PART I

ORIGINS AND EVOLUTION

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What Does the World Bank Do and How Does It Do It?

BRIEF ORIGINS

The World Bank, in the form of the International Bank for Reconstruction and Development (IBRD), was founded at an international conference at Bretton Woods, New Hampshire, in 1944. Its purpose was to move toward the creation of a framework for world economic governance. The conference had been called, largely at the initiative of the United States, to work out a system for global economic stabilization following the depression of the 1930s and for reconstruction after the Second World War. Forty-four governments, including the USSR, attended.

The architects of the new system were, principally, Harry Dexter White, U.S. Treasury Secretary Morgenthau's chief economist, and legendary British economist John Maynard Keynes. At Bretton Woods, White took charge of the proposals for monetary stabilization. An outstanding intellect who authored the proposals that he hoped would help save the world from more wars, he was later brought before Senator McCarthy's Unamerican Activities Committee. Keynes, the leader of the UK delegation, had separately come up with his own ideas of a central bank for the world. However, he went along with the American plan, and he assumed responsibility, with reluctance, for running the discussions on the Bank.[1]

The initial focus at Bretton Woods was on the stabilization of the world economy, and the conference proposed the establishment of

[1] Keynes' many misgivings about the arrangements, invitees, and agenda for the conference are portrayed in Skidelsky, Robert, *John Maynard Keynes: Fighting for Freedom, 1937–1946*, Penguin Books, 2002, pp. 340, 347 et al.

the International Monetary Fund (IMF) as the center of the system. The World Bank, that is, the IBRD, was at the time the secondary concern and subject to less scrutiny. It was at the behest of the United States that it finally saw the light of day. This and its large financial contribution meant that the United States was allowed the main say in its design, including its location (the UK and others had pressed for it to be located outside the United States or else in New York), the role of its directors, the selection of its president, and the salary levels of its staff.[2] The British had wanted non-resident outside directors, while the United States wanted in-house executive directors to monitor the managers. Keynes thought the U.S.-proposed salaries were 'scandalous'; board directors were to get salaries of $17,000 a year, more than the U.S. vice president and more than five times as much as a British Member of Parliament. In terms of its governance, and staffing, it was a creature of U.S. design. The special status for its employees was deliberate and contrasted with its Washington neighbors in Congress and the federal government.

The Articles of Agreement, which were adopted at Bretton Woods, stated[3] that the IBRD's objectives were to provide assistance to governments. It was to assist in reconstruction and development by facilitating investment for productive purposes; to promote private foreign investment through guarantees or participations in loans and investments and to supplement private investment if unavailable at reasonable cost from the private sector; to promote the long-term balance and growth of international trade and payments; to coordinate priorities with other international lending agencies; and to assist in bringing about a smooth transition to a peacetime economy.

The IBRD started business in 1946, and its inaugural governors meeting was held in Savannah, Georgia, in March. There, its bylaws were adopted; its board of directors elected; and Washington, DC, confirmed as its location. Eugene Meyer, owner of the *Washington Post* and a Wall Street banker, took over as the first president in June. In September, at its first annual meeting, it had thirty-eight members and a staff of just seventy-two. It started slowly. Its first loan, for US$250 million, was to

2 For a further account of these events see Mason, Edward S. and Robert E. Asher, *The World Bank Since Bretton Woods*, Brookings, 1973.
3 IBRD Articles of Agreement, Article 1, pp. 1–2.

the French government in May 1947, a year after it formally started operations and when it was already into the term of its second president, John McCloy. The Bank became a specialized agency of the UN, which was itself founded in San Francisco in 1945, and its employees carry a UN laissez-passer. However, it has avoided close identification with the UN, distancing itself from the UN's ECOSOC, the committee of the UN General Assembly that should in principle oversee its work. By this and other means the Bank endeavored to maintain an independence of action and a special status as the leading agency in the financing of development.

