The Heritage Foundation Backgrounder

No. 501 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002-4999 (202) 546-4400

April 4, 1986

BARBER CONABLE AT THE WORLD BANK: NEW HOPE FOR WORLD ECONOMIC GROWTH

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INTRODUCTION

Ronald Reagan is nominating former Congressman Barber Conable, the New York Republican, to be the new president of the World Bank. Conable takes over an institution which has strayed far from its original purpose of promoting private sector growth. He will, however, have enormous power within the organization to reform World Bank operations to make them more effective and more consistent with Reagan's philosophy of aiding the developing world primarily through the private sector.

Conable could, for example, appoint staff committed to fostering market-oriented policies. He should reestablish the sound banking practice that loans are made to encourage growth and development--and use the Bank's leverage to nudge recipient countries toward free market policies. And by opposing a suggested $40 billion increase in the Bank's general capital, Conable could force the Bank to use its resources more effectively.

During his long tenure as World Bank president, Robert McNamara showed that a strong president, virtually by himself, can fundamentally alter the Bank's direction. If it could be done once, it can be done again--this time turning the Bank back toward the private sector and making it a more effective engine of development in the hard-pressed Third World.

HISTORY

The World Bank was established after World War II principally to aid reconstruction of war-torn Europe. During its first decade or so, the bulk of its loans went to industrialized countries, such as Japan and France. As these countries advanced, the Bank turned its attention increasingly to the less developed countries of Asia, Africa, and Latin America. In 1960 the Bank established the International Development Association (IDA) as a separate facility to make "soft" loans at below market rates to poor countries.

In its first two decades, the Bank saw itself largely as facilitating the flow of private capital to the Third World, not as a substitute for private capital flows. Explains a recent history of the World Bank: "From the beginning and through most of the first quarter century of its existence, the Bank saw itself dealing with only a minor part of total development finance; the major part would have to come from private investors."[1]

Hence the Bank was much concerned with "climate" for investment in developing countries. In the 1950s, under President Eugene Black, the World Bank took a hard line against countries which expropriated private property without just compensation, which defaulted on foreign loans, and which relied too heavily on government, rather than the private sector, for growth. Indeed, the Bank had a policy of not lending directly to governments for industrial projects unless they were intended to be transferred to the private sector upon completion.[2]

The Bank maintained that "soft" loans had no role in international development finance, that a lack of capital was not the major detriment to growth in the developing countries, and that loan amounts should be limited so that debt service payments remained manageable. Typically, the Bank became alarmed if debt service payments grew above 10 percent of export earnings.[3]

In the late 1960s, however, the Bank began to soften its opposition to government involvement in the development process and

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1. Edward S. Mason and Robert E. Asher, The World Bank Since Bretton Woods (Washington, D.C.: The Brookings Institution, 1973), p. 336.

2. Ibid., pp. 336-338, 371-373.

3. Ibid., pp. 458-470. Today the debt service ratio of all indebted countries is 22 percent of exports, ranging from 11 percent in Asia to 40 percent in Latin America. World Economic Outlook: April 1985 (Washington, D.C.: International Monetary Fund, 1985), p. 268.

also took a softer line on lending terms. The Bank came to view the capacity of developing nations to absorb capital as being much greater than it previously thought and increased its lending accordingly. By the late 1960s the Bank was even willing to lend directly to governments for industrial projects.

