BETWEEN TWO WORLDS: THE WORLD BANK'S NEXT DECADE

Richard E. Feinberg and contributors

Gerald K. Helleiner, Joan M. Nelson, Sheldon Annis, John F.H. Purcell, Michelle B. Miller, Charles R. Blitzer, Howard Pack

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Foreword

This year marks the beginning of a new stage in the work of the World Bank group—the International Bank for Reconstruction and Development, the International Development Association, and the International Finance Corporation. Established in the aftermath of World War II to finance the rebuilding of war-torn Europe, the Bank, over the ensuing decades, has evolved into the international system's most important development institution.

A 'new era' at the World Bank is signaled by two separate events. First, the Bank's member governments have assigned it the lead role in dealing with the debt crisis that has preoccupied policy makers in both developed and developing countries since 1982. Developing-country debt now totals nearly $1 trillion. By mid-1985, slow growth in the developing countries was damaging the economies and interests of both the Third World and the industrial nations. In response, U.S. Treasury Secretary James Baker proposed a series of initiatives (which quickly became known as the "Baker plan") to restore growth as the end goal of dealing with the debt of Third World countries; his proposal singled out the World Bank (along with the Inter-American Development Bank) for the prime role in guiding the process of adjustment with growth in the major debtor countries.

At the same time, the World Bank's president, A.W. Clausen, having guided the Bank through one of the most difficult periods in its history, announced that he would step down when his term ended in mid-1986. His successor, the distinguished former U.S. Congressman Barber Conable, will become the sixth president the World Bank has had since it was established. Thus, the Bank will be under new leadership precisely when it has been given an unprecedentedly important role in the management of a global economy caught in the throes of the challenging crisis of development and debt.

The Bank's new charge and leadership prompted the Overseas Development Council—which has long been concerned with the Bank's role in international development—to plan this special volume in its U.S.-Third World Policy Perspectives series. *Between Two Worlds: The World Bank's Next Decade* is designed to analyze the policy issues that the Bank's new president will encounter when he takes office in July 1986; hence the open-letter format of our recommendations. It is of course our intent to focus much wider attention on the challenges facing the Bank, its member states, and its new leadership as they address the difficult problems of restoring growth and assuring its more equitable distribution to the three-quarters of the world's people living in the developing world.

The Bank clearly does not take on this task alone, but its role—among the other multilateral and national agencies—is unique and critical. The issues before the Bank are of considerable direct importance to the Overseas Development Council's prime audience: decision makers in the public and private sectors in the United States. It was a U.S. initiative that led to the Bank's current leadership position, with all of the attendant expectations. It will be important, therefore, for both Congress and the executive branch to offer full political and financial support for the Bank in the period ahead.

This Policy Perspectives was written and produced in a very short period of time. In the course of its preparation, a large number of people commented on drafts of the policy papers and participated in discussions of the main conclusions. In addition, the authors conducted extensive interviews with World Bank officials, and had access to a wide range of Bank documents. As is usual, the views expressed in this volume—some of which are of course controversial—are those of the authors and do not necessarily represent the views of the ODC as an organization or of the individual officers of its Board, Council, or staff. The analyses, views, and recommendations contained herein are presented in the hope of making an important contribution to the serious consideration and debate of issues that merit policy makers' attention.

On behalf of the Council, I would like to extend special thanks to the Rockefeller Foundation, and particularly to John Stremlau and Catherine Gwin, for the grant that enabled us to take on the preparation of this volume—and for having encouraged its preparation in the first place. The continuing program support of the Ford, William and Flora Hewlett, and Rockefeller Foundations for the work of the Overseas Development Council has also contributed to this special project.

John W. Sewell, *President*
Overseas Development Council

June 1986

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Between Two Worlds:
The World Bank's Next Decade

Overview

An Open Letter to the World Bank's New President

Richard E. Feinberg

You have been appointed to what one of your predecessors, Robert McNamara, calls the "best job in the world." As the premier development finance institution, the World Bank houses an extraordinary collection of first-class economists and has the clout associated with an annual loan level of over $15 billion. You inherit an agency that has earned a reputation in industrial countries for professional competency and financial soundness, and that is respected in the Third World for its fairness and good will.

