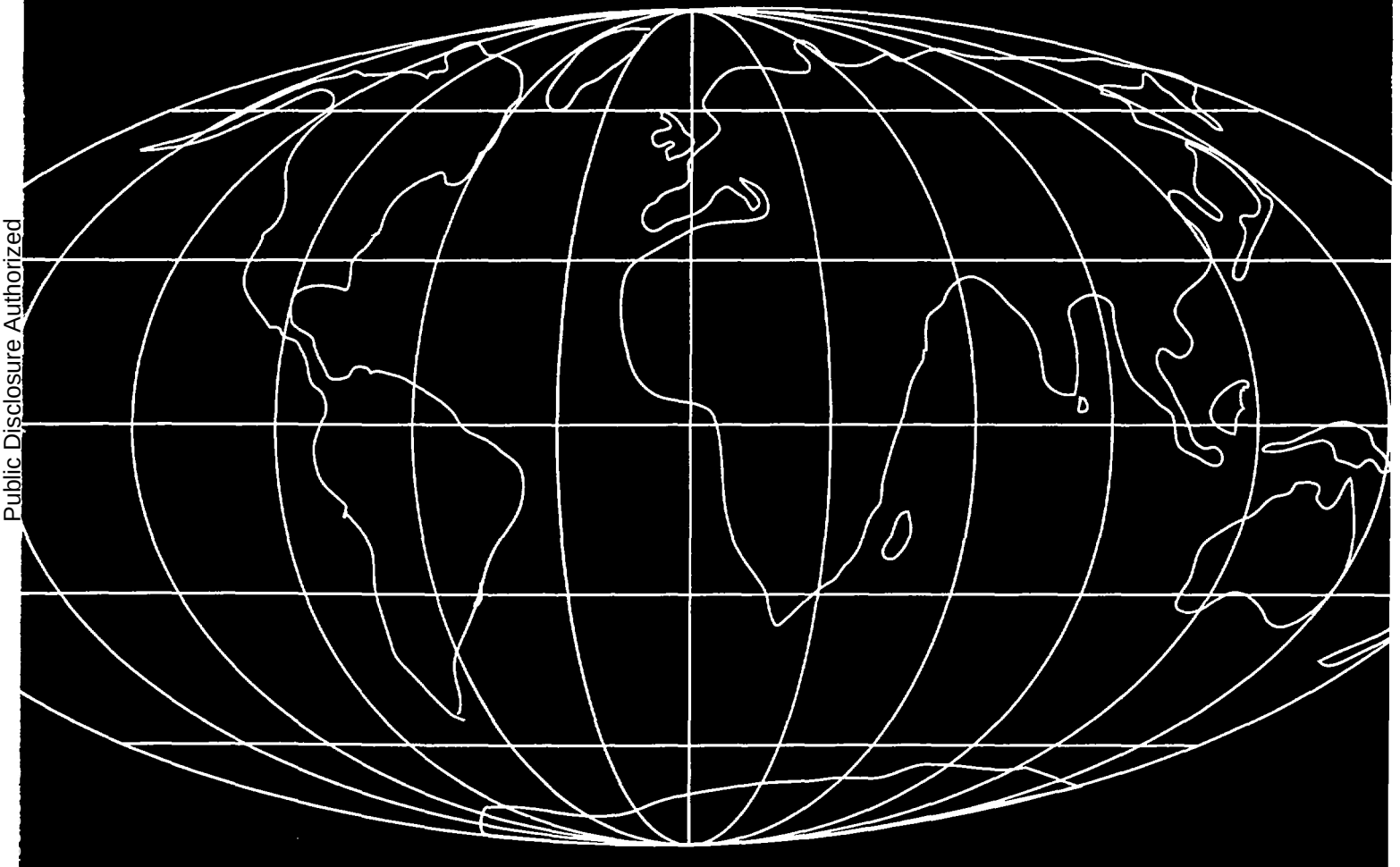
THE EVOLVING ROLE OF THE WORLD BANK



Helping Meet the Challenge of Development

K. Sarwar Lateef, editor

The Evolving Role of the World Bank

Helping Meet the Challenge of Development

Editor

K. Sarwar Lateef

The World Bank
Washington, DC

Manufactured in the United States of America
First printing August 1995

The complete backlist of publications from the World Bank, including those of the IFC, is shown in the annual *Index of Publications,* which contains an alphabetical title list (with full ordering information) and indexes of subjects, authors, and countries and regions. The latest edition is available free of charge from the Distribution Unit, Office of the Publisher, The World Bank, 1818 H Street, N.W., Washington, D.C. 20433, U.S.A., or from Publications, The World Bank, 66 avenue d'Iéna, 75116 Paris, France.

ISBN 0-8213-3234-1

Contents

Foreword

The world has changed dramatically over the past five decades, and so has the World Bank. The Fiftieth Anniversary of the World Bank has provided us with an opportunity to reflect on and learn from the Bank's experience and to apply the lessons to the Bank's future agenda.

This collection of essays is devoted to improving understanding of the evolving role of the World Bank. Each essay analyzes the Bank's approach to the major development challenges its borrowing countries have faced, starting with the reconstruction and development needs of Europe and Japan in the 1940s and 1950s and ending with the transition of Central and Eastern Europe and the former Soviet Union. One essay examines the evolution of the Bank's relations with the world's capital markets as it mobilizes private savings for development. An overview provides a picture of the fifty-year period as a whole.

The story that emerges is one of an evolving and learning institution that has built on its successes and its mistakes. The Bank has responded with vigor and energy to the challenges confronting its borrowers. In this process, it has made a significant contribution to the impressive developmental gains recorded in these past fifty years. In responding to those challenges, the Bank itself has changed, learning from its experiences, deepening its understanding of the development process, and recasting its analytical and financial support to help its borrowers better.

The Bank will continue to nurture its tradition of self-evaluation and learning. This book will, I hope, contribute to a better-informed debate on the Bank's future role. They complement the recently issued paper, *The World Bank Group—Learning from the Past, Embracing the Future*, which sets out the future directions for the Bank Group.

Armeane M. Choksi
Vice President, Human Resources Development and Operations Policy
and Chairman of the Bank Group Committee on the 50th Anniversary

Contributors

Balu L. Bumb is Senior Scientist in the Economics, Research, and Development Division, International Fertilizer Development Center, Muscle Shoals, Alabama.

Kemal Dervis is Director, Central Europe Department, Europe and Central Asia Regional Office, World Bank.

Caroline Doggart is a London-based economist and consultant to the World Bank.

Sebastian Edwards is Chief Economist, Latin America and the Caribbean Regional Office, World Bank.

Ishrat Husain is Director, Poverty and Social Policy Department, Human Capital Development and Operations Policy Vice Presidency, World Bank. At the time he wrote the paper in this volume, he was Chief Economist, Africa Regional Office, World Bank.

K. Sarwar Lateef is Economic Adviser, International Economics Department, Development Economics Vice Presidency, World Bank. At the time these papers were written, he was Staff Director for the Fiftieth Anniversary, Human Resources Development and Operations Policy Vice Presidency, World Bank.

Kenneth G. Lay is Director Understudy, Latin American and the Caribbean Country Department II, World Bank. At the time he wrote the paper in this volume, he was Director, Financial Operations, World Bank.

Uma Lele is Adviser, Agricultural Research Group, Environmentally Sustainable Development Vice Presidency, World Bank. At the time she wrote the paper in this volume, she was Graduate Research Professor of Food and Resource Economics, University of Florida at Gainesville.

Marcelo Selowsky is Chief Economist, Europe and Central Asia Regional Office, World Bank.

Peter Stephens is Chief, Communications Unit, External Affairs Department, World Bank. At the time he wrote the paper in this volume, he was External Affairs Officer, East Asia and the Pacific Regional Office, World Bank.

Vinod Thomas is Director, Economic Development Institute, World Bank. At the time he wrote the paper in this volume, he was Chief Economist, East Asia and the Pacific Regional Office, World Bank.

Christine Wallich is Lead Economist, Central Europe Department, Europe and Central Asia Regional Office, World Bank.

The World Bank Group

The World Bank Group is a family of multilateral development institutions owned by and accountable to member governments. These governments exercise their ownership function through Boards of Governors on which each member country is represented individually. All the powers vested in the Board of Governors, with a few exceptions, have been delegated to Boards of Executive Directors, who are appointed or elected by member governments. The President of the Bank Group is appointed by the Executive Directors.

The World Bank Group today includes five international organizations:

The International Bank for Reconstruction and Development (IBRD), the original institution in the group, opened its doors for business in 1946. Today, it is the largest source of market-based loans to developing countries and is a major catalyst of similar financing from other sources. It lends to governments or to public or private entities with government guarantees. It is funded mainly through borrowings on the international capital markets.

The International Finance Corporation (IFC) was established in 1956 to support private enterprise in the developing world through the provision and mobilization of loan and equity financing and through its advisory activities relating to, among other things, capital market development and privatization. IFC is also a major catalyst of both local and foreign private investment. Its lending and equity investment activities are based on the principle of taking market risk along with private investors. Under the terms of its Articles of Agreement, it cannot accept government guarantees.

The International Development Association (IDA) was created in 1960 to provide finance on concessional terms to low-income countries that lack creditworthiness for IBRD borrowing. IDA is primarily funded from grants it receives from donors in periodic replenishments.

The International Centre for Settlement of Investment Disputes (ICSID) was added to the World Bank family in 1966 to provide conciliation and arbitration services for disputes between foreign investors and host governments that arise directly out of an investment.

The Multilateral Investment Guarantee Agency (MIGA) was created in 1988 to provide noncommercial investment risk insurance and technical services that help promote investment flows. It also disseminates information on investment opportunities.

As is now common practice, the "World Bank" or simply the "Bank" are used interchangeably to mean both IBRD and IDA. The "World Bank Group" refers to IBRD, IDA, IFC, ICSID, and MIGA.

The First Half Century

An Overview

K. Sarwar Lateef

With the hardships of the Great Depression and war years still a fresh memory, few people would have predicted in 1944 that the next fifty years would witness the most rapid growth in living standards the world had ever known. Certainly not many of the delegates from forty-four nations who gathered at a conference in Bretton Woods, New Hampshire, were thinking of such a future. They were there to reform a global economic system that had failed miserably during the Depression and, through a process of intergovernmental cooperation, to lay the foundation for a new era of growth with stability. To oversee the birth of this new economic order, the conference established the International Bank for Reconstruction and Development (IBRD) and the International Monetary Fund (IMF). Parallel negotiations in Havana were coordinating the establishment of an International Trade Organization to complement the Bretton Woods institutions. The trade organization never came to fruition, though it survived in truncated form as the General Agreement on Tariffs and Trade (the GATT).

Few people would have predicted in 1944 that the next fifty years would witness the most rapid growth in living standards the world had ever known

This overview presents the highlights of a series of seven essays on the evolving role of the World Bank and the economic and social performance of developing countries. It examines the challenges the Bank has faced in its first half century and how they have

reshaped the institution, transforming it from an organization established mainly to address postwar reconstruction needs into the world's largest development agency, focusing on sustainable poverty reduction and growth.

Economic and Social Gains since 1944

The past fifty years have seen dramatic, unprecedented gains for developing countries. Some poor economies—Hong Kong, Singapore, and Taiwan (China)—have become richer than some former colonial powers, such as Portugal and Spain. Per capita income, after growing by a plodding 0.5 percent a year in Asia and Latin America in 1913–50, shot up to 3.3 percent a year during 1950–73 and 3 percent in 1973–89.[1] Only in Africa has progress come in fits and starts, with many setbacks.

The past fifty years have seen dramatic, unprecedented gains for developing countries

Social indicators have improved greatly in developing countries, particularly in the past thirty years, while poverty has declined (most dramatically in East Asia). Between 1960 and 1990:

- Average life expectancy increased by six months each year.
- Infant mortality rates fell from 169 to 69 per 1,000 live births.
- Food production increased 240 percent, much faster than population growth.
- The proportion of people chronically undernourished fell from 36 percent to 20 percent.
- Adult literacy rose from 46 percent (in 1970) to 69 percent.
- The share of households with access to safe water more than doubled, to 70 percent.

While poor data cloud the trends in poverty, evidence suggests that "there has been considerable progress in reducing the incidence of poverty, a more modest reduction in the number of poor, and the achievement of somewhat better living standards for those who have remained in poverty."[2] The most dramatic gains have come in East Asia. Even as the region's population

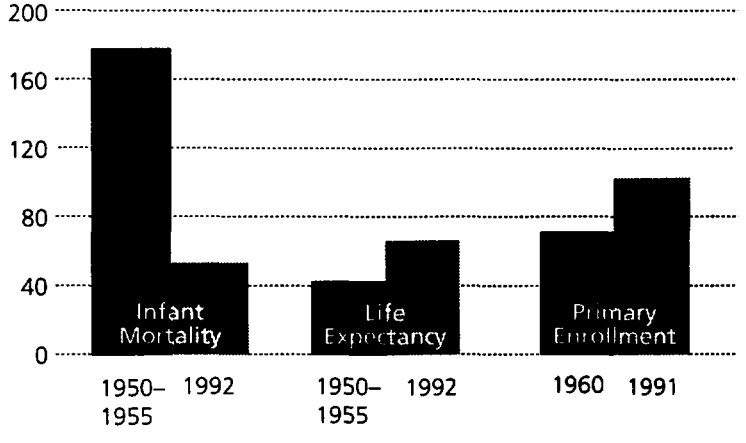
grew by 425 million, the number of absolute poor fell from an estimated 400 million in 1970 to between 170 and 180 million in 1990.[3] Progress was more modest but still impressive in South Asia, where the bulk of the world's poor live. Only in Sub-Saharan Africa did poverty continue to spread as the number of poor increased. What is clear, however, is that without the impressive overall economic performance, hundreds of millions more people would have slipped into poverty in the developing world.

The reasons for the post-war miracle are numerous and varied—expanded international flows of capital, goods, services and technology; development of efficient institutions and human resources; harnessing of entrepreneurship, from small farmers to large industry; higher social spending; better infrastructure; and more investment. In some countries in the 1990s these trends have greatly accelerated, and developing countries have become a major source of growth in the world economy. The World

Without the impressive overall economic performance, hundreds of millions more people would have slipped into poverty in the developing world

Figure 1

People's lives have improved dramatically in developing countries



Source: World Bank Group and United Nations data.

Bank was one of many institutions trying to promote these trends, but the lion's share of credit goes to the countries themselves.

Progress has not been unbroken or universal, however. Since 1980, per capita incomes have stagnated or declined in Latin America and Africa. Development, it became clear, was not a one-way street. For many countries in those regions, the 1980s were a lost decade. But for developing countries as a whole, progress continued even during that bleak period for some. Per capita income accelerated from 2.6 percent a year in 1973–80 to 3.4 percent in 1981–93 (for GDP weighted by population).[4] Improved performance in China and India (each more populous than Sub-Saharan Africa and Latin America combined) and rapid growth in East Asia generally more than offset setbacks elsewhere (see Table 1).

But even with all the progress in the past fifty years, more than 1 billion people still live on one dollar a day or less, and many lack access to safe drinking water, schools, and health

Progress has not been unbroken or universal, however

Table 1 Population-weighted growth of developing countries' real GDP per capita, 1965–93
(percent)

	1966–73	1974–80	1981–93
Developing countries[a]	3.5	2.6	3.4
East Asia	5.4	4.0	6.9
China	5.9	3.9	8.1
South Asia	0.9	1.6	2.9
India	1.1	1.5	3.0
Middle East and North Africa	3.5	2.8	-0.7
Sub-Saharan Africa	1.7	0.2	-1.2
Latin America and the Caribbean	4.3	2.5	0.0

a. Excluding Eastern Europe and the former Soviet Union.
Source: World Bank.

clinics. Environmental degradation threatens the sustainability of development in many areas. Gender bias and urban bias remain serious problems. Much has been achieved. Much remains to be done.

The Role of the Bank

The world has changed tremendously over the past fifty years, and so has the Bank—in its membership, organizational structure, the size of its operations and its development agenda. From 38 members in 1946 to 177 members today, the Bank has expanded to near-universal membership. New affiliates were established to complement the Bank's work and to address its new priorities. In 1956 the International Finance Corporation was formed to promote the private sector in member countries, and in 1960 the International Development Association (IDA) was established to address the needs of the poorest member countries. As foreign direct investment flows increased in size and importance, the International Centre for Settlement of Investment Disputes (ICSID) was established in 1966 to provide conciliation and arbitration services to foreign investors and host countries, and the Multilateral Investment Guarantee Agency (MIGA) was founded in 1988 to provide noncommercial investment risk insurance to foreign investments. The World Bank had become the World Bank Group (see Box on page ii). But throughout this period of change, the Bank's two principal roles remained the same: to mobilize financial resources from private savings and public sources and on-lend them for development and to help client countries address the "what" and the "how" of development. The Bank also responds selectively to shareholder requests for regional and global development initiatives (see Figure 2).

The Financial Role

The World Bank was born of the conviction—strongly held by those assembled at Bretton Woods—that the twin disasters of depression and global war could be averted through international cooperation for mutual benefit, open trade, and

The World Bank was born of the conviction that the twin disasters of depression and global war could be averted through international cooperation

full participation in the world economy by all nations. The conference delegates knew as well that open trade and full participation required healthy, functioning economies, recovered from the ravages of war and capable of providing a decent standard of living for all. It was clear then (as it is today) that domestic savings and investment could not do the job alone. For most of the world's developing economies, foreign financial flows—both private and official—would also be required. The World Bank was one of the financial intermediaries established to facilitate these flows.

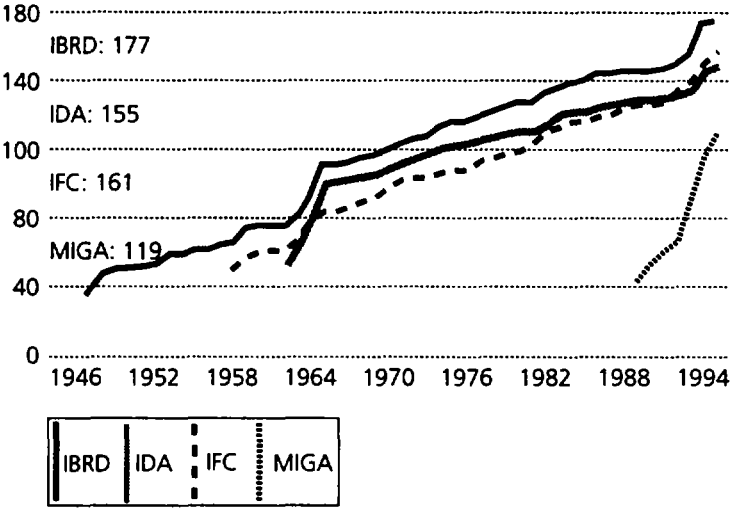
The World Bank was established to facilitate foreign financial flows—both private and official.

THE ROLE OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT. Named formally the International Bank for Reconstruction and Development (IBRD), the institution soon came to be known simply as the World Bank. Yet it is not a bank in any conventional sense. The IBRD accepts no deposits; has only governments as shareholders; lends to members with limited access to capital markets, rather than to its

Figure 2

World Bank Group membership

Number of countries (in June 1994)



richest, most creditworthy members; and limits its lending (by charter) to the value of its equity and callable capital—a 100 percent adequacy ratio against a normal banking ratio of 8 percent.

The IBRD was structured to rely on private resources to fund its operations, and to "promote private foreign investment." Indeed, the IBRD has many of the characteristics of a private sector institution. It is organized as a stock corporation, with voting rights proportional to equity investment. It finances itself in private capital markets, through medium- and long-term bond issues on commercial terms,[5] applying conservative financial policies that have earned and preserved a triple-A bond rating.[6] It insists on disciplined lending, charges market-based rates of interest, and demands prompt payments of interest and principal. It has consistently earned a profit (over $1 billion in fiscal 1994), which its shareholders reinvest or direct to causes appropriate to its mission.

The IBRD has been remarkably effective in its financial intermediation. It borrows in capital markets at fixed rates (for maturities of thirty years and more) only a few hundredths of one percent higher than those paid by its largest government shareholders for their own borrowings. It passes this finance on to its members with a spread of 0.50 percent or less, from which it covers administrative expenses and generates a profit. Such long maturities and low interest rates are available nowhere else to the IBRD's developing country members—not even to the most creditworthy. Such terms represent a savings to developing countries of at least $3 billion a year (on loans outstanding of more than $100 billion). The IBRD has achieved all this at a total cost to its shareholders of $10.7 billion in paid-in capital.

The IBRD was structured to rely on private resources to fund its operations, and to "promote private foreign investment"

THE ROLE OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION. The Bank's concessional arm, the International Development Association (IDA), is also a financial intermediary. It is funded by grants from richer member countries, which it onlends to the poorest and least creditworthy members. IDA

Poverty reduction is the over-arching objective of IDA

funds are replenished every three years. The tenth and most recent IDA replenishment of $18 billion covers the period beginning July 1993. At this level of funding (some $6.5 billion annually), IDA accounts for about 12 percent of all concessional assistance worldwide. These replenishments are supplemented by IDA reflows (repayments) and transfers to IDA from IBRD's profits. IDA loans are interest free (they are called credits) but carry a service charge of 0.75 percent a year. Until the mid-1980s these loans were repayable over fifty years with a ten-year grace period before payments had to start. Recently, the maturity period was lowered to forty years for the poorest countries and thirty-five years for others.

IDA's membership and subscriptions (and hence its voting rights) differ from the IBRD's. But instead of creating a new bureaucracy, the Bank's shareholders decided that the Bank would carry out IDA's work, receiving a management fee in compensation. There is no separate IDA staff, an arrangement that promotes the best possible coordination between the soft and hard lending areas and eases a country's transition from one to the other as country circumstances change. The arrangement also ensures that IDA-financed projects are subject to the same rigorous standards as IBRD-financed projects. The criteria for the allocation of IDA funds are agreed afresh in each replenishment. Current criteria focus on the strength of a country's efforts to reduce poverty in an environmentally sustainable manner and on its per capita income. There are guidelines on the amount of IDA resources that are made available to Sub-Saharan Africa (45-50 percent) and to blend countries—i.e. countries that are IDA-eligible but also borrow from IBRD—(30–35 percent).

The IDA replenishment process also provides a forum for the IDA donor countries to agree on the general uses of the resources provided. The consensus that poverty reduction is the over-arching objective of IDA has been translated into an increased operational focus on poverty reduction. In the 1990s, IDA has increased lending for basic human resource

development and social services, while emphasizing the importance of country policies in encouraging broad-based growth that increases the productivity and incomes of the poor.

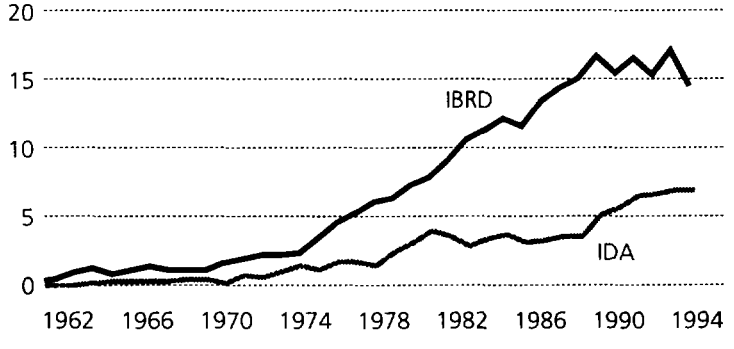
MOBILIZING RESOURCES FROM MULTIPLE SOURCES. Through fiscal 1994 the Bank had lent over $330 billion for some 6,000 operations, of which IBRD accounted for some $250 billion and IDA the rest. The largest growth in lending took place in the 1970s and the first half of the 1980s. Since then IBRD lending has leveled off, reflecting poor policy environments in some cases and increased availability of private flows in others. IBRD and IDA lending has been relatively stable in real terms over the past several years, with total commitments currently running at about $21 billion.

To help ensure that loan funds are put to proper use, the Bank lays down conditions with its loans. Though these conditions are widely perceived as efforts to correct government failure, they are as often designed to correct market failures and imperfections. Because markets do not address income distribution or ensure that the poor receive basic services, the Bank also sees an important role for improved governance. It seeks to strengthen both markets and

Figure 3

IBRD and IDA loan commitments, FY 1960–94

Billions of US dollars



In the 1990s, IDA has increased lending for basic human resource development and social services

governments in the areas that are most appropriate for each.

The Bank addresses market imperfections in global capital markets and in domestic markets of developing countries. Through its intermediation function the Bank makes funds available to countries on terms to which most countries would otherwise never have access, thereby addressing global market imperfections. The imperfections affecting developing country markets are as different as the countries themselves. Impediments include everything from inadequate roads, telecommunications, credit agencies, electricity, and agricultural extension services to underdeveloped human resources.

The Bank makes funds available to countries on terms to which most countries would otherwise never have access

Before World War II creditworthiness alone determined a country's access to market lending. For enterprise loans, banks did some rudimentary project appraisal, but they relied mainly on collateral and credit standing to ensure repayment. The World Bank devised a new lending paradigm by welding together the fragmentary concepts of project appraisal (to make sure the schemes it financed would be profitable enough to generate returns to repay the loan); competitive procurement procedures (to ensure the lowest project costs); the monitoring of the end-use of funds (to ensure that the money was not diverted); loan supervision (to see that the project progressed as envisaged and to make mid-course corrections if necessary); and, beginning in the 1970s, evaluation after a project was completed (to see how well it worked and to learn lessons for future lending). All these elements improved the quality of lending, strengthened the chances of success, and built up the expertise of borrowing institutions in developing countries.

In addition to its own resources the Bank helps catalyze resources from other sources: official bilateral and multilateral institutions, regional development banks, nongovernmental aid agencies, official export credit agencies, and the private sector. Roughly, for every dollar the Bank puts in, it mobilizes an additional

dollar from such "cofinancing." Through more active use of Bank guarantees, greater efforts are being made to attract private-sector cofinancing, which helps borrowers gain access to syndicated commercial bank loans and international capital markets. These direct cofinancing efforts are supplemented by aid-coordination groups for selected countries. The Bank currently chairs some forty consultative groups aimed at coordinating donor response to country needs.

The Advisory Role

In addition to lending and cofinancing, the Bank takes advantage of its wealth of experience to help its members improve their policies, ideas, and expertise. Over time this role has increased in importance relative to the financing role. It takes four forms:

• The Bank engages in intensive *policy dialogue* with all its borrowers on policies that influence the outcome of investments it finances and on the overall macroeconomic environment, incentive structure, public expenditure policies, and institutional context that determines a country's economic performance. This dialogue is informed by regular and thorough analysis of economic and sectoral issues that is undertaken in close collaboration with borrowers. Frequently, it is the Bank's contribution to shaping its borrowers' policies, rather than the financing it provides, that has the stronger impact on the country's overall performance over the long term. Bank endorsement of borrower policies also catalyses other funding for that country and thus plays an important role in supporting the country's development objectives. Examples of how well this process works range from Japan in the 1950s and Korea in the 1960s to China, Ghana, and Indonesia in the 1980s and Argentina, Mexico, and Poland in the 1990s.

• The Bank promotes the use of *best practices* in project preparation, technology choice, organizational structure, procurement practices, monitoring, and supervision. This helps update and transfer the best available expertise in a continuing stream to recipients.

The Bank takes advantage of its wealth of experience to help its members improve their policies, ideas, and expertise

As new challenges to sustainable growth and the equitable distribution of the benefits of growth emerged over the past fifty years, the Bank adjusted its strategies

• To upgrade skills and to create new institutions or strengthen existing ones, the Bank has lent extensively for *technical assistance, training, and institution building*. The Economic Development Institute (EDI) of the Bank was established in 1956 to train developing country personnel, who then become trainers and institution builders at home. EDI now runs about 150 courses annually for 4,400 participants.

• As a development practitioner the Bank has a rich body of experience about what works in development, which it continually refines through *research, publications, and seminars*. Drawing on its own cross-country experience of fifty years in development and the analytical skills of its staff, seasoned by operational experience in the field, the Bank produces a formidable research output. Its many publications have elucidated the lessons of development—what works and what does not. Its *World Development Report* is perhaps the most widely read annual economic report.

A Regional and Global Role

In addition to its principal financial and advisory roles, the Bank has addressed specific problems of regional or worldwide import. These endeavors include the conquest of river blindness in West Africa, the amassing and dissemination of information on agricultural technologies through the Consultative Group for International Agricultural Research, and the funding of environmental projects of global importance through the Global Environment Facility (see Box 1).

The Evolution of the Bank

As new challenges to sustainable growth and the equitable distribution of the benefits of growth emerged over the past fifty years, the Bank adjusted its strategies to respond to those challenges. The Bank began as a financier of post-war reconstruction in Europe in the 1940s; shifted to conservative lending for what were considered "bankable" projects in the early 1950s; became a full-blown development agency in the 1960s, broadening its

Box 1 Beyond National Frontiers

While most of the Bank's work is specific to the countries to which it lends, some of its endeavors span countries and even continents.

River Blindness. One of the Bank's most successful partnerships with other institutions and governments has been in the conquest of river blindness (onchocerciasis) in West Africa. This parasitic disease caused by the bite of blackflies that breed in rivers, causes severe rashes, eye lesions, and ultimately blindness. In the mid-1980s it was estimated that 85 million people (mostly in West Africa but also in the Middle East and Latin America) were exposed to river blindness, of whom 17.7 million were infected and 340,000 blinded. In collaboration with other development agencies, the Bank helped to plan and finance an eradication strategy. The program devised mechanisms for detecting breeding grounds of blackflies and destroying them. Six types of pesticide were used in rotation to prevent resistance from developing in insects and to minimize pollution risks. The program has been so successful that river blindness has virtually disappeared from West Africa.

Agricultural Research. The Green Revolution was made possible by new varieties of wheat and rice developed at the International Center for Maize and Wheat Improvement (CIMMYT) in Mexico and the International Rice Research Institute. To help sustain and spread the Green Revolution the world over, the Bank took the lead in organizing the Consultative Group for International Agricultural Research, a multidonor group that supports sixteen international agricultural research centers in addition to the two pioneering ones. Since 1971 the CGIAR has mobilized over $1 billion for research and helped millions of farmers increase their yields. It has been the most important single developer of agricultural technologies in the tropics.

Environmental Activities. The Global Environment Facility (GEF), a partnership between the Bank, the United Nations Development Programme, and the United Nation Environment Programme, is funded by industrial countries in three-year tranches. It provides grants and concessional loans for environmental projects of global importance. The GEF focuses on four global problems: the greenhouse effect, biodiversity, ozone depletion, and pollution of international waters. The Bank is the GEF's executing agency. The grants cover the difference between the cost of the global projects and other projects that the implementing country might have taken up in the absence of global concerns. A council with sixteen developing countries, fourteen industrial countries, and two countries in economic transition chooses projects to be financed. The GEF committed around $400 million for more than 100 projects in the pilot phase 1991–94, and its coffers have now been replenished by $2 billion for the next three years.

sectoral coverage to the "soft" sectors and lending to poor countries on concessional terms through a soft-loan affiliate; focused on improving living conditions for the poor in the 1970s; shifted its attention to policy reforms to improve the prospects for development in the 1980s; and recognizing the range and depth of its activities, and drawing on the lessons it had learned from its past experience, it embraced in the 1990s a broad-based development strategy aimed at helping countries reduce poverty and increase living standards, by combining attention to sound economic policies, human resources development, and environmental sustainability.

The evolution in the Bank's thinking reflected its own experience and that of others and the improved understanding of what contributes to successful economic development

The Bank's evolution was influenced by new challenges such as the Indian food crisis of the 1960s and the debt crisis of the 1980s and by changes in global economic trends. The 1950s were a time of generally strong growth and high commodity prices, and capital investment (especially in infrastructure) was seen as the prime mover of development. In the 1960s and 1970s state-led development and import-substitution policies held sway, joined in the 1970s by a growing awareness of the need for agricultural development and for a sharing of the gains of development with the poor. The often misguided state-led investment boom of the 1960s and 1970s came home to roost as the debt crisis of the 1980s. Attention shifted from the volume of investment to the quality of policies and the need for reforms. The impact on the poor both of the failure to reform as well as of the reforms themselves refocused attention on issues of poverty. Coming in with the 1990s was a sharp increase in private capital flows, recovery of growth in Latin America and parts of Africa, and the emergence of new political and economic regimes in Eastern Europe and the former Soviet Union.

Development thinking the world over was undergoing transformation. The evolution in the Bank's thinking reflected its own experience and that of others and the improved understanding over time of what contributes to successful economic development. The Bank, never isolated from the currents of

the time, made the same mistakes as its borrowers and other development agencies. Above all, it was influenced strongly by its borrowers, both through their successes and their failures. The borrowers influenced what the Bank did by making new demands on it and by challenging it to respond, constantly expanding its horizons.

In this continuous process of learning, the Bank's emphasis shifted over time from individual projects to the policies, strategies, and institutions that help projects succeed. The changes in perspective were both large and small: from an emphasis on the volume of investment to the productivity of investment; from physical capital to human capital; from infrastructure and industry to developing poor rural areas; from a belief that the benefits of economic growth would trickle down to the poor to an appreciation that reducing poverty also requires extra measures directed to the poor; from a top-down to a bottom-up approach to projects that emphasize beneficiary participation, client-orientation, and preferences determined by markets; from state-led industrialization to the fostering of dynamic private enterprise; and from the exploitation of natural resources to ensuring sustainable development (see Box 2).

This evolution of the Bank is described below, in six phases. Each new phase heavily overlapped the phase that preceded it. The categorization is intended to highlight emphases rather than exclusive preoccupations. Though the Bank today is unrecognizably different from the Bank of the 1950s, there are important continuities that have provided strength to the institution during this constant process of change (see Figure 4).

A Reconstruction Bank: 1947–48

Bretton Woods conference participants were concerned foremost with post-war reconstruction, but they also saw the need for long-term development of poorer countries.[7] The Bank's first loan, for reconstruction, was to France in 1947 for $250 million, which in real terms remains the Bank's largest single loan

The Bank's emphasis shifted from individual projects to the policies, strategies, and institutions that help projects succeed

Box 2 How Sectoral Policies Evolved

As significant as the major shifts in the Bank's strategy over the past fifty years has been the evolution of its lending policies in different sectors. Consider three examples.

Agriculture. Most Bank lending in the 1950s went to big irrigation schemes, in keeping with the prevailing emphasis on infrastructure. Some loans were made in the early 1960s for plantation crops that looked commercially attractive. Then came India's food crisis, which focused attention on the need to improve foodgrain productivity and introduce new technologies. So the Bank began lending for agricultural research and extension, rural credit, market development, and the production of high-yielding seeds and fertilizers. In the 1970s, as the Bank turned its energies to alleviating poverty, activities emphasized integrated rural development programs—the bulk of the poor live in rural areas—directing services and inputs to smaller farmers and agricultural processors, and financing rural social services. However, by the 1980s it was apparent that faulty policies distorted incentives for farmers and seriously affected production in many countries. So the Bank shifted to sectoral adjustment loans that financed agricultural policy reforms.

In the 1990s greater attention is being paid to the environmental problems arising from earlier agricultural development—waterlogging, salinized soils, excessive use of pesticides, water shortages caused by subsidized supplies, and the social problems arising from the displacement of people by large dams. The Bank is also directing rural services and extension to women, who in many countries (especially in Africa) manage most crops. From its inception the Bank's overarching aim has been to raise productivity and incomes, and that goal has not changed. But Bank-supported agricultural projects in the 1990s differ radically from those in the 1960s, when there was little concern for policy frameworks, poverty alleviation, environmental protection, gender bias, or the privatization of inputs and services.

Education. Recognizing the critical linkage between the development of human resources and economic development, the Bank began lending for education in 1963. In that decade, the Bank's support for education focused on the construction and equipping of physical facilities and on producing high-level skills to meet manpower requirements. Over the years, the early emphasis on "bricks and mortar" and other education "hardware" has given way to increased support for teacher training, curriculum development, materials provision and the like, in an effort to enhance the learning achievement of students and generally raise education quality. Support for broad-based institutional development and policy reform in the sector, including strategies to target girls and women, the poor and disadvantaged populations, has increased over time. Moreover, basic education trebled between the late 1980s and the early 1990s. Overall, the volume of lending for education has risen steadily over time, now standing at close to $2 billion per year, or about 8 percent of total Bank lending, as compared with $0.6 billion, or 4 percent, only a decade ago. The Bank is now the single largest source of external funding for education.

Transport. The Bank's earliest loans went to finance the reconstruction of damaged networks in Europe and Japan. When that phase ended, it supported transport facilities that aided international and domestic trade, such as major highways, ports, and airports. During the 1970s the Bank redirected transport lending to areas with a high incidence of poverty. In rural areas projects were financed to build roads to improve the supply of agricultural inputs and the marketing of output and to facilitate the provision of social services. In urban areas, transport loans provided bus services to slum-dwellers. In the 1980s the Bank turned its attention to road maintenance, which had been sorely neglected, and to improving managerial capacities in borrowing countries. It also supported the liberalization and privatization of bus transport. The Bank has come a long way since the 1950s and now stresses improving productivity and customer satisfaction rather than big new projects.

(worth $2.44 billion at current prices). Other loans followed to the Netherlands, Denmark, and Luxembourg, totaling $247 million. Under its articles the Bank was expected to finance productive projects. But it immediately displayed the flexibility that was to mark its operations for the next fifty years, by giving loans to these countries for reconstruction rather than tying them to specific projects.

For the Bank these initial loans helped establish its presence on international capital markets. They also set Bank policies in a number of areas, policies that apply to this day:

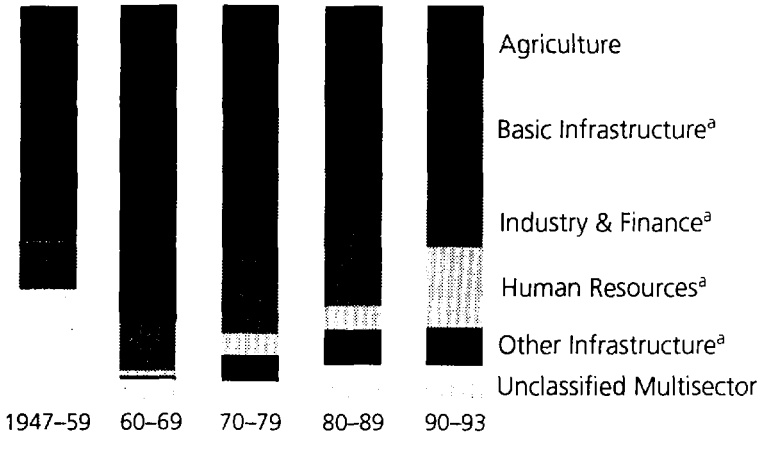
• Interest rates: IBRD established the principle that interest rates must be related to borrowing costs. It also decided to apply the same rate for all loans granted at any given time, regardless of the borrower's creditworthiness. This principle underlined the nature of the institution: a financial cooperative that treated all its borrowing members equally.

For the Bank these initial loans helped establish its presence on international capital markets and set Bank policies in a number of areas

Figure 4

Lending by sector

Percentage of World Bank Lending



a. Basic Infrastructure includes energy, telecommunications, transportation, and power. Industry and Finance includes tourism and mining. Other Infrastructure includes urbanization, water and sanitation, and environment. Human Resources includes education, public security, social services, and population, health, and nutrition.

• Supervision: As required by its Articles of Agreement, the Bank made arrangements to ensure that the proceeds of its loans would be used for the purposes for which they were granted. For the first loan to France, the Bank established an office in Paris, to supervise the project.

• Negative pledge: The Bank decided not to seek specific security for its loans (other than the government guarantee required under its Articles of Agreement) but rather to rely on the borrowing government's undertaking not to pledge its assets to secure international debt in a way that gives any external lender preference over another.

The Bank shifted gears and turned its attention to the long-term financing needs of Europe and Japan as well as the developing countries

It soon became clear, however, that the Bank could meet only a fraction of Europe's reconstruction needs. Its efforts were dwarfed by U.S. assistance under the Marshall Plan, which disbursed $13 billion from 1948 onward. European countries had huge balance of payments deficits (mainly with the United States) as well as war-time controls on trade and financial flows. So they needed not only reconstruction but structural adjustment as well. Marshall Aid was accompanied by policy conditions—the recipients were supposed to cut their fiscal deficits, open up their economies to foreign investment and trade, create a European Payments Union to facilitate multilateral clearing, and make their currencies convertible. Some European countries found these conditions unpalatable, but agreed to them because of their urgent need for dollars. The conditions, however, were not seriously enforced, and most recipients liberalized their economies much later than the United States had envisaged. As for the Bank, it shifted gears and turned its attention to the long-term financing needs of Europe and Japan as well as the developing countries.

A Conservative Lender: 1948–58

The Bank made its first loan to a developing country (to Chile) in 1948. Loans soon followed to Mexico, Brazil, India, and Yugoslavia. The Bank was still a financial fledgling in the 1940s and early 1950s and

needed to convince financial markets that it could deliver. It needed to highlight the soundness of its clients, as well as their projects. Many Bank loans in the early 1950s went to middle-income countries (including those of southern Europe), and significant sums went to Australia and Japan. Much of the lending focused on basic infrastructure. As the success of its operations became apparent, financial markets lent the Bank increasing sums and finally in 1959 gave it top credit rating.

Even in these early days the Bank saw itself as promoting economic development. The 1950–51 *Annual Report* made it clear that "the Bank does not conceive of itself merely as a source of funds for a few isolated projects, but is prepared to take an active and continuing interest in the overall development problems of a member country." And, even at that early stage the importance of its advisory role was becoming evident: "Increasingly, however, the Bank is called upon to provide advice or assistance without reference to any immediate financial operation. In large part, these requests for assistance show a growing appreciation of the need for establishing long-term development programs."

An important part of the Bank's evolution in this phase was its relationship with Japan[8], which in the initial post-war years was under allied occupation and depended heavily on U.S. finance and goods. Japan became a member in 1952, and the Bank quickly took over from the U.S. Export-Import Bank as Japan's main financier and economic adviser. The World Bank justified its lending to a country as industrialized as Japan in part on the basis of Japan's potential to become a financial and trading power within Asia, which would act as an engine of growth for the region. This belief proved well grounded.

