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Policy Brief

summary

Street protesters in Prague in September 2000 are not the only ones complaining about the World Bank. Conservative critics are pointing the finger too. On the left, champions of social justice argue that World Bank loan conditions hurt the poor. On the right, conservatives claim lending practices crowd out private investment. Critics from all sides compound public confusion about globalization and the impact of global financial institutions on people.

Nancy Birdsall dissects the critics' positions and proposes World Bank reforms rarely put on the table: end "cookie-cutter pricing" or the outdated tradition of a single interest rate and loan term no matter what; give countries like China and Brazil more voting power; and don't give up on much-maligned conditionality but fix and enforce it. Birdsall notes that governance of international financial institutions will never be perfectly representative nor accountable, in part because of failures of democracy in borrowing countries. But conceiving of the World Bank as a club, she argues for balanced reform not shutdown. ■

The World Bank of the Future: Victim, Villain, Global Credit Union?

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The demonstrations in Washington in spring 2000 were a reminder that the World Bank and its sister institutions are caught in a squeeze: on the left, the champions of social justice and on the right, the "Meltzer" Commission and Wall Street Journal editors. The commission – officially the International Financial Institution Advisory Commission and named for its head, Allan H. Meltzer from Carnegie Mellon University – was mandated by the U.S. Congress and released its report in March 2000.

Those on the left say the bank is a vehicle for globalization run by finance and corporate insiders, imposing austerity and "conditionality" that hurt the poor. Those on the right say the bank is crowding out private lending in middle-income countries and using loans to grease the wheels of wasteful and corrupt government practices. Knowledgeable World Bank insiders are no less critical. Economists inside the bank have published analyses showing that bank reform loans ("structural adjustment loans") have often failed to foster growth or reduce poverty, that conditionality linked to these loans has undermined country ownership of reforms, and that many bank-financed investment projects have produced little or no economic return.

What's right and wrong about these views? Do the critiques provide a basis for new thinking about the future of the World Bank – and whether it should have a future? Should the inexorable reality of globalization change what we think about the bank and its rationale, or change what the bank does and how it does it?

Consider two issues raised by the right and two by the left.

The Meltzer Commission attack: The bank's role in middle income emerging market economies

Last year, the private sector transferred approximately 20 times more resources, including for direct investment, to the developing countries than the World Bank and the other multilateral banks. Most of

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these private transfers went to a dozen of the big emerging markets – like Argentina, Brazil, and China. The Meltzer Commission says, given these private transfers, that the World Bank and the regional development banks should abandon lending to middle-income countries with investment grade ratings or per capita income over $4,000 (and should scale back in countries with per capita income over $2,500).

What is wrong with this argument is simple: The commission members' idea is boom-centric. Today countries such as Brazil, Mexico, Thailand, and South Africa can borrow from private banks and the global capital market. But when times are tough in world markets, their access to private credit is by no means assured. When the Russians defaulted on their domestic debt in the summer of 1998, even the most creditworthy countries of Latin America could not borrow – except, of course, from the World Bank and the Inter-American Development Bank. For those who could borrow, the costs skyrocketed; for this reason Argentina avoided borrowing altogether for much of 1998.

Furthermore, many middle-income countries cannot issue debt for terms beyond five years. Yet development investments – in schools and infrastructure – have much longer gestation periods. The commission's idea of restricting development-bank lending might help private international banks in their pursuit of short-term profits. But it would put at risk the long-term effort of building institutions in those countries that are yet to achieve sustainable market development.

Moreover, when global-market turmoil requires these countries to reduce government spending to rebuild credibility with private lenders, it is the international banks that provide credits to sustain their education and health programs. In Europe and the United States a recession automatically generates higher fiscal deficits – as unemployment compensation and food subsidies kick in. By definition emerging markets have not achieved the kind of credibility that permits them to borrow in bad times – either on domestic or foreign markets. So when economic downturns hit – because of a global financial crisis, a sudden drop in the price of coffee or copper, or a natural disaster – they cannot sustain social programs without the multilateral banks.

Paul Volcker has characterized emerging market economies as small boats in a turbulent sea. Even with a competent crew and a seaworthy vessel, a big storm can sink a small boat. One sign an economy is a small boat is the fragility of its hold on an investment grade rating. Colombia lost that rating last summer. Venezuela's investment grade rating of a decade ago disappeared well before its recent political troubles. Should the World Bank and the IDB be on-again/off-again in those countries?