Sixty years on, the Bank's membership has increased to 185, so that it now accounts for all but a handful of the world's nations. During its life, under the leadership of eleven presidents, it has managed the transfer of more than $500 billion of investment resources to the poor world, loans for development and for crisis assistance. Its lending steadily increased up to the late 1990s and broadened continually into new fields. It gained the confidence of and successfully raised a large amount of money from the private financial markets at low rates of interest, and it pioneered new financial instruments including derivatives. It has broadened its range of lending products and developed its advocacy platform. It also manages billions of dollars of Trust Fund money on behalf of other donor agencies.

The IBRD, which remains the major lending arm of the Bank Group, currently holds outstanding loans of about $100 billion. It has averaged more than US$1 billion per annum in profit since its foundation, which has allowed it to make grants to other organizations including the International Development Association (IDA), its soft loan partner that lends to the poorest countries (with national income per head of less than $865 a year, or $2.36 a day, at 2004 prices).[4] The IDA itself carries a similar level of assets, in the form of soft loans and grants.[5]

[4] The World Bank Group also consists of several other organizations. In addition to the IFC, these include the Multilateral Investment Guarantee Agency (MIGA), the International Center for Investment Disputes (ICSID), and the Center for International Agricultural Research (CGIAR).

[5] The value of the IDA's annual lending has been less, about two-thirds of that of the IBRD in recent years. However, its outstanding loans have recently grown to exceed those of the IBRD because of their longer average term (40 years as opposed to 16). Against this the IDA has recently started to forgive debt, resulting in a fall in the value of its outstanding loans.

Neither the IBRD nor the IDA has ever suffered from borrower defaults of any major significance, and, by its own account, the Bank has maintained a satisfactory project success rate, with steady improvement for the past twelve years.

These are impressive achievements, and equally impressive is the Bank's prize-winning, cathedral-like atrium entrance built in the 1990s, which reflects such achievements, with photographic displays of village children and energetic development activity, and the sculpture of a child leading an old man suffering from River Blindness, a scourge that Bank money helped to stamp out in large parts of West Africa. This atrium hosts every year a kind of bazaar called the Development Market Place, which for a few million dollars in prizes, successfully mobilizes thousands of small-scale development project ideas worldwide. In 2002, shortly after the Development Market Place was invented, the *Harvard Business Review* described it as 'nothing short of a miracle'.[6]

WHAT DOES THE BANK DO AND WHAT SHOULD IT DO?

The rationale for a public sector international financing institution like the Bank remains fundamentally a simple one. It has to meet a social (public goods) necessity that the private sector will not meet – that is, it has to address market failures, or market gaps, and it has to address them in relation to world development. The evolution of the market failures or gaps addressed by the Bank could be conceived as having gone through three stages. First, the problem was seen as a general capital deficiency. Second, it was seen as a structural one involving capital deficiency but with a related skill/know-how deficiency. Third, it came to be seen as largely a problem of indigenous capacity, know-how, and 'information', with capital scarcity only applicable to the more marginal, poorest economies, within a complex set of resource scarcities.

[6] Robert Chapman Wood and Gary Hamel, in the *Harvard Business Review* of November 2002, wrote, '[T]he development marketplace has laid to rest the broadly held suspicion that large organizations are incapable of grass roots innovation'. The marketplace is being extended to some of the Bank's overseas offices.

As the rationale for public intervention in imperfect markets, or the provision of public goods, has broadened out, so has the realization that a specifically global development institution should be developing its long-term rationale not in the general category of public goods, but rather in global public goods, that is, in failing global markets.[7] Such goods include vaccines, food security, environmental protection, and global climate initiatives. The category also includes the creation of new worldwide markets such as for carbon trading. These are goods and services whose supply requires collective global action. In the long run, therefore, it might be expected that the Bank would increase its focus on these types of products.

