expertise, and the use of the MDB as project appraiser and loan administrator. There has been a very significant growth during the 1970s in both total MDB co-financing and the private co-financing component. Total World Bank co-financing reached $6.5 billion in FY 1980, with private co-financing representing around 27 percent of the total. As of September 1980, 148 separate banks have been involved in World Bank co-financing projects acting as manager, co-manager or participant in a loan syndication. MDB private co-financing efforts have also expanded in terms of number of countries and sectors. Countries such as Thailand, Malaysia, Panama, and Honduras are recipients of co-financing funds in addition to the more obvious cases of Mexico, Argentina and Brazil. In addition, MDB co-financed projects can now be found in agriculture, tourism, and transport, in addition to the more traditional sectors of industry and power. The United States has and will continue to encourage both these trends.

Capital market imperfections associated with imperfect information are manifested in two other important ways -- the relatively short maturity structure of commercial bank loans which precludes socially beneficial projects with long gestation periods from being financed through commercial channels, and "bandwagon effects" in private lending which have destabilizing effects on LDC economies.

2. Short Maturity Structure. Commercial banks, as suppliers of loans, are purchasing an uncertain future stream of payments with present cash. Uncertainty about the probable course of events in a country (as it relates to the country's ability to continue servicing its debt) increases, the longer the period of time. From the point of view of the commercial lender, the riskiness of a given loan increases with the maturity of the loan. This tends to shorten the time horizon over which LDCs can borrow from commercial lenders. The result is a skewing of loan maturities to the relatively short term which has distorting effects on investment. The problem tends to be especially acute in periods of rapid inflation. Projects with long gestation periods, which include all sorts of physical infrastructure projects, power projects, many

kinds of human development projects, etc. are simply beyond the risk horizon of commercial banks. This is particularly true in cases involving LDCs other than the most-advanced. The average weighted maturity on 1980 syndicated Eurodollar loans to "low income" LDCs was, for example, only 5.5 years.

3. Bandwagon Effects. According to a recent IMF study of LDC debt, commercial bank lending has at times been pro-cyclical and, therefore, destabilizing to individual LDC economies. This occurs because uncertainty about the future economic and export growth prospects of a country causes commercial banks to rely too heavily on short term economic performance. Specifically, it has been observed that during the upswing of an LDC's commodity price cycle, private bank commitments tend to expand extremely rapidly, sometimes beyond the ability of a given country to absorb additional resources efficiently. During the downswing of the commodity price cycle, many banks may attempt to simultaneously reduce their exposure in the country. These swings in bank flows to individual LDCs not only produce the undesirable effect of macroeconomic destabilization but also result in serious misallocation of investment resources. In contrast, year to year MDB flows are significantly less variable and more attuned to long term considerations.

This bandwagon effect may be seen as well in extension of large and variable private trade credits. Moreover, driven by views of short term profits from a currently "fashionable" importing country, officially guaranteed medium term suppliers' credits -- usually one to five years -- for exports of machinery and other equipment to LDCs have grown to quite massive proportions. Since such credits are guaranteed by developed countries' governments, the transactions are not subject to normal commercial risk and evaluation and individual exporters feel less commercial risk in concentrating such flows over a short period of time. In contrast, MDBs by their charters have a longer term perspective which can serve to moderate these variations.

The Direction of MDB Lending

The four situations described above are intended to illustrate unique roles which the MDBs can theoretically play in meeting the development needs of the LDCs within the context of a free market oriented economic framework.

It is very difficult, however, to quantify the precise extent to which past MDB lending can be categorized as conforming to one or more of these often overlapping situations. A look at the percentage distribution of MDB lending by sector during the five year FY 1976-80 period (Table 1.5) suggests, nevertheless, that an overwhelming portion of MDB lending has been directed into sectors -- such as agriculture, transportation/communications, and power -- which tend to yield high positive externalities or otherwise fit within the described situations. This is true even though (as can be seen in Table 1.6) there has been a long term switch in lending emphasis from power and transportation to agriculture, rural development, and urban projects.

Table 1.5 Percentage Distribution of MDB Lending by Sector and Institution (FY 1976 - FY 1980)

Sector	1976	1977	1978	1979	1980
Agriculture					
WBG	23.7	31.1	36.6	27.2	28.1
IDB	23.0	33.5	17.1	19.9	24.0
ADB	29.7	32.3	24.1	29.8	29.1
AFDF	--	31.3	35.8	41.9	49.2
Subtotal	24.2	31.5	33.1	26.5	28.0
Preinvestment					
WBG	--	--	--	--	--
IDB	0.4	4.0	0.5	1.2	1.8
ADB	--	--	--	--	0.4
AFDF	--	--	--	0.9	--
Subtotal	0.1	0.5	0.1	0.2	0.3
Dev. Fin. Co.					
WBG	11.7	9.0	4.2	7.9	7.4
IDB	--	--	--	--	--
ADB	24.0	--	15.2	10.0	11.2
AFDF	--	--	--	--	3.9
Subtotal	11.3	7.1	4.5	6.8	6.7
Education					
WBG	4.7	3.9	3.0	4.8	4.1
IDB	6.2	7.9	3.1	7.3	5.1
ADB	1.6	--	2.8	6.5	4.3
AFDF	--	13.8	10.0	15.9	7.2
Subtotal	4.6	4.4	3.1	5.5	4.3
Ind./Mining					
WBG	11.7	13.1	14.2	10.7	8.1
IDB	10.0	18.0	25.8	14.2	10.1
ADB	--	20.8	7.7	10.7	0.4
AFDF	--	--	--	--	--
Subtotal	10.3	14.0	15.0	11.0	7.6
Non Project					
WBG	6.2	4.3	1.1	4.0	6.1
IDB	--	--	--	--	--
ADB	--	--	--	--	--
AFDF	--	--	--	--	--
Subtotal	4.8	3.4	0.9	3.1	4.7
Population/Health					
WBG	0.4	0.6	0.5	1.0	1.1
IDB	--	--	--	0.6	15.6
ADB	--	--	1.9	1.9	--
AFDF	--	4.7	9.1	--	--
Subtotal	0.3	0.6	0.7	1.0	2.9
Power					
WBG	13.8	13.0	11.8	13.3	20.3
IDB	27.5	9.8	26.8	35.7	--
ADB	--	10.6	21.5	17.5	25.9
AFDF	--	--	--	8.0	3.0
Subtotal	14.3	12.3	14.4	16.8	18.0
Tourism					
WBG	0.5	1.3	0.6	1.1	0.2
IDB	2.0	2.1	2.9	0.1	1.5
ADB	--	--	--	--	--
AFDF	--	--	--	--	--
Subtotal	0.6	1.4	0.8	0.9	0.4
Transp./Comm.					
WBG	20.9	16.4	16.2	17.0	13.9
IDB	19.6	16.9	6.1	14.8	15.8
ADB	18.6	26.0	11.3	13.7	13.8
AFDF	--	23.2	40.8	19.5	28.9
Subtotal	20.5	17.1	14.8	16.5	14.4
Urbanization					
WBG	1.2	2.2	3.8	3.7	2.4
IDB	2.0	0.5	2.7	--	--
ADB	--	4.4	1.6	3.3	3.5
AFDF	--	--	--	--	--
Subtotal	1.2	2.0	3.4	3.1	2.2
Water Supply					
WBG	4.9	4.8	7.4	7.6	4.9
IDB	9.1	6.7	15.0	6.1	--
ADB	26.0	5.8	13.9	6.6	8.8
AFDF	--	27.0	4.3	13.8	7.8
Subtotal	7.5	5.4	8.9	7.4	4.7
Export Fin.					
WBG	--	--	0.4	--	--
IDB	--	0.5	--	0.1	0.1
ADB	--	--	--	--	--
AFDF	--	--	--	--	--
Subtotal	--	0.1	0.3	--	--
Energy					
WBG	--	--	--	1.4	3.1
IDB	--	--	--	--	13.9
ADB	--	--	--	--	2.7
AFDF	--	--	--	--	--
Subtotal	--	--	--	1.1	4.4
Tech. Asst.					
WBG	0.5	0.2	0.1	0.3	0.2
IDB	--	--	--	--	--
ADB	--	--	--	--	--
AFDF	--	--	--	--	--
Subtotal	0.4	0.2	0.1	0.2	0.2
Multisector					
WGB	--	--	--	--	--
IDB	--	--	--	--	12.2
ADB	--	--	--	--	0.2
AFDF	--	--	--	--	--
Subtotal	--	--	--	--	1.6
Grand Total *	100.0	100.0	100.0	100.0	100.0

* Actual percentages may not add to 100.0 due to rounding errors.

Source: Appendix I, Table 2

Table 1.6 Sectoral Distribution Of IDB/IDA Commitments By Percentage

(Fiscal Years)

	Through 1963	1964-68	1969-73	1974-78
Agricultural and rural development	6	11	20	31
Communications	1	3	5	2
Education	--	3	5	4
Industry 1/	13	12	14	19
Nonproject	17	8	6	5
Population	--	--	1	1
Power	31	29	18	13
Tourism	--	--	1	1
Transportation	32	32	26	17
Urban	--	--	--	3
Water Supply	--	2	4	4
Total	100	100	100	100

1/ Industry includes industrial projects and industrial development financing through development finance companies and other intermediaries.

Source: World Bank

The MDB shift in sectoral emphasis favoring the rural economy and the production of the small farmer reflects the large numbers of rural poor -- an estimated 80 percent of the world's poor people are located in the countryside -- and their heavy dependence on agriculture. Also, increasing food production has generally proved to be an indispensable basis for overall development with most instances of higher economic productivity and growth having been supported by broadly based agricultural progress and, conversely, with most developing countries with slow growth having had a particularly poor record in agriculture.

The MDBs and the LDC Need for Resource Transfers

The need for capital, foreign exchange, and technical expertise is an essential element of any program of sustained economic development. Developing countries, particularly low income countries, generally face serious financial constraints to development. The limited or underdeveloped resource base of developing countries, the small productive capacity of their economies, and relatively low per capita incomes can severely retard their ability to mobilize a level of domestic savings adequate to generate satisfactory levels of growth and to earn foreign exchange sufficient to purchase foreign goods and services needed for their development.

Although growth requires capital, capital by itself does not automatically guarantee growth: the key is the efficiency with which the capital is utilized. If competently managed, foreign capital offers recipient LDC countries a major opportunity to bridge the gap between domestic savings and available investment opportunities. Foreign capital thus enables these nations to strengthen their economies at a rate above that which could be attained solely on the basis of available domestic resources. Since the productivity of capital is generally higher in developing countries than in the industrial countries, the global economic output of goods and services is also maximized.

It has already been pointed out that MDB assistance represents only a small proportion of external resources provided to the LDCs. However, the proportion of MDB financing can be significant for individual low income countries. The MDBs should not, however, be viewed solely in the context of the need for resource transfers. Their role in the development process is considerably broader than this. It is by combining the role of provider of project finance and technical assistance with the roles of financial catalyst (including the important area of co-financing), institution builder, and policy advisor which makes the MDBs unique, and it is in this context that their operations should be evaluated. 8/

8/ Treasury will be undertaking an in-depth study of co-financing in the months ahead.

B. An Evaluation of MDB Lending

No quantifiable cause and effect relationship between MDB loan totals and LDC rates of growth can be definitively established. Consequently, in assessing MDB effectiveness in promoting development, one is forced to rely on the impressionistic judgment of development and financial experts and upon micro-level economic and financial rate of return calculations computed for each individual project. A strong case can be made that the MDBs are effective in stimulating development if adequate economic and financial rates of return for each project are achieved. A high rate of return realized for each MDB project financed, coupled with concomitant improvements in the institutional efficiency of the project executing agency (e.g., the Ministry of Irrigation), suggests prima facie that economic growth and economic development are being promoted.

The principal measure used by the banks for selecting and comparing projects to finance is the internal economic rate of return (IER) and, to a lesser extent, the incremental financial rate of return (IFR). When these measures are not appropriate, e.g., the benefits from education or health projects are not easily quantified, the MDBs generally use the least cost method as the basic measure for appraising projects. 9/

The IER measures the impact of the project on the economy; and its purpose is to determine whether the project can be expected to create more net benefits to the economy than any other known (mutually exclusive) use of the resources. The IFR measures the flow of funds into and out of the project, thereby measuring its ability to meet financial obligations. 10/ The two measures, while related in concept, have different objectives; and the economic costs and benefits may be larger or smaller than the financial costs and benefits. In general, two types of adjustments are made to the financial data to reflect economic concepts. First, some costs and benefits are included or excluded in the financial analysis; and second, some inputs and outputs are adjusted (shadow prices) if their real value to the economy and market prices differ. For example, interest or tax payments that appear as costs in the financial analysis do not appear in the economic analysis because they are not direct claims on the economy's

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9/ If the benefits are not quantifiable in a meaningful sense, it is necessary only to consider costs and select the alternative with the lowest present value of costs when discounted at the (shadow) rate of interest. The approach assumes that benefits exceed costs.

10/ The technique for both methods is to find that discount rate which equalizes the present value of the cost and benefit streams over the life of the project.

resources but represent only internal transfers from one sector to another; conversely, a project may involve an economic cost, e.g., pollution, that does not involve a corresponding financial expenditure.

Until 1980, the MDBs used the so-called "efficiency" approach for calculating the IER, i.e., selecting the project that maximized the total real consumption of goods and services in the economy. But this approach weighted all consumption gains and losses equally, regardless of the income level of the groups affected; and the project's effects on savings and investment were also ignored. Now the MDBs have expanded their IER analyses to include these effects. 11/ This accommodation by the banks to multiple (and possibly) conflicting policy objectives is due to the recognition that the selection of projects to finance cannot be independent of the fundamental objectives of the borrower's economy, e.g., growth and a redistribution of income. Using this method, benefits are measured in terms of progress relative to the basic objectives and the costs in terms of the benefits foregone; and, the shadow prices must reflect all the adjustments necessary to achieve the several objectives instead of just the single one of the efficiency approach. Nevertheless, this approach is new and the IERs discussed below were calculated using the "old" efficiency approach. In other words, the project IERs reviewed here were estimated using only the efficiency criterion. To date, however, there has not been any major shift in the types of projects being financed, judging by the nature of the MDB projects considered in the U.S. Government's inter-agency review process. 12/

All of the MDBs evaluate their performance, but only the World Bank and the ADB have systematic programs for evaluating each project. Both institutions have established procedures whereby individual projects are evaluated six months after a project is completed, i.e., six months after the last disbursement.

In order to obtain some indication of how well the MDBs are assisting their borrowers, the three most recent project reviews by the World Bank and ADB were examined for their performance. The World Bank's Fourth, Fifth, and Sixth Annual Reviews of Projects totaling 318 projects and the ADB's First, Second, and

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11/ The basis for this approach is described in L. Squire, H.G. van der Tak, Economic Analysis of Projects, (Johns Hopkins Press, 1975).

12/ Not all the borrowers have developed the estimates (weights) necessary to utilize the new methodology so that many projects are still appraised using the efficiency approach.

Third Reviews of Post-Evaluation Reports totaling 40 projects were studied. 13/ These reviews focused on the problems the projects encountered in the process of being implemented, ranging from delays in the selection of consultants to changes in product output prices.

The principal measure for determining the success of the project is a re-estimate of its IER. A comparison of that re-estimate with the IER estimated at the time the banks initially appraised the project (before Board approval) is probably the best single measure for comparing how good the MDBs are at selecting successful projects which, in turn, becomes an indirect measure of how well the MDBs are at achieving their purpose.

Of the 358 projects reviewed by the World Bank and ADB, 265 projects (74 percent) were approved in the 1970-74 period, although some were initiated as early as 1964 and one as late as 1977. Of that number, 261 projects (73 percent) had IERs estimated at the time of appraisal and at evaluation. The remaining 97 projects (27 percent) did not have IERs calculated because the benefits from those projects, e.g., education, health, or intermediate credit institutions are either not quantifiable because they are too subjective in nature, or not known because the precise uses for the funds were unknown in advance. 14/ In terms of the individual banks, only 185 of the World Bank's projects actually had IERs calculated, but another 51 projects substituted the IFR as a proxy. Of the ADB's projects, 21 had IERs and 4 used the IFR as the proxy.

Using then the 261 projects with IERs (or IFRs), a comparison was made of the returns estimated at the time the individual projects were appraised and when they were evaluated. Weighting the IERs by the individual loans (by value) to estimate an "average" return for the institution's loans as a whole, the average return estimated at appraisal for the IBRD's projects was 20 percent and at evaluation it was also 20 percent (See Table 1.7). A similar calculation for IDA shows a small increase (2 percent) when the estimate for appraisal (20 percent) was compared to the re-estimates at evaluation (22 percent). The estimates for the ADB were 20 percent and 15 percent, respectively. 15/

13/ Through its 6th Annual Review, the World Bank had evaluated a total of 514 projects; and the ADB through its Third Review had evaluated 40 projects.

14/ Nevertheless, a judgment is made on whether the project was satisfactorily carried out. This judgment is based on how well the project was implemented and whether it achieved the objectives established within the initial cost estimates.

15/ The estimates for the ADB were not broken down by fund because the small number of projects available (25) is not sufficient to provide any confidence in the results.

Table 1.7 Summary of Economic Rates of Return by Sector for the IBRD, IDA and ADB a/

Sector	IBRD			IDA			ADB b/		
	Number of Projects	Appraisal	Evaluation	Number of Projects	Appraisal	Evaluation	Number of Projects	Appraisal	Evaluation
Agriculture	38	22	15	49	27	30	8	32	14
Transportation	42	21	27	47	18	18	7	22	23
Tourism	1	11	4	1	20	15	-	—	—
Industry	5	15	16	2	15	24	4	16	12
Power	19	17	13	6	16	11	2	13	13
Telecommunications	10	20	25	7	16	20	1	27	41
Water Supply/ Sewerage	6	13	9	3	13	11	3	10	5
Total	121	20 c/	20 c/	115	20 c/	22 c/	25	20 c/	15 c/

a/ IERs are not usually calculated for MDB loans for Intermediate Credit Institutions, Education, Power Transmission, Health, Population, and Non-Project Loans.

b/ Insufficient number of projects to warrant a division between Ordinary Capital and Special Funds.

c/ Average weighted by individual loan values summed for each of the institutions.

SOURCE: World Bank, Fourth, Fifth, and Sixth Annual Review of Projects
Asian Development Bank, First, Second, and Third Review of Post-Evaluation Reports.

Of the 261 projects, 113 projects (43 percent) had IERs at evaluation above that estimated at appraisal; 129 projects (49 percent) were below the appraisal estimate, including 20 projects that had either zero or negative rates of return; and 19 projects (7 percent) had the same estimate at both appraisal and evaluation (See Table 1.8).

Table 1.8 Summary Of Project IERs by MDB At Appraisal and At Evaluation

	IBRD	IDA	ADB	Totals	Percent
Above	53	50	10	113	43
Below a/	58	57	14	129	49
Same	10	8	1	19	7
Total	121	115	25	261	100

a/ Includes projects with zero or negative rates of return.

SOURCE: Treasury Department

The average estimates, however, must be treated with some caution because the sample was not drawn in any scientific manner, e.g., randomly; the estimates have an upward bias because the projects with negative IERs are entered only as zeros (their negative values are not known); and the large loans do affect the averages. Moreover, the small number of projects in some of the sector breakdowns limits the confidence that can be placed on the sector averages. Nevertheless, the comparison does provide an indication of how successful the two banks are at selecting their projects.

The relatively high average returns for the MDB projects may suggest that for most of their projects, the return is somewhat higher than the average return received on corporate capital in most of the OECD countries for approximately the same period (1970-1973). 16/ Nevertheless, it must be remembered that the estimates for the MDB projects are weighted by the size of their loan, not the total investment in the projects, whereas the corporate returns are measured in terms of total equity capital; nor is there any adjustment made for differences in

16/ See National Bureau of Economic Research, Research Summaries, "International Economic Growth" (Winter 1980).

risk. Conversely, an attempt to link the rates of return on MDB projects by country to their per capita income levels did not establish any relationship. 17/

There has also been an interest in the rates of return on projects that are directed to the lowest income groups or help to meet the basic human needs (BHN) of the poorest people in developing countries. Although there has been significant economic progress in many of the countries, and a significant decline in the proportion of the population living in absolute poverty, a very large number of people remain very poor. The World Bank categorizes roughly 800 million people in the developing world as living in conditions they term "absolute poverty". One result of this concern has been a change in the pattern of lending by the MDBs to concentrate more of their resources (and projects) on raising the productivity and incomes of the poor, thereby insuring their participation in the benefits of growth. This shift is reflected in the relative increase in lending (by value) for agriculture, urban housing (sites and services), rural health centers, etc., and away from large infrastructure type projects like power dams.

Although the concern for BHN had not developed by the time most of the projects in our data base were approved (1970-1974), in order to determine what return the MDBs were getting on their BHN type projects relative to other projects, the 236 World Bank projects were reviewed for their "BHN" characteristics. 18/

17/ The measure of correlation, using Spearman's rank method, was -0.1879. However, the number of projects per country available from the 236 World Bank projects was not sufficient to place any confidence in the results. The maximum number of projects for which estimates were available by country was 14 (India) and for all but two other countries -- Brazil (12) and Indonesia (9) -- the number was less than 9.

18/ The criteria for selecting the projects include those designed to increase the productivity of small marginal farmers, generating employment for landless laborers, and credit programs for production inputs, marketing, and storage. Other projects included rural access roads and water supply and sanitation. All of the projects for which IERs were available were rural development projects or water supply projects where the IFRs were used as a proxy for the economic benefits.

A total of 45 projects in 30 countries were identified as meeting the BHN criteria. 19/ In terms of their performance relative to the rest of the projects, the average rate of return for the BHN projects at appraisal was estimated to be 26 percent, and at evaluation 24 percent, or marginally higher than the returns on all the projects.

The somewhat higher returns on the BHN projects, when compared to the 20-22 percent return on the IBRD and IDA projects, might be attributable to: (a) the emphasis on directly productive activities with very few if any capital costs; and (b) the relatively short time period in which the benefits are realized, i.e., these projects usually have short gestation periods. However, it would be hazardous to place too much confidence on the higher return as an indicator for all BHN type projects because many of them, e.g., population, health, and education, have benefits that are not readily quantifiable, and if they were measured their value would be very subjective. Thus, comparable IERs are not available for all BHN projects; and most of the benefits from them -- if they could be quantified -- would occur only after a long period of time, e.g., education, resulting in a relatively low return because of the discounting process. Moreover, little confidence can be placed in the estimates because the projects were not randomly selected and the weighted averages are affected by the relatively large projects.

Since the projects reviewed by the MDBs themselves are quite dated (e.g., many of the projects evaluated were initiated more than 10 years ago) a review of the projects approved by the MDBs in the last three years (July 1978 - June 1981) was also done to get a more recent indication of performance. A large percentage of problem situations would suggest that many borrowers are pursuing inappropriate economic/financial policies and/or lax project appraisal standards. In this period, a total of 1,631 loans and technical assistance project proposals were reviewed by the U.S. Government for all of the MDBs. 20/ Restricting our review to just the macro- and micro-economic and financial concerns, e.g., poor financial performance by the borrower, the number of project proposals questioned totals 443 -- still only about 27 percent of the total -- over the three year period. A total of 15 concerns about economic/financial aspects were raised, ranging from the borrower's limited administrative capability to inadequate local contributions to projects (self help). (See Table 1.9.)

19/ The projects were selected on the basis of descriptions appearing in the NAC Annual Reports for FY 1971-1975.

20/ Includes, in addition to the MDBs covered in this review, loans and technical assistance grants by the International Fund for Agricultural Development (IFAD).

Table 1.9 Problems Identified in MDB Loans
(July 1978-June 1981)

Problem	Number of Projects In Which Problem Was Identified
Administrative Capability: Ability of the implementing agent to carry out the project successfully questionable (absorptive capacity).	43
Alternative Financing: Quite probable that other lending institutions would have financed the project.	22
Cost Overrun: Providing a second loan to finance additional project costs.	16
Cost Recovery: Inadequate recovery through "user charges" from beneficiaries of project cost, usually not covering even operations and maintenance.	44
Development Priority: Project does not have sufficient economic merit to warrant priority in any program to increase material well-being.	15
Expropriation: Unresolved investment dispute generally focussed on different views of what constitutes "prompt and effective compensation."	9
Excessive Government Involvement: Governmental determinations replace all or most market related decisions.	6
Local Cost Financing: Making available free foreign exchange where there is no foreign exchange or savings "gap."	12
Non-Compliance with Previous (MDB) Covenants: Borrower failed to fulfill on a condition of an earlier loan.	10
Poor Financial Performance: The borrower is not likely to be financially able to carry out its activities without substantial subsidies from the central government or elsewhere.	55
Product Demand: Concern over whether the price and quantity projections for the project's output are realistic.	10
Pricing Policies: A concern that prices are (typically) too low for the borrower to be financially viable.	127
Effective Protection: The level of tariff protection as measured by the value added in the production process is excessive, i.e., it becomes a prohibitive tariff.	10
Negative Real Interest Rates: The rate of inflation exceeds the rate of interest charged sub-borrowers resulting in the decapitalization of the lending institution in real terms.	141
Self-Help: The degree of effort to mobilize resource domestically to aid the development program.	8

SOURCE: Treasury Department

Not all of the problems, of course, are of equal severity. But the frequency at which some specific problems occurred, e.g., negative real interest rates, suggests that the MDBs have not been completely successful in persuading some of their borrowers to adopt the most appropriate economic policies within the time frame expected. (See Table 1.9.) Negative real interest rates are a significant problem in a number of countries, e.g., Brazil and Peru, affecting not only most of the loans being made to those countries but also their overall economic performance. Another problem commonly identified in the review of MDB loans is pricing, either because the borrower has to operate with artificially determined prices or because the government is restricting price movements for other (policy) reasons, e.g., controlling inflation. This concern was raised during the discussion of at least 127 of the loans reviewed. Other commonly identified problems include those related to cost recovery, poor financial performance, and the limited administrative capabilities (absorptive capacity) of implementing agents (borrowers).

The results suggest that, in terms of the banks' effectiveness, the MDBs are not always successful in convincing their borrowers to adopt the most appropriate economic policies. But the optimum policies are likely to be adopted only over time and it is generally true that more than one project is required to solve any one problem. In effect, this means that the returns on the MDB projects are likely to be lower than they otherwise would be under optimum policy conditions.

The United States actually opposed only 15 loans by abstaining or voting "no" during Board consideration for the same three year period, July 1979 - June 1981, and 5 of those "no" votes were due to expropriation problems in just one country -- Ethiopia. (See Table 1.10.) Many of the problems identified, e.g., inadequate cost recovery, are, to some extent, matters of judgment and views differ particularly when the problem also involves the degree to which projects -- with their financial arrangements -- are to be used as vehicles for changing the distribution of income. The low number of abstention and "no" votes should not be viewed as a particularly good measure of the severity of the problems (nor indirectly of the quality of recent MDB projects) because it has been very difficult to get a consensus of the diverse U.S. Government agencies involved that the seriousness of a financial or economic problem warrants a U.S. abstention or "no" vote. Nevertheless, it does not mean that U.S. concerns were not brought to the attention of MDB managements; in many instances, the same points can be made with equal effect without having to oppose the loan.

C. MDBs and the Private Sector

The multilateral development banks were established with varying degrees of emphasis on free market principles. The creation of these

Table 1.10 U.S. "No" Votes or Abstentions on Economic Grounds
(July, 1978-June 1981)

Country	Institution	Date	Project	Amount U.S. million	Vote	Reason
Colombia	IDB	12/79	Cauca Valley Hydroelectric	44.0	Abstain	Economic Viability
Colombia	IDB	06/81	Marine Seismic Studies	10.0	Abstain	Inappropriate Pricing Policies
Ecuador	IFC	06/79	Industry (Paper)	4.3	Abstain	Excessive Tariff Protection
Ethiopia	AFDF	02/79	Water Supply/Sewerage	8.6	No	Expropriation
Ethiopia	AFDF	04/80	Rural Roads	9.7	No	Expropriation
Ethiopia	AFDF	08/80	Wush-Wush Tea	8.9	No	Expropriation
Ethiopia	IDA	12/80	Agric. Min. Pkg. II	40.0	No	Expropriation
Ethiopia	IDA	05/81	Education	35.0	No	Expropriation
Guyana	IBRD	01/81	Structural Adjustment	22.0	Abstain	Inadequate Policy Reforms
Indonesia	ADB	05/79	Water Supply	8.0	No	Cost Overrun
Kenya	AFDF	12/78	Water Supply/Sewerage	5.5	Abstain	Lack of Absorptive Capacity
Lesotho	AFDF	12/78	Feed Lots	5.2	No	Financially Not Viable
Mexico	IDB	12/80	Fishing	80.0	Abstain	Inadequate Economic Justification
Nepal	ADB	12/78	Integrated Rural Dev.	14.0	No	Lack of Absorptive Capacity
Pakistan	ADB	12/78	Automotive Components	32.1	No	Inappropriate Development Strategy

SOURCE: Treasury Department

public institutions represented members' beliefs that private markets were not sufficient by themselves to meet all developing countries' needs, although their charters do not state this explicitly. What the charters do contain are various indirect references to the importance of private markets. The promotion of private investment is a primary purpose of five of the institutions: the IBRD, IFC, IDB, ADB, and AFDB; the African Development Fund and IDA charters make no specific reference to encouraging private investment. The expansion of international trade is an explicit goal of the IBRD, IDB, ADB, AFDB, and AFDF, while IDA and IFC are silent on this point. The IDB and the ADB are committed to helping their member countries to achieve the best use of resources, primarily through technical assistance, although no mention is made of the free market's role in determining such an efficient allocation. The charters of the IBRD, IFC, and IDB state that public funds may be used for productive investment where private funds are not available on reasonable terms or conditions, thus implying that the institutions are not to compete with private financial markets. Overall, considerations of market principles appear to have been most prominent in the establishment of four of the seven entities: the IBRD, IFC, IDB, and ADB.

The MDBs can provide financing for private business ventures, although this role is limited by policies which require all windows except the IFC to have government guarantees on loans. The IFC is unique in that it loans without government guarantees, purchases equity participations, and has flexibility to undertake more "creative" financing (e.g., co-financing, stand-by arrangements, guarantees, etc.). The Corporation functions essentially like an investment bank with a development focus. Projects are selected on the basis of their useful contribution to economic development and must show a higher probability of being profitable.

The IFC seeks to attract private capital flows by helping identify investment opportunities, bringing together domestic and foreign private capital and experienced management, supplementing private financial resources, and providing technical assistance. IFC participation in a project often serves as a catalyst for private investors who would not otherwise undertake a project perceived as a high risk, particularly in its early stages. The IFC's role is not to compete with private capital, but to supplement it when adequate funds are not forthcoming on reasonable terms and further encourage private funds by overcoming technical obstacles.

The other banks occasionally lend to private companies to carry out approved projects, but their most promising activity in this area is lending to development finance companies (DFCs) which in turn onlend funds to individual businesses. The DFCs are an economical vehicle for MDB financing of worthwhile private sector projects undertaken by small and

medium-sized companies, which would otherwise be difficult and costly to reach. Specific onlending targets are frequently established to offset the relative loss of control over project selection. On a cumulative basis, DFCs have received 14 percent of ADB lending, 10 percent of IBRD, and only 2 percent of IDA.

On the corollary question, the extent to which the MDBs actually discriminate against the private sector, the evidence suggests, that in general they do not, though it is by no means conclusive. In order to obtain some estimate of how the MDBs are directing their funds between the public and private sector, some 383 projects approved recently by the MDBs totaling $14.8 billion were reviewed. 21/ Using the United States' economy as the reference point, the criteria used for determining whether the MDBs were financing projects for the private or public sector were: (a) who is the ultimate beneficiary of the assistance and whether market forces are the principal allocator of resources for the activity, e.g., agriculture; and (b) a judgment of whether the particular economic activity, e.g., manufacturing cement, would be in the private or public sector in the United States. On this basis, the 383 projects and the sectors they represent were classified as private, public or mixed. (See Table 1.11.) The "mixed" category consists of those economic activities carried out by both the public and private sectors in the United States, e.g., railroad and power, or an activity carried out by private companies closely regulated by the public sector, e.g., telecommunications. 22/

The results of the classification show that just over two-thirds of MDB lending went for activities that would be clearly either public or private sector activities in the United States, that is, went into sectors which reflect the same sector allocations as in the United States and, therefore, to some extent represent an "acceptable" allocation of loan resources. Using the United States as the reference point may mean too much government involvement to some people and not enough to others.

21/ Because of limitations in the availability of project descriptions on which to make a judgment, the World Bank's projects were drawn from the description of projects in the FY 1980 Annual Report (July 1979 - June 1980), and the projects for the regional MDBs were drawn from similar descriptions in the NAC's Annual Report for FY 1980 (October 1979 - September 1980).

22/ One must not overemphasize the precision of the analysis. The categories are general ones and the United States, while a benchmark to which the reader can relate, does not provide clear examples of "private" sector activities which are not subject to challenge.

Specifically (See Table 1.11), almost 29 percent of MDB lending (by value) went to the agricultural sector which, with few exceptions, would be in the private sector in the United States; and another 13 percent of the loans went to intermediate credit institutions (DFCs) or to industry/mining, both of which are generally associated with private sector activities. Similarly, Table 1.11 indicates that 26 percent of the lending went for projects considered in the public sector in the United States, e.g., education.

During the review, an assessment was made to ascertain whether the MDBs were financing any projects for the public sector that would have been undertaken by the private sector using the U.S. economy as the model. Of the 383 projects reviewed, and using the same criteria cited above, some 38 projects receiving bank loans of $1.2 billion were identified as being managed by the public sector and directly competitive with the private sector (in the United States) which might have financed it had MDB financing not been available. These loans represent about 8 percent (by value) of the MBD loans reviewed. (See Table 1.11.)

D. Economic Policy Leverage over Borrower Members

The purpose of this section is to describe the process by which the World Bank provides policy advice to assist LDCs to further their development by rationalzing their internal policies, the tools at its disposal; and the constraints it faces. In addition, this discussion attempts to identify the conditions under which the Bank is able to influence LDCs' policies effectively, as well as those where it is likely to meet with less success. The discussion focuses on the World Bank because the size of its operations, experience, and analytical capability, makes it by far the preeminent MDB in providing policy advice to the LDCs.

The conclusions presented below are based on an intensive review of the Bank's experience over the last ten years in attempting to influence the course of economic policy formation in a number of its borrower members. While not a random sample, the group of countries was selected carefully to include the widest possible range of factor endowments, development policies and accomplishments, institutional characteristics, and political styles. Information concerning the Bank's relationships with the countries was gathered from exhaustive interviews with the Bank's senior project and program personnel involved and from a thorough perusal of Bank documents such as loan papers, economic reports, and special sectoral analyses covering the full ten-year period.

The results of this review are, of necessity, subjective and somewhat impressionistic. First, because of the activities of other donors, the IMF, and various domestic interest groups and

Table 1.11 MDB Lending by Sector in FY 1980

Sector	IBRD/IDA	%	IDB	%	ADB	%	AFDF	%	Total	Percent
A. Private										
Agric./Rural Dev.	3,458.4	30.1	323.1	18.8	374.4	26.8	131.5	59.1	4,287.4	28.9
DFC	817.5	7.1	100.8	5.9	160.0	11.5	—	—	1,078.3	7.3
Industry/Mining	682.5	5.9	127.5	7.4	44.2	3.2	9.7	4.4	863.9	5.8
Subtotal	4,958.4	43.2	551.4	32.1	578.6	41.5	141.2	63.4	6,229.6	42.0
B. Public										
Education	453.1	4.0	106.8	6.2	61.0	4.4	17.8	8.0	638.7	4.3
Highways	795.5	6.9	315.0	18.3	37.0	2.7	47.7	21.4	1,195.2	8.1
Water Supply/ Sewerage	631.1	5.5	244.0	14.2	125.9	9.0	8.5	3.8	1009.5	6.8
Ports	312.0	2.7	—	—	123.3	8.8	—	—	435.3	2.9
Nonproject	522.5	4.6	7.0	—	35.4	2.5	—	—	564.9	3.8
Subtotal	2,714.2	23.6	672.8	39.2	382.6	27.4	74.0	33.2	3,843.6	25.9
NON-COMPETITIVE Subtotal	7,672.6	66.8	1,224.2	71.3	961.2	68.9	215.2	96.7	10,073.2	67.9
C. Mixed										
Railroads	337.0	2.9	—	—	—	—	—	—	337.0	2.3
Telecommunications	131.0	1.1	13.7	0.8	—	—	—	—	144.7	1.0
Power	2,392.3	20.8	376.2	21.9	358.0	25.7	7.4	3.3	3,133.9	21.2
Energy	457.0	4.0	26.0	1.5	16.3	1.2	—	—	499.3	3.4
Health	143.0	1.3	78.0	4.5	—	—	—	—	221.0	1.5
Urbanization	348.8	3.0	—	—	60.0	4.3	—	—	408.8	2.8
Subtotal	3,809.1	33.2	493.9	28.8	434.3	31.1	7.4	3.3	4,744.7	32.0
D. Directly Competitive with Private a/	(936.6)	(8.2)	(96.8)	(5.6)	(80.5)	(5.8)	(38.9)	17.5	(1,152.8)	(7.8)
Total	11,481.7		1,718.1		1,395.5		222.6		14,817.9	100.0

a/ Includes loans for projects where the recipient of the funds is the public sector but if the United States is the model the recipient would be in the private sector. These loans are included in Categories A (mostly) and C.

Source: World Bank Annual Report for FY 1980.
NAC Annual Report for FY 1980.

policy making bodies, it is difficult to attribute policy changes exclusively to the Bank's influence. This is particularly true in the case of macro-economic policy issues, such as exchange rates, relative prices, and ceilings on government expenditures and domestic credit expansion, where the IMF has traditionally had a key role. Second, although the course of events in a country had the Bank not attempted to influence policy cannot be known, results of the Bank's efforts which may appear disappointing, may actually constitute significant improvements over other probable outcomes. Finally, the conclusions cannot be generalized from the limited number of countries reviewed to reach definitive conclusions concerning the Bank's overall effectiveness in influencing policy. However, the conclusions do represent our best judgment at this time of the conditions under which the Bank is able to exercise effective policy leverage.

Influencing Policy - The Bank/Borrower Relationship

The Bank has five principal tools of influence. The first instrument is its continuing dialogue on development policy issues with borrower-country nationals. The Bank's usual procedure is to discuss micro or project-specific issues, macro-economic policy issues, and broader questions of the country's fundamental development strategy with technical, managerial, and policy making personnel in the borrower's government. The Bank's objective is to build a consensus through this dialogue on the need for economic policy changes and on the nature of the changes required. In one case, the Bank's dialogue with members of the country's academic community and with private sector business leaders was also found to be influential in producing a broader political consensus on the nature of necessary policy changes.

Second, the Bank's economic and sector work (ESW) is the source of its knowledge concerning its borrowers and provides the basis for dialogue on policy. Instruments of ESW include basic economic reports, up-dating economic memoranda, reviews of the borrower's investment plans, special sectoral missions and reports, and aide-memoires for, and correspondence with, high level officials.

Third, the process of project selection, appraisal, negotiations, approval, and supervision also provides the opportunity for policy dialogue, usually at a fairly specific micro level. Policy changes are sometimes the condition for project appraisal, approval, or disbursement.

Fourth and less frequently, the Bank uses the size and sectoral composition of the country lending program to influence policy. In some instances, the Bank has delayed project appraisal or made project approval contingent upon specific, usually micro policy changes. The Bank has increased lending in particular

sectors as a response to policy changes agreed to by the borrower and has decreased and even terminated lending to a sector as a result of the lack of such changes. Sometimes, the entire country lending program has been used in the same fashion, in accordance with the Bank's judgment of the impact of the borrower's overall macro-economic policy framework on its ability to use the Bank's resources productively.

Finally, the Bank has sought to influence borrowers' policies indirectly through the establishment of inter-governmental Consultative Groups on particular borrowing countries. Through these groups, the Bank attempts to rally other donors around its recommendations.

Factors Affecting the Leverage Process

Many inherent constraints make exercising leverage very complex. These constraints occur at all levels. Although the Bank's fundamental orientation is toward the market-oriented structure of its major shareholders, it is nonetheless expected, by donor and borrower members alike, to adopt a pragmatic rather than ideological stance. Therefore, the Bank is usually constrained to working within the borrower's basic economic and institutional framework. The Bank's objective of maintaining a dialogue with a country's leadership, in order to bring the country into the international system or to keep it there, may in some cases override economic efficiency and effectiveness considerations and lead the Bank to continue operating at a -- usually -- sharply reduced, minimal level, even though the policy environment is relatively unfavorable. An additional constraint on the Bank's ability to promote private sector activities as an alternative to an ineffective public sector is its required public sector bias. Arising from the Bank's statutory mandate to lend only to government entities or to those enjoying the government's guarantee, this requirement is regarded as important not only by the Bank's donor and borrower members alike, but by its financing sources in international capital markets as well.

Constraints limiting the Bank's possible influence are present at the borrower's level too. Borrowers pursue political objectives which are important, if not paramount, and which cause them on occasion to shun the Bank's economically rational policy recommendations. This has often been the case with consumer subsidies. Sensitivities reaching back to the colonial period in one instance have prevented a government from accepting quickly or publicly the Bank's recommendations. Cultural or ethnic factors can also conflict with economically rational policies. In another instance, a borrower was relatively unresponsive to the Bank's urgings that it enlarge the role of the private sector because of the seriously destabilizing ethnic conflict it foresaw as a probable result.

The Bank's ability to influence borrower policy is also constrained by the role other donors play. In particular, bilateral donors pursue a wide range of political, humanitarian, economic, and commercial objectives through their aid programs, objectives that can conflict with the Bank's recommendations. The willingness of donors to subsidize interest rates in pursuit of their commercial objectives has sometimes contributed to what the Bank regards as an over-emphasis on capital intensive investment on the part of some of its borrowers. In one case, the Bank's position was seriously undercut by the eagerness of other donors to continue funding the country's investment program, largely because of their intellectual curiosity about the country's equity oriented development strategy and their philosopical support for its underlying tenets. In these instances, the Bank's cautionary remarks about the strategy's long run recurring cost implications fell on deaf ears, not only in the borrower's government but also in the inter-governmental Consultative Group meetings where the Bank also attempted to press its position. In another case, the degree of other donors' enthusiasm for a country's very orthodox restructuring of its basic development strategy led the Bank to caution the country (with some success) against getting technically and administratively overextended.

Other countries have the ability to tap international capital markets for the resources to finance investment programs viewed by the Bank as too ambitious or projects seen as uneconomic or of low priority, thereby contributing to the high debt service levels the Bank seeks to avoid. Because of their more narrow concern with financial rates of return and commercial guarantees, private lending institutions from time to time enable borrowers to insulate, for a period of time at least, their policies from World Bank recommendations.

Perceptions of the Bank's success or failure in influencing policy depend very much on the assumptions made concerning the proper pace for policy change. The reality of the matter is that such change occurs slowly, usually over a period of five or more years if the issue is a sectoral one (e.g., farmgate prices, water charges, or agricultural input subsidies) or a question of broader macro-economic policy (e.g., incentives for export production, size of the investment program, or an entire structure of consumer subsidies).