By the way, the argument made by World Bank President James Wolfensohn recently – that there are many poor in middle-income countries, and that the World Bank lends for social programs the private sector will not finance – misses the point. Meltzer and colleagues are right that countries like Turkey and Panama can use funds they borrow privately for any purpose they want, including investment in health and education for the poor. Their bondholders and banks care little where the funds go. The correct counter-argument is more technical, and less appealing: Still-emerging markets have at best poor, unsteady, and costly access to the global capital market. That is why we call them "emerging." When they are bigger boats able to brave big storms alone, they will have emerged. Israel, Ireland of course, and perhaps Hong Kong and Taiwan fit this bill – but not yet Argentina, Korea, or Uruguay, despite their relatively high incomes.

A better future: End cookie-cutter pricing at the World Bank. This is not to say there is no need for change. The World Bank has a cookie-cutter approach to pricing that is called "cooperative" – every borrower faces the same interest costs. World Bank pricing should become more situation- and country-specific. The bank's big loan to Korea in December 1997, in the midst of the Asian financial crisis, was a breakthrough because, for the first time, interest charges exceeded the cooperative rate. More generally, higher-income countries and those better able to access private markets should face higher interest rates and less bureaucratic hassle when they borrow from the bank. Higher rates for Brazil, China, and the Philippines would bring World Bank rates closer to the market, undoing the argument (from the right) that the bank is crowding out the private sector. They would also, incidentally, encourage a more efficient, competitive, and client-oriented bureaucracy.

Lending maturities could also be more flexible. Why should countries have to take a 15-year loan (all that cooperative arrangements allow) if good debt management makes a 10-year loan optimal? Countries should not be pressured (as is the case now in the World Bank) to "graduate," as Korea was and Barbados is. If countries don't want to borrow now but want the right to borrow when necessary, perhaps they should pay some "fee," equivalent to the implicit fee that bank depositors and credit union members pay whether they are borrowing or not.

Flexible and competitive pricing implies changes in cost-sharing and ultimately in the balance of power among shareholders. I return to this nigh-impossible barrier to change below.

Another Meltzer idea: Get the World Bank out of banking

The Meltzer Commission calls for the World Bank to get out of lending and move to grants and small technical-assistance programs for the poorer countries – to become a "World Development Agency." This ignores a fundamental reality. The World Bank is a club, or better, a peculiar kind of credit union. The members are governments. As in a credit union, their voting power is related to their "deposits," and their guarantees. The biggest depositor is the U.S. government, and along with Europe and Japan, the United States is the World Bank's biggest guarantor. It and its rich-country colleagues back all the borrowings of this peculiar credit union – whether the credit union makes good loans or bad loans, and whether its borrowing members, some very poor indeed, pay up or not. That means the credit union, even with relatively low deposits (the case for the multilaterals), can borrow outside at good rates, and lend at good rates to its less wealthy members.

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Put another way, economist John Maynard Keynes and his colleagues, who conceived the bank and the IMF at the Bretton Woods Conference in 1944, had a brilliant idea. Create a club, at low cost to the big depositors and guarantors (at that time only the United States for all practical purposes), which will reduce borrowing costs for the poorer members (at that time war-torn Europe) and make the world richer and safer. The rationale for such clubs, by the way, does not rely on transfers via a mix of rich and poor members. Like an everyday credit union, these finance clubs exist because the sum of the membership's credibility reduces borrowing costs for all members below what they would pay on their own. That is the logic of the European Investment Bank, which even today lends billions every year for infrastructure and other investments to all its European members, rich and poor.

Uruguay is an example of why countries with access to private funds should stay in a global credit union. In today's market Uruguay, with an investment grade rating, can cover some of its reasonable borrowing needs by issuing debt with maturities of up to seven years at manageable spreads (e.g., 300 basis points over 6-month LIBOR). The World Bank and the IDB offer 15- and 20-year debt at somewhat lower cost. To borrow on private markets for all its needs at longer maturities would raise its interest costs exponentially. Maybe Uruguay should pay more for its loans than Nepal or Nicaragua – but all the members benefit when its borrowing creates jobs and growth and reduces poverty. This is as true for Uruguay in the IDB and World Bank credit unions as it is for Spain in the European Investment Bank.

The most successful reflection of the Bretton Woods founders' vision is not, however, the World Bank or the EIB but the Andean Development Bank. The World Bank (and the big regional development banks) borrow cheap because they are backed by the AAA rating of their rich nonborrowing members. The Andean Development Bank may be a better model for the 21st century. Its principal members – Venezuela, Colombia, Bolivia, Ecuador, and Peru – are all borrowers for one thing, and more fundamental still, its credit rating is better than the rating of any of its members. The whole is better than the sum of its parts. Not surprisingly, the CAF (its Spanish acronym) has moved beyond cooperative pricing, and its lending "conditions" reflect mostly its concern that the loan be repaid, not any point of view about the right reforms.

