The Role of the World Bank in a Changing Global Environment

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Like the United Nations, the role of the World Bank has been subjected to a thorough review as has its sister organization, the IMF. Opinions range from "50 years is enough" to "cut it down sharply"; no one dares to advocate an expansion of its scope or scale.

The Bretton Woods Regime: A Historical Perspective

In 1944, some 50 years ago, the Bretton Woods conference met to design an institutional infrastructure that embodied the principles of a liberal international economic order, based on the consensus that such an economic order was essential to sustain a lasting world peace in the post-World-War-II era. The conference decided to create two international financial institutions; (1) the International Monetary Fund (IMF), and (2) the International Bank for Reconstruction and Development (IBRD or the World Bank).

A third institution, the International Trade Organization (ITO), was proposed and negotiated to be established in order to deal with the problems of reducing trade barriers among member countries. Trade barriers had increased to substantial levels over the two decades preceding the war as major powers had competitively increased their trade barriers while building economic blocs to secure their own markets and sources of supply of essential natural resources. The ITO was to facilitate negotiations for dismantling these barriers consisting of tariffs and nontariff barriers. The ITO, however, never came into being. Despite the disappointing abortion of the ITO, the General Agreement on Tariffs and Trade (GATT), which had been agreed

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upon earlier as a tentative measure to await the establishment of the ITO, survived. GATT maintained a relatively small secretariat in Geneva.

GATT turned out to be a remarkable success in the pursuit of its objective – liberalizing world trade. It achieved far more than had been anticipated at the time of its establishment, given the problems at its birth. Under GATT, global trade liberalization was promoted through a series of rounds of multilateral negotiations, the latest of which was the Uruguay Round. As a result of the Uruguay Round, the new World Trade Organization (WTO) has been created to provide a firmer institutional basis for further liberalization of the world trading environment. The scope of its activities has been expanded to cover not only merchandise trade but also trade in services as well as trade-related investment rules and issues in intellectual property rights.

GATT operated on four broad principles: (1) nondiscrimination, multilateralism, and the application of the most-favored-nation (MFN) principle to all contracting parties; (2) expansion of world trade through the reduction of trade barriers; (3) reciprocity; and (4) the establishment of a set of universal rules for the conduct of trade policy. Despite all attempts to bypass these principles through various forms of new protectionism, GATT achieved a remarkable success and has now finally transformed into a bona fide specialized organization, the WTO. Its objective is indeed to provide an essential international public good, namely a liberal world trading regime.

The IMF, another international institution conceived at the Bretton Woods conference, has been concerned with the objective of providing another public good, namely, an orderly international monetary system. The international monetary order which the IMF originally attempted to promote and maintain was a fixed exchange rate regime.

In the early 1970s, the fixed exchange rate regime collapsed and the world monetary system has since operated on a floating exchange rate regime. The role of the IMF has since changed radically. The original mandate for the IMF, which was to play a central role in maintaining the fixed exchange rate system was destroyed, and the organization faced a serious crisis — a constitutional crisis, as it were. However, subsequently, the IMF managed to play a key role in the recycling of "petro dollars" in the rest of the 1970s, in resolving the debt crisis in the 1980s and more recently, in the 1990s, in facilitating the integration of former planned economies in eastern Europe and Asia into the world economy as they have attempted to transform their economies into market-oriented economies.

It may be fair to say that since the early 1970s the IMF has not been completely successful as the watchdog of the international monetary system. The influence of the IMF on the macroeconomic policies of the industrial countries has not been adequate for assuring smooth functioning of the global monetary system. Under the present regime of floating exchange rates, the rules of the game in correcting external disequilibria among major industrial countries are not clear. Since the early 1980s, industrial countries have not borrowed from the IMF, and thus IMF's credits with conditionality have not had any chance to influence the behavior of industrial countries.

Despite prevalent criticisms of the effectiveness of the IMF and thorough review of the exchange rate system being undertaken around the world today (Sir Alan Walters argues that we should scrap the IMF); I believe that at the end of the day the world would agree that we need some core international organization dedicated to maintain a well-functioning global monetary regime, an essential international public good, and that that organization should indeed be an IMF, even if the existing one needs to go through a radical overhaul to suit the changing needs of the day.

Now, we turn to the World Bank. The World Bank was created to assist financially in "reconstruction" and "development" as its full name signifies.

Compared with the other two pillars of the international economic system, however, the need for a public, multilateral institution devoted to channeling capital from areas where it was plentiful to areas in need of economic reconstruction and development was not so obvious in the conventional understanding of the 1940s of the role of government and the need for international cooperation. In creating the World Bank, the debate was indeed focused on whether it should be created at all and what it should do rather than how it should do its business (Gavin and Roderik, 1995).