The Bank changed dramatically during the lengthy (1968 to 1981) presidency of Robert McNamara, former president of Ford Motor Company and Secretary of Defense under Presidents Kennedy and Johnson. He moved the Bank even further away from its founding principles. Said an observer of McNamara's approach:

> He has seemed almost obsessed with redistribution of income. He seems to have turned away from the concept of helping the poor by raising overall national economic standards. He seems to feel that dams and roads and ports and steel mills...may help the economy but they don't necessarily put extra food into the stomachs of the teeming poor.[4]

Bank lending ballooned from $1.4 billion in 1968-1969 to $10.3 billion in 1981-1982.[5] World Bank productivity seemed to be measured by how much money could be dispersed, rather than on the quality of the project or ability to repay.[6]

Late in 1980, Jimmy Carter chose former Bank of America president A. W. Clausen to succeed McNamara as World Bank chief. Upon taking office, Reagan confirmed Clausen's appointment. In his five years leading the Bank, Clausen has done little to change the direction set by McNamara. Although he says all the right things about the need to encourage growth through the private sector, he has done almost nothing to redirect Bank programs so that they foster private sector growth. Clausen's main accomplishment has been in the area of finance, where he has improved the Bank's ability to raise funds in capital markets. At last September's World Bank annual meeting in Seoul, Clausen announced that he would retire this June.

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4. Ann Hughey, "Is the World Bank Biting Off More Than It Can Chew?" Forbes, May 26, 1980, p. 123.

5. E. Dwight Phaup, The World Bank: How It Can Serve U.S. Interests (Washington, D.C.: The Heritage Foundation, 1984), p. 14.

6. Hughey, op. cit., p. 127.

THE WORLD BANK PRESIDENT

The problems of executing a market-oriented development strategy are many, but the World Bank president is uniquely situated to have a major impact on such a strategy. This is because of the Bank's enormous financial leverage. The World Bank and IDA together lend about $16 billion per year. But because of co-financing arrangements, the actual impact of this lending is much higher. In 1985, for example, the World Bank contributed $1.5 billion to co-financing projects worth almost $24 billion.[7]

The president of the World Bank has enormous power within the organization. The organization's Articles of Agreement specify that:

> The President shall be chief of the operating staff of the Bank and shall conduct, under direction of the Executive Directors, the ordinary business of the Bank. Subject to the general control of the Executive Directors, he shall be responsible for the organization, appointment and dismissal of the officers and staff.[8]

In short, the president has virtually total authority to hire and fire staff and direct the Bank's operation. Although some staff changes would be necessary to reorient Bank policy, major changes are neither needed nor desirable. Most of the Bank's professional staff is very competent. More important, most probably agree that economic growth comes principally from the private sector and that Bank operations should be geared more toward the private sector. Attrition will provide ample opportunity for Conable to put his "stamp" on the operating staff. In the meantime, he should not underestimate his ability to send "signals" to the staff through public statements and subtle actions which will tell the Bank staff that changes in policy are required. Most Bank staff are not ideologues, but professionals whose expertise is essential to efficient Bank operations.

The one staff change which Conable may find unavoidable is the Senior Vice President of Operations, who oversees the Bank's day-to-day functions. The person holding this post effectively determines what the lending policies of the Bank are, what projects will be funded, and what conditions will be attached to Bank loans. Naming someone to this position who is committed to market-oriented policies is essential if there is to be any change in Bank policy. One candidate for this position currently under discussion is David

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7. World Bank Annual Report 1985 (Washington, D.C.: World Bank, 1985), p. 27.

8. Article V, Section 5, paragraph vii.

Mulford, Assistant Secretary of the Treasury for International Affairs.

LENDING POLICY

Historically, productivity at the World Bank has been measured in terms of loan output. Making loans to developing countries has been seen, more or less, as an end in itself, rather than a means to an end. Bank staff are, in effect, rewarded for giving out as much money as possible. Neither praise nor reward accrues to those staff who resist making loans because the projects are unworthy or because the host government persists in following anti-growth policies.

A top Conable priority, therefore, should be reestablishing the sound banking principle that loans are made for a purpose--to encourage growth and development. Another priority is for the Bank to use its leverage more to nudge recipient countries toward free market policies. To be sure, the Bank already attempts to do this through "policy dialogues." Such efforts, however, tend to be short-lived and half-hearted. This is because there is too much pressure within the Bank to make loans, too little encouragement for staff to be "hard-nosed" about conditionality, to little follow-through on conditionality, and too many problems for those who would try to cut off project loans once the project has begun if the conditions attached to the loan are flagrantly ignored.