A better future: Rejuggle the membership shares in this peculiar credit union. Representation and risk-sharing in the club need to adjust to changing realities. In the next few decades we can hope that more emerging markets will "graduate" to advanced economy status. Meanwhile, as they progress their credit union will need to adjust. The capital shares of the World Bank have changed in the past only when more capital was being created through replenishments. In the next decade the single largest shareholder – the United States with about 17 percent of the World Bank – should lead an effort of the G-7 members to sell some of their shares so that countries like China, Brazil, and India can increase their shares, their voting power, and literally their ownership of the bank.

The challenge is to get global governance right in a club of nations, not increase old-style development assistance.

The Inter-American Development Bank already suggests a better model. Its current ownership is equally split – with borrowers and nonborrowers each holding 50 percent. If and when some borrowers' guarantees of their IDB borrowings achieve full credibility in global markets, the nonborrowers could sell some of their shares (without in effect reducing the real capital base of the bank) – making the IDB look increasingly like the European Investment Bank and the Andean Development Bank.

The World Bank's James Wolfensohn and Stanley Fischer, first deputy managing director of the IMF, have both said this is a good but hopelessly blue-sky idea. The rich countries treasure their shares and their power. The disinterested reform-minded left in the United States would do well to mount a campaign – directed to the U.S. Congress and administration on this issue. Why? Because for reform of a credit union, the challenge is not to extract more concessional finance but to align ownership and accountability. The challenge is to get global governance right in a club of nations, not to increase old-style development assistance programs.

The attack from the left: Conditionality confusion

The left says that the austere policies of the so-called "Washington Consensus," on which the World Bank conditions its loans, have hurt the poor. Indeed the issue of conditionality is the one on which all the critics, left, right, and center, seem to agree. The left says conditionality hurts the poor. The right says conditionality has undermined sovereignty and democracy in borrower countries. World Bank economists, focusing mostly on Africa, say conditionality has undermined countries' "ownership" of the reforms they have promised, and has ended up financing delay of reform, not reform. A report of the Overseas Development Council Task Force on the Future Role of the IMF in Development, released in April 2000, notes conditionality (in this case of the IMF) that is too detailed and far-reaching sends the wrong signal to investors – that countries don't want reforms they are forced to accept.

Should the World Bank eliminate conditionality altogether? Probably not. Lenders reasonably extract understandings in an effort to maximize chances of repayment. Conditions agreed in Latin America (often in the context of the Brady Plan and other commercial-debt deals) probably accelerated the return of private creditors to Latin markets. This worked because it was clear that the governments "owned" the reforms and that their voters and societies were prepared to back them. Indeed, the real problem is one of ownership. Conditions are no substitute for ownership, but if ownership is there – by governments that are accountable to their citizens – then agreements, understandings, and yes, "conditions," can complement that ownership, signaling a government's credible commitment to sustaining their reform efforts. In democratic societies, often the government wants to make its commitments transparent to voters as well as investors and make itself accountable for the policies it is adopting. The best mechanism may be the country's parliamentary vote on the loan, preceded by the discussion in the press and in parliament of those very conditions.

A better future: Don't end conditionality, fix it. Three steps are needed. First, the bank should work with countries on "conditions" that lock in justice, fairness, and equity (and lock out subsidies for the privileged). This category of conditions should be as visible and as widely discussed within countries as conditions meant to lock in fiscal discipline and growth.

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Second, the bank must enforce conditions once they are mutually agreed upon, including via cutoff of lending. Lack of enforcement in the past has done more harm than the conditions themselves. (On this point those who claim conditionality hurts the poor are mostly off-base on the facts. Government incompetence and waste are the real culprits.) In the poorest countries, mostly in sub-Saharan Africa, the result has been a lot of lending and a lot of debt without much in the way of development results. It has also meant that without debt reduction the World Bank will remain caught in defensive lending, i.e., new loans to help borrowers avoid defaulting on their old loans. The real crime, particularly in poor countries most dependent on World Bank lending, is not imposing conditions but imposing debt on future taxpayers even when it is obvious that borrowing governments are failing to use the loans to good purpose. Ignoring their own conditions for political reasons – as happened in Russia – undermines the bank's and the IMF's credibility with the taxpaying middle class in borrowing countries on whose support the reforms ultimately rely.