You take charge when the World Bank is being thrust into an unprecedented, and potentially very powerful, global role. As a result of the twin crises of development and debt, the Bank finds new opportunities for influence in Third World countries and on international capital markets. Desperate for help, debtors and creditors alike are willing to devolve a portion of previously guarded management prerogatives to a capable international agency, and the Bank alone is fit for the task. In the midst of a development crisis of historic proportions, a crisis both material and spiritual that has devastated national economies and the development models upon which they were constructed, the Bank has been charged by industrial-country governments and creditors with helping the Third World combine wrenching reforms in basic economic structures with renewed growth. Simultaneously, the Bank has been assigned the enormous job of reinvigorating badly shaken international capital markets by working with debtor nations to repair their economies and by providing new incentives to lenders.

Up to now, the Bank's power over this agenda has been more potential than realized. The Bank needs a strong guiding hand to restructure its relations with the International Monetary Fund, private capital markets, and the Reagan administration in ways that recognize both the constraints on Bank actions and the Bank's capacity for global leadership. A redefinition of Bank-Fund relations is required to correct for the relative decline in Bank stature occasioned by the Fund's more assertive response to the debt crisis. The scope and nature of Bank relations with international lenders and investors are evolving rapidly and call for innovative and at times forceful Bank initiatives. And finally, as the Bank positions itself for new influence, the smoothing over of past tensions with the White House will be an especially delicate task.

Many Bank staff are in an anxious and defensive mood. They feel that the Reagan administration, by initially labeling the Bank anti-capitalist, impeded it from responding more effectively to Third World needs, only to criticize the Bank recently for not doing more to manage the debt crisis. The new call for Bank leadership in the international economy has raised fears that the institution's independence and integrity will be subordinated to the interests of the commercial banks and the U.S. Treasury. Many of the Bank's four thousand professionals are also frustrated by internal divisiveness over development ideology and bureaucratic turf. One of your highest priorities will no doubt be to overcome this uncertainty of purpose and restore a clear sense of direction and mission among the staff.

The Bank's Next Decade: Four Critical Roles in a Dynamic Environment

This overview and the policy papers that follow were prepared in the frank hope of providing a set of fresh ideas on where you might take the Bank during the next decade. The complexity of the issues confronting the Bank will present you with a series of tough conceptual and policy dilemmas. The issues addressed in this letter and throughout the study include:

- **Is there more that the Bank can do to tackle the chronic debt crisis?**
- **How can the Bank manage "conditionality" so as to be simultaneously an effective agent for resource transfers and a force for structural adjustment in developing nations? And can the Bank square its inherent interna-**

tionalism with the Third World's aspirations for national sovereignty?

- **What relationship should the Bank have with the International Monetary Fund? What can be done to overcome the long-standing resistance to more familial ties between the two Bretton Woods sisters?**
- **How can the Bank maintain its historic concern for equity and poverty alleviation even as it seeks to promote efficiency and the expansion of private sectors within developing countries?**
- **Whose Bank is it, in the final analysis? Should the Bank primarily be the servant of its most powerful stockholders, or should it seek to mediate between North and South—to be a bridge between two worlds?**

Our thinking on these questions has been guided by a vision of the Bank as performing *four critical roles* in the future global political economy:

First, the Bank can be a **coordinator** of global capital flows, pulling together a widening array of official and private lenders and investors behind projects and programs, especially in the more debt-ridden nations. As coordinator, the Bank can combine its traditional role of financial intermediary between taxpayers and bond-buyers in the North and borrowers in the South with the roles of investment banker and strategic planner—helping to design country-specific strategies by forging macro analyses and projects with attainable financial resources.

Second, the Bank can function as a **mediator** of political and economic differences between industrialized and developing countries. The Bank can strive to reduce international tensions by reinforcing a shaky international economy while providing a forum where even the weaker nations have some voice in the debate about their economic and political futures.

Third, the Bank should be a **stabilizer** in the global economy, working to reduce the sharp gyrations in global capital flows that have unhinged so many developing economies. By launching new, more flexible financial instruments, upgrading countries' management of their external accounts, and helping to shape a more open and less conflictive trading system, the Bank can contribute to steadier global growth.