Apart from the inherent constraints on the process of influence, a number of factors contribute to the slow pace. The first of these pertains to the nature of the issues, some of which develop into serious economic problems only over a relatively long period of time. Examples found of these include debt management, institutional handling of budgetary expenditures, and the burden of recurring charges resulting from the composition of investment. In one case, the clarity of hindsight enabled the Bank after a

period of years to perceive that what it had been interpreting as cyclical fluctuations in export volume actually constituted a long term decline. Other issues arise not because of the borrower's "mistakes" in policies, but rather because of the success of earlier policies. Examples found of these include the lack of adequate attention to operation and maintenance of existing investments and growing regional income disparities.

In one instance, it appears that the Bank may have overestimated the sophistication of the borrower's policy formulation capability, offering general recommendations as to the direction of policy change, but insufficient guidance as to the specific, step-by-step changes required to move in that direction. Not surprisingly, progress in such cases has often been slow. Sometimes the answer has not been clear to the Bank either, as in the case of a country where the need to improve factor productivity of the pervasive state enterprise sector has been apparent for some time, but where the right mix of fiscal, trade, and employment policies providing suitable incentives and penalities has not yet been found. On an issue such as employment generation, fundamental changes may be required in traditional policies in the agriculture, industry, education, and urban sectors. Two or more years can elapse while the Bank and the borrower prepare the terms of reference, select the necessary experts, participate in the studies, and prepare final reports. As policy changes are often initially painful, negotiating a timetable for phasing specific measures must be added to the process, as well as the phase-in period itself.

Another factor which may help account for the slow pace of change is the Bank's low key approach to influencing policy. This approach is characterized by sensitivity to the borrower member's sovereignty, a preference for gentle persuasion, hesitancy to recommend solutions until it has acquired a substantial body of knowledge about the borrower, and finally, by what appears to be a great deal of patient persistence over time. The Bank attaches great importance to maintaining a dialogue with the borrower. Issues where no progress is likely -- i.e., where the Bank's high level policy discussions generate little or no support for its recommendations -- tend not to be raised formally with the borrower. Although the Bank has on occasion advised a borrower that it will be unable to support the latter's programs in a given sector or, indeed, its entire investment plan unless key policy changes are made, the Bank is generally reluctant to use such "brinkmanship" tactics and risk a rupture of relations with the borrower. The Bank's ability to resolve policy differences without rupturing relations with its borrowers contributes appreciably to its image of competence, credibility, and creditworthiness which it must continue to project in order to tap resources in capital markets.

The Bank can more easily influence micro-level policy at the margin of the borrower's overall policy framework than it can the core of a borrower's macro-eonomic policy. This results basically from two factors: the less central nature of the micro-level policies in question and the wider variety of tools the bank has to influence micro-level policy. Instances were found where the Bank has been effective in influencing producers' prices, cost recovery in the power and irrigation sectors, and specific consumer subsidies. Principal tools used have been dialogue during the course of special sector studies and project appraisal and project conditionality. In several instances, the Bank delayed project appraisal or approval until desired changes had been effected. In other cases, the Bank has withdrawn its support for entire sectors of the borrower's investment program because of an inability to reach agreement with the latter on an appropriate policy environment for the sector. Although change has taken place slowly in some instances, such as water charges, in other cases, such as raising bus fares and creating the policy environment for efficient production in one country's fertilizer sector, the changes have taken place quite rapidly.

At an intermediate level, the Bank has also been able to help create over a relatively short period of time in some countries the appropriate institutional framework for policy formulation at the sectoral level and for policy coordination among sectors.

Macro-economic policies tend to affect several sectors. Examples of such issues with which the Bank has been concerned include export promotion policies, the size and composition of government recurring expenditures or of the investment program, and debt management. In these areas, there are few opportunities to link projects to desired changes. Although conditions have been attached to program and structural adjustment loans with some success, such operations are, at the insistence of the Bank's major shareholders, a minor part of the Bank's total lending. The Bank has also sought to use overall country program size as a lever. However, a certain stickiness was observed on the downside; more often, program size appears to be increased to reward major, favorable shifts in policy rather than decreased as penalty for persistent pursuit of poor policies. Sharply decreased program levels are better described as the result of the reluctant decision by the Bank that the minimum policy conditions for the borrower's effective use of funds no longer exist.

Dialogue resulting from the Bank's economic and sector work is the major tool used to effect macro-level policy. The Bank's bias toward dialogue, its non-doctrinaire approach, and the absence of a wide range of tools to affect macro-level policy has led

the Bank on some occasions to accept "second best" policies at the micro level. Persistence on the Bank's part is also required. Agreement by a borrower to limit the size of its investment program for one year does not guarantee that the following year's program will not be too ambitious. Artificially low farmgate prices and consumer subsidies "reappear" with inflation and the passage of time, thus necessitating new negotiations with the borrower. In addition, changes made in the context of one project are not always carried over by the borrower to subsequent projects in the same sector.

It was also observed that the collaboration of other donors and the IMF is particularly important when it comes to influencing macro-level policy. Thus, structural adjustment loans are usually approved only when the borrower has negotiated an Extended Fund Facility agreement with the IMF, a factor which is producing increasingly close Bank/Fund collaboration. Without the added weight and broader focus achieved through collaboration with other donors, the Bank's leverage over macro-level policy is limited.

Evaluations

Conditions Conducive to Success and Failure. There is a joke that goes, "How many psychiatrists does it take to change a light bulb? Only one, but the bulb has to have a sincere desire to change." This describes the single most important condition for the Bank's effectiveness. A pragmatic and non-ideolgical stance on the part of the borrower has been found a major factor in its willingness to collaborate with the Bank in identifying and implementing policy changes. The length of the Bank's involvement in the country is also important because of the knowledge the Bank accumulates over time and its resulting ability to make increasingly specific policy recommendations without additional lengthy studies. Other factors found to be conducive to success include the collaboration of other donors and the borrower's lack of significant access to other sources of capital and, finally, the absence of "noise" resulting from important strategic or political considerations of an international nature.

The factors conducive to a failure to influence policy are the flip side of the coin. The most important are, first, dogmatic adherence on the part of the borrower to a particular political and/or economic strategy and, second, conflicting views in the international donor community as to the need for the borrower to change and the latter's consequent access to alternative sources of capital. Borrower's shortages of skilled technical, managerial, and policy making personnel are also significant.

Appropriateness of the Bank's "Style" of Influence. The Bank attaches considerable importance to the quality of its relationship with a borrower member, emphasizing dialogue rather

than strong arm techniques. When faced with the dilemma of how to promote an important policy change when the overall macro-level policy environment is unfavorable, the Bank appears to have a preference for opting to stay in the country or sector in question and attempt to build a consensus based on small increments of change over time, rather than to "turn off the tap." Since the latter alternative involves opting out of the country, the Bank views it as leading to the loss of all means to exercise any leverage.

The genuineness of a borrower's willingness to make difficult decisions concerning fundamental policies and his actual ability to implement those decisions in the face of possible domestic constraints are impossible to measure precisely. With the benefit of an outsider's hindsight, it is possible to say that the Bank has a tendency to give the borrower the benefit of the doubt for too long, prolonging its financial support for the borrower's investment program or one sector of the program longer than is productive.

On the other hand, there is no evidence that the Bank's withdrawal of support for a country's investment program has by itself forced the former borrower to reconsider its policies and adopt the Bank's recommendations. Such a reversal appears likely to come about only as the result of a major realignment of domestic political forces. However, it is clear that once such an realignment has taken place and the country's development strategy is significantly reoriented, the Bank can be extremely effective in assisting the country to restructure specific policies and in mobilizing resources to support its new programs.

E. Conclusions

As government institutions, the MDBs should be viewed as instruments designed to provide benefits that private investors would not or could not generate. There are a number of situations where MDB intervention is a valuable element of the development process both for correcting internal/external "market imperfections" and for generating economic activity with high positive externalities or benefits for the community as a whole. Increased MDB co-financing with the private sector has been a particularly valuable aspect of MDB operations which the United States has welcomed and encouraged.

A look at the percentage distribution of MDB lending by sector suggests than an overwhelming proportion of lending has been directed into those sectors which tend to be within this desirable framework. The extent to which MDB activity also appears to have co-opted private sector activity also appears minimal. While data are incomplete, an analysis of the economic rates of return of World Bank and ADB projects indicates that

the rates of return on these projects are relatively high. This suggests that the institutions are making a positive contribution to development. However, the effective implementation of a fairly high percentage of recent loans has been hindered by conditions in borrowing countries which could have been avoided had there been stronger efforts by the lending institutions to encourage appropriate economic policies in recipient countries.

During the 1980s the MDBs will continue to be important to developing countries both as a catalytic force for facilitating private financial flows and, for the lower income countries, as a source of financial support. The MDBs' effectiveness will depend to a large extent on their success in encouraging appropriate economic policies in borrowing countries. The MDBs' record on the economic leverage issue is mixed, with influence more easily exerted at the micro-level of policy and in countries which evidence a pragmatic and non-ideological willingness to cooperate with the MDBs in identifying and implementing policy changes. Enhancing the MDBs' ability to secure necessary policy changes should be an important objective if the MDBs are to achieve a maximum return on what have become increasingly scarce development assistance flows. This would suggest that the country allocation of lending should shift in favor of those borrowers willing to work constructively with the MDBs to insure projects are carried out in an efficient and rationale economic framework.

Chapter II

CRITICISMS OF THE MDBs

This chapter discusses and evaluates criticisms which have been raised regarding the MDBs in general and specific MDBs in particular. It is, in effect, a summary of the more detailed assessment of such criticisms contained in Appendix III.

The Administration has carefully noted the studies on MDB operations undertaken in recent years by Congressional staff (e.g., the 1979 House Appropriations Committee "Investigators Report", and the reports of the Senate and House Appropriations and Authorizing Committees) as well as other recent criticisms of the banks. We believe many valid concerns have been raised regarding MDB performance, and consider an objective evaluation of these concerns to be an essential factor in determining those areas where the United States should seek policy and operational improvements in these institutions.

For the purpose of this evaluation, it seems reasonable to focus on the most frequently highlighted criticisms and/or those most seriously affecting MDB operations which will be explicitly dealt with in evaluating the MDBs' performance in Chapter III. A total of nineteen criticisms were judged to be sufficiently important to be seriously evaluated.

A. Survey of Criticisms

It is possible to organize the criticisms made of the MDBs into several groups. One broad class of criticisms (fundamental criticisms) questions whether the MDBs, by their very nature, are desirable or necessary. A second broad class of criticisms relates to specific MDB policies or operational procedures. Within this class, specific criticisms have been raised with respect to MDB lending policies and procedures; MDB financial policies; and MDB administrative policies. A listing and description of many of these criticisms, organized as between these two broad classes, is set out below.

Fundamental Criticisms

One fundamental criticism which has been raised is that the MDBs are by definition an instrument inferior to bilateral assistance in the achievement of U.S. objectives. This criticism states that the rationale for foreign aid is inherently political in nature and bilateral aid, over which the U.S. has greater control and with which the U.S. is directly identified, is better able to meet our political objectives.

A second criticism of a fundamental nature is that the MDBs, along with the IMF, act on behalf of the private commercial banks by increasing LDC demand for foreign capital and by insisting on the need for high tax rates in order to service these international obligations. The IFIs, which are supported by taxpayers in the developed countries, operate then largely to serve the interests of the private banks and not the LDCs themselves.

A third fundamental criticism is that the MDBs rely on government interventionist solutions to resolve economic problems. In so doing, the MDBs support extravagant and imprudent government policies, foster inflation, discourage private investment, and buttress the forces of statism.

Another criticism which has been raised questions whether the MDBs are needed to channel capital to the developing countries in light of the enormous growth of international capital markets in the 1970s. Insofar as developing countries can potentially rely on private capital markets, the MDBs, thanks to the backing they enjoy from developed countries, only serve to provide a lower cost source of funds for the LDCs.

An additional criticism of a fundamental nature argues that because of their intergovernmental nature the MDBs are insulated from market considerations. Privatization of the MDBs, through sale of their shares to the public, would enforce market discipline on their operations, ensuring that loans would be allocated by country and sector on the basis of economic returns and their effect on the desired loan portfolio.

Criticisms of MDB Policies and Operations

A number of criticisms have been raised with respect to the lending policies and practices of the MDBs. In this regard, the MDBs have been criticized for placing too much emphasis on redistributional rather than pro-growth goals. The World Bank, in particular, is criticized for emphasizing too many basic human needs-type projects, e.g., education, health, and population control.

A second criticism relating to MDB lending policies and practices is that MDB lending has primarily benefited the rich

rather than the poor in developing countries. It is claimed as well that too much MDB lending is devoted to large infrastructure projects rather than projects which directly benefit the poor.

A somewhat similar criticism has also been raised against the MDBs for making what are considered to be insufficient efforts to involve the poor directly in their lending activities. The MDBs are criticized for channeling their assistance through large, operationally-centralized agencies instead of indigenous non-governmental organizations that understand local needs and resources.

Another criticism of MDB lending policies and procedures has been raised with respect to what is regarded as an excessive concern with expansion in their lending programs. The World Bank, in particular, has been singled out for criticism for being more concerned about the quantity of loans rather than their quality.

A somewhat similar criticism raised in this regard is that the rate of growth of MDB loan commitments has exceeded the developing countries' ability to absorb resources. To the extent that individual countries receive more assistance than they can effectively use, MDB resources have been wasted.

The World Bank's structural adjustment lending program has also been criticized on the grounds that these loans will be used to finance current account deficits in developing countries with little emphasis on conditionality. By providing finance of this type, the World Bank is moving away from its project lending emphasis into an area of balance of payments support more appropriate to the IMF.

Among the criticisms made of MDB lending policies and practices is one with regard to their efforts to graduate countries, either from soft loan terms to hard loan terms (sometimes referred to as "maturation") or out of the banks altogether. It is claimed that the MDBs do not have specific criteria governing graduation out of hard loan windows and apply graduation policies inconsistently.

The MDBs have also been criticized for a lack of coordination among themselves and between themselves and bilateral aid donors. It is claimed that there is a significant degree of duplication of activities among the MDBs and inadequate project-level coordination among multilateral and bilateral donors.

Several criticisms have been raised with respect to the financial and lending policies followed by the MDBs. One criticism in this regard is that the lending terms used by the banks are inappropriate. Rather than providing hard loans and soft loans as the MDBs do, they should provide, depending upon the relative rates of return, either hard loans or annual grants to developing countries.

The rate of return to the MDBs on their activities has also been criticized. In particular, the World Bank has been criticized for the low rate of return on its assets. Since 1970, the World Bank's net income has only doubled, whereas its loan commitments have increased ten-fold.

A number of criticisms have also been raised with respect to the administrative policies of the MDBs. The MDBs have been criticized for being essentially run by their management, with little direction exercised by the executive directors. The degree of donor control of the World Bank, in particular, is criticized; it is claimed by some that the U.S. exercises greater influence in the regional MDBs than in the World Bank.

The MDBs have also been criticized for having inadequate loan preparation and supervision. The excessive rate of growth in MDB lending, it is claimed, has strained the institutions' capacities.

The internal auditing and evaluation procedures of the MDBs have been subjected to criticism. Specific criticisms cited include the lack of a central office, detached from operating responsibility, to investigate and resolve alleged or suspected irregularities; inadequacies in the conduct of broad program audits of departmental and operational activities; and problems of productivity.

The MDBs have been regularly criticized about the level of their staff salaries and compensation. It is claimed that MDB staff are overpaid.

B. Assessment of Criticisms

The following provides a listing of these nineteen important criticisms, and summarizes the conclusions reached regarding their validity. As noted earlier, a more detailed discussion analyzing each criticism is provided in Appendix III.

1. Bilateral Aid is Superior to Multilateral Aid. U.S. bilateral and multilateral aid have different comparative advantages depending upon the U.S. objective in question and complement, rather than substitute for, each other. The U.S. bilateral aid program can often move more quickly to support U.S. short-term political interests and priority countries, and also stimulates LDC growth by bringing to bear particular U.S. expertise on key development constraints in recipient countries; multilateral assistance primarily serves long-term U.S. interests, can be very cost-effective, and promotes a stable international economic environment through the encouragement of market oriented policies. Thus it appears reasonable for the United States to use both bilateral and multilateral assistance in fashioning a foreign assistance program which maximizes its contribution to U.S. national interests at the lowest possible cost (Appendix III, p. 153).

2. The MDBs Primarily Serve the Interests of Private Banks. To the extent that the MDBs promote sound development policies and growth, the MDBs promote efficiency in the international economic system, which benefits developing and developed countries and the international economic system does not in any way imply that the MDBs (or the IMF) are their creatures.

MDB lending constitutes only a small share of what the largest private bank borrowers require to service their debt to private banks. Moreover, the vast bulk of MDB lending is intended to meet the foreign exchange costs of identifiable projects. Furthermore, unlike private banks, the MDBs do not extend debt relief. Thus, the MDBs cannot be said to be "bailing out" the commercial banks in crisis situations (Appendix III, p. 157).

3. MDBs Encourage the Public Sector Over the Private Sector. Analysis of the MDBs' project lending (Chapter I) shows that a very high proportion of the lending is not competitive with the private sector. Moreover, the policy prescriptions promoted by the MDBs have been along market-oriented lines. However, a question remains as to the willingness of the MDBs to enforce their market-oriented policy prescriptions in countries not favorably disposed to such policies (Appendix III, p. 160).

4. The MDBs are too Insulated from the Pressures of the Marketplace. The MDBs are already subject to a degree of market influence which will grow in the future. However, they are not intended to be purely commercial lending institutions. Thus, the MDBs must of necessity allocate capital on other than solely financial criteria, although such criteria are important among and within countries and sectors (Appendix III, p. 163).

5. The MDBs are not Needed to Transfer Capital to the LDCs. MDB finance plays a somewhat different development role than does private sector finance, and the finance provided by the private capital markets is not a perfect substitute for that provided by the MDBs. MDB finance is accompanied by technical and policy advice and is provided in the context of specific development projects. Private market finance, on the other hand, generally tends to be more for balance of payments support. Moreover, full reliance on private lenders would lead to a more concentrated distribution of external financial flows. This would favor the more advanced LDCs, and would be to the serious disadvantage of the poorest and middle income developing countries which do not have access to capital markets (Appendix III, p. 165).

6. The World Bank Emphasizes Redistributional Rather than Pro-Growth Goals. Traditional-type projects still receive considerable emphasis. Moreover, projects addressing basic human

needs are not "redistributional" but are aimed at capital investment and can be important to an economy's development. Although returns on such projects are more difficult to quantify, they appear to match those achieved on more traditional projects. In certain specific countries, however, the World Bank may have overemphasized redistribution considerations at the expense of sound economic policy reforms which would have represented the best approach to poverty elimination (Appendix III, p. 166).

7. MDB Projects Benefit the Rich in Developing Countries. While there are instances in which individual MDB projects have in fact benefited the rich, this criticism is not valid as a general proposition. Moreover, the MDBs, particularly the World Bank but also including the regional MDBs, have made major efforts to insure that the poor receive a greater proportion of the benefits of MDB-financed projects (Appendix III, p. 168).

8. The MDBs Do Not Sufficiently Involve the Poor. The MDBs, particularly the World Bank, have made substantial progress in developing better techniques for involving the poor directly and actively at all stages of the project cycle. MDB activity in this regard is, however, constrained by the receptivity of recipient countries to the more direct involvement of local organizations (Appendix III, p. 169).

9. There Has Been an Emphasis on Quantity Rather than Quality in the World Bank. It appears that the World Bank has emphasized strongly the achievement of specific lending targets. There are indications that this has had an adverse impact on loan quality. It also appears that the emphasis on lending targets has on balance eroded the Bank's effectiveness in encouraging sound economic policies in recipient countries (Appendix III, p. 171).

10. The MDBs Lend in Excess of Absorptive Capacities in Developing Countries. The evidence from a global point of view is that MDB lending does not appear to be in excess of absorptive capacity constraints in developing countries. However, this issue is, by its nature, country and sector specific, and definitive conclusions are not possible. Indications that World Bank programs may in some instances have exceeded the absorptive capacity of small African countries reinforce the need to pay closer attention to the particular absorptive capacity constraints of such low income countries (Appendix III, p. 174).

11. Structural Adjustment Lending (SAL) Lacks Conditionality. The key issue is the World Bank's success in securing appropriate conditionality of its SAL loans. This has been a basic U.S. concern from the very beginning of SAL programming. Given the medium-term nature of SAL programs, more time will be needed before a final judgment on the effectiveness of the programs can be made. However,

the Bank does appear to be making reasonable efforts to complement IMF programs and enforce the conditions on outstanding SAL loans (Appendix III, p. 175).

12. There are Anomalies in MDB Graduation Policies. There appears to be considerable scope for improving both the maturation and graduation policies of the banks to more realistically reflect the needs of the recipients. In the past, however, this issue has been politically difficult (Appendix III, p. 178). The issue of MDB maturation and graduation policies is also addressed in Chapter V.

13. Coordination is Inadequate Among the MDBs and Bilateral Aid Programs. The MDBs do make efforts to maximize coordination among multilateral and bilateral donors. Coordination at individual project level could be improved but might entail considerable costs (Appendix III, p. 180).

14. MDB Lending Terms are Inappropriate. The MDBs insist on a rate of return standard (10 percent) for individual projects and decide between hard and concessional resources on the basis of countries' creditworthiness. Other approaches, appearing theoretically more sound, pose major practical difficulties (Appendix III, p. 181).

15. Growth in the World Bank's Earnings Has Lagged Behind Growth in Its Assets. While criticism of the lack of growth in World Bank earnings had some validity in the early to the mid-nineteen seventies, the lending rate policy adopted in 1976 at the urging of the United States has led to a significant upgrading of the Bank's profitability. More importantly, the Bank's return on its equity has been above both its average and marginal cost of funds. Recent changes in capital and exchange markets, however, pose new risks for future profitability which are receiving close attention (Appendix III, p. 184).

16. MDB Members Lack Control Over the Institutions. MDB Boards attempt to operate on the basis of consensus. Individual board members can have a clear impact on overall bank policies. (See Chapter IV regarding U.S. influence in the banks.) The impact of members on individual loans is considerably more limited (Appendix III, p. 186).

17. There is Inadequate Loan Preparation and Supervision in the MDBs. The documentation and testing of MDB project proposals are generally more extensive than those financed by bilateral agencies or private commercial banks, although this in part reflects the types of projects financed. There are generally extensive periods, usually of one to two years, of preparation and appraisal for each project. Project implementation is the responsibility of the borrower, but there is extensive MDB supervision and follow-up (Appendix III, p. 187).

18. MDB Evaluation Systems Are Deficient. There have been changes and improvements in the audit and evaluation systems of the IBRD, ADB and IDB. Audit committees are active and improvements have also occurred in the functioning of the evaluation systems themselves. Close attention will have to be paid to ensure that the increased coverage of the audit evaluations does not detract from the overall quality of individual loan evaluations (Appendix III, p. 190).

19. MDB Staff Are Overpaid. Substantial progress has been made in dealing with the compensation question at the IMF/IBRD on a satisfactory basis and defusing criticism of this issue. However, there may be future problems in this area and the United States will have to fight hard to assure that the progress made is not lost (Appendix III, p. 192).

C. Conclusions

Careful attention should be paid on an ongoing basis to criticisms which imply that policy and/or operational deficiencies detract from the institutional effectiveness of the MDBs. In this context, all of the criticisms which have been surveyed in this assessment should be kept under review.

In some cases, such as independent audits and evaluation and staff salaries, the situations which generated criticism have already been remedied or improved. While a significant number of other criticisms appear to have little validity, others focus on areas (such as evaluation systems, and the issue of absorptive capacity) where the evidence is not conclusive or the extent of the problem has not been quantified. These particular areas warrant additional follow-up. In addition, there are two specific criticisms which appear sufficiently valid and serious so as to justify priority attention being given to specific U.S. initiatives in the banks. These are: (1) the indication that in some instances there has been an overemphasis on loan quantity rather than loan quality, which has served to erode MDB policy leverage (also see discussion of this issue in Chapter I), and (2) the strong indication that a more effective maturation/graduation policy is required to make MDB lending more reflective of country need and the availability of alternative financing. These two issues will be discussed in more detail in subsequent chapters.

The results outlined in this Chapter and discussed in more detail in Appendix III are drawn upon in the next Chapter in assessing the effectiveness of U.S. objectives in the MDBs.

CHAPTER III

U.S. OBJECTIVES AND MDB PERFORMANCE

This chapter reviews the foreign policy objectives the United States has pursued through its participation in the MDBs and draws some conclusions about the extent to which the banks have served those objectives, taking into account key criticisms (discussed in Chapter II and Appendix III) which have been made of the banks. These conclusions provide a basis for some suggested new policy directions presented in Chapter VI which, in light of the Reagan Administration's economic and political philosophy, reaches overall conclusions and makes recommendations for future U.S. participation in the banks.

A. U.S. Policy Objectives

From the start, the United States has viewed the MDBs as an important multilateral foreign policy vehicle to enhance our security, economic, and humanitarian interests. The basic long term, systemic goal has been to build and to maintain an international economic framework that is open, predictable, growing, and characterized by increased efficiency and output. Such an international economic system was expected to encourage the development of democratic, pluralistic and capitalistic societies similar to ours. The hope has been that economic growth and improvements in the quality of life for poverty stricken people would contribute toward a more stable international political environment. In both a long and short term sense, the MDBs were considered to be a vehicle for moving toward this broad goal.

In a very fundamental way, other donors and many of the developing countries have shared our desire to strengthen the international economic system and enhance the ability of the developing countries to participate fully; they have also shared our perception of the important contribution the banks can make to this process. Because of this broad commonality of interests, the MDBs have enjoyed strong international support from both donors and recipients.

In seeking a more stable international environment, the United States has pursued over time three general kinds of policy objectives: political/strategic, global economic and financial, and humanitarian.

Political/Strategic Objectives

U.S. leadership of the non-Communist world has been a consistent objective of U.S. foreign policy since World War II. To the developing world, our willingness and ability to assist in their highest national priority -- economic and social development -- has been an important factor in their acceptance of U.S. leadership. Partly as a result of playing the most significant role of any single country in the creation and functioning of the MDBs, the United States has been able to retain a strong leadership in the management of the international economic system while at the same time serving a number of its own specific interests. There has been a general view that by assisting LDC development we could encourage policies and actions by those countries more consistent with long-term U.S. strategic and political interests.

The operations of the MDBs can contribute to specific U.S. political/strategic interests in at least three ways. In the long term, by promoting steady economic growth, the MDBs contribute to a more secure and politically stable world with less likelihood of conflict over economic disparities. In the medium term, the fact that the actual country allocation of MDB lending is generally compatible with current U.S. foreign policy preferences means that friendly governments are receiving development assistance far greater than the U.S. alone could supply. For example, the World Bank and IDB have been particularly active in Mexico and Brazil; the World Bank in Egypt; and the World Bank and ADB in Korea. In addition, the MDBs can also be helpful as relatively apolitical institutions in allowing the United States to show some indirect support for countries with whom U.S. bilateral relations are still sensitive but which are susceptible to improvement, such as Yugoslavia and Romania. In the short term, the MDBs, especially the World Bank, can provide fast disbursing assistance, such as program or structural adjustment loans (SALs), to U.S. "friends" (although the loan processing, especially for SALs, can sometimes take as long as project loans). The World Bank helped Peru in this manner in 1979 and Turkey in 1980-81.

Global Economic and Financial Objectives

The United States, along with most members of the international community, has had a major interest in a free, open, and stable international economic/financial system. By promoting economic and social development in the Third World, fostering market-oriented economic policies, and preserving a reputation for impartiality and competence, the MDBs encourage developing countries to participate more fully in an international system based on liberalized trade and capital flows. Ultimately, this process of bringing the LDCs into the international system as responsible, full fledged members culminates when a country is able to terminate dependence on the MDBs for financing and policy advice and rely on private sources of capital and expertise. This means expanding opportunities for U.S. exports, investment, and finance. It also supports the U.S. long term systemic goal by contributing to an open, predictable, and growing international economic framework. The MDBs have pursued this objective in several ways.

Acting as a catalyst for private investment and other private capital flows, plus trade and technology flows. The MDBs can perform this "catalytic" function through their basic country analysis work, technical assistance, equity participation (the IFC), and by encouraging direct private lending through such means as co-financing and sale of participations. The banks are expected to reduce the risks and information costs associated with capital, trade, and technology flows; the MDB "stamp of approval", conveyed by their very presence in a country, can be an important part of the catalytic effect by inspiring investor confidence. (Conversely a decision to terminate prematurely MDB lending to a LDC could have serious repercussions on that LDC's creditworthiness and retard private flows.) They work with relevant economic actors, in borrowing and donor countries, and with banks, producer firms, and investors in an attempt to reduce the chances of misunderstanding, precipitous action, or miscalculation of risk. They also attempt to help borrowing countries improve their creditworthiness and thereby their access to and reliance on private international credit sources, thus broadening and deepening these markets.

Mobilizing and transferring government backed capital directly to the developing countries. With regard to their hard loan windows, the MDBs perform this "resource transfer" function by acting as financial intermediaries between private investors and developing countries by selling bonds, guaranteed by the callable capital of donor members, in private capital markets.

On the basis of donor contributions, the MDBs lend on concessional terms from their soft loan windows to their poorest borrowers. The MDBs also mobilize official development assistance through aid coordination activities which reduce overhead costs and duplication of effort by individual donors. The banks also provide an alternative for small donors who are unable to administer bilateral programs on any scale and thus prefer to lend indirectly. This concessional lending provides the poorest LDCs with access to capital which is otherwise in scarce supply to them. With this and other sources of external capital, these LDCs are able to pursue programs of economic development which are aimed at improving standards of living for their populations and promoting their economic development to bring them into the mainstream of the world economy.

Encouraging rational LDC economic policies under free market concepts and global economic efficiency. In performing this "economic policy leverage" function, the MDBs can make available to borrowing countries a body of relatively apolitical economic policy expertise. The MDBs can also seek to encourage individual country practices that increase the global efficiency of resource utilization. The goal is to help countries specialize in areas where they have a comparative advantage, to rely more on international trade, and to use market mechanisms wherever possible to increase the efficiency of pricing and allocation decisions. The MDBs can be more effective at this than individual donors because of the substantial resources at their command and because of their "non-political" international character.

Humanitarian Objectives 1/

Among other things, U.S. foreign policy has sought to show leadership in relieving poverty and suffering and improving the material well-being of the poor in the developing world. While the main rationale of assistance to even the poorest LDCs is to promote overall economic development in order to integrate them into a stable international economic system, there is also a humanitarian aspect to the programs. By promoting overall economic growth and productivity in LDCs, and by pursuing programs targeted directly on the poor, such as agriculture, urban and rural development, nutrition, and education, the MDBs can assist countries in attempting to meet their people's basic needs while at the same time helping them to develop the ability to achieve minimum standards of living. The banks have also provided emergency relief and/or reconstruction assistance; for example, the World Bank and IDB have lent to Haiti and the Dominican Republic for post hurricane reconstruction and to Peru in the aftermath of an earthquake.

B. U.S. Operational Objectives

In the interest of maximizing the relative cost effectiveness of the MDBs as a policy instrument, the United States has been concerned with the economic returns to the United States and the financial impact on the U.S. taxpayer of U.S. participation in the banks, as well as promoting their operational and administrative efficiency. Other donors and borrowing member countries have shared similar concerns about the operational effectiveness of the MDBs. Basically, these commercial, budgetary, and institutional efficiency goals can be considered "operational" since they relate to the way (i.e. least cost) in which the overall "policy" objectives concerning our security, economic, and humanitarian interests have been, and can be, pursued in the banks. That an objective is considered to be "operational", rather than a "policy" objective, does not imply that it is of lower priority.

1/ Section 701 of the International Financial Institutions Act (PL 95-118) instructs the U.S. Government to use its voice and vote in the MDBs to channel assistance toward countries other than those whose governments engage in a consistent pattern of gross violations of internationally recognized human rights, or those who provide refuge to individuals committing acts of international terrorism by hijacking aircraft. This legislation also requires the U.S. Government to seek to channel assistance to projects which address basic human needs of the people of the recipient country. The Department of State is currently reviewing U.S. human rights policy, including implementation of Section 701.

Commercial Objectives

Although perhaps not in a strict free market sense a legitimate objective, by promoting economic and social development and the adoption of market oriented policies in the Third World, the operations of the MDBs are consistent with U.S. commercial interests. Developing countries can provide vital raw materials important to the US and other industrial economies; examples of the MDB role in raw materials development can be found in World Bank lending to Bolivia for tin mines and to Zambia for cobalt production and ADB lending to Malaysia and Thailand for rubber production. LDCs are a dynamic export market, and their continued growth and the liberalization of their trading practices, as fostered by some kinds of MDB lending, can benefit industrial countries' export industries. Importation by the United States of LDC industrial and agricultural goods, resulting from MDB financed projects, can increase competition domestically and restrain inflationary pressures, provided that U.S. domestic markets are not disrupted or protectionist forces stimulated. An improved investment climate in LDCs, fostered by MDB supported market oriented policies, can benefit U.S. investors. In addition to participation in projects funded by the MDBs, broad use of international competitive bidding practices followed by the MDBs can more generally improve access of U.S. firms to procurement opportunities in LDCs.

Budgetary Objectives

Because of the resource leveraging nature of multilateral assistance, particularly in the hard windows, the United States should be able to carry on its foreign policy objectives through the MDBs at a lower overall cost to the United States taxpayer than if an equivalent amount of funds were to be appropriated by the United States itself. Since the United States contributes about 25 percent on average of total MDB financial resources, other countries provide $3 for every $1 from the United States. Inasmuch as only 10 percent or less of the U.S. contribution to the hard loan windows is paid in and involves budget outlays, mobilizing funds from other donors and private capital markets theoretically allows $1 of U.S. direct budgetary outlays to support 40-60 times as much development assistance when loaned through the ordinary capital windows.2/ As far as the individual banks are concerned, every dollar the United States currently makes available in paid in capital and contributions to the World Bank (IBRD/IDA) will eventually support between 15 and 20 times as much lending. The leverage factor in the IDB and ADB is about half that in the World Bank.

2/ This leverage factor varies significantly between the hard and soft windows and from bank to bank. The leverage factor in the ordinary capital windows is significantly greater than in the soft funds, contributions to which are entirely paid in.

Institutional Efficiency Objectives

The United States has been concerned with how well the banks carry out their development mission, in terms of operational and administrative efficiency and the impact of lending activies on growth and development. MDB capability to administer programs productively and efficiently ensures cost effectiveness and can maximize the use of scarce development resources. The ability of the MDBs to design and implement high quality development loans can contribute to economic growth and social development in recipient countries.

C. How Well US Objectives Are Served

In this section, drawing heavily on Appendix III which contains a detailed analysis of the major criticisms leveled against the MDBs, we identify those valid and important criticisms which relate to each objective and evaluate, in light of the criticisms, the extent to which the MDBs have served that objective.

Political/Strategic Objectives

Criticisms. One fundamental criticism, relating to the relative merits of multilateral vs. bilateral assistance, stresses the lack of direct U.S. control over the MDBs as limiting the extent to which they serve our political/strategic objectives. More specifically, the MDBs have been criticized for their inability to respond rapidly enough to short term U.S. needs, and because the country allocation in the soft loan windows has emphasized countries of relatively low strategic importance to the U.S. Non-project lending, the principal MDB rapid response mechanism, has been criticized as not being used correctly by the World Bank and not providing the United States with sufficient political credit. Because it is subject to our direct control and clearly identified as coming from the United States, the bilateral aid program is believed to be a superior foreign policy vehicle.

Performance. U.S. bilateral and multilateral aid have different comparative advantages and disadvantages. Although any generalizing is difficult, the two tend to complement rather than substitute for each other.

With respect to achieving short term political objectives, flexibility and quick disbursements are the key factors. The flexibility or "controllability" of both bilateral and multilateral development asssistance in terms of rapidly providing support to countries of particular political/strategic interest to the United States is constrained by an average 18-24 month project cycle (the time from project identification to obligation of funds), though the timing of bilateral projects is more controllable by the U.S. Government. The U.S. bilateral program, which contains substantial amounts of economic supporting assistance and PL-480, has the clear advantage in terms of serving U.S. short term political interests. It can also be cut off much more rapidly in response to U.S. political concerns than can multilateral.

Both bilateral and multilateral assistance serve U.S. long term political and economic objectives. Bilateral aid can stimulate steady LDC growth through its technical and capital assistance projects focused on key constraints to LDC development. In addition, the funding mix between Development Assistance (DA), ESF, and PL-480 can be altered as needed to enable the bilateral program to meet the current mix of assistance objectives chosen by the executive branch and the Congress. U.S. multilateral assistance, primarily the hard loan windows, contributes to the achievement of long term U.S. political/strategic interests by lending to key countries such as Brazil, Mexico, and Korea. Although some recipients such as Pakistan are of immediate importance to the United States, the soft loan windows, especially IDA and the ADF, do not contribute to U.S. political interests as immediately or directly. In terms of U.S. geo-political priorities, the IDB probably contributes the most to U.S. interests and the ADF the least.

Over the short and long term, both bilateral and multilateral aid highlight U.S. interests in particular countries or regions. While bilateral assistance is more readily identifiable as coming from the United States, the multilateral channel also complements and enhances U.S. efforts to help key countries and regions (e.g., the Caribbean Basin) by coordinating bilateral assistance programs.

Global Economic and Financial Objectives

Criticisms. The most fundamental economic criticisms of the MDBs center around their role in the international economic system, and charge that: the MDB resource transfer function is unnecessary given the growth in private capital markets; the MDBs lend in excess of some LDCs' absorptive capacities; the MDBs do not pursue or support market oriented environments in LDCs; and, the MDBs do not seek or achieve appropriate economic policy changes in LDCs. More specific program related criticisms in this category make reference to graduation policies and the utility of structural adjustment and program lending. Finally, there is a philosophical/theoretical concern deriving from the view that the MDBs are not subject to the pressures of private markets.

Performance. Although all financial flows to LDCs have grown substantially in the 1970s, private flows have tended to be relatively concentrated in a number of higher income countries. Because of the continued importance of official capital flows to LDCs which have no, or very little, access to private capital, MDB lending covers a broader range of countries than private lending. Some prominent examples, such as the Sahel countries and Bangladesh, tend to be the poorest countries which, in some specific instances, have absorptive capacity problems.

There is strong evidence that the MDBs do seek to promote market oriented environments. Policies advocated by the Banks tend to follow neo-classical economic lines emphasizing open trading systems, realistic exchange rates, use of market forces to determine appropriate resource allocation, realistic pricing policies, cost-recovery, and maintenance of sensible fiscal and monetary policies. Furthermore, Treasury analysis suggests only 8 percent of IBRD/IDA lending supports public sector activity in areas generally reserved for the private sector in the United States. In total, 32 percent of MDB lending was judged to be potentially competitive in that, while such activities in the United States are provided in part by the private sector, they are provided by the public sector in most LDCs. The remaining 68 percent was viewed as non-competitive in that it either supported the private sector or represented activities which in the United States are normally provided by the public sector or are closely regulated by it. This evidence does not, however, contradict the view that the MDBs could be doing more to stimulate the private sector.

With regard to the MDB economic policy leverage function on the other hand, there is evidence that the MDBs have not been as effective as they could be. Of all the MDBs, the World Bank plays by far the largest role in seeking to promote appropriate economic policies in borrowing countries at the micro level through conditions attached to individual loans as well as at the macro level through long term lender-borrower dialogues. As indicated in Chapter I, the World Bank is most effective when borrowers are receptive to such economic policy guidance, and appears to have the most influence at the micro-economic level. Evidence suggests that where borrowers have access to alternative sources of finance or where the World Bank over emphasizes lending volume targets to "move money", its economic policy leverage is considerably weakened. Furthermore, the Bank has shown a tendency to continue lending to a country or a sector where, in spite of efforts to encourage reforms, the macro level policy environment continues to be unfavorable. Such an approach would appear to reward bad policies and entail a failure of the policy leverage function. In addition, the frequency with which economic and financial policy problems have arisen in recent MDB loans indicates that the banks have not been entirely successful in persuading borrowers to adopt appropriate policies (Table 1.9, Chapter I).

Turning to more specific program concerns, it appears that there are inconsistencies in the IBRD's implementation of its graduation policy. (None of the other hard windows has an articulated graduation policy.) In addition, the World Bank's structural adjustment program has had mixed results thus far. Conditionality has generally been enforced, although in some cases there have been weak programs and faulty in-country implementation. However, the program has not been in operation long enough to afford a more definite judgment.

The MDBs are subject to a degree of market discipline since the hard windows can only function with capital market borrowings. However, they are development banks, i.e., semi-governmental

institutions designed to overcome market imperfections and achieve various objectives, including socio-economic objectives. Thus, they allocate capital on other than solely financial criteria.

Humanitarian Objectives

Criticisms. Criticisms in this area are contradictory. On the one hand, it is said the MDBs do not do enough to help the poor directly and that the benefits of MDB projects accrue to the rich in LDCs. On the other hand, it has been asserted that growth, not redistribution, should be the MDBs' objective. Furthermore, it is said that the results of helping the poor are hard to evaluate and are improper activities for institutions dependent upon capital markets.

Performance. The soft loan windows of the MDBs, especially IDA, make a significant contribution to meeting U.S. humanitarian objectives. In the past decade, they have moved far in providing more assistance to poorer countries and more projects of direct and immediate benefit to the very poor. Although there has been substantial progress in improving the standard of living of the poor, much remains to be done. At the same time, as a by-product of the development process, some of the benefits of MDB projects may have accrued to the rich, although this is the exception rather than the rule. Although evaluation of poverty oriented or "new style" projects is sometimes difficult, economic rates of return on such projects so far seem to match or exceed those achieved on more traditional projects.

Commercial Objectives

Criticisms. It has been charged that U.S. business does not receive a fair share of MDB procurement when measured against the U.S. share of financial resources provided to the MDBs.

Performance. The United States receives substantial procurement benefits from the MDBs. On a cumulative basis, MDB procurement of U.S. merchandise exports has totalled $8.7 billion for a return of $1.10 in U.S. exports for every dollar actually paid into the banks.

Budgetary Objectives

Criticisms. The MDBs have been criticized on the grounds that cost-sharing is, in principle, also available under bilateral aid, which also has other advantages not available from the MDBs. A fundamental Congressional criticism has been the increasingly larger appropriations requests for the MDBs.

Performance. Channeling aid through the MDBs has often been justified on the basis of the financial leverage arising from cost-sharing and borrowing against callable capital. In this context, the hard loan windows are clearly more effective than the soft loan windows. Although there have been year-to-year fluctuations, requests for MDB funding have steadily increased from $686 million

in FY 1970 to $3.6 billion in FY 1980. However, increasing the multiplier effect of MDB loans by utilizing more private funds through greater cofinancing or increased borrowings against callable capital would enhance the budgetary objective.

As to the supposed availability of bilateral burdensharing, effective coordination and allocation of assistance among donors would necessitate a higher degree of convergence between individual donor political/strategic and commercial interests than is likely to exist in view of divergent national interests. Finally, a successfully coordinated bilateral approach would not offer the financial leverage arising from callable capital and would, assuming all other factors are unchanged, result in significantly larger bilateral appropriations requests.

Institutional Efficiency Objectives

Criticisms. Criticisms of MDB administrative efficiency include inadequate loan preparation and supervision, deficiencies in program and project auditing and evaluation, and excessive staff salaries. Furthermore, it has been charged that World Bank emphasis on meeting lending targets has caused a decline in project quality.