The Raison d'Etre and Scope of the World Bank

What was the justification for creating the World Bank? In difference to the other two international economic institutions, the Bank was not justified on a need to provide some kind of an institutional infrastructure to provide an international public good. It is evident that the World Bank was created to take care of a market failure, an anticipated big market failure, in the international market for long-term capital. Capital had long been channelled through a private capital market and official loans, grants and guarantees had regularly been provided only on a bilateral basis.

So, the following fundamental questions were asked: (1) why do we need a public organization to take care of what used to be taken care of by the private capital market? and (2) if such official capital flows were justified, why did they have to be pushed through a multilateral agency rather than through bilateral, government-to-government channels?

On the first question, there was reportedly a reasonable consensus at the Bretton Woods conference that there might be a serious market failure in transferring capital resources from capital-abundant countries to capital-scarce countries because of the widespread default experience in the 1930s. Thus, the need for some large-scale public intervention in the international long-term capital market was not questioned much.

Why it should be a multilateral institution instead of a traditional one through means of bilateral official transfers that undertake the task of filling the gap in international investment to supplement private capital movements was more controversial. The World Bank's intellectual father, Harry Dexter White, argued for a need to build a truly international organization, in which all members had some stake and felt responsible for decision-making. He argued that debtor countries would feel responsible for the success of the enterprise only if they, as well as creditors, had some say in decision-making, and they had contributed something to it (Gavin and Roderik, 1995, p.330).

The World Bank was originally designed to operate both through making loans on its own account and through guaranteeing private loans. However, the Bank has placed primary emphasis on direct lending rather than on guarantees or participation in private loans. Only in recent years, has the Bank begun to use its guarantee function more frequently.

The source of funds for the Bank operations has been the private capital markets. It raises these funds through sales of World Bank bonds in major capital markets around the world — e.g., New York, Tokyo, London, Frankfurt, Zurich and so on. For most of its history, the Bank has had an easy time in its sales of bonds, thanks to the AAA rating it has enjoyed. The Bank has been able to maintain this AAA rating for three broad reasons: (1) Its obligations are guaranteed by its founding governments; (2) its lending has been well diversified in terms of borrowing countries; and (3) its loans default rate has been remarkably low. Because of the top rating position it has enjoyed, the Bank has always been able to raise the needed funds at most favorable terms. Thus, because of the low-cost funds, the Bank has been able to make its loans at most advantageous rates which no developing country on its own could command from the international capital markets.

Evolution of the World Bank Group

After the first decade's experience, it became clear that so many of the poorest countries, particularly in South Asia and Africa, could not afford the Bank loans. Even though Bank loans were provided at most favorable rates, the rates charged by the Bank on these loans could not be lower than the most favorable market rates because these were the rates the Bank was paying to borrow the necessary funds. Thus, the International Development Association (IDA) was created as a remedy in 1958. The sources of the funds for the IDA have been donor government grants to the IDA. IDA credits have been provided to the poorest member countries at very favorable terms — longer repayment periods, no interest charges except for modest administrative costs, etc. Although these are called "soft loans," presumably the same rigorous standards have been applied in project selection. The IDA does not have any staff of its own. All its business is carried out by the World Bank staff. Since IDA money runs out quickly, it has periodically been "replenished," although it has become increasingly difficult to raise the necessary funds in recent years.

Another venture launched by the World Bank in the 1950s was the creation of the International Finance Corporation (IFC) (established in 1956). The IFC's objective is to facilitate private investment in developing countries. It participates in the equity of private investment in developing countries and /or makes loans to private enterprises in developing countries without requiring any guarantees by governments. (World Bank loans must be guaranteed by the borrower governments even though loans could be made directly to private companies.)

A further expansion of the World Bank's scope of activities was effected in 1966, when the International Center for Settlement of Investment Disputes (ICSID) was established. In order to promote private investment in developing countries, ICSID was created to provide for resolving international investment disputes, especially those relating to expropriations and nationalizations of investment properties. In practice, utilization of this facility has been rather limited so far.

More recently, the Bank established the Multilateral Investment Guarantee Agency (MIGA) in 1988. MIGA supplements national and private agencies supporting foreign direct investment through investment insurance. It is designed to encourage foreign investment by filling gaps in investment insurance against noncommercial risks in developing countries so as to make investment opportunities in those countries more competitive with alternatives in industrial countries.

Thus, the World Bank has now four affiliated organizations — i.e., the IDA, the IFC, the ICSID and the MIGA. The so-called World Bank Group consists of these four affiliates and the World Bank itself.