Fourth, the Bank can be the leading **intellectual center** for thinking about development. Employing the single largest concentration of economists specializing in the Third World, it can gather data globally, synthesize research done outside its walls, and bring its own brainpower to bear on emerging problems. By disseminating its findings worldwide, the Bank can substantially affect the development agenda.

These roles are complementary and mutually reinforcing. While they are not entirely new to the Bank, fulfilling them in today's more complex world will require both an internal restructuring of the Bank and innovative approaches to Bank programs.

The Bank has continuously altered its programs in response to changes in the international environment. In the years following its establishment at the Bretton Woods Conference in 1944, the International Bank for Reconstruction and Development (IBRD) concentrated its energies on contributing to the reconstruction of war-torn Europe. In the 1950s, in keeping with the expressed needs of its clients in Latin America and Asia—and with the then conventional theories of development—the Bank built roads, hydroelectric power facilities, and ports. In 1961, its soft-loan window—the International Development Association (IDA)—was opened to lend on concessional terms to poorer developing countries, especially in South Asia, that could not afford the near-market interest rates charged by the IBRD. In the 1970s, the Bank found that the benefits of growth were not "trickling down" to the poor majority in many developing societies, and chose to devote a rising proportion of its resources to projects directly targeted for poverty alleviation.

In the 1980s, "policy-based lending" ascended the stage: The Bank began rapid disbursement of balance-of-payments support to countries that agreed to alter specified economic policies. This form of lending was a response to three big problems. As a result of the global recession in the early 1980s and the contraction of private capital markets, many developing countries badly needed quick injections of foreign exchange. At the same time, the Bank's traditional project approach was running into trouble: Foreign-exchange and fiscal squeezes deprived governments of the financial means to initiate new World Bank projects, many of which had to be cancelled; equally alarming, a growing number of projects, particularly in rural Africa, were failing. Voices in both the North and South rose in crescendo to argue that many countries were pursuing flawed development strategies that impeded the success of even well-designed projects.

Before commenting on the future of this significant Bank initiative, it is important to consider what is both a symptom and a cause of the slowdown in Third World growth: the debt crisis.

The World Bank and the Debt Crisis

It would be unfair to fault the Bank for failing to foresee the debt crisis. Few predicted the gravity of the global recession of the early 1980s or foresaw soaring interest rates and the sudden retreat of the commercial banks. Still, the Bank's record might have been better. Its data on cumulative debt underestimated the problem and consistently ran one to two years behind events. Bank projections of global growth rates and of the growth of Third World economies and exports were overly optimistic; in 1981, the Bank was working with growth rates of between 4.1 per cent and 5.3 per cent for the 1980–85 period—well above the actual rate of 3 per cent. With these flawed expectations and data base, the Bank repeatedly misjudged debt-servicing capacities. While individual country studies often did note a potential debt problem, they typically concluded that, with adequate external aid and good domestic policies, a happy ending was within reach. Country economists did not want to discourage their clients or their foreign lenders, and judgments of "not creditworthy" also would have raised inconvenient doubts about the Bank's own lending program.

When the debt crisis first broke and threatened the very stability of the international financial system, the Bank arguably was obliged to join opinion leaders in issuing assurances that the problem was only one of short-term liquidity. But after an intense internal debate, Bank management seemingly convinced itself that most nations could surmount their debt problems within a few years through a combination of import restraint, export-led growth, and continued if slowed commercial bank lending. The Bank took a back seat to the IMF, not sufficiently anticipating that severe austerity would de-fund the investment projects that were the Bank's stock in trade as well as play havoc with nations' development plans. In retrospect, the Bank should have issued pointed warnings regarding the long-term problems posed by the crisis instead of painting a reassuring face over it. Now that the mural has been chipped away, many in the Bank argue that the institution should have foreseen that prolonged austerity would cut down on investment and therefore eventually on exports, miring many countries in a no-growth trap. Furthermore, rather than relying on the wishful thinking that private banks would resume lending, the Bank might have warned that the commercial banks had experienced a severe jolt, and that the resulting financing gap might have to be filled largely by official sources.