During most of the past century, market failure was regarded as an inevitable constraining factor on economic development, and consequently the public sector was regarded as playing an important, if not a critical, role. For example, the experience of the 1930s depression, the loss of trust in the financial system, and the New Deal era in the United States lent considerable weight to arguments about the imperfections of financial markets. It was a time of central controls – fixed exchange rates, trade barriers, capital controls, and very little external private lending or investment in poorer countries. The tasks of reconstruction and development, and the stabilization of the world economy, were ones that par excellence were thought by mainstream economists to be impossible if left to private enterprise, because developing economy markets were thought to be beset by structural problems that discouraged the right type or quantity of private investment.[8] In 1956, the Nobel Laureate Gunnar Myrdal wrote that '[S]pecial advisers to underdeveloped countries who have taken the time and trouble to acquaint themselves with the problem . . . all recommend central planning as the first condition of progress'.[9] While the

7 Global public goods are those that, once produced, provide net benefits to their consumers and users that are greater than could be gained by a private investor or an individual country, and so justify international public provision.

8 This does not mean that there were no opponents of public intervention, even in the case of structural impediments. One of the most notable was Peter T. Bauer, a professor at the London School of Economics, in *Economic Analysis and Policy in Under-developed Countries*, Cambridge University Press, 1957; and *Dissent on Development: Studies and Debates in Development Economics*, Weidenfeld & Nicolson, 1971.

9 Myrdal, Gunnar, *An International Economy: Problems and Prospects*, Harper & Bros, 1956.

need for central planning itself was hardly supported in the West, benign public intervention through market regulation was broadly accepted.[10]

How did the Bank's product menu evolve to meet the deficiencies in markets?

With its planned role in postwar reconstruction, the primary purpose of the Bank at the start was to provide finance or guarantees to a capital-constrained world economy. Initially it acted as a reconstruction financier in Europe. It soon moved on during the 1950s to assume a general infrastructure and industry financing role to governments in poorer economies. As it shifted its priorities to developing economies, the needs came to be perceived as beyond finance, incorporating wider problems of economic structure and growth. For this reason the IDA, the Bank's soft loan arm, was established. Nevertheless, the key factor was still regarded as finance, to fill savings and investment gaps, in accordance with then-conceived growth models. Capital went to large infrastructure projects such as telecommunications and power, and to industry.

The role of the Bank, the IBRD and the IDA, evolved to become considerably more complex over the next decades. It diversified into different sectors of lending outside infrastructure, including social sectors, support to economic reform, capacity, and institution-building lending. It incorporated technical assistance projects, advisory services, training, research, and advocacy.

The initial emphasis on large infrastructure projects shifted during the presidency of Robert McNamara (1968–1981) in response to the increasing belief that growth and large investments alone were not addressing the problem of poverty, and that direct, redistributional assistance to the rural and urban poor was needed, in terms of both finance and know-how.

The paradigm shifted further in the 1980s, which were dominated by the issues of debt and adjustment and restoration of private capital flows to developing countries. There was a move away from project lending to macroeconomic adjustment and program lending to

[10] Bauer, however, wrote for forty years about misconceptions of central planning and state interference in development.

accommodate this. This was the era of the so-called Washington Consensus on macroeconomic balance and growth.[11] While international debt was a dominant issue at this time, this no longer implied a pure capital constraint. Rather, indebtedness was seen as a function of a combination of excessive borrowing and inattention to macroeconomic management and capacity building. By now capital market imperfections were seen as applicable more narrowly. The Bank's offshoot, the International Finance Corporation (IFC), addressed one of the narrower needs, the development of emerging equity markets.

The resolution of the 1980s debt problems enabled the private banks to resume lending to the developing world, and World Bank lending per se became less important as the international capital market opened up. Bank lending was reduced to a very small component of international financing. While capital market cycles still created intermittent needs for international public institution financing, generally the international capital market was substantially different from what it was in 1945.