Performance. In recent years, criticisms of administrative efficiency have received considerable attention and considerable progress has been made, especially in the World Bank. Loan preparation and supervision is generally good; new program auditing and project evaluation procedures have been instituted; and growth in staff salaries has been reduced. While there is no clear evidence (including that obtained from economic rate of return calculations for MDB projects) of a general decline in loan quality, it appears that "excessive" growth in World Bank lending, in some cases, has affected the quality of individual projects; in other words, there is still too much emphasis on meeting country and/or regional lending quotas.

Conclusions

On the basis of the preceding analysis, some general conclusions are suggested about MDB performance in contributing to U.S. foreign policy objectives -- objectives which are shared to a broad degree by other member countries of the banks:

-- the MDBs, by and large, have been most effective in contributing to achievement of our global economic and financial objectives, and thereby also helping us in our long term political/strategic interests, in spite of there being room for improvement in terms of exercising more effective economic policy advice and implementing graduation policies more consistently.

-- the soft loan windows of the MDBs are particularly effective in advancing U.S. humanitarian interests.

-- the MDBs, particularly the hard loan windows, contribute significantly to the achievement of U.S. long and medium term political/strategic interests but are less effective with regard to achievement of short term objectives, where identification of the assistance with the United States is important.

With regard to the operational objectives, we concluded that:

-- the MDBs have served U.S. commercial interests well.

-- the MDBs, particularly the hard loan windows, are particularly effective in serving the budgetary objective because of cost-sharing with other donors and the financial leverage derived from MDB borrowing against callable capital guarantees. Greater reliance on private funds through greater cofinancing or reduced reliance on paid in capital would enhance this objective.

-- the MDBs have served the U.S. institutional efficiency objective reasonably well through operational and administrative efficiency and the generation of generally high quality loans, although here too there is room for improvement.

We have not made any assumptions in this chapter about the relative priorities among these foreign policy objectives. The next chapter, however, indicates that for the United States to apply influence successfully in the MDBs, it is imperative that U.S. policymakers set clear priorities among policy objectives and time their campaigns carefully, not only because the stock of U.S. political influence is finite but because conflicts between objectives continually arise. Thus, in recommending a new direction for U.S. participation in the MDBs, Chapter VI relies on the Reagan Administration's overall economic and political philosophy and objectives to set priorities among the six objectives we have identified and assessed in this chapter.

CHAPTER IV

U.S. INFLUENCE IN THE MDBS

Ultimately, the effectiveness of the new policy and planning framework, which will emerge in the final sections of this assessment, will depend on the U.S. ability to apply influence effectively in pursuing its interests in the banks. The purpose of this chapter is to develop general conclusions about the extent to which the United States has been able to do this successfully and about the factors contributing to the success or failure of the United States' efforts to achieve its specific policy or operational objectives in the banks. These conclusions, based on an analysis of a number of instances in which the United States sought to achieve specific results, provide the basis for an identification of the necessary and sufficient conditions under which the United States can maximize its influence in the banks.

A. Sources of Influence

The sources of U.S. power, from which our influence in the MDBs derives, originate in the advantages inherit in our predominant position in the banks; the expectation of others as to our ability and will to use those advantages; and our position as a world leader.

The magnitude of the U.S. financial participation in the MDBs and the central U.S. role as a founding member have assured us a major role in the MDB decision making process by tradition, law, and practice. The United States was instrumental in shaping the structure and mission of the World Bank -- the institution which also served as a blueprint for the regional banks -- along Western, market oriented lines. We were also responsible at Bretton Woods for the emergence of a corporate entity with weighted voting run by a board of directors, with high caliber management and well qualified professional staff. As a charter member and major shareholder in the World Bank, the United States secured the sole right to a permanent seat on the Bank's board of directors. U.S. participation in the Asian and Inter-American Development Banks has followed a similar pattern.

The United States has been perceived as strongly supportive of the banks and of their efficient, cost effective operation and administration. The U.S. role as a world leader has provided a larger, complementary framework for our pre-eminent position in the banks. Because of a broadly shared commonality of interest in an open,

predictable, and growing international system, other significant actors -- management, major donors, and major recipients -- have recognized the United States as a major voice in the banks. They know from past experience that we are capable and willing to pursue important policy objectives in the banks by exercising the financial and political leverage at our disposal.

B. Differences Among the Banks

The U.S. ability to achieve policy and operational objectives in the MDBs has varied from issue to issue and from institution to institution. In addition to such factors as the level and consistency of the U.S. commitment to a particular objective and the interests and positions of other key actors, the individual characteristics of the banks themselves also play a role in determining the success or failure of a particular policy objective.

On the whole, the policies and programs of the World Bank Group have been consistent with U.S. interests. This is particularly true in terms of general country allocation questions and sensitive policy issues. The international character of the World Bank, its corporate structure, the strength of the management team, and the Bank's weighted voting structure have ensured broad consistency between its policies and practices and the long term economic and political objectives of the United States. Major donor coordination on World Bank issues has proved effective and has been used frequently by the United States. The major donor countries (Canada, France, Germany, Japan, the United Kingdom, and the United States) consult regularly on MDB issues and achieve common views on upcoming issues.

It is also probably true that the World Bank has more often been the focus of U.S. initiatives in the past because:

-- it is the largest and most important of the MDBs;

-- the dollar amount of U.S. financial participation in the World Bank Group far exceeds that in the regionals;

-- its location in Washington permits U.S. policymakers to interact first hand with Bank management and other member countries;

-- cross cutting policy issues, such as maintenance of value obligations and salaries, which are settled in the Bank generally determine the outcome in the other banks; and

-- innovations initiated in the Bank, such as "new style" projects and emphasis on energy development, tend to be picked up in some form by the regionals.

Although the United States has greater individual voting strength in the Inter-American Development Bank than it does in any of the other banks, it has proved more difficult to pursue U.S. interests in the IDB because the combined voting strength of the donor countries

is relatively weak. The Bank is dominated by its Latin American members who, despite relatively small hard currency contributions, hold the majority voting power and who tend to present a united front on operational, administrative, and budgetary issues which affect them. Management also tends to be more responsive to borrower concerns than in the World Bank. The United States has sometimes been able to make its views prevail in the IDB, particularly if supported by other developed donor members, but not without expending considerable effort and incurring political costs. The anticipated costs have seemed too high in many cases and have prevented the United States from pursuing various issues.

The United States has found the Asian Development Bank's policies and practices generally consistent with our concerns. Our ability to influence policy within the Bank has been aided by the donors holding the majority voting strength and by the confluence of interest between the Japanese and the United States.

C. Methodology: Gauging Influence

We identified some 70 issues where, over the past ten years, the United States had pursued a specific objective by seeking to change MDB policy, practice, or procedure. These issues involved a variety of financial, operational, and administrative policy concerns which originated with the Executive Branch or Congress or as a reaction to a MDB-initiated proposal. Many issues were pertinent to all the banks, others were unique to a particular MDB. (We did not include the African Development Bank since the United States is not a member.)

The list of issues was then cut in half by eliminating the duplicates of those issues which arose in more than one bank and those issues which were low priority to the United States in terms of the effort expended to achieve the objective and the extent to which we were perceived as being committed to the objective. The remaining issues were evaluated in terms of whether the United States succeeded (S), partially succeeded (PS), or failed (F) in achieving its objective; about 80 percent of these were considered successes or partial successes. Finally, the most significant issues were selected, about 85 percent of which were successes or partial successes. In other words, the success/failure composition of the list of most significant issues is generally representative of the success/failure composition of the larger list.

Most Significant Issues

	Rating
Increasing lending to the poor	PS
Graduating high income borrowers	F
Improving auditing and evaluation systems	S
Containing administrative expenses	PS

Promoting human rights (1977-81)	F
Halting lending to Chile (1970-73)	S
Lending to Indo-China (1975-78)	PS
Halting lending to Afghanistan (1979)	S
Resuming concessional lending to Indonesia, Thailand, and the Philippines (1977)	S
Blocking PLO observers from IBRD/IMF annual meetings (1979-81)	S
Initiating and then halting the World Bank energy affiliate (1980-81)	S
Improving the World Bank's financial condition through slowing lending and a new interest rate formula (1975-76)	S
Avoiding open ended financial obligations and preserving certainty in voting rights (1978-81)	S
Improving donor cost-sharing by expanding IDB membership (1972-1979)	S

Each issue was then analyzed to determine:

-- how serious the United States was in seeking the specific objective concerned in terms of the willingness to expend political capital and the level and scope of our lobbying effort;

-- the positions and roles of other relevant actors such as bank management, other major donors, LDCs, and Congress, as appropriate;

-- the degree of success in terms of the extent to which the results matched the objective and the variation in results among the banks; and

-- which elements -- strong or weak U.S. commitment to objective; support, opposition, or indifference of other key actors; the varying nature of the banks themselves -- contributed to the success or failure of U.S. efforts to achieve the objective.

D. Conclusions

Exercising Influence

Whenever the United States sought a particular objective, some degree of "political capital" was expended in exercising political and/or financial leverage to achieve that objective. The United States has exercised influence in the broadest sense by drawing on

its prestige as a world leader, its position as a major MDB shareholder, and its capabilities as a primary actor in the banks, and on the shared interests of the community of international actors. This has been especially true where high priority objectives involved politically sensitive issues, threatened established interests, or faced strong opposition, e.g., the PLO issue; human rights; MDB compensation practices; lending for Chile, Afghanistan, and Indo-China; and valuation of World Bank capital.

Financial leverage has been exerted -- frequently effectively -- during replenishment negotiations where the U.S. participation was made contingent on specific MDB actions. It has also come into play when Congress acted or threatened to act on funding requests to secure a specific MDB response.

Over the years the United States has used its influence to further its interests in the MDBs in a variety of ways, e.g., by formal diplomatic representation through State Department channels; informal donor coordination mechanisms; letters, telephone calls, and personal visits from high level U.S. officials. The higher the objective's priority, the greater has been the amount of effort devoted to it and the higher the level of the U.S. officials involved. For example, the President and Secretaries of State and Treasury were involved in U.S. efforts to further human rights in the MDBs; the Treasury Secretary and Under Secretary for Monetary Affairs were active in seeking to contain MDB salaries; the Treasury Under Secretary for Monetary Affairs was closely involved in seeking to improve the World Bank's financial condition; the Treasury Assistant Secretary for International Affairs negotiated resumption of soft lending to Indonesia, the Philippines, and Thailand; and the U.S. Executive Directors were primarily responsible for improving MDB audit and evaluation systems.

The mere exercise of influence and the expenditure of political capital, even in considerable amounts, does not per se assure a successful outcome. The following sections identify factors which have contributed to the success and failure of U.S. efforts to achieve particular policy objectives.

Factors Contributing to Success

The United States was found to have been completely or partially successful in achieving its objective in 85 percent of the cases examined in detail. Many of these cases had factors in common which appeared to contribute directly to their successful outcome.

In over half the cases the successful achievement of the U.S. goal depended to a large degree on the United States' being clearly and fully committed at a high level to a well defined, consistent policy/operational objective. This was especially true in the following cases where the United States effectively influenced MDB policy in:

-- containing administrative expenses, particularly salaries;

-- avoiding open-ended financial obligations and voting rights uncertainty;

-- blocking PLO observers from IBRD/IMF annual meetings;

-- promoting donor burdensharing in the IDB through membership expansion;

-- halting the creation of a World Bank energy affiliate;

-- improving the World Bank's financial condition by slowing the commitment rate and introducing a lending rate formula which assured cost coverage;

-- halting World Bank and ADB lending to Afghanistan; and

-- halting World Bank and IDB lending to Chile.

The support of U.S. efforts or agreement with the U.S. objective by other major donors and/or by bank management was an important factor in a number of instances. The support of like-minded key donors was instrumental in convincing the ADB to resume concessional lending to Indonesia, Thailand, and the Philippines; in improving the financial condition of the World Bank; in halting lending to Chile and Afghanistan; in resolving the PLO issue; and, in improving auditing and evaluation systems. Management support played an important role in U.S. efforts to expand the number of developed country donors in the IDB; management concerns about lending to Chile and Afghanistan and increasing World Bank lending to the poor coincided with U.S. interests.

Congressional actions or attitudes also appeared to influence significantly the outcome of some events. Congressional threats to reduce U.S. shares in the banks convinced IDB members of the seriousness of U.S. efforts to improve burdensharing by expanding membership. Congressional attitudes toward lending to Chile, Afghanistan, and Vietnam; about the PLO; and about salaries and administrative expenses put both borrowers and managements on notice about possible MDB funding repercussions. Congressional oversight exercised through the General Accounting Office has been highly influential in securing ongoing improvements in MDB auditing and evaluation systems.

Factors Associated with Failure

U.S. efforts to exercise influence have met with failure or only partial success when we have been faced with opposition from other key actors, have simultaneously pursued objectives which are inconsistent, or have sought a poorly defined or unfocused objective.

The positions of bank managements, major donors, and borrowers have played a particularly crucial role. Although major progress has been made, management concern in the regional banks about staff limitations and possible over-emphasis on the poor contributed to the less than fully successful realization of U.S. efforts to expand lending to the poor. Strong opposition from borrowers and

from donors where special country interests were involved has contributed to the inability of the United States to make headway on the graduation issue. Absence of a donor consensus on which countries were human rights violators and reluctance to make this a determinant of MDB lending contributed to U.S. failure to improve human rights by blocking MDB lending to specific countries. Opposition of World Bank management and disagreement with other donors on how to treat Vietnam resulted in IDA lending to that country in spite of a U.S. "no" vote.

The simultaneous pursuit of conflicting objectives has tended to undermine U.S. efforts to achieve a particular policy objective. The United States has vacillated between seeking to rationalize MDB efforts to graduate high income borrowers, on one hand, and seeking reinstatement of graduated borrowers on the other. This conflict between economic and political objectives has made U.S. efforts on the graduation issue relatively ineffective. U.S. efforts to achieve administrative cost-effectiveness by limiting staff size were complicated by U.S. advocacy of staff intensive activities such as new style agricultural projects and increased ex post project evaluation.

The prime example of a policy failure caused by unfocused or nonspecific objectives is the U.S. human rights policy. By attempting to stop loans to a broad range of countries rather than focusing on human rights situations on which a clear international consensus existed, the United States generated opposition to its efforts; by continuing bilateral programs in some countries where we were opposing MDB loans, the United States eventually came to be perceived as not seriously pursuing a coherent policy. Initiating discussion in the World Bank on graduation and subsequently scuttling a management proposal emerging from those discussions (although we disagreed with it because it would have delayed graduation of major high income borrowers) tended, probably accurately, to signal the lack of a clear cut U.S. objective with regard to the Bank's graduation policy.

Implications for the Future

On the basis of the preceding analysis and conclusions, it appears that there are two basic conditions, both of which are necessary, for effectively exercising influence in the MDBs. The U.S. must be strongly and clearly committed at high levels to a well defined policy objective and be prepared to expend political capital to succeed. One or more of the other significant actors -- management, other major donors, or borrowers -- must support, or at least not oppose, the United States.

An important factor which may contribute to, but not necessarily assure, success in achieving a particular objective is action or threat of action by Congress.

To increase the chances of achieving a particular objective, policymakers will have to be extremely careful to avoid pursuing inconsistent objectives. This will require setting clear priorities,

careful choice of timing, and orchestration of campaigns. Policy makers will also have to keep in mind that pursuing an objective in the face of opposition from MDB management or donors will require heavy expenditure of political capital and possibly the exercise of financial leverage. Since political capital is a scarce resource, policymakers will be forced to consider carefully the relative priorities of various policy objectives and to focus on the most important ones.

Consideration will also have to be given to the particular MDB forum in which an objective is to be sought. It is likely that the policies and practices of the World Bank and the Asian Development Bank will continue to be consonant with U.S. interests. Achieving any given objective is likely to be more difficult and require more effort in the Inter-American Development Bank.

In the final analysis, U.S. influence has been directly related to our traditionally predominant position in the MDBs, our financial participation, and our leadership role as a major shareholder. Drastic or precipitous reductions in U.S. financial support for the MDBs could undermine our ability to influence MDB policies and practices in the future. Reversal of our traditionally positive, active role in MDB decision making processes could weaken U.S. leadership in the banks. If other significant actors perceive the United States as no longer willing or able to continue to play a major financial and political role in MDBs, they may be less likely to support U.S. policy initiatives in the banks.

CHAPTER V

IMPROVING MDB EFFECTIVENESS

Developing country growth is important to U.S. economic, political/strategic, and humanitarian interests. The United States thus shares with the MDBs the goal of successfully integrating the developing countries into the international economic system. MDB policies and operations are consistent with overall U.S. interests to the extent that they promote economic growth and development by encouraging appropriate economic policies and enhance the prospects for international stability.

As shown in Chapter III, it has been in the national interest for the United States to support the MDBs. Although the MDBs have generally served U.S. objectives effectively, our analysis in Chapters I and II also shows specific aspects of the MDB resource allocation process which warrant improvement. It is our judgment that the United States does have sufficient influence in the institutions to work constructively with like-minded members and MDB management to secure such improvements and that these can have a significant impact on the need for, and use of, capital resources by the MDBs.

The next chapter will present the overall policy conclusions of the assessment and set out a series of specific policy recommendations which the United States should pursue in the MDBs. In completing the analysis on which those conclusions and recommendations will be based, this chapter explores the relationship between the MDB resource allocation process and the development rationale which underlies this Administration's approach to the MDBs.

A. Appropriate Economic Policies

Foreign assistance provides an opportunity for the developing countries to strengthen their economies by investing at a rate above that which could be attained solely on the basis of available domestic resources and external private finance. Based on the empirical evidence of developing country performance in the 1960s and 1970s, however, it is clear that if development is to succeed, the developing countries must mobilize their

own resources to the maximum extent possible, and adopt appropriate domestic policies which are conducive to the efficient allocation and utilization of these domestic resources in conjunction with external assistance. Unless a recipient country adopts such policies, no amount of external assistance is likely to produce sustained economic progress.

There are a broad range of domestic policies which significantly affect developing country growth, although the relative importance of each will depend to a large extent on the economic and financial situation, the absorptive capacity and the economic potential, of individual countries. It is clear, however, that policies geared to stimulate and enlist private sector initiative in mobilizing a country's human and material resources, and policies which foster efficient production of goods and services in response to domestic and international market forces have been at the forefront of contributory factors for most of the more successful developing countries.

To achieve maximum impact, foreign assistance must complement and encourage those domestic policies geared to producing goods and services efficiently in response to market forces. In particular, foreign assistance should have a catalytic effect on domestic resources and external investment, while helping to establish an environment, both on a micro and macro-level, which stresses these market forces and incentives. In this context, the stimulation of private sector economic activity and modification of inefficient public policy are paramount objectives.

To further ensure that capital transfers are effectively utilized, foreign assistance must also take absorptive capacity constraints into account and, where necessary, seek to relieve them through the provision of technical assistance. This is particularly important in those low income countries most vulnerable to such constraints.

MDB effectiveness in promoting LDC development in the 1980s will depend to a large extent on the banks' success in encouraging borrowing countries to pursue sound economic policies. In this regard, it is important to note that the MDBs lend on terms that are more attractive than what is available from commercial sources. In the soft loan windows, the cost of borrowing is highly concessional. In the hard loan windows, the maturities are longer and the interest rates lower than can be obtained elsewhere. Thus from the standpoint of developing countries, MDB loans are desirable because alternative sources of capital are either non-existent or more expensive. The fact that the MDBs possess significant amounts of a scarce, desirable resource should enhance their ability to encourage improved policies.

In Chapter I, our examination of past MDB operations indicates that the MDBs have been able to influence micro-level policy to a much greater extent than they have been able to affect borrowers' overall macro-economic and sector policies. We believe that the World Bank has a comparative advantage relative to the regional banks in working with countries at the macro-level and think the Bank could do more -- in cooperation with the IMF as appropriate -- to help developing countries to select appropriate macro-policies. We also recognize that the cumulative impact of micro and sector policy advice provided by the MDBs over time can be considerable. This is particularly relevant for the regional MDBs which we believe should focus their efforts at the micro-level through sound project and sector oriented policies. In any case in all the banks, priority attention must be accorded to insuring that every project is implemented in a coherent economic framework.

We also found that MDB policy advice is more effective in those countries which evidence a pragmatic and non-ideological approach to development and MDB project implementation. This strongly implies that the willingness of borrowing countries to adopt and implement appropriate policies should be a prime consideration in the country allocation of MDB lending. The focus should thus be on the quality rather than the quantity of MDB lending, and the result could either be an increase, or a decrease, in annual lending levels, depending upon the efficacy of recipient country efforts to pursue appropriate policies. In this context, efforts should be taken to curb the practice, noted in Chapters II and III, whereby the MDBs, particularly the World Bank, have used arbitrarily determined aggregate country or sector lending targets as a basis for annual lending activity. Such "targetry" is likely to erode the MDBs' ability to encourage appropriate policies in recipient countries as well as detract from the quality of the resulting loans because of pressure to "move money". The elimination of "targetry" would presumably permit more selectivity in the loan process with judgments on loan programs based more closely on the quality of loans and their relationship to effective micro and/or macro policies.

B. MDB Resources and Maturation/Graduation

Concurrent with the important emphasis the MDBs need to place on the pursuit of appropriate country policies -- both when determining the level and composition of country loan programs and in loan implementation -- it should also be the ongoing responsibility of the MDBs to ensure that bank resources are reserved for those countries whose need is greatest. Both the scale and the terms of bank lending should reflect the needs of individual recipient countries, the economic realities of the 1980s, and the fact that decreased -- and eventual termination of -- reliance on MDB funding is a normal and desirable step in the development process. This requires an efficient and equitable MDB policy for ensuring a country's eligibility for lending also takes into account the country's current debt servicing capacity and the extent of its broader access to the usage of other financing sources, particularly the much larger

private financial markets. Successful implementation of such a maturation/graduation policy is closely inter-related both to overall U.S. policy objectives in the banks and to the budgetary implications of U.S. participation.

Development is an evolutionary process and a developing country's need for external capital, both official and private, will change over time. At an advanced point in the development process, a country should be able to decrease its reliance on external resource flows, and the net inflow of funds should decline and eventually be eliminated as amortization and interest obligations are fulfilled. At the present time, most developing countries remain below the point of development at which such a decline in total external transfers is possible consistent with achieving a reasonable level of growth.

Progressive change in this process is marked by developing countries' ability to acquire access to and adequately service external capital resources. Broadly speaking, the spectrum ranges from those least developed countries whose limited economic prospects can support only the inflow of grant or grant-like funds, to the more advanced developing countries whose more dynamic economies are able to support the servicing of inflows financed entirely by private capital markets.

The establishment of both "soft" and "hard" windows within all of the MDBs is intended to accommodate the variations in debt servicing capacity which exist among developing countries. As recipient country creditworthiness improves, adjustments should also be made in the nature and the extent of access to available MDB resources. For MDB recipients, there are two basic transitional stages: (a) "maturation" from the status of borrowing only from the soft windows, to the intermediate step of borrowing a "blend" of soft and hard window funds, and eventually to the status of borrowing only from the hard windows, and (b) "graduation" from the status of borrowing from the hard windows to full reliance on other sources of external capital, primarily private market capital.

In principle, both maturation and graduation entail a gradual process whereby countries are phased out in accordance with a lending program worked out between the recipient countries and the MDBs and which addresses the specific development and financial constraints that justify either the soft or hard loan windows' continued support. Even if there were a sharp cutback in new soft loan commitments to potential maturing countries or hard loan commitments to graduating countries, MDB disbursements would continue for some years. These borrowers' share of the MDBs' portfolio would decline very gradually and only after some time. However, the phasing out of new commitments to these countries would "free up" corresponding resources for other borrowers with more limited debt servicing capacity.

Although this discussion of maturation/graduation focuses heavily on the World Bank Group (i.e., IDA and the IBRD), the concept is also applicable to the regional MDBs.

Maturation

The International Development Association (IDA) was established to provide assistance to the poorer developing countries on terms commensurate with their limited foreign exchange earnings and debt servicing potential. While IDA projects must meet the same economic and financial standards as other World Bank projects, IDA credits are for 50 years, with repayments beginning after 10 years, and with an annual service charge of .75 percent. 1/

IDA has three nominal criteria for determining country eligibility: low per capita income (currently up to $730 in 1980 dollars), inability to service additional debt on more conventional terms, and the ability to use IDA resources efficiently. The size of a recipient country's population is an additional major consideration for the amount of resources to be allocated.

Since 1961, twenty-nine countries have been phased out of IDA borrowing as a result of their improved economic situation. However, seven of these countries later resumed borrowing from IDA, and IDA lending continues to four of them. Only 38 percent of 1978-80 IDA lending went to IDA-only recipients, while 62 percent went to "blend" countries judged able to adequately service a combination of IDA and IBRD lending 2/. Almost 80 percent of IDA lending to these blend countries was directed to three recipients -- India (65%), Egypt (8%), and Indonesia (6.5%) -- although Egypt and Indonesia have subsequently been moved to sole reliance on IBRD borrowing.

1/ Bank management was reconsidering the terms of IDA credits at the time this assessment was being written.

2/ About 86 percent of ADF lending is received by countries which would qualify for lending on IDA-only terms, and 14 percent is received by four IDA/IBRD blend countries. Over 76 percent of AFDF funds are received by IDA-only borrowing countries and 21 percent by countries which receive blend terms in the IBRD/IDA. Largely due to Latin America's relatively advanced development, only 3 percent of FSO lending now goes to borrowers which would qualify for lending solely on IDA terms and 34 percent to countries which would qualify for blend terms in the IBRD/IDA.

Table 5.1: World Bank Recipients - Country Categories 1/

"IDA-only Eligible" Countries -- World Bank borrowers receiving only IDA funds.

Afghanistan*, Bangladesh, Benin, Burma, Burundi, Central African Republic, Cape Verde, Chad, Comoros, Congo, Ethiopia, Gambia, Ghana, Guinea-Bissau, Haiti, Laos, Lesotho, Madagascar, Maldives, Mali, Nepal, Niger, Pakistan, Rwanda, Sao Tome, Sierra Leone, Somalia, Sri Lanka, Sudan, Togo, Tonga, Uganda, Upper Volta, Vietnam*, Western Samoa, Yemen AR, Yemen DR, and Zaire

* Afghanistan and Vietnam are not current borrowers.

"Blend" Countries -- World Bank borrowers receiving both IDA and IBRD funds

Bolivia, Botswana, Cameroon, El Salvador, Guyana, Honduras, India, Jordan, Kenya, Liberia, Malawi, Mauritania, Nicaragua, Papua New Guinea, Philippines, Sao Tome, Senegal, Swaziland, Tanzania, Thailand, and Zambia

"Potential Graduate" Countries -- Major IBRD borrowers with present or potential future capacity to gradually phase out reliance on Bank funds.

Argentina, Portugal, Romania and Yugoslavia crossed the IBRD's per capita income "threshold" in the 1970s. Another six major borrowers (Algeria, Brazil, Chile, Korea, Malaysia and Mexico) appear likely to cross the threshold in the 1980s.

-- Other IBRD borrowers with present or potential future capacity to gradually phase out reliance on bank funds.

Bahamas, Barbados, Cyprus, Oman, Trinidad and Tobago, and Uruguay have crossed the IBRD's per capita income threshold, and Costa Rica, Fiji, and Panama appear likely to cross the threshold in the 1980s.

1/ These country categories reflect the country specific situation as it existed at the time the analysis was undertaken. Since then there have been some shifts in country classification which are not reflected here.

Source: Treasury Department

IDA's stated criteria for maturation, i.e., per capita income, creditworthiness, and performance, appear sensible. However, the application of these criteria also appears to warrant more detailed and operational guidelines particularly with regard to the weight that each criterion should have in the maturation process. While IDA has been very successful in allocating resources to the poorest countries (over 75 percent of cumulative commitments have gone to countries with 1978 per capita incomes of $345 or less), creditworthiness and performance standards do not appear to have always been given due consideration and have sometimes been applied on an ad hoc and inconsistent basis. As a result, there is considerable scope for improving the implementation of IDA's maturation policy.

IDA is now moving to mature all recipients with a per capita income above $500, but does not believe there is much room for maturation below that level. Clearly full maturation would not be appropriate at this point for those blend countries now experiencing serious financial or balance of payments problems. However, given current market interest rates, it may be hard to justify continued grant-like lending of IDA funds to those other blend countries with a better resource base and creditworthiness. Therefore, with a view towards greater efficiency in resource allocation, these blend countries should be closely examined as potential candidates for full maturation even though their per capita incomes are relatively low.

Analysis of balance of payments projections for a selected group of IDA blend countries indicates that full maturation beginning in 1985 would have no significant differential impact on the level of debt burden for these selected countries through 1990. Implicit in this finding is the assumption that increased IBRD lending will substitute for IDA flows. It also reflects the fact that -- given both the time lag between the commitments and disbursements of new IBRD funds and the grace period of these loans -- the increased cost of servicing IBRD lending would buildup only over time and would not be significant through 1990. The ability of current blend countries to service a portfolio of hard window loans in the post 1990 era would depend more on the efficiency with which such lending was utilized, on the overall economic and financial policies being pursued by the recipient countries, and on world and regional economic conditions, than on the marginal increase in debt service costs resulting from harder terms.

Graduation

Graduation is not a new concept and the IBRD already has an articulated (if somewhat vague) policy on graduation from its hard loan window. A per capita income of $1,750 in 1977

dollars or approximately $2,160 in 1980 dollars is supposed to trigger more rigorous analysis of the need for continued bank assistance. There are no precise guidelines, however, nor an explanation of what this more rigorous analysis should entail. Moreover, there is no per capita income ceiling on eligibility for IBRD loans and, in the past, key questions concerning timing, scale, and content of the phase-out lending program have been decided on an ad hoc basis.

Seven countries have graduated since the IBRD formulated its policy in 1973, nearly all with a per capita income well above the threshold level at the time they ceased borrowing from the bank. Four current major borrowers crossed the per capita income threshold between 1973 and 1979. Another six major borrowers appear likely to cross the threshold in the 1980s.

These ten "potential graduate" countries accounted for 29 percent of the IBRD's outstanding loans in June 1980 and approximately 31 percent of undisbursed loan balances. While they also accounted for 40 percent of FY 1981 bank loan commitments, the IBRD has generally held constant or reduced the nominal level of lending (i.e., a decline in real terms) to the four countries above the per capita income threshold. The IDB also has a similar practice, with lending to the 3 largest borrowers held roughly constant in nominal terms. In addition, these three largest IDB borrowers now provide hard-currency contributions to the soft window FSO.

For most "potential graduates", private financial flows already account for a very high percentage -- in some cases over 90 percent -- of total gross foreign flows. Even though the MDBs provide them with only a small proportion of their external financing, the amounts involved for some of the potential graduates are large relative to the availability of MDB resources. Graduation of countries already able to borrow large amounts in capital markets thus could "free up" significant MDB funds for the other hard window recipients with more limited private market access.

Three arguments frequently used to justify continued MDB lending to the more advanced LDCs are that such lending: (a) provides a "stamp of approval" which enhances a recipient's access to private capital markets, (b) encourages recipients to pursue more efficient macro and/or sector policies than would otherwise be the case, and (c) is needed because many recipient countries have a greater absorptive capacity for external funds than can be financed by private capital markets where the flow of funds is restricted by internal country exposure limits administratively established by private banks doing the bulk of international lending.

Proponents of these views do not, however, give adequate weight to the fact that it is the economic and financial policies

of recipient countries and the extent of their perceived determination to make whatever economic adjustments are necessary to retain creditworthiness -- rather than their association with the MDBs -- which are of paramount concern to private lenders.

This is reinforced by the MDBs' difficulty in influencing borrowers' macro-policies -- particularly in situations where the MDBs account for only a very small portion of external financing -- and the greatly enhanced capacity of private institutions to perform independent sophisticated economic analyses of potential borrowers. Moreover, if private market borrowers do encounter temporary balance of payments difficulties, it is adherence to an IMF program -- rather than adherence to a World Bank or regional development bank endorsed strategy -- which is a major determinant of continued private market access.

In addition, private market lending to developing countries is generally most readily available when such lending constitutes a good investment for the lender. In situations where individual private banks' "country limits" restrict the lending of a specific institution or institutions, there are generally a large number of other similar institutions available to respond to potential funding shortfalls as long as such investment is deemed to be profitable.

In view of the great diversity of socio-economic and political characteristics among the potential graduates, there does not exist a uniform graduation or phase-out program appropriate for all countries. In this context, once they have adopted a general policy, the MDBs will require considerable consultation and policy flexibility to determine the appropriate role for the banks in the period immediately following a country's passage beyond the per capita income threshold. It would be particularly important, for example, for any country's transition period to be managed so as to maintain, if not enhance, its standing in world credit markets and remove any other serious developmental constraints that have required the MDBs' presence.

Maturation/Graduation and the U.S. Budget

There is sound economic rationale for encouraging the implementation of efficient and equitable maturation/graduation policies even in the absence of MDB budgetary constraints: maturation on the grounds that concessional resources should be reserved for those low income countries whose debt servicing capacity will not support nonconcessional financing; graduation on the basis -- emphasized in Chapter I -- that the MDBs should be viewed as institutions designed to provide benefits that private investors would not or could not generate. Existing and projected budgetary constraints do, however, clearly underscore the importance of according priority attention to the maturation/graduation issue.

U.S. financial support for future international cost sharing arrangements for funding the MDBs will have to reflect fully the realities of U.S. budgetary constraints and the Administration's determination to reduce the growth of overall budget expenditures. The impact of the Administration's tightly disciplined national budget extends across a broad range of important domestic programs, and it would not be realistic -- nor in our judgment would it be sustainable in the Congress -- to exempt future MDB funding arrangements from the general budget policy.

In this context, U.S. contributions to the soft loan windows would appear to offer the greatest scope for U.S. budget reductions, reflecting the high proportion of U.S. budgetary expenditures for the MDBs now attributable to soft window contributions and the much higher cost-effectiveness of U.S. hard window subscriptions. While the Administration's position on the extent and the scope of U.S. participation in future soft window replenishments will be subject to specific review in each case, it is obvious that the rates of growth which have characterized MDB soft window lending over the last decade do not appear to be broadly substainable in terms of increased U.S. budgetary contributions.

Assuming other donors are unlikely to make up any significant U.S. funding reductions to soft loan windows, decreases in the level of U.S. financing are likely to reduce the overall availability of MDB resources. Thus, in general, the greater any reduction in U.S. contributions to future replenishments of the soft windows, the more urgency there is for maturing countries from concessional lending and graduating recipient countries from the hard windows.

There is also a trade-off between our desire to control U.S. budgetary outlays and the political costs and economic repercussions of accelerated graduation/maturation in the MDBs. In the past the issue of maturing/graduating countries has been difficult when concrete cases rather than general principles have been involved. The extent of China's access to IDA and/or IBRD financing will also impact on IDA/IBRD net funding availabilities for other borrowers and thus have important consequences for the speed and scope of required maturation and graduation.

Therefore, deliberations on the levels of future U.S. MDB contributions must carefully weigh their impact on MDB operations, on the objectives the United States is seeking in the institutions, on political relations with other developed country donors and on the resulting consequences for individual countries (and/or their access to alternative financing).

C. Conclusions

Effective use of MDB resources requires a clear focus on increasing the quality rather than quantity of MDB lending, with

country allocations of MDB lending directed on the basis of both policy performance and relative economic need. The budgetary constraints now facing the United States and some other MDB donor governments and the implications of such constraints on the overall availability of MDB resources, particularly in the soft windows, underscore the importance of maximizing the efficiency and effectiveness of MDB resource allocation.

MDB effectiveness in promoting LDC development in the 1980s will depend to a large extent on the banks' success in encouraging borrowing countries to pursue sound economic policies. More attention should be accorded to encouraging appropriate policies in recipient countries. The elimination of "targetry" would permit more selectivity in the loan process and strengthen the relationship between loan programs and effective micro and/or macro policies. MDB efforts should also be directed at catalyzing domestic, particularly private, resources and encouraging individual incentives in a free market environment.

The desirability of focusing scarce MDB resources on the most needy countries requires that renewed attention be focused on the adoption and equitable implementation of MDB maturation and graduation policies. Existing policy in the IBRD is somewhat vague and not uniformly implemented. It also appears to overemphasize the per capita income level criterion. A more sophisticated approach which incorporates a range of factors including debt servicing capacity, access to private capital, and others, is warranted. In the case of graduation, the Administration views a country's eventual reliance on private markets for external flows to be a normal, and desirable, step in the development process.

It is important to recognize that effective implementation of maturation/graduation policies will over time change the country composition of MDB loan portfolios. Thus in order to maintain the MDBs' international credit standing, particular care will have to be taken to ensure that the allocation of MDB resources continues to reward good economic management and performance and contributes to maintenance of a sound MDB loan portfolio.

CHAPTER VI

CONCLUSIONS AND RECOMMENDATIONS

As indicated previously (Chapters III and V) this chapter develops overall conclusions about U.S. policy objectives regarding the MDBs, in light of the Reagan Administration's development philosophy and U.S. domestic budgetary realities. A series of policy recommendations for the United States to pursue in the banks is then set out, and their possible consequences discussed. Finally, the potential dilemma regarding the relationship between U.S. financial support for the MDBs and the pursuit of the new U.S. development policy orientation in the banks is addressed.

Chapter VII will identify the illustrative resource allocation choices flowing from the policy actions outlined here.

A. Conclusions: Economic Rationale for U.S. Participation

At this point we are prepared to draw conclusions about the relative priorities of the U.S. policy objectives discussed in Chapter III. This Administration believes continued U.S. participation in the MDBs is justified by a fundamental national interest in a more stable and secure world, which can be best achieved in an open, market-oriented international system. To the extent that the MDBs encourage the participation of developing countries in that international system on a permanent and self-sustaining basis, they are viewed as one of the major vehicles available for pursuing these U.S. economic and political/strategic interests. The political/strategic benefit to the United States while at least as important as the economic one, is less immediate, less direct, and less "programmable". Moreover, as their charters specify, the MDBs are to be apolitical. Thus, the value of the MDBs lies primarily in their cost-effective contribution to LDC economic growth and stability.

With this conclusion in view, U.S. support for the MDBs should be designed to encourage:

-- Adherence to free and open markets, on the grounds that this maximizes economic efficiency and encourages self-sustaining development--an orientation which is wholly consistent with the economic mandate of the MDBs.

-- Emphasis on the private sector as a vehicle for growth through innovation, risk-taking, adaptation of technology, and efficiency in resource use, in order to improve the economic prospects of developing countries.

-- Minimal government involvement, to permit concentration of limited administrative capacity of LDC governments on functions that are essential, such as provision of "public goods"; distributing the benefits of, and imposing the costs of, external economies and diseconomies, respectively; and correcting identifiable market imperfections.

-- Assistance to the needy who are willing to help themselves, in keeping with our historical tradition and willingness to aid those less fortunate than ourselves.

This philosophical orientation requires that U.S. policy seek greater emphasis upon the MDB financial role as catalysts for private flows (the "banking" function) and their advisory role as sponsors of appropriate policies -- as distinct from their significance as sources of official capital transfers. We should also emphasize the broader development role of these institutions, which lies primarily in the area of encouraging the most effective economic policies, including greater LDC reliance on market forces. Among the MDBs, those to be most favored are those which are most effective at promoting economic growth and development.

B. Building a New Policy Framework

Application of the Administration's development philosophy requires examination of the major financial and lending policy questions relating to the developmental effectiveness of the banks, as well as other issues raised in the preceding chapters with regard to a wide range of policy concerns. This analysis leads to a series of conclusions, along with action recommendations, for improving MDB effectiveness and reducing the budgetary impact of U.S. participation in the MDBs. These are summarized at this point for the convenience of the reader.

1. Market Forces. Lending policies and programs should increasingly emphasize attention to market signals and incentives, to private sector development and to greater financial participation by banks, private investors, and other sources of private financing (with particular emphasis on the IFC's approach and type of program).

2. Promoting Policy Reform. Annual country and sector lending levels should be more flexible and less target-oriented. The banks should be encouraged to introduce more selectivity and policy conditionality within projects and sector programs they support. The banks should concentrate their lending in those sectors where they have the most expertise and where they will have the most policy leverage. The IBRD structural adjustment

lending program and the IDB sectoral lending program should be closely monitored to assess the potential for achieving policy reform.

3. Sector Allocation. The MDB sector allocation process should be based upon the economic and social priorities of the borrower government -- but only to the extent that their priorities are consistent with the basic economic principles of the MDBs. Increased emphasis should be given to the economic rate of return and policy improvements that can be obtained in the project selection process, and lending should increasingly be linked to specific policy reforms. Due consideration should also be given to the relation of the project to the overall development strategy, and to its overall economic impact.

*4. Graduation. The existing IBRD graduation policy should be implemented more effectively and emulated in the regional banks. Countries above the agreed income threshold should be phased out over a reasonable period, with the Bank assisting the graduation candidate to remove the remaining constraints to self-sustaining growth during the phase-out period.

5. Maturation. The United States should encourage better allocation of soft lending funds through a more systematic "maturation" policy. This would require obtaining agreement to move countries into the hard loan windows as rapidly as their debt servicing capacity permits, also giving due consideration to the impact on the loan portfolios of the banks' hard loan windows.

6. Paid-In Capital. The United States should develop and implement a plan to phase down and eventually phase out, new paid-in capital for the hard loan windows, on a schedule consistent with maintaining the financial integrity of the MDBs.

7. Soft Loan Windows. The United States should begin to reduce its participation in real terms in the soft loan windows, especially IDA because of its large share of the budget, but at a pace consistent with U.S. economic and political objectives. This is also consistent with our desire to realign the concessional windows more closely to assisting the poorest developing countries, and saves budgetary resources. We should also place increased emphasis on the adoption of effective policies by the remaining soft loan recipients.

8. U.S. Budget Priorities. The following factors should be carefully considered in determining U.S. allocations to the institutions:

-- to the extent needed, callable capital allocations to hard loan windows are preferable to concessional window replenishments;

-- the World Bank Group has been more successful than the regional banks in promoting appropriate economic policies; and

-- among the regional banks, the Inter-American Bank ranks particularly high in terms of our political/strategic interests. The Asian Bank ranks highest in institutional efficiency. The African Bank ranks high in terms of humanitarian concerns.

C. Recommendations: Improving MDB Effectiveness

Policy Reform

Chapters I and V stressed the importance of encouraging those domestic policies geared toward producing goods and services in response to market forces. They also discussed the MDB role in fostering sound and appropriate LDC policies, the difficulties facing the banks, and their problems in this crucial area. For this Administration, the issue is how to encourage the banks to exercise their leverage more effectively. Such policy leverage may appropriately be applied at the sector or project level, or in the special case of the World Bank, at the macroeconomic level. At the same time, there is a need for complementary pressure from the IMF and close coordination (or possibly specialization) between the IMF and the MDBs to achieve improved economic performance. One example of close coordination is the use of the World Bank's structural adjustment lending (SAL) program and other forms of non-project lending to secure major policy reform.

The elimination of "targetry" would presumably encourage tougher application of policy criteria to loans. The result could be either an increase or a decrease in annual lending levels, depending upon how effectively a country used funds.

Recommendation #1. Lending policies and programs should increasingly emphasize attention to market signals and incentives, to private sector development and to greater financial participation by banks, private investors, and other sources of private financing (with particular emphasis on the IFC's approach and type of program).

Consequences. This is fully consistent with the Administration's views of the private sector as the most effective means to promote economic growth and to allocate resources efficiently. It also responds to a major Congressional criticism that the MDBs over-emphasize public sector loans. Some recipients may oppose this both on ideological grounds and as a threat to central government control.