Japan was wary of foreign advice and economic linkages, however. It initially resisted Bank loan conditions, such as international competitive bidding for projects and charging appropriate prices for

Much of the lending focused on basic infrastructure. As the success of its operations became apparent, financial markets lent the Bank increasing sums

The Bank had to evolve in a new direction if it were to respond to the needs of the poorer developing countries

electricity. Japan resisted the Bank's efforts to lend for agriculture, believing that this was not an appropriate area for foreign borrowing. Such differences were ironed out through a constructive policy dialogue that helped shape Japan's evolution, including its cautious opening up to the world. The Bank helped Japan launch its first bond issue in the U.S. market in 1959. Japan influenced the Bank as well. It wanted the Bank to finance the local costs of projects, not just their import content as had been Bank practice. The Bank eventually agreed, setting the stage for large-scale financing of local costs in poor countries in the coming decades.

By the end of the 1950s it had become clear that recovery in Europe and Japan was proceeding apace. Since it was not the Bank's business to substitute for private funds, those industrial countries would soon cease to be Bank clients, having demonstrated their capacity to borrow directly from world markets. It was also clear that developing countries, with their limited abilities to borrow on the near-commercial terms that IBRD offered, could not easily step into their place. An internal Bank assessment in 1956 had shown that countries like India and Pakistan were having trouble servicing even the limited debt they had accumulated. The Bank had to evolve in a new direction if it were to respond to the needs of the poorer developing countries.

A Development Agency: 1958–68

India's foreign exchange crisis in 1958 marked a turning point for the Bank. The United States and other donors formed an Aid India Consortium, with the Bank as coordinator, to make annual aid pledges. India persuaded the donors that concessional finance could help the economies of developing countries take off, just as Marshall Aid had helped the economies of Europe and Japan. The analogy turned out to be overdrawn, but it influenced the Bank's evolution as a development agency. By 1958 the financial markets were willing to go along with the much greater development orientation in the Bank's

lending patterns. The creation in 1960 of the International Development Association as a soft-lending arm of the Bank helped this process. The Aid Consortia for India and Pakistan were precursors to the Consultative Groups that the Bank now chairs for some forty countries, to provide a forum for coordination of donor lending and policies in support of the recipient country's development strategy.

A significant development in this phase was the Bank's growing relationship with Korea and Taiwan (China), which showed how rapidly poor economies could grow rich if they followed the right strategy. Planning and state-led growth were the fashion during this period, and the Bank supported five-year plans in many countries. Korea and Taiwan (China) demonstrated that the important part of planning was not capturing the commanding heights of the economy for the public sector but stressing education, paying attention to rural development, adopting an outward-orientation in trade, creating conditions in which dynamic entrepreneurs could prosper, and building strong institutions. This lesson was not absorbed immediately by other countries or the Bank: during the 1960s and most of the 1970s increasing investment levels were still considered the main force for development.[9]

This perception was buttressed by rapid economic growth in the 1960s in Latin America, fueled by state-led import-substituting industrialization strategies. The region accounted for more than a third of all Bank lending in the 1960s, mainly for electricity and transport. This expansion of infrastructure aided rapid growth in many countries, particularly Brazil. Some two-thirds of Bank resources in the 1960s were devoted to basic infrastructure and over one-fourth of Bank resources went to Latin America. It became apparent in later decades that some of this state-led growth was unsustainable, reflecting faulty economic policies. Some Latin American countries and Turkey experienced debt problems even in the 1960s, leading to debt-rescheduling agreements, an early harbinger of things to come.

In the 1960s Latin America accounted for more than a third of all Bank lending

The Green Revolution spread to other countries, its dispersal encouraged by financial and technical support from the Bank

Thanks to IDA, lending also increased substantially to India and Pakistan. India suffered a major food crisis in the mid-1960s. It had neglected agriculture in the 1950s and early 1960s, financing industrialization through policies that pulled resources out of agriculture. In consequence, India became dependent on food aid, primarily from the United States, even in years of bumper crops. When two successive droughts hit India in 1965 and 1966, food aid rose to 10 percent of global wheat trade, making some experts despair of India's viability. But even before the twin droughts India had started experimenting with high-yielding varieties. Provoked by stop-go United States food aid policies, the Indian authorities began to give high-priority to reviving India's agriculture. The Bank and other donors played an important role in helping to finance and shape the technological breakthrough in agriculture that followed (and came to be known as the "Green Revolution"). New policies were needed along with additional finance, and India accepted the need for new technology, prices that reflected resource costs, and public investment in rural infrastructure. The Green Revolution spread to other countries, its dispersal encouraged by financial and technical support from the Bank.[10] India's experience also demonstrated that industrialization was not an easy route to prosperity and that to stave off hunger and deprivation, attention to rural development was critical—an insight that helped shape the next phase of the Bank's evolution.

An Advocate for the Poor: 1968–80

Under the Presidency of Robert McNamara (1968–81) the Bank was transformed in many ways. IBRD and IDA lending rose tenfold, from under $1 billion in 1968 to over $12 billion in 1981 (at current prices), a nearly fourfold increase in total commitments in real terms. As important as the increase in lending was the increase in attention to poverty alleviation and human resource development.

The Bank had from the beginning considered poverty reduction to be an essential part of development. What has changed are its views about the best way to achieve that goal. Initially, the Bank had relied on general economic improvement, to reach the poor indirectly. But Bank studies in the 1970s revealed that hundreds of millions of people in developing countries lived in poverty, lacking such basic facilities as safe drinking water, schools or health clinics. These conditions stifled productivity and kept earning capacity low, setting in motion a self-perpetuating cycle of poverty transmitted from one generation to the next. Poverty was concentrated in rural areas and could be traced to insufficient investment in agriculture and social sectors like education and health. During this period the Bank focused on absolute poverty, affecting 40 percent of people in developing countries, and switched its emphasis to projects designed to reach the poor directly. The Bank greatly expanded its lending for rural areas, especially for agriculture, from which the poor derive most of their income. Lending for agriculture and rural development soared from $1.3 billion in the 1960s to $14.8 billion in the 1970s, more than doubling its share of Bank lending to nearly 28 percent. Lending for human resources development went from $244 million in the 1960s to $2.9 billion in the 1970s (from 2.3 to 5.4 percent of Bank lending). For the first time the Bank began to view rising population as a major development issue but stressed that population could not be controlled without first paying attention to health and education. The Bank also sharply expanded lending for urban development, water, and sanitation. Meanwhile, the share of basic infrastructure fell from 65 percent of Bank lending in the 1960s to 37 percent in the 1970s.

The Bank greatly expanded its lending for rural areas, especially for agriculture

The strong push on the agricultural front had a high payoff in South and Southeast Asia. In the 1970s the Bank helped India finance rural electrification for tubewells, the training and visit system in agricultural extension, agricultural research, rural credit,

rural roads, and facilities for storage and transportation. It helped demonstrate that small farmers could grow high-yielding varieties as efficiently as large farmers, if given appropriate support. This experience brought to light two important lessons that government and development agencies had overlooked in the 1960s: that small farmers constitute a vast untapped potential for agricultural development and that over-taxing agriculture to finance industrialization is a mistake. The Bank support to India, Pakistan, Indonesia, three of the four most populous countries in the world today, helped in their transformation from large importers of foodgrains in the late 1960s to dynamic agricultural producers in the developing world today. Because the spread of the Green Revolution and the rural infrastructure that accompanied it was largely confined to irrigated technologies, its impact in Africa and other rainfed agricultural regions was limited, but in the populous regions of Asia it had a profound impact on poverty.

The policy and institutional environment in which projects were implemented was a major determinant of the performance of the Bank's growing project portfolio

A Policy Reformer: 1980–90

By the end of the 1970s it was becoming clear that the policy and institutional environment in which projects were implemented was a major determinant of the performance of the Bank's growing project portfolio. Even in countries where faulty policies distorted incentives and discouraged efficiency, the Bank continued to expand lending for new projects, believing that these would at least help improve conditions for the poor and counteract some of the negative effects of bad policies. Then a 1981 Bank study, popularly called the Berg Report, concluded from a review of internal and external factors affecting Africa's performance that policy-induced distortions were so severe in many countries that projects could not be expected to succeed no matter how well designed.[11] Policy reform was a prime need, and not just in Africa.

THE DEBT CRISIS. The two oil price shocks of the late 1970s brought home that lesson anew. The first price shock of

1973 dealt a devastating blow to oil-importing countries. As these countries' trade imbalances grew, the Bretton Woods institutions were anxious to relieve human distress by recycling petrodollars, while commercial banks, flush with funds, were eager to direct them toward countries in need. Between 1970 and 1980 public and publically guaranteed debt to developing countries soared from $46 billion to $410 billion. Not enough attention was paid to the possibility that in financing trade deficits, international lenders were underwriting poor investments and policies that could lead to debt problems down the road. By the time of the second oil shock in 1980, the lesson had taken hold. At the World Bank–IMF meeting that year, President McNamara argued that the problem could not be tackled simply by recycling petrodollars. Structural adjustment was necessary in many borrower countries. In any case, rising interest rates and falling commodity prices soon made such recycling prohibitively expensive for borrowers.

Soon, the drop in oil demand hit oil exporters, who had borrowed large sums in anticipation of an unending boom, and the debt crisis exploded in 1982. Problems were most severe in Latin America, which accounted for 37 percent of developing country debt in 1980.[12] Africa was also hit hard. Mexico was the first country in the 1980s unable to service its debt, and others followed in a cascade. Inflows of private capital, which had accounted for three-fifths of the increase in officially held debt stock in the 1970s, plummeted. The debt crisis was a calamity not only for borrowers, but also for the lending banks. The threat of an international banking collapse loomed, reminiscent to many of the beginning of the Great Depression.

The need of the hour was for emergency balance of payments support from the IMF and the World Bank and debt rescheduling by commercial banks and bilateral donors. It was evident that the IMF alone could not provide sufficient resources and that debtors needed long-term finance and structural

Structural adjustment was necessary in many borrower countries

Bank support for reform in Latin America focused on the underlying causes of the debt crisis

adjustment policies that would make their economies more efficient and outward looking. So the Bank adapted the low-conditionality program loans it had made to a few key countries in the 1960s and 1970s to current conditions—and started making structural adjustment loans tied to policy reform. These loans were intended to be fast-disbursing, to meet the immediate cash needs of borrowers while paving the way for longer-term reform. Support for structural and sectoral adjustment lending became a major feature of Bank lending in the 1980s, although it accounted for less than one-fifth of Bank lending on average between 1980 and 1994. Lending for human resources and the environment also began to accelerate in this period, reflecting other needs and concerns.

The importance of external debt as a cause of the Latin American crisis has been exaggerated.[13] Much of the debt was induced by high interest rates and sharp exchange rate fluctuations that were the outcome of policies in industrial countries. And much of it was brought about by a failure of borrowers to invest their loans wisely; indeed, many loans went to finance the expansion of inefficient public enterprises and to insulate consumers from high energy prices. That is why Bank support for reform in Latin America focused on the underlying causes of the debt crisis, while helping member countries restructure their external debt.

In Latin America countries had firm control of the design and implementation of their reform programs. The Bank's contribution consisted mostly of analysis, advice, and financing to ease the pain of adjustment. The fundamental themes of reform have been reducing the size of the state and its interventions in the economy, restructuring public finances, liberalizing prices and controls, reducing the bias against exporting, and increasing the reliance on the private sector. These reforms are now beginning to pay off, as evidenced by the decline in the ratios of public expenditures to GDP, a shift in the composition of public spending toward the social

sectors, the success of privatization programs, and the sharp drop in external tariff levels. The resumption of large volumes of private capital flows to Latin America, such as foreign direct investment and portfolio flows, signifies the gradual return of confidence and the end of the debt crisis.

Unlike the case in Latin America, in Sub-Saharan Africa the debt crisis occurred primarily in low-income countries with weak institutions, low human resource development, and an underdeveloped private sector.[14] Structural adjustment loans and credits were again the main mechanism for meeting balance of payments needs and supporting economic reforms. As in Latin America the debt crisis was symptomatic of a larger crisis in economic management. But the record of implementation of adjustment policies has been mixed. Although the response of private investment has been slow, countries that have consistently implemented sound policies have witnessed a positive turnaround in GDP, agriculture, exports, and industry. In many countries, domestic price controls have been replaced by market-driven prices; governments are getting out of the business of setting exchange rates, interest rates, and producer prices. Nontraditional exports are beginning to appear. So, too, are active stock exchanges. Incentives for agriculture have improved, and there is some evidence that the rural poor have benefited. This progress, however, is confined to only half of the twenty-six largest economies, with particularly impressive results in Ghana and more recently in Uganda. With the devaluation of the CFA franc, prospects for the CFA zone countries have improved considerably, however. But other countries, which have suffered from natural and man-made disasters or the small size of their economies, have been largely left out. The number of Africans in poverty rose in the 1980s, more often because of the failure to adjust but sometimes because adjustment policies in early programs did not pay sufficient attention to the impact on the poor.

A Strong Performance in Asia. Despite the debt crisis the 1980s brought as much good

The resumption of large volumes of private capital flows to Latin America signifies the gradual return of confidence and the end of the debt crisis

The most sensational performance of all in the 1980s came from China

news as bad for developing countries. India, Indonesia, Korea, Malaysia, Pakistan, and Thailand were among those countries that had needed special assistance from the IMF and the Bank to overcome the second oil shock and its aftermath. Yet they not only recovered but grew rapidly. The enormous difference in the performance of Asia, which accounts for two-thirds of the population of the developing world, and Africa and Latin America showed that a country's internal policies mattered much more than external conditions. Superior performance in Asia, particularly in East Asia, was due to several factors.[15] Important among them were better macroeconomic management, a mutually supportive relationship between the state and the private sector, better sectoral policies, more outward-looking policies, greater institutional capacity to deal with change, and greater diversification of exports.

Even during a difficult time of adjustment to external shocks—including reductions in public expenditure and comprehensive tax, trade, and financial reforms—Indonesia continued to reduce poverty in both relative and absolute terms. This was possible because of the government's emphasis on improving the agricultural sector on which the livelihood of most people, especially the poor, depended. It was also due to Indonesia's emphasis in the mid-1980s on a labor-intensive, outward oriented industrialization strategy, and on the large investments in human resources made throughout the decade. Between 1978 and 1987, primary school enrollment among the poorest 40 percent rose from 78 percent to 90 percent, and lower secondary enrollment rose from 42 to 65 percent.[16]

The most sensational performance of all in the 1980s came from China. In little more than a decade, it transformed itself from a centrally planned economy to a dynamic, market-oriented one, whose burgeoning exports gave it a massive trade surplus with the United States by the early 1990s. When China started its transition it had little idea of

how to go about it and was eager to absorb lessons from abroad. It used the World Bank as its main sounding board for changes in policy and organizational structures, and a highly productive policy dialogue ensued. The Bank trained many Chinese personnel at the EDI and translated its economic policy research into Chinese. Its role was far more important in the realm of ideas than in finance. China adapted Bank advice to its own ends and succeeded in pushing GDP growth into double digits. It proved that rapid growth need not be limited to small countries like Singapore—good policies work everywhere.

That many Asian countries fared so well in the same external context that plunged Latin America and Africa into crisis led to introspection within the Bank in the late 1980s. Three successive *World Development Reports* from 1990 to 1992 addressed different aspects of this internal learning. *World Development Report 1990* focused on poverty, exploring why some countries, mostly in Asia, had been so much more successful than others in reducing poverty. *World Development Report 1991* revisited the main lessons of development, noting in particular that success came to countries where there was a healthy relationship between the government and the private sector and where governments provided a regulatory and incentive framework that was outward oriented and conducive to private savings and investment. *World Development Report 1992* focused on an area of increasing concern to the World Bank in the 1980s, the deteriorating state of the global environment, and explored the link among poverty reduction, growth, and the environment. (The key lessons drawn from this process of introspection are summarized in Box 3.) The Bank took away from this process a renewed commitment to the goal of poverty reduction and improved living standards and a recognition of the need for a sharpened focus on human resources development and on growth that is environmentally sustainable and driven by a healthy private sector.

That many Asian countries fared so well in the same external context that plunged Latin America and Africa into crisis led to introspection within the Bank in the late 1980s

Box 3 Learning from the Past

Several lessons stand out from the development experience of the past fifty years:

Poverty reduction is best pursued through a dual assault on the conditions that perpetuate poverty. One way is to pursue rapid economic growth through strategies that make use of the most abundant asset of the poor—labor. This calls for policies that harness market incentives, social and political institutions, infrastructure, and technology to this end. **The second is to invest in people, by providing basic social services to the poor.** Primary health care, family planning, nutrition, and primary education are particularly important. These two strategies are mutually reinforcing. One without the other is insufficient.

A prime requirement for rapid economic growth is a stable macroeconomic framework. Beyond a point, budget deficits, excessive government borrowing, and monetary expansion are quickly followed by inflation, chronic overvaluation of the currency, and loss of export competitiveness.

Integration with global markets for goods, services, finance and technology yields major gains. Openness to trade, investment, and ideas is essential in encouraging domestic producers to reduce costs by adopting new technologies and improving existing ones.

Private enterprise and governments both have vital roles to play in development, and success lies in building on their complementarities instead of trying to choose between them. Competitive markets are the best way yet found to efficiently produce the goods and services consumers want. Such markets require a dynamic private sector motivated by adequate incentives and an environment conducive to savings, investment, and labor-intensive growth. But markets do not work in a vacuum—they require legal and regulatory frameworks that governments need to provide efficiently. At other tasks, markets may be inadequate or fail altogether. That is why governments must ensure adequate investments in infrastructure, provide essential services to the poor, and create safety nets to prevent others from slipping into poverty.

This renewed commitment reflected a further evolution in the Bank's approach to poverty reduction. The Bank of the 1990s is addressing poverty in a more holistic manner (see Box 3) and through a more strategic, country-focused approach relying on a comprehensive analysis in the form of in-depth and increasingly participatory poverty assessments. Twenty years after the first push towards poverty reduction, there is more data on poverty and better ways of identifying the poor, targeting them, and monitoring the impact of Bank policies and projects. The macro-micro linkages in the Bank's current approach enable a better integration of poverty issues within country assistance strategies. The increased emphasis on participation and environmental management adds to both the complexity and richness of the agenda as well as to its quality.

Toward a Holistic Approach: The 1990s

In many respects, as the Bank entered the 1990s the challenges facing its borrowers remained the same as they had

ever been. More than a billion people lived in acute poverty. Rapid population growth and economic expansion were contributing to pressures on the environment. And in many countries the institutional infrastructure was an impediment rather than a mechanism for addressing these problems adequately. At the same time, the context in which the Bank operates was becoming more complex, more challenging, and changing rapidly.

There has been rapid integration in the global economy, with the growth in trade outpacing growth in GDP. Developing countries are leading this trend: they account for the fastest component of the growth in trade. Private capital flows to these countries have more than recovered from the precipitous decline following the debt crisis and are now at record levels. These flows are projected to reach $113 billion for 1993, over three-fifths consisting of foreign direct investments ($56 billion) and portfolio equity investments ($13 billion). This is three times the level at the end of the

For development to be sustainable, the environmental basis of production must be protected. Fortunately, many policies that encourage growth also protect the environment. These include removing subsidies that encourage excessive use of fossil fuels, irrigation, electricity, pesticides, and logging; clarifying rights to manage forests, fisheries, and land; and providing sanitation and drinking water to poor areas. Appropriate pricing and property rights are not enough in some cases, where strong institutions and clear rules are needed to guard against degradation. Local participation can be of major assistance.

Rapid development requires good governance. Experience has shown that how power is exercised for economic and social development is extremely important. Efficient legal and administrative structures, clear rules for economic actors and enforcement of contracts, speed and transparency in decision-making, and high standards of financial and political accountability are needed.

Participation is essential for economic development. Participation in project design and execution by beneficiaries can improve outcomes. Projects that give beneficiary communities a sense of ownership and a stake in their outcome elicit grass-roots support that protects projects from erosion by vested interests. Decentralization of power from capitals to local communities yields positive results.

Investing in women is of vital importance to the economy, to households, and to children. The education of girls has a long-term impact on the productivity of women in the work place and on fertility and infant and child mortality. Economic returns to education are often higher for women than for men.

If reforms are to succeed and take root, they must be "owned" by politicians and technocrats, who must believe in their efficacy and direct their design. Experience shows that reforms work where the Bank supports local technocracies that are committed to the reforms and are able to tailor the new policies to local conditions. The borrower's commitment is the single most important factor explaining success in Bank project outcome.

1980s and reflects the increasing integration of global financial markets. Implementation of the Uruguay Round agreements will keep these trends on an upward path.

There have been equally dramatic political developments, with the spread of democracy, the expansion of political participation, and the surge in nongovernmental organizations. The most dramatic change, of course, has been the collapse of the former Soviet Union, which has contributed to the globalization of the Bank's membership.

There have been equally dramatic political developments, with the spread of democracy, the expansion of political participation, and the surge in nongovernmental organizations

The complexion and composition of the groups of countries that make up the Bank Group's clients have changed as well. There are now four. Many countries are prospering in the new global environment, and these include the most populous countries in the developing world (China and India), other countries in East Asia, and Latin America. These countries will progressively rely less on official development finance. At the other extreme are many countries, mostly in Africa, that have lagged behind. For them poverty is increasing, and they risk being excluded from full participation in global markets and the benefits that brings. In the middle are the countries that require further policy and institutional reforms and a more supportive international environment to join the ranks of the first group. Then, there are the nations of Eastern Europe and the former Soviet Union. They have abundant human capital but face obsolete and deteriorating physical capital and have seen massive declines in output. These countries are moving from command to market economies in a fluid political and institutional context. If successful in their reforms, they can look forward to restored growth that would be a massive stimulus to the global economy. There are early signs of hope (notably in Poland and the Czech Republic), but the journey for many may be long and difficult.[17]

To address this new context, the Bank outlined its development agenda in a recent paper,

The World Bank Group: Learning from the Past, Embracing the Future. The Bank's fundamental objectives, as set out by its founders fifty years ago, remain valid today. Within these broad objectives, the World Bank is attempting to position itself to help its borrowers meet the challenges of the twenty-first century. New vice presidencies have been created to strengthen internal capacity to meet emerging new challenges:

- A vice presidency for Human Resources and Operations Policy, to support a major emphasis on poverty reduction and human resource development.

- A vice presidency for the Environment and Sustainable Development, to bring a clearer focus on sustainability issues in all aspects of the Bank's work.

- A vice presidency for Finance and Private Sector Development, to enhance support for growth and private sector development and financial sector reform.

- A vice presidency for Europe and Central Asia, to assist new member countries of the former Soviet Union and Central and Eastern Europe in their transition to market-based economies.

In addition, important changes are occurring in the Bank Group's institutional culture. There is now greater concern for quality in the performance of the project portfolio, more support for innovation and cost consciousness, and more transparency and openness in external dialogue.

The Bank's fundamental objectives, as set out by its founders fifty years ago, remain valid today

Five Development Challenges

The Bank Group has renewed its commitment to help borrowers reduce poverty and improve living standards by promoting sustainable growth and investing in people. The paper *Learning from the Past, Embracing the Future* identifies five major development challenges facing the Bank Group's clients and on which the Bank will focus in the coming years:

- Pursuing economic reforms to enhance growth and reduce poverty

- Investing in people
- Protecting the environment
- Stimulating the private sector
- Reorienting government.

The five challenges are all closely linked and reflect the Bank's more holistic approach to development in its sixth phase of evolution toward a truly global development agency.

SIX GUIDING PRINCIPLES The agenda is large, and the Bank Group must be agile and responsive while avoiding the danger of stretching itself too thin. Six guiding principles have been adopted:

- Selectivity—identifying actions that will help most in improving a client's potential and the Bank's impact.
- Partnership—seeking alliances with other development agencies (governments, international agencies, nongovernmental organizations, private sector investors) to maximize the effectiveness of development assistance.
- Client-orientation—responding to the needs of clients and facilitating their participation in the design and implementation of Bank-supported programs.
- Results-orientation—looking beyond lending volume to maximizing development impact and improving service quality and efficiency.
- Cost-effectiveness—ensuring that scarce resources are spent wisely.
- Financial integrity—maintaining the Bank's high standing in financial markets to ensure that it can provide finance on the best possible terms to members.

The agenda is large, and the Bank Group must be agile and responsive

The Unfinished Agenda

The rapid changes in the global environment are bound to influence the Bank's future just as they have done in the past. Many successful countries in Asia may soon stop borrowing from the Bank, just as European members did in the 1950s. The regional development banks, the European Union, and Japan are

increasingly influential and financially important players on the development scene. Many borrowers are developing their own analytical skills and using the resources of other agencies, official and unofficial.

This increased competition offers new opportunities for the Bank to become even more responsive to the needs of its clients, demonstrating the flexibility that has helped it remain a relevant institution over time. Fifty years of evolution have already achieved a great deal, but much unfinished business remains. And history shows that new challenges relentlessly follow old. History also shows that the Bank has successfully changed with the times to serve its members better. It is doing so again to help them eradicate poverty and ensure sustainable development.

The author is grateful for the substantial contribution made by Swaminathan S. Aiyar, a Delhi-based economist and journalist, and a consultant to the World Bank, on which this piece draws heavily. He is also grateful for contributions and comments from numerous Bank colleagues.

Notes

1. Angus Maddison (1991). *World Economic Growth: The lessons of long-run experience*. (Background paper for the WDR 1991).
2. World Development Report 1990, p. 40; World Bank 1990.
3. In this series, Vinod Thomas and Peter Stephens, *East Asian Economic Miracle*, World Bank 1994.
4. A growth rate for all developing countries can be calculated by weighting, individual country growth rates by each country's income or population. Weighting by income does not distinguish between a dollar accruing to a more populous and poorer country and one accruing to a less populous and richer country. Population-weighted indices measure the change in income of a typical individual, treating the income growth of each person equally. For a discussion of this issue, see *Global Economic Projects and the Developing Countries*, World Bank, 1994, page 6.
5. In this series, Kenneth G. Lay: *Mobilizing Private Savings for Development: IBRD and the Capital Markets*, World Bank 1994.
6. Kenneth G. Lay, ibid.
7. In this series, Caroline Doggart, *From Reconstruction to Development: Europe and Japan*, World Bank 1994.
8. Caroline Doggart, ibid.
9. Vinod Thomas and Peter Stephens, ibid.
10. In this series, Uma Lele and Balu Bumb, *The World Bank's Response to South Asia's Food Crisis: the Case of India*, World Bank, 1994.
11. World Bank, *Accelerated Development in Sub-Saharan Africa*, 1981.
12. In this series, Sebastian Edwards, *Latin America and the Debt Crisis*, World Bank, 1994.
13. Paper presented by S. Shahid Husain to the Institute of Latin American Studies, University College, London, February 1991.
14. In this series, Ishrat Husain, *The Challenge of Africa*, World Bank 1994.
15. Vinod Thomas and Peter Stephens, ibid.
16. Vinod Thomas and Peter Stephens, ibid.
17. For a discussion of the Bank's program in this group of countries, see in this series Kemal Dervis, Marcelo Selowsky, and Christine Wallich, *The Transition in Central and Eastern Europe and the Former Soviet Union*, The World Bank, 1994.

From Reconstruction to Development in Europe and Japan

Caroline Doggart

The Setting

It was not an auspicious moment to sign an international agreement. Fighting continued in Europe, the Middle East, and Asia. The outcome of the war was still uncertain. There was widespread anxiety about inevitable political and economic changes that would come with peace. There were suspicions, too, about American and Russian ambitions. Even so, "greatly encouraged by the critical and even carping spirit in which our proceedings have been watched and welcomed in the outside world," Lord John Maynard Keynes moved for acceptance of the Final Act of the Bretton Woods conference in July 1944. Thus the foundations were laid for the International Bank for Reconstruction and Development (later to be known as the World Bank), and the International Monetary Fund (IMF) to support post-war international economic cooperation.

It was called a Bank "mainly because no satisfactory name could be found in the dictionary for this unprecedented institution"

Before the meeting, years of work had gone into drafting the IMF's charter. Plans for the World Bank were less advanced—so tentative, in fact, that invitations to the forty-four countries represented at Bretton Woods described the meeting as "one intended to formulate definite proposals for an International Monetary Fund,

and possibly, a Bank for Reconstruction and Development." It was called a Bank "mainly because no satisfactory name could be found in the dictionary for this unprecedented institution."[1] Without the good will of the delegates at Bretton Woods, it would have been impossible to draft the Bank's charter in so short a time. In Keynes' words, the delegates had to perform simultaneously the "tasks appropriate to the economist, to the financier, to the politician, to the journalist, to the propagandist, to the lawyer, to the statesman, even . . . to the prophet, and to the soothsayer."

The Articles of Agreement provided that the Bank be used for both development and reconstruction, with special regard paid to easing the financial burdens of countries devastated by the war

In 1944, many of today's developing countries were still colonies. The developing countries represented at Bretton Woods were independent nations (mostly in the western hemisphere) and not directly involved in the war. Their concern was that post-war reconstruction would absorb most of the new bank's resources and that their less-defined needs would be crowded out. To allay these fears, special efforts were made early on to start lending to Latin America, and the first development loans were made to Chile and Mexico. The Articles of Agreement provided that the Bank be used for both development and reconstruction, with special regard paid to easing the financial burdens of countries devastated by the war. Certainly, reconstruction was a more pressing consideration in the minds of the U.S. and European delegations in 1944, and as it turned out, the concern of the developing countries was not unjustified.

Parallel to the Bretton Woods negotiations for multilateral payments and development aid were discussions on creating an International Trade Organization (ITO) to complete the institutional framework for a new international economic order. The ITO was to apply the same multilateralist principles in the area of trade that the Bank and IMF would apply in international finance. Its first priority was to reduce world-wide trade restrictions that had contributed to the 1930s recession. Discussions on the

ITO began in 1943, and although the organization was sunk in 1947 by opposition from governments dissatisfied with its compromise charter, it did not sink without a trace. A General Agreement on Tariffs and Trade (GATT) had been negotiated as part of the ITO program. It was intended to be a temporary expedient until the ITO came into operation. GATT, however, survived, and became permanent in 1955. Slowly but determinedly, it has nudged member countries toward a more liberal system of world trade. It has now been instrumental in reviving a transfigured ITO—the new World Trade Organization—which will succeed GATT in 1995.

The Dollar Lifeline

In part the ITO failed because it coincided with the first post-war attempt to operate a multilateral monetary system. At the end of the war, only the U.S. economy was able to produce the enormous volume and range of foodstuffs, raw materials, and manufactured goods needed to feed and rebuild Europe and Japan. The U.S.-financed United Nations Relief and Rehabilitation Administration (UNRRA), which provided essential supplies and services to liberated areas between 1943 and 1946, came to an abrupt end. So did the Lend–Lease program that covered wartime U.S. exports to Britain (estimated at $13.8 billion) and to the USSR ($9.5 billion). European countries, including Britain, had insufficient dollars to pay the United States for the goods they needed and had no means of boosting their own dollar-generating exports to the U.S. The ensuing "dollar gap" completely undermined United States plans for a speedy revival of world trade. Europe, and Britain in particular, needed a dollar lifeline. With no apparent alternative available, Britain applied to the United States for a $5 billion loan to cover its yawning trade deficit. The loan was approved in 1946, for $3.7 billion (plus $650 million in final settlement of Lend–Lease operations) at 2 percent interest, repayable in fifty years with a five-year grace period. Britain made the granting of the loan a

At the end of the war, only the U.S. economy was able to produce the enormous volume and range of foodstuffs, raw materials, and manufactured goods needed to feed and rebuild Europe and Japan

prerequisite for its ratification of the Bretton Woods agreement—without which the setting up of the Bank and the Fund would have been seriously delayed. Meanwhile, the United States attached to the loan the condition that Britain had to commit itself to membership in the ITO, and to make sterling fully convertible into dollars.

Before the war, sterling-denominated trade within the sterling area (independent Commonwealth nations, such as Australia and South Africa, British colonies, and countries with which Britain had bilateral agreements) accounted for half the world's exports and imports. Convertibility of these countries' currencies into anything but sterling was limited, restricting their capacity to buy in dollars and hence to import from the United States. The United States considered the maintenance of such sterling convertibility controls incompatible with efforts to reduce world trade barriers and it did not want its loan used to prop up the British-dominated sterling area trade reserve. Although the British were reluctant to agree to convertibility, the barriers finally came down in July 1947, prompting a stampede from sterling into dollars. When British dollar reserves (including the proceeds of the U.S. loan) shrank by $868 million in four weeks, convertibility was suspended. It would not be restored until 1958.

Although the British were reluctant to agree to convertibility, the barriers finally came down in July 1947, prompting a stampede from sterling into dollars

The U.S. loan to Britain was the largest of the first two years following World War II. France received $650 million (on the heels of a $550 million loan from the Export–Import Bank), just ahead of crucial national elections. The United States lent Italy $330 million, and $430 million went to the Benelux countries. Eastern Europe received $550 million (far less than expected due to growing U.S. reluctance to help countries within Russia's sphere of influence). In 1945, the Soviet Union itself asked for $6 billion in reconstruction aid in exchange for supporting the Bretton Woods agreement. This was scaled down to $1 billion and eventually came to nothing in the face of U.S. congressional opposition to the

Stalinist government and to the Soviet Union's decision not to apply for Bank and Fund membership.

The Marshall Plan

The lines were being drawn for the Cold War. The global community ideal that inspired the Bretton Woods delegates began to dissolve into a world dominated by two nations strongly opposed to one another. The World Bank, like the IMF, was firmly in the U.S. camp. The United States put up a third of the capital and held a third of the votes. The Bank's headquarters were in Washington, DC, under the watchful eyes of the U.S. Congress, and most of the top brass at the Bank were U.S. citizens. Although partly by default—most European candidates had their hands full at home—these facts reinforced the impression of a U.S.-driven organization. This was particularly hard for countries like Czechoslovakia and Poland, who were Bank members and wanted to borrow, but found themselves under conflicting political pressures. Compelled by geopolitical realities, they eventually gave in to the Soviet Union.

By early 1947, the Truman administration had grown anxious about the lack of progress in Europe's post-war recovery, the political and economic disarray, and the persistent dollar shortage. In March, President Truman called for renewed support for Europe "to help free peoples maintain their free institutions and their national integrity against movements that seek to impose upon them totalitarian regimes." This political message, canonized as the "Truman doctrine," marked the beginning of a period of discussions and intense preparations, culminating in Marshall aid (or the European Recovery Program). Secretary of State George Marshall's ideas for aid to Europe were expressed in an eloquent speech in June 1947. His policy was "directed not against any country or doctrine, but against hunger, poverty, desperation, and chaos. Any government that is willing to assist in the task of recovery will find full

Marshall's ideas for aid to Europe were expressed in an eloquent speech in June 1947. His policy was "directed not against any country or doctrine, but against hunger, poverty, desperation, and chaos"

The Bank made a courageous leap when it announced its first loans to Europe in the spring and summer of 1947. It stepped in when Europe's dollar shortage was at its worst: the U.S. post-war loans had been spent, and Marshall Plan funding was still uncertain

cooperation . . . on the part of the United States Government." The offer appeared to be open to all.

The plan would deal with Europe—including Germany—as a single economic entity. It came at a time when European confidence was rock-bottom. In addition to budget deficits, the sterling crisis, and coal and power shortages, Europe was drought-stricken and had depleted harvests. Hunger and social unrest threatened.

Response to the U.S. offer was enthusiastic. Even the controversial requirements that Europe liberalize its trading and investment systems and move toward economic integration seemed acceptable, if they brought in dollars. The Russians came to the initial Paris meetings to plan the European response, although (as the United States had probably hoped) they soon withdrew. The Soviets could not agree to an open-door policy for foreign private investment, nor to the rebuilding of what would be a unified Germany. The country was ultimately split into Anglo-American, French, and Soviet administered zones. The Soviet government also made sure that Czechoslovakia and Poland withdrew their participation.

The World Bank and Post-War Europe

The Bank made a courageous leap when it announced its first loans to Europe in the spring and summer of 1947. It stepped in when Europe's dollar shortage was at its worst: the U.S. post-war loans had been spent, and Marshall Plan funding was still uncertain.

Self-preservation also played a part. Expectations about the Bank were low, and some member governments regarded the institution as nearly a dead issue.[2] The Bank's first year had been spent looking inward. Qualified staff had been engaged on the basis of "competence and with due regard to geographical representation."[3] For the sake of efficiency and economy, the Bank planned to use expert consultants to deal with specific problems as they arose. In

modest offices at 1818 H Street in Washington, DC, about seventy bankers, economists, lawyers, stenographers, and other support staff divided their time between establishing guidelines for the Bank's future lending operations and preparing the way for borrowing on U.S. markets.

Reconstruction Loans

The appointment of John McCloy as the Bank's second president in February 1947 marked the start of true operations. That reconstruction would come first in the Bank's lending priorities had been foreshadowed at Bretton Woods. Six of the nine loan applications received by the end of April 1947 were for reconstruction in Czechoslovakia, Denmark, France, Luxembourg, the Netherlands, and Poland. With no previous loan appraisal experience, Bank staff had to improvise in analyzing projects and assessing creditworthiness. By today's standards, the process was perfunctory, but it was fast.

THE BANK'S FIRST LOAN. The $250 million loan to France (actually to Crédit National, a semipublic corporation) was the Bank's first. It was an act of faith for several reasons—including the fact that the loan accounted for a third of the Bank's available resources at the time. Soon after came a large loan to the Netherlands and smaller ones to Denmark and Luxembourg.

France originally applied for $500 million. The Bank agreed to half this amount, with the possibility of a second tranche. In nominal terms, the loan (number 1FR) would remain unmatched in size for the next twenty-two years. In real terms, it is still the Bank's largest single loan, with a 1994 value of $2.4 billion.[4]

The loan application arrived as a simple letter attached to an outline of the French government's reconstruction program, the Monnet Plan. The Bank's loan department was already stretched to capacity, making its own balance-of-payments projections for five to fifteen years on the basis of rudimentary statistical data. Even so,

The $250 million loan to France . . . was the Bank's first. It was an act of faith for several reasons—including the fact that the loan accounted for a third of the Bank's available resources at the time. . . . In real terms, it is still the Bank's largest single loan, with a 1994 value of $2.4 billion

While the French loan was not meant to be a model for future lending, it soon became the practical example of Bank policies on interest rates, end-use supervision, and the use of the contractual negative pledge clause

analysis took only two months, by which time it was clear that whether the Bank lent $250 million or $500 million, neither would be enough to cover the enormous payments deficit. The Bank offered $250 million, leaving the way open for an equivalent loan later that year depending on the pace of economic recovery.

The timing of the French loan was ideal for the Bank to establish its credibility as a lender. It was also just before the Bank's first bond issue. France was expected to make good use of the dollars and was an acceptable credit risk. It was also understood within the Bank that this loan would not set a precedent.[5] The loan was not "for the purpose of specific projects of reconstruction or development," as specified in the Bank's charter, but was covered by the "special circumstances" provision. For years to come program loans like the first French (and the three subsequent) reconstruction loans would remain in a minority as the Bank concentrated on project lending.

While the French loan was not meant to be a model for future lending, it soon became the practical example of Bank policies on interest rates, end-use supervision, and the use of the contractual negative pledge clause. Regarding interest rates, the French loan established two important principles. Rates would be set to correspond with the Bank's own borrowing costs. After vigorous debate within the Bank, moreover, it was decided to use the same rate for all loans granted at any given time because "it would be difficult to have different basic conditions for different countries and even more difficult to have different interest rates for different countries."[6] The Bank, after all, gave its members equal status and its loans were not granted, as on international capital markets, on the basis of the borrower's credit rating.

The Bank's first bond issue was only weeks away, and its success depended on what Wall Street would think of the Bank's potential performance as a lender. A commitment to equal interest rates for borrowers with widely differing economic performances could

have jeopardized the whole venture and might have had a negative impact on future borrowing. When the July 1947 bond issue was over-subscribed, there was a collective sigh of relief at 1818 H Street.

Although end-use supervision was required under the Bank's Articles of Agreement and would become a standard feature of Bank lending, it is hard to imagine a more demanding baptism than the French experience. Supervision had not been part of pre-war banking practice, and the French were unhappy with Bank supervisors peering over their shoulders. Even so, a supervision office was set up in Paris. It investigated 5,500 vouchers and routing slips and prepared specific end-use reports for $242 million worth of goods. The Bank felt that its responsibility should extend beyond the delivery of materials and equipment to cover the uses to which equipment was put. In retrospect, this was the first attempt at operation evaluation—to assess the impact on the transport and industrial sectors that had benefited most from imports under the loan.

The third major issue settled during negotiation of the French loan concerned collateral, which was eventually covered by a negative pledge, under which a borrowing government commits itself not to pledge its assets to secure international debt, so that no one external lender is given preference over another. Both negative pledges and pledges of specific security were featured in public bond issues of the 1920s, so the idea was not new. In the French loan, the commitment was made in a letter–covenant. In all subsequent loans, it was included in loan or guarantee agreements. Insistence on this clause was difficult, but through it, the Bank established an important element of the "level playing field" for future lending. Seven years later, in 1954, the question of a negative pledge from France arose again during negotiations for a French West African railway loan. Faced with French reluctance to agree to a newly strengthened clause, the then-president of the World Bank,

The Bank felt that its responsibility should extend beyond the delivery of materials and equipment to cover the uses to which equipment was put. In retrospect, this was the first attempt at operation evaluation—to assess the impact on the transport and industrial sectors that had benefited most from imports under the loan

Eugene Black, explained tactfully that "it would be impossible for the Bank to get the least creditworthy member countries to accept an adequate Negative Pledge Clause if the Bank did not insist on having the substance of the same clause in its contracts with the most creditworthy member countries."[7]

While the Bank wanted to set precedents for lending, it was also anxious to respond to France's particular needs. Because there was no quick solution for the French payments deficit, the Bank arranged a manageable repayment schedule "guided by the truism that it is often easier to get one's money back by the granting of liberal terms."[8] France was given a five-year grace period, which coincided with the period when its existing foreign debt-servicing obligations were at their heaviest. Thereafter, amortization would increase gradually. The loan was repayable over thirty years at 3.25 percent interest plus commission of 1 percent per year on the outstanding loan, earmarked for the Bank's special reserve. Other reconstruction loans were repayable over twenty-five years.