The Relationship of the World Bank and the United Nations

Although the World Bank is a Specialized Agency of the United Nations (UN), the Bank has so far operated quite independently of the United Nations. The only formal relationship has been through the Administrative Committee on Coordination (ACC) organized by the Secretary General of the United Nations. The ACC is chaired by the Secretary General and attended by the heads of the specialized agencies including the World Bank.

The past relationship between the UN and the Bank may be best described as that of "arms' length." Most importantly, the United Nations has not had any say on the Bank's decisions on individual loans.

The United Nations' decisions are based on a "one country one vote" principle, while the voting powers of individual countries on the World Bank Board are based on the number of shares owned by these member countries, which are based on the contributions to the Bank's capital subscriptions. Thus, at the Bank, major industrial countries command more weight in the Board decisions. For example, Japan alone has more voting power than all sub-Sahara African countries combined.

The World Bank's charter prescribes that the Bank is not a political organization and that it should pursue the cause of development disregarding politics, although in reality, politics does affect the Bank's operations. In fact, the World Bank has from time to time ignored the UN resolutions of political nature, such as those in the context of the Arabe-Israeli conflict and relating to the Union of South Africa, etc.

However, recently, the Bank has decided to work more closely with the UN. In July 1995, at the High-Level Meeting of the UN Economic and Social Council, held in Geneva, Mr. James D.Wolfensohn, the current President of the World Bank, made a statement proposing a "stronger partnership" between the UN and the Bank. This may mark a distinct departure from the traditional "arms' length" relationship. The call for changing relationship stems from the earlier Halifax communique which emphasized the need for "improved coordination among the international organizations." It aims to achieve stronger synergy, increased efficiency, and reduced overlap. How this broad change may be implemented in reality remains yet to be seen.

The Future Role of the World Bank

The World Bank is a financing institution. If the main justification for the existence of the Bank is the imperfections of the international private capital markets, we would have to concede that the need for the Bank has declined, in view of the stunning recovery of international capital market. In other words, if the "product" of the Bank is perceived to consist mainly of financial services, the justification for its existence may seem to have been radically eroded. However, the World Bank has established itself also as a development institution; it has indeed accumulated development expertise. The Bank is, in fact, in a unique position to combine the development expertise and advice with financing services.

International capital markets have developed vastly over the last half century, especially in the last two decades. Ironically, the "oil crisis" and the breakdown of the fixed exchange rate system in the early 1970s helped develop the international capital markets at the private sector level. All kinds of money are available through these markets on a commercial basis. It may be going too far to say that there are no longer any market failures in today's global capital markets, but no one would dare to deny that today international capital markets are far less imperfect than 40 or 50 years ago.

For what the World Bank calls "upper-middle-income" countries, their access to international commercial capital markets is wide open. Countries such as Turkey and Malaysia approach these markets on an everyday basis for raising short-term funds (Eurodollar markets) and many of them are able to sell bonds to raise medium-to long-term funds as well. Thus, a number of these countries have "graduated" or are about to graduate from IBRD lending. Japan, of course, graduated a long time ago. The Republic of Korea is graduating right now, and several others are expected to graduate soon.

Also, foreign direct investment is available to many developing countries. Not only "upper-middle-income" countries but much poorer countries have been accepting inflows of foreign direct investment (equity participation). Thus, we notice that such relatively low-income countries as India, China and Vietnam are attracting growing inflows of foreign direct investment. Foreign direct investment is coming not only from high-income industrial countries but also from so-called Newly Industrializing Economies (NIEs) such as the Republic of Korea, Hong Kong, Singapore and Taiwan. Recently, some international direct investment comes from next-tier NIEs such as Indonesia and Malaysia. Thus, both the sources and the destinations of international direct investment have diversified.

For the poorest group of developing countries, however, their access to commercial financing capital markets is next to impossible. Their ability to attract direct foreign investment is also limited. For these countries, "political risks" are too high, in the eyes of suppliers of commercial capital. Many of the sub-Sahara African countries, SSAs, fall in this category. Thus, the "soft-loan" agencies such as the IDA and other "concessionary" official development fund providers have a great challenge facing them perhaps for a long time to come.

The World Bank is a development institution as well as a financing agency. One unique feature of the World Bank has been in the area of development policy advice. As former Bank vice president in charge of development policy, Dr. Laurence Summers, said, "World Bank money is valuable because it comes with good advice." This statement may be controversial as there have been cases where Bank advice has not been so effective, but there are many cases where the Bank's policy inputs have helped successful development. Whatever the judgment on this score may turn out to be, it remains true that the Bank has accumulated a great deal of knowledge and experience on development policy. "Thanks to its far-flung lending operations, the Bank is the single most important external source of ideas and advice to developing-country policymakers." (Gavin and Roderik, 1995)

The World Bank Group thus has yet a substantial lot of challenging business ahead for a long time to come, if not for the entire period of the second 50 years.

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