Recommendation #2. Annual country and sector lending levels should be more flexible and less target-oriented. The banks should be encouraged to introduce more selectivity and policy conditionality with projects and sector programs they support. The banks should concentrate their lending in those sectors where they have the most expertise and where they will have the most policy leverage. The IBRD structural adjustment lending program and the IDB sectoral lending program should be closely monitored to assess the potential for achieving policy reform.

Consequences. On the one hand, for some countries a reduced growth rate in MDB lending could result from greater policy conditionality, particularly if that conditionality is applied by the World Bank to major macro-economic issues rather than project specific concerns. This could obviate some absorptive capacity problems identified in Chapter II. On the other hand, it could also lead to fewer problems with projects and higher economic rates of return. Such selectivity could have political costs if countries important to the United States receive fewer loans. It is also possible that other donors' country/sector priorities could be adversely affected.

Sector Allocation of Lending

Aside from their rapid growth rates, the greatest single change in the MDBs' lending policies during the seventies has been the shift in sector priorities from infrastructure development toward "basic human needs", i.e., social sector or "quality of life" projects. The purpose was to change development strategy from an emphasis on growth to an emphasis on "growth with equity". The Administration believes that no conclusive case can be made for an exclusive emphasis either on growth or on aid to the poor as a development strategy. Nonetheless, the Congress has mandated an emphasis on aid to the poor. (Chapter I suggests that where direct quantitative comparisons can be made, there is little difference between the economic rates of return on BHN or non-BHN projects.)

On the other hand, a very important factor in development is the set of basic macro-economic and micro-economic policies that a country follows, regardless of the specific sector emphasis. The MDBs can make their greatest contribution when they help countries to design and carry out programs consistent with sound market-oriented policies in the context of each country's particular needs. Each country has its own unique set of policy prescriptions, economic and social structure, and institutions. Consistent with the economic efficiency orientation of the MDBs, MDB assistance should be targeted to helping those countries that help themselves by adopting effective policies.

Recommendation #3. The MDB sector allocation process should be based upon the economic and social priorities of the borrower government -- but only to the extent that their priorities are consistent with the basic economic principles of the MDBs. Increased emphasis should be given to the economic rate of return and policy improvements that can be obtained in the project selection process, and lending should increasingly be linked to specific policy reforms. Due consideration should also be given to the relation of the project to the overall development strategy, and to its overall economic impact.

Consequences. Close consultation with the Congress, and perhaps amendments to existing legislation, will be necessary. Coordination of project, sector and country policy reforms will have to be improved to maximize benefits from MDB assistance.

The Recipients of MDB Loans

The country allocation process in the MDBs is among the most sensitive MDB issues. Five year country plans usually set the upper annual lending limits, with the annual aggregate lending level being approved each year by the executive directors. The determination of annual country levels, however, is a source of conflict among geographic departments. The allocation process is not always as economically rational as it could be (i.e., stressing the most efficient allocation of capital). The Administration would clearly prefer a greater economic content in such decisions, emphasizing the economic rate of return and necessary policy reforms. As previously described, it is desirable to downplay specific country targets. Poor policies or projects should lead to diminished or, in the extreme, interrupted lending.

This approach tends to conflict, however, with our conclusions with regard to graduation. There are arguments on both sides. If MDB loans are viewed as scarce, subsidized resources, they can be provided either to whoever can best utilize them or to whoever most requires the subsidy. If the potential graduates can provide the highest rate of return and improve the quality of a bank's portfolio one could argue that they should have a claim on MDB resources even though they may have alternative sources of capital. (To be sure, the proposed graduates will argue that their alternative sources may dry up if the MDBs move them out. That depends, however, on timing and phasing.) Their claim to scarce MDB resources may only be valid if the subsidized funds promote policy reforms which would not otherwise be achieved. A major related consideration centers around the fact that some potential graduates are very important to the United States and/or to other key stockholders. But poorer countries may have a greater claim on MDB resources on the basis that subsidized capital is more necessary to them because of market imperfections which have more impact upon their access to alternative financing.

Whereas the graduation process addresses LDC access to funds provided at "near-market" rates of interest, the issue with regard to "blend" countries (which receive both hard and soft funds) deals with access to both concessional and non-concessional funds. If concessional aid is viewed as an increasingly scarce resource, then there is some virtue in moving less needy recipients into the hard loan windows. The difference, in economic terms, relates primarily to the ability to service an adequate amount of debt to maintain development, since access is available to either window. Some would argue that any country which has access to private markets has already demonstrated an ability to service debt on harder terms. The blend recipients would argue that the process must be more gradual for balance of payments reasons.

Recommendation #4. Existing IBRD graduation policy should be implemented more effectively and emulated in the regional banks. Countries above the agreed income threshold should be phased out over a reasonable period, with the Bank assisting the graduation candidate to remove the remaining constraints to self-sustaining growth during the phase-out period.

Consequences. This would have to reflect both long term U.S. interests and current world economic conditions.

Implementation of this recommendation would have no significant financial impact on the MDBs over the short to intermediate term. Over the long term, however, the MDB portfolio mix would shift and the present blend countries would represent a progressively larger share of the portfolio. Whether this would result in a downgrading of the portfolio quality depends on the extent to which the constituent countries move up the creditworthiness ladder, as a result of adopting more effective economic policies and of sustained growth. (In any case, per capita income is not by itself a very reliable indicator in the determination of creditworthiness.)

Recommendation #5. The United States should encourage better allocation of soft lending funds through a more systematic "maturation" policy. This would require obtaining agreement to move countries into the hard loan windows as rapidly as their debt servicing capacity permits, also giving due consideration to the impact on the loan portfolios of the banks' hard loan windows.

Consequences. This should foster a positive perception that countries can be, should be, and are progressing away from the need for concessional assistance. A significant concern will be voiced regarding the medium and long term economic outlook for blend countries and whether the timing is right for harder lending terms. On the other hand, both development and humanitarian interests may be better served if scarce concessional resources are channeled more toward for the poorest countries, with intermediate countries relying more on less concessional money.

D. Recommendations: Reducing Budgetary Impact

The developmental considerations previously discussed and the Administration's economic philosophy share one fundamental principle -- resource transfers alone are not the answer for LDCs endeavoring to develop. The Administration's first priority has been to develop a comprehensive domestic program to address our own economic requirements and which necessitates a relative reduction of government expenditures. In this regard, the most important contribution we can make to the global economy, in the near term, is to provide the basis for healthy, non-inflationary growth in the U.S. economy. Reductions in federal expenditures over this time period represent a vital part of the President's program for economic recovery. Consequently, this Administration's commitment to budget stringency must be a factor in decisions on funding levels for the MDBs.

Reducing U.S. MDB Expenditures

The Administration's policies to limit unnecessary government involvement and reduce MDB appropriations raise fundamental long term questions about the need for, and duration of, public financing of the MDBs, defined as both capital increases and concessional window replenishments. Clearly, as Chapters I and II point out, there are market imperfections, externalities and public goods arguments, as well as political/strategic considerations, which justify continued U.S. support for the MDBs. However, in cases where LDC development proceeds satisfactorily, public financing should be expected to phase down and eventually cease.

In the hard loan windows, a reduction in public finance would suggest a phasing down, and eventual phasing out, of new paid-in capital. However, additional callable capital increases, charter amendments to permit a "fractional charge" against lending authority for guarantees, 1/ and/or a change in the gearing ratio for all lending could eventually eliminate future national budgetary outlays. In the soft loan windows, such policies would focus on reducing replenishment levels, while gradually moving countries into nonconcessional (hard windows and private) financing as their economic situation and debt servicing capacity improves.

A major factor in the speed with which these changes can be implemented is the impact of MDB lending and policy suasion on LDC economies. If the MDBs are effective at achieving appropriate policy reforms and encouraging private flows into the LDCs, then developing countries should gradually be able to reduce the amount of official development assistance necessary for continued development. As noted in Chapter I, such policy changes in reality occur only slowly.

1/ The bank charters currently give equal weight to loans and guarantees in determining their lending ceilings. As a result, there is no institutional advantage to guarantees, which is mainly why there have been none.

In principle, few would argue with the above scenario. The crucial issue for this Administration revolves around the speed with which these financial steps can be taken. In the hard loan windows, for example, eliminating the dependence upon government payments and callable capital guarantees for borrowings may result, inter alia, in higher lending rates and the need for high quality MDB loan portfolios, which heretofore has been less of a factor in determining the MDBs' Triple A bond ratings because investors anticipated 100 percent coverage of MDB bonds by government guarantees. With less than full coverage of outstanding loans by callable capital guarantee, the country and sector allocation of loans -- along with the economic rate of return on projects -- would become more salient factors to the markets. Implementation must therefore stress the need to maintain the financial integrity of the banks.

From another perspective, however, the more rapidly this process occurred, the more independent the MDBs -- especially the hard loan windows -- might become of donor government influence. First, as the loan repayments become an increasingly larger share of MDB resources, LDC governments may demand more influence in the institutions. In addition, as the banks become less dependent on new paid-in subscriptions, their managements could act more independently. Nevertheless, their actions -- particularly, in the hard loan windows -- would have to give greater weight to the financial markets upon which they would become increasingly dependent. As government funds and callable capital guarantees become less a factor, the increase in financial leverage would necessitate MDB policies more acceptable to the private markets. The pressure for high quality loan portfolios, for example, might mean more discriminating lending, to avoid countries with poor policies or with debt service problems. It should be noted that the policy directions advocated here for the MDBs would in general fit with preparing the hard loan windows to be more responsive to the pressures of the marketplace.

Recommendation #6. The United States should develop and implement a plan to phase down and eventually phase out, new paid-in capital for the hard loan windows, on a schedule consistent with maintaining the financial integrity of the MDBs.

Consequences. The impact of a phase out of paid-in capital on financial markets is difficult to predict exactly, especially with regard to the banks' interest rates and lending levels. However, the existing callable capital, including increases which have already been agreed but which will only be subscribed over the next few years, will provide a high degree of protection to bondholders. Nevertheless, given a goal of strong U.S. support for the financial integrity of the banks, we need to proceed carefully.

The soft loan windows present a more complicated picture for the intermediate term. Since their financial leverage is not as great because they do not borrow in capital markets, the soft windows, especially IDA, represent a greater draw on U.S. budgetary resources. However, soft window recipients have much lower per

capita incomes than the hard loan window borrowers making concessional lending far more crucial in helping them move toward self-sustaining economic development. If continued progress is not maintained, frustrated expectations in the poorest countries could adversely affect international stability.

Keeping in mind that the U.S. economic objective is to encourage appropriate policies leading to increased LDC growth and participation in an open international system, we want to be sure that adequate help is available to those countries which are moving in the right direction. The limited nature of donor budgetary resources will not permit assistance to either those unwilling to help themselves as much as possible or those consciously pursuing ineffectual policies. At the same time, there are sound reasons -- also factored into our bilateral assistance programs -- for the provision of resource flows on concessional terms. Decisions on future U.S. contributions to soft loan windows will have to balance these considerations, determining the extent to which concessional resource transfers through the MDBs are justified.

The extent to which foreign debt benefits a borrowing country depends fundamentally on the cost and uses of the resources thus gained. The cost of capital generally is not as great a constraint for the fast growing developing countries. Poorer developing countries, however, face a substantially different set of development problems which make it difficult to generate sustainable growth: domestic savings are virtually always discouragingly low, the process of establishing basic institutions is still incomplete, many have little export potential, and all are under considerable pressure to satisfy the basic human needs of their people. The lack of access to external funds would mean economic stagnation, and yet the provision of such funds on non-concessional terms would quickly translate into unsustainable debt servicing problems. External official assistance with appropriate concessionality and policy conditionality is thus an extremely important element for their development process and one for which private flows cannot easily substitute.

The United States has traditionally supported efforts to integrate the economies of the low income countries into an efficient free market global environment. The alternative of confining these countries to their own minimal resources is not attractive from a systemic point of view, and would moreover foster even greater political and/or economic instability than currently prevails. The scarcity of concessional funds, however, underscores the importance of using available resources effectively and in a framework which maximizes the probability of a economic development in the recipient country. The broad based technical expertise of the MDBs would appear to make them well qualified to monitor and guide such effective resource use. Most of the low income countries have extensive needs, and, even with sound development projects, results are likely to be evident at first only on the project and/or sector level. Sustained overall growth will require an extended effort.

The range of options in the soft loan windows are eliminating, reducing, or in some case increasing U.S. participation in replenishments. In foreign policy terms, a refusal to participate at all would be interpreted as an abdication of U.S. leadership. It would seriously damage U.S. relations with the poorest developing countries and be resented by our important industrial allies. It would also seriously impede our economic and humanitarian objectives, since the soft loan windows would have to cease or drastically reduce operations.

On the other hand, an overall real increase in U.S. funding for the soft windows for the foreseeable future seems unlikely given budgetary pressures. Furthermore, the substantial LDC growth which has occurred in the last two decades, and the logic of maturation/graduation, argue for declining real growth for the concessional windows. We therefore conclude reduced U.S. soft loan window contributions, at least in real terms, are appropriate, with the precise amounts for each bank to be determined by our economic, political, and humanitarian interests.

Recommendation #7. The United States should begin to reduce its participation in real terms in the soft loan windows, especially IDA because of its large share of the budget, but at a pace consistent with U.S. economic or political objectives. This seems necessary on budgetary grounds, and it is also consistent with our desire to realign the concessional windows more closely to assisting the poorest developing countries. We should also press for increased emphasis on the adoption of effective policies by the remaining soft loan recipients.

Consequences. Domestic reaction to a reduction would presumably on the whole be favorable, although there will be some opposition to the decreased emphasis upon concessional aid and upon humanitarianism. There would doubtless be serious criticism from LDCs, from other donors, and from MDB managements.

U.S. Budgetary Priorities

The potential conflict among policy objectives is nowhere more apparent than in the U.S. budgetary allocation among MDBs. In this process, all MDBs are not equal. In their country allocations, the hard loan windows are currently more consistent with U.S. political/strategic and economic priorities. The soft loan windows serve poorer countries, and in many cases less strategic countries -- although these concessional funds are essential to sustaining their political stability, achieving long term economic development, and meeting humanitarian goals.

Overall, it can be argued that the World Bank Group best serves U.S. objectives, albeit at a much greater absolute cost than the regionals. U.S. participation in the regionals was orginally based more explicitly on political grounds than its participation in the World Bank. Among the regionals, the IDB is usually viewed as having the most political and strategic importance, while the African Bank serves the poorest region in the world. The ADB, on the other hand, is generally felt to be the most efficiently run.

In the past, the U.S. budgetary process did not require extensive trade-offs among the MDBs. Usually, each capital increase or replenishment level was decided on its own merits, rather than as a competitive exercise among the banks and windows. Trade-offs did exist at the Congressional appropriations stage, but the basis for choosing executive branch priorities was often a determination of where reductions would least affect programs. The relative benefit obtained by the United States from each window was not the principal explicit consideration.

The current budgetary constraint now emphasizes the need to put scarce U.S. funds where we can achieve the greatest benefits, requiring in turn a clearer understanding of our own policy priorities.

Recommendation #8. The following factors should be carefully considered in determining U.S. allocations to the institutions:

-- to the extent needed, callable capital allocations to hard loan windows are preferable to concessional window replenishments;

-- the World Bank Group has been more successful than the regional banks in promoting appropriate economic policies; and

-- among the regional banks, the Inter-American Bank ranks particularly high in terms of our political/strategic interests. The Asian Bank ranks highest in institutional efficiency. The African Bank ranks high in terms of humanitarian concerns.

Consequences. With the above priorities, the United States could be accused of neglecting the humanitarian role of the MDBs, and playing upon "special" political interests (e.g., Latin America). We nevertheless feel that in time, such an approach could gain international support. It would be prudent to expect pressures on our bilateral aid program, however, in order to compensate for losses of concessional assistance by certain poorer countries.

E. Implementing the New U.S. Policy

The analysis of U.S. influence in the banks (Chapter IV) concluded that our traditionally predominant position in the MDBs, our significant financial participation, and our leadership role as a major shareholder have been major factors in shaping the banks. This raises a fundamental dilemma as between the preceding recommendations to reduce U.S. MDB budget expenditures and the U.S. ability to influence the adoption of policies in the banks that are compatible with the new U.S. policy orientation.

These proposals might be expected to result in a loss of U.S. influence if, as commonly believed, "money buys power" and "less money buys less power." Second, to the extent that the Reagan economic philosophy implies a change in previous MDB policies, then the United States might be viewed as seeking a shift in direction by the banks -- a more difficult task than " business as usual", requiring more, rather than less, influence. It is therefore a fair question to ask how we can expect to get "more" (influence over MDB policies) with "less" (financial participation). The answer to that question lies in several areas.

Continued Major U.S. Role

The Administration believes it highly important to fulfill those MDB cost sharing arrangements which have already been agreed to internationally. It also intends to continue playing a major role in each of the MDBs. Our ability to do so should not be severely hindered by the overall reduction in MDB appropriations because: (a) in the hard loan windows, we will seek to maintain our share of capital increases (the largest of any country in the IDB and the World Bank and second largest in the ADB) and lower our budgetary costs by reducing or eliminating paid-in capital; and (b) in the soft loan windows we will seek to reduce our share or, at a minimum, reduce our budgetary costs in real terms. In the latter case, if other donors do not increase their shares significantly, the United States will still be the largest donor.

Overall, in spite of reduced financial participation in absolute terms, given the increasing relative importance of the capital windows the United States could remain nearly in the same relative position, and certainly the largest shareholder/donor. Whether or not "money buys power", we will still be putting up a larger share of the money than anyone else.

Evolutionary, Consensus-Building Process

The Administration does not envision abrupt shifts by the MDBs in policy terms. Rather, we seek an evolutionary process in which a consensus will be built around the new developmental orientation described earlier in this chapter and in Chapter V. Success will require realistic expectations about short term accomplishments, persistence over the long term, and an acknowledgment that even longer term objectives for the MDBs should be kept realistic.

There will obviously be difficulties in carrying out these eight recommendations because of the multilateral character of the institutions. While the United States is likely to remain the largest single contributor, the views and policy objectives of other countries must be given careful consideration. Considerable skill and effort will be required to build an international consensus supporting U.S. policy objectives. Our approaches to other donors and to MDB managements must be based on the positive, evolutionary aspects of the U.S. recommendations. Funding constraints

will entail difficult negotiations on the financial aspects of new replenishments; this highlights the need for positive U.S. leadership if we are going to realize key policy goals.

It cannot be overstressed, however, that our goal must be pursued through a series of incremental steps. We should not imply that we expect to do "more with less", but rather that we seek an evolutionary consensus on a series of policy changes which will serve the interests of both donors and recipients.

U.S. efforts to implement these recommendations will require extensive dialogue with MDB managements, other industrial countries, and the developing countries. One obvious focal point is replenishment/capital increase discussions. Another would be the more frequent, informal meetings we have with other members on MDB issues. A third is the ongoing dialogue our EDs have with other directors and MDB managements. Dialogue with these interested parties may point the way to modifications in implementing the recommendations. The United States must be flexible to facilitate achievement of our goals.

The United States must also recognize that all eight recommendations cannot be achieved immediately. Phasing out additional paid-in capital in the hard loan windows may require time, particularly in light of the need to maintain the MDBs' financial integrity. On the other hand, the process of reducing U.S. contributions in real terms in the soft loan windows can begin soon. The recommendations regarding MDB lending policies -- annual lending levels, private sector development, sector and country allocation -- can be taken as guidelines for the U.S. Executive Directors to follow in the course of their normal duties. Care will have to be exercised in the implementation of the recommendations regarding graduation and maturation, so as to minimize the financial impact upon the affected countries. Finally, the precise timing for each of these recommendations will vary from bank to bank and window to window.

Improved U.S. Credibility

In the past, U.S. relations with the MDBs and other donors have frequently been clouded by uncertainties regarding U.S. implementation of internationally negotiated arrangements. It is important that U.S. efforts to improve the effectiveness of MDB operations not be undermined by such uncertainties. This underscores the importance of consultations between the Executive and Legislative Branches on funding arranagements prior to and during the course of international negotiations, as well as prompt Congressional consideration of the U.S. contributions and subscriptions which follow from such international negotiations.

In view of the fact that a number of Congressional guidelines already exist for U.S. participation in the MDBs, the Administration, before implementing these recommendations, will have to undertake

a careful review of existing legislative provisions. If there are inconsistencies, the Administration should consult the Congress and may need to propose changes in legislation as appropriate.

CHAPTER VII

U.S. BUDGETARY IMPLICATIONS

This chapter will discuss the budgetary implications of the proposed U.S. policy objectives, including the major MDB budget choices facing the United States over the next few years. Attention will also be given to the various possibilities for expanding the lending capacity of the MDB hard loan windows with minimal budgetary impact.

Drawing on our assessment of the MDBs and on the recommendations set forth in Chapter VI, it is important to focus on how the proposed U.S. policy direction for the MDBs in the 1980s will affect U.S. budgetary appropriations for the MDBs. Early decisions on the extent of U.S. participation in upcoming ADF and AFDF replenishment negotiations also are required. Early in 1982, negotiations are scheduled to begin for the replenishment of the capital windows of the ADB and the IDB, as well as for the FSO. Future MDB budget levels will provide important parameters for USG participation, and the pursuit of U.S. objectives, in each of these institutions in the 1980s.

A. U.S. Policy Directions and the Budget

The Administration remains committed to financing those MDB cost-sharing arrangements which have already been negotiated internationally. Based on the conclusions of the preceding chapter, we see the following points as having a direct budgetary impact:

-- the United States should participate in upcoming MDB capital increases but seek agreement that no paid-in capital is required. This is not likely to be easy to negotiate;

-- U.S. subscriptions to callable capital should continue to be made on the basis of program limitations rather than appropriations;

-- the United States should begin to reduce its participation, in real terms, in the soft loan windows, especially IDA; and

-- the United States should work to implement a more consistent "graduation" policy in the hard loan windows and a more systematic "maturation" program in the soft loan windows. 1/

* The maturation/graduation trade-off is much more significant for IDA and the IBRD than in the regional MDBs. However, eventual graduation of the more advanced LDCs in the IDB also raises some significant issues.

B. Principal Budgetary Issue: the "Soft Loan" Windows

The principal U.S. budgetary issue relates to whether the United States should participate in soft loan window replenishments and, if we do participate, at what levels.

With regard to the hard loan windows, where U.S. shares are the principal determinants of U.S. voting power in the banks, the IBRD's General Capital Increase is now in place, and we do not envision any further expansion of IBRD resources during the GCI period, i.e., through the mid-1980s. We believe that on financial grounds future capital increases of the IDB and ADB are not likely to require any paid-in capital. To the extent paid-in capital is agreed to in future replenishments the United States may participate in, there will be direct budget and programmatic trade-offs between appropriations for the hard and soft windows. The already negotiated capital increase for the AFDB covers the period through FY 1986, although the prolonged delay in opening the Bank to non-regional membership may affect U.S. participation in and contributions to the Bank.

Regarding the concessional windows, given the importance attached to cost-sharing traditions, any significant U.S. funding reductions probably would also reduce the overall availability of MDB resources and thereby to a large extent determine the speed with which our recommendations regarding graduation and maturation will be implemented. In general the greater the U.S. contribution in future replenishments of the soft windows, the longer and more gradual could be the maturation of countries from concessional lending and the graduation of recipient countries from the hard windows. In effect, there is a trade-off between our desire to reduce budgetary outlays and the political costs and economic repercussions of accelerated graduation/maturation. The extent of China's access to IDA and/or IBRD financing will also have an impact on IDA/IBRD net funding availabilities for other borrowers and have important consequences for the speed and scope of maturation and graduation.

1/ See Table 5.1 for a listing of "IDA-only eligible" countries, "blend" countries, and "potential graduate" countries.

Therefore, deliberations on the level of future U.S. MDB contributions must carefully weigh its impact on MDB operations, on political relations with other developed country donors, and on the resulting consequences for individual developing countries. Such consequences include the debt service impact on borrowing countries and/or their access to alternative financing, the implications for the pace of growth and development, and the probable effect on U.S. bilateral relations with, and economic and strategic interests in, the "maturing" and "graduating" countries.

In order to maintain U.S. voting power in the banks, it will be important to retain our current share of capital subscriptions to the hard loan windows. In addition, even with a significant reduction in real terms in U.S. contributions to future soft window replenishments, the United States would likely remain the largest overall soft window contributor by a significant margin.

C. Range of U.S. Participation in Soft-Loan Windows

We have reviewed the implications of three illustrative ranges of U.S. MDB financing for the FY 1983-87 planning period. In this context, we assume the following:

-- The poorest developing countries should have first claim on available concessional resources up to a level which would permit lending to these IDA-only eligible countries to grow at a nominal rate of 9 percent per year from a 1978-80 base level. (This would permit little or no growth in real terms and lending would be allocated selectively to encourage policy reform. As noted in earlier chapters, the poorest countries have minimal access to private capital flows and rely significantly on MDB flows.)

-- Only after this requirement for the IDA-only eligible countries has been met should "blend" countries with current or foreseeable debt service problems have access to concessional resources. Any remaining concessional resources should focus on the other "blend" countries.

The three illustrative funding ranges discussed below call for annual U.S. appropriations to the MDBs in the mid-1980's based on the following basic choices:

-- no U.S. participation in soft loan replenishments,

-- a major reduction in the real levels of U.S. participation in soft loan replenishments, or

-- a modest real reduction in U.S. participation in soft loan replenishments.

Continued U.S. participation in soft window replenishments, i.e. the second and third ranges, would leave open the option of alternative allocations among the various components of the budgetary package, particularly with regard to the trade-offs between IDA and the regional soft windows, and among the regional soft windows themselves.

No U.S. Participation in Soft Loan Replenishments

This implies an annual U.S. appropriation for budget authority of $125 million after FY 1984 2/. Given the importance attached to equitable cost-sharing, particularly with regard to IDA, most other key donors would either sharply reduce or cease contributions to soft window funds. Available soft window funds would be dependent on reflows, plus whatever small contributions were provided by other donors, and would only constitute a small fraction of current lending in nominal terms to "IDA only" recipients. There would be an increased demand by soft window recipients for hard window resources, hardening their debt profile and contributing to debt service problems for some. In order to accommodate former soft window recipients, the IBRD would have to think seriously about speeding up the graduation of countries from hard window lending. To the extent that individual developing countries considered the soft windows important, relations with the United States could be affected adversely.

A Major Reduction in U.S. Participation in Soft Loan Replenishments

This implies an annual U.S. appropriation for budget authority of $1.0 to $1.25 billion in the mid 1980s and focuses soft window lending almost entirely on the very poorest countries. It would represent a reduction from levels of current replenishments as originally negotiated of roughly 30 to 45 percent in real terms in U.S. contributions to the soft loan windows. While U.S. funding would be below international expectations, the United States would retain the flexibility to participate in either most (lower end of range) or all (upper end of range) soft window replenishments, but at reduced levels. There would also be moderate funds for encouraging the development of the private sector in recipient countries. Concessional lending to IDA only countries could grow at 9 percent per year in nominal terms from 1978-80 levels.

2/ Budget authority primarily for the World Bank GCI. Budget authority for remaining IDA VI payments, for the current FSO replenishment, and for unfunded prior year requests for the FSO and the ADF are excluded since they are concentrated largely in FY 1983/84.

Moderate Real Reduction in U.S. Participation in Soft Loan Replenishments

This implies an annual U.S. appropriation for budget authority of $1.5 to $1.75 billion in the mid 1980s, and is geared to a more gradual maturation/graduation process. It would represent some nominal increase from levels of current replenishments as originally negotiated, but a reduction of roughly 12 to 16 percent in real terms in U.S. contributions to the soft loan windows. The United States could participate in replenishments of all concessional windows and a private sector initiative. Soft window lending would focus not just on the very poorest countries (growth at 9 percent per year in nominal terms), but also on selective lending to blend countries linked to policy reform. These levels would imply a slower pace of maturation/graduation and slower movement toward increased reliance on market forces.

D. U.S. Share Considerations

While the importance of the various factors affecting shares differs from institution to institution, it would appear that the United States either should, or will have to, maintain its current share in nearly all the windows. There would be no benefit to the United States from reducing its share in the hard windows, especially if future capital increases do not require paid-in capital. Moreover, share reductions could be costly in that the United States could lose veto power (IBRD and FSO) and its leadership position (voting power) in the institutions.

Given the domestic budgetary constraints facing the major donors to the soft windows, "equitable cost-sharing" will be the single most important issue in any future replenishment. This may well mean insistence on continuing the present cost-sharing arrangements, leaving little room for the United States to reduce its shares. While reducing our shares in the soft windows, particularly in IDA, should remain an objective, we will need to establish our priorities for future replenishment negotiations. Implementation of graduation/maturation policies, reducing the size of the United States contributions to concessional window replenishments, and pursuing increases in the quality of MDB lending are probably higher priorities than seeking further reductions in U.S. shares.

E. Reducing The Budgetary Impact of Capital Increases

As the budgetary impact of MDB capital increases arises from the paid-in element, this involves examining the possibilities for expanding MDB lending on the basis of no increase in paid-in capital. There are basically two options on this score: increasing MDB gearing ratios (i.e., the relationship between an MDB's lending and its total capital and reserves) and capital increases with no paid-in element.

The present level of paid-in capital as a proportion of total capital and reserves varies significantly from MDB to MDB, and is a function largely of the age of the institution. The longer the institution has been in operation, the more important the role that reserves from retained earnings play in terms of total MDB equity (paid-in capital plus reserves).

The rationale for equity capital is to provide a cushion against loan defaults, so that MDB bonds can be sold at reasonable rates and the likelihood of calls on callable capital is minimized. The appropriate level of financial indicators for the successful marketing of MDB bonds can only be determined by the actual reception of MDB securities in the capital markets. However, there is much more to selling MDB securities than a mechanistic examination of the financial ratios. Investor perceptions of the support of member governments for the institutions have been a key factor. In the future, it is likely that the MDBs will have to sell themselves to a much greater extent on the quality of their underlying assets, i.e., their loan portfolios. To maintain investor confidence the MDBs will have to continue to act with predictability. This includes meeting net income targets which affect most important financial indicators through additions to reserves.

This said, it is nonetheless useful to examine the effects on key financial indicators of expanding MDB lending while holding paid-in subscriptions constant. One such indicator is the ratio of reserves to disbursed loans, which measures the capability of the MDB to withstand losses without adversely affecting shareholders' capital. The IBRD considers 10 percent to be adequate for investor confidence, while the regionals aim for a 15 percent level. Another indicator is the usable equity/disbursed loan ratio which measures the protection provided bondholders against possible defaults. The IBRD aims for a 15 percent level on this indicator to maintain its AAA rating. A third indicator, the interest coverage ratio or ICR (net income plus interest on the funded debt relative to interest on the funded debt), measures the extent to which the MDB can meet interest payments on its funded debt, i.e., actual borrowings, out of its own resources. The World Bank's view has been that the 1.10-1.30 range is adequate to maintain its rating, but the level should not be less than 1.15 on a regular basis.

As can be seen in Table 7.1, all these indicators for the IBRD, IDB and ADB are presently comfortably above the targets, and the situation is expected to continue through the mid-1980s, provided that income enhancement policies presently under discussion in the World Bank are implemented as expected.

Table 7.1 Financial Ratios as of FY 80

		IBRD 1/	ADB 2/	IDB 2/	AFDB 2/
1.	Paid-in Capital	3,996	1,744	1,665	300
2.	(Of which usable paid-in)	(2,950)	(1,344)	(1,282)	(300)
3.	Reserves	3,487	607	1,045	96
4.	Callable Capital	35,963	7,084	13,479	970
5.	Total Capital and reserves	43,446	9,435	16,189	1,366
6.	Paid-in as % of 5	9.2	18.5	10.3	22.0
7.	Usable paid-in as % of 5	6.8	14.2	7.9	22.0
8.	Usable equity as % of 5 4/	14.8	20.7	14.4	29.0
9.	Disbursed loans	26,660	2,096	3,494	396
10.	Usable equity as % of 9 4/	24.1	93.1	66.6	100.0
11.	Reserves as % of 9	13.1	29.0	30.0	24.2
12.	Interest Coverage Ratio	1.30	2.06	1.85	1.15
13.	Funded Debt	29,635	1,870	3,029	324
14.	Funded Debt as % of 4	82.4	26.4	22.5	33.4
15.	Funded Debt as % of DAC/OPEC callable capital	114.0 3/	43.0 3/	44.0	--

1/ Year ended June 30, 1980

2/ Year ended December 31, 1980

3/ Excludes Indonesia

4/ Usable equity equals usable paid-in capital plus reserves

SOURCE: U.S. Treasury

The following paragraphs examine the implications for each of the hard loan windows of expanding their lending capacity while holding constant the amount of paid-in capital. In the case of the IBRD the implications of both a gearing ratio change and a callable capital increase with no paid-in element are compared; for the regional development banks only a callable capital increase with no paid-in element is considered. This different treatment reflects the greater maturity of the IBRD, as indicated by its financial ratios in Table 7.1. The World Bank already relies implicitly on its loan portfolio to some extent as the IBRD's funded debt exceeds the value of the subscriptions by the DAC and OPEC members and, thus, IBRD creditors presently ascribe some value to the Bank's portfolio 3/. Thus, a gearing ratio change which makes explicit reliance on the IBRD's portfolio represents a possible next step in its financial evolution. For the regional development banks, a gearing ratio change would represent a much more abrupt acceleration of their financial maturation and would likely have an unfavorable impact on the financial markets.

World Bank

When all the GCI shares are subscribed, the IBRD will have a sustainable lending level of about $13.0 billion per year. If that level is exceeded there must eventually be either a cut-back in lending, a further capital increase, or a change in the gearing ratio. Under the Charter, this ratio, defined in the IBRD as the relationship between disbursed loans outstanding and total capital and reserves, is presently not allowed to exceed one.

While a change in the gearing ratio or an increase in callable capital are essentially the same from a national budgetary standpoint, so long as callable capital does not require appropriation, they are perceived differently by the financial markets. Because the contingent liabilities of members are not changed with a gearing ratio change, this effectively dilutes the protection offered investors, forcing the Bank to sell its securities more on its own creditworthiness. Thus, an all callable capital increase would be preferred by the financial markets to a gearing ratio change. In the event serious consideration is given to changing the gearing ratio on future bank operations, the interests of past investors should be protected and consultations undertaken with the private financial community to ensure full support.

A gearing ratio change and a callable increase with no paid-in element could also differ with respect to the degree of control they provide members over lending levels. A capital increase can provide members with a significant degree of control over expansion in hard loan activity as increases can be tailored to whatever size is deemed

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3/ However, recently it has cost the World Bank slightly more to raise funds in the United States than it has cost the IDB, reflecting the greater callable capital coverage provided IDB bondholders. In Europe and Japan, the ADB has also been able to borrow on at least as favorable terms as the IBRD.

appropriate. A gearing ratio change could offer less control since, once agreed to, the management in effect is less constrained in expanding its activity.

In the IBRD the need for either a capital increase or a gearing ratio change will depend on the rate of expansion in its lending. If the Bank were to follow a lending program in which the lending level grew a nominal rate of 11-12 percent per year to twice the sustainable level under the GCI (i.e., approximately $30 billion per year), the sensitive indicators (ICR and reserves to loans) would all remain essentially unchanged from present levels. Such a scenario would require though either a doubling of the IBRD's capital or a change in the gearing ratio from the present 1:1 level to a 2:1 level by approximately FY 1988. A generally accepted approach as to how an expansion of this magnitude might be financed would be needed by FY 1983-84, when the steady-state lending level would be first exceeded.

On the other hand, a more accelerated use of the GCI coupled with a decision to change the gearing ratio or increase callable capital would lead to a considerable diminution in the present levels of the financial indicators. This would occur because the Bank would be borrowing and disbursing more heavily in the mid-to-late 1980s and accordingly building up its earnings more slowly.

If a decision were made to accelerate use of the GCI, prior to a change in the gearing ratio, a very close examination of the Bank's ability to withstand adversities in the mid-1980s as the expansion progressed would be required. In particular, the reserve and net income targets would require re-examination under this scenario. Increased income can be obtained quickly through increases in commitment fees and loan commissions and more slowly through increases in the lending spreads 4/. However, neither the size of resources needed by the IBRD nor their terms could be separated completely from the amounts made available to IDA. To the extent IDA lending were reduced, there would be an increased need for hard and/or blended loans to the least creditworthy countries and thus a shift in the quality of the IBRD portfolio, which itself might require increased reserves.

The broad conclusion which can be reached is that, with no acceleration in use of the GCI, there is no immediate need for a decision on either a capital increase or a gearing ratio change in the IBRD. On this assumption, a decision is not needed before FY 1983-84, one to two years away, which should allow adequate time to evaluate carefully the two options. However, an acceleration in the use of the GCI would push this decision forward. Thus, the need to address this issue will depend upon the level of IBRD lending which we envision over the near term.

4/ Proposals, presently before the Board, to increase commitment fees and introduce loan commissions, would generate substantial additional amounts of income.

Asian Development Bank

The ADB is presently the most unleveraged of the three MDBs in which the United States is presently a member. The Bank's cumulative paid-in capital represents 18.5 percent of total capital and reserves as compared with 9.2 percent in the IBRD and 10.3 percent in the IDB. The cumulative total of usable equity, i.e., usable paid-in capital and reserves represents 20.7 percent of total capital and reserves in the ADB, compared with 14.8 percent in the IBRD and 14.4 percent in the IDB. Similarly, the ADB's interest coverage ratio, its ratio of usable equity and reserves to disbursed loans, and the coverage of its funded debt by callable capital are all much more conservative than the World Bank's ratios, and comparable with or more conservative than the IDB's ratios.

In the current replenishment discussions, the ADB has proposed a 125 percent capital increase, of which ten percent would be paid-in (40 percent in cash and 60 percent in local currency letters-of-credit) to become effective in CY 1983. The management's proposal would effectively perpetuate the present structure of the Bank, with considerable budgetary obligations for member countries. In addition, the Bank has extraordinarily restrictive limitations on its lending and borrowing capacities: under its Articles of Agreement its loans outstanding, which the ADB interprets to mean loan commitments, are limited to an amount equal to total capital and reserves. In contrast, the IBRD interprets this as loans disbursed and outstanding. The ADB is further limited in its bond covenants to borrowing only up to the callable subscriptions of those members having convertible currencies, as defined by the IMF. However, its prospectus states that, in practice, the Bank limits borrowing to only 75 percent of convertible callable capital.

The combination of these two factors has generated a need for a capital increase at this time, since almost 50 percent of ADB capital is effectively immobilized. Relaxation of some of the self-imposed limitations should be one of the goals in the capital increase.

A capital increase with a zero paid-in element, and no changes in Bank financial policies, would leave the ADB in the late 1980's with financial indicators comparable with those presently existing in the World Bank. As things stand there appears no financial need for paid-in capital, given the Bank's more than adequate present position and the long time available in which to adjust policies to seek greater reserves than those likely to be generated under present policies.

Inter-American Development Bank

A capital increase of the IDB will be the subject of international discussions in 1982, with decisions required in time for inclusion in the FY 1984 budget.

The IDB is presently in a more conservative situation than the IBRD. Much of its ordinary capital and some of the inter-regional capital is presently immobilized under the terms of bond covenants which indicate borrowings will be only up to the amount of U.S. subscriptions. However, in the future it is likely that the two classes of capital will be merged. Some of this immobilized capital (callable of the developing members) can then be used as borrowing collateral, leading to an expansion in its borrowing capacity. In the World Bank, for example, funded debt is 114 percent of DAC/OPEC callable capital, while the comparable figure in the IDB is 44 percent.

Detailed analysis of the effects of different capital increases on the IDB's financial indicators has not yet been done. However, based on the analysis undertaken for the ADB, whose financial indicators are roughly comparable to those of the IDB, we can make a tentative preliminary judgment that appropriate financial targets during the 1980s can be attained in the IDB without further paid-in amounts, with some possible adjustments in income generating items. This judgment will need to be confirmed by more detailed analysis.

The question of a capital increase for the IDB will also need to be examined in light of any efforts made to encourage a more realistic graduation policy. A high percentage of IDB lending is concentrated in the potential graduates (Argentina, Mexico, Brazil and Chile). Graduation or even a phase down of lending to these countries would reduce significantly the potential claimants on IDB hard loan resources.

African Development Bank

This institution must effectively be viewed as a start-up operation once developed countries membership is ratified and implemented. The Bank is an unproven entity with regard to the capital markets, and the next few years must be seen as a period in which it develops a presence in the markets and financial practices in line with those carried on in the other MDBs.

The present capital increase should carry the Bank through FY 1986, so discussions about its future are several years in the future. It is far too soon to determine whether the Bank will eventually develop a sufficiently sound financial base to be completely separated from a need for further paid-in capital.

F. Conclusions

The actual amount the Administration will request from Congress to fund U.S. participation in new replenishments in the future will be dependent on the results of Congressional consultations, international negotiations, and on how successful the United States is in pursuing our new policy recommendations in each of the MDBs. With this caveat, however, the Administration has made some judgments for planning purposes on a range of

appropriations requests for the MDBs through the mid 1980s. The Administration believes the middle budget range described earlier best meets international, institutional, and domestic requirements.

Although this middle budgetary range would represent a substantial real reduction in the appropriations for U.S. MDB funding of the soft loan windows, it is fully consistent with the conclusions we have reached and with the Administration's view of how development can be most efficiently promoted. This budgetary range would encourage a substantially greater degree of discipline in both the MDBs themselves and in borrowing countries. A reduced flow of financial resources in real terms would still provide adequate financing for the poorest countries who are willing to take appropriate measures to help themselves but are unable to obtain external resources from other sources. It would also necessitate more effective maturation/graduation, reinforce selectivity in lending linked to economic policy reform, and require the MDBs to step up their efforts as financial catalysts. Greater private sector involvement, including expanded co-financing, would now be seen as essential steps, not just potential improvements. The middle budgetary range is thus in keeping with the Administration's overall economic philosophy and our desire to improve the operational effectiveness of the MDBs.

In contrast, the budgetary numbers implied by the lower range would be unrealistic in terms of U.S. long term international economic and political interests, particularly in the developing world. On the other hand, the numbers implied by the upper range are inappropriate at home in the light of the Administration's basic economic philosophy and program of reduced government intervention, greater reliance on market forces and the need for stringent budgetary restraint over the next several years.

In sum, the Administration's policy preferences reflect an attempt to improve MDB operations, and thereby maximize their effective contribution to a more stable international environment, while at the same time take into account the real budgetary constraints upon the United States.

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APPENDIX I

THE MDBS: AN OVERVIEW

A. Introduction

The purpose of this appendix is to describe the multilateral development banks (MDBs) and how they function. It will focus on four institutions - the World Bank Group, the Inter-American Development Bank (IDB), the Asian Development Bank (ADB) and the African Development Bank Group (AFDB).

The World Bank Group is composed of three separate legal entities, the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA); and the International Finance Corporation (IFC). The regional banks also have capital and soft loan windows structured in much the same way. Specifically, the IDB has two major funds, Ordinary Capital/ Inter-Regional Capital (OC/IRC) and the Fund for Special Operations (FSO); and the ADB has two funds, Ordinary Capital (OC) and the Asian Development Fund (ADF). The AFDB Group is composed of two separate legal entities, the African Development Bank (AFDB) and the African Development Fund (AFDF).

The MDBs are institutions designed to assist the economic growth of their developing members. But they are not simply aid agencies because the manner in which they mobilize most of their resources -- through the issuance of bonds -- requires a financial structure and discipline resembling that of financial institutions. Nevertheless, the degree of concessionality present in loans, the emphasis on the economic relative to the financial rate of return on projects, and the technical assistance made available to borrowers underscore the principal purpose of the banks.