The loan was approved practically on the nod, for reasons that included the Dutch people's "capacity for hard work" and the country's long tradition as an important creditor nation

Other Reconstruction Loans. Unlike the French loan to Crédit National, the next three reconstruction loans were made directly to governments. Because so many start-up problems had been resolved with the French loan, the next one, to the Netherlands, was processed without delay. The loan was approved practically on the nod, for reasons that included the Dutch people's "capacity for hard work" and the country's long tradition as an important creditor nation.[9] The original application requested $535 million to cover reconstruction between 1947 and 1949. While the Bank limited its commitment to the first year's estimated requirements of $195 million (mainly to cover imports from the dollar area) the way was left open for further loans. The Bank's third and fourth reconstruction loans, to Denmark and Luxembourg, were also approved in August 1947.

Preliminary assessment of the French and Dutch loans had

taken place in Washington, but the $40 million loan to Denmark provided an opportunity for the Bank's first loan preparation mission. Small supervision offices were set up in both the Netherlands and Denmark.

The $12 million loan to Luxembourg was a balance-of-payments support loan for the rehabilitation of the steel industry and for railway rolling stock. Modernization and reequipment in these two sectors were expected both to reduce widespread shortages of steel products and to improve transport links of the inland mining and industrial areas with North Sea ports. With only two broad categories of imports covered, end-use supervision was easy. The loan (which was partly for imports from Belgium) also provided the Bank with the first opportunity to use its nondollar capital, namely francs from Belgium's paid-in subscription to the Bank's capital stock.

By the end of June 1948, the Bank had disbursed $470 million of $497 million in reconstruction loan commitments, of which, 90 percent was spent on dollar-zone imports, with the United States supplying 85 percent of the total. The French and Dutch loans were disbursed in less than a year, and the other two within two years of the loan agreements. The European loans were the first to be sold to buyers which included private banks. This provided the Bank with an early opportunity to satisfy Article I of its charter, a requirement to promote private foreign investment. The sale took place in 1948–49 and was covered by the Bank's guarantee. In the next few years, more loans were sold without recourse, and the practice of attaching a Bank guarantee was discontinued in 1956.

There is no doubt that lending to Europe helped bridge the dollar gap, but the Bank was realistic about how much it could do for European reconstruction. In May 1947, when the $250 million French loan was approved, the Bank's loanable resources amounted to $730 million. Investing one-third of available capital in a single loan would be unthinkable today. The July

In May 1947, when the $250 million French loan was approved, the Bank's loanable resources amounted to $730 million. Investing one-third of available capital in a single loan would be unthinkable today

bond issue increased lending capacity to almost $1 billion, of which $497 million had been committed to the four reconstruction loans by the end of August. There was little room to maneuver.

Meanwhile, the Marshall Plan was beginning to take shape, and the Europeans submitted their first wish lists, adding up to a mind-boggling $28 billion.[10] It became clear that the Bank could be no more than a marginal contributor to the emergency reconstruction phase (1945–48).[11] Because Marshall aid was expected to provide the bulk of Europe's import support for the period 1948–52, Bank assistance in Europe concentrated on long-range investments. Both the volume of Marshall aid funds (the initial allocation was $5 billion, the final amount $13 billion) and their cost (mostly grant aid with interest on loans at 2.5 percent) made them more attractive than Bank loans (interest of 4.5 percent).

Because Marshall aid was expected to provide the bulk of Europe's import support for the period 1948–52, Bank assistance in Europe concentrated on long-range investments

Post-Reconstruction Lending

Nevertheless, the Bank continued to lend in Europe during the Marshall aid period, and not only for long-term purposes. Its first post-reconstruction loan was again to the Netherlands, for the purchase of six U.S.-made merchant ships. This was followed by a loan to Herstelbank for on-lending to specific industries, the first of many loans to development finance institutions. Other European loans went to Belgium, Finland, and Italy (for development of the Mezzogiorno) and to less developed Iceland, Turkey, and Yugoslavia—about $200 million in all. Of the Bank's total commitments of nearly $1.4 billion at end-June 1952, about half had been lent to countries also participating in the Marshall aid program.

The Bank's opportunities to lend to Czechoslovakia and Poland evaporated as the influence of the Soviet Union strengthened and anti-Soviet attitudes hardened in the United States. Both countries had submitted large loan applications in the first months of the Bank's operations, but both had been cut back during subsequent negotiations. When the two countries withdrew

from Marshall aid under pressure from Moscow, they put themselves beyond the reach of the Bank. Knowing that the U.S. Executive Director would have to vote against them because of U.S. government reservations, loan proposals for both countries were quietly shelved before presentation to the Bank's Board. Poland left the Bank in 1950, Czechoslovakia at the end of 1954. The Bank made one loan to a socialist country, Yugoslavia, and one to Finland, a country on the fringe of the Communist Bloc. They were the Bank's first and only attempts at short-term lending; they were also the first loans to be repaid.

The First Development Loans

Between 1947 and 1949, while the Bank's attention appeared to be concentrated on European reconstruction, a considerable effort was made to begin development lending. The Bank had no role model to follow, and even with careful preparatory work, there would be trials and errors. Much reliance was placed on the work done by Bank missions whose members had been recruited to provide country- and sector-specific expertise. The first mission went to Brazil in 1947 and was followed by missions to Chile, the Philippines, Peru, India, Turkey, and Egypt. Missions did not "think up brand new development programs or come up with bright new ideas that had never been thought of before. What they did . . . was to support the people in a country who try to do the right thing but who frequently did not have enough power or political influence to do it."[12] They were sent to listen and played a key role in building good relations between the Bank and member countries.

Missions did not "think up brand new development programs or come up with bright new ideas that had never been thought of before. What they did . . . was to support the people in a country who try to do the right thing but who frequently did not have enough power or political influence to do it"

THE FIRST LATIN AMERICAN BORROWER. Chile was the first recipient of a Bank development loan and the first Latin American borrower, but it was not smooth sailing. The Chileans were unhappy about the loan conditions and signed only after being assured that the French had agreed to similar provisions—vindicating the Bank's conviction at the time that precedents were being set to last.

There was also the matter of defaults on Chile's bond debts of the 1920s. Wall Street had not forgotten and might have refrained from buying Bank bonds if the Bank had lent to an unrepentant Chile. It was also considered important that Chile clear its credit record in order to attract private international investment capital on its own account. The Bank's part in mediating an agreement between Chile and the bondholders' committee attracted some criticism. But eventually Chile settled and the Bank made the two loans. It was a useful experience that led to several other requests for mediation of default problems. It also created an image of neutrality that helped make the Bank—and particularly its charismatic president, Eugene Black, a key participant in attempts to solve disputes among member countries during the 1950s. Among these was the crucial Indus River agreement on water sharing between India and Pakistan.

Although such [development] loans are now common, they involved much soul-searching at the time.

LACK OF BANKABLE PROJECTS. Economic analysis done by Bank missions in 1947–48 led to development loan agreements in 1949 to finance projects in Mexico (for electric power, the Bank's first sector loan), Brazil, and India. The first African loan—to the government of Ethiopia for highway rehabilitation—was agreed to in 1950. Except for a $75 million Brazilian loan for electric power and telecommunications, most loans granted in 1950–52 were under $25 million. The Bank also began to lend for development. The Belgian government acted as guarantor for a $40 million loan to finance equipment and materials in a ten-year development plan for the Belgian Congo (the first colonial loan). There were two loans to Australia (for a total of $150 million) and a commitment to regional development in Italy's poverty-stricken southern provinces.

Although such loans are now common, they involved much soul-searching at the time. The Bank's position was that unless "a national development program . . . is properly worked out in terms of the projects by which the objectives of the program are to be attained . . . such programs

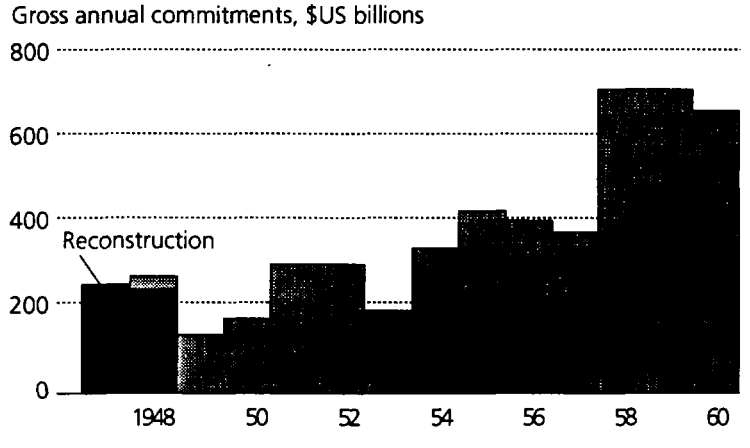
provide no adequate basis for judging whether financial investment will in fact be translated effectively into the concrete substance of development."[13] The issue of program loans and whether or not the Bank should finance local currency expenditures was particularly relevant then, because the Bank was faced with few well-planned projects that needed only funds to begin.[14] This lack of bankable projects is reflected in the static performance of new loan commitments during the Bank's first five years (see Figure 1). Supporters of program lending within the Bank saw it as a chance to respond flexibly to borrowers' needs. At the same time, a commitment to program loans would have provided an opportunity for increasing annual lending rates. This issue would arise again in the context of the Bank's lending to Japan.

The Bank's fifth annual report (for 1949–50) provides insight into the Bank's understanding of its role during reconstruction and early development lending. Priority was given to specific project loans, as

The issue of program loans and whether or not the Bank should finance local currency expenditures was particularly relevant then, because the Bank was faced with few well-planned projects

Figure 1

The transition from reconstruction to development



prescribed in the Articles of Agreement. The four reconstruction loans were "special cases where project investigations are neither necessary nor feasible." In determining what projects were to be financed and how, the Bank was deeply conscious of its responsibilities in setting precedents. Borrowers were expected to apply gradually the same stringent criteria to projects financed from their own resources as those applied by the Bank. They were pushed to be as self-reliant as possible: "where it is reasonably possible for a country to defray the local currency part of its investment program from its own resources without inflationary effects, the Bank believes that it should do so." The experience of El Salvador's Rio Lempa electric power project illustrated the Bank's willingness to help develop local capital markets as an essential step toward increased financial self-reliance. Throughout, the report stressed the importance of projects, their selection, and their financing within the context of a borrowing country's overall development needs. It reflected the preoccupations of a caring investment banker, but of a banker nevertheless. The broader development issues gradually gained in importance during the 1950s, when more Asian countries joined the Bank, and in the 1960s, with the influx of newly independent African states.

Throughout, the report stressed the importance of projects, their selection, and their financing within the context of a borrowing country's overall development needs. It reflected the preoccupations of a caring investment banker, but of a banker nevertheless

The First Five Years: An Overview

During its first five years the Bank was driven by the need to prove to a skeptical world that it could be both a pioneering development lender and a financially sound borrower. Operations were conducted with one eye on member governments' diverse requests for funds and the other on Wall Street. Although the Bank did not have the means to make more than a small contribution to European reconstruction, the four loans were well-targeted, and—above all—well-timed.

With the implementation of the Marshall Plan, responsibility for financing Europe's import needs, which far exceeded the Bank's means in any case, was shifted back to the United

States. For the Bank, these loans provided an invaluable learning experience in project appraisal and supervision, in negotiating loan agreements and in establishing a level playing field for relations with member countries as borrowers.

The problems of reconstruction in Europe, which heavily overshadowed the Bank's early days, gradually gave way to concerns about economic development. The first economic missions established working relations with future borrowers and, in some cases, helped to lay the foundations for national development programs. Projects for infrastructure development dominated the early loan portfolio. A few program loans were made during that period, but they were too diverse to allow any significant conclusions to be drawn about their usefulness in development financing. As the Bank gained more experience, it also became more flexible in responding to members' needs—from mediation in disputes to technical assistance for the development of local capital markets.

The World Bank and Japan, 1952–61

When Germany and Japan joined the Bank in 1952, the institution had already made its mark on international capital markets, gaining high credit ratings in the United States. European exchanges were increasing their trade in dollar-denominated Bank bonds. The first nondollar issue had been launched on the London sterling market in 1951. Nail-biting days, when Wall Street considered the Bank's credit only as good as its U.S. shareholding, were receding. On the lending side, sixty-eight loans represented gross commitments of $1.4 billion. Almost two-thirds of the value of this loan portfolio was earmarked for development, mostly in Latin America and in Europe's African colonies. The lending explosion in Asia was still to come (see Figure 2).

Japan was under the occupation of the Allied Forces from 1945 until early 1952. In those seven years, United States aid had covered more than $2 billion in imports. Further American support was

As the Bank gained more experience, it also became more flexible in responding to members' needs—from mediation in disputes to technical assistance for the development of local capital markets

After the war, Japan was forced to provide for a rapidly growing domestic population and for millions of Japanese repatriated from the former territories from a greatly reduced resource base.

assured—Japan was an essential ally at a time of serious regional instability. The war in Korea had been under way for two years, and China had become a People's Republic in 1949, dashing Western hopes of a more politically compatible Nationalist government.

From the start of occupation, the Japanese economy had recovered rapidly. The 1949 Dodge stabilization program (named for Allied Powers economic advisor Joseph Dodge) introduced fiscal and monetary austerity where there had been runaway government spending and rapid inflation. A single exchange rate, fixed at yen 360 to the U.S. dollar, replaced the multiple-rate system. This provided the anchor for subsequent financial stabilization, in much the same way that European governments had opted for U.S. dollar parities to facilitate current-account operations among themselves through the Marshall Plan-sponsored European Payments Union.

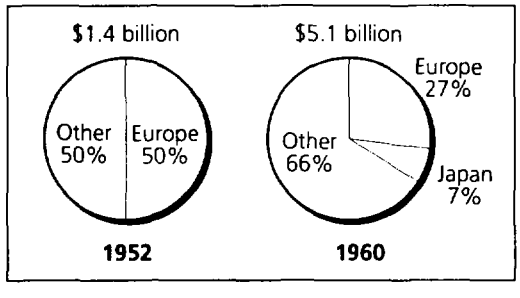
The Bank's First Contacts with Japan

By 1952, the Japanese economy was experiencing the beginning of an export boom driven by U.S. procurement for the Korean war. The boom, however, was more apparent than real. In volume terms, exports were still less than one-third of pre-war levels and its imports about half. Japan ceded its overseas territories—

Figure 2

And the shift away from Europe

Percentage of World Bank loans



among them Formosa and Korea. These areas and Manchuria, in 1938, had absorbed 61 percent of its exports and supplied 40 percent of its imports. They had provided the bulk of Japan's imported staples—rice, soya beans, sugar, and industrial raw materials like coal, iron ore, and pig iron. After the war, Japan was forced to provide for a rapidly growing domestic population and for millions of Japanese repatriated from overseas from a greatly reduced resource base. Japan came to depend on the United States for a large part of its import needs and incurred a huge dollar-zone trade deficit in the process. At the same time, surpluses grew on trade with the sterling area and other nondollar countries, due partly to Japan's restrictive trade and exchange regimes. U.S. aid and other forms of U.S. local expenditures more than covered the dollar-area trade deficit, so Japan was able to accumulate substantial dollar reserves. At end-1952, they could have paid for six months' worth of imports, a situation then unheard of in most of Europe.

JAPAN BECOMES A MEMBER. In 1950, Japan expressed interest in joining the Bretton Woods institutions during informal contacts with the IMF. Membership in the Bank and the Fund was seen by the Japanese as essential for restoring the country's international standing. Japan signed the Articles of Agreement of the Bank and the Fund in August 1952, shortly after the Allied occupation had officially ended. Then, and throughout the next fourteen years, Japan considered an ongoing Bank lending program an important seal-of-approval. This was one of many factors that set the relationship with Japan apart from those with other member states.

Japan considered an ongoing Bank lending program as a demonstration to the rest of the world of its creditworthiness

The Bank's first mission to Japan took three months, starting in October 1952. The Bank's vice president, Robert Garner, participated in the trip, raising the mission's profile and that of its meetings with local officials and private sector representatives. The U.S. State Department was closely involved in the preparatory work. One of the

If there were to be development lending in Japan, the Bank felt that it would be justifiable only in the context of close policy dialogue. But for that to be achieved, there needed to be only one official outside lender—either the Eximbank or the World Bank

mission's objectives was to find out how dependent Japan was on special dollar incomes and how their gradual withdrawal might affect the country's creditworthiness. At that time, armistice discussions were under way in Korea, raising the likelihood of an early reduction in U.S. spending in the region.

The first mission's report was published in 1953. In the same year, the Bank told Japan that—based on continuing U.S. balance-of-payments support—for the time being, the Japanese economy "could support borrowings not in excess of $100 million."[15]

RESOLVING THE OVERLAP WITH U.S. EXIMBANK. But before the Bank could start lending, something had to be done about the overlapping activities of the U.S. Eximbank. The World Bank felt that a lender–borrower relationship on the lines suggested by the Japanese would have to differ from current Bank practices. Japan was an industrialized country that had been able to finance post-war reconstruction primarily with its own and U.S. funds. The investment in modernization and infrastructure, which was both necessary and beyond local financing capacity, was a long way removed from the kind of development in which the Bank was involved elsewhere.

If there were to be development lending in Japan, the Bank felt that it would be justifiable only in the context of close policy dialogue. But for that to be achieved, there needed to be only one official outside lender—either the Eximbank or the World Bank. Although Eximbank was already in advanced discussions concerning loans to the power sector, intense negotiations led to an agreement under which the Bank would take over financing of the power projects. This was the first step toward possible further lending, closely linked to ongoing discussions between the Bank and the government of Japan on Japanese economic policy. Having taken over from the Eximbank, the World Bank had to move fast so not to delay the power projects.

In Japan, meanwhile, a special law had to be passed under which the Japan Development Bank could obtain World Bank loans guaranteed by the Japanese Government. The various procedures were completed within three months, and the loan agreement was signed in October 1953.

Before its first official mission landed in Tokyo, the Bank helped to pave the way for a resumption of Japan's pre-war debt service. Had this not happened, it would have been difficult for the Bank to start a lending program. Preliminary loan negotiations with Chile in 1947 had established that a prospective Bank borrower needed a clear record for meeting past debt obligations before the Bank could commit itself. In September 1952, therefore, the Japanese government agreed with representatives of pre-war sterling and dollar bondholders to resume payments and settlement of all interest and principal in arrears. The Bank's president, Eugene Black, later mediated personally in a debt dispute between French bond holders and the City of Tokyo[16] and did much to cement the relationship between Japan and the Bank.

ENCOURAGING JAPAN'S REGIONAL TRADE. Japan had had several contacts with the Bank before it officially joined. As early as 1950, a Bank mission to Thailand had been in touch with the Supreme Commander for the Allied Powers in Japan, General Douglas MacArthur,[17] to explore the possibilities for an increase in exchanges of Thai rice for Japanese capital goods. At that time, a wider view of Asia–Pacific development was taking shape within the Bank, one in which Japan would play a central role. When the time came to scale down U.S. support, Japan would have to increase its imports of food and raw materials from nondollar suppliers. New export opportunities would be created for other countries in the region that could undercut the high freight costs of Japan's trade with Europe and the Americas. In turn, this would encourage investment in the region's agricultural and

A wider view of Asia–Pacific development was taking shape within the Bank, one in which Japan would play a central role

mining potential. The Bank expected to contribute to this export-oriented regional development; it also envisioned growing Japanese capital participation.

Throughout its relationship with Japan, the Bank has been conscious of the international implications of changes in Japan's investment and trading policies. The Bank hoped to play an advisory part in shaping these policies, which is why it wanted to be Japan's only banker and to keep the dialogue strong. Despite occasional misunderstandings, Japan was aware of the Bank's vision and agreed that "loans to Japan for the modernization and expansion of her industries will enable her to embark upon the task of economic development of the countries of South-East Asia."[18]

If loans [to Japan] were limited to the import contents of high-priority power, steel, and transport projects, the Bank would lose both its capacity to influence project implementation and the opportunity to expand its lending program

LOCAL CURRENCY LOANS. In April 1952 the Japanese government asked whether the Bank might be prepared to depart from specific project lending and make local currency loans. At that time, the Bank's economists were divided about such loans, and the lending policy statement in the *Fifth Annual Report, 1949–1950* struck a cautious note. Local currency lending was considered justifiable only under certain conditions, two of which would have been relevant in the case of Japan. First, "if the project to be financed is of such economic urgency that the country's ability to undertake foreign borrowing . . . is better utilized in financing this project than in financing the foreign exchange costs of alternative projects." Second, "If it is apparent that unless foreign exchange is made available to the borrowing country to be employed for imports . . . the local currency expenditures involved in the project will lead to inflationary pressures."[19]

But as Bank staff acquired a better understanding of the Japanese economy, the logic of such lending to Japan became irresistible. They were convinced that if loans were limited to the import contents of high-priority power, steel, and transport projects, the Bank would lose both its

capacity to influence project implementation and the opportunity to expand its lending program. From 1958 on, therefore, loans to Japan had important local currency expenditure components.

THE ISSUE OF PREPAYMENT. During Robert McNamara's stewardship of the Bank beginning in 1968, the question arose whether developed countries should prepay their Bank obligations in order to release more funds to developing countries.

Almost from the start, Japan was excluded from the prepayment program because of its growing importance as an investor in the developing world. A dollar-for-dollar replacement of Japanese aid with Bank loans would not have been to the advantage of developing countries. In 1967, four-fifths of Japanese net long-term capital exports went to these countries on more favorable terms than the Bank could offer. Although much aid was tied, it was preferable to that on offer from other bilateral donors, because of the competitiveness of Japanese exports. The Bank was also impressed by the fact that Japan did not appear to be inhibited by the lack of creditworthiness of some borrowers and concluded that the "net effect of an acceleration of the repayment of Japan's loans to the Bank might be to reduce the flow of capital to the less creditworthy developing countries in Asia."[20] In the early 1950s, the Bank decided to lend to this industrialized country because of Japan's potential to become an engine for growth among less-developed Asian economies. Just fifteen years later, that decision was vindicated in fact.

Working with the Japan Development Bank

The government-owned Japan Development Bank (JDB) was relatively unknown. Established in 1951 to provide medium and long-term capital for industry, it replaced the discredited Reconstruction Finance Bank. JDB's charter allowed it to borrow in foreign exchange and to guarantee the foreign currency debts of private firms, a great advantage at a time when

The Bank was also impressed by the fact that Japan did not appear to be inhibited by the lack of creditworthiness of some borrowers

foreign exchange remittances were strictly controlled. The World Bank loans provided JDB with its first foreign borrowing experience.

Initially, both the Japanese government and the JDB were unhappy about two aspects of the loan agreements. The first problem was opposition to the negative pledge clause, which spilled over into adverse media coverage. The second problem related to the Bank's request for separate project agreements with power companies. Anxious to adhere to the project-loan concept, the Bank wanted direct contact with the ultimate borrowers as part of its project supervision. The Japanese, on the other hand, wanted as little interference as possible in the affairs of the electricity industry, particularly with respect to setting power rates. Despite these initial differences, an agreement was reached.

JDB gained in stature as a result of its involvement in the Bank's lending program and became a major force in building Japan's industrial base

A sound working relationship developed between the Bank and JDB, during which the Bank continued to take an interest in the performance of companies borrowing through JDB. It was not always easy. There were many lengthy discussions, particularly with the steel companies, on what did and did not constitute adherence to accepted financial targets. Eventually, the Bank recognized a special expertise within JDB and grew confident enough to relinquish responsibility for loan applications and the administration of loan funds. A formal understanding was reached in 1958, after which it was JDB, not the Bank, that asked for collateral. The cumbersome requirement for project agreements was also dropped in favor of less-demanding subsidiary agreements.

JDB handled more than two-thirds of the $448 million committed to Japan between October 1953 and June 1961, and the partnership between JDB and the Bank paved the way for foreign participation in Japan's industrial growth in the 1950s (see Figure 3). JDB gained in stature as a result of its involvement in the Bank's lending program and became a major force in building Japan's industrial base.

Japan's Relationship with the Bank

The Bank's relationship with Japan in the 1950s was not without difficulties. A steady stream of Bank missions to Japan braved the long journey and demanding meeting schedules. Their reports reflect widely differing perceptions of what the Bank could contribute. Even with all the knowledge gathered in Japan, continuity of Bank staff working on Japan, and the close contacts maintained between the Bank and Japanese officials in Washington, inevitably there were misunderstandings. Partly, they were due to different ideas of the banker–client relationship. Repeatedly the Japanese asked for a Bank commitment to a two- or three-year lending program, and the Bank restated its policy of lending only for properly assessed individual projects and not on a fungible, multiyear basis. When news of such discussions reached the Japanese press, another series of critical articles were published. How or why the stories were leaked was never clear, but they introduced hesitance and a distance into the relationship between Bank staff and their Japanese counterparts.

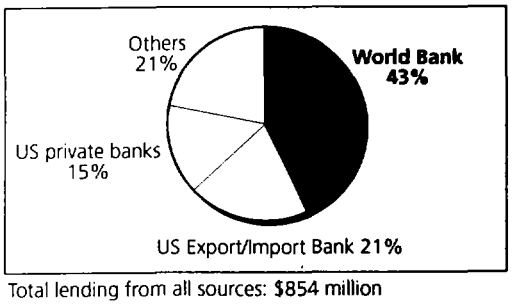
Difficulties also arose concerning development priorities. The Bank had been eager to encourage investment in agriculture and financed land development and irrigation

Even with all the knowledge gathered in Japan, continuity of Bank staff working on Japan, and the close contacts maintained between the Bank and the Japanese embassy in Washington, inevitably there were misunderstandings

Figure 3

The World Bank was the major lender in Japan's development in the 1950s.

External lending to Japan, 1950–1960



Total lending from all sources: $854 million

projects. But the Japanese authorities were reluctant to see foreign borrowing for this sector. They were particularly concerned that such projects, which required the line ministry to put up part of the funds, would increase extra-budgetary government spending and have an inflationary effect.

In the 1950s, periods of rapid economic expansion alternated with brief bouts of disinflationary monetary restrictions. Despite this stop-and-go process, Japanese GDP grew an average of 7.5 percent per year.

It had always been understood that Japan's borrowing from the Bank would be a temporary expedient related to post-war recovery, and that, if sufficient long-term financing appeared to be available from other sources, the Bank would cease to be involved

By 1958, post-war recovery was over and the economy had taken off. It was becoming clear that Japan had outgrown its need for Bank loans and that the lending program was to be phased out. It had always been understood that Japan's borrowing from the Bank would be a temporary expedient related to post-war recovery, and that, if sufficient long-term financing appeared to be available from other sources, the Bank would cease to be involved. At the Annual Meeting in 1957, the Bank's president Eugene Black gently reminded Japan's finance minister, Mr. Ichimanda, that the Bank's charter did not allow it to compete with private capital in project-financing, if such capital was available on reasonable terms.[21] The pressure was on for Japan to start looking for alternative sources of long-term funds.

The Nagoya–Kobe Express Highway Project presented an ideal opportunity to find out whether international investors were interested in Japan. The Bank was prepared to finance part of this project and recommended that Japan raise some of the balance through an international bond issue. Eugene Black became personally involved in encouraging the Japanese to reenter the New York market. Although unhappy about the uncertainty and risk of failure, the Japanese decided that the market was more likely to finance a project that had Bank participation than one that did not. It took over a year to complete the preparations, which included the Japanese Diet approval of the enabling

legislation. The issue was made in February 1959, and was a success. It was particularly gratifying for all involved that the terms for Japan's first post-war venture into the capital market were better than those achieved shortly before by Denmark, a well-established borrower. The successful issue marked the beginning of the end of Bank lending to Japan.

From 1959 on, Japan's capacity to borrow on international capital markets became an increasingly important factor in determining the size of Bank commitments to individual projects. Japan had a large program of high-priority public-sector investments to be financed in areas that had been relatively neglected. Local savings and investment rates were already high and could not be raised much further. It was logical for the Japanese to look to foreign financing for these projects, provided that the price was right. Bank loans were attractive, and the government had learned to respect and live with the Bank's ways of doing business. The relationship was highly valued—not only for the loans, but also because Bank involvement was seen as a positive endorsement of the country's economic policies.

But despite the initial difficulty Japan faced in gaining access to foreign capital markets, access was only a matter of time. In 1961, it fell to the Bank to end the lender-borrower relationship, and the two sides came to an understanding. The Bank would proceed with loans in various stages of negotiation, while Japan increased its capital market operations. After that, the lending door would be closed but not locked.[22]

When the United States introduced the Interest Equalization Tax (IET) in 1963, it came as a blow to Japan's financing expectations. The IET was introduced as a U.S. balance-of-payments measure to stem capital outflows. At that time, U.S. market interest rates were lower than those in most foreign markets, making the United States particularly attractive to foreign borrowers. The tax raised the cost to U.S. citizens of investing in

In 1961 . . . the two sides came to an understanding. The Bank would proceed with loans in various stages of negotiation, while Japan increased its capital market operations. After that, the lending door would be closed but not locked

Starting from a strictly banker–client base, the Bank's role evolved to include advice on the use of capital markets, mediation, and partnership in providing aid to Asia's developing countries. Today's vitally important Bank–Japan collaboration owes much to mutual respect, not easily earned, in those early years.

securities issued in U.S. markets by non-U.S. borrowers. Its effect was similar to a tariff barrier and reduced foreign issues in the United States (as intended) until it was withdrawn in 1974.

The Bank helped to negotiate a partial IET exemption for new Japanese issues. Even so, the tax was likely both to reduce the amount of capital forthcoming and to increase its cost. The situation was considered serious enough for the Bank to shelve the 1961 understanding and resume loan operations. Nevertheless, the Bank insisted that Japan continue to make every effort to raise the maximum possible in private capital markets worldwide,[23] not only in the United States.

The new lending program did nothing to resolve the dilemma created by Japan's conviction that its credit rating in world capital markets depended on parallel loans from the Bank. The inconclusive dialogue continued through the second lending period until 1966, when the Bank made its last and largest loan to Japan. The $100 million highways loan ended a thirteen-year lending program, during which a total of $862 million had been committed, mainly for infrastructure and heavy industry. Paradoxically Japan, then the Bank's second largest borrower in Asia, was an increasingly important supplier of development aid for the region. Japan would become a strong supporter of and contributor to the Asian Development Bank, begun in 1966.

Relations with Japan: An Overview

In the first two decades of the Bank's operations, its relationship with Japan went through many stages. Starting from a strictly banker–client base, the Bank's role evolved to include advice on the use of capital markets, mediation, and partnership in providing aid to Asia's developing countries. Today's vitally important Bank–Japan collaboration owes much to mutual respect, not easily earned, in those early years.

In contrast to the European lending program, Bank participation in Japan's post-war recovery came after the worst was over. The industrial modernization and upgrading of infrastructure, which were both necessary and beyond the capacity of local financing, were also very different from the type of development the Bank was becoming involved in elsewhere. Bank mission work and personal contacts between Japan's finance ministers and Bank management at the Annual Meetings came to play an important part in keeping the lending program moving.

The connection with Japan helped to define certain key aspects of the Bank's relations with its borrowers, particularly the need to consider member countries' different and special circumstances in tailoring credit programs. For Japan, this led to a series of "impact" loans to finance local expenditures. Such loans were exceptional among the Bank's operations at the time. They were attractive to the Bank because they provided the means to influence the design, organization, and execution of projects even when the import content was minimal. That flexibility gave the Bank a say in encouraging moves toward tighter financial discipline in the electricity and steel industries, for example, and helped to set leading-edge construction standards for Japan's new motorways.

The Bank was the single largest source of external finance for Japan in the 1950s, much of it disbursed through the Japan Development Bank. Cooperation with JDB provided an early opportunity to establish acceptable procedures for indirect lending to private sector industries. But it was as the successful intermediary between Japan and foreign investors that the Bank made its most important contribution to the country's post-war recovery. It was clear by the late 1950s that the Bank could not substitute for private capital flows and therefore would not be able to justify

The connection with Japan helped to define certain key aspects of the Bank's relations with its borrowers, particularly the need to consider member countries' different and special circumstances in tailoring credit programs.

lending to Japan for much longer. The country would have to rely on international capital markets for its outside financing needs. However, the Bank was also conscious of the fact that the existing banker–client relationship was considered by the Japanese to be an essential signal of credit-worthiness to the outside world. So, while continuing to make new loans, the Bank worked hard to help Japan gain access to international capital markets. The Bank also took an active part in preparing the way for Japan's first post-war issue on the New York market. Throughout the lending period ending in 1966, the Bank supported Japan in its vital roles both as provider of aid to Asia's developing countries and as the region's main trading partner.

The author is grateful to William M. Gilmartin, Jochen Kraske, and Yoshiaki Abe for their comments.

Notes

1. Proceedings and Documents of the UN Monetary and Financial Conference, Volume I, p. 1219.
2. Columbia University Oral History: Richard Demuth p. 14, Davidson Sommers p. 26.
3. World Bank First Annual Report to the Board of Governors, September 1946, p. 9.
4. The deflator used was the World Bank Budget Price Index, FY1946–94, Budget and Planning Department.
5. Ibid.
6. Columbia University Oral History: Daniel Crena de Jongh p. 15.
7. Bank Archives: Memo on Meeting at the Ministry of Finance, Paris, May 25, 1954.
8. Bank Archives: Memo on Repayment of Loan to France, March 29, 1948.
9. The World Bank since Bretton Woods by Edward Mason and Robert Asher, quotation from the Netherlands Loan Application Recommendations R-121, August 6, 1947, p. 8, and World Bank Second Annual Report, 1946–1947, p. 18.
10. Rebuilding Europe, Western Europe, America and Postwar Reconstruction, by David W Ellwood (Longman), p. 90.
11. World Bank Third Annual Report, 1947–1948, p. 8.
12. Columbia University Oral History: Richard Demuth, p. 71.
13. World Bank Fifth Annual Report, 1949–1950, p. 8.
14. World Bank Fourth Annual Report, 1948–1949, p. 9.
15. Bank Archives: Loan Committee Meeting, March 29, 1954.
16. Columbia University Oral History: Eugene Black, p. 41.
17. Bank Archives: Letter from General MacArthur to the Bank's Engineering Advisor, January 10, 1950.
18. Bank Archives: Japanese Government Memorandum, August 17, 1954.
19. Bank Archives: Memo on Loans for Local Expenditure in Japan, July 17, 1958.
20. Bank Archives: Memo on Prepayment of Japanese Loans, May 28, 1968.
21. Bank Archives: Memo on Discussions with the Finance Minister of Japan, September 24, 1957.
22. Bank Archives: Letter from Mission Leader to Department Chief, April 2, 1962.
23. Bank Archives: Minutes of Meeting with Japan's Minister of Finance, September 26, 1965.

The Food Crisis in South Asia

The Case of India

Uma Lele and Balu Bumb

Thirty years ago, the world regarded India as an economic basket case. Today, India manages the world's largest public grain stock and has even become a minor grain exporter. In 1993, the country's exports increased 20 percent (and are expected to continue increasing rapidly), and the economy as a whole attracted $4.7 billion of foreign investment. These positive economic trends make India one of the largest emerging markets in the world.

Thirty years ago, the world regarded India as an economic basket case. Today, India manages the world's largest public grain stock

Clearly India's (and the rest of Asia's) Green Revolution is a development success of major proportions—and one in which the World Bank has played a significant role. By increasing food production and creating millions of jobs, it allowed India to reduce dependence on food imports and lower the share of its population living in poverty from 50 percent in the 1970s to 30 percent by the end of the 1980s. It is also estimated that, by making land already under cultivation more productive, some 45 million hectares have been saved from the plow—land roughly equivalent to the land under India's best remaining forests. This triple phenomenon of enhanced food security, poverty alleviation, and environmental sustainability has been repeated in much of South and South East Asia. Moreover, enhanced food security and the ability to maintain low urban food prices and wages, combined with global political and economic changes have allowed South Asian countries to follow the path of their East Asian neighbors towards economic liberalization.

India's repeated food and economic crises pushed two successive Prime Ministers, Mr. Lal Bahadur Shastri and Mrs. Indira Gandhi, to try new ideas and innovative ways to develop the country's agriculture. The advice of many assistance agencies, including private United States foundations, and some of the world's top experts on agriculture, reinforced the credibility of agricultural reform. The international character of the World Bank Mission's agricultural team (led by Sir John Crawford) increased its acceptability among the handful of strategically placed Indian policy makers such as Mr. C. Subramaniam, India's then Minister of Agriculture. His support was crucial at a time when Indo-United States relations had soured. With the blessings of both prime ministers, Mr. Subramaniam and several other Indians played a key role in selling the reforms internally to a wide array of skeptics. Their efforts laid the foundation for sustained growth in agricultural productivity in the irrigated parts of India and South Asia for well over three decades.

The Green Revolution in South Asia is one of the most important (yet misunderstood) development stories of technological change, international cooperation, and national perseverance

The character of World Bank assistance to India has changed over time as it has learned from its experience. However, many more lessons are still to be distilled and applied.

The Green Revolution in South Asia[1] is one of the most important (yet misunderstood) development stories of technological change, international cooperation, and national perseverance. It has been controversial, for its contributions as well as its form. Clearly, much remains to be done to make sure that South Asia's 300 million poor do not have to go to bed hungry, lacking employment and income to buy the increased food supplied by the Green Revolution.

Certain policies and institutions introduced to propel the revolution have also caused other problems in their wake; excessive use of chemicals, the peaking in yields, increased salinization, silting of dams, waterlogging, interregional disparities, and mounting agricultural subsidies. Today water shortages threaten to become India's greatest environmental crisis. Interregional

specialization in cropping patterns also need to advance more rapidly. But with the population having doubled in three decades, both the environmental stress and poverty would have been much worse without the Green Revolution—particularly in India's semiarid areas on which larger populations would have had to depend for food security and livelihood.

The heart of the Revolution was the introduction of miracle wheat and rice varieties, which dramatically changed India's agricultural production function, and increased total factor productivity. But technological breakthroughs would have had little effect without policy reforms. New technologies required new policies, and India's leaders responded to the challenge. The country's evolving national agricultural strategy included a complex mix of price incentives; a goal-oriented national agricultural research system; support services responsive to farmers; a system of short-run imports and long-run production and distribution of fertilizer and seed; a public system of grain procurement, storage, and transport; and additional investment in irrigation. With millions of scattered small farm households with little money or access to physical or institutional infrastructure, public policy was crucial. Many agribusiness activities can now be handled easily by the private sector and by nongovernmental community organizations. In the early years of the Green Revolution, however, both these sectors were far weaker and food shortages were acute, placing the burden for change on government.

The heart of the Revolution was the introduction of miracle wheat and rice varieties, which dramatically changed India's agricultural production function, and increased total factor productivity

Why Focus on India

South Asia contains 22 percent of the world's population and 47 percent of its poor. Within South Asia, India accounts for 74 percent of the population, earns 78 percent of its GNP, and produces 77 percent of its foodgrain.

As the world's largest democracy (and one of the oldest among developing countries), India was viewed by the West as a counter to communist China. India took center stage in development planning in the 1950s and the 1960s, attracting

some of the best known western economists. They not only backed India's import-substituting industrialization strategy, they also lent it intellectual credibility by developing state-of-the-art multisectoral models to explore planning options. India was only displaced as the model for development practice when East Asia achieved more rapid and more broad-based economic growth.

Throughout the 1950s and 1960s, India attracted a substantial amount of financial, commodity, and technical assistance from the United States and became the largest recipient of concessional IDA lending. After Robert McNamara became president of the World Bank in 1968 and poverty alleviation became its principal goal, agricultural lending quadrupled in his first term. As part of this commitment, India received 26 percent of worldwide IDA credits, 60 percent of IDA commitments (about $35 billion) to the South Asian Region, and 70 percent of total Bank commitments (about $60 billion) to the region through 1993.

Before the end of the 1970s, India commanded a dominant share in the Bank's lending for agriculture and rural development

Before the end of the 1970s, India commanded a dominant share in the Bank's lending for agriculture and rural development.[2] Even so, in per capita terms, and as a proportion of India's own public sector investment, the World Bank share has been modest. IDA lending to India averaged about $2 per person annually in 1979–81, which was less than 2 percent of total investment expenditures.[3]

In 1965–1967, when her foodgrain imports constituted 80 percent of the South Asian total and 10 percent of the world cereal trade in 1965–67, India's food crisis was of global significance. Following the Green Revolution, India's share of total South Asian foodgrain imports declined to just 16 percent in 1972 and less than 7 percent in 1979 (see Figure 1).

Undivided Pakistan and Sri Lanka both enjoyed higher initial land productivity, higher agricultural growth,[4] and higher and more stable per capita domestic food availability, possibly because both had a more assured initial supply of

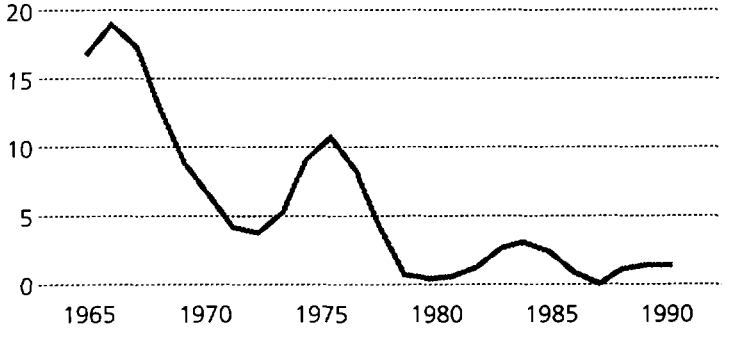
water. (To maintain this supply, Bank agricultural assistance to both countries has focused on irrigation, for example, at Tarbela in Pakistan and Mahaweli in Sri Lanka). The Bank also played an active role in bringing about the 1960 Indus Waters Treaty between India and Pakistan, which expanded irrigation and increased food productivity in both countries, and averted regional conflict over water. Had there been an agreement between the two countries on joint development and management of waters, this could all have been achieved at much lower cost.