As the capital market constraints eased, concern with know-how and information market constraints emerged. Under President James Wolfensohn there was an overt shift with the 1996 announcement of the 'knowledge bank', toward capacity building and knowledge creation, and with it a shift from infrastructure and macroeconomic adjustment projects into institution building, market regulation, legal reform, and anti-corruption measures. At the turn of the millennium funding of investment per se remained a core rationale only in the more marginalized economies, and here increasingly it is in the form of grants linked to capacity building. Knowledge development came to be seen as a key role of the Bank, on a par with financing.

Thus, over the last quarter of the twentieth century, culminating in the collapse of the Soviet Union, the assumptions about the need for public investment were diluted or shifted, although the belief that the public sector still had an investment role in transitional economies was reflected in the establishment of the European Bank for Reconstruction

[11] The term 'the Washington Consensus' was originally coined in 1989 by John Williamson of the Institute for International Economics, to describe the basic elements of liberalization reform that were accepted by major donors.

and Development (EBRD), as late as 1991, to finance the rehabilitation of the former Eastern bloc states.

What about the provision of global public goods (GPGs)? The initial Bank focus on large infrastructure development provided such goods to the extent that the private sector and national governments would not have been prepared or able to finance waterways, dams, and power stations critical to international development. However, most of the work that the Bank has done up to now has not been for global interests, but for national governments, and the GPG rationale has been promoted rather late in the day. Work is now being stepped up in areas such as climate change, environmental degradation, and communicable diseases. It is also being carried out in knowledge-intensive areas such as the infrastructure for international financial stability and in the creation of completely new markets such as the carbon trade.

While the product menu has broadened considerably, the Bank's output can still be thought of, however, as consisting of two basic products – financing and information. In the first case it has diversified over time from the provision of loans at semi-commercial interest rates, into soft loans, and, more recently, into outright grants to finance development projects in poorer countries. In the second case it has provided advice, information, and analysis, supported by its relatively large research department, and this knowledge output has also evolved over time from a focus on technical project issues to country economic policy, and in more recent years to proactive advocacy on world economic problems. Its research and advice have provided a forum for development thinking and technical know-how, and provided training for many developing country professionals.

The allocation of the Bank's resources between financing and information or knowledge creating is a key determining factor in the Bank's role as a development assistance organization and is also a potentially critical factor in its financial sustainability because knowledge generation does not generally pay for itself. This has led to some recent reversion from knowledge creation back to large-scale lending. The split between money and knowledge is in fact quite complex, since, to a degree, money leverages knowledge by providing it with a transmission vehicle and a high profile in the eyes of the governments that approve projects. Thus the role of finance in the Bank's production line is likely to remain important regardless of how far knowledge generation is elevated to priority status.

HOW IMPORTANT IS THE BANK?

The Bank's diversification away from financing has reduced its importance in international finance. Even during its major lending expansion, under McNamara, its contribution to total international resource flows was not more than 5%. Private flows from banks, investors, suppliers, and migrant labor are dominant. The Bank Group was in the top ten of individual global financiers from its early days up into the 1970s. However, as the world recovered from the 1980s debt crisis there was a boom in private lending and investment, starting in 1992 and resuming after the Asian economic crisis, and it now accounts for about 85% of total capital flowing to developing countries, mainly in the form of direct investments in foreign enterprises and portfolio investments.[12] Private migrant labor remittances (to countries like Mexico, India, and the Philippines) are also now worth far more than official aid, well over $100 billion a year, and that is only the amount reported. The Bank has also fallen to nearer fiftieth place in the league of lending institutions.

Thus, the Bank is providing a reducing proportion of official funds, and a very small proportion of the developing world's investment. Only in Africa, which gets a tiny proportion of private investment, does official aid still play an important part, exceeding the amount of private finance. In Africa workers' remittances are also still a relatively small proportion of the total amount of money coming in. Countries like Mozambique remain aid-dependent.

Given its relatively small role in the financial market, the level of concern by the stakeholders with what the Bank does with its money can be somewhat excessive. More important has been the leverage it has exercised, and indeed expected, over its client country economic

[12] Source: 'Global Development Finance: Mobilizing Finance and Managing Vulnerability', World Bank, 2005.