This appendix considers the U.S. role in the institutions, the mobilization of their resources, their lending activities, their quantitative and qualitative roles in development, and, finally, their institutional arrangements.

B. U.S. Role in the MDBs

Origins

The United States played an important part in the establishment of each of the MDBs, with the exception of the AFDB.[1] The establishment of the International Bank for Reconstruction and Development (IBRD) in 1946, was based on a U.S. proposal to the Bretton Woods Conference (1944) that had as its origin a desire to assist reconstruction of the war torn economies and to avoid a repetition of the protectionist trade and investment policies of the 1930's. The purpose of the IBRD was then to facilitate the provision of private capital for the immediate post war reconstruction period in Europe and later to encourage rational economic development in the rest of the world.

As originally envisioned by the United States, the IBRD was to rely primarily on guaranteeing private loans with direct lending as a secondary function. For the original subscription, of the authorized (and subscribed) capital, 2 percent was to be paid-in in gold or dollars, 18 percent in the currency of the member and the remaining 80 percent was to serve as a guarantee fund to discharge the obligations of the Bank on its borrowings or guarantees.[2] In addition, the borrower had to be unable to secure funds from other sources on reasonable terms; repayment had to be guaranteed by the borrowing government; the Bank was to be politically neutral in granting loans; and loans were to be made solely on the basis of economic and financial considerations.

Subsequent capital increases have reduced the percentage share of paid-in to 10 percent and increased the callable capital proportion to 90 percent in the Bank's financial structure. The percentage of paid-in capital will fall further in coming years since the present General Capital Increase (GCI) provides only for a 7.5 percent paid-in portion of the subscription. The World Bank's financial arrangements did become the model for all the hard windows of the regional MDBs.

1/ The United States did participate (1973) in drafting the charter of the African Development Fund (AFDF), the concessional window of the AFDB, which, unlike the Bank, was open to non-regional members; nevertheless, the United States did not actually join the AFDF for another 3 years (1976).

2/ The IBRD has never used its guarantee authority.

The United States also proposed in 1959, the establishment of the International Development Association (IDA) in order to provide concessional assistance to the poorest developing countries with debt service problems. IDA was proposed because the most likely alternative to helping those countries would have been an organization directly under the United Nations' General Assembly and there was a concern that it might lower the lending standards established by the IBRD. Conversely, the United States initially resisted the establishment of the International Finance Corporation (IFC) to assist private entrepreneurs in developing countries because of concerns about using public funds to acquire equity in private enterprise. Ultimately though, the United States did agree to join the IFC in 1956, to prevent it being established under United Nations' auspices.

With respect to the regional MDBs, the U.S. role was more catalytic than creative. The concept of an inter-American financial institution dated back to the 19th century but it wasn't until the late 1950's, when U.S. policy shifted towards a "special relationship" with Latin America, that the United States endorsed the Bank. United States willingness to establish the Inter-American Development Bank (IDB) was to demonstrate U.S. interest and financial support for the economic development of the region. Similarly, the ADB did not gain sufficient support from others until the United States endorsed it in 1965, largely for the same reasons as the IDB. Moreover, with the escalation of the war in Vietnam at that time, it was even more important to demonstrate visible support for the economic aspirations of the region.

Structure and U.S. Participation

The MDBs closely resemble each other in structure and operating style. All are owned by member governments contributing resources which essentially determine their relative voting strength; all are characterized by lending primarily for discrete investments (projects) through a "hard" loan window at terms related to borrowing costs, and a "soft" loan window at highly concessional terms. In addition, each MDB loan requires a government guarantee. 3/

3/ Only the IFC does not require a government guarantee.

The United States, as of September 1981, subscribed to 23.03 percent of the capital of the IBRD, the hard loan window of the World Bank. This subscription represents the current U.S. share (ownership) of the Bank and determines U.S. voting strength which, as of September 1981, was 20.84 percent of the total. The U.S. subscription to IDA, the soft loan window of the Group is 30.56 percent as of September 1981, but the U.S. share of the last (sixth) replenishment is only 27 percent. As of September 1981, the U.S. subscribed to 31.71 percent of the capital of the IFC which is, among all the MDBs, the only "window" focusing strictly on the private sector.

The United States had subscribed to approximately 34.7 percent of the IDB's Capital, the hard loan window of the Bank. This percentage also includes subscriptions to Ordinary and Inter-Regional Capital (IRC). The latter is a new class of stock that was created at the time the non-regional members joined the Bank in 1976. The United States has 40.5 percent of the IDB's voting power; this provides the United States with a veto over the operations of the FSO, the soft loan window, because the IDB Charter provide for a two-thirds majority for approval of FSO loans. (In the hard loan window (OC/IRC) and in the other MDBs, proposals are approved by simple majority.) The United States, on a cumulative basis, has contributed about 57 percent of the resources to the FSO.

The United States had subscribed, as of December 1981, to 13.4 percent of the Ordinary Capital of the ADB, the hard loan window. The United States has contributes about 20 percent to the ADF, the ADB's soft loan window at the end of 1981. (The latter figure is affected by the timing of contributions to the ADF. The United States has agreed to a 20.7 percent share of the Second Replenishmemt.) Finally, the United States contributes 13.8 percent to the AFDF, the soft window of the AFDB. When the AFDB's Ordinary Capital is open to non-regional membership, the United States share will be about 6 percent of the capital.

The IBRD has 141 members but the five major donors -- the United States, the United Kingdom, Germany, France, and Japan -- largely dominate the institution with nearly 44 percent of the total vote. In contrast, however, the regional MDBs are not so dominated even though the same five donors provide most of the usable (convertible) resources. In the ADB, there is a rule that the regional countries (mostly borrowers) will have two seats on the Board of Directors for every one of the non-regionals (donors).

But, to some extent, the rule is offset by the fact that with Japan, Australia, and New Zealand listed as regional countries, the donors have a majority of the shares and votes. In the IDB, the Latin American countries have more than a majority of the voting power (56 percent) because the same weight is given to all subscriptions whether or not payment is made in convertible or non-convertible currencies. In the AFDF, regional control is maintained, for the most part, by reserving 50 percent of the voting power for the AFDF for the AFDB. (A 75 percent majority is required for approval in the AFDF.)

As a major donor to each MDB, the United States is entitled to its own Director and Alternate on the Board of Directors, with the exception of the AFDF where the United States, the United Kingdom, and Yugoslavia share a constituency. 4/ The U.S. Director is the major channel through which the United States makes its views known to the Banks; and in turn, he is responsible for informing the U.S. Government of Bank activity. While there is considerable unofficial staff contact between Treasury, AID/IDCA, and State with the MDBs' staff, particularly for those located in Washington, the contacts are too diverse to be effective channels of communication.

The amount of influence the U.S. Directors have to affect MDB actions varies with the particular MDB and the circumstances. Only in the IDB/FSO does the United States have sufficient voting strength to block a loan based solely on its vote. Nevertheless, all of the MDBs do listen carefully to U.S. views, and on major issues of importance to the United States, are generally accommodating. In most cases, U.S. influence is probably greater than its actual voting strength would suggest. Finally, the United States does have sufficient voting strength now to veto any amendment change in the World Bank's Articles of Agreement which requires more than 80 percent of the vote for adoption. (However, it will be lost temporarily when the GCI comes into effect if other countries subscribe in full and the United States subscribes over a 5 year period as it plans to do.)

In addition to the U.S. Directors, the annual meetings of the Board of Governors and negotiations for capital increases or replenishments provide additional opportunities for the United States to participate in the development and formulation of MDB policies.

4/ Currently, an American is the Director.

C. Resource Mobilization

The MDBs mobilize most of their resources from three major sources -- the private capital market through issuing bonds, contributions from governments, and loan repayments. Only in the IDB have funds entrusted to it by individual donor countries been an important source of lending.

Sources of Funds

For the hard windows, all of the MDBs derive a portion of their loanable funds from paid-in capital, has although this amount is relatively small. For the IBRD, for example, paid-in capital amounted (before the GCI) to 10 percent of the subscribed capital but only 1 percent must be paid in gold/or dollars and the remaining 9 percent can be provided in the form of non-interest bearing letters of credit denominated in the member country's currencies, which can be released only with the member's consent. In practice, however, the developed members and the more advanced developing members have released most or all of their paid-in subscription for use by the Bank. In the IBRD usable paid-in capital (that portion of paid-in that has been released and is convertible into other currencies) represents 74 percent of the total, or $2,950 million of the $3,995 million paid-in. In the IDB, paid-in capital, on average, is 11 percent of the subscribed capital. Historically, half of the paid-in was to be in gold/or dollars and half in the member's currency but under the terms of the current Fifth replenishment only one third of the borrowers' subscriptions is payable in local currency. Thus, in the IDB, usable paid-in capital represents 77 percent of the total, or $1,282 million of the $1,665 million paid-in. In relative terms, then, the amounts paid-in to date total $3,995 million for the IBRD, and $1,665 million for the IDB, which support loans of $44,770 million and $9,473 million, respectively. Similarly, the usable paid-in capital totals $1,344 million in the ADB (77 percent of $1,744 million total paid-in) and supports loans of $4,457 million.

The majority of the funds for lending from the hard windows is derived from borrowings in the various capital markets and private offerings. In FY 1980, the IBRD alone issued bonds totaling $5.6 billion and the IDB raised $460 million in the same fashion. The ADB issued bonds totaling $325 million. These amounts represented 65 percent, 32 percent, and 42 percent, respectively of the funds provided during the year. The IFC's articles of agreement permit it to borrow funds from the IBRD to maximum of four times the Corporation's net worth; these funds can only be used for loans, not equity investments. The AFDB has not yet issued

any long term bonds. At the end of FY 1980, the outstanding borrowings of the IBRD totaled $29,635 million, the IDB $3,039 million, and the ADB $1,870 million. The backing for these bonds is the callable capital of the hard windows which serves as the guarantee to avoid a default by the banks on the bonds. To date there has never been a call in any MDB, nor is one ever expected.

For their borrowings, the MDBs try to issue bonds in the capital market where rates are lowest, in order to minimize interest costs for their borrowers. Over the past few years, this approach has led the MDBs to do most of their borrowing outside the United States where interest costs have been relatively high. This has kept the nominal cost of borrowing down with no adverse consequences to the banks since they pass the exchange risk through to the borrowers. 5/

The importance of borrowing as the source of funds for the hard windows is not as important, in relative terms, as it once was because of the relative increase in loan repayments. For example, in FY 1980, for the IBRD, repayments totaled nearly $1 billion or about 22 percent of the year's disbursements. Similarly, repayments to the IDB in 1980, totaled $271 million representing 33 percent of the $813 million disbursed for both OC and IRC loans. A similar trend is also evident in the hard window of the ADB.

Another possible source of expanding the lending programs for the hard windows, particularly the IBRD, would be to permit the adoption of a higher "gearing ratio". In other words, the Bank could increase its loans disbursed and outstanding to some multiple of its total capital plus reserves. The IBRD's Articles of Agreement does not permit it to go beyond a 1 to 1 ratio. But, the Bank is giving some preliminary consideration to changing the Articles so that the ratio could go, for example, to 2 to 1 which would permit the Bank to double its lending without a capital increase. The other MDBs have similar restrictions on their lending authority.

The sale of loans or their early maturities is also a source of funds whose importance varies from bank to bank and over time. They are also generally limited to loans from the hard windows.

5/ This is due to the other MDBs' practice of borrowing, lending, and accepting repayment in the same currencies. The AFDB, however, does absorb the exchange risk.

For example, the IBRD's loan sales in FY 1979 were $67 million but fell in FY 1980 to only $23 million. Similarly, the loans sold by the ADB were only $1.9 million in 1979, and $1.3 million in 1978. Conversely, IDB loan sales were much more important, totaling $127 million in 1980, and $35.7 million in 1979, representing about 9 and 3 percent, respectively of the funds available. Loan sales are sensitive to policy changes in the MDBs which may explain some of the increases and decreases in sales. However, the Administration is currently examining ways in which the sale of MDB loans (and/or participations) can be expanded as part of its overall desire to see more private co-financing take place with the MDBs. Nevertheless, it must be kept in mind that the opportunity to sell loans depends, to some degree, on what the loans for and the recent shift toward agriculture may reduce the chances of selling them. Loans for agriculture typically have longer disbursement periods (5 to 7 years) than do loans to industry (3 to 4 years), thereby delaying repayment which, in turn, reduces their attractiveness to commercial banks that prefer the shorter term loans.

Virtually the only source of funds for the soft windows of the MDBs is contributions from donor governments. The terms of the concessional loans virtually preclude the possibility of repayments being a significant element for many years. IDA's credits, for example, have a service charge of 0.75 of one percent per year, ten years grace with repayment over 50 years, and a grant element of 83 percent. 6/ As a consequence of the long grace period and extended repayment period, repayments to IDA in FY 1980 totaled only $26.7 million or only 2 percent of resources provided. AFDF and ADF terms are very similar and being newer institutions repayments are even less important. Only in the IDB are the terms of the FSO varied depending on the relative economic standing of the country and the nature of the project. Nevertheless, the hardest of the terms is only 4 percent for 25 years with 5 to 6 years grace. Even so, the repayments totaling $159.9 million in 1980 represented only 28 percent of the funds provided for the year; and, as a means to increase their concessionality most of these loans were made repayable in local currencies which signficantly reduces the value of the reflows for new lending. 7/

6/ The grant element is the difference between the nominal amount of the loan and the discounted amount, expressed as a percentage of the face value. The discount rate usually applied is 10 percent.

7/ However, in 1973, loans from the FSO were made repayable in the currencies disbursed which, in time, will eliminate that problem.

Trust funds being administered on the behalf of other donors are another source of funds for MDB loans. But only the IDB and the AFDB have such funds at the present time. The IDB is administering a total of 10 such trust funds from various sources. The two most important funds are the U.S. Social Progress Trust Fund (SPTF), from which 122 loans have been made totaling $541 million, and the Venezuelan Trust Fund (VTF) from which 32 loans have been made totaling $524 million. The terms and uses for which these funds can be used are established by the donor; in the case of the SPTF, the United States decided to accept local currencies in repayment and limited the fund's use initially to agriculture, housing, health and education. This fund is now virtually exhausted of hard currencies (dollars) to lend. The VTF was similarly established to encourage exports, Latin America integration, and the extractive industries. Through 1980, the IDB had approved a total of 187 loans for $1.2 billion from the 10 trust funds. The only other MDB with trust funds is the AFDB which is administering the Nigerian Trust Fund (NTF) totaling $160 million. The NTF is unique, though, in that no special restrictions have been placed on its use.

Financial Structure

Any discussion of the financial structure of the MDBs is usually concentrated on the hard loan windows of the banks. The nature of the soft loan windows and the manner in which they are replenished does not require the same adherence to financial performance standards as the hard windows, largely because the funds raised are not from the capital markets and do not have to be repaid.

All of the hard windows of the MDBs are structured financially in much the same fashion; all of the authorized capital stock is subscribed to by member governments. In the case of the IBRD, authorized capital now totals some $85 billion, including the recent General Capital Increase (GCI) of $40 billion dollars which virtually doubled its authorized capital. However, the subscribed capital presently totals only approximately $39.6 billion. Moreover, as noted above, members are able to control the release of a portion of their paid-in subscriptions. As a consequence, the usable paid-in capital (i.e. subscriptions in convertible currencies and usable by the MDB without limitation) is relatively small. For example, the usable paid-in capital for the IBRD, IDB and the ADB is only 74 percent, 77 percent, and 77 percent, respectively.

One result of the small subscribed equity base is that the reserves accumulated from retained net income become quite important in terms of the banks' bond rating, since they represent the first line of defense in case of a default on any of their bonds. Callable capital, the largest source of funds to cover bond defaults, would be the second line of defense. Over its lifetime, the IBRD, for example, has accumulated $3,487 million in reserves. Thus, the IBRD has a total usable equity base -- usable paid-in plus reserves -- of $6,287 million.

All the banks have an explicit liquidity policy, i.e., each holds sufficient short term liquid investments to finance its loan disbursements with minimum disruptions. In the case of the IBRD, its policy is to hold 40 percent of the next three years gross borrowing requirements in order to provide sufficient flexibility to reduce or avoid borrowings at times of market stress, or when the Bank may be closed out of a particular capital market. At the end of 1980, the IBRD for example, held $9.5 billion in short term investments, approximately 70 percent of which were in U.S. dollars. In order to minimize potential liquidity problems, the Bank's policy is to extend the average maturity of its outstanding borrowings (6.33 years) to match the maturity structure of its outstanding loans (8.77 years) as close as possible. The IDB's liquidity policy is to hold liquid assets equal to 50 percent of undisbursed loan commitments; and the ADB's policy is to hold liquid assets equal to the higher of: (i) 40 percent of the undisbursed loan balances or (ii) the projected disbursements over the next 18 months. The AFDB has so far not been able to borrow long term at fixed interest rates; consequently, when short term rates rise its earnings are reduced.

There are four key financial indicators the MDBs seek to maintain at satisfactory levels to assure their continued access to capital markets, namely: total reserves as a percentage of disbursed loans, usable equity as a percent of disbursed loans, the level of net income, and the interest coverage ratio. The present status of these four indicators and others in the banks are seen in Table 1.

Table 1 Financial Indicators for FY 1980

	IBRD	IDB	ADB	AFDB
Reserves/Disbursed Loans (percent)	13.10	30.00	29.00	24.20
Usable Equity/Disbursed Loans (percent)	24.10	67.00	93.00	100.00
Net Income ($ millions)	587.00	198.00	151.00	7.50
Return on Equity (percent)	9.20	9.43	9.56	1.60
Interest Coverage Ratio	1.30	1.85	2.06	1.15
Average Borrowing Cost (percent)	7.30	7.88	7.75	11.60
Borrowing Cost (Past 12 months percent)	8.20	9.60	8.70	N.A.
Lending Rate During FY 1980 (Percent)	9.60	9.25	9.25	8.0

Source: U.S. Treasury

The ratio of reserves to disbursed loans measures the capacity of the bank to withstand reverses without adversely affecting the shareholders capital. The IBRD considers 10 percent to be adequate, while the regional MDBs are aiming for 15 percent. The usable equity/loan ratio is a measure of the protection provided bondholders against possible reverses, and a 15 percent level is considered necessary by the IBRD to maintain a Triple A rating. A rising level of net income is judged to be important since it assures continued additions to reserves. The IBRD believes that to maintain its present rating, income should be sufficient to provide at least a 10 percent margin over the interest on the funded debt. Consideration also needs to be given to the return on equity (usable paid-in capital and reserves), to measure whether the MDBs are being de-capitalized. Finally, the interest coverage ratio, i.e. net income plus interest on the funded debt relative to interest on the funded debt, is a measure of the MDBs' capacity to service debt. The IBRD has established 1.15 as desirable for this indicator and the ADB 1.25.

One of the results of the consistently high ratios maintained over the years by the MDBs is that the IBRD, ADB and IDB are rated AAA by both Moody's and Standard and Poors. The AFDB has not yet borrowed and, as a consequence, is not rated; however, it is working with underwriters for a rating.

To date, the bond markets have not focused much attention on the quality of the MDBs' loan portfolios simply because of the strength of the guarantees, i.e. usable equity plus callable capital. Nevertheless, as the value of MDB borrowings increase to the point where the amount of borrowings exceeds the equity plus callable capital subscriptions of the United States and the DAC/OPEC members, the bond markets will increasingly pay attention to the quality of the MDB loan portfolios.

One of the major elements affecting their financial performance is the rate the MDBs charge their borrowers. The MDBs review the lending rate for their hard loans every quarter or every two quarters; and, for the most part, set their lending rate at 30 to 50 basis points above the average of their estimated borrowing costs for the next twelve month period. The spread is intended to cover administrative and liquidity costs and varies slightly from bank to bank. It should be noted that the AFDB has a negative spread between its lending rate and its average borrowing costs (See Table 1). In addition, the banks' charge borrowers a commitment fee, usually one percent or less, on undisbursed loan balances.

Non-Convertible Currencies

Subscriptions to paid-in capital in the ordinary capital windows of the MDBs are required to be made partially in dollars or other convertible currencies and partially in local currency. The local currency contribution, the proportion of which varies from bank to bank, is typically made in the form of a non-interest bearing letter of credit to be drawn-down either at the mutual agreement of the MDB and the member country, as in the IBRD, or by agreement to an encashment schedule established during the negotiations for capital increases in the other banks. The performance of the various MDBs in making the local currency contributions usable in their operations varies somewhat and some countries have taken different positions on this issue in different banks.

Paid-in capital subscriptions to the World Bank are payable 10 percent in U.S. dollars (valued at $1.20635=1SDR) and 90 percent in local currency. The latter payment can be made by letter of credit. Paid-in subscriptions to the World Bank totalled $3995 million on June 30, 1980, of which approximately $2950 million was fully usable and approximately $950 million (24 percent of paid-in capital) remained unavailable.

Members of the IBRD that have not released their contributions were typically among the poorer of the developing countries. Among the major Latin American countries, Brazil and Argentina have released their contributions, while Mexico has made its partially usable. In Asia, borrowers such as Thailand and Malaysia have released their contributions while Korea has not done so. Among DAC members, only New Zealand to date has not released its contributions while France has not yet released a small portion of its contribution. (The United States has indicated it will exercise its option and allow the letter of credit portion of its subscription to the GCI to be encashed on a scheduled designed to minimize the budgetary impact in the early 1980's.)

Votes in the MDBs are based primarily on share subscriptions of which only a relatively small portion is paid-in. The callable capital portion of the subscription, counts in the determination of voting power on the same basis as paid-in capital. The paid-in capital subscriptions, however, represent the direct governmental budgetary burden of providing resources to the MDBs, since callable capital is relatively costless to member governments.

A result of not releasing the local currency contributions then is to magnify the difference between voting power and the provision of resources by member governments. For instance, the United States had contributed 23.4 percent of total paid-in capital on June 30, 1980, qualifying it for a 21.1 percent voting share in the World Bank. However, at this date, it had contributed 33.4 percent of the usable paid-in capital. By contrast, India had contributed 3.8 percent of total paid-in capital, but only 0.4 percent of usable paid-in capital; nevertheless, its voting power was 3.5 percent.

The IDB has two classes of capital, ordinary and inter-regional. Subscriptions to paid-in ordinary capital on December 31, 1980, totaled $1198 million, of which subscriptions in U.S. dollars were $730 million (61 percent) with the remainder in other member currencies, of which only $85 million was convertible. All the $467 million subscriptions to inter-regional capital are convertible. The net effect is that $378 million, or 24 percent of total paid-in capital subscriptions (ordinary plus inter-regional capital) are in non-convertible member currencies. The IDB can use these non-convertible funds for local procurement and local administrative expenses which are much higher than in the IBRD, since there is a permanent field office in each member country.

The same difference between voting power and provision of resources also occurs in the IDB. The United States has provided 36.5 percent of total paid-in subscriptions but 48.2 percent of the total usable paid-in resources, while only receiving 34.5 percent of the votes. The borrowing members have provided only 28 percent of usable paid-in capital while receiving over 50 percent of the voting power.

There are anomalies between the way some countries treat their contributions to the IBRD and IDB. Argentina, for instance, has made its $54 million in paid-in subscriptions to the IBRD usable, while only $102 million out of its $194 million subscriptions to IDB paid-in capital are fully usable by the Bank -- the 48 percent of its subscriptions representing local currency contributions are only available for local procurement and administrative expenses.

The FSO, unlike the concessional windows of the other MDBs, also has local currency contributions from its regional members. In the present replenishment of the FSO, Venezula and Trinidad and Tobago have made their contributions fully convertible; Argentina, Brazil, and Mexico have made 75 percent of their contributions either fully convertible or broadly usable, and the remaining Latin American countries' contributions are without a convertible currency requirement. Under the terms of the present replenishment, the United States will provide 40 percent of the total resources but 45 percent of the usable resources. (The U.S. vote, determined by subscription to OC/IRC, is 34.5 percent)

Almost one fifth (19.8 percent) of the subscribed capital of the ADB is paid-in, totalling $1744 million on December 31, 1980. Of this paid-in capital, $1344 million is freely usable or in unrestricted demand notes, $117 million has not yet matured, and the remaining $283 million is in non-convertible letters of credit.

In the second General Capital Increase, which became effective in 1977, ten percent ($81.4 million) was paid-in, of which 40 percent ($32.6 million) was to be in gold or convertible currencies and the remaining 60 percent ($48.8 million) in member country currencies in the form of non-interest bearing letters of credit, $29 million of which is likely to be unrestricted. Accordingly, the total usable paid-in resources amounted to 7.5 percent of subscriptions. The letter of credit of all the developed member countries of the Bank, except New Zealand, are freely usable when needed, whereas, all the developing member countries (including Hong Kong, Singapore, Korea, Malaysia, and Thailand) have placed restrictions on the use of their local currency contributions, as they are entitled to do under the Bank's charter. Interestingly, Malaysia and Thailand have made their paid-in contributions to the IBRD usable.

The local currency contributions can be used for local administrative expenses and procurement. The Philippines local currency contribution is almost fully used in operating the Bank's headquarters.

The divergence between provision of fully usable resources and voting power also appears in the ADB. Japan has subscribed to 17 percent of ADB paid-in capital, provided approximately 21.6 percent of fully usable resources and has a 14 percent voting power. The United States has provided 19.2 percent of fully usable resources and has a 11.2 percent vote, while India has provided approximately 4.4 percent of fully usable resources but receives a 6.78 percent vote.

In the AFDB all contributions to paid-in capital have been in convertible currency. However, in the upcoming capital increase, the regional countries will have the option of making their subscriptions in convertible currency contributed over a fifteen year period, or subscribing fifty percent in convertible currency and fifty percent in local currency.

Again the anomalous situation is likely in which countries that have blocked subscriptions to other MDBs, such as Korea and India, will be making their AFDB contributions fully convertible.

D. Lending Activities

Terms of Lending

The funds lent by the MDBs are channeled through their hard and soft windows. The hard window loans have terms reflecting bank borrowing costs and currently range from 10.0 to 12.0 percent, 3 to 4 years grace and 13 to 30 years repayment. The soft funds are all contributed by governments so they can be lent at very concessional terms. Currently, the terms range from 0.75 to 4 percent, up to 10 years grace with repayment from 25 to 50 years. The degree of separation between the hard and soft funds varies between the MDBs, but the differences in terms are greater in the IDB than in the other banks.

Levels of Lending

Total lending commitments by the MDBs have increased in absolute terms over the last five years by approximately 80 percent, from roughly $8.9 billion in 1976, to $16.3 billion in 1980. (See Table 2) The average annual increases, in nominal terms, in total MDB lending have exceeded 15 percent over the same period, with a 23 percent increase in 1980 alone. Most of the loans, by value, are made from the hard windows of the banks, for example in FY 1980, 68 percent of the loans were from the hard loan windows. (See Table 3)

Table 2 MDB Lending by Sector for Five Years
FY 1976 - FY 1980
(millions of dollars)

Sector	1976	1977	1978	1979	1980	Total
Agriculture						
WBG	1,627.6	2,276.5	3,424.6	2,752.5	3,528.8	13,610.0
IDB	283.2	418.2	263.7	394.1	498.5	1,857.7
ADB	262.0	159.2	241.6	294.1	417.1	1,374.0
AFDF	--	37.0	55.5	87.0	121.8	301.3
Subtotal	2,172.8	2,890.9	3,985.4	3,527.7	4.566.2	17,143.0
Preinvestment						
WBG	--	--	--	--	--	--
IDB	5.2	50.3	7.7	23.5	37.0	123.7
ADB	--	--	--	--	6.2	6.2
AFDF	--	--	--	1.9	--	1.9
Subtotal	5.2	50.3	7.7	25.4	43.2	131.8
Dev. Fin. Co.						
WBG	805.2	656.2	390.5	802.2	929.6	3,583.7
IDB	(a)	(a)	(a)	(a)	(a)	(a)
ADB	212.0	(a)	152.0	98.9	160.0	622.9
AFDF	--	(a)	--	--	9.7	9.7
Subtotal	1,017.2	656.2	542.5	901.1	1,099.3	4,216.3
Education						
WBG	321.3	288.6	279.9	488.0	510.1	1,887.9
IDB	76.7	99.1	48.7	145.4	106.8	476.7
ADB	14.5	--	28.2	64.0	61.0	167.7
AFDF	--	16.3	15.5	33.0	17.8	82.6
Subtotal	412.5	404.0	372.3	730.4	695.7	2,614.9
Ind./Mining						
WBG	806.3	956.5	1,330.8	1,080.3	1,020.9	5,194.8
IDB	123.1	224.9	399.7	280.9	209.5	1.238.1
ADB	--	102.5	77.1	105.2	5.2	290.0
AFDF	--	--	--	--	--	--
Subtotal	929.4	1,283.9	1,807.6	1,466.4	1,235.6	6,722.9
Non Project						
WBG	429.0	316.5	105.0	406.5	772.5	2,029.5
IDB	--	--	--	--	--	--
ADB	--	--	--	--	--	--
AFDF	--	--	--	--	--	--
Subtotal	429.0	316.5	105.0	406.5	772.5	2,029.5
Population/Health						
WBG	25.8	47.3	50.1	97.0	143.0	363.2
IDB	--	--	--	12.8	324.1	336.9
ADB	--	--	19.5	19.0	--	38.5
AFDF	--	5.5	14.2	--	--	19.7
Subtotal	25.8	52.8	83.8	128.8	467.1	758.3
Power						
WBG	949.3	951.5	1,102.9	1,344.9	2,554.8	6,903.4
IDB	339.0	122.7	414.1	706.2	--	1,582.0
ADB	--	52.0	215.5	172.1	369.3	808.9
AFDF	--	--	--	16.6	7.4	24.0
Subtotal	1,288.3	1,126.2	1,732.5	2,239.8	2,931.5	9,318.3
Tourism						
WBG	31.9	98.6	52.3	113.2	26.0	322.0
IDB	24.9	26.6	45.0	1.7	32.0	130.2
ADB	--	--	--	--	--	--
AFDF	--	--	--	--	--	--
Subtotal	56.8	125.2	97.3	114.9	58.0	452.2
Transp./Comm.						
WBG	1,435.1	1,202.6	1,513.7	1,720.5	1,747.7	7,619.6
IDB	241.7	211.0	94.6	293.5	327.9	1,168.7
ADB	164.6	128.4	112.8	135.3	197.5	738.6
AFDF	--	27.4	63.3	40.4	71.6	202.7
Subtotal	1,841.4	1,569.4	1,784.4	2,189.7	2,344.7	9,729.6
Urbanization						
WBG	79.6	158.2	356.6	374.5	304.8	1,273.7
IDB	25.2	6.5	41.0	--	--	72.7
ADB	--	21.7	16.0	32.3	50.0	120.0
AFDF	--	--	--	--	--	--
Subtotal	104.8	186.4	413.6	406.8	354.8	1,466.4
Water Supply						
WBG	334.6	354.7	696.2	773.3	616.1	2,774.9
IDB	111.5	84.1	232.1	120.6	(b)	548.3
ADB	229.8	28.5	139.2	64.8	125.9	588.2
AFDF	--	31.9	6.7	28.7	19.4	86.7
Subtotal	675.9	499.2	1,074.2	987.4	761.4	3,998.1
Export Fin.						
WBG	--	--	33.6	--	--	33.6
IDB	0.5	5.7	--	1.3	0.5	8.0
ADB	--	--	--	--	--	--
AFDF	--	--	--	--	--	--
Subtotal	0.5	5.7	33.6	1.3	0.5	41.6
Energy c/						
WBG				142.2	385.0	527.2
IDB				--	288.2 d/	288.2
ADB				--	39.0	39.0
AFDF				--	--	--
Subtotal				142.2	712.2	854.4
Tech. Asst. e/						
WBG	32.0	16.9	9.3	29.7	29.3	117.2
IDB	--	--	--	--	--	--
ADB	--	--	--	--	--	--
AFDF	--	--	--	--	--	--
Subtotal	32.0	16.9	9.3	29.7	29.3	117.2
Multisector						
IDB					254.0	254.0
ADB					2.2	2.2
Subtotal					256.2	256.2
Total	8,991.6	9,183.6	12,049.2	13,298.1	16,328.2	59,850.7

a/ Amounts are distributed between agriculture and industry and mining.
b/ Included in population/health.
c/ Energy projects prior to 1979 were generally under power.
d/ Energy and power sectors combined.
e/ IDB provides its technical assistance on a grant or reimburseable basis, not loans.

Source: NAC Annual Reports FY1976 - FY1980

Table 3 Multilateral Development Bank Lending for 1980

Sector	World Bank			IDB		ADB		AFDF	Total	Percent
	IBRD	IDA	IFC	OC/IRC	FSO	OC	ADF			
Agriculture	1,992.4	1.509.8	26.6	254.4	244.1	125.9	291.2	121.8	4,566.2	27.96
Preinvestment	-	-	-	-	37.0	-	6.2	-	43.2	.26
Development Finance Companies	720.0	147.5	62.1	(a)	(a)	120.0	40.0	9.7	1,099.3	6.73
Education	405.1	105.0	-	72.5	34.3	15.0	46.0	17.8	695.7	4.26
Industry/ Mining	430.5	29.0	561.4	229.0 (b)	7.5	-	5.2	-	1,262.6	7.73
Non-Project	480.0	292.5	-	-	-	-	-	-	772.5	4.73
Population/ Health	65.0	78.0	-	206.0	118.1	-	-	-	467.1	2.86
Power	1,742.5	807.8	4.5	-	-	339.4	29.9	7.4	2,931.5	17.95
Tourism	-	-	26.0	5.0	-	-	-	-	31.0	.18
Transportation/ Communications	1,441.0	306.7	-	172.0	155.9	164.0	33.5	71.6	2,344.7	14.35
Urbanization	205.8	99.0	-	-	-	50.0	-	-	354.8	2.17
Water Supply/ Sewerage	425.4	190.7	-	(c)	(c)	125.9	-	19.4	761.4	4.66
Export Financing	-	-	-	0.5	-	-	-	-	0.5	0.00
Energy	256.5	128.5	-	195.7 (d)	92.5 (d)	39.0	-	-	712.2	4.36
Technical Assistance	-	29.3	-	-	-	-	-	-	29.3	.17
Multisector	-	-	-	144.0	110.0	-	2.2	-	256.2	1.56
Total	8,164.2	3,723.8	680.6	1,279.1	799.4	979.2	454.2	247.7	16,328.2	100.00

(a) Loans for Development Finance are distributed between "Agriculture" and "Industry/Mining".

(b) Including two loans ($27 million total) with tourism component

(c) Included in "Population/Health"

(d) "Power" and "Energy" combined

Source: U.S. Treasury

In terms of lending commitments the World Bank Group is by far the largest, committing a total of $12,568 million in 1980. This represents an 83 percent increase in terms of the 1976 level, an average annual increase of roughly 16.5 percent. In 1980, there was a jump of 24 percent in the level of lending over 1979.

Among the regional banks, the IDB is the largest lender in absolute terms. The IDB's commitments in 1980 reached $2.1 billion and averaged nearly 14 percent increases each year since 1976. The AFDF is the smallest lender ($248 million) but on the basis of percentage increases in annual lending levels, it has increased at an average of 25 percent per annum since 1977. But being a relatively new window (1973) such percentage increases are to be expected as the lending program develops. The ADB's commitments in 1980, amounted to $1.4 billion and represented a 45 percent increase over its 1979 lending level. On average, the ADB has increased its absolute lending level about 12 percent each year.

An important complement to MDB lending programs is technical assistance. Most of the technical assistance provided by the banks is for designing or developing better projects or helping their borrowers implement the projects. The banks finance, for example, to design better irrigation systems or train local highway engineers. In this manner, the MDBs carry on substantial training programs and the level of assistance is relatively significant; for example in 1980, the IDB extended approximately $32 million in non-reimbursable technical assistance for these purposes. Additionally, all of the MDBs fund consultants through their loans which represents another form of technical assistance for actually implementing projects.

The IFC has stepped up its non-project related technical assistance activities, in two areas: (1) development of private capital markets, and (2) assisting governments to improve conditions for private investment. Such assistance has included financial sector surveys, advisory missions to governments, training, and policy analysis in response to a member's request. Primary objectives in devleoping local capital markets are to facilitate access of local finanical institutions and enterprises to international capital markets.

Criteria for Hard vs Soft Lending

In terms of the MDBs' own resources, all of the loans are made from either the hard or soft windows excluding the IFC. The criteria for determining whether a loan is made from the hard or soft window are generally country criteria for all the MDBs. For the World Bank specifically, it is determined by the level of the

country's per capita income, debt service requirements, and balance of payments situation. 8/ For the ADB's OC, there are also country criteria, i.e., the level of the country's per capita income, but this is modified by the conditions of the economy and the country's debt capacity. The IDB follows a similar set of country criteria in practice. However, no formal criteria exists because the wealthier Latin American countries -- Argentina, Mexico and Brazil (Group A) -- while they do not currently borrow convertible currencies from the soft window insist, as a matter of principle, they remain eligible to borrow FSO funds. 9/

Because sufficient concessional funds have not been available to apply the country criteria exclusively, blends of hard and soft funds have been adopted for medium income countries with soft funds generally being used for non-revenue earning projects, e.g., education or health. Conversely, in very poor countries that have viable projects to finance, the MDBs have adopted a "two-step" procedure whereby the MDB's concessional loan is made to the government which, in turn, on-lends the funds to the implementing agent at terms and conditions prevailing in the borrowing country. In this fashion, the difference in the repayment flows is made available to the government in the interim period for its programs and the MDB's concessional terms do not provide the implementing agent with a subsidy; nevertheless, the MDBs do not attempt to control the use of those funds during that interim period.

Only the World Bank does any considerable amount of non-project lending. For example in FY 1980, IBRD/IDA lent $773 million or about 7 percent of their lending for non-project assistance. Nevertheless, the choice of whether a non-project loan is made from hard or soft funds is made on the same basis as any other loan, namely, country criteria. In a similar fashion, the ADB and the IDB both have limited sector lending programs, in which they finance the import bill for certain specified items, e.g., fertilizer. 10/ The terms of those loans are also determined on the basis of the country criteria and not a project one.

8/ The current IDA per capita income limit is $680 (1979).

9/ Venezuela has not borrowed at all from the IDB since 1973; additionally, three other countries -- Trinidad and Tobago, Chile, and Uruguay -- have also agreed not to borrow hard currencies from the FSO.

10/ The IDB has not yet adopted a specific sector lending policy.

Historically, the MDBs have concentrated their lending on economic infrastructure, particularly transportation, although the relative degree of emphasis has varied among the banks. However, over the last several years, there has been a trend to increase the amount of MDB lending to the agricultural sector. (See Table 2) In 1980, for example, MDB lending for agriculture and rural development reached approximately 28 percent of the total. (See Table 4) Although agriculture has attracted an increasingly larger share of MDB resources, other sectors such as power, industry, transportation, and communication have remained high priority investment targets. During 1980, almost 40 percent of total MDB lending was absorbed in these key sectors.

With respect to the World Bank Group, there have been significant variations recently in its lending program by sector. In 1980, lending in support of agriculture and rural development totaled roughly 28 percent of its total; and there has been a dramatic increase in the proportion of lending for new energy sources, i.e., oil, gas and coal. The percentage of total World Bank lending for these activities increased from 1 percent in 1979, to about 3 percent in 1980.

The regional MDBs have also focused a large proportion of their resources on projects in agriculture. In the IDB's case, agriculture has always been an important recipient; and in 1980, IDB's lending for agriculture amounted to 24 percent of its total. (See Table 4) But at the same time, the IDB's proportion of lending for infrastructure remained at approximately 24 percent. The ADB has also maintained its sectoral emphasis towards agriculture, channeling 29 percent of its 1980 commitments for projects in agriculture. In the case of the AFDF, the sectoral emphasis has always been on agriculture due to the conditions prevailing in most of Africa; but an increasing proportion (39 percent) of its commitments in 1980 went for agricultural projects. (See Table 4)

Country Allocation

In terms of allocating loan funds by borrowing member countries, only the IDB has adopted an explicit procedure and its impact is relatively limited. Under the terms of the last (Fifth) Replenishment, the wealthier countries (Group A) were limited to borrowing only $3 billion in total ($750 million annually) from the hard window, an amount which they agreed to split evenly among themselves. Moreover, the Group A countries agreed not to request hard currency loans from the soft (FSO) window. In turn, the poorest countries (Group D) were to receive 75 percent of their funds from the FSO for the first two years of the replenishment and 80 percent in the second two years. The Group B and C countries were to receive the rest of the OC/IRC and FSO funds accordingly, but there was no explicit division of funds by country.

Table 2 . Percentage Distribution of MDB Lending by Sector and Institution
(FY 1976 - FY 1980)

Sector	1976	1977	1978	1979	1980
Agriculture					
WBG	23.7	31.1	36.6	27.2	28.1
IDB	23.0	33.5	17.1	19.9	24.0
ADB	29.7	32.3	24.1	29.8	29.1
AFDF	--	31.3	35.8	41.9	49.2
Subtotal	24.2	31.5	33.1	26.5	28.0
Preinvestment					
WBG	--	--	--	--	--
IDB	0.4	4.0	0.5	1.2	1.8
ADB	--	--	--	--	0.4
AFDF	--	--	--	0.9	--
Subtotal	0.1	0.5	0.1	0.2	0.3
Dev. Fin. Co.					
WBG	11.7	9.0	4.2	7.9	7.4
IDB	--	--	--	--	--
ADB	24.0	--	15.2	10.0	11.2
AFDF	--	--	--	--	3.9
Subtotal	11.3	7.1	4.5	6.8	6.7
Education					
WBG	4.7	3.9	3.0	4.8	4.1
IDB	6.2	7.9	3.1	7.3	5.1
ADB	1.6	--	2.8	6.5	4.3
AFDF	--	13.8	10.0	15.9	7.2
Subtotal	4.6	4.4	3.1	5.5	4.3
Ind./Mining					
WBG	11.7	13.1	14.2	10.7	8.1
IDB	10.0	18.0	25.8	14.2	10.1
ADB	--	20.8	7.7	10.7	0.4
AFDF	--	--	--	--	--
Subtotal	10.3	14.0	15.0	11.0	7.6
Non Project					
WBG	6.2	4.3	1.1	4.0	6.1
IDB	--	--	--	--	--
ADB	--	--	--	--	--
AFDF	--	--	--	--	--
Subtotal	4.8	3.4	0.9	3.1	4.7
Population/Health					
WBG	0.4	0.6	0.5	1.0	1.1
IDB	--	--	--	0.6	15.6
ADB	--	--	1.9	1.9	--
AFDF	--	4.7	9.1	--	--
Subtotal	0.3	0.6	0.7	1.0	2.9
Power					
WBG	13.8	13.0	11.8	13.3	20.3
IDB	27.5	9.8	26.8	35.7	--
ADB	--	10.6	21.5	17.5	25.9
AFDF	--	--	--	8.0	3.0
Subtotal	14.3	12.3	14.4	16.8	18.0
Tourism					
WBG	0.5	1.3	0.6	1.1	0.2
IDB	2.0	2.1	2.9	0.1	1.5
ADB	--	--	--	--	--
AFDF	--	--	--	--	--
Subtotal	0.6	1.4	0.8	0.9	0.4
Transp./Comm.					
WBG	20.9	16.4	16.2	17.0	13.9
IDB	19.6	16.9	6.1	14.8	15.8
ADB	18.6	26.0	11.3	13.7	13.8
AFDF	--	23.2	40.8	19.5	28.9
Subtotal	20.5	17.1	14.8	16.5	14.4
Urbanization					
WBG	1.2	2.2	3.8	3.7	2.4
IDB	2.0	0.5	2.7	--	--
ADB	--	4.4	1.6	3.3	3.5
AFDF	--	--	--	--	--
Subtotal	1.2	2.0	3.4	3.1	2.2
Water Supply					
WBG	4.9	4.8	7.4	7.6	4.9
IDB	9.1	6.7	15.0	6.1	--
ADB	26.0	5.8	13.9	6.6	8.8
AFDF	--	27.0	4.3	13.8	7.8
Subtotal	7.5	5.4	8.9	7.4	4.7
Export Fin.					
WBG	--	--	0.4	--	--
IDB	--	0.5	--	0.1	0.1
ADB	--	--	--	--	--
AFDF	--	--	--	--	--
Subtotal	--	0.1	0.3	--	--
Energy					
WBG	--	--	--	1.4	3.1
IDB	--	--	--	--	13.9
ADB	--	--	--	--	2.7
AFDF	--	--	--	--	--
Subtotal	--	--	--	1.1	4.4
Tech. Asst.					
WBG	0.5	0.2	0.1	0.3	0.2
IDB	--	--	--	--	--
ADB	--	--	--	--	--
AFDF	--	--	--	--	--
Subtotal	0.4	0.2	0.1	0.2	0.2
Multisector					
WGB	--	--	--	--	--
IDB	--	--	--	--	12.2
ADB	--	--	--	--	0.2
AFDF	--	--	--	--	--
Subtotal	--	--	--	--	1.6
Grand Total *	100.0	100.0	100.0	100.0	100.0

* Actual percentages may not add to 100.0 due to rounding errors.