The World Bank and the United States (then India's premier donor) played a central role in helping to change agricultural policies and institutions in India, and subsequently throughout South Asia. For India, President Lyndon Johnson personally instituted and oversaw a "short-tether" requiring India to adhere to policy reforms devised by the World Bank. In the midst of India's worst post-independence food crisis in 1965–67, and following a decade of U.S. support to India, Johnson made food shipments available on a month-to-month basis. Indian policy makers found the experience humiliating, and the

Figure 1

Declining dependency on food imports in India

Cereal imports
Kilos per person



Johnson later described India's Green Revolution as "one of the most difficult and lonely struggles" of his presidency

episode soured relations with the United States. Johnson later described India's Green Revolution as "one of the most difficult and lonely struggles" of his presidency.[5] This testifies to the almost insurmountable difficulties that Indian policy makers and the World Bank faced in instituting new agricultural policies.

With considerable diplomacy, the Bank helped to convince India's policymakers that agriculture was the country's chief priority. To help them develop institutional and policy reforms, the Bank also provided concessional finance and foreign exchange partially to make up for the loss of U.S. aid after the 1960s.

For the next twenty years, Bank financing enabled India to expand irrigation and agricultural credit and supply fertilizers to millions of small farmers. Although its financial presence was still small, the Bank's influence on Indian policy was the greatest in the mid-1960s.

According to Mason and Asher, ". . . India has influenced the Bank as much as the Bank has influenced India."[6] The Bank's experience in India helped it to clarify policies regarding balance-of-payments support for countries during a foreign exchange crisis, local and recurrent cost financing, the broad-based use of local contracting, and poverty alleviation. A vocal member of the Bretton Woods conference that fashioned the IBRD in 1945, India also played an important role in the creation of IDA in 1960, and in transforming the World Bank from its 1950s role as a financial institution to a development bank in the 1960s and 1970s.

From Food Insecurity to Growth

At the time of independence in 1947, India's per capita income was a mere $50 in nominal terms, and had been declining for almost fifty years. Average daily per capita grain consumption was only 400 grams, with the poor consuming a fraction of that.[7] Recurring droughts and lagging growth in food-grain production forced India to depend on food imports. In drought years, such dependence created both food

and foreign exchange crises. In the early years of scarcity, surplus commodity aid from the United States stabilized domestic food supplies, ensuring food security for the poor. These shipments saved India the much-needed foreign exchange to import intermediate capital goods for industrialization. Moreover, the sale of food aid provided domestic revenue to finance public expenditures, while keeping food prices, inflation, and real wages low. Over 40 percent of India's net foreign resource transfers in the ten years from mid-1962 to mid-1972 came in food aid, causing concern that such aid had become a disincentive to domestic production.[8]

Agriculture, which provided employment for almost 75 percent of India's population, was a major source of raw materials for industry, and offered a large market for goods and services. Indian consumers, particularly the poor, spent over two-thirds of their budget on food. Given the large share of food consumption in the urban consumer budget, food prices determined the level of real wages, and thus indirectly, the pace of industrialization.

Yet despite the commanding position of agriculture, Indian planners did not see agricultural factor productivity as the obvious engine of broad-based economic growth, on which depended cheap food, employment, income, savings, investment, and markets for urban goods and services. Agriculture was seen as a holding ground for surplus labor while industry would be the primary source of employment and income generation.

But industrialization (based on a minuscule, capital-intensive, heavy industrial sector) was unable to generate sufficient jobs to achieve full employment. Planners considered institutional changes (such as land reform, cooperative farming, and community development) and infrastructure development (such as irrigation) to address the basic needs of India's farm households. Raising the motivation of the largely illiterate Indian farm households was considered an important challenge.

Over 40 percent of India's net foreign resource transfers in the ten years from mid-1962 to mid-1972 came in food aid, causing concern that such aid had become a disincentive to domestic production

Foodgrain production fell by more than five million tons in 1957–58, contributing to India's first major balance of payments crisis. In 1958, India cut back on its investment program and agreed to give higher priority to agriculture

Influenced by the Soviet state and China's cooperative farms, Indians saw the importance of institutional reforms and investment in irrigation. But the public sector continued to focus on—and monopolize—such "basic" industries as steel and power.

In line with development thinking of the time, donors such as the World Bank and USAID wholeheartedly supported the Indian priority on heavy industry and infrastructure development and underwrote India's economic strategy financially. Nevertheless, from the mid-1950s, the thrust of World Bank and U.S. advice on agriculture had begun to promote the importance of price incentives, technological change, investment in irrigation and fertilizers. The intellectual foundation for that view began to emerge with, among others, W. David Hopper's work on Senapur village in the state of Uttar Pradesh in the 1950s on the theme of the poor but rational farmer, which later formed the basis of T.W. Schultz's book, *Transforming Traditional Agriculture*. Hopper's work emphasized the allocative efficiency of traditional farming and stressed the importance of technical change in increasing farm productivity. Influential people in India (such as A. P. Jain, then Minister of Food and Agriculture) also began to stress the role of price incentives in promoting growth in farm output, but such advice was slow to penetrate the ruling party, which favored institutional reforms.[9] Foodgrain production fell by more than five million tons in 1957–58, contributing to India's first major balance of payments crisis. In 1958, India cut back on its investment program and agreed to give higher priority to agriculture.

The World Bank coordinated donor efforts to meet the Indian crisis and created one of the first Bank-led Aid Consortia. It also established a resident mission in New Delhi. But problems with foodgrain production and the balance of payments turned out to be far from temporary. In the early 1960s, food production stagnated. Two successive droughts in 1965–66 and 1966–67, caused annual food imports to rise to 10 million

and 11 million tons, respectively. The droughts also came at a time when the Third Five Year Plan's ambitious targets of industrial expansion had increased import demand for intermediate goods while exports had stagnated-creating another balance of payments crisis. India lacked both the foreign exchange to import the food and the port and handling capacity to receive, store, and transport massive food aid shipments from the United States.[10]

Changes in the global political and food situation and worsening bilateral relations with the United States and its neighbors combined to weaken India's external position. United States food surpluses had also begun to decline. President Johnson was reluctant to go to Congress for more food aid for India. By his own admission, the lives of almost 50 million Indians were at risk. He held out against the urging of all his advisers and a "shrill (United States) press" to induce other nations to lend India a helping hand in the short run, to make India self-reliant in the long run.[11]

India was also engaged in a dispute with the United States over investment in a public sector fertilizer plant by Bechtel Corporation. It was disappointed at not receiving sufficient military aid from the United States during wars with China (in 1962) and Pakistan (in 1965), and it opposed the Vietnam War. Donors were beginning to suffer from aid fatigue.

By the mid-1960s, weaknesses in Indian development policy—and particularly the failure of the agricultural sector—generated a consensus among outsiders that India's policies and programs in agriculture needed change. By 1965, Indian scientists were field testing many new varieties of wheat developed by Dr. Norman Borlaug in Mexico. In November 1965, Orville Freeman, U.S. Secretary of Agriculture under President Johnson, signed a secret agreement (the so called Treaty of Rome) with India's Minister of Agriculture, C. Subramaniam, committing India to extensive agricultural sector reforms. That agreement was followed by the "Woods–Mehta"

Two successive droughts in 1965–66 and 1966–67, caused annual food imports to rise to 10 million and 11 million tons, respectively

The Crawford report observed that India's farmers were unlikely to adopt new technology unless there was public intervention through price supports and an effective public system of grain procurement, which would increase profitability by raising and stabilizing producer price levels

agreement in May 1966, between the World Bank President George Woods and the Indian Planning Minister, Asoka Mehta. The agreement was intended to create a well-focused program of incentives, technologies, and institutional reforms for transforming India's agriculture. The World Bank's controversial Bell Mission Report in 1965 also set out clearly India's macroeconomic and agricultural sector problems, but its recommended devaluation of the Indian rupee took the spotlight away from Sir John Crawford's important agricultural sector review.

The Crawford report observed that India's farmers were unlikely to adopt new technology unless there was public intervention through price supports and an effective public system of grain procurement, which would increase profitability by raising and stabilizing producer price levels. It recommended an increase in support prices for rice (which were raised by nearly a third from 1964 to 1969) and wheat (raised by almost half). It also supported the newly established Agricultural Prices Commission (APC) to ensure the systematic formulation of floor prices (based on cost of production and other considerations) on a regular basis. Crawford also supported a Food Corporation of India (FCI) to implement an effective price support program.[12] The APC and FCI became the two major pillars of India's agricultural price policy over the next thirty years. More than thirty years later, 1991–92, the public sector procured 18.3 million tons of grain and made available 18.8 million tons for retail public distribution through 8,000 fair price shops. About 80 percent of that procurement came from only three states. This system of public procurement and distribution, however, is now in need of major reform.

The Crawford Report also recommended:

- Substantial increases in imports of fertilizers and their allocation to irrigated areas and to progressive farmers who had the capacity to take risks in the adoption of new technology.

- A timely supply of high-quality, improved seed.

- A liberal and timely supply of agricultural credit to facilitate the use of fertilizers and other inputs.

- Cost-effective and socially desirable use of fertilizer subsidies where prevailing prices discouraged the liberal use of fertilizers.

- Reliance on and expansion of the irrigation system.

Influenced by the Crawford Group, Bank lending to India increased in the 1970s, contributing significantly to maintaining the momentum of the Green Revolution. The Bank was less successful, however, in mobilizing the promised aid to meet India's growing import needs. Net foreign resource transfers (20 percent of both gross domestic investment and central government expenditures in 1966–67) declined to a mere 1.7 and 1.9 percent in less than five years in 1970–71.[13]

The Rockefeller Foundation, meanwhile, had been working with Indian agricultural scientists to undertake experiments on high-yielding varieties of wheat (developed in Mexico at the International Center for the Improvement of Maize and Wheat) and rice (developed in Taiwan and at the International Rice Research Institute in the Philippines). Both had shown dramatic results. Where there was ample water and high doses of fertilizers, they yielded 6 to 8 tons as compared to 1 to 2 tons with traditional farm practices and few inputs. Yet in India, there was considerable resistance from scientists and administrators. The Rockefeller Foundation concluded that India's agricultural research, extension, and seed production system needed radical revamping if it was to meet the practical needs of Indian farmers. It recommended administrative changes in the Indian Council of Agricultural Research (ICAR) including vesting leadership in scientists rather than administrators and tying salary and promotions to well-defined performance standards for farmer-oriented researchers. USAID, which supported policy changes, recommended a land

The Rockefeller Foundation, meanwhile, had been working with Indian agricultural scientists to undertake experiments on high-yielding varieties of wheat . . . and rice

grant system of universities responsible for research, extension, and training in place of the departments of agriculture at the state level. Such reshaping was crucial to ensure the high returns to the pricing, fertilizer, and credit policy reforms recommended by the Crawford Group.

To implement reforms in the face of widespread opposition, Prime Minister Shastri, in a shrewd move, persuaded the strong and able C. Subramaniam to take on the agricultural portfolio. Opposition came from several quarters. India's scientists resisted the changes being sought in research. Leftist political parties opposed the importation and distribution of improved seed on grounds that it increased India's dependence on the West. The Ministry of Finance was reluctant to allocate foreign exchange and budgetary resources to import seed and fertilizer and pay for higher producer prices. State governments opposed the divestment of research and extension, to autonomous agricultural universities. On the grounds that it would increase regional income disparities, social scientists opposed the concentration of fertilizer and credit in states with the most water control. Some argued that land reform needed to precede the introduction of new technologies.

To implement reforms in the face of widespread opposition, Prime Minister Shastri, in a shrewd move, persuaded the strong and able C. Subramaniam to take on the agricultural portfolio

India's economic crisis and inadequate foreign aid pushed Prime Minister Shastri and later Mrs. Gandhi to go along with the recommendations of the World Bank and United States. But the prime movers behind the reforms, apart from Mr. C. Subramaniam was his Secretary of Agriculture, Mr. Sivraman; and the Director General of ICAR (and later Secretary of Science and Technology), Dr. M. S. Swaminathan. Scores of Indian scientists and administrators played a key role in adapting and multiplying hybrid wheat and rice and developing the network of services to meet the complex needs of India's millions of farm households. In the midst of a foreign exchange crisis Mr. Subramaniam persuaded India's cabinet to import 18,000 tons of wheat seed from Mexico. Ten years later, India had raised producer

prices and instituted a large food procurement system, adapted and developed over 200 wheat and rice varieties, and greatly expanded the supply of irrigation water, agricultural credit and fertilizers to millions of small farmers.

Sustaining the Revolution

Although the Bank played only a small role in creating the physical and institutional infrastructure for launching the Green Revolution, Indians saw its assurance of assistance to agriculture in the mid-1960s as crucial to the launching of the new strategy.[14] More significantly, the Bank became a long-term partner of the Government of India. Bank lending to India for agriculture and rural development in the McNamara years (1968–81) increased from $124 million in 1950–68 (6 percent of all lending to India) to $687 million (31 percent) in 1969–74. Agricultural lending increased even more sharply to about $4.2 billion (50 percent) in 1975–81. In addition, through nonproject lending in 1967–76, the Bank provided $311 million to support imports of fertilizer and other inputs. Although lending for agriculture continued to increase until the mid-1980s, agriculture's share of total lending dropped to 33 percent in 1982–87[15] and has fallen sharply in both absolute and relative terms since.

This decline stems from the global shift toward increased efficiency, an emphasis on (macroeconomic) policy reforms, the role of markets and prices, and a reduced emphasis on public investments. Growing food surpluses in OECD countries, and declining world prices of cereals and fertilizers reduced returns on investment in irrigation and fertilizer production capacity. India's agricultural subsidies, which had grown to equal total planned public investment in agriculture and its growing foodgrain stocks also became a cause for concern.[16] Moreover, the expanding lending came at the expense of addressing fundamental problems in Indian agriculture. This led to growing criticism by Bank staff about the quality of the agricultural portfolio and externally by environmentalists about, for

Although the Bank played only a small role in creating the physical and institutional infrastructure for launching the Green Revolution, Indians saw its assurance of assistance to agriculture in the mid-1960s as crucial to the launching of the new strategy

example, the adverse environmental impact of irrigation and chemical inputs. Such criticisms have contributed to a decline in the Bank's global lending to agriculture, of which India was only a part.

India's share in the Bank's total agricultural lending to the South Asian region, which stood at 73 percent in 1975–81, declined to 56 percent in 1988–93. The number of projects financed by the Bank showed a similar trend. It had increased from nine in 1950–68 to twenty-four in 1969–74 and sixty-two in 1975–81. By 1981, agriculture and rural development and related lending accounted for 48 percent of the projects and programs financed by the Bank in India, but that dropped, to 26 percent in 1988–93.

Irrigation, fertilizer, and credit projects dominated the Bank's agriculture and rural development portfolio, accounting for over 67 percent of the total. Seed, research, and extension were other agricultural projects financed by the Bank to sustain the Green Revolution. Although these projects accounted for a small share, they were instrumental in alleviating seed shortages (for example, the Tarai Seed Project). They also spread new crop technologies among millions of small farmers through location specific adaptive research, training and visit extension. Likewise, area development projects played a small role, but financed technology and infrastructure components. Forestry and watershed management followed later.

IDA has played a critical role in sustaining the Green Revolution, financing eighty-six of the ninety-six operations by 1981 and 135 of the 159 operations by 1993. It has also provided over 90 percent of lending commitments in the 1968–81 period

IDA has played a critical role in sustaining the Green Revolution, financing eighty-six of the ninety-six operations by 1981 and 135 of the 159 operations by 1993. It has also provided over 90 percent of lending commitments in the 1968–81 period. Without IDA, the Bank would not have been able to promote food production in India. Like most other developing countries, India was hesitant to borrow for agriculture on IBRD terms because of the long gestation lags in achieving response in agriculture, its subsistence rather than export-oriented nature, and the difficulty in

capturing benefits of technology generation from a large number of dispersed farmers.

Fertilizer Supply

The Bank's support for fertilizer import and production was crucial during India's extreme fertilizer shortages in the late 1960s and the 1970s. Without increased fertilizer use, food production would not have increased to the level it did. Funds for the import of fertilizers, plant protection material, and agricultural machinery augmented input supplies in the short-run, while lending for the development and rehabilitation of fertilizer production built new capacity. By making free foreign exchange available and requiring international competitive bidding, World Bank projects ensured internally compatible and technically efficient plants. But increased fertilizer use in irrigated areas has now become a cause for concern as marginal returns to fertilizer use are peaking. Fertilizer subsidies have now become a major source of concern for the budget, and the fertilizer sector is in need of major restructuring for improved efficiency and growth.

Seed Production

Despite large initial imports, shortages of the new high yielding varieties of seed for wheat, rice, and maize became widespread in the late 1960s. This called for supervision and quality control at various stages of breeding, production of foundation seed, and commercial production of seed for a market which had not yet been developed. High quality seed supply needed public investments in plant and equipment for screening and drying. In addition to the 1969 loan, the Bank supported seed production through an IBRD loan of $25 million in 1976 and an IDA credit of $16 million in 1978. India's seed production increased from 420 tons in 1966 to 28,000 tons in 1973 and over 200,000 tons by 1981. Now a combination of rapid liberalization of seed production and distribution, combined with stringent public regulation of quality control, will greatly accelerate diversification of Indian agriculture.

The Bank supported seed production through an IBRD loan of $25 million in 1976 and an IDA credit of $16 million in 1978. India's seed production increased from 420 tons in 1966 to 28,000 tons in 1973 and over 200,000 tons by 1981

India's irrigation systems are among the largest in the world. They present complex technological, institutional, and environmental challenges in design and management, with particular difficulties in efficient water allocation across states, watersheds, households, seasons, and crops

Credit

Bank lending to rural credit projects in 1970–74 amounted to more than $325 million, directed mainly at developing groundwater resources in the private sector. While lending to public sector tubewells was less successful, the Bank has estimated that private sector tubewell irrigation had economic rates of return of well over 30 percent, and have impacted over 2 million hectares with at least that many households. The Bank's contribution to the development of a viable rural financial infrastructure through support of the Agricultural Refinance and Development Corporation, however, has been undermined by poor loan recovery, subsidized interest rates, and political interference in management. The future of Bank involvement in agriculture credit remains uncertain.

Irrigation

The Bank provided about $1.6 billion to projects with the potential to irrigate 5 million hectares. Its early support focused on the completion of ongoing large scale surface irrigation projects and, later, improvements in distribution systems. This was followed by investments in rehabilitation and modernization of the existing irrigation systems, construction of medium and minor irrigation schemes, and introduction of new technology for public tubewells.

India's irrigation systems are among the largest in the world. They present complex technological, institutional, and environmental challenges in design and management, with particular difficulties in efficient water allocation across states, watersheds, households, seasons, and crops. These problems are due partly to intense competition among states for acquiring control of the scarce water resource. To establish political support for acquiring water rights, the states have tended to design irrigation systems stretching access among as many farmers as possible. The resulting overinvestment in physical infrastructure and underinvestment in design of institutional arrangements to deal with the complex technical, equity, and

efficiency issues has contributed to a suboptimal performance of both Indian schemes and the Bank-financed projects.

India has yet to develop a national long-term strategy for water management. Due to the politically sensitive nature of water allocation issues among states, the Bank has been kept out of the loop. This has forced it to focus on individual schemes rather than the development of river basins. The Bank introduced many innovations in its water management strategies, such as canal lining, the command area development programs, underground piped distribution, sprinkler irrigation and others. Some of these technological innovations were introduced to solve institutional problems, and others to improve the performance of the main irrigation systems. Although these innovations proved useful in some areas, their uniform applicability across regions, agro-ecosystems and cropping patterns have resulted in increased costs without significant improvement in performance.

In reality, irrigation problems tend to be highly diverse, complex and inextricably related to climatic and sociocultural conditions. Their solution requires active cooperation among competing states and location-specific approaches with the active participation of the local communities in the design and implementation of water management systems.[17]

The challenges still facing the Bank and the Indian government in the area of water management include institutional reforms of interstate allocation of water resources and local organizational arrangements to deal with water distribution among farmers, the problem of rent-seeking among irrigation officials, and the need for a further reform of rate structures for both greater efficiency in distribution and better cost recovery.[18]

Research and Extension

Although Bank involvement in agricultural research has been modest, the Bank has considered its training and visit projects to be very successful.

Irrigation problems tend to be highly diverse, complex and inextricably related to climatic and sociocultural conditions. Their solution requires active cooperation among competing states and location-specific approaches with the active participation of the local communities in the design and implementation of water management systems

Less than ten years after the introduction of the new agricultural strategy in India in 1966–67, the area under high yielding varieties had expanded from less than 2 million hectares to over 30 million hectares. It reached over 60 million hectares in 1990

These promote a message-oriented approach through a highly structured training of extension workers and their systematic interaction with farmers. The principles crucial to its success include: a time-bound program of farmer visits and training by extension workers, permitting close supervision and merit-based promotion; concentrated efforts to achieve a clear and visible impact by working on the most important crops within the most promising agro-ecosystems; regular visits and field trials with selected farmers who offer the best prospects for a rapid spread of innovations; and linkages with a vigorous farmer-responsive research program.[19] Whether a uniform approach to extension across diverse production conditions is desirable may need to be examined.

Assessing the Revolution

By the year 2000, the combined domestic production and imports of the South Asian region will have to feed 1.4 billion people and by 2025, two billion people. If domestic production cannot meet these requirements, the region will need adequate foreign exchange to import food. The shrinking global capacity to deliver enough food and fertilizers could well affect world prices. Future increases in production, moreover, must be brought about with less incremental use of modern inputs, such as water, fertilizers and pesticides. The poor must command enough income to have access to food and other essentials for a healthy life. These are daunting challenges.

Less than ten years after the introduction of the new agricultural strategy in India in 1966–67, the area under high yielding varieties had expanded from less than 2 million hectares to over 30 million hectares. It reached over 60 million hectares in 1990. Over the same period, fertilizer consumption rose from 1.1 million to over 12.5 million tons. Per hectare, use increased ten-fold, from 7 to 70 kilograms. From crop year 1965–66 to 1988–89, irrigated area expanded from 30 million hectares to 45 million hectares increasing by 50 percent the area double-cropped, which now accounts

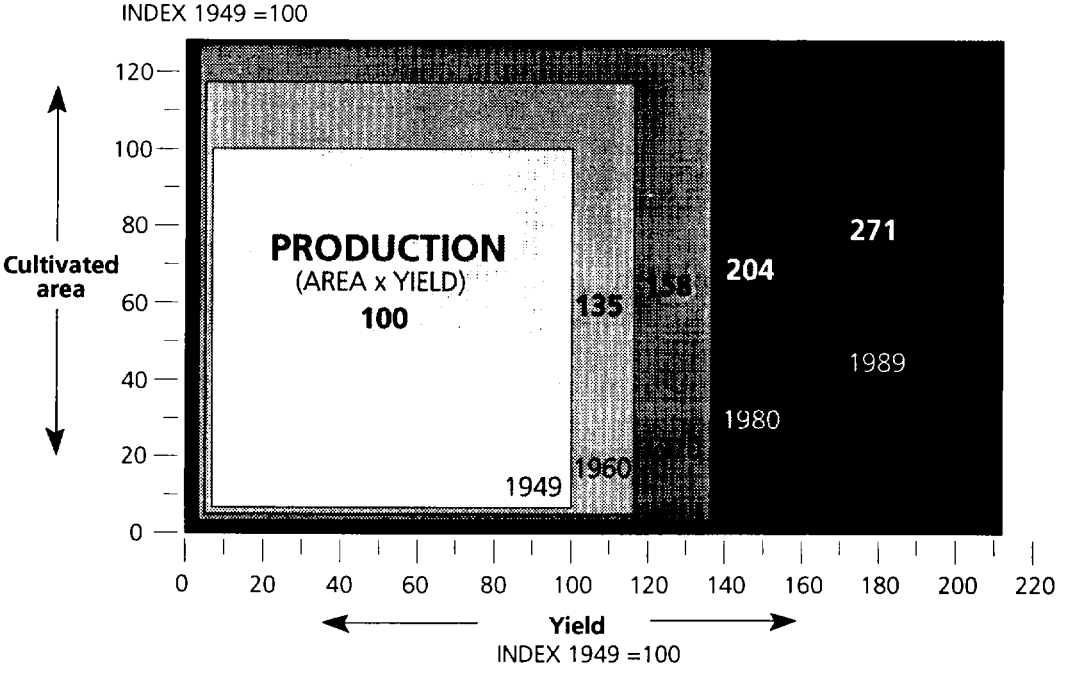
for 27 percent of the sown area. Most importantly, by 1989–90, average Indian yields had increased by more than 100 percent over the drought year yields of 1965–66 and 1966–67 and by 85 percent over the predrought record yields of 1964–65. Yield growth, of course, has been far greater in the areas covered by the Green Revolution.[20]

Output Gains

The combined impact of these developments was that food-grain production increased by 2.7 percent a year in 1966–90, compared with 2.3 percent in 1950–66. This was a small increase in overall growth. However, the qualitative difference was immense. Much of the increase in production

Figure 2

Increases in agricultural production are mainly due to improvements in yields



prior to the Green Revolution came from area expansion. Most came from increased yields and multiple cropping on irrigated land. Indeed, area under cultivation declined in the early 1990s without a decline in growth of production (see Figure 2).

The growth in food production has enabled India to manage disastrous droughts without food aid—even in fiscal 1979, when foodgrain production plunged by 22 million tons.[21] The country's ability to stabilize food supplies and prices for years has helped areas most vulnerable to food deficits, especially in regions such as Bihar and Eastern Uttar Pradesh.

Nevertheless, adoption of high-yielding varieties has been concentrated in the irrigated areas, especially Punjab, Haryana and Uttar Pradesh

Regional Inequities and Employment Growth

Nevertheless, adoption of high-yielding varieties has been concentrated in the irrigated areas, especially Punjab (where 93 percent of the area under foodgrains was irrigated in 1987–89, compared to the all-India average of 33.2 percent), Haryana (82 percent) and Uttar Pradesh (54.9 percent). Productivity differences among regions have widened so that in fiscal 1989, 36 percent of foodgrain production and 80 percent of the public cereal procurement came from three states that account for only 23 percent of India's total area under foodgrains.[22]

Because the new technologies were neutral as between large and small farms, small farmers gained substantially. Employment, both direct and indirect, surged with the spread of new technologies.[23] Recent evidence, however, suggests that the elasticity of employment with respect to output has declined, and that relatively little additional employment is being generated. This seems to be the result of the Revolution's success in agriculture and of multiplier effects in other sectors of the economy, which have caused considerable tightening of labor markets leading to increased real wages. Certainly, the percentage of population below the official poverty line is far lower in the Green Revolution states—for example in Punjab (7.2 percent) and Haryana (11.6 percent)—than in Bihar (40.8 percent) and Orissa (44.7 percent). Thus, the substitution of capital for labor

in these areas seems to be mainly a response to labor shortages and higher wages.[24] By the 1980s, the Green Revolution had begun to spread to eastern Uttar Pradesh, Bihar, and Orissa, which have abundant ground water and fertile lands but poor infrastructure and institutions. In these states there is little evidence of substitution of capital for labor. Indeed, had there been better-functioning institutions (that is secure land tenure, efficient labor, capital and product markets, effective state and local governments) and better physical infrastructure (roads and irrigation systems), the Green Revolution would have spread much more rapidly. Given the high risks and costs involved in adopting new technology, it is not surprising that the Revolution came first to better-organized states and richer farms. But India's half-hearted land reform effort has only tended to make tenants more insecure. Institutional reforms are overdue.

Many feel that benefits to the poor, particularly in terms of increased food consumption, have not been commensurate with the growth in food production and that the reduction in poverty has been slow at best.[25] Yet where 50 percent of Indians were once poor, poverty today is under 30 percent overall, and 33 percent in the rural areas. India's large public food distribution system has also helped to keep urban food prices and real wages low. The low food prices in turn have helped maintain political stability.

Another concern is the growth of subsidies, which now rival planned public expenditures on agriculture in India. Fertilizer subsidies alone amounted to one percent of GDP,[26] a major fiscal, environmental, and poverty concern. To the extent that public sector resources are allocated to subsidies, (which benefit the few), they compete with resources that could be invested in poorer regions. Improvement in infrastructure helps spread new technologies faster and thereby creates more employment and generates food. Moreover, reduction of subsidies on irrigation water, fertilizers and electricity—which now together amount to

Many feel that benefits to the poor, particularly in terms of increased food consumption, have not been commensurate with the growth in food production and that the reduction in poverty has been slow at best. Yet where 50 percent of Indians were once poor, poverty today is under 30 percent overall, and 33 percent in the rural areas

While the agricultural strategies proposed by various groups for India contributed to the Green Revolution's success, the implementation of these strategies owes much to the fruitful partnership between India and the World Bank and bilateral donors

some $4.6 billion[27] discourages their inefficient and wasteful use. In these areas, efficient production, environmental protection, and fiscal prudence converge.

That environmental and poverty concerns do not always intersect is illustrated by the controversial Sardar Sarovar Dam Project. One of the largest projects of its kind in the world, it is intended to produce 1200 megawatts of electric power, domestic water for 40 million people, irrigation for 1.8 million hectares of land, and 3.8 million tons of additional grain, enough to feed 18 million people. Its costs are environmental degradation and the displacement of some 100,000 families in a country that still contains over 200 million poor and whose population is projected to increase by over 500 million persons between 1990 and 2025.[28] Yet public debate over irrigation remains sadly uninformed, and a systematic analysis is called for to counter the incomplete measures now proposed and implemented.[29] The success of India's Green Revolution makes a strong argument for finding rational, scientifically sound solutions to the emotion-charged problems of poverty, food security and the environment.

The World Bank's Contribution

The World Bank does not work alone. All its operations in India were devised and carried out by Indians and often supported by other donors. For example, in irrigation, India had a large internal capacity for development before the Bank arrived. The Bank helped to expand its supply and introduced engineering innovations. Agricultural research and the spread of new high yielding varieties of cereals were the result of long term collaborative efforts among the Bank, U.S. official bilateral aid, private foundation assistance, and the Indian international scientific community. Initially, the Bank helped spread the new technologies more rapidly by fostering seed and fertilizer production and increasing small farmers' access to inputs and extension. Only recently has it become involved in supporting research. While the agricultural strategies proposed by various

groups for India contributed to the Green Revolution's success, the implementation of these strategies owes much to the fruitful partnership between India and the World Bank and bilateral donors.[30]

For its part, India helped the World Bank increase its understanding of the fundamental interactions of agriculture, poverty alleviation, and environmental development efforts. In particular, the Bank saw how a substantial presence on the ground made it more responsive to India's actual needs.

Lessons and Challenges

The World Bank–India partnership, in sustaining the Green Revolution, offers several lessons for designing and developing programs and policies to combat hunger in other parts of the world, especially Africa.

- For agriculture to move forward, productive technology and sound and stable national policy are equally indispensable. Promoting one at the cost of the other will yield few results, particularly in rainfed areas. Moreover, India's experience shows that even with spectacular technologies for irrigated agriculture, price incentives are essential to generate and sustain rapid technological change. Although, if sustained, price supports become a crutch to inefficient farmers, they are crucial in the early stages of development. Notwithstanding the many weaknesses of the seed-fertilizer technology, it has had a tremendous positive effect. Policymakers must not throw the baby of the Green Revolution out with the bath water, and instead must address the complex second-generation problems.

- Sequencing and phasing are important. It may be necessary to make the difficult political choices to concentrate physical, financial, and human resources on areas with the highest agricultural potential. In India, such concentration provided policy makers with much needed breathing space to address complex second-generation challenges of semiarid areas and environmental problems in irrigated areas. While irrigated areas were attended to first in India, in Africa, the choice

Sequencing and phasing are important. It may be necessary to make the difficult political choices to concentrate physical, financial, and human resources on areas with the highest agricultural potential. In India, such concentration provided policy makers with much needed breathing space to address complex second-generation challenges of semiarid areas and environmental problems in irrigated areas

With pressures to reduce bilateral aid generally, and the limited resources at the disposal of such international agencies as the Consultative Group on International Agricultural Research (CGIAR), the Bank becomes even more important as coordinator of partnerships and mobilizer of international information, funding, and advice

often tends to be between areas of assured high rainfall and good soils and less well endowed areas with insufficient physical and administrative infrastructure. Donors in Africa have generally sought to address the problems of the poorest of the poor households in resource poor areas. It is now time to consider the complex preconditions needed to achieve and sustain technological changes that can address the continent's growing agricultural and food crisis.[31]

- The human, physical and institutional infrastructure needed to disseminate proven technologies is crucial. To ensure high rates of return on past investments in human and institutional capacity, the Bank in India helped expand existing physical infrastructure. Today it must help countries generate human capital through education and training and develop effective organizational structures that can simultaneously address the productivity and environmental sustainability conundrum.

- With pressures to reduce bilateral aid generally, and the limited resources at the disposal of such international agencies as the Consultative Group on International Agricultural Research (CGIAR), the Bank becomes even more important as coordinator of partnerships and mobilizer of international information, funding, and advice. As a facilitator, the Bank can help to promote institutional reform at the national, state, and local levels to promote technology transfer vital to the future of the world's developing countries.

The authors gratefully acknowledge the discussions with and comments from S. Aiyer, S. Barghouti, D.J.W. Berkoff, D.E. Brown, G. Donaldson, R. Grimshaw, W. David Hopper, W.I. Jones, J. Kraske, P. Narayan, D. Seckler, R. H. Slade, M.S. Swaminathan and C.H. Hanumantha Rao; research assistance from R. Cryan, and the generous help of C.P. Zigler and his staff in locating documents in the World Bank's Archives.

Notes

1. This paper uses the Bank's traditional definition of South Asia as including Afghanistan, Bangladesh, Bhutan, India, Nepal, Pakistan, and Sri Lanka.
2. Lending for agriculture and rural development is defined to include both lending for agriculture and rural development (as defined in the World Bank's annual reports) and lending for related projects such as fertilizers, rural electrification, and others.
3. The World Bank, *IDA in Retrospect*, 1982.
4. Pakistan's agricultural output was growing at an annual rate of over 6 percent in the late 1960s. See *IDA in Retrospect*, 1982 for details.
5. Johnson 1971.
6. *The World Bank Since Bretton Woods*. The Brookings Institution. Washington, D.C. 1971 (p. 675).
7. Lele and Goldsmith 1989.
8. Lele 1991.
9. Rosen 1985.
10. Subramaniam 1979.
11. Johnson, ibid.
12. As a result of the recommendations made by the Agricultural Prices Committee chaired by L.K. Jha, the APC and FCI were permanently established in mid-1964. The World Bank's claim in IDA in Retrospect that these institutions were established as a result of Bell Mission recommendations is incorrect. However, the Bank's insistence of incentive prices since the mid-1950s must have had some influence on their creation.
13. Table IX.1, page 219 in John W. Mellor, *The New Economics of Growth*, Cornell Univeristy, Ithaca, N.Y. 1976.
14. See Subramaniam's statement in IDA in Retrospect.
15. Since the Bank's lending for ARD accelerated after the launching of the Green Revolution in India and McNamara's arrival at the Bank, we have divided the lending period into three periods, namely the pre-McNamara years (1950–1968), the McNamara years (1969–1981), and the post-McNamara years (1982–1993). The latter two periods have each been further divided into two sub-periods of almost equal duration to show trends throughout the periods.

16. Balu Bumb "World Bank Conditionality in Irrigation Projects: An Assessment." Unpublished World Bank paper. May 1986.
17. Berkoff 1990, Frederikson and others 1993, and Wade 1982
18. Balu Bumb, op cit.
19. D. Benor and J. Q. Harrison, *Agricultural Extension: The Training and Visit System*, World Bank, Washington D.C., 1977.
20. Ministry of Agriculture. Indian Agriculture in Brief, various issues. Delhi: Government of India, 1978–1993.
21. This decline is almost identical to the sum of declines in foodgrain production in 1957–58 (5.5 million tons) and 1965–66 (17 million tons) both of which triggered major food and foreign exchange crises.
22. Based on Bank lending for 7 million hectares of additional irrigated area, realization of 80 percent of irrigation potential, and incremental yield of 2 tons to 2.5 tons per hectare, the Bank may be estimated to have contributed 11 to 14 million tons of additional annual food/grain production.
23. Mellor, ibid.
24. C. H. Hanumantha Rao. *Agricultural Growth, Rural Poverty, and Environmental Degradation in India*. Delhi: Oxford University Press, 1994.
25. Sarma 1981 and 1990.
26. World Bank. 1993
27. World Bank 1991.
28. David Seckler. *The Sardar Sarovar Project in India: A Commentary of the Report of the Independent Review*. Center for Economic Policy Studies: Arlington, Virginia, 1992.
29. G. Le Moigne., S. Barghouti, and L. Garbus. "Developing and Improving Irrigation and Drainage Systems: Selected Papers from World Bank Seminars." World Bank Technical Paper Number 178, 1992. D.J.W. Berkoff, Irrigation Management on the Indo-Gangetic Plain. World Bank Technical Paper Number 129, 1990.
30. Ministry of Agriculture
31. Uma Lele, ed. *Aid to African Agriculture: Lessons from Two Decades of Donors' Experience,* Johns Hopkins University Press, Baltimore, 1993.

Works Cited

Ahluwalia, Montek S. "Rural Poverty, Agricultural Production, and Prices: A Reexamination," in Mellor and Desai, 1985.

Bardhan, Pranab K. "Poverty and 'Trickle-down' in Rural India: A Quantitative Analysis," in Mellor and Desai, 1985.

FAO Agrostat-PC, 1993 (computer data set).

Fuhrman, Peter, with Michael Shuman, "Now We Are Our Own Masters," Forbes, May 23, 1994, pp. 128–138.

Johnson, Lyndon Baines. The Vantage Point. New York: Popular Library, 1971.

Lele, Uma, and Manmohan Agarwal. "Four Decades of Economic Development in India and the Role of External Assistance" in Leleand Nabi, 1991.

Lele, Uma, and Arthur Goldsmith, The Development of National Agricultural Research Capacity: India's Experience with the Rockefeller Foundation and its Significance for Africa, monographic the Managing Agricultural Development in Africa series, 1989.

Lele, Uma, and Ijaz Nabi, eds. Transitions in Development. San Francisco: ICS Press, 1991.

Mason, Edward S., and Robert E. Asher. The World Bank Since Bretton Woods.Washington: The Brookings Institute, 1973.

Mellor, John W. "Determinants of Rural Poverty." in Mellor and Desai, 1985.

Mellor, John W. The New Economics of Growth. Ithaca, N.Y.: Cornell University Press, 1976.

Mellor, John W., and Gunvant M. Desai, eds. Agricultural Change and Rural Poverty. Baltimore: The Johns Hopkins University Press, 1985.

Ministry of Agriculture. Indian Agriculture in Brief, various issues. Delhi: Government of India, 1978–1993.

Ministry of Finance. Economic Survey, various issues. Delhi: Government of India, 1974–1993.

Paddock, William, and Paul Paddock. *Famine, 1975!: America's Decision: Who Will Survive*. Boston: Little Brown, 1967.

Rao, C.H. Hanumantha. Agricultural Growth, Rural Poverty, and Environmental Degradation in India. Delhi: Oxford University Press, 1994.

Report on India's Food Crisis & Steps to Meet It, sponsored by the Ford Foundation. Delhi: Ministry of Food and Agriculture, 1959.

Rosen, George. *Western Economists and Eastern Societies*. Johns Hopkins University Press, Baltimore, 1985.

Sarma, J.S. *Growth and Equity: Policies and Implementation in Indian Agriculture*. Washington: I.F.P.R.I., 1981.

Sarma, J.S., and Vasant P. Gandhi. Production and Consumption of Foodgrains in India: Implications of Accelerated Economic Growth and Poverty Alleviation. Washington: I.F.P.R.I., 1990.

Schultz, T.W. *Transforming Traditional Agriculture*. New Haven: Yale University Press, 1964.

Seckler, David. *The Sardar Sarovar Project in India*. Arlington, Virginia: Winrock International, 1992.

Sen, Amartya, "Food, Economics, and Entitlements," in The Political economy of Hunger, Volume 1, ed. by Jean Dreze' and Amartya Sen; Larendon Press: Oxford 1990.

Sen, Amartya. "Dharm Narain on Poverty: Concepts and Broader Issues." in Mellor and Desai, 1985.

Subramaniam, C. The New Strategy in Indian Agriculture. Delhi: Vikas, 1979.

Wall Street Journal. "India's Market Reform Requires Perspective," June 6, 1994, p.1.

World Bank. India: Agriculture Public Expenditure Review. Washington, D.C., 1993.

World Bank. Report on India's Economic Development Effort ("The Bell Mission Report"). 1965.

IDA in Retrospect, 1982.