Observes Stanley Please, a former World Bank senior staff member:

> Policy dialogue in the past has rarely gone beyond "gentle persuasion" at the political level, combined with technical discussions among economists to review the analytical foundations of the diagnosis of problems and the general policy options open to a government....The inner dynamics of the technical, financial, and administrative arrangements associated with the project cycle, generate a momentum of project development and implementation within a project agency and within the Bank. It is extremely difficult and often costly--but not, of course, impossible--to interfere with this process in order to address broader problems than those directly relating to the project....Experience...suggests that unless the policy issues are of very great importance, a presumption exists that the benefits fall short of the costs of delaying a project's development and implementation....This is reflected in the frequency with which covenants relating to policy issues, agreed to by a government in good faith and formally embodied in loan agreements, are subsequently not complied with and where little or no credible action is taken to have the covenant implemented. For this reason,

> emphasis is typically placed on implementing policy changes before the signing of a loan agreement although this procedure is often of limited usefulness when it is vital that governments sustain policy changes over a period of time. Effective monitoring of these changes, therefore, requires an equal ability to sustain action by the Bank with action or nonaction by a government. Bank credibility in respect of enforcing policy covenants is...not very great. It is certainly not as great as is demanded by the urgent need for policy reform.[9]

STRUCTURAL ADJUSTMENT LENDING

One approach to the problem of imposing conditions on project loans--those made for building a particular road, dam, or bridge--is for the Bank to make more "structural adjustment" loans. These are made specifically to encourage a change in policy, rather than for the building of tangible projects. They are, in short, a kind of "bribe" to encourage constructive policy change. Though such loans have been made since 1980, they are only a small part of Bank lending. The reason is the requirement in the Bank's Articles that "loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development."[10] And as Please notes, this legal requirement "has been taken extremely seriously by the Bank."[11] Thus, structural adjustment loans have been limited to no more than 10 percent of Bank lending. Through 1985, approximately $4.5 billion of such loans have been made.[12]

Please argues strongly that structural adjustment lending is far more appropriate to current development problems than traditional project lending. "If the Bank is to refocus its support towards policy and institutional reform," he says, "then, once again, its operations must be designed in such a manner that the progressive improvement in tax policy and other distortions of industrial and employment policy are placed on center-stage."[13]

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9. Stanley Please, The Hobbled Giant: Essays on the World Bank (Boulder, Colorado: Westview Press, 1984), pp. 26-28.

10. Article III, Section 4, paragraph vii.

11. Please, op. cit., p. 10.

12. Annual Report, op. cit., p. 52.

13. Please, op. cit., p. 44.

On the other hand, leading congressional critics of the Bank argue that emphasis on project lending at least focuses the Bank's efforts on things of tangible value and that Bank lending is limited by the availability of eligible projects. Elimination of the project criteria and its replacement by ill-defined policy objectives, they fear, might open the flood-gates to additional lending and possibly be used for inappropriate objectives, rather than the pursuit of market-oriented policies. And, of course, there would still be the problem of sustaining reforms once the structural adjustment loan is completed. The problems of monitoring and enforcing the conditions of the loan, that currently exist with project loans, would still exist with structural adjustment loans.

A better approach to Bank lending may be to cut back Bank lending by ending loans for projects that can be financed commercially and by limiting lending to funds for noncommercial activities that strengthen the framework within which the private sector can operate.

Another option would be to privatize in effect more of the Bank's operations. The Bank need not restrict itself to dealing exclusively with governments. Loans could be made for private sector, profit-making projects and then the loans sold to obtain additional funds to make new loans. In short, the World Bank would operate more like a private bank, funding projects of genuine economic value in the private sector.