Source: Table 2

In the World Bank, country allocations are made following a regional and sector allocation process. Following these allocations, country determinations are based largely on the Bank's assessment of the individual country's creditworthiness and the number of viable projects pending in their current five-year lending program. In general, the ADB procedure for deciding appropriate amounts of lending for each country is a "consensus" approach whereby the donors, principally the United States and Japan, the borrowers and management reach informal agreement. The informal criteria used for allocating hard loan resources among countries include relative size, access to other financial sources, and the number of acceptable projects. The country allocation process for soft loans is done primarily on population size when the countries share the same degree of relative poverty.

E. Quantitative/Qualitative Role

Lending Relative to Requirements

During the last decade the resources provided by the MDBs, as measured by net disbursements, have grown significantly. According to data from the Development Assistance Committee of the OECD, the net resources provided by the MDBs to the developing countries (as defined by the OECD) increased from $1.1 billion in 1970 to an estimated $5.58 billion in 1979, an increase of 426 percent. (See Table 1.2, Chapter I.)

MDB assistance represents only a relatively small proportion of the total external financial resources provided to LDCs (See Table 1.2, Chapter I). Net disbursements by the MDBs to the LDCs typically represent about 6-7 percent of the total net external receipts of the developing countries. 11/ Even with the rapid growth in MDB lending, the proportion has remained relatively stable, reflecting, on the one hand, growing LDC financial needs in the face of higher oil prices and greater access by them to private capital on the other hand. In recent years, MDB assistance to the developing countries has been about one-fourth the level of bilateral official development assistance provided by the OECD countries; and it has also run about one-fourth the level of financial resources provided by private sources as well. The private flows, while representing roughly half of flows, were considerably more volatile than the MDB flows on a year to year basis. (See Table 1.2, Chapter I.)

11/ The World Bank has based its lending program on the basis of providing 10 percent of the total.

However, the aggregate statistics conceal some significant variations in the importance of MDB financing for individual countries. Specifically, MDB disbursements to Brazil in 1979, amounted to $310 million, or only about 8 percent of external financial flows. Conversely, MDB disbursements to the Philippines, only $265 million, represented almost 20 percent of external financial flows.

Role as Catalyst

The relatively small quantitative role the MDBs play does not provide, however, a complete picture of the assistance the banks provide their borrowers. The banks also serve as a catalyst for mobilizing funds from other public and private sources of finance. Specifically, the banks attempt to get other co-financiers involved in their projects or sell participations in their loans. While this role is limited, for the most part, to the hard windows, the IDB does utilize repayments to the Social Progress Trust Fund (SPTF) to purchase participations in FSO loans.

Co-financing with other official lenders is one means of extending the MDBs' influence and their role as principal coordinators. Many MDB projects are co-financed with a wide range of bilateral and/or other multilateral donors, including for example the OPEC Fund and the International Fund for Agricultural Development (IFAD). These other institutions find co-financing attractive because they can rely on the MDBs' greater experience, their apolitical character, and their larger (more qualified) staffs to design, appraise, and supervise projects. Although resource additionality resulting from co-financing among official lenders is difficult to quantify, the procedure does seem to result in accelerated project consideration and promotes policy coordination among the lenders. On a cumulative basis, the MDBs have participated in co-financing operations totaling $22 billion, of which approximately 85 percent was with official and 15 percent was with private lenders.

The fastest growing source of co-financing is with private institutions, primarily commercial banks. For the World Bank, for example, in the three year period 1975-78, there were only 29 co-financed operations with commercial banks involving $900 million in private funds; in 1979 alone, there were 16 co-financing operations involving $550 million in private funds. Moreover, its influence extends beyond just financing as many commercial banks base their country risk limits and general attitudes towards many developing countries on Bank attitudes. Commercial bank officers have increasingly established working relationships with their counterparts in the MDBs, particularly the World Bank, to exchange information on developments in the countries they follow. The

IFC mobilizes financing from other investors, principally commercial banks, by selling participation in projects. During 1976-80, the IFC syndicated an average of 37 percent of its holdings.

Alternative Sources of Financing

The MDBs do not currently employ any additional mechanisms, beyond direct loan sales or IFC loan syndications, to improve their borrowers access to alternative sources of financing. For example, the MDBs have not been asked to assist a country to float a bond issue on the New York or London market. Nevertheless, on a very preliminary basis, consideration has been given by the MDBs, particularly the IBRD, to guaranteeing member borrowings in capital markets. This could be part of a planned process of "graduating" the more advanced borrowers from direct MDB assistance. But to be workable, however, it would require a change in the bank's articles of agreement in order that guarantees not count "dollar for dollar" against the MDBs' available lending ceilings.

Economic Policy Advice

The amount of influence the MDBs have over their borrowers in terms of macro/micro-economic policy varies with the institutions. The MDBs, particularly the World Bank, try to provide considerable assistance in the areas of economic analysis and policy guidance. A common form of this type of help is the "Economic Memoranda" and special sector studies prepared by all of the banks (excepting the AFDB). These economic reports analyze each borrower's strengths and weaknessess and provide the analytical framework for advice and policy guidance on all aspects of the borrower's economy, including the resolution of particular sector issues, methods for mobilizing additional domestic resources, and ways of managing balance of payments problems. The World Bank reviews all its major borrowers annually and all the others at least every three years.

An important aspect of this policy guidance is the extent to which changes in economic or financial policy are made a condition of further lending. This aspect is controversial and the degree of "conditionality" on loans varies between the MDBs. Some types of loans, e.g., structural adjustment loans from the World Bank, are specifically linked to policy changes judged to be necessary conditions for any improvement. Similarly, "program" loans are provided on the condition that the country has adopted or is adopting, appropriate economic policies and the foreign exchange content of the available projects is not sufficient to cover the resource transfer believed necessary.

The provision of "sector" loans by the IDB and ADB, a relatively new activity for them, is also based on appropriate sector policies but their extension (approval by the Board of Directors) needs to be more directly linked to specific policy changes. Finally, the MDBs do not generally condition their approval of project loans on specific changes by the borrower prior to Board consideration on such matters as pricing policies, positive real interest rates, etc., although most project loan agreements include covenants covering future actions. In part, this reluctance to condition loan approval is because any single project affects such a small part of that economic activity in the country; and, in part, because the regional MDBs -- do not have (or choose not to use) adequate leverage. Moreover, while a particular policy change (price increases, etc.) might be highly desirable, few projects are designed so that the success of the project is dependent on the change per se.

Nevertheless, the influence over policy changes in borrowers is visible in loan proposals, particularly structural adjustment loans. For example, the IBRD's structural adjustment loan to Kenya in 1980 required policy measures by the Kenyan government to enhance competition among producers by removing legislated constraints on trade. The IBRD was also successful in urging Thailand to increase substantially its energy prices through the negotiation process for several project loans in that sector. In general, the MDBs increase or decrease their lending levels in individual borrowers depending on their receptiveness to changes in economic policies; and urging the borrower to make several changes over a series of loans appears to be more successful than jeopardizing the entire effort over a single issue in one loan. For example, the World Bank reduced its lending to Sri Lanka in the mid 1970's because of the inappropriate economic polices being pursued at the time. Finally, if, as a last resort, the MDBs were to stop lending altogether to a borrower because of inappropriate policies, such a step would probably reduce the interest of other lenders. This, in turn, would give the banks additional "moral suasion" over borrower policies.

An equally important, but less visible source of influence over borrower economic policies, is the contact between Bank economists and borrowers that the discussions of the economic memoranda provide. These discussions are less confrontational than loan negotiations and more structured in terms of helping borrowers select the most appropriate economic policies. In addition, MDB policy advice is enhanced and coordinated with other donors through individual country consultative groups. Currently, there are twenty-four such groups, all but two (Indonesia and Turkey), are chaired by the World Bank. The groups generally meet once a year and are designed to prevent any duplication of effort and provide the forum in which donors and borrowers can exchange views on the policies being pursued and level of assistance.

F. Institutional Considerations

Management Framework

The boards of directors, management, and staffs of the MDBs are very similar in form but their relative strengths and weaknesses differ. As might be expected, the World Bank's management and staff are considered the strongest and most independent from outside pressures. As a result the Board of Directors is not extensively involved in the day to day operation of the Bank. Conversely, the IDB's staff is not so independent and there is considerable intervention by the Board in the day to day activities of the Bank. These interventions mean that most standards and regulations in the IDB are negotiable.

All of the MDBs have centralized management systems with all significant decisions being made in the headquarters. Although the World Bank is developing regional offices/or country representatives and the IDB has always had an extensive country representative system, most of the work is done in the headquarters or by teams sent out from the headquarters.

With the exception of the AFDB, which draws its staff from the regional members, the MDBs draw their staffs from all member countries though not proportionally. In the World Bank, there is a disproportionate number of North Americans and Europeans; and in the IDB, the staff is mostly Latin American. In the ADB there is a heavy South Asian concentration, partly a reflection of the Bank's regional location, partly its salary practices, and partly the formerly unfavorable U.S. tax treatment of U.S. staff members. In general, the staffs are considered to be high quality and, as a whole, relatively free of any major criticism on their work.

Administrative Performance

In terms of most administrative performance measures, the ADB's reputation of "being lean" is justified. For example, if administrative expenditures relative to loan commitments or net income are compared, the ADB is the most efficient MDB, whereas the IDB by the same measures is the least. (See Table 5) The World Bank, while it is not as efficient as the ADB in terms of most administrative performance measures, carries on a much wider range of activities and is not nearly as specialized. Furthermore, the IBRD being the oldest and largest MDB has been able to take on greater responsibilities for research and other activities from which the regional MDBs eventually benefit.

Quality of Loans

Each MDB uses cost/benefit ratios, internal rates of return, etc., as the basic measures for testing their loans and have done so for many years. In fact, the World Bank is probably now in the forefront of the research on loan evaluation techniques.

Table 5 MDB PERFORMANCE INDICATORS a/

	IBRD		ADB		IDB	
	1980	1981	1980	1981	1980	1981
Professional Staff Years	2,475	2,625	387	447	996	996
Number of Loan/Tech. Asst. Proj.	247	256	132	123	226	226
(Number of Loans)	(247)	(256)	(58)	(54)	(80)	(84)
Commitments	11,000	12,200	1,436	1,678	2,250	2,243
Number of Loans Under Administration	1,595	1,670	278	317	450	467
Gross Income ($m)	1,922	2,155	309	344	653	692
Net Income ($m) c/	554	578	151	109	248	238
Admin. Budget ($m)	334	392	43.3	53.3	97.3	110.4
Operating Staff (Professional)	1,629	1,716	257	290	N/A	N/A
Admin. Staff (Professional)	798	845	130	157	N/A	N/A
Professional Staff Years/Loan projects	10.02	10.25	6.7	8.3	12.45	11.85
Admin. Exp./Gross Income b/ (Percent)	10.1	10.8	14.0	15.5	8.4	10.0
Admin. Exp./Net Income b/ (Percent)	33.6	38.4	28.7	48.9	20.5	28.4
Operating Staff/Total Professional Staff (Percent)	67.1	67.0	66.3	64.9	N/A	N/A
Admin Exp./Commitments (Percent)	3.03	3.21	3.01	3.18	4.12	4.71

a/ Comparable AFDB data are not available.

b/ Ratio of Administrative Expenses attributable to hard loan window to the Gross (or Net) income of the hard loan window.

c/ Gross income less administrative expenses and interest on borrowings for hard and soft windows combined.

Source: MDB Administrative Budgets and Annual Reports

One criticism often heard regarding loan quality is that of "bunching", i.e., a disproportionate number of loans being approved in the last quarter of an MDB's fiscal year. With the exception of the AFDB, where loan approvals are rather evenly spread throughout the year, the other MDBs follow a pattern of approving over 40 percent of their loans in the last quarter of their respective fiscal years. Administratively, this practice puts considerable strain on the institutions but the impact on the quality of loans is debatable. For example, loans approved in the last quarter do not appear as "problem loans" any more often than others in terms of slow disbursements or in the subsequent evaluation of the loans.

The World Bank, IDB, and ADB, have also established post project evaluation programs. (The AFDB is still working on such a program.) This evaluation process was given added impetus by the U.S. Congress when it passed legislation (in 1967 for the IDB and in 1973 for the World Bank and the ADB) directing the U.S. Directors to urge the Banks to establish "independent" evaluation units reporting directly to their respective boards. The purpose of these evaluations is to determine whether the purpose of the project was achieved and help improve the design of future projects.

The World Bank and ADB have concentrated mainly on individual project evaluations. The IDB, on the other hand, has concentrated almost entirely on its own internal operational procedures and only recently on some sector studies; it has not yet adopted a procedure for systematically reviewing individual loans. The establishment and continued improvements to these evaluation systems are considered a major achievement for the United States.

G. Current Congressional Attitudes

Congressional attitudes toward the MDBs have been shaped by several developments which took place during the 1970s. These developments include: a change in the relationship between the Legislative and Executive branches with Congress seeking a more assertive role in foreign policy matters and exercising more detailed review of MDB activities; the very significant increase in the level of U.S. subscriptions and contributions to the MDBs over the past decade both in absolute terms and as a percentage of overall U.S. foreign economic assistance; the rapidly rising costs for domestic social programs which have generated increased pressures to hold down other budgetary costs, including those for the MDBs; and a continuing lack of a well-organized and effective domestic constituency which could support MDB and other foreign economic assistance legislation on the Hill.

As a percentage of total U.S. budgetary outlays, the MDBs peaked in FY 1976 at 0.27 percent and have since declined to 0.14 percent in FY 1980 (due largely to lags introduced by delays in U.S. contributions to IDA). Annual appropriation for the banks increased from $700 million in FY 1970 to $2.3 billion in FY 1980. (See Table 6)

The large increase in appropriations for the MDBs focused much greater attention on MDB policies and programs and led to growing criticisms on various MDB issues. These criticisms have included a number of academic articles as well as majority and dissenting views put forward as part of Congressional committee reports. Some of the criticisms have led to the adoption of legislative amendments dealing with U.S. participation in the MDBs. For example, specific legislation has been enacted concerning salaries, procurement of commodities that compete with U.S. producers, and countries with records of human rights violations.

Over the years too, the Congress has requested the General Accounting Office (GAO) to do a number of studies on various aspects of the banks (particularly the evaluation and review of completed projects); and it also requested a lengthy evaluation of the banks by the Surveys and Investigations staff of the House Appropriations Committee in 1979. This Appropriations Committee Report emphasized lending to the poor, U.S. influence in the banks, audits and evaluation, and the flow of information. In general, with the exception of the House Appropriations Committee Report, these studies have not been overly critical of the MDBs.

Table 6 - U.S. Appropriations for the MDBS *
FY 1971 - FY 1980
(millions of dollars)

IBRD	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Paid-in	—	12.3	—	—	—	—	—	38.0	16.3	16.3
Callable Capital	—	110.7	—	—	—	—	—	342.0	146.8	146.7
IDA	160.0	—	320.0	320.0	320.0	320.0	430.0	800.0	1,258.0	1,072.0
IFC	—	—	—	—	—	—	—	38.0	40.0	19.0
Subtotal	160.0	123.0	320.0	320.0	320.0	320.0	430.0	1,218.0	1,461.1	1,254.0
IDB										
OC/IRC										
Paid-in	25.0	75.0	25.0	25.0	—	—	56.0	36.7	27.3	44.2
Callable Capital	200.0	136.8	168.4	168.4	—	—	640.0	328.6	561.4	544.6
FSO	50.0	—	225.0	225.0	225.0	225.0	210.0	114.7	175.0	175.0
Subtotal	275.0	211.8	418.4	418.4	225.0	225.0	906.0	480.0	763.7	763.8
ADB										
OC										
Paid-in	20.0	—	—	—	24.1	24.1	24.1	16.8	19.5	15.4
Callable	—	—	—	—	96.5	96.5	96.5	151.2	175.0	138.3
ADF	—	—	—	50.0	50.0	25.0	25.0	49.5	70.5	111.3
Subtotal	20.0	—	—	50.0	170.6	145.6	145.6	217.5	265.0	265.0
AFDF	—	—	—	—	—	5.0	10.0	10.0	25.0	25.0
Total	455.0	334.8	738.4	788.4	715.6	695.6	1,491.6	1,925.5	2,514.9	2,307.7

* Includes MOV payments

Totals may not add due to rounding.

Source: OIDB, Treasury

APPENDIX II

ECONOMIC/FINANCIAL SITUATION OF LDCs TO THE MID-1980s 1/

A. Introduction

In order to place the assessment in a realistic context this appendix was prepared analyzing the financial requirements and prospects of the developing countries for the 1981-1985 period. This was undertaken essentially to describe the environment in which the decisions affecting U.S. participation in the MDBs would be taken. This analysis in no way is meant to be a "gap-filling exercise." Rather, it is an attempt to establish a quantitative framework within which decisions on future participation in the MDBs would be made.

In order to support the MDB assessment, we have prepared a detailed analysis of the financing requirements and prospects of the developing countries to the mid-1980's. We have specified three alternative scenarios which concern the predominant international influences--industrial country growth, world trade expansion, world inflation and energy prices--that help determine the current account positions, and hence, the external financing needs of the developing countries. In order to evaluate the financial implications of variations in these external influences, the real GDP growth rate of developing countries is assumed to be the same in all three scenarios: an average of 4.5 percent per annum in 1981-85 period (or 2.1 percent per capita). Case I, the optimistic scenario, and Case II, the pessimistic scenario, span the range of reasonable expectations regarding OECD economic growth, world trade growth, and oil prices. The "best guess" scenario represents an attempt to narrow the resulting range of estimates of financing demand.

Under Case I, real growth in OECD GNP is expected to proceed at an average annual rate of 3.3 percent, real oil prices remain constant, and the volume of world trade, which depends primarily on economic growth in the industrial countries and industrial country trade policies, grows by 5 percent per annum. Under Case II, OECD economic growth proceeds at an average annual rate of 2.6 percent, real oil prices rise at an average rate of 3.5 percent

1/ In this appendix "LDCs" includes low and middle income countries of Africa, Asia, Latin America, the Middle East, and Europe. The The definition excludes the "capital surplus" oil exporting countries: Saudi Arabia, Kuwait, The UAE, Libya, Iran, Iraq, and Qatar.

per annum from 1982 onward, and the volume of world trade expands by 4.0 percent per year. The "best guess" estimate is based on the following assumptions: 3.0 percent average annual economic growth for the industrial countries; a 4.5 percent average per annum expansion in world trade; no increase in industrial country protectionism; and an increase of 2.5 percent in real oil prices from 1982 onward. These represent "midpoint" assumptions among published medium-term forecasts. Under all scenarios, world inflation is expected to proceed at 7 percent per annum.

B. The Economic Environment

Adjustment to oil shocks

The economic and financial situation of the LDCs in 1981 and beyond will be difficult due to a combination of high energy prices and slower growth in the industrial countries. In 1980, their aggregate current account deficit (before official transfers) rose to about $70 billion or to 4.5 percent of their aggregate GNP. Many developing countries financed their current account deficits by a combination of short-term borrowing and reserve drawdowns. External payment arrears also grew in 1980 for a number of countries. These, of course, are only temporary expedients.

Preliminary estimates for 1981 indicate increasing trade and payment deficits aggravated by high real interest rates on borrowed funds. Given the difficult external situation, growth rates are likely to dip below current levels, which are already below trend growth. Demand for external financing will be substantial, even if domestic policy reforms are undertaken by these countries.

In the period following the first oil price shock, the developing countries (at least the middle income LDCs) generally exceeded expectations in their ability to adjust to adverse external circumstances while sustaining reasonably high levels of economic growth. In 1974-1975, their rates of economic and export growth fell less than those of the industralized countries, helping to moderate the slowdown in world trade growth; in 1975-79, their overall economic growth rate approached their long-term trend growth rate.

This growth performance by middle income LDCs was made possible by higher volumes of official development aid, and by a greater recourse to the IMF, but especially by the recycling

of the oil exporters' financial surpluses through private capital markets. 2/ These increased capital inflows allowed the LDCs to "buy time" until economic recovery in the industrial countries and internal policy adjustment would permit them to reduce their deficits to more sustainable levels. As pointed out in the 1981 World Development Report, the countries that coped best after the first oil price shock were those which quickly adopted structural adjustment policies, especially export promotion and diversification, appropriate energy pricing policies, realistic exchange rates, incentives to savings and efficient use of borrowed funds to support productive investment.

With the second oil shock of 1979-80, it has become even more necessary for the LDCs to accelerate the adjustment of their economies in order to adapt to higher oil prices and sluggish world trade. However, successful structural adjustment would require heavy investment, often combined with some sacrifice of near term growth, in order to accelerate long-term development. For instance, developing alternative energy sources (hydroelectric, coal, nuclear, geothermal) and exploiting known oil and gas deposits in such countries as the Ivory Coast, Chad, Pakistan, the Philippines, India, and Thailand would require billions of dollars of capital. Without adequate external financial flows to augment domestic savings, there is a risk that these structural adjustment efforts will be severely limited. As in the past, however, private capital must be relied on to provide the bulk of this financing.

Adjustment in the 1980s may prove more difficult than in the 1974-78 period for the reasons discussed below.

The Situation of the Industralized Countries.

The industrialized economies now face more serious economic difficulties than at the time of the first oil price explosion, for reasons not solely related to higher energy prices. National authorities believe that reduction of inflation and inflationary expectations is a necessary condition for restoration of investment and sustainable growth in the future. Hence, restrictive fiscal and monetary policies are being pursued to reduce inflation, and

2/ The low income African LDCs, which had almost no access to international capital markets to meet their financing needs, did not do so well during this period. Their real GDP growth equalled about 2.02.5 percent per annum and their real GDP per capita was actually negative. The Asian low income LDCs, on the other hand, registered somewhat higher than average economic growth due to favorable weather and rising migrant remittances, and, in Indonesia's case, from its being an oil exporter with significant access to international capital markets as well as official source financial flows.

slow economic recovery may persist for some time in the industrial countries. Since two-thirds of the exports of the developing countries go to the industrialized countries, lower industrial country growth would constrain the demand for LDC exports, particularly primary product and service (basically labor) exports.

LDC exports of manufactures are less sensitive to medium-term changes in industrial country GNP because the LDC share of manufactures in world markets is small; LDC manufactures tend to be at the low end of the price spectrum, which is least affected in times of reduced growth in the industrial countries; and trade in manufactures is becoming important among the LDCs themselves. Nonetheless, lower economic growth and higher unemployment in the industrial countries is likely to result in increased pressure for trade protectionism, which, should it be granted, would particularly hurt those developing countries that export manufactured goods such as textiles, clothing, and leather goods. Moreover, a recent study by IMF staff suggests that a one percentage point reduction in the annual growth rate of industrial countries on the average reduces the export volume of the oil-importing LDCs by 1-1/2 percent.

The Situation of the Capital Surplus Oil Exporters

Even if the real price of oil continues to rise, more conservative development programs among the capital surplus oil producers are expected to lead to a slower rate of growth in their real imports. The import volume growth rate could fall from 19 percent per annum in the period 1974-78 to about 12 percent per annum in 1981-85. This would primarily affect industrial country growth since the capital surplus oil exporters buy about 75 percent of their imports from the industrial countries. It also would have secondary effects on LDC growth. If the capital surplus oil exporters increased their imports more from LDCs, as the 1981 IBRD Development Report suggests, this would help these countries achieve sustainable current account positions.

C. The Size of the Financing Problem

Oil Prices

Table I projects the developing countries' oil import bill in 1985 under two different scenarios. In the Case I scenario, real oil prices remain constant (i.e., nominal increases are offset by OECD inflation) during the next five years. In Case II, real oil prices are assumed to remain constant in real terms in 1981 and thereafter rise at an average per annum rate of 3.5%. In both Case I and Case II, LDC real GDP growth is assumed to proceed at an average rate of 4.5% per annum during 1981-85.

Table 1 Imports of Oil by Developing Countries 1/

	1980	1985 Case I 2/	1985 Case II 2/
Case I (Constant Real Prices for Oil)			
1. Volume (mmbd)	8.3	10.6	10.2
2. Cost (current $ billion)	94.0	168.3	185.6
3. Cost (constant $ billion)	94.0	120.2	132.6
4. Current price per barrel ($)	31.00	43.50	49.9
5. Constant price per barrel	31.00	31.00	35.6
Price deflator	100.0	140.2	140.2

1/ The major factors affecting petroleum demand can be divided into an income effect and a price effect (which encompasses conservation effects). The annual increase in petroleum imports can then be expressed as a function of income growth and price changes. This simple equation takes the following form:

a. Annual percent growth in oil imports = |a| x (percent real income growth) minus |b| x (percent real price increase) where a is the income elasticity of demand for oil and b is the price elasticity of demand for oil imports. We have assumed an income elasticity of 1.1 and a price elasticity of -.25 for the period. In order to project oil import demand, let annual percentage growth in oil imports equal r. Then we have the following:

b. $Y_T = Ae^{rt}$
where Y_T equals oil imports in year T, T = 1985; A equals oil imports in the base year 1980; and t equals 5 (years).

2/ Case I assumes constant real prices for oil. Case II assumes real oil prices increase 3.5% per annum in 1982-1985.

Source: Treasury Department

In addition to the immediate impact of larger oil bills for the oil-importing LDCs, there would be secondary effects of the oil price rise which would continue to depress their export performance. The increased oil bill of the industrial countries could lead to restrictive demand management and import policies in those countries. However, this could be partially offset by the LDCs through increasing trade among themselves.

Debt Service

At the end of 1980, the LDC debt situation was also more worrisome than after the first oil crisis. There was a much higher stock of debt (in both nominal and real terms) to service, and a hardening in the average terms of debt, due to the relative shift away from official source borrowing to private source borrowing. Variable interest rates (LIBOR plus spread) and shorter maturities of commercial bank loans have increased the LDCs' debt service burden by effectively accelerating amortization, and have added new uncertainties about the future level of interest rates and refinancing possibilities. 3/ Also, real interest rates have been at record high levels in 1981.

In current dollars, medium-term and long-term LDC externa, debt stood at $426 billion at the end of 1980, compared to $174 billion at end-1975. Interest payments on LDC medium-term and long-term debt rose to $34 billion in 1980 from the 1975 level of $8.6 billion. Amortization payments equalled about $45 billion in 1980, compared to $17 billion in 1975. This rapid rise in debt amortization and interest payments means that in the next few years a steadily increasing portion of borrowed funds (gross) will have to be devoted to servicing debt. (This increase is offset to some extent by the earnings on LDC assets.)

LDC Financing Needs to 1985

In spite of the more difficult nature of the financing task following the second oil crisis, this does not, in itself, mean that LDC demand for external financing will not be met. This section examines the financing outlook over the next five years for the LDCs under two alternative scenarios based alternatively on optimistic assumptions (Case I) and pessimistic assumptions (Case II).

3/ In a period of inflation, variable interest rates contain an element of compensation to the lender for erosion of capital values and have the effect of advancing the time of principal repayment in real terms, and thus can add to cash-flow difficulties of borrowers. They do not, however, increase the real debt service burden over the whole length of the loan.

A "best guess" scenario is also selected in order to narrow further the range of estimates. Case I and Case II span the range of reasonable expectations about industrial country growth, world trade growth, and oil prices. 4/

To evaluate the financial implications of the two cases, the real GDP growth rate of the developing countries is assumed to be the same in both scenarios: an average of 4.5 percent per annum in the 1981-85 period (or 2.1% per capita). The assumed growth rate is relatively low compared to LDC experience in the 1960s and 1970s when LDC average annual GDP growth was about 5.3 percent, but is still considerably higher than industrial country growth rates. Under the two different scenarios, the annual (net) external financing levels that would be needed in 1985 to sustain a 4.5 percent annual growth rate have been calculated, along with a "best guess" estimate within that range. The "best guess" estimate is based on the following assumptions: 3.0 percent average annual economic growth for the industrial countries; a 4.5 percent average per annum expansion in world trade; no increase in industrial country protectionism; and an increase of 2.5 percent in real oil prices from 1982 onward. These represent "midpoint" assumptions among published medium-term forecasts. Financing requirements were obtained by combining projected current account deficits with the change in reserves that would be required in order to continue providing three months of merchandise import coverage. Projected financing needs are shown in Table II below.

It should be reemphasized that projections of this sort are highly tenuous. Moreover they are quite sensitive to changes in assumptions on interest rates, LDC inflation and LDC growth rates. For instance, lowering LDC growth by 0.5 percent per year implies a $13 billion reduction in external financing requirements in 1985.

4/ It should be stressed that the projections which follow depend critically on the underlying global assumptions identified in each scenario. The model employed is completely demand-oriented and static. It ignores LDC domestic policy choices, which are obviously a major determinant of LDC economic performance and in turn, external financing requirements on the one hand, and the willingness of private lenders to extend credit on the other hand. Thus, the results of an exercise of this type should be used with caution.

Table 2 External Financing Requirements of the LDCs, in 1985 Under Alternative Scenarios

"Assumptions" (% per annum)	Case I	Case II	"Best Guess"
OECD real GNP growth	3.3	2.6	3.0
Real oil price change	0	3.5 1982-1985	2.5 1982-1985
LDC real GDP growth	4.5	4.5	4.5
Expansion of World Trade	5.0	4.0	4.5

(in billions of constant 1980 $)

Projection	1980	1985 Case I	1985 Case II	1985 "Best Guess"
Exports, fob 1/	390	523	501	519
Imports, fob 2/	-446	-578	-590	-586
Trade Balance	- 56	- 55	- 89	- 67
Services and private transfers (net) excluding interest payments on long-term and medium-term loans	+ 20	+ 25	+ 24	+ 25
Interest Payments on long-term and medium-term loans 3/	- 33	-38	- 40	- 39
Current Account Balance (excluding official transfers)	- 69	-68	-105	- 81
Increase in reserves (+ = -) 4/	-10	-10	- 10	- 10
Total demand for external financing	-79	-78	-115	- 91

1/ The basic assumption underlying LDC real export growth of goods other than manufactures (X) is:

$$X = a + bG$$

where G is equal to the rate of industrial country growth; b is a parameter which reflects the relationship between X and G and a is a constant. In this study b has been estimated to equal 1-1/2, meaning that a 1 percentage change in industrial growth will produce approximately a 1.5 percent change in the volume of LDC non-manufactured exports. It is also assumed that in Case II, lower economic growth and higher unemployment in the OECD countries result in increased protectionism which limits the LDC share of manufactured goods in world markets to its' present level. In Case I, the LDC share of manufactured good exports rises from 10 percent in 1980 to 12 percent by 1985, equivalent to a 10 percent real growth rate.

2/ Merchandise import growth is projected by subdividing imports into non-oil and oil imports. Growth in the volume of non-oil imports depends on income growth and the income elasticity of demand for non-oil importables, which has been estimated to be 1.2. Income and price elasticities of demand for oil imports and the related income and price assumptions are indicated in Table 1.

3/ Case I taken from IBRD model.

4/ Assumes 3 months of import coverage is continuously maintained.

Source: U.S. Treasury

D. The Outlook For Capital Availability

To meet their financing requirements over the next five years, the developing countries will seek external financing from a variety of sources, both private (commercial bank loans, direct investment, bonds and other private credit) and official. In this section, projections of the various financial flows to the LDCs in 1985 are compared with the estimated demand for external financing in the two scenarios and in the "best guess" case. The financial flow projections are based on the historical growth rates of the different types of financial flows, which are adjusted to reflect the latest information and views about future financial flows. As with the external financial demand projections, these projections depend critically on the underlying assumptions that are identified. Moreover, any estimate of capital availability for LDCs in the aggregate marks the very disparate situations facing the LCDs.

Direct Foreign Private Investment

The net inflow of private foreign direct investment to the LDCs in 1980 was approximately $9 billion. It is widely believed that, by 1985, foreign direct investment will be providing more capital to developing countries in real terms. If direct investment by the OPEC countries accelerates, the flow of foreign direct investment could expand in real terms by as much as 4.5% per annum to about $11.5 billion in 1985. On the other hand, if foreign private direct investment were to grow no faster than it did during the past decade (2.2% per annum in constant dollars), foreign direct investment would be about $10 billion in 1985. In either case, the low income LDCs, traditionally bypassed by foreign investors, are expected to receive less than $300 million (in 1980 dollars) in net direct foreign private investments in 1985.

Commercial Bank Lending

Including all types of bank flows, the net flow of lending in 1980 by the private banking system to the LDCs was on the order of $34 billion. In 1981, net lending from the commercial banks to the LDCs is anticipated to be on the same order of magnitude, in real terms. Beyond 1981, it is extremely difficult to predict the level of international bank flows to the LDCs. It will depend on the borrowing capacities and economic policies of the developing countries, and the attitude of financial intermediaries as well as the overall level of liquidity in the international financial system. There has been much discussion of the possibility that in the 1980's the commercial banks will not be able to assume as large a role in the financial intermediation of funds from the capital surplus countries as in earlier years. Several factors point in this direction.

The Euromarket, after very rapid growth throughout the Seventies (total Euromarket assets grew at an average annual rate of 25% in 1975 - 1980), may begin to show more modest growth in the 1980s because individual banks or groups of banks may feel it necessary for reasons of prudence to restrain their international lending. There is also concern that the major money market banks have become too highly leveraged and because of low spreads and low bank stock prices will find it difficult to expand their capital base.

It has also been suggested that the share of loans to LDCs in the assets of the Euromarket banks may decrease somewhat through the 1980s. In this connection, the following issues have been raised. Commercial banks may be more cautious with regard to the LDCs given those countries' prospects for large and persistent imbalances and the size of foreign debts already accumulated by them.

Also, some banks are concerned about their very large loan exposure to certain key LDC borrowers. It is widely believed that growth in loan exposure to these countries cannot duplicate the exceptionally rapid rate of growth of the late 1970s. Further, it is unlikely that the industrial countries will eliminate their current account deficits as rapidly as they did in the 1974-78 period, especially if the real price of oil rises. Consequently, private banks may reduce their relative lending to LDCs as more "creditworthy" customers (the OECD countries) offer attractive alternatives.

Close examination of these concerns leads to the conclusion that they are overstated. The OECD countries will prefer to float bonds on which they can get better terms, rather than to increase their borrowings solely from the international banks. In any case, the international banking system is extremely liquid, in large part due to continuing oil exporter surpluses. Thus, banks will continue placing funds in LDCs with less than ideal creditworthiness, given sufficient pecuniary incentives. The Euromarket will adjust by differentiating terms, increasing margins and shortening maturities for certain countries. Many banks are nearing internal limits on certain borrowers, but these limits may prove quite flexible, and other LDC borrowers may be able to achieve high rates of growth in borrowing from these banks. In addition, new capital is continually being injected into the international banking system via entry of new institutions. Second-tier banks are comparatively "underlent" relative to their capital base, and new Arab banks are likely to expand international lending to the LDCs. Thus, we project that international bank lending will continue to increase in real terms up through 1985, and the LDC share in international bank lending will not deteriorate.

The actual volume of funds going to individual LDCs is quite another matter. In the next five years, the geographic distribution of bank lending among LDCs will be determined by the banks' assessment of the creditworthiness of individual borrowers, that is, their future ability to service debt (make payments on schedule), and the relative attractiveness of alternative LDC assets. Considerable attention will be directed to the medium-term balance of payments prospects of individual countries. Generally, those countries facing relatively buoyant export markets and terms of trade, or making major efforts to improve their export prospects via structural adjustments will be the major recipients of increased private bank flows because they will appear most able to contract and service greater commercial debt.

Also, private bank lending attitudes may be influenced by whether the IMF, the IBRD and the regional development banks increase their role in the recycling process. It is often argued that if these sources of foreign exchange were to dry up, bank financial flows to LDCs which are large recipients of multilateral funds would contract slightly or at least not grow. This is because such a development would be perceived by the banks as reducing the ability of these LDCs to service their bank debt and as evidence which the LDCs may require. However the level of macroeconomic conditionality (e.g., for structural adjustment) attached to IMF and MDB funds is probably a more important element influencing private bank flows to individual LDCs.

Portfolio diversification considerations will also affect the geographical distribution of private bank flows. To date, other than Indonesia (which is a major oil exporter), low income countries have been able to borrow very little commercially and have had to depend almost entirely on official (and mainly concessional) lending. However, there are exceptions to this rule, India, for example, has begun to borrow significant sums from international financial markets. Because low income countries have borrowed very little on commercial terms to date, the structure of their debt is quite favorable. We expect major Euromarket banks to be willing to increase the share of their loans going to those low income countries which demonstrate improved creditworthiness. For example, the Asian low income LDCs are expected to experience relatively buoyant GDP and export growth in the next five years and hence some growth in their debt servicing capacity. Their ability to service commercial debt should improve considerably over the decade if they invest their borrowed funds productively and expand their exports.

In sum, despite the increased liquidity of the international banking system, it is unlikely that private bank lending to the LDCs during the 1980's will duplicate the exceptionally rapid rate of growth of the 1970's. As the absolute volume of bank lending increases over time, it is to be expected that the rate of growth of lending will fall. Nonetheless, we still expect net bank flows to LDCs to grow by about 10-11 percent per annum in nominal terms over the period 1981-1985 or 3 to 4 percent per annum in real terms. We expect that bank lending to the LDCs will be somewhat less concentrated in the 1980s compared to the 1970s, as Euromarket banks seek to diversify their international lending portfolio. Asian countries and oil exporters are likely to be the main beneficiaries of this trend. Low income Africa will continue to have extremely limited access to private bank flows.

Bond Financing

Bond financing accounts for a small fraction of LDC external financing and is available in significant amounts to only a very small number of higher income and oil-exporting (OPEC) LDCs (Mexico, Brazil, Argentina, Venezuela, Algeria, and Israel). This is because investors in foreign and international bonds, unlike large banks, are not equipped to assess country risks. Hence, investor acceptance in this market is acquired only very slowly. The outlook for improved LDC access to foreign and international bond markets is not good. Total net bond lending to the LDCs fell in 1979 over 1978 (when it peaked at $3 billion), and again in 1980 over 1979. Up through 1985, the LDC bond market for LDCs is expected to remain depressed.

Bilateral Official Flows

Concessional aid from DAC members grew in real terms between 1973 and 1979 at an average per annum rate of about 5 percent. As the 1980s begin, there is serious doubt that these rates of growth can continue, as slow economic growth and inflation further constrain --both economically and politically -- bilateral economic assistance. As a Case I assumption for DAC bilateral flows we project that DAC bilateral ODA will be maintained at .25% of aggregate OECD GNP (the ratio of DAC bilateral ODA to DAC GNP in 1979) and that OECD real GNP will grow at 3.3 per cent per annum. The Case II assumption projects that DAC bilateral ODA flows will fall off to .22 percent of aggregate OECD GNP and real OECD GNP will grow at a rate of 2.5 percent per annum.

Throughout the 1970s, the trend has been for a smaller share of DAC ODA flows to go to the low-income countries. In 1979, DAC bilateral ODA to the low income countries equalled .09 percent of aggregate OECD GNP.

Bilateral OPEC flows are difficult to project because of the absence of any multi-year aid plans in these countries, and because OPEC commitments have fluctuated quite a bit from year to year. We project that real OPEC bilateral flows will rise from the 1980 level of $4.5 billion to $6-7 billion by 1985.

Multilateral Flows

Multilateral development banks and other multilateral financial flows grew rapidly in the period 1975-1980. In nominal terms, MDB net disbursements to LDCs grew at an average annual rate of 15.3 percent during this period, with the greatest increase occurring in 1979 and 1980, several years after commitment levels increased sharply. Other multilateral flows grew by a remarkable 46.7 percent per annum, with most of the increase taking place between 1975 and 1977 and again in 1980. In the medium-term future, multilateral flows are expected to grow quite rapidly even if U.S. capital contributions to the MDBs are scaled down. This is because MDB disbursements to the middle of the 1980s are determined by commitments already made. Thus, it is our expectation that at least until 1985, net disbursements from multilateral institutions will grow at an average annual rate of over 6.5 percent, and MDB flows will increase as a proportion of total external financial flows to LDCs.

Table 3 Sources of Financing of LDC Deficits

(billions of 1980 dollars)

Item	1980	1985		
		Case I	Case II	"Best Guess"
Current Account Deficit (excluding official transfers)	-69	-68	-105	- 81
Increase in Reserves (- = increase)	-10	-10	-10	- 10
Total Financing Requirement (net)	-79	-78	-115	- 91

External Financing Flows

(billions of 1980 dollars)

	1980	1985	
		Range	"Best Guess"
Private Source Financing:	47	52-57	55
Private Direct Investment	9	10-12	11
Banking Sector Flows (including private export credits extended by banks)	34	38-41	40
Bonds	2	2	2
Other Private Credits	2	2	2
Official Source Financing:	32	37-40	38
DAC Bilateral Grants, Loans and credits	18	19-21	20
OPEC Bilateral Grants, Loans and credits	4.5	6- 7	6
CMEA Bilateral Grants, Loans and credits	1	1	1
IMF	1	-	-
Multilateral Flows (MDBs plus UN and Arab multilateral)	7.5	11	11
Total Financing (net)	79	89-97	93

Source: U.S. Treasury

E. Conclusion

The range of external financing required to sustain moderate rates of economic growth in the LDCs under different global assumptions is quite large. Moreover, such projections of financial requirements are quite tenuous and highly sensitive to LDC growth rate assumptions. Those caveats aside and assuming growth of the various sources of financing on roughly the magnitudes indicated above, projected aggregate external financing requirements should be met in both the optimistic scenario, Case I, and the "best guess" scenario. Only under the pessimistic scenario, Case II, does it appear that the developing countries would be unable to obtain sufficient financing in the aggregate to cover their projected current account deficits. In this case, many LDCs would have no choice but to cut back imports and economic growth. However, as indicated above, a rather modest curtailment in growth considerably reduces aggregate external financing requirements.