The Latin American Debt Crisis

Sebastian Edwards

When the debt crisis erupted in August of 1982, most analysts thought that Latin America was facing a liquidity problem. Thus in the early years of the crisis, countries improvised to generate massive resource transfers to the industrialized world. Argentina, Brazil, and Peru experimented with heterodox plans (which ignored the need for fiscal discipline) to reduce inflation. These were the last massive adjustment efforts based on the traditional Latin American structuralist approach to economic development. Their rapid failure ignited deep soul-searching among political leaders and intellectuals in the region.[1]

Since 1987–88, economic thinking in Latin America has been transformed. Protectionism and interventionism have given way to openness, market orientation, and competition. Four main causes exist for this transformation: the realization that the traditional, government-led development policies failed to create a modern economic system; the example of East Asia, with its high growth; the fall of Eastern Europe and the realization that socialism had led to generalized failure and frustration; and the policies of the multilateral institutions—especially the International Monetary Fund (IMF) and the World Bank—that conditioned their funds on the implementation of major reforms.[2]

Since 1987–88, economic thinking in Latin America has been transformed. Protectionism and interventionism have given way to openness, market orientation, and competition

The initial reaction by the creditor countries was that the debt crisis could be solved with a combination of macroeconomic adjustment, debt rescheduling agreements, and structural reforms

All this resulted in a new Latin American consensus driving the region's reforms.[3] This consensus, shared by most policymakers and analysts in the region, is based on four basic tenets. First, macroeconomic stability is fundamental for achieving sustainable growth with equity. Second, the Latin economies' massive (and largely unilateral) trade liberalization should help to transform exports into the region's "engine of growth." Third, massive privatization and deregulation should increase the role of markets and competition in development. Fourth, policymakers and political leaders recognize that, to consolidate reforms, the issues of poverty and inequality must be addressed. To this end, new programs targeted at the poorest and at social sectors are being devised in many countries.[4]

The World Bank played an important role in the way Latin America dealt with the debt crisis and has helped to shape its reforms. The Bank's analytical work facilitated dialogue and contributed to the design of specific policies. Bank resources helped cushion the severity of the crisis, especially during its early years. And Bank conditionality provided discipline and financial credibility to the reform process.

Initial Approaches to the Crisis

With the sudden halt of foreign capital in 1982, every country in Latin America was forced to finance debt payments through large trade surpluses. The initial reaction by the creditor countries was that the debt crisis could be solved with a combination of macroeconomic adjustment, debt rescheduling agreements, and structural reforms.

This approach was promoted by the United States government and coordinated by the IMF and the World Bank. The official approach called for "new monies" (up to $20 billion) to be lent to countries engaged in structural reforms. The banking community endorsed this view, although it argued for shifting the burden of new financing to multilateral and official

institutions: ". . . realism demands an increased share of new money to be furnished by official sources during the next several years."[5] Debt-restructuring operations, IMF-sponsored programs, and World Bank structural adjustment loans were the most important elements of the early official strategy. Between 1983 and 1988, Latin American nations engaged in twenty-nine debt restructuring operations with private banks.

The 1984 issue of the IMF's *World Economic Outlook* and the World Bank's *World Development Report* included optimistic projections, predicting a steady decline in the debt–export ratio of Latin American countries. Things did not work out that way. In the following years, analysts came to recognize that the magnitude of the problem had been seriously underestimated.[6]

Although the multilateral institutions had failed to grasp the size of the debt crisis during its early years, they did contribute significant resources to Latin America so that debtor nations could reduce the magnitude of their resource transfer to the rest of the world. Between 1980 and 1986, the World Bank more than doubled its net disbursements to Latin America, increasing them from $1.2 billion to almost $2.8 billion. In the same period, the net resource transfer from the Bank (net disbursements less interest) increased from $600 million to almost $1.1 billion. The IMF channeled even larger resources into the region at the start of the crisis. While IMF net transfers to Latin America and the Caribbean had been negative $173 million in 1980, they reached almost $6 billion in 1983.

From the early stages of the crisis, the World Bank was concerned with helping to engineer a smooth, sustainable adjustment to promote macro-economic stability; to restore growth, including a minimum increase in consumption; and to reduce the debt overhang. Within this framework, ensuring consumption growth during transition was

Although the multilateral institutions had failed to grasp the size of the debt crisis during its early years, they did contribute significant resources to Latin America so that debtor nations could reduce the magnitude of their resource transfers to the rest of the world

considered crucial from both economic and political standpoints. Without it, countries would lack the will to undertake reforms and would tend to stagnate.

Selowsky and van der Tak (1986) argued that this type of adjustment could not be achieved overnight. During the early stages, debtor countries needed additional foreign resources to gain time to implement the domestic reforms required to accelerate growth and reduce the debt burden. One aspect of the Selowsky–van der Tak analysis was that, in some circumstances, initial conditions were so severe that the only way to restore a viable debt–output ratio was for the creditors to forgive debt. In the late 1980s, this line of argument began to make headway among officials in creditor countries as it became evident that some debt reduction would benefit both debtors and creditors.[7]

Ensuring consumption growth during transition was considered crucial . . . Without it, countries would lack the will to undertake reforms and would tend to stagnate

The Brady Plan and the Bank

In early 1989, lack of progress in two of the large debtors—Argentina and Brazil—prompted a change in the official debt strategy. In March, U.S. Secretary of the Treasury Nicholas Brady announced a new initiative based on voluntary debt reduction. He proposed to exchange old debt for new, long-term debt with a lower face value. The conversion ratio and new instruments were to be negotiated between the debtor countries and their creditors.

To make this new approach attractive to creditor banks, industrial nations and multilateral institutions—including the World Bank—agreed to provide a substantial amount of resources ($30 billion or so) to guarantee "Brady" concessional bonds. Typically, principal payments on these new securities were backed by thirty-year, zero-coupon U.S. Treasury Bills, with interest payments subject to rolling three-year guarantees.[8]

To be eligible for Brady Plan negotiations, countries had to show some history of and willingness to engage in serious economic reform. This was

seen as a way to reward countries committed to modernization reforms. It was also expected that in some countries this requirement would lift the debt overhang burdens associated with extremely high payments.

The World Bank has supported Brady deals through a number of mechanisms. Together with the IMF, the Bank has been instrumental in helping countries design the steps required prior to reform. The Bank's involvement in the design of reforms has been indirect—through its Economic and Sector Work (ESW), and direct—through its adjustment loans. The World Bank has also supported Brady agreements by waiving negative pledges in their loan agreements, allowing them to use U.S. Treasury zero-coupon bonds as guarantees. The Bank has also provided fresh loans to most countries involved in Brady agreements.

In 1989, Mexico and Costa Rica became the first countries to reach broad agreements with creditors to reduce debt under the Brady Plan. Venezuela and Uruguay followed in 1990 and 1991, and Argentina and Brazil both signed draft agreements in 1992 (see Table 1). In this table, the first column contains the total value of the debt covered by each agreement. In the cases of Argentina and Costa Rica, it includes both principal and arrears. The debt subject to each arrangement was quite large. In the case of Mexico, almost $49 billion was exchanged for concessional bonds—a figure substantially higher than the $6.7 billion converted under the Mexican 2008 bond scheme.

The next three columns in Table 1 illustrate the amount of debt eligible for conversion under three different options.

One conversion option is a debt buyback, in which old debt is canceled by a cash payment at a fraction of the original liability. In Costa Rica, $159 million was used to retire old debt with a face value of $991 million. This operation

In 1989, Mexico and Costa Rica became the first countries to reach broad agreements with creditors to reduce debt within the Brady Plan framework

Table 1 Debt and Debt-Service Reduction (DDSR) in Selected Latin American Countries

(Millions of dollars)

			Conversion options				
Country	*Date of DDSR agreement*	*Face value of eligible debt*	*Buy-back (discount)*	*Discounted bonds (discount)*	*Par bond (interest rate)*	*New money (interest rate)*	*Total debt (Dec. 1991)*[a]
Argentina	1992[b]	23,160[c]	n.d. (35%)	n.d. (35%)	n.d. (4-6%)[d]	0	56,273
Brazil	1992[b]	44,000[e]	0	n.d. (35%)	n.d.[f]	n.d.[g]	118,148
Costa Rica	1989	1,602[h]	991 (84%)	0	579 (6.5%)	0	3,966
Mexico	1989	48,089	0	20,851 (35%)	22,427 (6.25%)	4,387 (L+13/16)	98,263
Uruguay	1991	1,610	633 (44%)	530	0	448 (L+1)	3,049
Venezuela	1990	19,098	1,411 (55%)	1,794 (30%)	10,333 (6.75%)	6,060 (L+7/8)	34,081

n.d. Not yet determined (subject to banks' choice).

a. Including IMF and net short-term debt.

b. Agreement in principle with creditor banks; not yet finalized.

c. Estimated. In addition, there are $8.6 billion in arrears, including imputed interest.

d. Interest rate increases from 4 percent the first year to 6 percent in the 7th year; 6 percent from then on.

e. Estimated. In addition, there are $6 billion in arrears, including imputed interest.

f. There are several par bonds offered, with different maturities periods, interest rates, and collateral:

A. 30/30 years, rate 4 percent to 6 percent first 7 years, 6 percent from then on, full collateral principal, 12-month interest.

B. 15/9 years, rate 4 percent to 5 percent first 6 years, LIBOR + 13/16 from then on, 12-month interest collateral for 6 years.

C. 20/10 years, rate LIBOR + 13/16 but interest above the rate in bond B is capitalized, no collateral.

D. 20/10 years, rate 8 percent interest above the rate in bond B is capitalized, no collateral.

E. 18/10 years, rate LIBOR + 7/8, no collateral.

g. New money equivalent to 18.18 percent of debt tendered for debt conversion bonds (see f, option E).

h. Including past-due interest.

Source: World Bank.

carried a discount of 84 percent—each $1.00 of old debt was exchanged for $.16 cash.

The second option is using discounted bonds to retire the original debt. Creditors receive long-term (usually thirty-year) bonds in exchange for the debt. Although the new bonds carry a market interest rate, the exchange between old debt and new bonds takes place at a ratio below one-to-one. The actual conversion ratio has varied from country to country. Argentina, Brazil, and Mexico negotiated a 35 percent discount, but Venezuela could obtain only a 30 percent discount.

The third option consists of exchanging old debt for new bonds with the same face value—so-called par bonds—but at a below-market interest rate. The collateral on the principal and the guarantee on interest payments are similar to those on discounted bonds. The recent Argentine and Brazilian agreements included several types of par bonds.

The Brady-endorsed debt reduction packages have helped Latin American countries by reducing debt burdens and allowing them to concentrate on implementing reforms. In Mexico, for example, the World Bank estimated that such debt relief would reduce the net transfer to creditors by $4 billion a year between 1989 and 1994, or close to 2 percent of Mexico's GDP. Even so, some countries—notably Chile and Colombia—have declined to participate in the Brady Plan, arguing that the strategies they have followed until now—a combination of multilateral support, economic reform, and market-based debt reduction—have worked well enough.

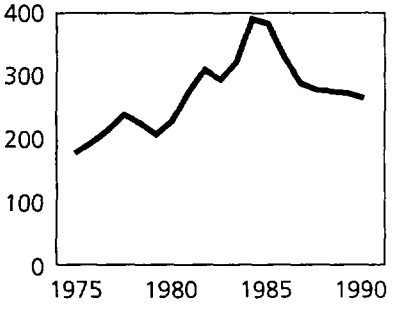
The Brady-endorsed debt reduction packages have helped Latin American countries by reducing debt burdens and allowing them to concentrate on implementing reforms

Most countries in the region are still suffering from the consequences of the debt explosion of the 1970s and early 1980s. Interest payments on foreign debt still represent high percentages of GDP—in Colombia almost 3 percent and in Brazil almost 2 percent. In a few countries the size of the debt is so large (more than three times GDP in Nicaragua, the prime example) that

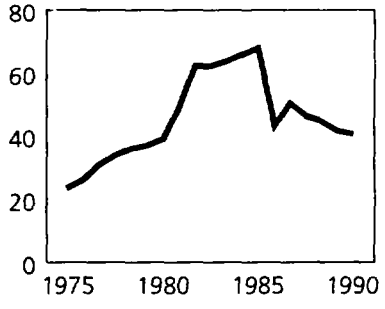
Figure 1

Turning the corner on debt

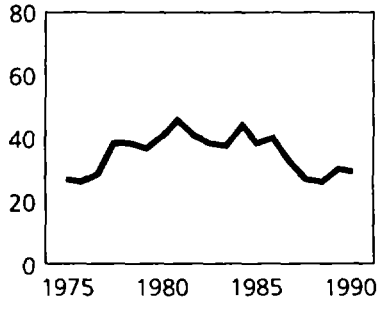
Total external debt as a percentage of total exports



Total external debt as a percentage of GNP



Debt service as a percentage of total exports



Source: World Bank.

massive debt reduction agreements will be required to achieve a longer-run solution.

Despite these continuing problems, many countries feel that the debt crisis is behind them. Recently, the price of some countries' debt in the secondary market has increased, and after almost ten years of negative net resource transfers, Latin America had positive transfers from the rest of the world in 1991. Net capital inflows into the region increased dramatically in 1992, passing $20 billion. To a large extent, this turn-around of net resource transfers reflects the fact that many of the countries in the region (Argentina, Chile, Colombia, and Mexico) have regained access to voluntary capital market financing.[9] This alone is an indication that, in some Latin countries, the debt crisis is almost over (see Figure 1).

Paradoxically, the recent increase in capital flows into Latin America has generated serious problems related to real exchange rate behavior. As capital comes into these countries, foreign exchange becomes overabundant, appreciating the real exchange rate. This results in a loss of international competitiveness and pressures politicians to implement policies that compensate exporters.

The Power of Ideas

Some authors (notably Williamson 1990) have suggested that the new approach towards development policy in Latin America was imposed from the outside by the U.S. Treasury, the World Bank, and the International Monetary Fund—the so-called Washington consensus. But while these institutions played roles in forging new views, it is an exaggeration to give them top billing. Fundamental soul-searching began in Latin America early on, when its traditional programs failed and following the Chilean experience. Still, the multilateral institutions exercised important influence in forging the new convergence of doctrinal views in Latin America. These institutions—and chiefly the World Bank—influenced policy in Latin America partially through empirical research, analytical work, conditional lending practices, and policy dialogue.

Trade Policy Reform

The World Bank did have an intellectual influence in shaping the reform process, due in great part to the central role it gave to trade liberalization. Several Bank studies showed empirically that less distorted economies outperform those that impede the development of markets. Early studies by Balassa (1982, 1985) and Feder (1983) suggested that countries that pursued outward-oriented policies encouraging exports grew faster than countries that followed protectionist strategies.[10] In a more comprehensive work, Agarwala (1981) argued that distortions in addition to trade protectionism also slowed growth. A series of Bank studies pointed out that careful deregulation of the financial sector would result in a more efficient allocation of investment—and eventually more rapid growth.[11] The 1987 and 1991 *World Development Reports* provided a wealth of evidence to support these notions, and the evidence in these documents was particularly influential in Latin American policy design. In the late 1980s and early 1990s, Latin American policymakers increasingly began to look at East Asian countries for guidance on what type of policy to pursue.

The World Bank did have an intellectual influence in shaping the reform process, due in great part to the central role it gave to trade liberalization

World Bank-sponsored economic and sector work has also been influential in determining the mechanics of liberalization attempts. For example, a series of studies presented at a 1983 conference addressed issues related to the sequencing and timing of reforms. Even at this early stage, most essays warned policymakers of the dangers associated with temporary real exchange rate appreciations during the transition toward market orientation. It was also pointed out that, under most circumstances, the appropriate sequencing of liberalization required an early elimination of the fiscal deficit followed by trade reform, and later, by capital market liberalization.[12] The same conference dealt with the crucial role of credibility to reform success, an idea that has gained popularity in the past few years.

Avoiding real exchange rate overvaluation was the single most important factor in the success of trade liberalization

In the 1980s, the World Bank undertook a monumental nineteen country comparative study on trade liberalization (Michaely, Papageorgiou, and Choksi, 1991).[13] The project analyzed the characteristics and consequences of different trade regimes and investigated the most appropriate ways to implement liberalization. Issues related to sequencing, speed, and transitional costs were analyzed and compared. By and large, the results supported the view that countries with more intense, sustained liberalizations have outperformed those with failed liberalization attempts. Moreover, avoiding real exchange rate overvaluation was the single most important factor in the success of trade liberalization. Findings from this and other World Bank research were disseminated widely in Latin America through conferences and talks. This helped regional leaders become aware of historical regularities and, in some cases (such as Brazil, Mexico, and Colombia) had an important impact on decisions to implement trade reforms.[14]

Studies sponsored by the World Bank also investigated the link between distortions (in particular, trade restrictions) and the creation of employment. In summarizing the experiences of eleven countries, Balassa (1982)

points out that, since primary activities and manufacturing for exports are more labor intensive, "reducing tariffs will tend to benefit employment." The most ambitious study on the labor market effects of trade liberalization reforms is Michaely, Papageorgiou, and Choksi (1991), which found that, in most successful structural reforms, medium-run net effects on employment have been positive. This finding has had an important role in the recent acceleration of trade liberalization reform in a number of countries—including Argentina, Colombia, and Nicaragua. As political leaders discover that the political costs of reform (in terms of unemployment) are not as high as once thought, they are willing to move more swiftly.

An illustration of the influence and persuasive powers of the multilateral institutions is the World Bank's role in the design of the Mexican reforms. Early on there was opposition to trade liberalization in some Mexican circles—especially those associated with the Secretary of Commerce and Industry. But World Bank-sponsored policy discussions, including public seminars in Mexico, helped create broader support for these measures, strengthening the position of then secretary of Budget and Planning Salinas and of Central Bank governor Mancera within the Mexican government. In 1985, almost two years after work had begun in this area, the World Bank approved a loan for Mexico to build a policy basis for the country's trade liberalization. The World Bank also helped create early awareness in Mexico of the need to implement public sector reforms and embark on a major privatization program.

In 1985 . . . the World Bank approved a loan for Mexico to build a policy basis for the country's trade liberalization

Brazil provides another example. In 1987, the Government of Brazil announced its intention to implement gradual trade reform. It did not contemplate reducing nontariff barriers (NTBs) in an aggressive fashion. The World Bank considered the program too timid, and discussed it with the authorities. To increase the Brazilian public's awareness of the benefits of opening the economy, the Bank organized

As a result of the Bank's advice and financial support, some countries have implemented emergency social-investment funds geared to community-based projects that provide work to the unemployed while solving basic infrastructure problems

seminars and conferences. This exchange of ideas generated reports that were discussed with Brazilian officials and intellectuals. As a result, the Collor government was in a position to act rapidly on reform in 1990, when most NTBs were eliminated and the tariff reduction program was instituted.[15]

Reform in Central America

The multilateral institutions also played a role in shaping economic reforms in Central America. Through reports, meetings, conferences, and discussions, a new generation of political leaders was persuaded to shift from the old interventionist policies toward market-based reforms. For example, early involvement of the World Bank and the IMF in Costa Rica helped set the stage for reform and paved the way for an early deal with private banks on debt reduction. The World Bank and the IMF were also intimately involved in launching the April 1991 Nicaraguan stabilization program, which put an end to hyperinflation. The macroeconomic adjustment efforts undertaken by the countries of Central America have been largely successful. Honduras, Nicaragua, and Panama, for example, were the only three countries in Latin America with single-digit inflation in 1992.

Social Programs

As a result of the Bank's advice and financial support, some countries have implemented emergency social-investment funds geared to community-based projects that provide work to the unemployed while solving basic infrastructure problems. Those projects have worked successfully in Bolivia and Jamaica and are now being implemented in Nicaragua. The World Bank's support of Mexico's *Programa de Solidaridad* has helped make that program a successful instrument for efficiently dealing with poverty and social problems. The World Bank's position on the importance of nutritional programs directed at children, pregnant women, and other vulnerable groups has also been accepted by most

political leaders in the region and is increasingly included in social programs.[16]

The Role of Conditionality

Multilateral lending programs also played an important role. By conditioning the release of funds on the implementation of certain basic reforms, the multilateral institutions forced Latin American authorities to develop comprehensive and consistent reform programs. Conditionality within World Bank programs has covered highly diverse areas, including trade reform, privatization, and financial liberalization (see Table 2).

Some nations initially resisted some of the conditions, but as time passed and adjustment proceeded, many countries began to move more rapidly than required to by the multilateral agencies. Mexico's privatization program, for instance, greatly exceeded the original World Bank goals. Likewise, the extent and speed of trade liberalization reform in Colombia went beyond what the multilaterals had originally requested.[17]

An Era of Reform

Although it is difficult to pinpoint the beginning of economic reform in each country, it acquired full and generalized force in Latin America in the late 1980s and early 1990s, after attempts to use traditional structuralist policies to solve the crisis had failed. Each country, of course, faced different initial conditions at the time reforms were initiated. Some faced rapid inflation and highly distorted incentive systems; others began with more moderate and manageable conditions. The economic role of the state also varied, as did the importance of state-owned enterprises. Although the intensity and scope of the reforms have differed, it is possible to classify them into four broad groups according to their approximate time of initiation: early, recent, very recent, and future-reformers.

Generally speaking, early reformers are further along in the process of transformation and have made progress in many areas. Chile represents a

Table 2 Conditionality Content of World Bank Programs

(Percentage of programs with particular conditions)

Trade liberalization	79
Exchange rate action	45
Tax and fiscal policy reform	67
Financial reform	51
Public enterprises reform and privatization	65

Note: Refers to all adjustment loans (mostly SALs and SECALs) during 1982–89. See World Bank (1990) for details.

case of its own, having initiated reforms in 1975, almost a decade before anyone else.[18] Mexico initiated reforms in 1985 and has also moved broadly and deeply, building new institutions to help consolidate the new economic system.

Recent and very recent reformers vary in intensity and scope. Some countries, such as Argentina, have dealt with many sectors rapidly and simultaneously. Others have moved selectively on structural reforms or have not been able to enact credible macroeconomic programs.

In almost every Latin American country, the early post-debt crisis years (1982–87) saw severe declines in per capita GDP. After 1987, per capita GDP generally began to recover. Interestingly, growth has shown a stronger trend among advanced reformers than among those countries that delayed adjustment.[19] In 1992–93, most Latin American countries, with a few exceptions, experienced respectable to strong growth.

Macroeconomic Stabilization

Macroeconomic stabilization, including the reduction of the debt burden, has been the centerpiece of reform. Recognition by industrialized nations that the crisis was more than a liquidity crunch was a fundamental step toward stabilization. In general, voluntary debt reduction agreements—the Brady deals—were undertaken only after the country in question had made significant progress in reducing fiscal imbalances, curbing inflation, and achieving macroeconomic stability.[20]

Policy questions related to sequencing and speed were often addressed by policymakers designing stabilization programs: Should macroeconomic adjustment precede structural reform, or could both be undertaken simultaneously? Should gradual stabilization be attempted, or would abrupt policies be more appropriate?[21] In some countries, fixed nominal exchange rates have been used as anchors in the anti-inflationary effort. But this has been a controversial policy. While a number of analysts

argue that fixing the exchange rate provides credibility to a stabilization program, others point out that fixed rates contribute to real exchange rate overvaluation during the transition to lower inflation, undermining the sustainability of the stabilization effort.[22]

Trade Liberalization

Trade liberalization is the core of structural reform. Throughout Latin America, it has reduced import tariffs from an average of 70 percent to near 12 percent and has almost eliminated nontariff barriers in a short period. As a result, the Latin countries have experienced rapid productivity improvements and significant expansion in exports. Recently, this unilateral opening process was supplemented by efforts to create (or revitalize) regional trading blocks—such as MERCOSUR, the Andean Pact, the Central American Common Market, and CARICOM.[23] And most countries have expressed interest in joining the North American Free Trade Area (NAFTA).[24] A competitive real exchange rate—and, in particular, the avoidance of overvaluation—has played a key role in the success of trade reforms. The pressure that massive capital flows have recently exercised on real exchange rates throughout the region, therefore, has been a cause of concern among policy analysts.

Reorienting Government

A salient feature of the recent Latin reforms, and one that distinguishes them from past efforts, is the emphasis on reducing the size of the state through massive privatizations. In many countries, privatization has been linked to debt reduction schemes based on debt–equity swaps. As a result, foreign firms have played an important role in reshaping Latin America's manufacturing and financial sectors. This development constitutes a marked change from a traditional history of mistrust of foreign firms. Although privatization has taken different forms in different countries, in many it has created thousands of new shareholders. While Latin American policymakers have also discovered that a

Trade liberalization is the core of structural reform. Throughout Latin America, it has reduced import tariffs from an average of 70 percent to around 12 percent and has almost eliminated nontariff barriers in a short period

modern regulatory framework is needed for the efficient functioning of a newly privatized sector, progress in this area has been uneven throughout the region,[25] and labor market deregulation has shown little improvement. In most countries labor market duality continues to exist, and labor distortions negatively affect the public welfare and international competitiveness.[26]

Financial Sector Deregulation

For years, most Latin American countries controlled capital markets, quantitatively allocating credit and keeping interest rates below inflation.[27] But financial sector deregulation has been an important component of most countries' reforms. Interest rates have been freed, and the creation of new financial institutions has been encouraged. Some important policy debates in this area have dealt with the optimal timing of financial reform, the role of capital market supervision, and the opening of the capital account. But despite reforms of Latin America's capital markets, investment and savings remain low in most countries. Explaining the behavior of private savings is rapidly becoming one of the most pressing issues in Latin American analysis.

Despite reforms of Latin America's capital markets, investment and savings remain low in most countries. Explaining the behavior of private savings is rapidly becoming one of the most pressing issues in Latin American analysis

Poverty Reduction

Latin America has a long tradition of poverty and inequality, and many social indicators have further deteriorated since the eruption of the debt crisis. There is now a general recognition that economic growth and education are the main long-run determinants of reduced poverty. Yet both take considerable time to effect change. As a result, many governments and multilateral institutions have decided to implement programs directed at alleviating poverty and inequality, an approach that contrasts acutely with traditional practices. Instead of providing blanket subsidies through price controls and other distortions, targeted subsidies are being directed toward the most vulnerable segments of society.[28] It is argued that, to help the poor and avoid a return to populist practices, it is necessary to tackle social problems effectively and to develop new institutional settings that ensure

stability and protect the economy from short-term, myopic political impulses. Many have pointed out that this type of reform will not only help maintain the path toward growth and prosperity but is also likely to strengthen the region's nascent democracies.[29]

The Future of Reform

Despite the real progress made by most Latin American countries, problems persist. Physical infrastructure has deteriorated severely, and in many countries poverty has increased. Inflation continues to be high, and even where it has been cut dramatically it often remains in the double digits. In some countries, economic reforms have not been accompanied by the modernization of political institutions, which can lead to political unrest. Serious crises have already arisen in Brazil, Guatemala, Haiti, Peru, and Venezuela. Additionally, large capital inflows have recently financed increasingly large current account deficits in many countries, generating sizable pressures for real exchange rate appreciation.

Latin America faces tremendous challenges in the years ahead. If the reforms of the 1980s and 1990s are to be sustained, policymakers will need to address such pressing issues as maintaining prudent macroeconomic management, alleviating poverty, reducing inequality, increasing domestic savings, and creating the solid economic, social, and political institutions that are the foundation of long-term growth.

The World Bank should continue to play an important role in the region's development in the years to come, helping to consolidate its reforms. In some countries the Bank will play its traditional role, in others it will provide technical assistance, in still others it will help create modern institutions. Throughout Latin America, the Bank will be active in social and infrastructure projects, for it is clear that now is not the time to scale down Bank involvement in the region. In grappling with problems of equity and growth, Latin America needs to be able to rely on the Bank's experience and strength.

If the reforms of the 1980s and 1990s are to be sustained, policymakers will need to address such pressing issues as maintaining prudent macroeconomic management, alleviating poverty, reducing inequality, increasing domestic savings, and creating the solid economic, social, and political institutions that are the foundation of long-term growth

Notes

1. Edwards (1986) discusses the extent to which the international financial market anticipated the debt crisis. See also Edwards (1984). For a detailed discussion of the muddling through years see Edwards (1988).
2. For an evaluation of the early relationship between the IMF and the developing countries see Edwards and Santaella (1992). For critical evaluations of the IMF role in the initial years of the debt crisis see Edwards (1989b). On the initial evolution of Latin American thinking in the post-crisis period see Edwards (1989a).
3. Some analysts have referred to this process as the "Washington Consensus," and have suggested that the new policies were imposed on Latin America by the U.S. Treasury, the IMF, and the World Bank. This interpretation is overly U.S.-centrist and clearly misses the internal Latin American political dynamics.
4. For details on the social consequences of structural reforms and labor market behavior during adjustment, see Edwards (1993b).
5. Morgan Guaranty (1987), p. 2.
6. See the 1986 issue of the IMF's *World Economic Outlook.*
7. Work undertaken at the IMF under the leadership of Jacob Frenkel was highly influential in this area.
8. See Cline (1989) for a discussion of the genesis of the Brady Plan.
9. A nontrivial proportion of the capital inflows have been reverse capital flight. See Calvo, Leiderman, and Reinhardt. (1992).
10. See Fishlow (1991) and Edwards (1993a) for some methodological criticisms of these studies.
11. See, for example, Hanson and Neal (1985).
12. Lal (1985), however, argued for an early liberalization of capital controls.
13. The countries covered were Argentina, Brazil, Chile, Colombia, Greece, Indonesia, Israel, Korea, New Zealand, Pakistan, Peru, the Philippines, Portugal, Singapore, Spain, Sri Lanka, Turkey, Uruguay, and Yugoslavia.
14. For a discussion of the way in which the World Bank influenced policy making in Latin America during the reform process, see Hicks (1992).
15. ibid.
16. See World Bank (1992).

17. Miguel Urrutia, current Governor of the Central Bank of Colombia and former Planning Minister, documented the World Bank's role in forging the Colombian trade liberalization program in Colombia Williamson (1994).
18. On the Chilean reforms see Edwards and Cox–Edwards (1991).
19. It is important to note, however, that dspite recent growth, by 1991 only thirteen countries in the region had income per capita that exceeded that of 1980: Colombia, Chile, Paraguay, Bahamas, Barbados, Belize, Jamaica, Antigua, Dominica, St. Kitts and Nevis, St. Vincent and Grenadines, and St. Lucia.
20. The recently approved Brazilian deal is a departure from this norm.
21. On the sequencing issue see Edwards (1990). On the debate over the opening of the capital account see Edwards (forthcoming).
22. On this debate see Edwards (1993e), Bruno (1991), and see also Edwards and Losada (1994). A number of recent analyses have related inflation and the fate of stabilization policies to political economy developments. See, for example, Cukierman, Edwards, and Tabellini (1992).
23. On Latin America's integration efforts see Edwards (1993d).
24. On trade reform and economic performance see Edwards (1992, 1993a).
25. See, for example chapter 6 of Edwards (1993c).
26. For an analytical discussion of some of these issue see Edwards (1988b).
27. McKinnon (1991) documents that the ratio of loanable funds to GDP in Latin America was significantly lower than that of Asia during 1960-85.
28. See chapter 8 of Edwards (1993c).
29. On these issues see the detailed discussion in chapter 8 of Edwards (1993c).

References

Agarwala, Ramgopal. 1981. "Price Distortions and Growth in Developing Countries." World Bank Working Paper 575. Washington, D.C.

Balassa, Bela. 1982. *Development Strategies in Semi-Industrial Economies*. Baltimore: Johns Hopkins University Press.

Balassa, Bela. 1985. "Exports, Policy Choices and Economic Growth in Developing Countries After the 1973 Oil Shock." *Journal of Development Economics* 18 (2).

Bruno, Michael. 1991. "High Inflation and the Nominal Anchors of an Open Economy." New Jersey, Princeton Essays on International Finance.

Calvo, Guillermo, Leonardo Leiderman, and Carmen Reinhardt. 1992. "Capital Inflows and Real Exchange Rate Appreciation." Working Paper 62. International Monetary Fund, Washington, D.C.

Choksi, Armeane, and Demetris Papageorgiou, eds. 1986. *Economic Liberalization in Developing Countries*. Oxford: Basil Blackwell.

Cline, William. 1989. "From the Baker Plan to the Brady Plan." In Ishrat Husain and Ishac Diwan, eds., *Dealing with the Debt Crisis*. Washington, D.C.: World Bank.

Corden, Warner Max. 1987. "Protection and Liberalization: A Review of Analytical Issues." Occasional Paper 54. International Monetary Fund, Washington, D.C.

Cukierman, Alex, Sebastian Edwards, and Guido Tabellini. 1992. "Seigniorage and Political Instability." *American Economic Review* 82 (3).

Edwards, Sebastian. 1984. "LDC's Foreign Borrowing and Default Risk: An Empirical Investigation." *American Economic Review* 74 (4).

Edwards, Sebastian. 1986. "The Pricing of Bank Loans and Bonds in International Financial Markets." *European Economic Review*, June.

Edwards, Sebastian. 1988a. "Structural Adjustment Policies in Highly Indebted Countries." In Jeffrey Sachs, ed., *The Developing Countries Debt Crisis*. Chicago, University of Chicago Press.

Edwards, Sebastian. 1988b. "Terms of Trade, Tariffs and Labor Adjustment in Developing Countries." *The World Bank Economic Review* 2 (1).

Edwards, Sebastian. 1989a. "The Debt Crisis and Economic Adjustment in Latin America." *Latin American Economic Review* 24 (3).

Edwards, Sebastian. 1989b. "The International Monetary Fund and the Developing Countries: A Critical Evaluation." In Karl Brunner and Allan Meltzer, eds., *Carnegie-Rochester Series on Public Policy* 31.

Edwards, Sebastian. 1989c. *Real Exchange Rates, Devaluation and Adjustment.* Cambridge, MIT Press.

Edwards, Sebastian. 1990. "The Sequencing of Economic Reform: Analytical Issues and Lessons from Latin America." *World Economy* 13 (1).

Edwards, Sebastian. 1992. "Trade Orientation, Distortions, and Growth in Developing Countries." *Journal of Development Economics* 39 (1).

Edwards, Sebastian. 1993a. "Openness, Trade Liberalization, and Growth in Developing Countries." *Journal of Economic Literature* 31 (3).

Edwards, Sebastian. 1993b. "Economic Reform, Labor Markets, and the Social Sectors: A Latin American Perspective." Working paper, Institute for Policy Reform, October.

Edwards, Sebastian. 1993c. "Latin America and the Caribbean a Decade After the Debt Crisis." Report prepared for the Vice-Presidency of the Latin America and the Caribbean Regional Office of The World Bank.

Edwards, Sebastian. 1993d. "Economic Integration in Latin America: New Perspectives on an Old Dream." *World Economy* 16 (3).

Edwards, Sebastian. 1993e. "Exchange Rates as Nominal Anchors." *Weltwirtschaftliches Archiv* 129 (1).

Edwards, Sebastian (ed.). Forthcoming. *Capital Controls, Exchange Rates and Monetary Policy in the World Economy.* Chicago: University of Chicago Press.

Edwards, Sebastian and Alejandra Cox-Edwards. 1991. *Monetarism and Liberalization: The Chilean Experiment.* Chicago: University of Chicago Press.

Edwards, Sebastian, and Fernando Losada. 1994. "Fixed Exchange Rates, Inflation, and Macroeconomic Discipline." Working Paper 4661, National Bureau of Economic Research. Cambridge, Mass.

Edwards, Sebastian and Julio Santaella. 1992. "Devaluation Controversies in Developing Countries: Lessons from the Bretton Woods Era." In Michael Bordo and Barry Eichengreen, eds., A Retrospective on the Bretton Woods System. Chicago: University of Chicago Press.

Feder, Gershon. 1983. "On Exports and Economic Growth." *Journal of Development Economics* 12 (1/2).

Fishlow, Albert. 1991. "Liberalization in Latin America." In Tariq Banuri, ed., *Economic Liberalization: No Panacea.* Oxford: Oxford University Press.

Hanson, James, and Craig Neal. 1985. "Interest Rate Policies in Selected Developing Countries, 1970-1982." Working Paper 753, World Bank, Washington, D.C.

Hicks, Norman. 1992. "The Role of the World Bank in the Latin American Reform Process." World Bank Office Memorandum, Washington, D.C.

International Monetary Fund. 1985. World Economic Outlook. Washington, D.C.

Khan, Mohsin, and Roberto Zahler. 1983. "The Macroeconomic Effects of Changes in Barriers to Trade and Capital Flows: A Simulation Analysis." IMF Staff Paper 30, Washington, D.C.

Krugman, Paul. 1988. "Financing vs. Forgiving a Debt Overhang." NBER Working Paper 2386. National Bureau of Economic Research, Cambridge, Mass.

Lal, Deepak. 1985. "The Real Aspects of Stabilization and Structural Adjustment Policies: An Extension of the Australian Adjustment Model." Working Paper 636, World Bank, Washington, D.C.

McKinnon, Ronald. 1991. *The Order of Economic Liberalization*. Baltimore: Johns Hopkins University Press.

Michaely, Michael, Armeane Choksi, and Demetris Papageorgiou, eds. 1991. *Liberalizing Foreign Trade*. New York: Basil Blackwell.

Morgan Guaranty and Trust Company. 1987. "World Financial Markets." Morgan Guaranty International Economics Department, New York.

Sachs, Jeffrey. 1987. "Trade and Exchange Rate Policies in Trade-Oriented Adjustment Programs." In Vittorio Corbo, Morris Goldstein, and Mohsin Khan, eds., *Growth-Oriented Adjustment Programs*. Washington, D.C.: International Monetary Fund.

Selowsky, Marcelo, and Herman van der Tak. 1986. "The Debt Problem and Growth." *World Development* 14 (9).

Williamson, John, ed. 1990. *Latin American Adjustment: How Much Has Happened?* Washington, D.C.: Institute for International Economics.

Williamson, John, ed. 1994. *The Political Economy of Policy Reform*. Washington, D.C.: Institute for International Economics

World Bank. 1990. *Adjustment Lending Policies for Sustainable Growth*. Washington, D.C.

World Bank. 1991. *Financial Flows to Developing Countries*. Washington, D.C.

World Bank. 1992. *Poverty and Income Distribution in Latin America: The Story of the 1980s*. Washington, D.C.

The Transition in Central and Eastern Europe and the Former Soviet Union

Kemal Dervis, Marcelo Selowsky, and Christine Wallich

From Eastern Europe to Central Asia, countries have embarked on a path of systemic transformation, the extent of which has few parallels in history. The Bank, too, is now engaged in one of the greatest efforts in its history. In fiscal years 1990–94, twenty-two states in this region became new members, while the Bank committed US$13.5 billion and opened seven new resident missions. These countries face the task of creating wealth and improving living standards. Both the opportunities and the challenges are immense. Many countries are rich in technology, agriculture, and natural resources. Huge resources, historically devoted to military output and unnecessarily high levels of investment, can now be used to improve the quality of life.

Both the opportunities and the challenges are immense. . . . Huge resources, historically devoted to military output and unnecessarily high levels of investment, can now be used to improve the quality of life

In some countries, much progress has taken place on both the institutional and policy front, especially as regards privatization. In many, however, there is still a need to reduce the dominance of state monopolies and to limit heavy political and administrative interference. All countries share the need to restructure and privatize heavy industry. All also need continued fiscal retrenchment.

Successful transformation will require macroeconomic stability, free prices, the building of modern institutions, including a modern state, and the development of financial markets with a legal framework that supports the operation of markets. Infrastructure needs to be revamped to avoid hindering restructuring and recovery. Finally, in most countries, a readaptation of skills and an improved social safety net will be particularly important.

Stabilization and Transition

In all transition economies, systemic transformation has been made more difficult by the serious macroeconomic imbalances in place when the old order collapsed. Price controls, along with underlying budgetary imbalances, had repressed inflation and created a large monetary overhang. The severing of supply links among enterprises within countries, as well as the disruption of COMECON trade, led to economic contraction and large output losses. Movement to a market economy required freeing prices and exchange rate adjustments. Thus, transition economies were faced with a hard choice. Much-needed stabilization programs had to be adopted at the same time as these structural causes were leading to output decline. But, failure to pursue stabilization would risk hyperinflation, since monetary financing of the deficit would take place at a time when the demand for money was collapsing.

In all transition economies, systemic transformation has been made more difficult by the serious macroeconomic imbalances

When they joined the Bretton Woods institutions, these countries engaged in discussions with the IMF on stabilization efforts, and many negotiated formal IMF approval for financial programs. The Bank played a supportive role with a series of fast disbursing operations, financing either general imports (structural adjustment and economic recovery loans) or agreed on lists of priority imports (critical import and rehabilitation loans). These operations provide non-inflationary finance to the budget, since Bank-financed imports generate counterpart fund revenues (Table 1). Bank loans were, of course, only part of larger financial packages,

including IMF, G–24, and other contributions.

While committed loans were substantial, the actual flow of disbursements in the first twelve months after approval was only a fraction of total funds committed. This is due partly to the fact that many of these loans were "tranched," with tranche release dependent on agreed policy actions, and partly to the Bank's procurement rules. IBRD shareholders insist that Bank funds be spent

Table 1. IBRD and IDA Import Financing Loans and Credits

Country	*Loan type*	*Amount ($ million)*	*Month of approval*	*Dollars per capita*	*Percentage of GDP*	*Percentage of funds disbursed 1 year after approval*
Albania	Critical imports	43	June 1992	12	6.2	22.0
Bulgaria	SAL	250	August 1991	28	3.4	56.8
Czechoslovakia	SAL	450	June 1991	29	1.4	44.4
Hungary	SAL	200	June 1990	19	0.6	100.0
	SAL II	250	June 1991	24	0.8	70.0
Poland	SAL	300	July 1990	8	0.5	33.3
Romania	Critical imports	150	June 1991	6	0.5	8.1
	SAL	400	June 1992	17	2.1	57.7
Russia	Rehabilitation	600	August 1992	4	0.7	51.1
Belarus	Rehabilitation	120	November 1993	12	1.9	14.7 [a]
Moldova	Rehabilitation	60	October 1993	14	2.6	40.4 [a]
Estonia	Rehabilitation	30	October 1992	19	1.5	60.9
Latvia	Rehabilitation	45	October 1992	17	3.2	35.6
Lithuania	Rehabilitation	60	October 1992	16	1.9	47.3
Kazakhstan	Rehabilitation	180	September 1993	11	1.8	41.5 [b]
Kyrgyzstan	Rehabilitation	60	May 1993	14	3.3	60.3
Slovakia	Recovery	80	November 1993	16	0.1	20.0
FYR Macedonia	Recovery	80	February 1994	36	3.7 [c]	100.0

Note: Underlying data on GDP and population correspond to the calendar year of loan approval.
a. 7 months.
b. 9 months.
c. Percentage of GNP.

to finance imports procured in ways that allow competition among suppliers. Specific rules must be followed and documentation must be available. Both requirements are difficult for new member countries for whom these procedures are new. Although disbursements often speed up with experience, slow disbursement of import-financing loans has often been criticized. Until now, there has been little scope for greater flexibility in the procurement rules.