Instead, for over two years the Bank stood on the sidelines while many countries in Latin America and Africa lost the gains won by a decade or more of development efforts. The Bank's gross disbursements to fourteen highly indebted countries rose from $2.7 billion in 1982 to $3.9 billion in 1985, a significant jump in percentage terms, but still a tiny increment compared to these nations' financial requirements. Even today, while the Bank's regional divisions are seized with the debt problem, management has not yet spoken out with a clear voice on the major North-South issue of the 1980s. Instead, drawing attention to the damage that the debt burden is wreaking on development has been left to U.N. agencies, the regional development banks, and private voluntary organizations. The Inter-American Development Bank in particular has focused on the problem of reverse resource transfer: From 1982 through 1985, Latin America transferred some $106 billion in net resources (defined as the difference between new capital inflows and amortization, interest payments, and profit remittances) to foreign creditors and investors. The World Bank's own most recent debt tables, which exclude interest payments on short-term debt, disclosed that for all developing countries the resource drain has been growing steadily worse, from negative $8 billion in 1983 to an estimated negative $22 billion in 1985; prior to 1983, net flows were solidly positive—standing at a positive $19 billion as recently as 1981.

Even if thoroughly restructured, the debt overhang will cast a looming shadow on the growth prospects of many developing nations. But it is imperative that the debt crisis be permanently deflated—for the sake of the debtors as well as the commercial banks and the World Bank. Without such a shift, investment rates will remain low in many debt-ridden nations and economic actors will continue to be preoccupied by short-term financial turmoil. The Bank will be unable either to catalyze adequate financial resources to pursue investment projects or to persuade clients to attempt necessary but costly long-term reforms. Furthermore, prolongation of the debt crisis endangers the prospects for new World Bank funding in the U.S. Congress, where populist lawmakers will argue that the Bank's monies will merely go to servicing the debts owed to large Wall Street banks.

Need for a World Bank Initiative

The industrial countries' current economic well-being creates a propitious climate for new initiatives to alleviate the debt problem. It is too late to talk of a preemptive strike on debt, but the oil-price crash provides an opportunity for all parties to abandon defensive postures. As World Bank President, you may want to place priority on seeking the intensified personal involvement of Secretaries James Baker and George Shultz, and of Chairman Paul Volcker, as the first step in a multinational effort to attack the debt problem and extend help both to newly afflicted oil-exporting nations and to countries that have endured multiple years of austerity policies and economic recession.

A World Bank Initiative might encompass the following actions:

1. Amend the welcome "Program for Sustained Growth" announced by Secretary Baker last fall in Seoul to include equity. IMF and World Bank conditionality should explicitly address the distribution of the domestic benefits and costs of adjustment programs and should provide interested governments with ideas on how to protect the more vulnerable groups.

2. Establish target figures for reducing the resource drain that is afflicting many developing nations. The country targets should be consistent with reasonable rates of economic expansion. Increased official flows are part of the answer, but there should also be a renewed effort to narrow the gap between the interest bill being paid to commercial banks and the amount of new money they are willing to extend. The Baker plan stopped short of establishing the necessary mechanisms and procedures for inducing sufficient private bank cooperation. Concerted action now is required on the part of official lenders, central banks, and bank regulatory authorities to alter the banks' current preference to delay until reforms are well under way. When heavily indebted nations agree to World Bank structural adjustment programs, commercial banks generally should promptly respond by extending parallel loans or foregoing some interest payments, since up-front financing greatly increases the likelihood of successful economic reform.

3. Adopt a genuinely case-by-case approach to debt which concentrates on speeding up the renewal of creditworthiness for some countries but which admits that others simply *cannot* carry their existing burdens and resume economic growth. For this latter category, a portion of a country's debt may have to be written off to restore order to its financial transactions. Country financial agreements should include contingency clauses to allow for changing levels of debt relief or new loans to reflect, for example, shifting interest rates and commodity prices. Financial packages tailored to each country could build on methods that the private capital markets have been developing for chipping away at accumulated debt, including debt-for-equity swaps, the conversion of debt into local currency, and the sale of discounted loans on secondary markets.