Historically direct MDB financial assistance represents only a small proportion of the total external financial resources provided to LDCs. Net disbursements by the MDBs to LDCs typically represent about 6-7 percent of the total net external receipts of the developing countries and provide less than 1-1/2 percent of total investment financing in developing countries. So a cutback in the rate of growth of MDB financial flows would appear to have little impact on overall LDC growth in the near-term future and beyond. Even the low-income countries, which are signicantly more dependent on MDB flows, should not find their growth prospects unduly impaired by the cut-back in the longer-term real growth of these flows that is implied by reduced U.S. participation in IDA and other soft loan windows, if the allocation of soft lending improves through accelerated maturation. This would permit the MDBs to direct a higher proportion of their resources to the low-income countries. In any event, for the foreseeable future MDB flows will continue to grow buoyantly in real terms, even if the U.S. scales back its commitments to the MDBs, because of the multi-year time lag between commitments and disbursements.

An aggregate analysis of financing needs overlooks one major point. MDB flows and private flows are not entirely substitutable, and the geographical location of financing for the two flows tends to be quite different. For all LDCs and particularly the low income LDCs, technical and managerial assistance on the micro-economic level, and outside pressures to pursue sound macro-economic policies are important. These are precisely what the MDBs provide and which private lenders are ill prepared to provide.

For this reason, MDB flows are more important to LDC growth than indicated by their quantitative magnitude. The closest private substitute for MDB assistance is private direct investment which is projected to increase in real terms by only $2.5 billion under the most optimistic assumptions. Moreover, this increase is presumably concentrated in only a few countries with relatively high incomes.

APPENDIX III

CRITICISMS OF THE MULTILATERAL DEVELOPMENT BANKS

This appendix surveys and assesses nineteen criticisms made of the MDBs in general and specific MDBs in particular and attempts to reach conclusions with respect to the validity and importance of the criticisms raised. The survey, while extensive, cannot be considered exhaustive. Also, it must be noted that the distinctions made among some of the specific criticisms are somewhat arbitrary, as in many instances several inter-related criticisms have been drawn from a single source.

The criticisms have each been carefully examined and analyzed with the aim of determining the validity of each criticism. This analysis and examination drew upon a wide variety of information available within the U.S. Government and took into account, as well, material specifically provided by the individual MDBs themselves for this purpose. The results of this examination are set out below for each criticism.

A. Bilateral Aid is Superior to Multilateral Aid

The MDBs are said to be by definition an instrument inferior to bilateral assistance in the achievement of U.S. objectives. This criticism, which has been advanced in the Heritage Foundation study Agenda for Progress, as well as by P.T. Bauer in his comment in Challenges to a Liberal International Economic Order, states that the rationale for foreign aid is inherently political in nature and bilateral aid, over which the donor has greater control and with which the donor is directly identified, is better able to meet our political objectives. P.T. Bauer states, in addition, that by virtue of its greater degree of control, bilateral aid is a better instrument for rewarding correct, i.e., market oriented, economic policies in recipient countries. The Heritage Foundation also argues that the alleged advantage of multilateral aid, i.e., cost sharing, is, in principle, available under bilateral aid. Countries could achieve cost sharing arrangements through coordination of bilateral aid programs.

The real issue posed by these criticisms is which channel--multilateral or bilateral -- is appropriate to the particular objective being sought. There exist very real differences among the various forms of official assistance, each with advantages and disadvantages, which may or may not have relevance to the objectives being sought. In this context, distinctions must be made among the different forms of U.S. bilateral assistance and their actual and, to a lesser extent, potential application: bilateral development assistance (DA), economic supporting assistance (ESF), and PL-480. DA funds are the hard currency funds which are allocated for specific projects. ESF provides fast disbursing hard currency, with amounts of local currency normally programmed for use in development projects (does not apply to ESF program for Israel). Under the food aid component of the bilateral program, loans are provided on concessional terms for purshases of surplus U.S. agricultural commodities; local currencies are made available by the beneficiary governments for use in approved development projects; and food donations are distributed through international organizations and through private voluntary organizations. The allocation of funds among the three program components varies from year to year. In FY 1982, ESF was about 40 percent of the program total, Development Assistance 36 percent, and PL-480 18 percent.

Both multilateral development assistance and DA are particularly effective in promoting U.S. long term political interests because they generally entail longer term programming. Both multilateral and bilateral development assistance programs promote medium and long term economic growth (see comparisons below), which can contribute to a more secure world consonant with U.S. political/security interests. While the MDBs reach a somewhat larger group of countries -- some 84 as opposed to 75 for U.S. bilateral assistance -- the bilateral program can be more directly targeted. On the other hand, the multilateral channel is able indirectly to serve U.S. global long term political interests by having programs in countries where bilateral relations may be politically sensitive, e.g., Zimbabwe, or in countries which, for political reasons, prefer not to accept direct aid from the United States, e.g., Mexico and Brazil. On the other hand, bilateral aid in all its forms can serve as a more visible sign of U.S. political commitment since the extent of the United States contributions to LDC development via the MDBs is often overshadowed by the multilateral character of the institutions.

Turning to the assertion that bilateral assistance is a better political instrument for serving the short-term political/strategic interests of the United States, flexibility or "controllability" and rapid disbursement of funds are key factors. Based on these criteria, both multilateral assistance and DA are constrained by an average 18-24 months project cycle (the time from project identification to obligation of funds).

In looking at other aspects of flexibility of DA, Congress has indicated a desire for the program to focus on relatively needy countries (per capita incomes below $680). Congress also provides guidance in each year's Foreign Assistance Act on the appropriate sectoral focus for that year's program. While such Congressional involvement illustrates the potential for DA to factor in short term political considerations, it also implies some rigidities in annual or longer term programming. As part of AID's presentation to the Congress, a detailed country and project breakdown is submitted but these allocations can be changed to meet changing situations by providing 15 days' notification to the Congress.

While U.S. DA and multilateral assistance do not have any particular advantages in terms of flexibility in promoting short term U.S. political interests, Economic Supporting Assistance and PL 480 do. Economic Supporting Assistance derives its primary rationale from U.S. political interests as is demonstrated by the relatively high concentration of ESF resources on a few recipients; the Middle East -- primarily Egypt and Israel -- accounts for more than two thirds of the current program. ESF is also used for cash transfers to meet balance of payments problems and essential import requirements. Although the list of recipients and levels of assistance are subject to Congressional approval (the same procedures cited above for DA), there is also provision in ESF for unforeseen events (the Special Requirements Fund). PL-480 Title I sales are also directed towards "friendly" countries, although there is a limitation that 75 percent of Title I must benefit low income countries. Nevertheless, in FY 1981, Egypt, Indonesia, Bangladesh, Korea, Pakistan, Poland, and Sudan accounted for well over one-half of the program. In general, the only form of fast disbursing MDB assistance is World Bank structural adjustment lending, which is designed to promote economic adjustment over the medium term.

While bilateral aid, particularly Economic Supporting Assistance, better serves U.S. short term political interests, multilateral assistance can provide a useful complement in individual cases. For example, in Egypt where political interests inhibit U.S. ability to promote economic policy changes, economic policy reforms have been fostered, in part, through the IBRD.

It is unquestionably true that all forms of bilateral aid can be cut off much more rapidly in response to U.S. political concerns than can multilateral assistance. As in meeting long term U.S. political objectives, bilateral assistance also has the political advantage of being readily identifiable as coming from the United States, assuming a highly visible U.S. presence is desirable in a particular instance.

In meeting the U.S. economic objectives of promoting LDC economic development within an open, predictable, and growing international economic framework, both bilateral and multilateral aid serve U.S. interests, and there are some important complementarities between the two, reinforced by their particular comparative advantages.

Because of recipients' perceptions of the impartiality of the MDBs, as well as the significantly larger scale of their assistance, the banks are better placed to advise LDCs of the benefits of an international system based on liberal trade and capital flows and to elicit market directed changes in recipients' economic policies. MDBs also offer the means, through movement from concessional to hard loan terms, to wean recipient countries gradually from concessional aid. Finally, in many cases MDB programs may be more predictable and stable than U.S. bilateral programs because proposed MDB policy changes generally require a multilateral consensus.

On the bilateral side, both DA funds and local currency generations of PL-480 Title I and ESF, if appropriately integrated into a U.S. bilateral development assistance strategy, can promote long term economic growth. The major difference is that with bilateral assistance the United States directly and immediately controls the country and project focus and the degree of conditionality. The use of PL-480 and ESF local currencies and conditionality under bilateral programs are, however, constrained to the extent they detract from U.S. political objectives (i.e., imposition of conditions can entail a political cost). Finally, in bilateral programs, the United States can directly take measures to improve program efficiency if needed. However, there is no reason to presume that MDB management would take any less immediate steps to make necessary program improvements.

Clearly both bilateral and multilateral assistance can meet U.S. humanitarian objectives. Humanitarian programs carried out bilaterally are likely to give the United States more political benefits, however, than those done through the MDBs.

As far as cost-sharing is concerned, the multilateral mechanism has an advantage in light of the efficiency it provides for coordination among donors. The MDBs can achieve a more desirable budgetary impact, at lower institutional overhead, due to the formal cost-sharing among donors. More importantly, the hard loan windows are able to leverage U.S. budgetary contributions by borrowing from private capital markets against callable capital. As a result, for example, each dollar of U.S. paid-in capital to the IBRD has historically supported about $60 of lending. Since bilateral cost-sharing (e.g., dividing sectoral/regional responsibilities) among individual national foreign assistance programs could not generate the financial market borrowing leverage generated by MDB callable capital, the U.S. budgetary cost of substituting bilateral DA for even a small portion of such hard loan MDB lending would be

prohibitive. The leveraging impact is much smaller with regard to concessional MDB lending, where each dollar of U.S. contributions has supported about $4 of lending.

The multilateral channel can also offer an effective means of coordinating and allocating assistance, which can minimize waste and duplication of effort by individual donors. Given the differing geographic focus of major donors' political/strategic and commercial interests, effective efforts to coordinate bilateral assistance programs would be very difficult to achieve. Even the extent to which donors with likeminded political/strategic and economic interests could agree to divide the cost of concessional assistance effectively is problematic.

In conclusion, U.S. bilateral and multilateral aid have different comparative advantages depending upon the U.S. objective in question and complement, rather than substitute for, each other. The U.S. bilateral aid program can often move more quickly to support U.S. short-term political interests and priority countries, and also stimulates LDC growth by bringing to bear U.S. expertise on key development constraints in recipient countries; multilateral assistance primarily serves long term U.S. interests, can be very cost effective, and promotes a stable international economic environment.

B. <u>The MDBs Primarily Serve the Interests of Private Banks</u>

This criticism has been raised by, among others, Jude Wanniski in his article entitled "A Supply-Side Foreign Policy". In this article, he states that the IMF and the World Bank are run by and for the large private banks with the aim of averting international financial collapse and their own bankruptcies. The large level of LDC indebtedness, if defaulted on, would bankrupt the large private banks. To avoid this eventuality, taxpayers in developed countries are squeezed for resources for the World Bank which are provided to the developing countries. The IMF, for its part, squeezes the taxpayers in developing countries to service these international obligations. Thus, both the World Bank and the IMF, which are supported primarily by the developed countries, in fact operate to secure financing for the large private banks.

Wanniski's criticism implies that averting an international financial collapse is in fact a misguided objective for the IMF and the Bank to pursue. To the contrary, and in large part because of U.S. initiative, the IMF and the World Bank were created specifically to prevent the recurrence of the economic havoc of the 1930s. These institutions enable developing countries to weather temporary balance of payments crises and to pursue their goals of economic and social development, thereby helping to perpetuate a free and open international economic order. That the money center banks also benefit from a healthy international economic system does not in any way imply the Bank and Fund are their creatures.

Wanniski's criticism also seems to suggest that the IMF's various lending facilities merely transfer resources to the developed countries (and, money center banks). In fact, however, the IMF's facilities do not provide concessional long term development assistance but, rather, merely allow for a relatively short and medium term exchange of assets at rates of interest and maturities better than those obtained in capital markets.

Wanniski's contention also suggests that the sole purpose of the World Bank and, by implication, the other MDBs is to "bail out" commercial banks that find themselves imprudently exposed in developing countries which have borrowed too heavily in international capital markets and would not be able to service their debt to private creditors without MDB lending. In fact, however, a careful analysis of the proposition demonstrates that this is not the case.

First, the MDBs lend primarily for projects, not for general balance of payments support. Developing countries are obligated to use the proceeds of such loans for the specific costs of discrete, identifiable activities. The vast bulk of MDB lending is to meet the foreign exchange costs of these projects, and the drawdowns on MDB loans are linked to the import needs of the project. Furthermore, the MDBs do not extend debt relief, whereas other creditors, including private banks, do. Thus, the MDBs cannot be said to be "bailing out" the commercial banks in crisis situations; if anything, the reverse is true.

Of course, it could be argued that since money is fungible, the resources provided by the MDBs merely "free up" other resources developing country borrowers can use to meet obligations to commercial banks. However, this is unlikely for two reasons: (a) at least some part of MDB funding is "additional", i.e., it goes to projects that the borrowers would not otherwise be able to undertake; and (b) the total volume of lending by the MDBs is dwarfed by the resources developing countries receive through private financial institutions. In the aggregate, the LDCs' net flows from the MDBs during 1977-1979 amounted to only 6.3 percent of total net flows from all sources, including bilateral official donors and private financial intitutions in capital markets. In contrast, net flows from private financial institutions (PFIs) in international capital markets (including private export credits, but excluding direct investment) amounted to 40.9 percent of the total.

An examination of net resource flows to individual developing countries confirms this point at the country level. In the following table the net financial flows of the twelve developing countries which were large borrowers in private capital markets and major recipients of MDB finance are examined. Even though the twelve countries in the table below are important borrowers from the MDBs, the ratios in column B show that, with the exception of Peru,

they depend primarily on private financial institutions for external capital. Furthermore, as seen in column A, the resources these countries obtain from the MDBs constitute a small share of what they require to service their debt to the PFIs. Clearly, even if the MDBs wanted to "bail out" the commercial institutions which have lent to these countries, they would not be able to do so.

Table 1. Net Financial Flows to LDCs 1/

Country	A. Ratio of Net Flows From IFIs to Debt Service Payments to PFIs 2/	B. Ratio of Net Flows From PFIs to Net Flows From All Creditors 2/
1. Chile	.032	1.612 3/
2. Algeria	.033	.896
3. Mexico	.043	.931
4. Argentina	.075	.775
5. Brazil	.080	.927
6. Peru	.083	.406
7. Panama	.097	.828
8. Ecuador	.133	.870
9. Malaysia	.191	.671
10. Ivory Coast	.217	.800
11. Korea	.238	.706
12. Colombia	.337	.653

1/ Data from World Debt Tables, November 15, 1980.

2/ Ratios based on average net flows for 1977-1979.

3/ Chile's net flows from the PFIs are greater than its total net flows because the total includes Chile's very large negative net flows from (i.e., net payments to) official bilateral sources. This accounts for the fact that the col. B ratio is greater than one.

There is another group of countries consisting primarily of the poor nations of South Asia and Sub-Saharan Africa that depend almost entirely upon official bilateral and multilateral sources for external resources. Although their net annual flows from the MDBs are a multiple, rather than a fraction, of their debt service to the PFIs, this does not indicate a bail-out. Instead, it reflects the fact that these countries are generally considered less creditworthy for borrowing on commercial terms from the PFIs. This is amply illustrated in the following table:

Table 2. Financial Flows to Officially-Financed LDCs 1/

Country	A. Ratio of Net Flows From IFIs: Debt Service Payments to PFIs 2/	B. Ratio of Net Flows From PFIs: Net Flows From All Creditors 2/
Ghana	7.6	0.146
Mali	54.0	0.048
Haiti	15.0	0.047
Bangladesh	9.7	0.007
India	6.3	0 3/
Pakistan	2.2	0.065

1/ Data from World Debt Tables, November 15, 1980.

2/ Ratios based on average net flow for 1977-1979.

3/ India recorded net negative flows from PFIs in this period.

C. MDBs Encourage the Public Sector Over the Private Sector

This criticism has been raised specifically with respect to the World Bank in Barron's (June 16, 1980) in an article entitled "Blood and Treasure." In this article the World Bank is criticized for providing funds for such purposes as collectivization of farms, which are antithetical to free societies. In this respect, P.T. Bauer criticizes the World Bank for massively supporting the Tanzanian Government which forceably collectivized agriculture. World Bank support for Mrs. Ghandhi and her campaign of compulsory sterilization is also criticized.

The criticism levelled against the World Bank, and implicitly the other development banks as well, is that they have tended to encourage state intervention in developing countries' economies, promoting government intervention to resolve economic problems. As such, they have encouraged the state at the expense of the private sector, leading to greater economic centralization. Another criticism in this same vein is that MDB officials' own positions as international civil servants make them naturally compatible with bureaucratic counterparts in developing countries, giving rise to a policy bias in favor of interventionist type solutions.

As noted in Chapter I, available evidence on MDB lending does not support the contention that MDBs have sought to support the public sector at the expense of the private sector.

The analysis of IBRD/IDA lending in FY 1980 uses the U.S. economy as the reference point and is based on: (a) who is the ultimate beneficiary of the project and whether market forces are

the principal allocator of resources for the activity, and (b) a judgment of whether the particular economic activity would be in the public or private sector in the United States. The analysis indicates that 67 percent of IBRD/IDA lending in that year was either to support private sector activities or for activities which would be in the public sector in the United States. The remaining 33 percent of IBRD/ IDA lending in that year went for activities which in the United States are provided by both the public and private sector or which are closely regulated by the public sector. However, in many developed countries, as well as virtually all developing countries, many of these activities are traditionally supplied by the public sector. Further analysis of individual MDB loans identified only 8 percent of IBRD/IDA lending which supported public sector activities which would, on the basis of U.S. criteria, have been clearly supplied by the private sector.

It should be noted, though, that the analysis does not take into account the possibility that some of the public sector activities financed by the World Bank, which on the basis of U.S. criteria should have been provided by the private sector, would not be so provided in the developing country due to the small size of that sector in most developing countries. Thus, the actual amount of private sector displacement, measured from the developing countries' point of view, would be less than 8 percent.

Analysis of IDB and ADB lending for FY 1980 reveals a similar pattern. In the IDB a total of 71 percent of the lending could be classified as clearly non-competitive with the private sector on the basis of U.S. criteria; the similar percentage for the ADB was 69 percent. Thus, only 29 percent of the IDB lending and 31 percent of the ADB lending in FY 1980 fell into the mixed category. Further analysis indicates that only 6 percent of the IDB and ADB projects appeared to be directly competitive with the private sector.

The high proportion of MDB loans which is judged noncompetitive with the private sector is explained, in part, by the emphasis in MDB lending on infrastructure investment, e.g., water supply and sewerage, much of which is considered to be traditionally either a public sector activity or a regulated private sector activity in the United States. Such lending can in fact indirectly promote the private sector by providing services essential to its development. In addition, the recent emphasis by the World Bank on "new style" projects has led to lending in some areas, e.g., education, which are also typically provided by the public sector in the United States. The World Bank has sought in some of its lending in the educational sector to relieve shortages of technical and trained personnel to the indirect benefit of the private sector.

All the MDBs, with the exception of the IFC, require a government guarantee on their loans. Thus, of necessity, MDB personnel must work with bureaucracies in developing countries. In their

approach to funding individual projects, the MDBs are essentially agnostic with respect to the question of ownership. To varying degrees, the main concern of the MDBs is with the economic policies followed in the developing country as they affect economic development in general and the feasibility of individual projects in particular.

Of all the MDBs, the World Bank plays by far the largest role in the realm of policy advice. While it is difficult to summarize the wide variety of policy reform urged upon developing countries by the World Bank, a review, such as that submitted for the record in 1981 at the request of the Subcommittee on Foreign Operations of the House Committee on Appropriations, of the individual country reports prepared by the Bank staff reveals that the advice is generally along neo-classical economic lines. On the external side, the reports emphasize the need for open international trading systems, realistic exchange rates, and the use of world market prices to reflect real opportunity costs. On the internal side, there is an emphasis on appropriate resource allocation (i.e., in accordance with true costs and benefits), realistic pricing policies, cost-recovery, and the maintenance of sensible fiscal and monetary policies.

The fairly conventional, market oriented economic approach of the World Bank has from time to time cast the Bank in the role of antagonist vis-a-vis the recipient country. The Bank's experience in Tanzania is instructive on this point. According to Robert Ayres' article in the Summer 1981 issue of Foreign Policy, entitled "Breaking the Bank", a 1974 World Bank report on the Tanzanian agricultural sector criticized the Tanzanian Government's "villageization" policy and promoted a production first policy. Similarly, a 1976 World Bank report emphasized the need for sound performance by public sector firms. In both instances the Tanzanian Government took issue with what it considered to be the Bank's emphasis on production and efficiency at the expense of what it considered to be social equity goals. It should be noted, though, that in spite of these unfavorable reports, World Bank lending to Tanzania did not stop and actually grew between FY 1974 and FY 1977.

Similarly, an article in the Far Eastern Economic Review of May 29, 1981, reports on a World Bank study on Indonesia which criticizes the Indonesian Government's reliance on economic controls which, it is alleged, have led to a misallocation of resources. The report urges less reliance on controls and criticizes the government's approach as frustrating the development of local entrepreneurs. This critical report has apparently upset elements in the Indonesian Government which have claimed that the World Bank exerts too much influence over Indonesian economic policy.

While the policy prescriptions promoted by the World Bank have, with occasional exceptions, been along market-oriented lines, the Bank's record on inducing borrowers to adopt specific policies is mixed. Bank influence is more effective when countries are

already favorably disposed to pragmatic, market oriented policies, and a question remains as to the willingness of the Bank to enforce its policy prescriptions in other situations. In the macro-economic area, the World Bank has on occasion ceased lending to individual developing countries, e.g., Chile, when, in the Bank's view, the policies of these countries have threatened their creditworthiness. Such instances have, though, been relatively rare.

D. The MDBs Are too Insulated from the Pressures of the Marketplace

This criticism was raised by Wilson Schmidt in Policy Review (Fall 1979), in an article entitled "Rethinking the Multilateral Development Banks." In this article, Dr. Schmidt argues that the MDBs should pay dividends. (In all the MDBs except the IBRD net earnings are retained within the institution; in the case of the IBRD a portion of the net earnings is transferred to IDA.) Payment of dividends by the MDBs would facilitate marketing their shares directly to the public. This would have several advantages: it would depoliticize the MDBs; make them more profit oriented; and encourage an optimal allocation of resources in the institutions.

In evaluating this criticism, it should be noted that the MDBs are not immune to the pressures of the marketplace, since they finance the majority of their hard loan operations through borrowings in the capital markets. In FY 1981, the IBRD borrowed an estimated $6.2 billion in the capital markets, $3.6 billion of which reflects new borrowings, to finance an estimated $3866 million in net disbursements (gross disbursements less repayments). The gross and net borrowing requirements are expected to grow to $10.5 billion and $6.0 billion respectively by FY 1985, to finance approximately $6.0 billion in net disbursements.

Its dependence on market borrowings exerts some pressure on IBRD lending policies because of the market's implicit reliance on the quality of the IBRD's loan portfolio. The IBRD's funded debt is now 4 times the size of U.S. subscriptions to callable capital and exceeds the value of the subscriptions of all DAC and OPEC members by a considerable margin. The market, therefore, has had to look gradually beyond the callable capital subscriptions and ascribe some value (however small) to the loan portfolio and the repayment record of the borrowers. This market dependence will increase as the influence of paid-in capital declines; it would increase sharply in the event a decision is made to change the Bank's gearing ratio.

The MDBs, however, were not designed to be mere commercial banks; they provide somewhat different services (technical assistance, project development, long term fixed rate loans); have different objectives; and meet a perceived market failure. The United States has various objectives in belonging to the MDBs as explained in detail in Chapter III. Accordingly, the country distribution of lending in the MDBs reflects factors other than the purely commercial, although they do tend to lend more to countries having sound economic policies. For example, Kenya or Korea receive a far greater amount of funds than Tanzania or Burma. To the extent that the United States and others successfully pursue political and

developmental objectives with regard to the lending distribution in the MDBs, a lending distribution different from that of a commercial institution must result. However, whether this is a misallocation of capital depends on the objectives being served.

Furthermore, even within individual countries, the MDBs have developmental objectives that necessitate the financing of projects in different sectors rather than financing projects solely on the basis of their financial rates of return. Economic rates of return are the prime criterion for financing MDB projects, and available evidence from the World Bank and the ADB in fact shows that the projects of these institutions do, on average, have quite respectable economic returns, i.e., on the order of 15-20 percent.

Clearly, if the MDBs were forced to pay dividends on most or all their annual net earnings, their dependence on the market would be increased. In FY 1981, this policy would have increased the World Bank's gross borrowings by 10 percent and its net borrowings by 17 percent. On a cumulative basis, this might tend to change the lending profile marginally by raising the significance of financial concerns relative to developmental objectives.

Dividends to member countries are a possibility even under the present structure of the MDBs. However, selling off shares in the MDBs to private investors would involve decisions beyond the payment of dividends at an appropriate level. To be attractive to private investors the shares would need a rate of return higher than could be obtained on MDB bonds. In addition, MDB shares are unlike normal common shares since they are only partially paid-in with a large contingent callable liability. Investors would surely demand a very substantial yield premium to assume a liability up to ten times their investment. Unless the paid-in shares and the callable obligations could be separated, the value of paid-in shares would have a market value substantially below present book-value. (The BIS, however, has a few shares publicly held that have a callable liability three times the paid-in portion.) Without a suitable assumption of the callable risks by the common shareholders, MDB bonds would also require a substantially higher premium than at present.

In conclusion, the MDBs are already subject to a degree of market discipline which will grow in the future. However, as presently constituted, they are not intended to be purely commercial lending institutions. The banks must of necessity allocate capital on other than solely financial criteria, although such criteria are important in determining the allocation of MDB lending among and within countries and sectors. To the extent the United States has other objectives in belonging to the institutions, these factors affect the distribution of MDB funds. While a policy of paying dividends would increase market discipline on the MDBs, the privatization of the MDBs would raise very serious practical difficulties and policy questions (not least, is whether the complete privatization is a desirable goal in itself) that are not addressed in this paper.

E. MDBs Are Not Needed to Transfer Capital to the LDCs

This argument has been advanced by, among others, Norman Ture in his chapter on the Treasury Department in the Heritage Foundation study, Mandate for Leadership. In support of this argument, it is pointed out that 64 out of the 89 country recipients of World Bank assistance during the period 1976-79 were able to borrow money on international capital markets during 1976-79. Such a high percentage suggests substantial LDC access to private capital markets and does not suggest any market imperfections which limit access.

Private capital flows to developing countries did increase substantially during the 1970s. OECD data contained in its annual Development Assistance report show that net private capital flows, defined as the sum of direct investment, bank and bond lending, and private export credits, increased from a level of $9.15 billion in 1970 to an estimated $42.58 billion in 1979. This rapid growth took place during a time when LDC financing needs were increased substantially. The current account deficit of the non-oil producing developing countries, as estimated by the OECD, increased from $8 billion in 1970 to $51 billion in 1980. These higher current account deficits were the result, in large part, of the large oil price increase which occurred during this period.

While private lending to the developing countries increased substantially in the 1970s, this was in the context of sizable increases in all financial flows to the developing countries. Over the period 1970-75, private financial flows, as defined above, accounted for 49.7 percent of total net financial flows to developing countries according to OECD data. By comparison, while the level of private financing had increased over threefold for the period 1976-79, private finance as a proportion of total net finance had increased to only 55.7 percent. The proportion of the developing countries' financing needs provided by the MDBs remained substantially constant, at a level of around 6-7 percent of total LDC net financing, in the 1970s. Thus, while private capital flows to LDCs expanded significantly in the 1970s, this was in a context in which financial flows from all sources to LDCs were increasing rapidly, the result in part of structural current account deficits consequent upon the OPEC price increases. While there was some increase in the proportion of net financing provided by private lenders, it was comparatively modest, on the order of 12 percent.

In providing external finance to the LDCs, there are significant differences between the finance provided by the private market and by the MDBs. Private capital flows to developing countries are concentrated on a smaller group of developing countries. World Bank data on publicized foreign and international bond issues and eurocurrency credits, show that the vast bulk, over 90 percent, of the private capital provided to LDCs during the period 1976-79 went to the middle income developing countries, defined as those countries with GNP per capita of over $360 (in 1978 dollars). This

result is to be expected in light of private lenders' desire to minimize their risk by lending to the most creditworthy developing countries. This desire is also evident in the concentration of private lending in relatively few countries. The ten largest developing country borrowers (Algeria, Argentina, Brazil, Indonesia, Israel, Korea, Mexico, the Philippines, Spain, and Yugoslavia) accounted for over 60 percent of the total borrowing recorded over the period 1976-79.

By way of contrast, those same ten countries accounted for only 37 percent of total project commitments by the IBRD/IDA, IDB, and ADB over this same period. (The African Development Bank/Fund does not lend to any of the ten countries.) This result is not surprising in light of the fact that one of the objectives of the MDBs is the promotion of economic development and the fact that the soft loan windows of the MDBs are able to provide resources to LDCs, e.g., Bangladesh, which have no significant access to private capital markets. Thus, the pattern of MDB lending can be expected to be less concentrated than that of private lenders. (Two of the ten largest private borrowers, Israel and Spain, have been graduated from the IBRD.)

In addition, the resources provided by the private capital markets are not a perfect substitute for those provided by the MDBs. MDB financing is provided in the context of specific development projects while private market resources with the exception of direct investment, tend to be more for balance of payments purposes. MDB financing also carries with it technical advice and a set of policy prescriptions which are typically not present in private capital flows. Finally, MDB financing is provided at longer maturities than provided by private capital markets and is, therefore, more suited to support longer term development projects which, while viable, have longer payout periods.

In conclusion, MDB and private sector financing play somewhat different roles, and both are necessary for the developing countries. Reliance on private lenders to finance developing country development would lead to a much more concentrated distribution of financial flows. Resources would go primarily to those developing countries with the highest per capita incomes at the expense not only of the poorest developing countries, such as Bangladesh, but also of many middle income developing countries as well, such as Egypt. Also, exclusive reliance on private sector funding would lead to a different allocation of resources within the country and would provide less leverage on economic development policies.

F. The World Bank Emphasizes Redistributional Rather Than Pro-Growth Goals

This criticism has been raised specifically of the World Bank by Jude Wanniski in his article, "A Supply-Side Foreign Policy", as well as in an article in Forbes, (May 26, 1980), entitled, "Is The World Bank Biting Off More Than It Can Chew?". The criticism deals

with the shift in World Bank lending from the more traditional infrastructure projects financed during the 1950s and 1960s to the so-called "new style" projects of the 1970s. The focus of the criticisms, as reflected in the Wanniski and Forbes pieces, is primarily on the characteristics of the new loans which supposedly emphasize redistribution, or "aid to the poor", as opposed to pro-growth goals.

The criticism raised has some validity in that the new project appraisal methodology employed by the Bank explicitly takes into account distributional considerations. Nonetheless, the criticism is misplaced in certain key respects. First of all, there continues to be a considerable amount of World Bank lending which goes to traditional-type projects. A recent study estimates the proportion of traditional lending to be between one-half and two-thirds of total World Bank/IDA lending, compared to perhaps three-quarters in the 1960s. Secondly, new style projects are not redistributional projects, or "welfare" projects, as is sometimes alleged. The projects addressing basic human needs, and intended to reach the poor, are projects aimed at human capital investment and can be as important to an economy's development as a dam, road, or port project, although the returns on human capital investment projects are difficult to quantify.

Human capital projects must in principle pay their way by creating a stream of benefits which can be monetized. Where possible, the projects are not to be financed from general revenue sources but are expected to be financed out of project related revenues. In the Bank's urbanization projects, for example, the revenues take the form of mortgage payments, rental fees, and sewerage and water user charges. Because the Bank expects these projects to serve as examples for future national development activities, the key elements in each project are affordability, cost recovery, and replicability.

The rates of return earned on the new style projects also do not support the criticism, although the evidence on this does not cover the more recent World Bank projects. An analysis of comparative rates of return indicates that the economic rates of return on the so-called "new-style" projects match or exceed those achieved on the more traditional projects. It should be noted, though, that the projects analyzed represented only a sub-set of the "new style" projects as, for many of these projects, calculation of economic rates of return is not feasible. Our results are, though, consistent with a recent World Bank study of rates of return to education investment in developing countries which indicated that estimated rates of return ranged from 22 to 27 percent in primary education (World Development Report, 1980).

The fact remains, however, that in certain specific country cases, e.g., Tanzania, the Bank may have placed undue emphasis on distributional considerations at the expense of other objectives.

There is little evidence that redistribution policies per se effectively promote growth, and the most meaningful way the MDBs can assist the poor is by using their leverage on borrowers to ensure that sound economic policies are adopted rather than by any specific sectoral emphasis. Enough examples from the developing world exist (Korea, Taiwan, and Singapore) to demonstrate that MDB market oriented conditionality can facilitate the improvement in productivity which represents the best approach to poverty elimination. The banks can best help the poor by utilizing their lending to ensure borrower willingness to rationalize their economic policies. This means as well that MDB donors must not depend upon the banks to advance their immediate political and strategic interests, but instead should rely on them to secure the adoption of necessary economic policy reforms.

G. MDB Projects Benefit the Rich in Developing Countries

This criticism relates to the distribution of benefits associated with MDB financed projects. A 1979 report for the House Appropriations Committee (The Investigators' Report) was critical of the distribution of MDB financed project benefits. It identified several instances in which the relatively rich had been the prime beneficiaries of projects financed by the IBRD and the IDB.

This criticism is premised on the assumption that the MDBs should allocate their lending so as to benefit the largest number of poor people. While there are instances in which individual MDB projects have in fact primarily benefited the rich, this criticism is not valid as a general proposition. In fact, the MDBs, particularly the World Bank, have made major efforts over the last decade to insure that the poor receive a greater proportion of the benefits of MDB-financed projects.

The World Bank has developed for most of its borrowing countries estimates of poverty based upon measures of "absolute" and "relative" poverty in each case. The absolute measure is based on an estimate of subsistence level income in the country, while the relative measure is defined as a level equivalent to one-third of the country's GNP per capita. These measures are revised yearly and are used in project design methodology to estimate the poverty impact of World Bank projects. The IDB and the ADB have also attempted to define low income levels for use in their own lending activities. It should be noted, though, that the IDB measure, which is based on a country specific absolute measure of poverty, yields significantly higher estimates than that used by the World Bank in the same Latin American countries; it has the effect of increasing the estimate of low income beneficiaries of IDB financed projects.

Based on these measures, the MDBs are able to classify the beneficiaries of MDB projects. These definitions have been coupled with changes in MDB sectoral lending policies, and with greater emphasis on agricultural development, which has had the effect of

increasing the number of poor beneficiaries served. In the World Bank, for example, agricultural lending rose from 12 percent of total lending in FY 1961-65 to 31 percent of total lending in FY 1980. In addition to this shift in sectoral emphasis, the MDBs have also instituted a number of changes in project identification and design, as well as monitoring and evaluation, which are aimed at ensuring that benefits to the poor are emphasized in the individual projects. These procedures have been supplemented by specific lending targets in some cases. In the World Bank, for example, 50 percent of the lending for agriculture and rural development and 33 percent of the lending for urban development is expected to benefit the absolute and relative poor. In the IDB, 50 percent of its lending is to be directed to low income (as distinct from poor) groups. In the World Bank in FY 1980, an estimated 40-45 percent of its total lending benefitted the poor, as defined by the Bank.

H. MDBs Do Not Sufficiently Involve the Poor

The report of the House Appropriations Committee on the 1981 Appropriations Bill claims that the MDBs have not "involved poor populations to the extent possible in the planning, design, and implementation of programs and projects"; that the assistance provided by the MDBs fails, to a large extent, to reach the poor; and that there is a growing number of Third World indigenous non-governmental organizations (NGOs) that legitimately represent the interests of the poor and are better able to deliver assistance to them than the large, centralized agencies frequently chosen by the MDBs to execute their projects. The Report, in effect, calls for the MDBs to work more directly with the poor in developing countries in the provision of development assistance.

This criticism is not well taken, though, as the MDBs, particularly the World Bank, are in fact doing much more than may generally be realized to involve the poor directly and actively at all stages of the project cycle. The World Bank has, for some time, demonstrated its understanding of the need to appraise the degree to which projects respond to local needs; adapt to the local economic, social, and cultural context; and make use of local capabilities and resources. A number of Bank studies have investigated ways to increase grass roots participation and their results have been disseminated through reports and seminars. Detailed operational guidelines exist which assist program and project officers to collaborate more effectively with groups representing the poor. In addition, the Bank has established a liaison committee and has met frequently with international private voluntary organizations having direct ties with Third World non-governmental organizations. A joint Treasury/IDCA review in 1981 of the Bank's performance (responding to a House Committee Request) revealed a number of projects whose implementing agencies are indigenous NGOs.

Our review of the Asian Development Bank (ADB) shows similar concerns within that institution about participation of indigenous groups. The ADB has an on-going research program on the role of traditional institutions in socio-economic development, one of which is currently responsible for the operation and maintenance of an ADB funded irrigation project. Loans to development finance corporations are increasingly being used for community development activities of local associations.

The Inter-American Development Bank's Small Projects Program had committed $18.6 million for 41 projects executed by NGOs in 15 Latin American countries by the end of 1980. Other large loans to NGOs included one for $17.5 million to the Latin American Confederation of Savings and Credit Cooperatives with some 1.6 million individual members.

The African Development Bank (AFDB), being the youngest of the MDBs, has the least experience working with NGOs. However, it has provided institutional support to the Association of African Development Finance Institutions and the African Training and Research Center for Administration, and is helping establish a pan-African housing development and finance institution.

Thus, the MDBs have made substantial progress in developing better techniques for involving the poor directly. It needs to be noted as well that MDB activity in this regard is constrained by the receptivity of recipient countries to more direct involvement of local organizations in project preparation and implementation.

Nevertheless, the United States could seek additional changes in this policy area, if it were determined to be of sufficient priority to the Administration. Additional steps that could be undertaken by the banks include: evaluating previous experience with NGOs and projects where collaboration has been successful; advising borrower governments of MDB interest in funding projects involving indigenous NGOs; compiling a roster of Third World NGOs possessing suitable characteristics; formulating more detailed policy and operational guidance for program and project officers concerning involving the poor in all stages of the project cycle; and, where requested by the borrowing countries, replicating successful projects involving NGOs.

It is important to realize, though, that there are drawbacks to involving NGOs to a greater extent. First, the MDBs' operational costs associated with project appraisal and supervision are likely to increase. Second, many governments are likely to be reluctant to see their agencies by-passed as project implementors in favor of NGOs, many of which cannot legally enter into contracts and lack managerial and technical skills. Third, some NGOs are likely to hesitate to collaborate with the MDBs, fearing the loss of their policy and operational independence. Finally, selection

of suitable NGOs will be difficult in that such organizations may be operated by and for the local elites, with little or no effective participation by the poor members of the community.

I. There Has Been an Emphasis on Quantity Rather Than Quality in the World Bank

This criticism has been made about the World Bank by, among others, Barrons and Forbes. In an article in Barron's (June 18, 1980) entitled "Blood and Treasure", it is claimed that under Robert McNamara's direction the Bank was more concerned with the quantity of lending rather than the quality of individual projects. Loan officers were pressured, especially toward the end of a fiscal year, to fund projects. As a result, there was a deemphasis of project quality; in one recent year 11-50 percent of World Bank projects were found by the Bank to have problems ranging from "moderate" to "severe".

The Forbes (May 26, 1980) article entitled "Is the World Bank Biting Off More Than It Can Chew?" states that McNamara set high loan quotas and insisted that they be met. A World Bank staff association report is quoted in the article criticizing the Bank's approach to project preparation as being more concerned with form and procedure rather than substance. The result of this quantitative approach was a diminution in the Bank's ability to influence policy changes in the recipient country.

Figures clearly shows that IBRD/IDA lending increased substantially during McNamara's tenure. In FY 1969, the IBRD and IDA committed $1.8 billion for 122 projects. By FY 1980, the amounts committed had increased to $11.5 billion covering 247 projects, increases of 539 and 102 percent, respectively. However, part of the increase in nominal lending levels was attributable to inflation. Using the World Bank's commitment deflator to calculate real lending levels, the increase from FY 1969 to FY 1980 amounted to 73 percent, equivalent to an average annual growth rate in real terms of slightly over 5 percent per year. By way of contrast, IBRD and IDA lending grew at roughly 3.7 percent per year in real terms between FY 1964 and FY 1969.

One way of evaluating whether the rapid rate of growth in IBRD/IDA lending in recent years has been a matter of policy is to consider how closely actual lending levels have corresponded to those forecast. A close correspondence would tend to indicate that attainment of specific rates of growth in lending was a policy objective in the World Bank. The evidence shows that the annual lending levels of the IBRD have in recent years conformed almost exactly with those projected one year in advance in the World Bank's Review of World Bank Group Financial and Operating Programs. Between FY 1977 and FY 1980, the largest variation between projected and actual lending levels was 2.8 percent (in FY 1979). IDA lending levels showed

somewhat greater variation, but with actual lending exceeding projected lending by a significant extent. Comparing actual IDA lending levels with those projected one year in advance over the period FY 1977 to FY 1980 shows variations of -3.1 percent in FY 1977, + 0.6 percent in FY 1978, + 16.2 percent in FY 1979, and + 9.7 percent in FY 1980. The greater variation in IDA lending levels may reflect uncertainties in the timing of IDA contributions.

The close correspondence between actual IBRD lending levels and those projected one year in advance reflects in part the relative ease in forecasting the timing of loan commitments in light of the Bank's own project pipeline. However, looking over a longer period, the same close correspondence holds. Comparison of actual IBRD lending levels with those forecast by the Bank in January 1977 for the period FY 1977 to FY 1981 shows that actual lending levels were quite close to those forecast. Actual IBRD lending over the period FY 1979 to FY 1980 was within 0.3 percent of that originally forecast, and the maximum differential in any given year between actual lending and the amount projected in January 1977 was + 2.8 percent (in FY 1979).

The close correspondence between actual and projected IBRD levels in recent years tends to corroborate the anecdotal evidence cited in Forbes and elsewhere that the World Bank has, as a matter of policy, emphasized achievement of specific lending targets. However, the effect of this on the quality of World Bank loans is not immediately clear. The World Bank has quite strict standards for project appraisal and has a minimum rate of return standard for loans of 10 percent. There have, in fact, been very few World Bank loans with lower rates of return than this. (This may, of course, merely reflect the fact that the requirement of a 10 percent rate of return is not a binding constraint; the expected rate of return on World Bank loans, while remaining above 10 percent, could have fallen with the expansion in its lending.)

Such empirical evidence as is available does not indicate a clear decline in project quality. The World Bank's audit of the more than 500 projects evaluated in the past 5 years reveals that 94 percent of the investments turned out to be worthwhile. However, the audit covers only a fraction of the lending undertaken in recent years. The percentages of World Bank projects under supervision, i.e., projects still in the implementation stage, classified as having moderate problems did increase from 41 percent in 1976 to 52 percent in 1980. However, some of this increase may reflect greater strictness in application of the ratings to individual projects. The major problems, i.e., those of a type requiring immediate attention, actually fell during this period, from 134 to 124. This decline is even more precipitous when account is taken of the increase in the number of projects under supervision. As a percentage of the total number of projects under supervision, those having major problems fell from 14 percent in 1975 to 8 percent in 1980.