Debate continues about the role of balance-of-payments loans from the Bretton Woods institutions to support stabilization efforts. Substantial up-front external finance can make a huge difference by helping to stabilize the exchange rate, finance the budget deficit in a non-inflationary way, and create positive expectations. But to have such a decisive impact, the external assistance package must be of a substantial magnitude and disbursed rapidly.

On the other hand, if there is insufficient domestic policy effort, such financing flows do more harm than good, increasing indebtedness without paving the way to the sustained growth needed to avoid a debt trap. Moreover, if the Bretton Woods institutions provided large amounts of nonconcessional financing to unsuccessful adjustment programs, they would not only undermine their credibility but would build a portfolio of problem loans that could lead to serious financial problems for them in the medium-term future. Clearly, both flexibility and caution are needed to prevent a waste of resources where the real economic returns on external financing are likely to be nil.

If there is insufficient domestic policy effort, such financing flows do more harm than good, increasing indebtedness without paving the way to the sustained growth needed to avoid a debt trap

Institution-Building and the New Role of Government

Lack of appropriate institutions has been an impediment to implementing stabilization policies and a major bottleneck to modernization and restructuring. To meet the needs of a market economy, the state apparatus for civil service, the organization of public finances, and the regulatory frameworks all need reform. There are limits,

however, in trying to accelerate institution building, especially in some countries of the former Soviet Union that lack the prewar institutions and memory of markets shared by most countries in Eastern Europe.

To move a public administration from a system based on direct control of the economy toward one based on incentives involves a reorientation of the state's role—indeed, a reinvention of public institutions. The Central Bank, for example, needs to be strengthened in new functions of indirect monetary control, domestic debt and interest rate management, and bank supervision. Many countries inherited centralized state structures that no longer serve them well and are now strengthening local governments that can mobilize resources and deliver public services more efficiently. The introduction of a market economy also brings with it a need to strengthen tax administration to ensure that the budget will be able to tap newly emerging tax bases—consumption and private-sector incomes. Better tax administration and a broader tax base would permit, in turn, lower tax rates that are less of a disincentive to private sector development.

Also required are predictable incentives and the rule of law—reforms in the financial and payments systems, accounting systems, the introduction of new legal frameworks, and courts able to enforce contracts. To provide headroom for the private sector also requires a reorientation of the state's fiscal role, including a reallocation of public expenditures and better public investment programming so that the infrastructure needed to support private sector activity develops. Without such changes, the supply response expected from economic liberalization will be dampened, making macroeconomic stabilization more difficult to sustain.

Retooling the state involves sensitive issues that are difficult to resolve. Initial Bank intervention in some member countries was through assistance in strengthening the

To move a public administration from a system based on direct control of the economy toward one based on incentives involves a reorientation of the state's role—indeed, a reinvention of public institutions

While it is important to reduce deficits, reducing the share of public expenditures is also key to creating the economic headroom needed for the private sector to flourish

institutional capacity to implement reforms in areas key to transition. Such Bank support, however, is recent and experience is still being gained. The strengthening of core state functions has been supported through free-standing technical assistance loans, investment lending, and quick-disbursing operations—each focusing on different aspects of institution building. Throughout the former Soviet Union, institution-building loans were designed to strengthen economic management capacity, including aid coordination, and to establish modern treasuries to improve public expenditure and debt management. Targeted technical assistance projects for tax administration (in Albania and Hungary, for example) have sought to bolster resource mobilization—as well as tax policy and its implementation—by strengthening tax and customs offices, training tax officials, and computerizing tax records.

Streamlining the state budget, rechannelling its focus, and making its impact more transparent are perhaps the most important aspects of retooling the state. While it is important to reduce deficits, reducing the share of public expenditures is also key to creating the economic headroom needed for the private sector to flourish. Economic studies undertaken early in the dialogue with each country identified the sustainability and rationale of many government transfers and subsidies. These were typically provided in nontransparent forms though subsidized credits, uncollected debts, tax and social security arrears, and controlled prices. Moreover, the proliferation of extra-budgetary accounts and parallel budgets make controlling both the level and composition of public expenditures difficult. The Bank has tried to encourage making such subsidies explicit and to analyze their justification—both in terms of equity and efficiency.

Important studies of this type were undertaken for Russia, Ukraine, and Uzbekistan, where credit and energy subsidies had major macroeconomic implications. In Hungary, work has focused on the consolidation of

budgetary, extra-budgetary, and other institutional funds, whose continued proliferation puts fiscal stabilization at risk. Work on the sustainability and reform of fiscally costly pension systems is also continuing. Projects in this area have helped to improve administration and computerization of social benefit systems in Hungary and Albania, for example.

Finally, development of the financial and economic infrastructure needed by a market economy—including payment systems, banking legislation, accounting and securities regulatory systems—is also being supported:

- A financial institutions development project of $200 million was recently approved for Russia—one of the larger technical assistance projects approved by the Bank. It supports the modernization of both commercial banks and Russia's payments and clearing system, the strengthening of the supervisory capabilities of the Central Bank, and an overhaul of accounting and auditing standards.

- Bank loans under way in Poland, Albania, and Slovakia provide technical assistance to improve central banking skills, bank supervision, financial and capital market regulation, and auditing and accounting.

- In Armenia, Belarus, Kazakhstan, and Ukraine, institution-building loans focused on strengthening banking and financial-sector accounting as well as developing a modern payments system. Even so, major challenges remain. These institutional reforms must be followed by concrete restructuring of financial institutions still burdened by bad loans and old habits.

Today neither the level nor composition of public investment is compatible with the growing needs of the private economy. Current public investment levels—sometimes as low as 2 percent of GDP—mortgage the future. To ensure that scarce budgetary resources go where returns are highest, reform of public investment programming is crucial. The Bank has supported the design of public investment programs

Current public investment levels—sometimes as low as 2 percent of GDP—mortgage the future. To ensure that scarce budgetary resources go where returns are highest, reform of public investment programming is crucial

The redesign of social sector spending is also key to fiscal adjustment. Social sector spending now absorbs as much as 30 percent of GDP in some countries and without policy reform, could grow, compromising stabilization

in Albania and Poland and has undertaken in-depth public expenditure reviews in the Baltic countries.

Legal reforms are also key to the transition but are long-term in nature, involving fundamental changes in institutions, processes, and procedures. In the former Eastern Bloc, major gaps exist in the legislation needed to support economic reforms, including the definition of property rights, commercial and financial laws, banking legislation, and regulatory systems. For example:

- In initial rehabilitation loans to Russia, Kazakhstan, the Baltic states, and the Kyrgyz Republic, loan conditionality encompassed the legal and institutional framework for private-sector development, including pro-competition and anti-monopoly policies and an environment conducive to foreign direct investment.

- In Slovakia and Poland, adjustment operations have supported the introduction of bank and securities market regulation and anti-monopoly policies.

- In some former Soviet republics, the Bank has also provided direct support for legal reforms in the areas of privatization, energy legislation, and banking through grants and loans for legal advisers, legal information systems, training, and judicial reform.

Labor Markets, Social Sectors, and Safety Nets

Strengthening social policies (employment, education, health, and the social safety net) is another cornerstone of economic transformation in Eastern Europe. Restoration of this region's growth and international competitiveness depends on the restructuring of industry, or physical capital, and also on the restructuring of human capital to meet the needs of a market economy. The redesign of social sector spending is also key to fiscal adjustment. Social sector spending now absorbs as much as 30 percent of GDP in some countries and without policy reform could grow, compromising stabilization. At the same time, the government must ensure that core social services (such as education, health, and

social welfare) do not deteriorate over the transition.

Toward Flexible Labor Markets

Output and employment declines associated with transition were greatly underestimated. Across Eastern Europe and the former Soviet Union, output has declined by as much as 60 percent, and unemployment in some countries has reached 15 percent or more. In Eastern Europe, unemployment closely tracks output decline. In the former Soviet Union, despite large cumulative output declines, open unemployment remains lower—perhaps because of labor hoarding, often unpaid, which enables workers to continue to avail themselves of enterprise social benefits. But the direction is clear: as budget constraints tighten, the state sector has been shedding employees. Employment growth relies on the development of new activities, and especially of small-scale, private businesses. Policies to reduce labor market rigidities and facilitate mobility, including housing reform, also need to be developed.

Bank Support for Labor and Employment Policies

STRENGTHENING LABOR POLICIES. The primary goal is to support programs that will enhance labor mobility by making it easier to hire and dismiss workers, by improving wage determination policies, and by introducing market-driven training programs for the unemployed. For example:

- The Second Russia Rehabilitation loan now in preparation proposes that unemployment fund resources be used for unemployment only and not for job-creation schemes in state-owned enterprises.

- In Poland, the structural adjustment loan (SAL) and employment services projects are designed to minimize the effects of mass layoffs, with proactive labor market policies focused on strengthening governmental labor offices, retraining, micro-enterprise credit, and other supports.

- Projects designed to strengthen labor offices and services to the unemployed

The primary goal is to support programs that will enhance labor mobility by making it easier to hire and dismiss workers, by improving wage determination policies, and by introducing market-driven training programs for the unemployed

have been approved for Russia and Armenia and are in preparation for the Kyrgyz Republic and Kazakhstan.

TARGETED PROJECTS FOR MASS LAYOFFS. Whether these employment services projects can meet their objectives will only be seen with time. There is concern, for example, that some of these policies are better suited for "frictional" unemployment situations than for countries with high (and likely long-term) structural unemployment. Thus the Bank is exploring a more proactive targeted approach, tying labor and employment support to enterprise restructuring or financial sector operations that entail mass layoffs, severe restructuring, or downsizing. A study of Russia's coal sector recommends twinning a targeted labor component with any projects that restructure or downsize enterprises.

Many countries see the need to move . . . toward more general secondary and technical education and better designed, market-driven training that meets labor market needs

Redesigning Social Sector Programs

Many countries of the region have recognized the need to redesign and reorient their social sector programs in health, education, and training. Health care under the command system was generally free, and such health indicators as morbidity and mortality in Eastern Europe and (until recently) in the former Soviet Union were generally quite good. But the command system emphasized more expensive, curative interventions over cheaper, preventive measures. Virtually all transition economies need to move away from the public sector's monopoly over healthcare, to restructure health expenditure to strengthen primary care, and to improve and reorganize the pharmaceutical industry. Even with these measures, however, improved health outcomes may be elusive, since environment and diet factors also play a role.

In education, many countries see the need to move from an emphasis on narrowly focused vocational education and over-specialized training programs toward more general secondary and technical education and better designed, market-driven training that meets labor market needs. Curriculum redesign—especially for courses in finance, accounting, and management-related

subjects—is high on the agenda. While inflation is rapidly eroding budgets, higher education receives a disproportionately large share of spending in many parts of Eastern Europe and the former Soviet Union.

World Bank Support to the Social Sectors

The World Bank has used a range of vehicles to finance social sector policy reforms and associated investments. In some cases—such as adjustment, recovery, or rehabilitation operations in the former Czechoslovakia, Slovakia, the former Yugoslav Republic (FYR) of Macedonia, and Russia—implementation of selected social policies has been an integral part of a Bank-supported structural adjustment program. In other cases (as in Armenia and Belarus), World Bank assistance for social sectors has been provided through institution-building loans or traditional investment loans.

While projects in the social sectors usually have high economic returns, they may have low financial returns, and countries in the region are often loath to borrow for this purpose. Their concern is that such projects do not directly generate income and need to be repaid from general government revenues and scarce foreign exchange. Because of this, Bank support to the social sectors has been limited. Even so:

- In Poland, a health project is in place to help move the focus toward primary care and prevention, improve sector management, contain costs, and decentralize and demonopolize delivery.

- In Hungary and Romania, Bank-supported projects have introduced targeted, cost-effective public health interventions such as the rehabilitation of medical facilities, the introduction of management information systems to hospitals, and technical assistance for health services management.

- In Albania, a project to rehabilitate schools, ensure textbook provision, and restructure outmoded curricula is under implementation.

In Hungary and Romania, Bank-supported projects have introduced targeted, cost-effective public health interventions such as the rehabilitation of medical facilities, the introduction of management information systems to hospitals, and technical assistance for health services management

- In Russia, a management and finance training project will set up a public–private foundation to strengthen the skills needed in a market economy, such as management, finance, and professional services.

Strengthening Safety Nets

To maintain consensus and support, governments must maintain the safety net that protects those hurt most by transition. Social expenditures, especially pensions, are the most explosive element in state budgets and are almost certainly unsustainable. Despite their expense and generosity, however, some are so poorly targeted that they fail to protect those most at risk.

Social expenditures, especially pensions, are the most explosive element in state budgets and are almost certainly unsustainable. Despite their expense and generosity, however, some are so poorly targeted that they fail to protect those most at risk

Across the region, countries are focusing on how to reform their pension and unemployment programs and their social welfare systems—which in some countries now consume as much as 20 percent of GDP. Financed by payroll taxes that sometimes account for over 60 percent of wages (including those for health), the system is distortional and thought to affect competitiveness and the demand for labor. The reallocation of expenditures within this sector is made somewhat easier by its large budget share; and for fiscal, labor-market, efficiency, and international competitiveness reasons, cutbacks are inevitable.

The World Bank has supported reforms in this area through its lending, sector work, poverty assessments, and technical assistance. Social sector reviews, typically a prelude to project identification, have been prepared recently for Kyrgyz Republic, Russia, Ukraine, Hungary, and Poland. Poverty assessments are based on Bank-sponsored statistical surveys of household income and expenditure.

On the lending front, a rural poverty alleviation project in Albania was designed to test different approaches to rural public works and small-scale credit and to create employment and improve the cash incomes of rural households. The remarkable success of this pilot project speaks for its replication on a larger scale in urban areas.

Infrastructure

Public infrastructure investments and private-sector growth are strongly complementary, and the contribution of public investment to private productivity is rarely disputed. Efficient investments in transport and other infrastructure can make a significant difference in supply response. In central Asian countries, for instance, greater integration with nearby (but still largely inaccessible) South Asian markets and access to a wider range of trade partners will depend critically on the improvement of the region's transport and communications infrastructure and its oil and gas pipelines. To create a more efficient infrastructure, however, major policy reforms are needed. And across the region, there needs to be a shift from new capacity-expanding investments to rehabilitation and maintenance.

Large sums will be required. Countries will have to avoid "white elephant" projects and realize that even substantial public resources and donor involvement can contribute only a small fraction of the investment needed. Internal cash generation and private investment are essential. The Bank's role will lie as much in coordinating assistance, easing constraints to foreign direct investment, helping countries frame "market friendly" regulatory systems, and supporting institutional development to raise and allocate resources for infrastructure as in directly financing investments.

The World Bank has financed some $840 million in infrastructure and housing investments in FY93 alone. Catching up on the public investment and maintenance backlog is key to attracting foreign direct investment and facilitating trade flows and the supply response. There are, for example, severe capacity constraints in telecommunications—a sector neglected in the past that today suffers from outdated technology. In both the Czech Republic and Slovakia, telecommunications projects have sought to expand capacity, establish a regulatory framework, and support commercialization that readies enterprises

(In infrastructure) the Bank's role will lie as much in coordinating assistance, easing constraints to foreign direct investment, helping countries frame "market friendly" regulatory systems . . . as in directly financing investments

for privatization. In Hungary, a Bank telecommunications loan supported one of the largest ever privatizations in an infrastructure sector.

In many countries, transport needs to be reoriented toward new markets and different modes, for example, away from rail toward more flexible (and more easily privatized) road traffic. In Russia, for example, a highway rehabilitation and maintenance loan is designed to help shift from rail to road for short-haul freight traffic by improving the reliability of roads.

Housing reforms will help create labor mobility and efficient labor markets. They will free state enterprises from burdensome social assets and state and local governments from the fiscal burden of social and communal housing, allowing them to turn their energies from ownership to public service provision:

- Bank activities planned for Russia include promoting land market reform, housing privatization, and demonopolization of the construction industry.
- In Poland, emphasis is on housing finance. The housing sector is a challenge. It is often highly subsidized, and the macroeconomic environment is not conducive to developing housing finance.
- In Albania, a project focuses on completion of unfinished housing units, and the privatization of communal housing by municipalities.

The Role of Guarantees

Keeping the emphasis on indirect support of infrastructure development, the Bank has also engaged in dialogue with countries in the region on the use of guarantees, which permit large-scale investments without directly adding to public sector debt. Contractual compliance guarantees are designed to separate commercial risk from contractual risk. They guarantee loans made by a private lender to a private project against the risk that the government will not meet undertakings critical to the project's viability. Several operations have been discussed concerning motorway projects

Keeping the emphasis on indirect support of infrastructure development, the Bank has also engaged in dialogue with countries in the region on the use of guarantees, which permit large-scale investments without directly adding to public sector debt

in the Czech Republic and Poland and a pipeline project in Poland. In the first of these, private lenders to a private toll road concession are beneficiaries of the guarantee. The contractual risk is that the government will not stick to a pre-agreed schedule of toll rate increases critical to financial viability of the concession. Private financing allows a government to focus its limited spending and borrowing capacity on other high priority and socially desirable projects. But structuring these guarantees and pricing them is not easy.

Cleaner Environments

Incentives under the command regime had much to do with the poor ecological state of Eastern Europe. Across Eastern Europe and the former Soviet Union, water and air pollution continue to undermine both livelihood and health. The socialist system's underpricing of energy, its drive to promote heavy industry, and the prevalence of industrial subsidies encouraged energy-intensive, environmentally harmful industries and technologies. The main sources of air pollution are power generation, industry, motor vehicles, and road transport, while industrial effluents cause a great deal of water pollution. With energy prices sometimes still at one-third of world prices, overconsumption is rife.

To stop (and reverse) environmental damage requires both know-how and financing. Lack of funds and weak implementation capacity have impeded environmental improvements. But everything cannot be done at once, and difficult choices must be made and priorities set. The World Bank has supported measures to raise public awareness and strengthen institutions. It has also helped governments establish incentives to reduce energy consumption and adopt more environment-friendly technologies.

Some countries (notably Kazakhstan, Turkmenistan, and the Russian Federation) are major energy producers—Russia alone accounts for 20 percent of the world's oil and gas output. Others (the Baltics, Ukraine, and much of Eastern

To stop (and reverse) environmental damage requires both know-how and financing. Lack of funds and weak implementation capacity have impeded environmental improvements

It is necessary to find ways to move ahead with energy price reform while compensating the most vulnerable groups

Europe, for instance) are heavy importers and, for the time being, reliant on a sole supplier. In producing regions, the aim is to increase the efficiency of production and exploitation, attract foreign investment, and improve incentives for energy conservation through pricing and other policies. In consuming countries, the aim is to diversify supply, develop regional networks for major energy carriers, promote energy saving investments, reduce waste, and address the safety aspects of nuclear power generation.

Adjusting energy prices both in relative terms (between households and industry) and absolute terms is key in all countries. Change, however, will be neither quick nor easy. Private households—which benefitted for years from subsidized energy—are likely to resist. So, too, will industrial users, where demand elasticities in the short run are low. Organized labor has also resisted, fearing what industrial power price increases may do to enterprise profitability and employment. If such objections successfully slow price adjustments, reductions in pollution will also be slower, since lower energy prices mean continued high energy consumption, lower energy sector profitability, and fewer funds available for reinvestment in pollution-abating technologies. It is necessary to find ways to move ahead with energy price reform while compensating the most vulnerable groups.

While some environmental problems will be helped by price changes, others will need targeted investments. Bank-supported environmental investment projects are currently under way in some countries:

- In Slovenia, an environmental project seeks to help households and industry shift from polluting fuels (such as coal) to gas or district heating by financing gas-connection works and purchases of gas-fired appliances.

- In the Czech Republic, another project is working to improve power system efficiency and reduce air pollution in northern Bohemia.

The same project also aims to reduce lignite consumption by making power plants more efficient, to curtail power plant sulphur dioxide emissions with flue-gas desulfurization, and to increase the reliability and efficiency of power transmission systems.

- In Russia, the Bank helped to establish an environmental framework program under which some $200 million in pledged funds will strengthen Russia's environmental management and finance resource recovery and pollution projects—"win–win" projects meant to generate foreign exchange to pay off investment costs.

The Bank's involvement in this area has also included environment strategy studies, now completed for most countries. These studies rank environmental priorities on the basis of health impact and cost effectiveness and can help clarify a country's policy regime. The key issues are: How strict should environmental standards be? How quickly should they be enforced? How serious will the impact of closing polluting enterprises be on workers and nearby towns?

Foreign investors and those interested in privatization are particularly concerned with liability for cleaning up past pollution. Ensuring that environmental policies are "market friendly" is also key. Generally, the Bank has emphasized the importance of reducing ongoing pollution before addressing the clean-up of already polluted areas, which must be done over time and when resources become available. Past environmental damage is generally deemed the responsibility of the government, while stricter pollution standards typically apply to future operations of a private enterprise or joint venture.

Research on environmental taxes and other instruments continues. Vehicle taxes, fuel taxes, and improved traffic management, for instance, can contribute substantially to environmental improvement. Such economic policies can often make a difference, but at lower cost than direct

The Bank has emphasized the importance of reducing ongoing pollution before addressing the clean-up of already polluted areas, which must be done over time and when resources become available

investments. These measures can go a long way toward reducing the demands on the environment that, over time, economic growth would otherwise bring.

Energy Projects

With varying degrees of success, the Bank's energy projects have sought to support policy reform, institution building, improved investment efficiency, environmental benefits, and regional integration. In addressing the severe underpricing of all energy, the Bank has had some influence in most countries. This has been achieved through its economic and sector work, through conditionality in some adjustment and investment lending operations, and through ongoing dialogue. For some early reformers in Central Europe (for example, Hungary and the Czech Republic) most forms of energy to industrial consumers are now close to or at economic costs, and the financial positions of energy enterprises have also improved. Further east, progress is slower, although even in Russia, petroleum and gas prices have substantially increased in real terms.

For some early reformers in Central Europe (for example, Hungary and the Czech Republic) most forms of energy to industrial consumers are now close to or at economic costs, and the financial positions of energy enterprises have also improved

Other key aspects of energy policy reform—particularly in sector restructuring, commercialization, and privatization—have made less progress. Major energy enterprises have yet to be privatized, and private investment, particularly in the oil and gas sector, has not been substantial relative to needs. This reflects political and economic instability, as well as inadequate and uncertain regulatory, legislative, and fiscal frameworks.

One project that highlights the importance of policy reform is a $610 million loan (for a $1 billion project) supporting the first major effort to rehabilitate Russia's oil sector. The project supports major pricing, taxation, legislative, and institutional reforms to encourage new investment, both foreign and domestic. The benefits and economic returns are high and will begin to be realized when the first round of equipment arrives at Russian oil fields. A second project will build on the first.

Achieving greater efficiency and conservation in energy use is crucial. For the Baltics, a district heating rehabilitation project in Estonia and a power rehabilitation project for Lithuania have just been approved. Greater efficiency is also an objective of the Bank's planned power-transmission projects in Slovakia and Poland, which will link these countries with the rest of the European grid.

Investment projects have dominated the Bank's energy lending, but among adjustment loans, an energy sector adjustment loan to Poland is noteworthy. This loan supports government efforts to develop an energy sector regulatory and pricing framework and to restructure and commercialize public utilities. Such steps are needed to attract the approximately $3 billion in energy investment required by the gas and power sectors over the next years.

In the nuclear energy sector, the Bank has participated in a G–7 study of environmental clean-up possibilities for phasing out unsafe plants and replacing them with internationally certified plants or with power plants based on alternative fuels. For some countries in the region, this transformation is not easy. The Baltics, for example, which now rely on a sole supplier of gas, might become more vulnerable with conversion to gas. The Bank has not to date been involved in financing nuclear projects; that financing is generally led by the private sector or other international financial institutions.

Private Sector Development

The challenge of moving an economy where 90 to 95 percent of productive assets are owned by the state or workers' collectives to one where private ownership is dominant (60 percent or more) has no historic precedent. The Bank has used three means to directly support ownership change and private sector development:

- Adjustment loans that support specific policies to speed up privatization.

- Technical assistance loans to finance expertise.

The challenge of moving an economy where 90 to 95 percent of productive assets are owned by the state or workers' collectives to one where private ownership is dominant (60 percent or more) has no historic precedent

Box 1. World Bank Group Assistance for Privatization in Kazakhstan and Russia

Kazakhstan. Following independence in late 1991, Kazakhstan initiated a privatization program. Enterprises were transferred through a slow, case-by-case process and went primarily to worker collectives at highly favorable prices and with restrictions on business practices. By mid-1992, the drawbacks were obvious and the government invited the World Bank to assist in the development of a new strategy.

In the fall of 1992, the Bank, together with EBRD and USAID, worked with the Kazakh State Property Committee (SPC) and other agencies to define a comprehensive, action-oriented privatization strategy with policy recommendations on competition policy, capital market development, and private sector development. By March 1993, it was signed by the President. Parliament passed relevant legislation shortly thereafter.

The program's four components provide for (a) local auctions of almost all small-scale enterprises by the end of 1994; (b) mass privatization of the roughly 3,500 medium and large, nonagricultural firms between 1994–96 (with most shares sold to investment funds using coupons invested in them by individuals); (c) case-by-case privatization of some very large or special enterprises, mainly through international tender; and (d) privatization in the agricultural sector, with the allocation to individual farmers of long-term use rights for state farmland.

This sound program enjoys broad consensus. Execution began by mid-1993 and has proceeded quickly. Pilot programs for small-scale privatization in six large cities and for truck and warehouse auctions have begun. The first international tender for a very large enterprise was also launched, and SPC has started share auctions for mass privatization.

Implementation support has been provided by the World Bank, the European Union, and USAID. The World Bank will provide additional technical assistance under two sequential loans, and further Bank projects may help restructure enterprises after their privatization and seek to improve the economic environment in which they operate.

Russia. A major turning point in Russia's transition to the market occurred in late November 1991 with the implementation of the Law on Privatization. In March 1992, a Bank team of technical advisors—management consultants, lawyers, public relations specialists, economists, and accountants—helped to construct the detailed mechanics of the program. This detailed exercise provided crucial assistance to the conceptually sound but poorly implemented program. Since that time, the Russian Privatization Fund (GKI) has:

- Elaborated an economically defensible and politically palatable privatization program.
- Begun the sale of vouchers permitting 146 million Russian citizens to participate directly in the privatization process.
- Changed firms to joint stock company status, distributed shares to insider workers and managers, and sold, by March of 1994, much of the remaining stock for vouchers in more than 9,000 medium and large-sized firms—an outcome remarkable in its scope and scale.

Between late 1991 and early 1992, before Russia joined the World Bank Group, when GKI was formulating its key privatization policies, IFC maintained a permanent advisor in Moscow who participated in GKI's policy meetings and helped elaborate a conceptual framework of the program—that has stood up remarkably well over the ensuing three years.

In conjunction with the EBRD, the Bank prepared a $130 million privatization loan which was approved by the Executive Directors in December 1993. The Bank and IFC continue to work closely with the Russian privatization program and have assisted firms after they have been privatized.

- Credit lines to augment the resources of banks and to encourage them to lend to the new private sector.

Through the IFC, the Bank Group has also taken an equity position in private enterprises, and MIGA provides insurance services to foreign investors. As discussed earlier in relation to infrastructure financing, the use of various forms of guarantees (including liquidity-enhancing guarantees for capital markets) could become an important instrument to support private sector development.

Bank Support for Private Sector Development

The Bank has not used policy-based lending to promote a particular model of privatization. Rather, adjustment loans were generally used to speed up privatization following whatever method or mix of methods (privatization tracks) the particular country wanted to pursue. Hungary and Bulgaria, for example, did not want to use voucher schemes for mass privatization. Bank adjustment loans set targets in terms of "share of value-added privatized by a certain date," using public offerings or direct sales. In the Czech Republic, Slovakia, and Poland, very different methods of mass privatization were supported by Bank adjustment loans. Countries of the former Soviet Union, too, are pursuing a variety of approaches accepted by the Bank and incorporated into Bank-supported operations. The Bank also supports privatization of agricultural land and state farms—just as important as privatization in the industrial and service sectors.

In addition to its early support for Central Europe (particularly Poland), the Bank has been active in the Russian Federation, Kazakhstan (see Box 1) and the Kyrgyz Republic—with both economic work and technical assistance. Early support to Russia included technical assistance for the mass privatization program, a public information campaign, and policy advice on such issues as corporate governance, interenterprise liabilities, competition policy, environmental issues

The Bank has not used policy-based lending to promote a particular model of privatization. Rather, adjustment loans were generally used to speed up privatization following whatever method or mix of methods (privatization tracks) the particular country wanted to pursue

The Bank's message has been that it is more important to move toward private ownership than to try to perfect any particular privatization method. Experience is teaching both the Bank and member countries what works and what doesn't

associated with privatization, and divestiture of enterprises' social assets.

Drawing on early experiences in Poland, the Czech Republic, and Slovakia, the Bank has been active in disseminating lessons, making transparent the costs and benefits of different types of mass privatization, as well as comparing mass privatization (via vouchers) to case-by-case methods based on auctions and special management or labor buyouts. The Bank's message has been that it is more important to move toward private ownership than to try to perfect any particular privatization method. Experience is teaching both the Bank and member countries what works and what doesn't. But much depends on the circumstances of individual countries, including the political rapport between insiders and outsiders in the enterprise sector.

From the beginning, there was concern about the availability of credit both to newly privatized enterprises and to enterprises attempting to restructure before privatization. Lines of credit were prepared for Hungary and Poland in the late 1980s and early 1990s to provide long-term resources to new commercial banks and to encourage them to lend in support of the transformation. A recent loan for restructuring private enterprise in Russia will test the demand for credit by the emerging private sector. The project is innovative. It is accompanied by equity funds and technical assistance centers (financed by the EBRD, IFC, and bilateral donors). The credit will be intermediated by a selected group of commercial banks required to comply with internationally accepted banking standards and practices.

Strong demand for investment credit, however, is unlikely to emerge before an economic upturn, as evidenced by the poor initial disbursement of the Polish and Hungarian credit lines. And wholesale credit that is supposed to reach new entrepreneurs through the intermediation of a banking system itself in crisis may be putting the cart before the horse. A stronger banking sector may be a prerequisite for

rapid private sector development in transition economies.

THE ROLE OF IFC. IFC has supported the private sector by investment in private enterprises and technical assistance with privatization, capital markets, and promotion of foreign investment. The number of approved IFC investments in the region rose from two in FY90 to twenty-nine in FY94. Beneficiaries include Bulgaria, the Czech Republic, Estonia, Hungary, Kazakhstan, Poland, Romania, Russia, Slovakia, Slovenia, Ukraine, and Uzbekistan. IFC's investments have concentrated on manufacturing and capital market projects. Examples of the former include a cement plant in Estonia, float-glass and special steel plants in Poland, and glass container, wheel manufacturing, carbon black, and newspaper investments in the Czech Republic. In addition, IFC has made telecommunications investments in Hungary (including a joint venture to operate Hungary's national telecommunications system) and has two oil projects in Russia. Other ventures have included agribusiness projects in Hungary and Poland, a hotel and an office building in Warsaw, coal-bed methane gas recovery in Poland, and gold mining in Uzbekistan.

Capital market projects have included the privatization of banks, the creation of new banks in Hungary and Kazakhstan, credit lines—including one to the Moscow International Bank, the creation of leasing and factoring companies, and the participation in venture capital and investment funds both at the national level—the Ukraine Fund, for instance—and on a multi-country level. Technical assistance in capital market development is also available and consists of advice on securities legislation, the creation of stock, bond and, commodity markets, the framework needed for banking and leasing, and the registration and custody of shares in newly privatized companies.

Technical assistance to small-scale privatization is now under way in Ukraine and Belarus. Meanwhile, IFC has provided advisory services and

The number of approved IFC investments in the region rose from two in FY90 to twenty-nine in FY94

assistance to the privatization of major enterprises, often finding them suitable foreign joint-venture partners. FIAS has provided advice on how to improve the foreign investment legislation and climate.

Building the New Financial Sector

Systemic transformation from centrally planned economies to market economies requires not only a new banking system but also the regulatory and payments systems, and other economic infrastructure within which true financial intermediaries can function responsibly.

Systemic transformation from centrally planned economies to market economies requires not only a new banking system but also the regulatory and payments systems, and other economic infrastructure within which true financial intermediaries can function responsibly

The problem is time. Ideally, the first step should be to build the supervisory and regulatory environment and create or import financial intermediaries with the appropriate staff. Only then, should these new actors make the credit allocation decisions that influence the path of the economy. In reality, governments have not had this luxury and have had little choice but to use the shell of the old system. Monobanks were hastily split, and a two-tier banking system established. The new regionally or functionally specialized (but still publicly owned) banks continued to take deposits and make loans. And while much was expected of them in improved credit allocation, directed credit continued and little in the incentive framework changed. Too rapidly, some thought, the door opened to many small private banks, even though the regulatory and supervisory framework was far from adequate. All this took place simultaneously with restructuring, downsizing, and privatization in the enterprise sector, leading to the continued accumulation of nonperforming loans and deterioration of the balance sheets at new banks, public and private.

While there are important differences among countries in their financial sectors, there are enough similarities to suggest common issues that need to be addressed strategically. These include: improvements in legal and regulatory systems, especially in the areas of banking regulation and supervision; modernization of payments systems; restructuring and

privatizing the former state banks, support for moving commercial banks more rapidly toward international standards; provision of extensive training in banking services, credit operations, accounting and auditing and the like; and moving to market-based credit allocation by phasing out directed credit and non-budgeted interest rate subsidies.

Technical Assistance and Institution Building

World Bank support for financial sector development has tended to have two distinct phases. In phase one, there is intense focus on technical assistance both to the future regulators and supervisors and to bank staff. This involves developing banking infrastructure through basic legislation, introducing improved accounting and auditing, encouraging prudential regulation, modernizing the payments system, and training staff and managers in project evaluation, corporate finance, and risk assessment techniques. In Hungary, for example, an early modernization loan attempted to strengthen the payments system and to update banking technology. The Poland financial institutions development loan has aimed at twinning arrangements between Polish and international banks to strengthen credit policies and internal management practices.

In Russia, one of the Bank's larger technical assistance loans (a $200 million financial institutions development project) aims to build the capacity of a core thirty to forty private commercial banks, which will operate to higher banking standards. It also provides the basis for a private (federal) clearing system. The project consists of three components: commercial banking, consisting of institutional strengthening and a systems modernization program; bank supervision, consisting of the development of on-site supervisory capabilities and legal assistance for the Central Bank of Russia; and bank accounting, which will focus on the modernization of accounting and auditing standards and practices. A similar operation is under way in Kazakhstan.

The Poland financial institutions development loan has aimed at twinning arrangements between Polish and international banks to strengthen credit policies and internal management practices

Only when there has been some technical assistance, training, and institutional development can more ambitious adjustment operations be launched

In Albania, Lithuania, and Moldova, the strategic focus is more fundamental. The World Bank is emphasizing the need to establish a proper legal framework for commercial banking, to restructure state-owned banks, and to overhaul the payments system. In Ukraine, where credit policy has made financial sector reform especially difficult, the institution-building loan is financing a twinning arrangement for the state savings banks, and an institutional development fund (IDF) grant is financing technical assistance in accounting for commercial banks. Similarly, in Belarus, where reform is just beginning, an institution-building loan is providing financing for twinning arrangements for the savings banks and the largest private bank, and an IDF grant is financing accounting reforms.

In the less developed Kyrgyz Republic and in Uzbekistan, the strategy is different again. World Bank technical assistance is provided for auditing two key banks with problem portfolios and for training bankers and bank accountants. Under a project now being prepared, an agency would be created to handle insolvency, including the bad debt of state-owned banks. Basic issues such as supervision, auditing and accounting standards, and payments system modernization are also being addressed. In addition, diagnostic studies of the four state banks are being financed.

In Estonia, where reforms are more advanced and the macroeconomy has stabilized, it is possible to be more ambitious. Parallel support from the World Bank and the Swedish government aims at expanding both commercial bank capital and improving banking skills. In Latvia, the World Bank supports efforts to restructure and privatize state-owned savings and commercial banks and to modernize the payments system.

Financial Sector Adjustment

Only when there has been technical assistance, training, and institutional development can more ambitious adjustment operations be launched. In some countries, shell state banks are being allowed to shrink while newly-licensed private banks expand. In

others, the need to address problems in both the banking system and enterprises jointly is paramount. Dealing with the banks alone would risk that future lending would again be channeled to their traditional client base—including weak and debt-burdened or loss-making enterprises. Solving the enterprise problem is a sine qua non for lasting viability of the banking system (as distinct from a one-time overhaul).

Bank assistance recognizes the need to address nonperforming loans of commercial banks—a legacy that has undermined the dual objectives of restructuring enterprises and providing adequate credit to emerging enterprises. In some cases, the limited capacity of the banks has necessitated more centralized approaches in the short-term, with the most problematic enterprises isolated from the rest of the banking system. Increasingly, as banks have the technical capacity to participate in enterprise restructuring, a lasting solution can focus on the active involvement of banks that had lent to problem enterprises in the first place. In Poland, banks were thought to be the only agent of change for all but a certain subset of troubled, indebted enterprises (Box 2).

Phase two of the World Bank's financial sector support focuses on strategies for the recapitalization of banks and financial restructuring of enterprises that should allow the newly reformed, retrained banks to function as competitive entities with positive net worth. Key questions relate to the most desirable form and timing of the inevitable recapitalization, the degree of its linkage to bank privatization and to enterprise restructuring, liquidation, and privatization.

For some of the more advanced countries in Eastern and Central Europe, the enterprise and financial sector adjustment loan (EFSAL) has become the vehicle of choice to restore banking viability and strengthen financial intermediation. These loans support government policy reforms designed to resolve the debt overhang of state-owned enterprises and the portfolio problems of state-owned banks. Both are needed to unfreeze bank lending (much of which is now tied up in rolling over

For some of the more advanced countries in Eastern and Central Europe, the enterprise and financial sector adjustment loan (EFSAL) has become the vehicle of choice to restore banking viability and strengthen financial intermediation. These loans support government policy reforms designed to resolve the debt overhang of state-owned enterprises and the portfolio problems of state-owned banks

Box 2. Enterprise and Financial Sector Adjustment Loan (EFSAL) in Poland

In 1993, Poland embarked on a far-reaching enterprise and bank restructuring program (EBRP) supported by a $450 million adjustment loan from the World Bank. The program assumed that banking and enterprise problems must be jointly resolved, and that banks—not the government, a centralized agency, or a "hospital" for sick enterprises—were the only effective agent of change for troubled, indebted enterprises. Banks know their clients best and can distinguish better than a government agency or an outsider between borrowing enterprises that are loss-makers under any scenario (and should therefore be pushed into bankruptcy or liquidation) and those that could be restored to profitability if properly down-sized or restructured and their debt overhang reduced. For this scheme to work:

- **Banks must face a hard-budget constraint.** Practically speaking, this means that they must be privatized, and that they must believe that no further resources are forthcoming to support them. (In Poland, bank privatization is part of the loan conditionality, and the agent-of-change role is already being played by nonprivatized banks governed by a steadfast and determined Ministry of Finance).
- **The accounting and bank regulatory and supervisory framework must be right, with market valuation of loans in bank portfolios and provisioning required for nonperforming loans.** In Poland, a comprehensive program to strengthen bank supervision was supported by the EFSAL.
- **Banks must be recapitalized to give them a sufficient capital cushion to provision and write off loans to problem or nonviable debtors following restructuring or liquidation.**
- **The privatization program and governance framework for enterprises must ensure prudent management and a hard-budget constraint.** The Poland EFSAL supports the mass privatization program and sets specific targets for more traditional privatization tracks.
- **Bankruptcy procedures must function smoothly.** Given the expected workload and inexperience of courts, the Polish EFSAL supports a temporary out-of-court conciliation procedure led by banks that would facilitate creditor-led workouts. Banks were given a one-year window to conclude conciliation proceedings. Creditor banks accounting for 50 percent of loans were also permitted to impose a solution on minority creditors.
- For enterprises unable to agree on conciliation or bankruptcy in one year, **a government-managed intervention fund was set up with a limited budgetary envelope.** Banks will have to write off a large portion of loans handled by this fund.

With these incentives, a profit-minded bank will do its utmost to recover value from its nonperforming loans, either by pushing the borrower into bankruptcy or liquidation to recover whatever value remains, or by restructuring the borrower's debt (jointly with other creditors) such that the enterprise once again becomes profit-generating.

So far, two banks have been privatized and another is in the process. The mass privatization program and privatization through other routes are generally on track. By the end of the one-year window, banks had dealt with 80 percent of their bad loans in value terms and were expected to complete the job in a matter of weeks. Bank-led conciliations were used to work out 60 percent of bad loans in value terms. The balance was handled through triggering bankruptcy or by auctioning off assets. Some of the remaining loans are being "sold" to the intervention fund. It remains to be seen whether these sales will be at prices that reflect the intended punitive nature of state intervention.

One might not choose this creditor-led approach, however, where banks are not yet truly banks—as in Albania or Moldova, where banking and credit skills are still rudimentary. This approach is also not indicated where bank privatization is not on the agenda and where government policies for governing public sector banks are not credible.

nonperforming loans) so that credit can be redirected toward performing state-owned enterprises and the private sector. EFSALs support government policies aimed at strengthening bank management and governance and reforming bank supervision, accounting, licensing, and regulation. Increasingly, EFSALs incorporate incentives for bank-led conciliation and the restructuring of enterprise debt reduction. Such loans have already been made in Albania, Poland, and Slovenia and are now under consideration in FYR Macedonia, Bulgaria, Romania, and Slovakia.

Within these loans supporting financial sector development and deepening financial intermediation, the Bank has also provided technical assistance for capital market development and the strengthening of bank regulation and supervision. One such project in Poland supported an action program to strengthen financial institutions, the regulatory and supervisory capacity of the central bank, and the policy and institutional environment. It included technical assistance and institution building. Using twinning arrangements between Polish and European commercial banks, it has produced positive results.