The Bank's Articles make it clear that such a private sector approach was always intended to be a major focus of its activities. One purpose of the Bank, the Articles state, is "to promote private foreign investment by means of guarantees or participation in loans and other investments made by private investors."[14] The Bank, however, chose not to emphasize the private sector approach. Instead, it established an affiliate, the International Finance Corporation, to fill this purpose. The IFC, which invests about $1 billion per year, deals exclusively with private firms, even taking equity positions in private companies. If the World Bank chose to reorient its lending more toward commercially viable projects, then consideration might be given to spinning off the IFC altogether and making it a true private bank.

BANK FINANCES

Conable could redirect Bank lending by opposing the suggested $40 billion increase in the Bank's general capital. The U.S. taxpayer's

14. Article I, paragraph ii.

share of this would be approximately $8 to $10 billion. Politically it would be nearly impossible for the U.S. or most other Western governments to grant additional funds to the Bank against the wishes of the Bank's own president. By denying the Bank additional capital, pressure will mount inside the Bank to use existing resources more efficiently.

Most of the Bank's $60 billion capital is in the form of "callable" capital. Paid-in capital--money actually transferred to the Bank--amounts to only about 10 percent of total capital. The callable capital is like a loan guarantee which the Bank presumably would call upon only in the event that the Bank was about to suffer a major default on a loan. It is questionable whether Bank shareholders actually would kick in extra funds in the event of a default, despite having obligated themselves to do so. Nevertheless, callable capital represents a significant potential obligation on the part of U.S. taxpayers. At present, the U.S.'s share of the World Bank's callable capital is $11.2 billion.

Only about half of the Bank's callable capital is in "hard" currencies. In the event of a default and a call on the Bank's callable capital, the Bank might find many countries fulfilling their obligations with currencies which cannot be used to satisfy bondholders' claims.

The Bank maintains a very conservative capital-lending ratio. According to its Articles, outstanding loans and loan guarantees may not exceed 100 percent of capital.[15] This prevents the capital-lending ratio from exceeding one-to-one. Private banks, in contrast, often have capital-lending ratios of 1 to 10 or even 1 to 20. This suggests that the World Bank could alter its capital-lending ratio above 1 to 1 in order to increase its lending without increasing its capital.[16] Although the Bank's Articles would have to be amended, this might prove easier to accomplish than getting the world's governments to increase the Bank's capital.

To be sure, a price would be paid for such action. The Bank's credit rating--currently AAA, the best available--undoubtedly would suffer. Yet a modest expansion of Bank lending might be desirable without a general capital increase and without creating significant problems for the bond holders, if the alternative is a general capital increase which would impose additional risk on the U.S. taxpayer. A 1 to 2 ratio of capital to lending would still be extremely conservative, yet allow for a doubling of Bank lending. Moreover, the

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15. Article III, Section 3.

16. For a general discussion of these issues, see Eugene H. Rotberg, The World Bank: A Financial Appraisal (Washington, D.C.: World Bank, 1981), pp. 21-26.

Bank's credit rating is ultimately backed by the willingness of its member governments to contribute additional capital if necessary. This would not change.

BUILDING POLITICAL SUPPORT FOR REFORM

It would be useful for Conable to cultivate better relations with the Bank's bondholders--largely big financial institutions in New York and other money centers. They have a very strong vested interest in making sure that the Bank's lending practices are sound. The bondholders also can appreciate the virtues of reorienting Bank lending away from governments, which have proved risky in recent years, and toward the private sector. Bondholders know too how important it is for recipient countries to open their economies to competition and foreign direct investment. Thus the bondholders, a group previously neglected in terms of Bank operations, could provide support for new Bank policies.

Conable could also find support for policy changes among the countries which are the Bank's major shareholders. The finance minister of each country is a member of the Bank's board of governors. He also appoints his country's "executive director" who serves at Bank headquarters in Washington. Conable could find that he could win support for changes at the Bank from the finance ministers of such key countries as West Germany and Japan. Such support for policy changes could blunt predicted opposition from Bank staff, executive directors, and the recipient countries.