On the other hand, anecdotal information -- both solicited and unsoliticed -- from World Bank staff indicate that the emphasis placed on achieving lending targets has had a definite and adverse impact on loan quality. The frequency of these assertions, and the highly professional character of the sources, strongly suggest that the Bank needs to accord greater priority to assuring the high quality of all projects.

It is difficult to evaluate the assertion that the growth in World Bank lending has reduced the Bank's policy leverage in individual countries. A definitive evaluation would have to be based on what terms and conditions the World Bank sought in individual loans and those it actually obtained, information which is not available on any systematic basis.

However, a survey of individual MDB loans covering all the development banks plus IFAD for the last three years, analyzed by U.S. agencies, shows that 27 percent of the loans had problems of an economic or financial nature, many of which can be attributed to insufficient exercise of policy leverage by the lender. While IBRD/IDA lending is not broken out specifically, at least some of the problems are undoubtedly attributable to World Bank loans. It seems reasonable to conclude that the apparent emphasis in the World Bank on meeting lending targets has on balance eroded the Bank's ability to influence policies in recipient countries. While the World Bank has attempted to link its lending levels to policy changes in some cases, e.g., the rationalization of energy prices in Thailand, and has even suspended lending to some countries whose economic policies were sufficiently bad, in the Bank's view, to threaten their creditworthiness, these instances have been more the exception than the general rule. In Brazil, for example, the World Bank has had little success in its attempts to press the Brazilian government to establish positive real interest rates even though its lending to that country has increased substantially. The Bank has generally taken the view in such instances that rather than cutting off aid to a country entirely, it is better to keep its "foot in the door" and continue to press for policy changes. However, it is arguable that in the major developing countries, e.g., Mexico and Brazil, which rely primarily on private finance, the Bank's leverage must perforce be limited. The need to meet lending targets, which require sizable commitments to these countries, would tend to erode further the Bank's influence.

In conclusion, while available empirical evidence indicates otherwise, there are some indications that World Bank emphasis on lending targets has had an adverse impact on loan quality. It also appears that this emphasis on lending targets has on balance eroded the Bank's ability to encourage appropriate economic policies in recipient countries.

J. MDBs Lend in Excess of LDCs' Absorptive Capacities

The 1979 Investigations Staff Report claims that pressures to commit an increased amount of funds have strained the absorptive capacities of LDCs, making them more dependent on foreign aid. The 1979 Report of the House Appropriations Committee also raises the issue, citing a GAO study on Indonesia in this respect, and asks the Treasury Department to prepare reports on this issue for interagency consideration.

The critics' concern with absorptive capacity relates to the question of whether developing countries as a group or, more specifically, individual developing countries are receiving more foreign assistance from the MDBs and other donors than they can effectively use. While discussions with MDB staff indicate there may have been instances where World Bank programs exceeded the absorptive capacities of some small African countries, the evidence from a global point of view on this issue is not persuasive. MDB flows to developing countries as a group are relatively small, averaging, according to OECD data, only 6-7 percent of the total net financing provided to the LDCs in 1970s. Similarly, IBRD disbursements, the largest single source of MDB flows to individual developing countries, are typically only a small proportion of either GNP or imports. In addition, the MDBs, in their lending, try to take into account absorptive capacity constraints and, where necessary, relieve them through provision of technical assistance. This would be particularly important in low income countries where MDB flows generally account for a significant part of total external financing and which, because of their limited administrative and technical infrastructure, would be most vulnerable to absorptive capacity problems.

The evidence of an absorptive capacity constraint from the point of view of individual MDB projects is also not persuasive. The critical determinant of whether a developing country's absorptive capacity is being strained is the rate of return on investment; if absorptive capacity constraints are binding, then the effect should be to reduce the rate of return to near zero. However, a Treasury analysis of the rates of return on World Bank and ADB projects evaluated in the last three years shows that on average the actual economic rates of return at evaluation have been significantly above zero: on the order of 20-22 percent for the IBRD and IDA, and 15 percent for the ADB. It should be noted, though, that because of the lag in completion of the evaluation reports, these data do not take into account lending in the more recent years. However, World Bank data on projects under supervision show a decrease in recent years in the percentage of loans classified as having major problems. There has, though, been an increase in the percentage of projects reported as having some difficulties.

The World Bank's own evidence with respect to the performance of its program in Indonesia in comparison with those of other countries in the region does not fully support the charge of an absorptive capacity constraint in Indonesia. Evaluation of the 9 Indonesian projects to date shows an average rate of return of 25 percent, hardly indicative of an absorptive capacity constraint. In addition, analysis of various measures of project implementation indicates an Indonesian performance generally no worse than other countries in the region. The ratio of cumulative World Bank loan commitments to its cumulative disbursements in Indonesia steadily declined from FY 1974 to FY 1979 to a level slightly above that of the Philippines and well above that of Korea, Malaysia, and Thailand. Comparison of actual disbursements with those originally projected shows a lower percentage shortfall in FY 1977 for Indonesia than for Malaysia and Thailand that same year. While Indonesia's performance in this respect deteriorated in FY 1978 and FY 1979, it was still better than that of Malaysia and the Philippines in FY 1978. Similarly, the percentage of problem loans in Indonesia, while below that of Korea and the Philippines, was on par with that of Malaysia. In terms of delays in project effectiveness and completion, Indonesia's performance as of FY 1979 was actually better than that of other countries in the region. Thus, while constraints on manpower availability may have had some effect in Indonesia, it does not appear to have affected project implementation to a degree greater than that of at least some of the other countries in the region.

In conclusion, present MDB lending does not appear to be in excess of absorptive capacity constraints in developing countries. However, this issue is, by its very nature, country and sector specific and definitive conclusions are not possible. It cannot be excluded that absorptive capacity constraints may in fact exist for individual developing countries in individual sectors and that MDB lending may have in specific cases been in excess of the capacities of individual countries to put their funds to best use. Closer attention should be paid to the particular absorptive capacity constraints of the low income countries.

K. Structural Adjustment Lending Lacks Conditionality

The article in Forbes (May 26, 1980), entitled "Is the World Bank Biting Off More Than It Can Chew?" criticized the World Bank's structural adjustment lending program, alleging that these loans will be used to finance current account deficits in developing countries with little or no emphasis on conditionality. It also argued that by providing finance of this type, the World Bank is moving away from its project lending emphasis and into the area of balance of payments support more appropriate to the IMF. This criticism questions whether the World Bank will be willing to insist on a sufficient degree of conditionality on

these loans and whether, in any case, balance of payments support is an appropriate role for the World Bank.

The conditionality of structural adjustment loans (SALs) has been a basic U.S. concern from the beginning. At the time the program was under discussion, the U.S. position was that: SALs would have to include monitorable performance criteria with respect to policy changes and policy targets; non-project lending, including SALs, should, in keeping with past practice, not exceed 10 percent of total Bank commitments; and the Bank Board should be kept regularly and fully informed of the program's progress via timely reports from Bank management, with formal review to be scheduled at periodic intervals during the early stages of the program.

These principles are reflected in the Bank proposal on structural adjustment lending approved in May 1980. The paper stated that an SAL "would define the specific policy measures and institutional changes which the government has decided to carry out to achieve its objectives" and "specific items would be identified which would serve as the basis for the interim review (for the release of a second subsequent tranche), if such a review is called for." Regarding the 10 percent lending limit, the paper stated it was "expected that the volume of lending for structural adjustment might be between $600-800 million" for FY 1981; in fact it only reached $342 million or 2.8 percent of total commitments. Total non-project lending for FY 1981, including SALs, amounted to 8.2 percent of total commitments.

With respect to performance, of the eight SAL tranche release decisions thus far, two (Kenya and Bolivia) were delayed by 2-3 months, and one (the Philippines) by 6 months, in order to give the governments additional time in which to implement fully the agreement for tranche release. Three SAL tranche release decisions are currently being held up pending satisfactory action on outstanding issues. The second tranche for Senegal has been delayed since March 1981, for Guyana since May 1981, and for Malawi since November 1981. None of the tranches on two SALs to Turkey were delayed; during Board discussion on Turkey's second SAL the United States noted the remarkable progress made by Turkey under its first SAL, although part of this performance is attributable to the concurrent IMF stand-by program.

One major problem to date has been the Bolivian SAL program. Despite assurances by the Bolivian government regarding fulfillment of conditions governing release of the second (and final) tranche, the program has virtually collapsed because of lack of compliance. The United States also expressed serious doubts about the Guyana SAL and abstained in the Board on grounds that the SAL did not sufficiently address inadequacies in the public sector investment program and rigidities in price control mechanisms.

The SAL program is, in some sense, still in the experimental stage and needs to be monitored closely. However, as a preliminary judgment based on actions to date, the Bank appears to be making reasonable efforts to enforce the conditionality included in the loans (with the exception of Bolivia) and these conditions have been sufficiently strong and precise to secure positive results in at least one case, Turkey.

Given the structural and developmental situation of SAL recipients, the objective of attaining a sustainable deficit on current account can, in most cases, only be achieved in the medium-term. Thus, an important conditionality feature of the SAL program -- which is premised on a series of loans to a country over a 5-7 year period -- is the leverage the Bank can exert to secure policy changes called for in a recipient's first SAL by witholding approval for a second SAL. For example, in the Malawi SAL, the Bank has made it clear there will be no second SAL until a fundamental reorganization of a dominant private holding company along lines prescribed by the Bank is achieved. A final judgment on the effectiveness of a given SAL program will often have to await, not the policy changes specified in a single SAL, but the anticipated economic results sought over the medium-term.

With respect to the contention that the Bank is moving away from project lending, it is Bank policy, first enunciated by the Board in 1971 and reaffirmed in 1977 and 1980, that annual non-project lending must not exceed 10 percent of total annual commitments. As the numbers below indicate, non-project lending has fluctuated, but stayed within the Bank guideline. Any move to exceed the 10 percent limit would require Board approval.

Program Lending as a Share of Bank Group Commitments,

FY 1970-82

FY70	FY71	FY72	FY73	FY74
3.4	4.2	6.2	6.6	5.2
FY75	**FY76**	**FY77**	**FY78**	**FY79**
8.8	7.3	3.6	2.6	4.1
FY80	**FY81***	**FY82****		
4.8	8.2	10.0		

*Estimate
**Projection

Even if the SAL program has been operating relatively effectively, the question remains whether the objectives this program is designed to achieve are perhaps better reached through an expansion of the International Monetary Fund's activities, particularly its Extended Fund Facilities (EFF). One possible use for SALs, which would be distinct from EFFs, would be to facilitate countries' graduation out of the IBRD by providing fast disbursing assistance conditional upon policy prescriptions designed to remove those developmental constraints that have required the IBRD's presence.

L. There Are Anomalies in MDB Graduation Policies

The 1979 report of the House Appropriations Committee Surveys and Investigations Staff criticizes the MDBs for not having specific criteria governing graduation from hard loan windows. The report also states that the way the banks have applied their graduation from soft loan windows has resulted in a wide range of per capita income among countries still eligible. The report specifically cites the need for changes in access to the soft loan resources of the Inter-American Development Bank.

The IBRD has in fact an articulated policy on graduation from its hard loan window. The IBRD's principal criterion for determining eligibility is per capita income, although the country's creditworthiness and economic performance are also taken into account. Reaching $1,750 (1977 $) is supposed to trigger more rigorous analysis of the need for continued Bank assistance. (The Bank has not defined, though, what this more rigorous analysis entails.) However, there is no per capita income limit on eligibility and important questions concerning the timing, scale, and content of the phase-out lending program have been decided, when judged purely from an economic point of view, on an ad hoc and seemingly inconsistent basis.

Seven countries have graduated since the IBRD formulated its policy in 1973, nearly all with a per capita income well above the threshold level at the time they ceased borrowing from the Bank. Currently, four major (Yugoslavia, Portugal, Romania, and Argentina) and six minor borrowers are also above the threshold, with no evidence that the Bank is planning to phase out any within the next five years.

IDA's three major criteria for determining eligibility and the size of country allocations are poverty, lack of creditworthiness, and economic performance. Although there is no per capita income ceiling on eligibility, there is a strong presumption against further lending when per capita income is $680 (in 1979 $) or more. In some circumstances, IDA's criteria conflict; for example, improved economic performance is usually associated with improved creditworthiness, yet IDA policy calls for "rewarding" a country in the first instance with a higher allocation and, in the second instance, for "penalizing" the country with a lower

allocation. In the absence of guidelines for their use, inconsistencies in implementation are not surprising. Some countries (such as Ethiopia, Madagascar, Somalia, and Yemen (AR)) have relatively low levels of external indebtedness and poor economic performance, but a relatively high percentage of IDA resources in total flows from the Bank. Other countries, with relatively good performance and heavy external indebtedness (such as Thailand, Indonesia, and the Philippines) have relatively "hard" blends. Notwithstanding these anomalies, the end result has been the graduation of a number of countries and the concentration of IDA resources on the poorest countries. Some 22 countries have graduated, most with a per capita income well below the ceiling. Currently, 88 percent of new IDA commitments go to countries with per capita incomes below about $325 and this concentration is expected to rise to 90 percent for 1981-1985. The importance of economic performance, with lending linked to a rational economic framework, should of course be closely integrated into the poverty status/lack of creditworthiness eligibility criteria.

Inconsistencies in the World Bank's implementation of its graduation policy can result from a number of factors. First, the Bank's interest in maintaining a strong, well-diversified portfolio to keep its top credit rating in international capital markets creates a pressure to lend to more creditworthy countries, which usually have higher per capita incomes. In addition, absorptive capacity is an important consideration in the Bank's allocation of its resources. This tends to produce larger allocations to countries able to formulate sound projects and, again, these countries tend to have higher per capita incomes and more sophisticated institutions. The more advanced developing countries are eager to prolong their status as Bank borrowers as long as possible, not only because the terms of Bank loans are more favorable than those obtained in international capital markets, but also because the Bank's continued presence could be useful in gaining and expanding their access to non-official sources of capital. The political interests of donors intervene as well. For example, Indonesia, Thailand, and the Philippines graduated from IDA in 1974, but were readmitted in 1978, in large part at the urging of the United States despite the fact that the economic case for their readmission at that time was weak.

Implementation of the World Bank's policies could undoubtedly be tightened to eliminate some of the apparent inconsistencies and to improve the process of country planning. However, the question of whether the United States should make recommendations for doing so should be considered in the context of our broader foreign policy objectives. The economic benefits (better allocation of scarce developmental resources) of a more consistent implementation would have to be balanced against the political costs, since many of the potential graduates are countries that the United States, for a variety of geopolitical reasons, might wish to have continued access to the Bank and IDA.

In all the regional MDBs there are policies which distinguish among borrowers as to their access to hard and soft loan resources. The IDB, while it has no formal policy governing graduation, has, in the context of replenishments, limited the access of the more wealthy Latin American countries to hard loan resources. In the ADB, some of the wealthier borrowers have agreed to limit their access to only token amounts of hard loan resources. Graduation is not an issue for the AFDB in light of the low level of per capita income in Africa and the fact that Algeria, Libya, and Nigeria do not borrow from the Bank.

Among the regional MDBs there is substantial variation in the range of per capita incomes of the countries eligible for "soft" loans; this reflects the fact that the average per capita income within the Latin American region, for example, is substantially higher than it is within the Asian or African regions. In the case of the regionals, the question of access to soft funds is usually negotiated in the context of each replenishment. Countries with low per capita incomes are generally recognized by the banks as having, a priori, a greater claim on "soft" funds. In the IDB, the more advanced regional members have increased the share of convertible currencies in their contribution to the concessional Fund for Special Operations, and have voluntarily agreed not to borrow convertible currencies from the FSO. These improvements in cost-sharing and allocation of concessional resources resulted largely from the exercise of U.S. influence in the 1979 negotiations of the latest replenishment (1979-82). If the United States is to push harder in the area of graduation, it will be necessary to ensure consistency in policies as between the World Bank and the regional MDBs.

M. Coordination is Inadequate Among the MDBs and Bilateral Aid Programs

The 1979 Investigators' Report criticizes the MDBs for a lack of coordination among themselves and with bilateral donor agencies. This lack of coordination is particularly acute at the project level. The lack of coordination has resulted in duplication of efforts by the MDBs and other donors and a waste of funds.

The MDBs do, in fact, make efforts to coordinate their activities so as to minimize duplication. At the individual country level, the MDBs rely largely on approximately twenty-four consultative group mechanisms to achieve coordinated programs in the leading foreign aid recipients. These consultative groups, for the most part chaired by the World Bank, meet periodically to try to dovetail the assistance plans of the donors with the development plan of the country and to examine the current array of policy measures in place or projected. In practice, though, there is little real coordination which results from these groups. They mainly serve as a mechanism for the exchange of information and offer an opportunity to coordinate efforts to improve economic performance. However, the ability of the major

donors to achieve an overall consensus on policy direction in the recipient country is hampered by their reluctance to "gang up" on the country.

The individual MDBs do remain in contact with each other and there is exchange of information among them. The World Bank and the IDB have mounted joint missions, and the World Bank has encouraged the small Pacific island countries to rely in the first instance on the ADB for finance, with the World Bank willing to co-finance projects in these countries on the basis of the ADB's appraisal. In addition, the MDBs all regularly co-finance projects with each other and with other official donors. Co-financing with official aid donors by the World Bank in FY 1975-80 averaged $1.62 billion per annum.

With regard to coordination among the MDBs, the United States has encouraged frequent formal and informal exchanges among their staffs. The fact remains, though, that occasionally competition for "choice" projects in certain countries has been present in the activities of the banks. The practice of a borrowing country "playing-off" one donor against another is not unheard of. This is easier when donors seek to fulfill arbitrary lending targets.

There can be no doubt that coordination at the individual project level could be improved. However, improvement on this score needs to be weighed against costs. Resident missions in borrowing countries, as currently employed by the IDB, may prove to be necessary if coordination is to be most effective. However, opinion on the efficacy of such missions remains mixed, particularly in relation to their cost. The ADB is currently studying potential benefits and costs of resident missions and has decided to try out on an experimental basis a resident mission in Bangladesh.

At the project level, while the MDBs follow the same broad approach to project appraisal, differences in application of criteria, e.g., evaluation of shadow prices, and institutional biases do exist. Thus, it is possible for one MDB to fund a project which might not be funded by another.

N. MDB Lending Terms Are Inappropriate

This criticism was raised by Wilson Schmidt in an article in Policy Review (Fall of 1979) entitled "Rethinking the Multilateral Development Banks". In this article, Dr. Schmidt proposed that the terms on which MDB resources are provided should be related to the relative rates of return on investment in donor and recipient countries. When the rate of return in donor countries exceeds that in the recipient country, MDB resources should be provided as loans on hard terms; when the rate of return in donor countries exceeds that of the recipient countries, annual grants, in an amount equal to the annual return on investment in the recipient country, should

be provided. These annual grants would be provided in lieu of a concessional loan for purposes of investment in the recipient country. Such an approach would ensure the most efficient allocation of investment resources, maximize global economic returns, and minimize the cost to donors of providing assistance through the MDBs. By transferring capital from low return to high return countries, the global pie would be increased and by providing annual grants to low return countries, rather than concessional loans, the low return countries would reap at least some of the benefits from investment in their countries. As part of this proposal, there would be annual dividends provided to shareholders; this aspect of the proposal is dealt with elsewhere in this appendix.

The approach outlined by Dr. Schmidt, while sensible from a purely theoretical point of view, raises a number of difficulties of a practical nature. To begin with there is the difficulty of actually calculating rates of return on investment for individual countries. In principle, this would involve the calculation of the value of a country's stock of capital, relating this stock to a marginal efficiency of capital schedule, and deriving the rate of return on the marginal unit of capital. The actual calculation of a stock of capital in developed countries gives rise to difficulties of a conceptual and technical nature, as capital is not perfectly homogenous; the calculation of a unique capital stock for a developing country is even more difficult in light of the price distortions which exist in these countries.

The determination of a marginal efficiency of capital schedule poses major difficulties as well since it presumes a high degree of knowledge about investment opportunities in each country and assumes, implicitly, that investment resources are appropriately allocated. In any case, the assumption that such a schedule is static, particularly for a developing country, is likely to be erroneous. One aspect of economic development is in effect to raise the marginal efficiency of capital schedule by overcoming institutional constraints. The adoption of appropriate government policies in the recipient country can play an important role in this respect. All this points to the difficulty of arriving at a single rate of return attributable to individual countries as a consistent guide to MDB decision-making.

There have been some attempts made to calculate rates of return for a few developed countries. (See, for example, the NBER Working Paper by Bruno and Sachs entitled, "Macroeconomic Adjustment with Import Price Shocks: Real and Monetary Aspects".) Nothing comparable has been attempted, though, for developing countries.

The approach also does not take into account differential creditworthiness of individual countries. Even though the rate of return on investment in a country may be relatively high, the availability of foreign exchange and the country's immediate prospects for acquiring it may militate against providing a loan on hard terms.

It is in at least partial recognition of this fact that private banks are reluctant to lend to countries, like Zaire, which possess abundant natural resources and whose rate of return on investment is at least potentially high.

Thus, in practice, MDBs confront an array of rates of return for individual projects from countries of differential creditworthiness in allocating their scarce developmental resources. In reality, the second best solution employed by the MDBs, i.e., insistance on a rate of return standard (10 percent) for individual projects and allocation of hard and concessional resources on the basis of countries' creditworthiness, would appear to be the only one feasible.

It is important to note that Wilson Schmidt's proposal would not necessarily involve any budgetary savings. For all practical purpose, IDA resources are very close to grants on their current terms, and implementation of this proposal would require either annual budgetary appropriations by donor countries running into the indefinite future or the establishment by donors of a trust fund-type arrangement, the earnings on which would be used to fund the annual grants. In either case, the amounts of finance required could be substantial and would not necessarily be less than current contributions.

The political likelihood in the United States of either an annual appropriation running into the distant future or payments into a trust fund established for the developing countries would not appear to be terribly large. This then raises the question of whether such an approach would be acceptable to the developing countries themselves. Even assuming the developing countries are in fact indifferent between additional investment in their countries and a guaranteed stream of payments equivalent to the returns on this investment, as a practical matter donors are unlikely to be able to provide guarantees for a future stream of payments. Thus, the developing countries will prefer certainty, i.e., the investment, to an uncertain stream of payments of equivalent value.

Finally, it must be noted that the optics of this approach raise certain difficulties. In effect, this approach states implicitly that for some countries economic development is simply not cost-effective. For these countries an international income transfer would be provided, but there would be no attempt to improve the basic economic circumstances in these countries so that they could eventually be self-sustaining. Even assuming this fundamental premise is correct, such an approach implicitly disavows the notion that economic development is something to be sought in all countries. The ultimate conclusion of this approach would be to have the low rate of return countries invest all of their scarce savings in high return countries and simply live off their investments.

O. Growth In The World Bank's Earnings Has Lagged Behind Growth In Its Assets

A Barrons editorial (June 18, 1980) on Robert McNamara's presidency of the World Bank, entitled, "Blood and Treasure," criticizes the poor performance of the World Bank in generating net income. It states that the World Bank's earnings have lagged far behind the growth in its assets. Since 1970, compared to the ten-fold expansion in assets, net income has barely doubled. This editorial casts doubt on the financial viability of the Bank, particularly when coupled with the additional observation that over 11 percent of the World Bank's projects were suffering moderate to major difficulties and a quotation from McNamara to the effect that "If I had wanted to run a mere bank, I would have been a banker."

In evaluating this criticism, it must be borne in mind that the hard loan windows of the development banks differ from commercial bank operations in their dual objectives: promoting sound economic development, and operating in a manner designed to encourage confidence in their financial viability and guarantee their continued access to capital markets on feasible terms. Profit maximization has not been an objective per se in the World Bank. Nevertheless, the question remains as to whether the World Bank's net earnings performance has been satisfactory.

The World Bank, like the IDB and the ADB, has operated profitably in every year of its existence. Between FY 1970 and FY 1976, Bank net income remained essentially flat, fluctuating around $200 million per year. Since 1976, net income has risen steadily and fairly dramatically to a level of $588 million in FY 1980 and $623 million in FY 1981. During the same eleven year period gross assets have increased from $12.64 billion to $68.13 billion and usable equity (paid-in capital and retained earnings) from $2.7 billion to $5.36 billion.

Accordingly, while the criticism of lack of growth in World Bank earnings had some validity in the early to the mid-1970s, a new lending rate policy, adopted in 1976 at the urging of U.S. Treasury Secretary William Simon, has led to a significant upgrading of the Bank's profitability, and all financial indicators have stabilized or improved in the meantime. Over the course of the decade, earnings tripled (not doubled as stated in the editorial) while gross assets rose five-fold (rather than ten-fold as stated in Barrons). During the last five years, however, following the change in interest rate policy, earnings tripled while gross assets only doubled.

However, a comparison of net income with gross assets is not a good measure of World Bank performance, as the latter amount includes a large volume of undisbursed loans ($28 billion in FY

1981), making the return on gross assets appear artificially small. A more appropriate measure of profitability is the return on equity, i.e., paid-in capital plus reserves. After a 6 year period during which return on equity fell from 6.8 percent in 1970 to 5.1 percent in 1976, it has since risen to an estimated 9.6 percent in FY 1981. In the same period, the Bank's average borrowing cost, covering all its outstanding borrowings, has risen from 5.4 percent to 7.1 percent, and its most recent 12 month average borrowing cost has risen from around 6 percent to 9.1 percent. This latter increase has been minimized by borrowing largely in currencies other than the dollar. Thus, the Bank's return on its equity has been above both its average and marginal cost of funds.

The Bank's recent profitability has stood it in good stead in funding its operations in world capital markets. IBRD bonds are rated AAA and the yield spread between World Bank and U.S. Treasury Securities has remained stable in percentage terms in recent years, despite a marked lowering of the quality of coverage of funded debt by callable capital. (In 1970, funded debt was only 50 percent of U.S. subscriptions to callable capital alone, whereas in 1981, funded debt was some 400 percent of U.S. subscriptions and exceeded the callable capital of all DAC and OPEC members by a considerable margin.) So long as the rate of return on equity is above the weighted inflation rate in the countries from which it is borrowing and above its marginal borrowing costs, then the Bank is showing a real return, however modest, thereby avoiding decapitalization and maintaining its financial ratios.

If the gearing ratio of the Bank were to be changed, and the Bank had to rely exclusively on capital markets to finance its operations, then the quality of its loan portfolio and its earnings and reserves would become even more important. Such a decision would necessitate the Bank having to set higher net income and return on equity targets in the future, requiring that the Bank's lending rate be set at a higher spread over borrowing costs than at present.

On a historical basis, therefore, the Bank's net income has been broadly adequate in recent years. However, recent changes in capital and exchange markets have caused net assets to decline in U.S. dollar terms and increased borrowing costs leading to some concern about net income targets in the mid-1980s. The Bank -- which establishes lending rates at the time of loan commitments but must borrow to fund actual disbursements -- is particularly vulnerable to a rising interest rate scenario, given the lag between commitments and disbursements and the refunding risk, faced by all intermediaries, caused by the financial mismatch between the average maturities of assets and liabilities. The current situation is receiving close attention in the Bank.

P. MDB Members Lack Control Over The Institutions.

This criticism has been raised in the Investigations Staff Report. The Report made a number of criticisms with respect to the relationship between the executive directors (EDs) and the MDBs' managements and the extent to which the EDs actually exercised effective control over the institutions. Among the specific charges made were that the EDs did not have access to many documents in the banks and that the MDBs are run by their managements with the EDs playing only a minor role in the direction of the banks. The article in the June 16, 1980, edition of Barron's entitled "Blood and Treasure" makes a similar charge, stating that the executive directors are figureheads who, denied access to many sensitive documents, rubber-stamp whatever the management recommends.

This criticism is misplaced in that the EDs do, in fact, routinely have access to many MDB documents and can obtain any document on request. By common agreement though, some documents of a particularly sensitive nature are not routinely made available to the EDs because they could place individual Board members in a conflict of interest situation. For example, distribution of procurement evaluation documents may pit one ED against another and hamper the effectiveness of the institution. In addition, a large number of internal working papers and documents relating to the MDBs' day to day operations are not routinely distributed to the Board in order to minimize the amount of paperwork the Board has to deal with.

The role of the EDs in the management of the banks is most critical with respect to the establishment of MDB policy. Such major policy issues as the overall MDB lending levels, aspects of their financial operations, and sectoral lending emphasis are all issues in which the Boards both shape and determine MDB policy. This shaping can occur prior to management's submission of any proposal or as a result of the Board discussion.

The charge that EDs have little influence in the MDBs is usually cast in terms of their impact on individual projects. In this respect, the fact that in all the MDBs, except the IDB, the loan agreement with a country is negotiated prior to Board action is usually cited as an example of the Board's limited influence, as is the fact that no loan agreement, once presented to an MDB Board, has ever been turned down.

While it is true that the World Bank never formally turned down a proposed project, this is too simplistic a measure of the Boards' actual or potential influence 1/. As noted above, the EDs do determine the overall bank lending policy on the basis of which the individual projects are, in principle, developed. Second, EDs

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1/ This year the United States used its veto in the FSO for the first time to prevent two projects from going forward.

can act in advance to prevent certain loans from coming before the Board. Finally, it is by no means clear that having the Boards play an active role with respect to individual loans necessarily leads to better results from our point of view. In the IDB, for example, where the Board can play an active role in the establishment of terms and conditions for individual loans, it has used this discretionary authority at times to weaken the terms proposed by Management.

In conclusion, all the Boards attempt to operate on the basis of consensus; the actual casting of votes is relatively rare. The influence of the EDs is determinative with respect to overall bank policies, and individual Board members can have a clear impact in this area. The impact of the Board members on individual loans is considerably more limited.

Q. <u>There Is Inadequate Loan Preparation And Supervision In the MDBs</u>

The volume of MDB lending has been criticized as leading to inadequate loan preparation and supervision. The World Bank, in particular, has been singled out for criticism in this regard as being more concerned about the quantity of loans than their quality; it is alleged that the staff were being pressured to meet high loan quotas and, as a result, the World Bank's policy advice to borrowers is weakened. A <u>Barron's</u> editorial also claims that in one recent year, 11 to 50 percent of the Bank's projects had been found to have problems ranging from moderate to severe. (The general question of loan quality and bank leverage has been dealt with earlier; the focus in this criticism is on the adequacy of MDB loan preparation and supervision procedures.)

Almost all of the loans approved by the MDBs are for specific projects to finance, for example, schools, crop production, farm to market roads, or fertilizer plants. While no two projects are identical, each proposal passes through the same cycle -- identification, preparation/appraisal, supervision and evaluation -- which, with some minor variations, is followed by all of the MDBs. This cycle and the methods utilized for testing proposals are designed to prevent the approval of questionable projects. The documentation and testing of proposals by the MDBs, particularly the World Bank, are generally more extensive and time consuming (with, on average, two years being spent before the loan commitment is made) than those financed by AID, the Export-Import Bank, or private commercial banks; but some of the differences are attributable to the types of projects financed. The cycle is described in more detail below.

The first phase of the cycle, identification, is concerned with locating suitable projects for MDB financing which fit into

the economic and social development program of the member country.2/ As a matter of policy the MDBs have encouraged their borrowers to develop their own capabilities and to establish a capacity for identifying their own projects. Nevertheless, MDB economic and sector analyses provide an important complement to borrower efforts to find suitable projects for financing. Once identified, a project is then added to the MDBs' "pipeline" and enters an extensive period -- usually one to two years -- of preparation and appraisal.

Formal responsibility for project preparation rests with the borrowers, but very often they receive technical assistance from the MDBs or from the UNDP or bilateral aid programs. The MDBs themselves have found that active participation in the process is beneficial from the standpoint of bringing proposals into conformity with their requirements and standards as quickly as possible.

The work of project preparation includes consideration of the technical, institutional, economic, and financial elements necessary to achieve the proposal's objectives. A major consideration at this early stage is the identification and selection of the technical and institutional alternatives for achieving the proposal's objectives. Similarly, a preliminary assessment is made of the project's economic and financial viability by identifying outputs, potential markets, operating costs, etc., and calculating (on a preliminary basis) the estimated rate of return on the project.

Once project preparation is complete, the appraisal of the project is initiated. The appraisal is the sole responsibility of the MDB. It consists of the review and evaluation by bank staff of the same considerations as during project preparation, i.e., the technical, institutional, economic, and financial viability of the project. This is an important stage in the project cycle because it is the MDB's own comprehensive review of the proposal and it also lays the foundation for the project's subsequent implementation and evaluation.

The first consideration of the appraisal is the technical review of the design, engineering, and other physical standards of the project, as well as a review of the accompanying cost estimates to determine their accuracy within acceptable margins and whether the allowances for contingencies and expected price increases are adequate. The second important consideration is the critique of the implementing agent and, when appropriate,

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2/ The government must agree to the project and be willing to guarantee the MDB's loan; the only exceptions are loans from the International Finance Corporation (IFC) which, while they are not permitted to have a government guarantee, must still be acquiesced in by the host government on a "no objections basis".

recommendations for administrative or procedural changes that are necessary. Experience has demonstrated that insufficient attention to the implementor often leads to problems during project implementation. Finally, the economic and financial appraisals are made to measure the quantifiable benefits and costs of the project throughout its life in order to determine the economic and financial rates of return. The economic appraisal measures the real benefits and costs of the proposal to the economy; whereas, the financial appraisal measures the flow of funds into and out of the project. The financial review, when appropriate, also considers the need to adjust prices for products or services by the implementing agency and the project's ability to meet all its financial obligations, including debt service. The financial review also includes an assessment of whether there are sufficient funds from the government or other non-MDB sources, including project-generated funds, to cover all the costs of the project.

Once the appraisal is complete, a report is prepared by the MDB staff setting forth the findings and, if the standards are met (e.g., a minimum 10 percent economic rate of return), a positive recommendation for a loan is made. The findings are then reviewed by the management and if approved, the report becomes the basis for conducting negotiations with the borrower for a loan. If the negotiations are successful a loan document is then drafted and presented to the MDB's Board of Directors for approval.

Once a loan is approved by the Board, its implementation is the responsibility of the borrower, with whatever assistance has been agreed on from the Bank in the form of studies, staff training, expatriate managers, or consultants. However, all of the MDBs insist on supervising their projects directly and consider this to be relatively important. Project supervision is also a major consumer of staff resources, as more than 2,500 projects are now being carried out and require supervision. In many respects, supervision is a form of technical assistance because of the advice and guidance provided on operational problems that arise during implementation and, as such, is an important part of the lending process.

Common to all loan agreements is the requirement that borrowers submit regular progress reports covering the physical execution of the project, its cost and financial status, and information on the evolution of the project's benefits. These reports are an important complement to actual MDB on-site supervision and are considered to be one source for identifying problems that arise. According to the World Bank, between 40 to 50 percent of their projects experience of some kind of problem during implementation; however, projects with serious problems, i.e., those of such a magnitude and type requiring immediate attention, range from 8 to 10 percent on an annual basis.

The main purpose of MDB supervision is to ensure that projects achieve their stated objectives in terms of increased output, foreign exchange earnings, etc. An equally important objective of supervision for both the Banks and borrowers is the experience gained for "feedback" into the design and preparation of new projects to improve existing policies and procedures. Similarly, the monitoring of the procurement of goods and services financed by the loan is also important. Procurement is carried out in accordance with each Bank's guidelines, but it is the borrower, not the MDB, that is responsible for preparing the specifications, tender documents, and evaluating the bids. But the MDB must assure itself the borrower is acting properly and that the guidelines are being observed.

R. MDB Evaluation Systems Are Deficient

The 1979 report of the Surveys and Investigations Staff of the House Appropriations Subcommittee on Foreign Operations criticizes MDB auditing and evaluation procedures, citing, among other things: lack of a central office, detached from operating responsibility, to investigate and resolve alleged or suspected irregularities; inadequacies in the conduct of broad program audits or department and operational activities; and problems of productivity. The IDB, in particular, is criticized in some detail on this score.

The specific criticisms raised in the report have all been addressed by the U.S. Treasury Department and have, in some cases, already been dealt with by the institutions. Treasury gave a detailed response in the MDB Congressional Oversight Hearings of April 1979; specific inaccuracies were challenged while valid criticisms were acknowledged in the context of what Treasury would do or was doing to ameliorate the situation. Since then there have been changes and improvements in audit and evaluation systems of the IBRD, ADB, and IDB.

One such area is in audit committees. The IBRD Joint Audit Committee, on which the USED is a member, is of long-standing; it was increased from six to eight board members in November 1980. In June 1977, the ADB Executive Board established an Audit Committee composed of three Board members. Each year since its inception the Committee has become increasingly involved in reviewing operations. Both these committees have considerable scope, reviewing annual work programs and monitoring the activities of the independent evaluation systems and internal audit departments. They do a credible job of ensuring that alleged or suspected irregularities are dealt with fully and honestly and, in general, of monitoring audit and evaluation systems. Although it is still too early to tell how much scope it will have, the IDB recently established the Committee on Review and Evaluation of the Board of Executive Directors as liaison between the Board and the External Review and Evaluation Office (which implements the programs of independent assessments, and reports directly to the Board of Executive Directors).

Improvements have also occurred in the functioning of the evaluation systems themselves. The quality of the IBRD's Annual Review of Project Performance Audit Reports (PPARS) appears to have progressed steadily. PPARS are prepared on all projects; about 30 percent on the basis of abbreviated audits and 70 percent on the basis of full audits. There have been some indications that the broad coverage of the audits may detract from the quality of individual project audits. If this is substantiated, the United States may wish to recommend more selective but more thorough evaluations. One area where improvement could be made is in tracking management's response to the entire array of evaluation reports. The Director-General of the Operations Evaluation Department (OED) has informed us that efforts are now underway in this regard.

The performance of the separate Post-Evaluation Office (PEO), established by the ADB Board in August 1978, has improved, particularly with respect to the number of reports, as the staffing inadequacies normally associated with a new institution have eased. Broader based studies of sectors and issues emerging from PPARS are expected to start with the 1982 PEO work program (such studies had originally been projected for 1981 but were deferred at the request of the Audit Committee), and the Bank is establishing a system of management participation in following up on recommendations contained in PEO reports. These measures are useful in strengthening the evaluation system overall.

In general, the IDB has been the weakest of the three MDBs with respect to evaluation processes. In 1979, the IDB reorganized its evaluation process. The Bank alone among the multilateral institutions now has a dual system carried out by two separate entities, both independent of each other and of the operating units of the Bank. The internal evaluation system differs from that of the World Bank in that it contains a permanent feed-back mechanism which brings the results of past and ongoing evaluations to bear upon the formulation and execution of new projects, with the internal evaluation office participating directly in the programming process as well as in the consideration of all new lending proposals presented to the Loan Committee. The external evaluation office, which reports directly to the Board of Executive Directors, also monitors the utilization of evaluation results, as well as the implementation of its own recommendations, at both Management and Board levels. This unique dual system is undergoing further adaptation to become more systematic, effective January 1, 1982, and will bear watching. One specific change which could strengthen the system significantly would be to involve the External Review and Evaluation Office directly in selected evaluations of Bank projects.

(The AFDB continues to work on developing a project post-evaluation system. Since there are very few completed projects, the Bank is examining pilot projects in order to develop its methodology.)

The changes described above go a long way to address the shortcomings outlined in the 1979 Investigations Staff Report.

S. MDB Staff are Overpaid

This has been a perennial Congressional concern, highlighted in both the Senate and House Appropriations Sub-Committee reports. The House Appropriations Committee Investigations staff also examined the issue in some detail. Undoubtedly a prime motivator of the criticism is the fact that U.S. Government salaries have been "capped" off and on since 1968, whereas staff at international organizations at all levels have received regular adjustments. As a result, salaries for senior level U.S. government personnel are now more than 40 percent lower than they would have been had they received the same salary adjustments granted lower-level U.S. civil servants. Attention has been brought by critics to the number and percentage of MDB staff earning salaries greater than those earned in Congress and the Administration.

In considering this criticism, it must be borne in mind that the MDBs are international organizations, required by their Articles to have a multinational staff. Accordingly, their compensation practices must be broadly accepted by the majority of member countries, particularly by other high paying countries in which the organization also hopes to recruit staff. Other countries now have public sectors in which the compensation is frequently higher than that paid in the U.S. public sector, particularly at the senior levels. Furthermore, the MDBs cannot be completely divorced from comparisons with other international organizations (the UN System, OECD, etc.), with which they also compete for staff and which generally pay as well or better than the MDBs.

In order to develop a rational, comprehensible, and workable framework for determining future levels of IMF/IBRD compensation, an international committee (the "Kafka Committee") was established at the IMF/IBRD to examine the issue de novo. This Committee was aided in its deliberations by studies from several of the leading U.S. consulting firms specializing in compensation issues.

As a result of the Committee's recommendations, in May 1979, the IMF/IBRD Boards adopted policies to establish future organizational compensation by reference to that paid in the U.S. public and private sectors, so long as the U.S. market was fully competitive internationally. Pay caps and other political considerations in the case of U.S. Government comparators are ignored for purposes of identifying the relevant comparison levels.

Under the new methodology, salaries will continue to be paid non-U.S. citizens net of tax; U.S. citizens will receive the net of tax compensation paid non-U.S. staff, plus a tax allowance which together total the gross compensation paid in the comparator organizations. The tax allowance is calculated on the assumption that U.S. staff have the same average deductions taken by Americans at that particular income level, as determined from IRS data. Under the previous system, the assumption used was that U.S. staff used the standard deduction, which resulted in their general over-compensation.

As a result of this methodology, the gross salaries paid U.S. citizens are now in line with those paid in the comparator organizations; such gross salaries had been too high under the old system. Consequently, Americans joining the IMF/IBRD after January 1, 1981, received gross salaries approximately 15 percent less than they would have under the former system.

By basing compensation on that paid in the U.S. job market, the recommended new system is designed to de-politicize the issue. In order to implement the system properly, exhaustive studies were undertaken of the compensation paid in comparator organizations in the United States, France and Germany. The Boards acted upon these studies in June 1981, arriving at conclusions that stretched the Kafka Committee's recommendations to the limit, and established compensation levels in the IMF/IBRD several percentage points above those we believed to be warranted. In addition, the IMF methodology for the determination of future adjustment was accepted by the IBRD Board of Directors to maintain parallelism between Bank and Fund salaries. This means that compensation adjustments will be based on a comparison of direct compensation as opposed to total compensation. This practice, if followed, could cause future adjustments to be higher than the United States believes would be justified under the Kafka formula. After the recent adjustments, the average net salary of professional staff in the IBRD is now approximately $46,600 -- equivalent to $73,000 on a gross equivalent basis -- which would place staff around the 75th percentile of the chosen U.S. private sector comparators.

The IDB salary structure almost exactly parallels that of the IBRD. In the case of the ADB, the prime problem has been that the compensation package was too low to attract qualified U.S. staff. This was caused largely by U.S. tax laws as well as, in part, the unique housing situation in Manila. However, changes in ADB compensation over the last two years, together with actions taken by the U.S. Treasury Department to fund a salary equalization program and the changes in U.S. tax laws for Americans working abroad, have enabled the ADB to recruit additional Americans. Further changes in ADB compensation are expected to bring ADB compensation more in line with the other MDBs.

In conclusion, therefore, substantial progress has been made in dealing with the compensation question at the IMF/IBRD on a satisfactory basis and meeting criticisms of this issue. However, recent actions could cause problems in the future. The United States, which is the only strong, consistent voice for moderation on the compensation issue, will have to fight hard to assure that the progress made is not lost.

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