Of the eleven financial sector operations in fiscal 1990–94 (totaling $2.1 billion in commitments), one quarter were adjustment loans to help cover the budgetary costs of bank recapitalization or enterprise restructuring (Table 2). Other operations have aimed to strengthen the banking system in two complementary ways—directly, through the finance of equipment needs or technical assistance to the bank themselves, and indirectly, by providing long-term resources that banks intermediate.

Aid Coordination

Additional support for country programs can be leveraged by the Bank's economic work and cofinancing. Other donors (the European Union, bilateral sources, and other multilateral banks) often find the World Bank's analyses useful as a framework for aid coordination and as a compass for the policy

Of the eleven financial sector operations in fiscal 1990–94 (totaling $2.1 billion in commitments), one quarter were adjustment loans to help cover the budgetary costs of bank recapitalization or enterprise restructuring

Aid coordination is time-consuming but key to ensuring concerted policy advice, technical assistance, and investment financing

measures that donor-supported programs finance. A Bank-assisted public investment review of Albania, for example, led to greater donor and government agreement on a public investment program, and many donors have now chosen to provide financial support. Such aid coordination is time-consuming but key to ensuring concerted policy advice, technical assistance, and investment financing. Given constraints on the absorptive capacity of many countries, aid coordination is also needed to ensure that donor support will fit government priorities. The centerpiece of aid coordination is the consultative group process. In Eastern Europe and the former Soviet Union, the Bank has either organized or participated in many EU-led coordination efforts designed to help reduce

Table 2. Financial Sector Operations (July 1989 to June 1994)

Country	*Name of loan*	*Month of approval*	*Amount (US$ millions)*
Hungary	Financial systems modernization	Sept. 1989	66
Poland	Agroindustrial exports development[a]	Feb. 1990	100
Poland	Industrial export development[b]	Feb. 1990	260
Poland	Financial institutions development	June 1991	200
Poland	Enterprise restructuring and privatization	June 1991	280
Bulgaria	Private investment and exports[b]	June 1993	55
Romania	Industrial development[b]	May 1994	175
Russia	Financial institutions development	May 1994	200
Russia	Enterprise restructuring	June 1994	200
Poland	Enterprise and Financial Sector Adjustment	May 1993	450
Slovenia	Enterprise and Financial Sector Adjustment	July 1993	80
Total			**2,066**

a. With a component for developing the cooperative banking system.
b. Includes funds for technical assistance to strengthen the banking system.

constraints on external financing and to coordinate the overall provision of foreign resources. Sector-specific meetings have also been held, as, for example, conferences on the agriculture sector in Poland and Albania.

The Bank's Research and Training Support

As a knowledge-based institution, the Bank offers more than just a financial product, and its research has addressed issues ranging from macroeconomic stabilization to enterprise behavior. Bank macroeconomic studies have sought to understand the reasons for the output collapse in Eastern Europe and the former Soviet Union and have drawn lessons from the experience of early reformers. For example, how have the successes and failures of macroeconomic stabilization programs in Latin America compared with those in Eastern Europe? Another focus has been fiscal federalism, where a study compared the Russian experience to that of, among others, China, Brazil, Canada, and India. From these comparisons, the study was able to provide guidelines and general lessons for all transition economies faced with fundamental changes in their structures of taxation and assignment of revenue (including the thorny issue of natural resource rents) and expenditures among different levels of government.

Other Bank-sponsored studies have examined how state enterprises in Poland and elsewhere have responded to various reforms:

- Comparative studies of private manufacturing in Poland, Hungary, the Czech Republic, Slovakia, and Russia and a survey of the private sector in St. Petersburg have identified factors encouraging and constraining private sector growth.

- Comparative analyses of the emerging legal framework for private sector development in Eastern Europe have provided a baseline to assess the progress of reform.

- Extensive research has been done on agriculture's transition, including the collection

Bank macroeconomic studies have sought to understand the reasons for the output collapse in Eastern Europe and the former Soviet Union and have drawn lessons from the experience of early reformers

and analysis of data on farm-level restructuring.

Since transition implies major changes for households, an important focus of Bank research has been labor markets and poverty. Labor market studies have identified a growing pool of potentially long-term unemployed and a widening of skill premia in earnings distributions, and have assessed the implications of these findings for poverty. Transition countries inherited a comprehensive if inefficient and fiscally unsustainable social welfare system. Estimating the distributional impact of social spending was therefore a necessary prelude to effective targeting of social support and to the poverty assessments now beginning in the region.

One of the greatest challenges of transition has been the widespread need for the retraining of mid-level civil servants steeped in the ways of a planned economy

Research activities have also embodied institution building and extensive collaboration with leading analytical institutes and statistical offices. Scholars from the region have been brought to the Bank, and many joint conferences have been organized with institutions in Eastern Europe and the former Soviet Union.

To deal with the problematic area of data and national accounting, the Bank has produced two editions of its *Guide to Historically Planned Economies.* A Bank newsletter, *Transition,* represents a specific effort to communicate the results of Bank analyses and studies to a wider audience. Circulation is now more than 6,000, and demand in the transition economies is strong.

One of the greatest challenges of transition has been the widespread need for the retraining of mid-level civil servants steeped in the ways of a planned economy. They have had little exposure to market-based systems, and this mismatch in skills has constrained economic policymaking. The task is to raise skill levels while seeking greater consensus on economic policy among policymakers and throughout the population.

Since 1990, the World Bank's Economic Development Institute's (EDI) efforts have included direct training, the sharing of experience both within and across regions,

and—increasingly—the training of local teachers to train mid-level officials in local institutions and agencies. In Russia, where demand for retraining is enormous, EDI retrained a group of teachers recruited mostly from Russian universities and research institutions. In late 1992, a training center at Moscow State University was established that organizes a wide range of courses, targeted primarily at officials and taught primarily by local staff. This model is being replicated in the Ukraine and in Uzbekistan, with plans for Kazakhstan, Belarus, and Moldova. Similar programs have begun at the Center for Economic Research and Graduate Education in Prague, and at Warsaw University. Teachers are being trained in the former Soviet Union, at EDI in Washington, DC, and at a recently established (1993) program with the Joint Vienna Institute. Most recently, EDI has begun to reach out to journalists, parliamentarians, and the general public to disseminate more widely and effectively information on the objectives and likely results from reforms, both macroeconomic and structural.

Conclusion

The Bank's key challenge in dealing with transitional economies has been to calibrate the volume and composition of assistance so that it complements domestic reform, making it less socially and economically costly and more sustainable. Assistance that is too little or too late makes reform unnecessarily costly and may endanger its progress. Financial assistance that is premature may delay reform and lead to capital flight, adding to debt rather than to economic growth and public welfare. When a country's need is exceptionally large, it may threaten the portfolio of the Bank and increase the cost of borrowing for other members.

Assistance that is too little or too late makes reform unnecessarily costly and may endanger its progress. Financial assistance that is premature may delay reform and lead to capital flight, adding to debt rather than to economic growth and public welfare

In identifying the future direction of Bank lending, it is important to recognize that restructuring and growth in transition countries will depend on addressing two major constraints: demand-side constraints that impair the business environment and the desire to invest (such as lack of macroeconomic stability,

The key challenge is to ensure that adequate progress has been achieved toward an environment conducive to restructuring and private sector growth before transferring significant resources through infrastructure and credit

insufficient liberalization, and a weak legal framework) and supply-side constraints in the availability of resources such as credit to enterprises and key public infrastructure needed to complement the growth of the private sector. The key is to achieve a balance between interventions addressing both types of constraints.

Historically, lending operations have been well-geared for investment operations and credit lines. But lack of progress today in improving the environment for restructuring and investment may result in:

- Undisbursed credit lines, as occurred in countries where Bank loans were approved before investment demand and privatization progress required them.

- Balance of payments financing that ends in capital flight in response to an unstable macroeconomic situation.

- Investments that end in under-used infrastructure because the productive sectors have not yet been restructured.

The key challenge is to ensure that adequate progress has been achieved toward an environment conducive to restructuring and private sector growth before transferring significant resources through infrastructure and credit:

- Much legislation and price policy is in the hands of subnational governments and the division of responsibilities between these governments and the center is still unclear, particularly in Russia and Ukraine. In some countries, it is necessary to await the redefinition of political and economic authority between local governments and central authorities.

- Privatization alone does not assure improvement in governance and depolitization of firms, given the significant role played by insiders. Thus privatization loans and credit lines to newly privatized firms still involve significant risks.

- In some countries, law and order has deteriorated as governments have not refocused their roles in these areas. This may have a major

effect on the climate for new investment and private-sector growth.

The Bank will also have to recognize that legal and institutional development crucial for economic reforms will take time to yield results. These reforms cannot be accelerated with large amounts of financial support. Technical assistance faces absorptive-capacity limits that must be recognized.

The first four years of the transformation from communism toward markets and democracy have included massive output declines, a surge in unemployment, and in some areas, ethnic and religious conflict. After an initially cautious attitude by its major shareholders—at least regarding the Soviet Union—the World Bank Group has taken on the new challenge of supporting and financing the systemic transition in more than two dozen countries, including Russia. In terms of both the political difficulties in generating consensus and social support, and the technical difficulties in trying to implement the most appropriate policy measures, the task is daunting.

In 1994, however, encouraging signs are appearing: Central Europe has started to grow, with Poland leading the new expansion. Albania, having experienced a disastrous collapse in 1990–92, has seen GDP grow at close to 10 percent for almost two years. The Baltics seem ready for a rebound. And in Russia, the first six months of 1994 show better results than anyone expected a year ago. Throughout the region, momentous changes have already taken place, and perhaps the hope is justified that through the systemic transformation of Central and Eastern Europe and the former Soviet Union, a stronger and more integrated world economy is emerging.

Throughout the region, momentous changes have already taken place, and perhaps the hope is justified that through the systemic transformation of Central and Eastern Europe and the former Soviet Union, a stronger and more integrated world economy is emerging

The authors are grateful to their colleagues in the World Bank who provided contributions for the paper.

The East Asian Economic Miracle

Vinod Thomas and Peter Stephens

East Asia has been uniquely successful in fostering growth, reducing poverty, raising living standards, and integrating with world markets. The credit for this remarkable achievement belongs to the governments and peoples of the region. They were not alone, however. Open markets in industrial countries and development assistance contributed to progress. Since its first loan to Thailand in 1950, the World Bank has had a long and active involvement in the region—in lending some $71 billion through fiscal 1994, and in policy dialogue (see Figure 1).

East Asia has been uniquely successful in fostering growth, reducing poverty, raising living standards, and integrating with world markets

With remarkable commitment and perseverance, East Asia has practiced the key messages emphasized by the Bank in its development strategy: macroeconomic stability, investment in people, and building on export growth. The impact of the Bank's involvement is not easily defined in monetary or economic terms; it is better understood through the diversity and continuity of the relationship with its East Asian member nations.

It is a mature relationship, and there have been differences along the way. For example, the Bank and its member countries have, at times, differed on the allocation of resources across the spectrum of social and infrastructural services, or on the appropriate

timing of a switch in industry policy. And this is as it should be: the Bank's advice and recommendations are just part of the menu of options countries may choose from in managing their development.

Much has been achieved in East Asia, but much remains to be done

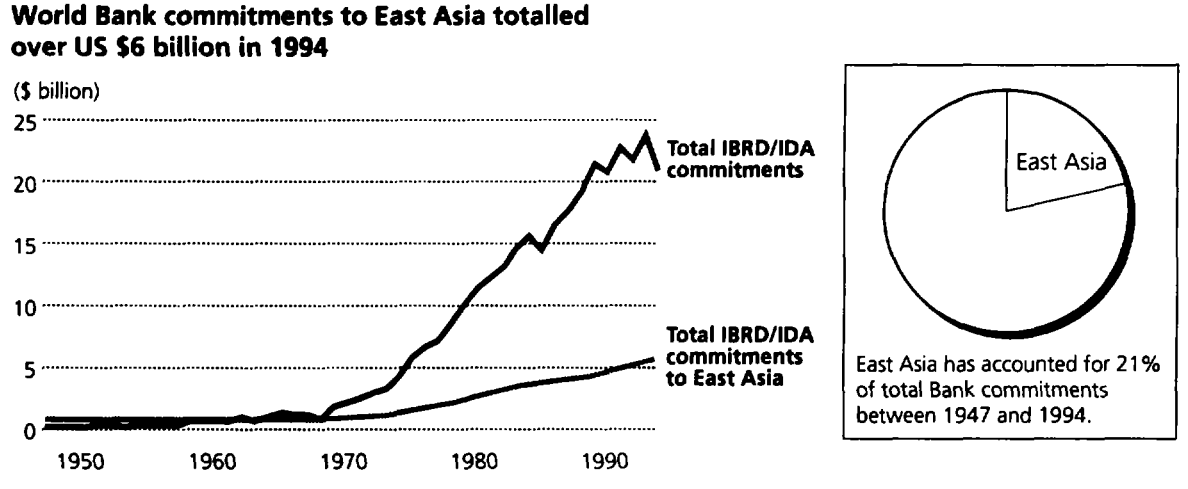
And though the region is the fastest growing, East Asia's record is not unblemished. Not all countries have sustained high rates of growth. East Asian governments have not always given adequate attention to such crucial issues as protection of the environment and investment in infrastructure, which have too often lagged behind rapid economic expansion. Much has been achieved in East Asia, but much remains to be done.

Diversity and Commonality

East Asian economies are remarkably diverse. The region includes some of the richest developing nations—such as Korea, and some of the poorest—such as Vietnam. It includes the world's most populous country, China, as well as one of the least populated, Laos. Some countries, like Malaysia, have a store of natural resources, while Korea has virtually none.

No single development formula lies behind the "East Asian

Figure 1. IBRD and IDA Commitments, 1950–94



miracle," and the Bank has not adopted a single development template. The sheer size and cultural diversity of a region that is home to 1.67 billion people—about one-third of the world's population and about 20 percent of its poor—provides a wide variety of development challenges and attendant development problems—including environmental degradation, infrastructural bottlenecks, and poverty.

Such problems notwithstanding, today, rapid economic development is a common feature of much of East Asia. There has been a near quadrupling of per capita incomes in the past twenty-five years, a marked improvement in health and education, a decline in fertility, and a surge in agricultural and industrial output. Outward-oriented East Asian economies have integrated with the global economy to a remarkable extent, and have emerged as the driving force behind global trade growth. Perhaps most important, economic growth has not only been dramatic, it has been broad-based and, on the whole, equitably distributed.

Why has East Asia, with its diverse economies and problems, been so successful? There is no simple answer. Policy approaches by East Asian economies have also been diverse. The first generation of newly industrialized economies—with the exception of Hong Kong—opted for relatively more state intervention, as had Japan earlier on. Among the second generation, Indonesia and Malaysia had little success with early interventions. Less interventionist over the past dozen years, they both achieved markedly better economic performance. Most recently, newly industrializing economies and areas such as Thailand and coastal China, have been inclined to less extensive intervention.

Behind country variations, however, are significant common features. One such factor is human resource development. In this respect, strong public policies were augmented with high household investments in education in most countries.

Investment in people is closely linked to the notion of equity

Outward-oriented East Asian economies have integrated with the global economy to a remarkable extent, and have emerged as the driving force behind global trade growth

with growth. Some economies, such as Korea, brought about an early and relatively equitable distribution of land. These countries, and others (including, for example, Malaysia) continued to ensure that a majority of the population shared the benefits of economic growth in a variety of ways. The result was a striking decline in absolute poverty, which is illustrated most dramatically in Indonesia.

Common to East Asia's success were policies for participation in world markets and macroeconomic stability. Because the economies took international prices as a primary guide to domestic resource allocation, macroeconomic stability was seen as central to maintenance of international competitivness. Moreover, most governments had a strong aversion to inflation, which strengthened the hands of technocrats. Where external or internal factors threatened overall equilibrium, governments moved quickly and credibly to restore stability.

At the core of development success in East Asia has been pragmatic policy making, from policy design to effective implementation. Pragmatism means the relative absence of ideology in setting policy and the willingness to change failed policies

At the core of development success in East Asia has been pragmatic policymaking, from policy design to effective implementation. Pragmatism means the relative absence of ideology in setting policy and the willingness and ability to change failed policies. Socialist economies in transition illustrate both the costs of ideology and the gains to be made from changing course. China's reform program has been little short of breathtaking.

The sections that follow are devoted to one important aspect of the Bank's involvement in each of the six countries in the region that accounted for 95 percent of the Bank's lending to East Asia (see Figure 2).

Investing in People in Korea

In the 1960s, when the Bank's involvement in the region began in earnest, East Asia's people placed high value on education, which was reflected in public and private spending. In later years, educational investments have provided universal primary education and widely available secondary education.

Education was revered not only for its own sake but as a means of achieving economic development. Equally important was the emphasis on strong human resources in government, which complemented the prevalent ethic of public service in East Asia. This provided fertile ground for the Bank's emphasis on human resource development.

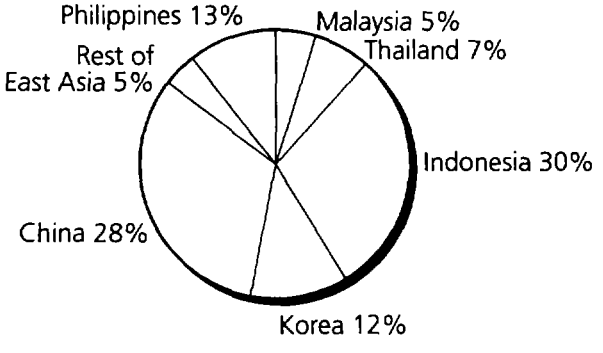
Witness Korea. In just one generation, Korea has left the ranks of those qualifying for World Bank loans. (Korea received its first IDA credit in 1962 and its first IBRD loan in 1968. By 1992, per capita income had reached $6,790, and by 1995 it will have graduated fully from Bank lending.)

From the 1960s, successive Korean governments invested heavily and effectively in primary, secondary, and high-school education. Korea's program involved heavy investments in physical facilities. In 1960–70, the number of primary schools increased from 4,496 to 5,961, and middle schools from 1,053 to 1,608. By 1989, they had reached 6,396 and 2,450, respectively. The number of high schools also expanded from 640 in 1960 to 1,672 by

In just one generation, Korea has left the ranks of those qualifying for World Bank loans

Figure 2. IBRD and IDA lending to East Asia by major recipient, 1950–94

Indonesia and China received the largest share of the US $71 billion lent to East Asia



In Korea, adult literacy reached 92 percent by 1985 and is almost 100 percent today

1989. Government financial support at the primary level also extended to targeted subsidies for items such as school meals and uniforms. Govern-ment education expenditures rose from 2.6 percent of GNP in 1960 to 3.4 percent in 1989, while—as a proportion of government expenditures—the allocation for education rose from 11 percent to almost 20 percent.

The impact on school enrollment was dramatic. By 1970, Korea had 100 percent enrollment in primary education, while between 1970 and 1989, those enrolled in middle schools grew from 57 to 99.7 percent of all school-age children. High school enrollment rose from 30.5 percent in 1970 to 78 percent by 1985. Along with population expansion, this meant that the number of primary school students in Korea increased from nearly 3.6 million in 1960 to 4.9 million in 1989. Middle school students rose from 530,000 to almost 2.4 million, while high school students increased from 273,000 to 2.3 million. The number of teachers also increased sharply in 1960–89, with the ratio of primary school students per teacher falling from 59 to 36, and for middle school students, from 40 to 29.

Korea's aim was two-fold: to achieve a high literacy rate and, by emphasizing technical skills, to create a well-educated work force capable of meeting the challenge of rapid and technology-based economic development. Korea succeeded on both counts. Adult literacy (and numeracy) reached 92 percent by 1985 and is almost 100 percent today. Since the 1960s, a large pool of educated labor, including many women, has helped underpin Korea's industry-intensive and export-oriented development drive.

Past Bank lending focused on strengthening science and technical education to underpin Korea's ambitious plans for industrialization. In the 1970s, lending was mainly for expansion and quality improvement of vocational and technical education in high schools, junior technical colleges, and undergraduate programs in science and engineering. In the early 1980s, emphasis was

placed on improving policy with the aid of two education sector loans, which led to institutional improvements in such areas as evaluation and accreditation, personnel planning, equipment maintenance, curriculum development, and private education. These efforts were reinforced by the Sector Survey of Science Education (1982) which set a long-term strategy for strengthening science education at the secondary and higher levels.

As Korea's industrial sector moved toward higher value-added, technology-intensive production, the government placed greater importance on strengthening local capacity for research and innovation. In response, Bank lending shifted its emphasis in the late 1980s toward strengthening graduate schools of science and engineering (which train research personnel) and directly supporting selected national research institutes.

In some recent projects, the Bank has also focused on strengthening environmental science and technology in universities and research institutes, in line with the government's increasing concern about environmental problems. The Bank has also continued lending for vocational and technical education to ensure that training of craftsmen and technicians keeps pace with rapid technological change in industry. A continued interest in supporting policy improvements is reflected in the last Bank education loan to Korea (1994). This includes a range of institutional improvements in secondary and higher science and technical education. Building on previous changes, these are expected to help guide policies over the next decade.

Over the past quarter century, the Bank made sixteen education loans totaling $906 million (and with total project costs of almost $2.6 billion). Lending has, in general, been consistent with Korea's needs and priorities in science and technical education and has paralleled the increasing sophistication of its industry. There was early recognition that the restructuring of industry toward skill-intensive, high technology production

Lending has . . . been consistent with Korea's needs and priorities in science and technical education and has paralleled the increasing sophistication of its industry

would require continuous upgrading of Korea's skill base. Bank lending matched this change in demand. But, in addition to helping Korea, the Bank learned much about forming workable policies to increase the quality and relevance of education and research. It also learned lessons on practical issues (such as mechanisms for curricular change and the preparation of equipment lists) relevant to a range of institutional, teaching, and research objectives. These lessons are now benefiting the design of projects in Thailand, Indonesia, and Malaysia.

In addition to helping Korea, the Bank learned much about forming workable policies to increase the quality and relevance of education and research

Human resource development is still a major challenge in East Asia. Problems concern not only the provision of basic education in low income economies but also the provision of adequate secondary and higher education and the adequacy and quality of all education. With the region committed to international markets, it is crucial that the educational system be flexible enough to respond to needs of skill formation so that countries remain competitive. The Bank continues to be a key player in facilitating financing and provision of best practices in human resource development in East Asia. This role is likely to assume even greater significance in the years ahead, as countries of the region continue to grow and become ever more competitive.

Reducing Poverty in Indonesia

An education policy aimed at broadening the base of the work force enables wider participation in the fruits of national growth, and can contribute significantly to poverty reduction and social equity. But poverty must also be addressed through other policy instruments. Here the East Asian record has been particularly impressive. As a result of rapid economic growth and a multi-faceted development approach, involving human resource development and the provision of basic physical infrastructure, absolute poverty in the region has declined by around two-thirds during the past twenty-five years.

The number of absolute poor in East Asia is estimated to have fallen from 400 million in

1970, to 300 million in 1980, to 180 million by 1990.[1] This is all the more remarkable given that the region's population has expanded by some 425 million over the past twenty years. Moreover, reducing poverty to little more than one-tenth of the region's population contrasts sharply with the experience of other developing regions. In 1990, the absolute poor still accounted for roughly half the population in South Asia and Africa and one quarter in Latin America. How did East Asia manage to reduce poverty to such an extent?

Indonesia is a good example. Twenty years ago, Indonesia was among the poorest countries of the world, with a per capita income much less than that of India, Bangladesh, and Nigeria. Today, Indonesia's GNP per head has reached $670, and those living in absolute poverty have dropped from around 70 million (60 percent of the population) at the beginning of the 1970s to near 27 million by 1990 (about 15 percent). This is the fastest rate of decline in poverty in any country, and it coincided with enormous improvements in nutrition, life expectancy, basic schooling, and health of the poor.

Three key reasons led to the progress of Indonesia's poor:

- Rapid economic growth generated strong growth in demand for labor (and so, in incomes), first in rural areas, and later in cities.

- Relatively free labor markets allowed workers to migrate to jobs, especially from rural to urban areas.

- Basic infrastructure, health, education, and family planning services were expanded and made accessible to most of the population, raising productivity and the quality of life, and breaking down barriers to the movement of goods and people.

Indonesia has achieved sustained and high economic growth, averaging more than 6 percent a year in 1970–90. More important, this growth was broadly based, spreading its benefits to even the poorest. This was because:

The number of absolute poor in East Asia is estimated to have fallen from 400 million in 1970, to 300 million in 1980, to 180 million by 1990

- The government placed emphasis on improving the agriculture sector, on which the livelihood of most people, especially the poor, depended.

- The shift to rapid industrial growth in the mid–1980s emphasized a more labor-intensive, outward-oriented path of industrialization.

- These two growth processes created new service jobs in non-farm activities and urban trade, construction, and finance.

One central reason why so many poor people were able to raise living standards was that the great increase in job opportunities coincided with slower growth in labor supply. Indonesia had been successful in reducing fertility and in providing basic education and health to the population. Reducing the growth of the labor force and increasing its quality, perhaps more than any single factor, lies behind Indonesia's sustained decline in poverty.

Reducing the growth of the labor force and increasing its quality, perhaps more than any single factor, lies behind Indonesia's sustained decline in poverty

Many of the dramatic gains in human capital came as a result of government decisions to provide education, health, family planning, and other social services nationwide. Special programs (the INPRES, or Presidential Instruction, programs) covered the countryside with roads, primary schools, and public health facilities. Between 1978 and 1987, primary school enrollments among the poorest 40 percent rose from 78 percent to 90 percent; lower secondary enrollments rose from 42 to 65 percent; and the utilization of health services doubled (though it remains low).

In the 1980s, Indonesia even managed to reduce poverty, in both relative and absolute terms, at a time of difficult adjustment to external shocks. External strains severely affected the economy, creating the need for two rounds of adjustment—in 1982–85 and again in 1985–88. These strains included a sharp decline in the terms of trade, falling oil prices, and an appreciation of the U.S. dollar, which then increased Indonesia's external debt burden. Adjustment involved significant devaluation of the rupiah, reductions in public

expenditure, and comprehensive tax, trade, and financial reforms. Some of these continue to be key challenges ahead.

Indonesia's attack on poverty, however, predates the adjustment period of the 1980s. In the 1970s and early 1980s, it made use of buoyant oil revenues to finance rural infrastructure (such as irrigation facilities, rural electrification, and roads for transporting produce to market) and to provide fertilizer subsidies. This was in marked contrast to the experience of other oil-exporting countries of the region. Though much of the initiative behind these programs was Indonesia's, the Bank was heavily involved in certain areas, such as irrigation. (The Bank has been prepared to throw its weight behind policies proposed by able technocrats—Indonesia's included—to help counter political and other vested interests ranged against economic reform. In the case of Indonesia's attack on poverty, however, the decision to protect rural groups found support at the highest political level.)

Indonesia still faces daunting problems, but why was the country able to avoid or overcome some of the problems encountered in other countries over this period? Credit goes to a clearly articulated long-term vision of development, an able economic team given considerable freedom to make decisions, a desire for macroeconomic stability, and a realization of the importance of the agricultural sector for economic growth and poverty reduction.

The World Bank played a supportive and vital role, providing timely and relevant economic advice and substantial financing for Indonesia's public investment program in education, health, agriculture, and infrastructure. The Bank's policy advice intensified during the crucial years of adjustment—the 1980s—on major macroeconomic reforms. It encouraged development of labor-intensive manufacturing industries, as an alternative to commodity exports, to absorb labor that might otherwise have entered the ranks of the poor. These reforms (backed by three World Bank structural adjustment loans) were effective

The Bank . . . encouraged development of labor-intensive manufacturing industries . . . to absorb labor that might otherwise have entered the ranks of the poor

because the government was committed to them. It implemented reforms quickly and consistently and took ownership of the reform agenda, adapting it to suit the country's needs and priorities.

But while East Asia has had great success in reducing poverty, the region still has a large share of the world's poor. The task of poverty reduction remains daunting. Increasingly, the challenge is to reach the so-called "hard-core" poor, which requires sustained economic growth as well as human resource development and targeted poverty programs.

East Asia's excellent inflation record is largely the result of sound fiscal policies and budgetary discipline

Macroeconomic Stability in Malaysia and Thailand

Almost universally, successful East Asian economies have adhered to sound macroeconomic policies. Steady economic growth and low inflation have provided a stable framework for long-term planning and encouraged saving, investment, and the efficient deployment of resources. At the same time, exchange rates have generally not been overvalued in real terms. From the 1970s onward, East Asian inflation averaged half that of other lower-middle-income countries. Real interest rates averaged a positive 4 percent (compared with a negative 3 percent elsewhere) ensuring a good return on savings and setting a clear benchmark for the cost of capital.

East Asia's excellent inflation record is largely the result of sound fiscal policies and budgetary discipline. Over the past twenty-five years, the region's fiscal and current account deficits averaged less than half those of other developing countries. Macroeconomic management also gained from generally strong and prudent central banking institutions.

While East Asian countries have not completely avoided macroeconomic difficulties, they have usually reacted more quickly, and often adjusted less painfully, than have other developing countries. In both Malaysia and Thailand, for instance, the central bank tends to be the most powerful economic agency and has a strong preoccupation with controlling inflation. But even

a conservative macroeconomic policy managed by able technocrats cannot insulate an economy against external shocks. Between 1980 and 1985, following the second oil shock and a general decline in commodity prices, Thailand came under severe financial strain, particularly on its external account. Malaysia also suffered severely, and at a time when heavy investments in capital-intensive industries were absorbing a large part of national resources.

But following the second oil shock—which revealed structural weaknesses in the country's balance of payments—Thailand adopted a strong adjustment program. The government redesigned its trade and industrial policies to offset the bias against exports. Tariffs were rationalized and average rates reduced (though effective protection rates for manufacturing remained significantly higher than in other East Asian countries). At the same time, the Board of Investments adopted foreign-exchange generation as a criterion for approving inward investments, thereby stressing export activities. The new outward orientation was supported by other policies, including a significant depreciation of the baht, tax exemptions for exporters, and the setting up of export-processing zones.

In the 1980s, when inflation and other macroeconomic variables were threatening to get out of hand, the Bank was called upon to intervene more directly. It provided Thailand with its first structural adjustment loan ($150 million) in 1982 and a second one ($175 million) in 1983. Subsequently, the Thai economy weathered the crisis: current account and fiscal deficits improved despite significantly higher world real interest rates, weaker export demand, and less favorable terms of trade.

The consensus among Thai government officials and Bank staff was that Bank involvement had made a real difference in helping to solve the country's problems. Here, too, the Bank's involvement can be said to have been cooperative with the government and responsive to concerns that were identified early on in

Even a conservative macroeconomic policy managed by able technocrats cannot insulate an economy against external shocks

what proved to be a protracted period of macroeconomic stress.

Bank support through structural adjustment loans had advantages. First, by underwriting a broad structural adjustment program, the Bank strengthened the domestic and external credibility of the effort and helped to maintain its momentum. Second, by working with the Thai government on the program supported by the loans, the Bank helped translate the structural adjustment strategy into policies and speed their implementation. Third, by including policy measures under structural adjustment lending, the Bank helped focus and supervise related technical assistance activities.

By underwriting a broad structural adjustment program, the Bank strengthened the domestic and external credibility of the effort and helped to maintain its momentum

In Malaysia's case, the Bank was asked to augment its traditional support for projects with greater involvement in macroeconomic adjustment. By 1985–87 the international price of oil had virtually halved, and Malaysia's heavy industry was absorbing a large part of the nation's investment resources. The seeds of this problem had been sown in the early 1980s, when frustration with the pace of economic development in Malaysia prompted a state-led drive to upgrade industry. This was buttressed by an increase in oil and gas revenues. By 1981, public expenditure had reached 58.4 percent of GDP, as Malaysia invested in a range of capital-intensive manufacturing activities—mainly through the Heavy Industries Corporation of Malaysia. But by 1988, the inefficiencies associated with this drive became evident when a set of major state-owned enterprises suffered a net deficit of M$1 billion.

By then, Malaysia's fiscal deficit had ballooned to 16 percent of GDP, and the country had generated large volumes of external debt. The Bank offered advice on macroeconomic management, fiscal controls, tax system reforms, and trade reforms aimed at encouraging foreign direct investment. It also advised on state involvement in heavy industry. Macroeconomic adjustment continued from 1986 to 1990, as government policy began emphasizing

market liberalization and promotion of private sector growth and foreign investment. During this period, too, Malaysia's external debt declined significantly and recourse to external borrowing was reduced in favor of foreign equity funding and domestic borrowing. The ringgit was depreciated to boost manufactured exports. While Malaysia did not require adjustment lending to carry out the World Bank's policy advice, both the Malaysian government and the Bank deemed Bank intervention successful.

Working with the Private Sector in the Philippines

East Asian countries have traditionally relied to a great extent upon market forces. Their development strategies cannot be characterized as *laissez faire*, but they have consistently subjected their industries to international price competition. Their ability to penetrate world markets is an indication of the validity of this strategy. Increasingly, East Asian countries are opening their markets to competition from abroad.

Accompanying a reliance on market forces has been East Asia's dependence on the private sector as the engine of growth. Nonsocialist governments in the region, too, have had public enterprises, but their support for the private sector is older and deeper than it is in other developing regions. Supporting this approach, the Bank has helped provide adequate financing for private sector activities, worked with governments to improve the economic environment, and encouraged governments to increase the range of activities open to the private sector. Formerly socialist economies in East Asia have also recognized the power of the private sector and are now moving, with Bank advice and assistance, to encourage rapid growth in their own private sectors.

Accompanying a reliance on market forces has been East Asia's dependence on the private sector as the engine of growth. Although nonsocialist governments in the region, too, have had public enterprises, their support for the private sector is older and deeper than it is in other developing regions

Rapid growth has created large demands for infrastructure—especially in power, telecommunications, and transport. But within their fiscal constraints, nations are increasingly unable to finance such demands. Governments have begun to turn to private financiers for

Rapid growth has created large demands for infrastructure. . . . Governments . . . unable to finance such demands . . . have begun to turn to private financiers . . . and to explore innovative forms of project financing and management

major projects and to explore innovative forms of project financing and management to accommodate these private interests.

The Philippines, for instance, has led efforts to involve the private sector in a wide range of development activities, particularly infrastructure. Early Bank support included dialogue with the Philippine government to encourage trade reforms and export development. Bank loans have supported such development finance institutions as the Development Bank of the Philippines, as well as improvement in the financial sector.

While the Philippine government is committed to the private sector as a mainstay of development, it has been less successful in providing a stable political and macroeconomic environment or to encourage efficient investment and competition. Consequently, growth did not accelerate in the Philippines as it did in other East Asian countries, and by the mid-1980s, the country's large private debt burden came to dominate economic policymaking.

The Bank has worked with authorities to redesign policies meant to promote stable growth and to recover from the problems of the 1980s. One Bank-supported activity was a market-oriented debt-relief scheme that the Philippines negotiated with its commercial creditors. Another was a macroeconomic reform program that gave the private sector new confidence to invest in the Philippines. The Bank has also supported policies to improve trade and industrial incentives that resulted in increased foreign and domestic competitiveness. While the Philippines' growth over the past twenty years has not matched that of its neighbors, both the government and the Bank have demonstrated a mutual commitment to overcome particularly difficult economic times that strengthens the basis for future collaboration.

Due in part to difficulties in managing its debt and to the burden that such debt placed on public finances, the

Philippine government has actively sought private sector help in providing infrastructure and public utilities. Since 1989, it has been working with private financiers to carry out build, own, operate and build, own, operate, and transfer projects to produce power for the electricity-starved Philippines economy. Already, thirty-three contracts have been signed and thirteen projects have been completed—greatly reducing power shortages and enabling faster economic growth. The Bank worked with the Philippine government to provide complementary financing for additional power investments, and innovative projects have been started in other sectors as well.

The Philippines now seems to have a solid policy foundation and is moving to restore economic stability and growth. These activities are being followed attentively in other countries in the region. China, Indonesia, Malaysia, and others are inviting more private sector involvement in infrastructure as well as in more traditional areas of production.

China and the Bank: Partners in Transition

While East Asia continues to give high priority to a stable macroeconomy, there are still serious concerns. Socialist economies in transition, such as China and Vietnam, are struggling to maintain stability while they carry out structural reforms and liberalizing price and trade policy. Far-reaching institutional reforms—for example, the restructuring of central banks or revenue and expenditure reassignment between the center and the provinces—are needed. One of the Bank's key tasks will be to bring to the table the best practices in macroeconomic management for socialist economies in transition.

One of the Bank's key tasks will be to bring to the table the best practices in macroeconomic management for socialist economies in transition

In 1979, after years of little contact with the world economy, China was eager to learn about the policies and experiences of market economies. It made great use of the Bank's accumulated cross-country experience and information on other countries. Even today, after having remarkably accelerated its participation in the world

The Bank has learned important lessons from its engagement with China. These include lessons of process, of the value of open discussion and debate, and of the need to disseminate ideas to all levels to effect change

economy, China's government remains strongly interested in how other countries address specific economic issues, an interest sustained and stimulated by World Bank economic work.

Chinese leaders have also invited advice from the world's most competent economic analysts. The World Bank's role here has been to gather international experts on China and organize brainstorming seminars with the highest levels of China's economic leadership. These conferences began in the early 1980s and were repeated every two or three years. At last year's conference at Dalian, China confronted several key macroeconomic issues. More specialized conferences have been organized around such specific themes as poverty (1991) and central banking (1993).

The Bank has learned important lessons from its engagement with China. These include lessons of process, of the value of open discussion and debate, and of the need to disseminate ideas to all levels to effect change. The Bank has also learned from China that where circumstances permit, there are merits in a gradual approach to economic change. China achieved notable progress using this approach in handling price reform, for example. Policymakers adopted a dual-track approach that allowed market prices to coexist with plan prices, while the scope of planned resource allocation was gradually reduced. Today, more than 90 percent of goods in China are at market prices.

China's approach to ownership change has been unusual. It has offered remarkable encouragement to nonstate enterprises, which now account for about half of industrial output. China's gradual but steady strides in other areas—from establishing a land market to giving state enterprises more autonomy; from financial sector reform to adopting sophisticated new markets in commodities and securities—illustrate that, with commitment to change at the highest levels, incremental market reform can work.

China is now among the Bank's most active borrowers. Serious involvement by the Bank began around 1980 with a good deal of basic work in documenting the size and nature of China's newly-opening economy. Operational involvement began with technical assistance loans to finance university education projects and quickly broadened to embrace economic and sector work and continuous monitoring of the Chinese economy. This phase culminated in two major reports on China—one at the beginning of the 1980s and one in 1985. The second report dealt with industry, agriculture, health, and other economic and social aspects of the Chinese economy. It was built around a uniquely designed long-term growth model, which estimated the conditions necessary to meet targets for overall and sectoral growth rates and offered comprehensive recommendations regarding the infrastructure support (social as well as physical) needed to underpin economic growth. Later studies looked at the need for trade liberalization and how China could exploit its comparative advantage in the world economy. Other sectoral studies examined such issues as revenue mobilization and fiscal reform, financial intermediation, and development of market and distribution systems.

Between 1981 and the end of 1993, the Bank's work in China has been backed by loans of $9.97 billion and by IDA credits of $6.97 billion, supporting various investment and technical assistance projects. Conceptually as well as financially, the Bank has supported China's own efforts throughout the transition from a command to a partial-market economy. For example, from the early 1980s the Bank began doing significant work on China's state-owned enterprises and on collectives and small-scale rural enterprises, looking at the kind of changes needed to make them more dynamic and competitive. A series of Bank reports around this time emphasized the need to reduce the number of government plan targets and to increase efficiency and managerial autonomy in state- owned enterprises. Many of the suggested reforms reflected or reinforced ideas already under consideration within China itself.

With commitment to change at the highest levels, incremental market reform can work

Given the size of China's economy, however, the Bank's lending assumes less significance than its technical assistance and economic advice

Given the size of China's economy, however, the Bank's lending assumes less significance than its technical assistance and economic advice. Initially, Bank advice to China initially drew more on the institution's broad experience with East Asian and other developing countries (as well as with industrial countries) than on lessons learned from other socialist economies in transition. In any case, China's economy is more decentralized than other transitional economies. This decentralization has increased with the initiation of economic reforms and center-local fiscal contracting, which builds on the local self-sufficiency and "cellular" structure inherited from the Third Front policies of the Maoist era.

Yet the fundamental problem of dealing with state-owned enterprises remains. Here the Bank has supported China's own strategy to work around the problem rather than to confront it directly, which would be politically risky in terms of unemployment and other social factors (such as health, education, welfare, and housing, for which state-owned enterprises have traditionally been responsible).

The Bank has supported China's drive to develop collective enterprises to provide employment and produce daily consumer needs. The Chinese government, however, has now widened the scope of its reforms to include price and financial market reform as well as measures aimed at ensuring macroeconomic stability. The need to develop a social-security net, to introduce measures to increase labor market mobility, and to offer better health, education, and housing services has also been central to the Bank's policy advice in China. The aim has been to create an internal market within which change can be introduced. This involves creating competition for state-owned enterprises from collectively owned, town, and village enterprises while encouraging the state-owned entities to contract out more production, a system that has already begun to make Chinese industry more competitive and dynamic. At the same time, the social consequences that accompany changes in the role of state enterprises are being addressed.

Fiscal and financial reforms—more efficient tax collection, equitable to both the center and the provinces—along with the creation of a strong central bank, are two other essential, parallel reforms.

The Bank's dialogue with China has been at the highest political and administrative level and has been characterized by a fruitful exchange of ideas. China has initiated and implemented much of the reform agenda, with the Bank providing guidance and support for what are essentially local initiatives. Chinese leaders listen to what Bank representatives suggest and adapt bank policy or project advice to fit their specific needs. The occasional policy differences—for example, over the relative priority to be given to rural education and health—stand out against a background of mutually rewarding dialogue.