Enforcing conditionality means in the end that lending will be much more selective across countries. Loans will go only to countries that have the policy arrangements, the institutional capacity, and the public support to make them work. (There is some evidence that this is happening, though in Africa big debtors seem to get new loans no matter what.)

A better World Bank credit union depends on more open and democratic systems in each of its member shareholders.

Third, end the analytic near-monopoly of the World Bank, and the other multilaterals, on the details of pension reform, privatization of water systems, the ideal bank deposit insurance system, and so many of the other nitty gritty issues of economic and social reform. The World Bank needs to foster and directly finance more use by country borrowers of its own competitors – including local research institutions and world-class, high-cost private consultancies – in implementing and designing policies and programs. Then the bank staff can and should take more of a hands-off approach on policy design.

A hands-off approach and more selective lending will not happen without changes in the institutional arrangements inside the World Bank – reversing incentives to lend no matter what, and making the bank more accountable for failed loans. But mostly it requires that the bank, and the IMF, find a way to end their own intellectual oligopoly.

The representation failure, a.k.a. the democratic deficit

The street protests in Washington were also about what is best called "representation" failure: The IMF and the World Bank seem to represent global (and invisible) corporate and financial interests and not the interests of the people whose lives are so affected by their decisions, especially in developing countries. (Some protesters want more protection for high-wage U.S. workers or want to dictate environmental and other standards to poor countries – positions that do not in fact represent the poor in poor countries.)

One irony is that the World Bank and the other development banks have been among the only vehicles for carrying poor-country interests into the power suites of the global marketplace. It is the World Bank, for example, that has called repeatedly for better access of poor countries to rich-country markets. But being among the few powerful vehicles has only heightened frustration with the bank's imperfections – and with the inability of the World Bank to reflect the many different views of even the well-intentioned social activists. In an ideal democracy, democratically elected leaders would "represent" different views and forge reasonable compromises. But any international institution is already one step removed from an ideal democracy at the national level. More complicated still, many government members of this international credit union are not themselves good representative of their peoples' views. Indeed many respond better to international market pressures and to domestic power groups than to the members of their own working and middle classes.

At the international level, this representation failure is virtually inevitable. It justifies the demands of civil society groups for more transparency, disclosure, and accountability by the World Bank. Those demands can help compensate for what is necessarily an imperfect governance structure with imperfect lines of accountability. Disinterested groups whose fundamental objective is a more prosperous and fair global society have already played a constructive role in opening up the bank and, for example, making its projects more environmentally sensible.

But the most powerful groups with the most influence are based in the United States and Europe and themselves represent imperfectly, at best, and misrepresent, at worst, the interests of developing country residents who are most directly affected by World Bank loans. Only their own representative governments and indigenous civil society groups can effectively (though still imperfectly) give them voice in bank business and bank lending.

A better future: Democracy and civil society in the south. Ironically, the most open and democratic societies profit most from the noisy insistence of civil society and nongovernmental organizations for more justice, more openness, and more representation. The United States is our most apt example. A better World Bank credit union depends in the end on more open and democratic systems in each of its member shareholders. Indeed, the ultimate fate of the people in developing countries depends on their own governments and their own societal decisions – far more than on any decisions, impositions, or conditions agreed with World Bank staff. The sensible and constructive left in the north – disinterested backers of social justice and sensible use of Earth's resources – would do well to concentrate more of their effort on alliances with and support for the forces of openness and democracy in the south. Among other things, this means supporting IMF and World Bank efforts to up the ante on their own member governments for transparency in financial and economic decision-making.

A final reflection: Will the baby be thrown out with the bathwater?

The left yearns for more and better management of "globalization," and wants the World Bank (and the IMF) to police the corporate insiders with better rules and higher standards – on environment, on justice, on worker rights. Unfortunately the constructive left has allied itself with the fair trade groups who want to restrict trade to protect rich-country workers irrespective of the harm this could do to women and children in poor countries. The constructive left has a second problem. They fundamentally want reform, not a shutdown of these global bureaucracies, because the World Bank and the IMF are among the few vehicles they have to make globalization a more manageable and just process.

The right, at the extreme, wants less management of the global economy and would do away with these institutions altogether. The unholy alliance of the constructive left with the fair traders creates a big risk – that the baby gets thrown out with the bathwater. By exacerbating public confusion about globalization and the role of international institutions, well-meaning protesters undermine already fragile public support – from the U.S. Congress, for example – for more just and fair management of globalization.

The peoples of the developing world should make their own choices and determine their own destinies. That requires fundamental new thinking about global governance, including governance of the global credit union known as the World Bank. It is wrong to reduce their options by closing down altogether their credit union.

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