The World Bank presidency is an important "bully pulpit" which can affect the economic policies of the world's "less developed" nations. Yet many of those most in need of lessons on economic development, ironically, are the industrial nations which control the Bank. Whether prompted by guilt over their own affluence or simply by ignorance, they have perpetuated Bank policies for many years which not only have not aided development, but in many cases retarded it by stressing the role of government, rather than the private sector.[17]

The focus on government-directed development reached its peak during the McNamara years. More than anyone else, he turned the Bank

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17. Milton Friedman, "Foreign Economic Aid: Means and Objectives," The Yale Review, Summer 1958, pp. 500-516; P. T. Bauer, Dissent on Development (Cambridge, Massachusetts: Harvard University Press, 1972). See also Doug Bandow, ed., U.S. Aid to the Developing World: A Free Market Agenda (Washington, D.C.: The Heritage Foundation, 1985); Alan Rufus Waters, "In Africa's Anguish, Foreign Aid is a Culprit," Heritage Foundation Backgrounder No. 447, 1985; and James Bovard, The Continuing Failure of Foreign Aid (Washington, D.C.: The Cato Institute, Policy Analysis No. 65, 1986).

away from the private sector toward government, transforming the Bank into a kind of international welfare agency, concerned about "basic human needs" and population control, rather than banking. Though it will take enormous effort to turn this around, the lessons of the McNamara years are instructive. McNamara proved that the World Bank president can, virtually by himself, fundamentally alter the Bank's direction. If it could be done once, turning the Bank away from the private sector, it can be done again, turning the Bank toward the private sector.

A PROGRAM OF ACTION

Ronald Reagan clearly spelled out the principles of international economic development and the role of the World Bank in an address to the annual meeting of the World Bank and the International Monetary Fund on September 29, 1981. "Trust the people," he said,

> This is the one irrefutable lesson of the entire post-war period, contradicting the notion that rigid government controls are essential to economic development. The societies which have achieved the most spectacular broad-based economic progress in the shortest period of time are not the most tightly controlled, not necessarily the biggest in size, or the wealthiest in natural resources. No, what unites them all is their willingness to believe in the magic of the marketplace.[18]

Since 1981 Reagan has renewed the traditional policy emphasis on the private sector, unleashing one of the strongest sustained periods of economic growth in American history. The same emphasis could be applied to World Bank policies. In his speech at last year's World Bank annual meeting in Seoul, Treasury Secretary James A. Baker III listed the institutional and structural policies which developing countries need to pursue to achieve growth and deal with their debts. They include:

- o increased reliance on the private sector, and less reliance on government, to help increase employment, production, and efficiency;
- o supply-side actions to mobilize domestic savings and facilitate efficient investment, domestic and foreign, by means of tax reform, labor market reform, and development of financial markets; and

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18. Public Papers of the Presidents of the United States: Ronald Reagan, 1981 (Washington, D.C.: U.S. Government Printing Office, 1982), p. 855.

o market-opening measures to encourage foreign direct investment and capital inflows, as well as liberalize trade, including the reduction of export subsidies.[19]

Barber Conable would do well to make this his agenda for the World Bank. So doing, he can make the Bank a key catalyst of growth in the developing world. In tandem with the principles of Reagan's economic program and the Baker Plan, a confident and assertive Conable could make his tenure as World Bank president the most successful in its history. And the chief beneficiaries would be those who need help the most--the world's poor.

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19. 1985 Annual Meetings of the Boards of Governors: Summary Proceedings (Washington, D.C.: World Bank, 1986), p. 209. See also Bruce Bartlett, "The Promises and Pitfalls of Baker's Third World Debt Plan," Heritage Foundation Backgrounder No. 474, 1985.