Conclusion

Whatever the level of World Bank involvement in East Asia, responsibility for the considerable successes of the region rests squarely with the countries themselves. Similarly, the countries have overall responsibility for managing the demanding agenda of the environmental, poverty, infrastructure, and trade issues that will dominate the economic horizon of the twenty-first century. Country commitment and effective policymaking is at the root of economic success—and failure—both now and in the future.

The Bank has had a strong and consistent involvement in East Asia, providing both money and policy and analytical support. The Bank has helped to produce tangible results and has learned valuable lessons, both from the region's considerable achievements and from areas needing much greater attention. But despite the challenges still ahead, one lesson offers considerable encouragement. In East Asia, even daunting tasks have a way of getting done, quietly and efficiently.

In East Asia, daunting tasks have a way of being performed quietly and efficiently

The authors are grateful for contributions from other regional staff.

Note

1. Source: Frida Johansen, *Poverty Reduction in East Asia—The Silent Revolution*, World Bank Discussion Paper 203, East Asia Pacific Region Series. This estimate uses individual country poverty lines that are made broadly comparable. Using another common US$1-per-day poverty line (at purchasing-power parity in exchange rates) yields a 1990 head count estimate for the poor in East Asia of 170 million. No comparable estimates exist for 1970.

The Challenge of Africa*

Ishrat Husain

The World Bank's involvement in Africa has spanned three decades and been wide-ranging. It has included direct lending in support of production, economic and social infrastructure, and policy reforms; "intellectual activities" (research and studies) that contribute to the diagnosis of problems and to the definition of priorities and policies of borrowing countries, donors, and the Bank; aid coordination and mobilization of resources; and technical assistance and capacity building.

The World Bank's involvement in Africa has spanned three decades and been wide-ranging

Development outcomes are a product of a wide range of factors (economic, political, geographic, institutional, and cultural). External finance and advice is only one element. Moreover, institutional and economic change takes time, and given the shortness of the Bank's intense involvement in Africa, it may be too soon to arrive at a definitive judgment. This paper attempts, nevertheless, to document Africa's development record since the inception of Bank–Africa relations. It examines the distance that the African region has traveled, identifies key elements of the current situation, both promising and distressing, reviews the Bank's involvement and how it has evolved, and assesses prospects and implications for the Bank's future involvement in Africa.

*Throughout this paper, Africa refers to Sub-Saharan Africa.

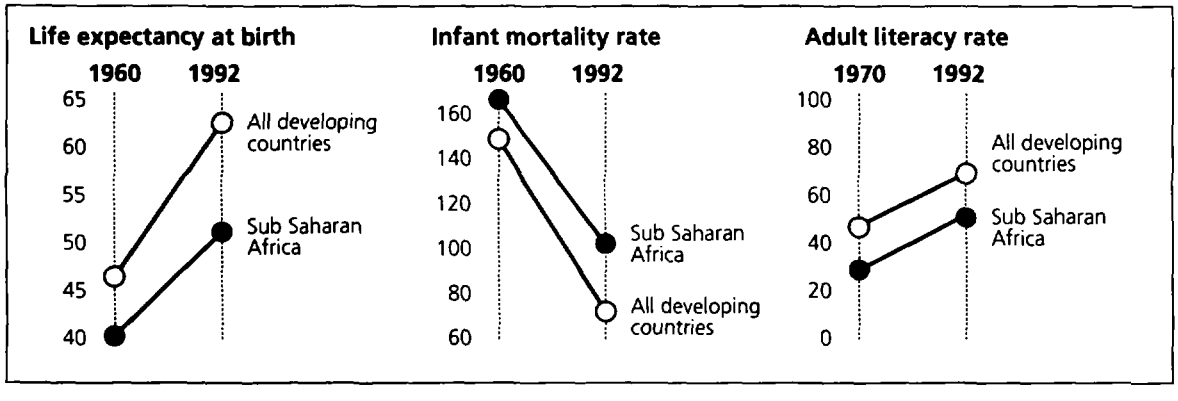
For almost all, economic planning was a means of achieving rapid, inward-oriented economic growth

Hope and Despair

Africa's record of the past thirty to forty years is one of advances and reversals. Wealth has been created and destroyed, institutions revitalized and atrophied, and economies stabilized, destabilized, and restabilized. The current situation is one of both hope and despair. The installation of a democratically elected government in South Africa, after centuries of racial discrimination and minority rule, is a promising prospect for the Southern part of the continent. At the same time, the mass carnage and upheaval in Rwanda reminds us of the fragility of the nation state and the importance for government to have the writ of its authority.

Most countries in Africa became independent around 1960, a few much later. Many of the new African governments believed that they had to intervene in the economy to mobilize resources, establish industries, and accelerate public investments. For almost all, economic planning was a means of achieving rapid, inward-oriented economic growth; the state was the instrument of such planning. Development meant the mobilization of capital for industry, which would, in turn, benefit from protection against the industrialized economies. Such African socialism took root in Angola, Benin, Congo, Ethiopia, Ghana, Guinea, Guinea Bissau, Mozambique, Tanzania, and Sao Tome and

Figure 1 Key Social Indicators in Africa



Principe. Even such mixed economies as Côte d'Ivoire, Cameroon, and Kenya adopted planning and substantial state intervention in marketing, agriculture, labor markets, external trade, public enterprises, and so on.

Africa's development record over the past thirty to forty years is mixed. Most social indicators have improved, particularly education and health indicators (Figure 1). Illiteracy and infant mortality are sharply down, and average life expectancy has increased by more than ten years. There has been economic progress, too (Figure 2 and 3). The real GDP of the continent is 2.3 times larger today than in 1965, not counting the output of the unrecorded sector which has exploded in recent years and is estimated to be as large as one-third of the recorded output in some countries. New physical infrastructure facilities (airports, highways, telecommunications, ports, power stations) have been built in most African countries, although maintenance has not always been adequate. Agricultural research, supported through the Consultative

Figure 2

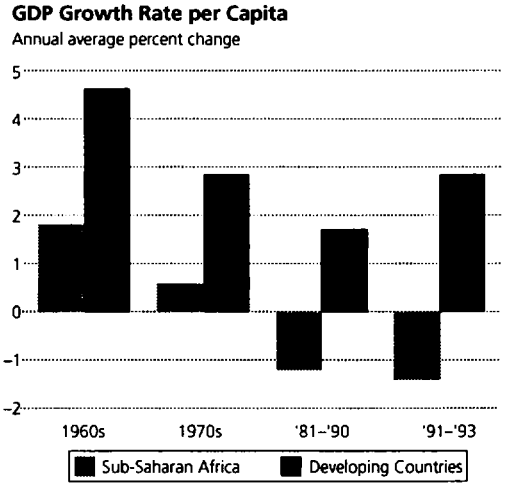
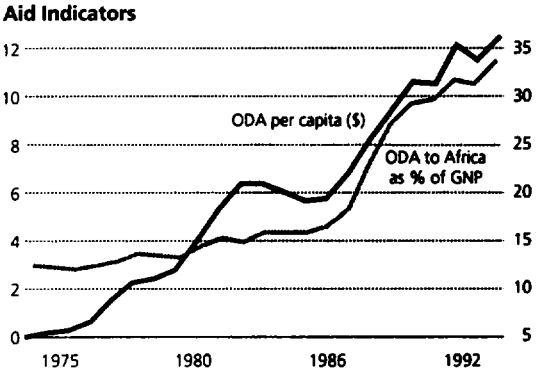


Figure 3



Economic growth has been much slower than in other developing regions, even that began with similar handicaps

Group on International Agricultural Research (CGIAR) by the Bank and other donors, has generated new varieties and techniques, albeit on a modest scale compared to Asia.

Lastly, there has been appreciable political progress. Twenty-three African countries are at various stages of political liberalization, transforming from military controlled or narrow, one-party authoritarian regimes to more participatory, broad-based, multi-party systems. A few years ago only four countries had a democratic regime. Freedom of press, freedom of association, discussion of human rights and civil liberties, and increased participation of civil society in the decisionmaking process are gaining acceptance in most African countries.

The tendency in discussions on Africa is to ignore the successes and focus on the failures. For example, economic growth has been much slower than in other developing regions, even those that started out with similar handicaps. The gap between Africa and Asia has widened although the two regions began with similar conditions and natural resource endowments and faced the same external trading environment. The benefits from advances in trade expansion, technology diffusion, and financial market integration have not been captured in Africa to the same extent as in other developing regions. Africa's share in world trade has declined from 3 percent to 1 percent; foreign direct investment flows remain extremely low, at 1 to 2 percent of the world's total; and the continent has not seen any technological breakthrough on the scale of the Green Revolution in Asia. Furthermore, population growth has accelerated; environmental stress has risen; and productivity gains have been weak or absent. The rise in population growth is a consequence of improved health which, in the absence of rapid economic growth, may increase poverty in the short run, though not in the long run.

There is no single explanation for Africa's economic decline. The African panorama is diverse. The continent consists

of forty-six countries ranging from Nigeria, with100 million people, to Sao Tome and Principe with a few hundred thousand. Progress has been uneven across countries, within countries, and over time.

• SMALL ISLAND ECONOMIES. There are ten countries with populations of 1 million or less—most of them small island economies with special economic characteristics and problems. Depending on a handful of major events—external or internal—there have been wide swings in the performance of this group.

• COUNTRIES EXPERIENCING MAN-MADE DISASTERS. Ethnic strife and prolonged civil wars have almost destroyed the economic, social, and physical infrastructure of another ten countries. Normal economic and social conditions in these countries can only follow from the restoration of security, law and order, and some semblance of political stability. Even then, sustained economic growth will take time.

• COUNTRIES PRONE TO NATURAL DISASTERS. From time to time, natural disasters, such as drought, desertification, and floods, have played havoc in many parts of Africa, mainly in the fragile ecological zones of the Sahel and the Horn of Africa. The 1992 drought in Southern Africa, however, showed that the economic costs and large-scale human sufferings of these natural disasters can be averted by advance planning and coordination.

• THE CFA ZONE COUNTRIES. There are thirteen former French colonies with larger economies, part of a common monetary arrangement with a currency freely convertible at a fixed exchange rate. Until January 1994, the currency of the CFA zone had become seriously overvalued and member countries were unable to make full use of policy instruments at their disposal. With the recent devaluation of the CFA franc, the situation has been rectified, but the future of these economies will depend on the supply response to this important policy change and other adjustment measures they will undertake.

Progress has been uneven across countries, within countries, and over time

Either all the difficulties were blamed on economic mismanagement and poor domestic policies or they were laid at the door steps of a hostile external environment

• COUNTRIES PURSUING STRUCTURAL REFORMS. The remaining thirteen larger economies, mainly Anglophone countries, have been on a course of structural adjustment for the past several years and have seen some positive results in growth, export expansion, and agricultural production.

The 1960s were a period of calm and tranquillity for most African countries so far as economic policies were concerned. Since then, there have been wide variations. Botswana and Mauritius have performed well steadily. Three star performers of the 1970s—Côte d'Ivoire, Kenya, and Malawi—had serious difficulties in the 1980s, while the poor performers of the earlier period (such as Ghana, Tanzania, and Uganda) turned around to make significant progress. It is yet to be seen whether this improved performance can be sustained in the 1990s.

Why has Africa lagged behind other low-income regions? The debate that took place in the 1980s to explain Africa's economic difficulties revealed a range of viewpoints, and some of the most strident voices were also the most extreme. Either all the difficulties were blamed on economic mismanagement and poor domestic policies or they were laid at the door steps of a hostile external environment symbolized by declining terms of trade, severe indebtedness, and primary commodity specialization. The consensus that emerged is that many factors have contributed to Africa's situation, including:

• The pursuit of an economic ideology represented by central planning, state controls and ownership, protection and discretionary regulation. This model created harmful social and economic consequences as it became entangled with kleptocratic governments in a number of African countries.

• Leadership in Africa was too preoccupied with consolidation of power and in some instances, with building nation states. The attention given to a long-term economic vision was at best sporadic and in most cases scanty. The harmful effects of poor governance on

economic outcomes were not recognized at the time by either the leaders or the external donors.

• Institutional decay in Africa occured at a much more rapid pace than elsewhere. A fast expansion of the state sector ignored the quality of personnel, shrinking the number of professionals within the civil service. The large-scale intrusion of external donors and the fragmentation of donor assistance accentuated the problem.

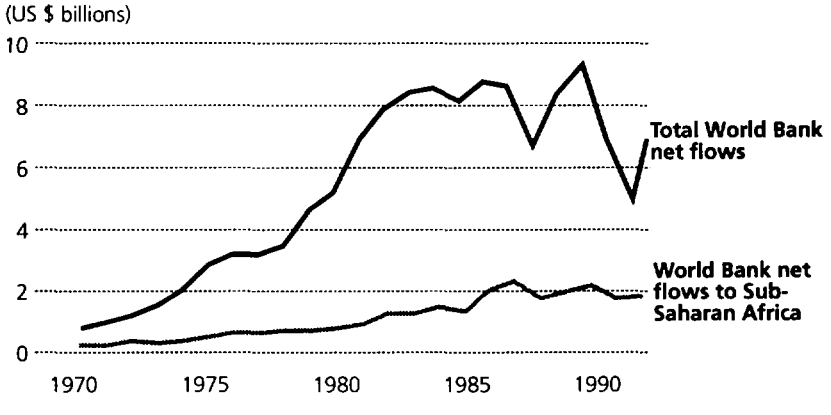
• The severe burden of external debt and the falling prices of major commodity exports did not permit those African countries embarked on the reform path a sufficient cushion for quick recovery and rapid growth.

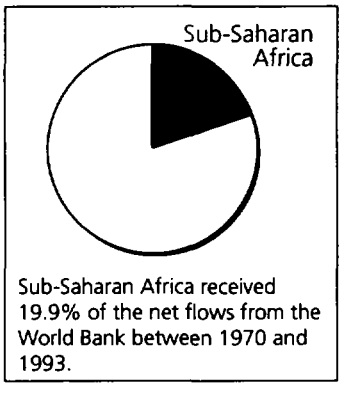
The external environment became onerous at the time when most African countries were just beginning policy reforms. The pressures of political transition also slowed the speed of economic recovery implementation in many cases. As a result of these and other factors, there is now a broad consensus that Africa did not invest enough in its people, utilize its resources efficiently, or adequately

There is now a broad consensus that Africa did not invest enough in its people, utilize its resources efficiently, or adequately respond to outside shocks

Figure 4 Net Resource Flows to Sub-Saharan Africa, 1970–1973

Sub Saharan Africa received over one fourth of World Bank net flows in 1993.





The Bank has approached the problems of Africa with the best combination of hands-on experience and intellectual tools available at the time; through its successes and failures, the Bank has learned and incorporated these lessons

respond to outside shocks. It is true that Asia's human capital base was much stronger than Africa's in the 1960s, but this could have been corrected in several African countries if other factors were in place, such as political and economic stability, adequate levels of investment, and a deliberate policy of investing in human resources. Unfortunately, ineffective functioning of institutions and a weak government machinery did not permit this.

The World Bank role in Africa has evolved over time and been shaped according to changing circumstances. Subsequent discussions detail Bank responses during the various periods but, at this stage, it may be useful to provide an overview. The Bank has approached the problems of Africa with the best combination of hands-on experience and intellectual tools available at the time; through its successes and failures, the Bank has learned and incorporated these lessons.

In the 1960s, most African countries enjoyed a fairly stable and tranquil economic situation. The new governments were in the process of defining themselves. As they fought for independence, most African leaders identified the private sector-driven model of economic management with the former colonial powers. Thus, they opted for the state-led model, suppressed private initiative and enterprise, and used the state's economic apparatus to win political favors and consolidate their power. What little Bank lending occurred in Africa in the 1960s was for capital investment in economic infrastructure.

The oil price shocks of the 1970s, coupled with the broadening of the Bank's internal agenda, prompted increased inflows of resources for a variety of activities in diverse sectors such as agriculture, education, and rural development, together with lending for public enterprises. But the results were generally disappointing—most countries began heading toward inevitable economic decline due to the expansion of state enterprises, close regulation of

economic activities, allocation of resources through administrative fiat, increased rent-seeking by privileged few, and the elimination of private sector elements that could have compensated for these shortcomings. It was not yet realized that the growing economic and financial crisis faced by most countries in Africa was not a result of adverse external shocks but stemmed from underlying economic and structural weaknesses including the build up of a large unproductive civil service.

In the early 1980s, a major study undertaken by the Bank analyzed the roots of the economic malaise in Africa. But the Bank's diagnosis and suggested remedy was hotly contested and only in the last few years has there been some convergence to the view that macroeconomic stability, incentives to agriculture producers, liberal trade and exchange rate regimes, and a deregulated economy are necessary for resumption of economic growth in Africa. The Bank, along with other donors, has begun to address this agenda of economic restructuring with its financial and intellectual resources. Yet skepticism about this approach, especially from the NGO community, has remained unabated.

In the 1990s, new modes of operating have been introduced as poverty alleviation and environment moved to center stage, governance issues were incorporated into aid coordination, and sectoral modes of operations were introduced to combat the fragmentation of donor investment. The challenge for the Bank is to use the whole array of instruments at its disposal—lending, advice, technical assistance, and coordination—in a pragmatic and responsive manner.

The Bank's Lending

The World Bank has provided US$49 billion to Africa since it began lending to the continent in FY1951. Most has gone to agriculture, human development, and infrastructure. Average annual commitments have risen from US$160 million in the late 1960s to US$3.4 billion in the early 1990s. Almost

Average annual commitments have risen from US$160 million in the late 1960s to US$3.4 billion in the early 1990s

The Bank and IDA accounted for 9.6 percent of net resource flows (including grants) to Africa in 1991–92 and for 48.1 percent of net concessional flows on debt

90 percent of new commitments in recent years have been on soft, highly-concessional terms (with forty-year repayment, ten-year grace periods, and a 0.75 percent service charge). The Bank and IDA accounted for 9.6 percent of net resource flows (including grants) to Africa in 1991–92 and for 48.1 percent of net concessional flows on debt. FY1992 net flows from the Bank and IDA are nearly $1.7 billion, compared to the annual average of $226 million in the 1970–75 period or nearly twice the level in real terms.

1960s—A Supporting Role

In the first phase of its association with African countries, the Bank played a supporting (but limited) role for several reasons. First, the main instruments deployed by the Bank financed economic infrastructure projects—ports, highways, electric power, and other public utilities. The Bank's philosophy at the time was that investment in infrastructure was a precondition for development. Between 1961 and 1965, three quarters of all Bank lending was for electric power and transportation; only 6 percent went to agriculture and 1 percent to social services.

Second, most African countries were just emerging from colonial rule, and their priorities lay in taking control of the essential elements of a new state—law and order, security, civil service, tax collection, and so on. Economic development did not figure prominently. For some countries, disillusionment with former colonial powers meant that the Bank—perceived to be a Western institution—had to be kept at a distance in economic policymaking.

Third, most African countries were eligible to borrow principally from the soft-loan window of the Bank, IDA, created in 1960. IDA, however, had only modest financial resources at that time, and the development problems of India and Pakistan loomed larger. These two countries accounted for a significant part of the population of the Bank's borrowers living below the poverty line; their development problems were daunting;

and while they badly needed external resources, they could not qualify for the hard terms of IBRD loans. By contrast, most African countries were considered better-off due to their sizable natural resources.

Finally, in the early part of its history, the Bank was fairly conservative in the ways it judged the performance and creditworthiness of borrowers, concentrating its portfolio in more creditworthy countries and emphasizing its more traditional role as a bank, rather than as a development agency. Only after 1960, following the creation of IDA, did the Bank's role begin to change, and the availability of concessional finance sway the Bank to initiate lending for projects with low financial, but high social, returns.

1970s—The Move Toward Development

With Robert McNamara at the helm, the Bank's role changed from a traditional bank to the world's largest lender for development in low-income countries. The number of projects financed, lending volume, sector coverage, geographical dispersion of activities, and size of Bank staff, all increased dramatically. This also brought about a change in the Bank's attitude and involvement in Africa. Mr. McNamara's Nairobi speech of 1973,[1] was a turning point, changing the Bank's focus from the financing of traditional infrastructure projects to the alleviation of poverty. Project lending for rural development, basic education, basic health, and low-cost housing increased dramatically. By 1981, lending for agriculture and rural development had grown to a third of total Bank lending, almost four times the level of such lending over the first twenty-two years of the Bank's existence. The share of infrastructure projects declined remarkably (from nearly 66 percent to 39 percent) by 1980.

By 1981, lending for agriculture and rural development had grown to a third of total Bank lending, almost four times the level of such lending over the first twenty-two years of the Bank's existence

At the same time, African (particularly oil-importing) countries, suffered two external shocks in 1973 and 1979. Africa's response to these oil price shocks was subdued—the recycling of petrodollars by the commercial banks at negative real interest

Over time, both adjustment and project lending have grown more poverty-focused

rates allowed domestic absorption to remain unchanged. Asian countries, on the other hand, embarked on retrenchment of government expenditures. The commodity price booms of the mid-1970s also helped postpone the immediate adverse effects of oil-price shocks. Reflecting these developments, net flows from the Bank and IDA to Africa by 1980 had risen to $707 million, or nearly 12 percent of net flows for the Bank and IDA as a whole.

Since 1980

The 1980s began with a serious financial crisis. The second oil price shock, combined with the cumulative impact of the large increases in public expenditures in the 1970s, led to high domestic inflation, balance-of-payments pressures, and severe external indebtedness. The Bank's approach to lending in Africa was heavily conditioned by that crisis, and by its decision to work selectively with countries willing to undertake reforms with the help of a new instrument: structural adjustment lending, in which financing of imports was provided in support of policy reforms aimed at addressing both short-term stabilization requirements and structural policy reforms.

The Bank's lending evolved in this period in three phases, reflecting modification of its approach as both borrowers and the Bank learnt from their new relationship. The first phase, in the early 1980s, emphasized adjustment lending in support of what were largely IMF stabilization programs. The second phase, (in the mid-1980s) recognized the importance of structural policy reform to restore growth, and the need to protect the poor during adjustment. The third phase, in the late 1980s, recognized that reform efforts need to be accompanied by long-term policies that support direct poverty reduction and investments in people, institutions, and infrastructure to ensure adequate outcomes.

Over time, both adjustment and project lending have grown more poverty-focused. Adjustment loans have given

increased attention to social safety nets and restructuring public spending. The most common safety nets have comprised nutrition programs, labor-intensive public works, and targeted food subsidies. The restructuring of public expenditure has taken the form of maintaining or increasing the share of expenditures on social services, particularly basic social services. In most cases, the focus has also been on improving the composition of social spending. Loans are based increasingly on an assessment of how reforms will affect the poor—both during transition and in the long term. Operations are increasingly supporting the systematic collection of poverty data and the monitoring of the impact of adjustment on the poor. A growing number of adjustment loans include conditions for the release of tranches related to the country's efforts to reduce poverty. The share of loans that include social sector conditionality increased from less than 5 percent of all adjustment loans in FY1984–86 to almost 30 percent in FY1990–92. In FY1992, eleven of the thirteen structural adjustment loans approved and three of the five sector adjustment loans contained tranche release conditions dependent on poverty reduction measures. Most of these conditions have stipulated the expansion or maintenance of public spending on social services.

Social funds and social action programs were originally established to protect those adversely affected by adjustment but can also operate as wholesale financing mechanisms that target the poor. Such interventions often help to increase political support for reform and mobilize external resources. The Bank has supported nineteen such interventions in seventeen countries, including eleven in Sub-Saharan Africa. Usually, these programs channel resources to small, demand-driven subprojects proposed by a local group (usually an NGO) or a local government agency. Typically, the programs involve local governments, private-sector groups, and NGOs in both design and implementation.

Loans are based increasingly on an assessment of how reforms will affect the poor—both during transition and in the long term

A recent evaluation of adjustment policies[2] in Sub-Saharan Africa suggests that implementation has been uneven but that the countries that have consistently implemented these policies have witnessed a positive turnaround in growth of GDP, agriculture, exports, and industry. After almost a decade of reforms, important and positive changes have taken place in most African countries. Domestic price controls have been replaced by market-determined prices. Exchange rates, interest rates, producer prices, and other key prices are no longer administered by governments. Nontraditional exports are beginning to appear. Discrimination against and high taxation of agriculture have given way to improved incentives that have already arrested the long decline in domestic food production. There is some evidence, too, that the rural poor have benefited from these policy changes.

After almost a decade of reforms, important and positive changes have taken place in most African countries

A useful instrument that evolved in the 1980s to underpin the allocation and efficient utilization of public-sector resources is the review of public expenditure undertaken by Bank staff in collaboration with African governments. These reviews focus on intersectoral and intrasectoral trade-offs and ultimately contribute to the restructuring of public expenditures. They examine the equity, effectiveness, and efficiency of planned spending in the context of the macroeconomic framework and poverty alleviation strategy. Possible imbalances between capital and recurrent spending, the impact on the conditions of the poor, and analysis of social safety net programs for cost effectiveness and coverage of target groups are key issues in the underlying policy dialogue.

The Bank's initial adjustment loans did not explicitly take environmental sustainability into account, but a 1989 review of adjustment lending found no evidence that policy changes associated with such lending were related to environmental degradation.[3] On the contrary, it concluded that adjustment programs appeared, on balance, to have a positive effect on the environment.

In the coming years, the Bank expects a stronger thrust in environment and in combined "population–agriculture–-environment" projects. Adjustment lending accounts for only 30 percent of the Bank's total lending to Sub-Saharan Africa (although, in 1993, it was only about 22 percent), while 70 percent goes to investment and sector lending. In FY1991–92, more than 60 percent of total lending was allocated for investment in small-holder agriculture, human resource development, and infrastructure.

Procedures have been set up to categorize investment projects according to their environmental impact and to assess this impact upfront. To encourage African countries to incorporate environmental considerations into their economic planning and budgeting processes, the Bank has helped eleven countries complete National Environmental Action Plans and mobilize donor funding for their implementation. The Bank is currently helping twenty-two other countries to develop such plans. The Bank's policy concerning forestry is not to finance any projects in the sector unless they are demonstrated to be environmentally sustainable. The Bank has also pledged not to finance commercial logging in primary tropical rainforests.

Intellectual Leadership

In the 1970s, the Bank supported a variety of economic systems ranging from the mixed-economy approach of Kenya, Côte d'Ivoire, and Malawi to the Ujaama Socialism of Tanzania and the Drege Marxism of Ethiopia. The Bank was also directly and indirectly responsible for the creation of public enterprises and parastatals in many African countries, mainly to facilitate execution of Bank-assisted projects. Thus, the Bank's present market-friendly approach to development is not motivated by traditional ideology but has evolved over time and should be seen in light of several failures, and of the Bank's experience with its own projects, particularly in Africa. A satisfactory recipe has not yet been found for the

In FY1991–92, more than 60 percent of total lending was allocated for investment in small-holder agriculture, human resource development, and infrastructure

The Berg report marked an intellectual watershed and provided the analytical underpinning for most structural adjustment lending by the Bank to African countries

enormous problems faced by Africa. The Bank's intellectual role, however, has followed an evolutionary but pragmatic path.

The Berg Report

In the early and mid-1970s, the attention of African policymakers and others was diverted, by necessity, toward finding ways to cope with the financial difficulties resulting from oil price shocks. In response the Bank designed the Structural Adjustment Lending instrument to provide quick-disbursing, balance-of-payment support. This marked a shift from the way the Bank traditionally provided assistance, namely by financing specific projects. To sharpen the focus of this instrument, the Bank commissioned a major study of Africa's economic problems and prospects.[4] This study, led by Elliot Berg, became known as The Berg Report. The report analyzed the respective roles of external factors and domestic policy failures, and concluded that serious policy distortions and poor economic management were the main reasons for the economic woes of Africa. It recommended that the donor community, including the Bank, provide financial support to those African countries making genuine efforts to reform their economic policies, remove policy distortions, and improve the quality of economic management.

The Berg report marked an intellectual watershed and provided the analytical underpinning for most structural adjustment lending by the Bank to African countries. The report, however, sparked heated controversy among African intellectuals and other Western academics, and not until the end of the decade was there a broader recognition among African governments of the need for policy reforms.

Structural Adjustment

The conceptual evolution which the Bank and its partners have undergone in the past ten years occurred in three distinct phases (Chart 1). In the first period, adjustment simply meant stabilization to

Table 1. Conceptual Evolution of Structural Adjustment in Africa

Adjustment Period	Design objective	Mode of Dominant Intervention	Constraints	Outcomes
Period I Early 1980s	Reduction in external and internal imbalances	Conventional expenditure reduction policies.	•Foreign exchange to meet debt servicing and import requirements •Recognition of lag on the part of recipients.	No growth but improvement in external and internal imbalances.
Period II Mid–1980s	Resumption of growth; increase in exports and agricultural output.	•Continuation of sound macroeconomic policies •Trade, exchange rate, agriculture sector reforms; expenditure switching; improved efficiency of resource use.	•Commitments and ownership lag on the part of recipients. •Depressed commodity prices, debt	Modest growth rates with reduction in distortions
Period III Late–1980s	Higher but sustained growth rates with reduction in poverty and in aid dependence.	•Consolidation of sound macroeconomic policies. •Continuation of structural policies. •Private sector development, capacity building, mobilization of domestic resources. •Increased social expenditures and social safety nets.	•Implementation lag •Uncertainties in extermal environment	Not yet known

In the case of the structural adjustment, no single universal model has emerged to suit diverse country circumstances; it is a learning-by-doing process

reduce external and internal imbalances. The dominant mode of intervention in the early 1980s was expenditure reduction, the normal means of stabilization. Unfortunately, most countries did not have enough foreign exchange to meet debt service and import requirements.[5] There was insufficient recognition among countries of the importance of stabilization. In many countries, there was even internal dissent and questioning about stabilization as urged by the IMF and the World Bank.

As a result, in this first phase of adjustment programs there was little or no growth, although there were improvements in the external and internal imbalances—mainly through import compression, cuts in domestic expenditures, and accumulation of arrears on domestic and external debt. It is relevant to stress that the Bank has followed prevailing theoretical and analytical insights to underpin its work. In many instances, it has used its rich cross-country experience to shed new light. But in the case of the structural adjustment, no single universal model has emerged to suit diverse country circumstances; it is a learning-by-doing process.

By the mid-1980s, adjustment program design was improving, and with the launching of the Special Program of Assistance in 1987(see below), adequate external financing for these programs was assured. Something had to be done if growth in imports, investment, and exports was to resume. The strategy was to help borrowers continue the same macroeconomic stabilization policies but to supplement them with trade, exchange rate, and agricultural reforms, and to reallocate public sector expenditures to improve the efficiency of resource use (weeding out "white elephant" projects and low-priority recurrent expenditures). The supply-side measures emphasized improved incentive structure; deregulation and demonopolization of domestic trade; decontrol of prices; and elimination of exchange controls, import licensing, and non-quantitative barriers to external trade.

The Bank responded to the critique of the absence of social safety nets, and the need to protect the poor from transition costs of adjustment by launching the Social Dimensions of Adjustment (SDA) program directed towards Sub-Saharan Africa (SSA).[6] Since 1990, the Bank has adopted a more comprehensive focus on poverty reduction with a two-pronged strategy that aims at broad-based economic growth to generate efficient labor demand and improve access to education, health, and other social services to increase the poor's income-earning opportunities.

The current phase of structural adjustment combines the efficiency-improving policies of the first phase with general concerns for poverty reduction, protecting the poor and disadvantaged in the transitional period through social safety nets, and reallocating public expenditures towards priority sectors, such as education and health. Reforms of public enterprises, and financial and public sector management also occupy a bigger place in this phase.

The Long-Term Perspectives Study

To shed some light on the controversy about structural adjustment and to place it in the context of a long-term development agenda, the Bank completed a Long-Term Perspectives Study (LTPS) in 1989.[7] The study was carried out in consultation and collaboration with African policymakers, intellectuals, donors, and other international organizations. It was the first attempt to arrive at a consensus on what needs to be done in Africa to achieve sustainable growth of 4 to 5 percent annually over the next twenty years.

The Long-Term Perspectives Study (LTPS) was the first attempt to arrive at a consensus on what needs to be done in Africa to achieve sustainable growth of 4 to 5 percent annually over the next twenty years

The strategic agenda developed in the Long-Term Perspectives Study put forth the following: (a) structural adjustment programs are no more than a beginning; (b) economic reforms, though necessary, do not fully address long-term constraints; (c) programs must protect budget expenditures on human resource development; (d) the goal of structural adjustment programs should be to achieve

The experience with implementation of adjustment programs in Africa confirmed that governance had to be a central concern in promoting growth

macroeconomic balance as well as a transformation of Africa's production structures; and (e) an enabling environment should support the informal sector in generating income and employment.

The differences of views on Long-Term Perspectives Study prescriptions relate to policy instruments rather than to goals. The Bank insists that the roles of price incentives, open and well-functioning markets, a competitive environment, trade liberalization, realistic exchange rates, and the private sector are critical. Those opposed to the Bank's policies believe that markets and prices cannot solve equity questions, and will in fact complicate them, even if the poor have access to assets.[8]

The most important contribution of the study was to address candidly for the first time the issue of governance. The experience with implementation of adjustment programs in Africa confirmed that governance had to be a central concern in promoting growth. To work, adjustment programs require not only technical efficiency, but political commitment by leadership to implement (and, therefore, accept) sweeping reforms. The study recommended that without transparency, accountability, predictability, and rule of law, it would not be possible for African countries to make any tangible progress in sustainable and equitable development.[9]

Helping the Poor

At the onset of the 1990s, the overall framework in which the Bank operated changed. There is no longer any disagreement over the fact that economic growth is necessary for poverty reduction, but concerns have been expressed that the environmental conservation approach, stressed by donor country governments and a large number of NGOs, ignores the inevitable trade off between economic growth for the benefit of the poor and for environmental sustainability.

The debate on adjustment and poverty in Africa has progressed without the benefit of solid empirical data. But experience from other

developing countries suggests that sustained per capita income growth is a necessary condition for sustainable poverty reduction, and the implementation of adjustment policies (including fiscal and monetary restraint) is necessary for the resumption of such growth. Few countries have been able to reduce poverty in the absence of rapid growth—that adjustment policies work against poverty reduction is fallacious. Insofar as these policies create conditions conducive to rapid economic growth of the type that use land and labor—the two factors that most of Africa's poor possess[10]—the overall effect of adjustment on the poor would be positive.

The pace of adjustment in each country is shaped by an awareness of the dangers of institutional, social, and market damage from overly quick shifts, and the difficulties of obtaining enough external funding (on soft terms) for a long enough period to allow a less compressed time scale. The evidence of increased debilitation, more sluggish responses, and a less favorable external environment than anticipated has led to a steady lengthening of structural adjustment programs.

Overly rapid measures did not succeed in Africa due to factors unique to the region, not because they were inherently wrong. Weak institutional and implementation capacity, deep-rooted structural rigidities in factor markets, an embryonic private sector, underdeveloped capital markets, lack of consultation and consensus among the rulers and the public, and the fear of economic domination by ethnic minorities or foreigners all contributed to dampen program outcomes.

It has taken many years of debate, dialogue, and demonstration from other parts of the world for most African countries to be convinced about the need for structural adjustment. Although a few countries embarked upon limited reforms in the early 1980s, it was not until later in the decade that a majority of countries decided to undertake more wide ranging adjustment measures. A dozen countries

Experience from other developing countries suggests that sustained per capita income growth is a necessary condition for sustainable poverty reduction

The Bank . . . took the lead and established one of the most successful mechanisms for mobilizing external resources and coordinating of aid flows to African countries that are implementing sound economic policies and undergoing economic reforms

which have implemented sound policies steadfastly and consistently have successfully turned their economies around. But the region's overall results have been less encouraging and the sustainability of reforms remains tenuous. Despite a positive turn around in more than half of the countries in the region, growth rates lag well behind those of adjusting countries elsewhere. Private investment response, needed to sustain economic recovery and growth, has not been adequately forthcoming. Adjustment efforts in the best performing countries remain dependent upon large donor transfers and the movement of international commodity prices. Moreover, policy change has lagged behind rhetoric—implementation has often proved more precarious than planning. Finally, as Rothchild and Chazan argue, "there is a crisis of political authority that is just as severe as the well-known crisis of economic production. These two crises are intimately interrelated, each being both a cause and an effect of the other."[11]

Mobilizing Resources

The Bank's experience with external donor assistance to adjustment programs revealed several weaknesses and a widening gap between the demand for these resources by the recipient countries and the fragmented and inadequate donor supply. The Bank therefore took the lead and established one of the most successful mechanisms for mobilizing external resources and coordinating of aid flows to African countries that are implementing sound economic policies and undergoing economic reforms. Since 1987, when the Special Program of Assistance for Africa (SPA) was launched, the Bank has played a leading role in securing adequate financial resources for low-income, debt-distressed countries. The Special Program of Assistance for Africa was established and has grown on the basis that it would help provide not only the additional financial resources needed but that, through strengthened aid coordination, it would add to the quality and hence the effectiveness of lending. The

program's conceptual framework included the following:

- Donor consultation on the design of adjustment programs at an early stage and more opportunity to participate in Bank missions.

- Preservation of the distinct identity of individual donors and their financial support.

- Greater attention to the social dimensions of adjustment, building on the initiatives the Bank took jointly with the UNDP, the AfDB, and bilateral donors.

- Closer collaboration between the Bank and the IMF, in particular through the formulation of policy framework papers.

- An appropriate balance between structural adjustment and sector adjustment programs.

- Sustainability of regular investment lending programs, along with adjustment programs.

- Firm criteria on country eligibility for participation in the SPA program with some flexibility at the margin.

The enthusiastic support for the SPA initiative can be gauged by the fact that, over six years, two phases of this program covering twenty-seven countries have been completed. New concessional resources totaling $9.2 billion have been disbursed by bilateral and multilateral donors other than IDA and IMF. There is hardly a significant donor to Africa today that operates outside this forum.

Considering the growing fragmentation of bilateral assistance for project and sectoral purposes, the SPA extended its coordination and monitoring to sectoral development lending while launching the third phase. Donors expect that this tool will improve the efficiency of sectoral lending to African countries.

In addition to the Special Program of Assistance for Africa, the Bank organizes and chairs Consultative Group

The enthusiastic support for the SPA initiative can be gauged by the fact that, over six years, two phases of this program covering twenty-seven countries have been completed

Different approaches . . . have all lacked one essential ingredient: they have not incorporated the central feature of building indigenous capacities—skills, knowledge, and institutions

meetings for several countries in Africa. Eleven such meetings took place in FY1994. The scope of these groups has evolved over time to offer greater opportunities for exchange of views and consultations on overall country strategy and the direction in which each country is moving.

Building Capacity

Recent Bank studies have shown an erratic, intermittent course of policy reform implementation in most African countries.[12] The reasons for this uninspiring record are twofold. In countries where the governance apparatus is dominated by the interests of the privileged groups which benefit from current policy distortions, the political commitment to bring about fundamental changes is lacking. On the other hand, there is a small group of countries where governance issues do not loom large, and where the leadership is genuinely interested in implementing reforms. In these countries, the bureaucracy and many domestic institutions lack the capacity to identify relevant options, analyze consequences, make appropriate choices, and follow those chosen. The continued substitution of expatriate personnel for local thinking and implementation produces short-term "blips" that satisfy the sponsoring donors, but a long-lasting change in policies or institutions is rare. Any move towards sustainable economic growth will depend on each country building technological capabilities and competence in overall economic management.

The different approaches applied in Africa by both donors and recipient countries have all lacked one essential ingredient: they have not incorporated the central feature of building indigenous capacities—skills, knowledge, and institutions. Experience shows that despite political ups and downs, the more successful countries in other parts of the world have managed to invest consistently in human capital and institutions. As a result, they have been able to exercise more control over economic events and greater autonomy in economic decisionmaking.

Africa has been treated differently and suffered as a result. External technical assistance to Africa, mainly in the form of long-term expatriate advisers and resident consultants, has increased by 50 percent since the mid-1980s and now stands at around US$4 billion a year. About 100,000 expatriate technical advisers work in Africa today, while an equal number of African professionals have emigrated elsewhere. Excessive reliance on external technical assistance, coupled with the "brain drain," has impaired the nurturing of local African expertise. Typically, externally funded projects, including the Bank's, have been prepared by expatriate consultants or firms, appraised by the Bank or donor staff, operated with the help of long-term expatriate staff, and supervised, monitored, and evaluated by Bank or donor staff. The project-executing agencies were established independent of the government's normal procedures, budgetary controls, and supervision. This, of course, expedited the fulfillment of project objectives in the time-frame laid out by the donors, but the lack of local ownership of the project and, most important, the absence of domestic capacity to manage projects after the donors had withdrawn resulted in many failures. Thus, the Bank has had to rethink its approach to the project cycle, consider ways to involve the recipient countries in the whole cycle, and minimize the use of long-term expatriate experts by relying more on domestic expertise, and strengthening that expertise through training.

In 1991, the Bank, together with the UNDP and the African Development Bank, established the African Capacity Building Foundation to help African countries with institution building and the training of their nationals. This initiative will need to be supplemented by the greater emphasis now being placed on human resource development and the redirection of external technical assistance. The Bank's own technical assistance program is being revamped and the existing mode of delivery is being replaced. The "training and visit" system of agricultural extension, for example, uses local institutions and expertise,

Excessive reliance on external technical assistance, coupled with the "brain drain," has impaired the nurturing of local African expertise

has a continuous training and skill upgrading program for extension workers, and is closely linked with agriculture research institutions. Reliance on outside experts is minimal, sporadic, targeted at specific skills not locally available, and accompanied by steps to ensure that these skills are transferred to local institutions.

There is not as yet widespread agreement about the need to modify the traditional approach of external technical assistance. The Bank is working with other donors in this difficult area, but the results are not yet encouraging. Lessons from past experience in Africa and successful models elsewhere suggest that a flexible, evolving, and comprehensive approach, in which African participation is enhanced and given the leadership role, is the only viable means of sustaining domestic capacity building efforts.

The most daunting challenge facing African countries is to reduce the incidence and depth of poverty

Unfinished Agenda

The most daunting challenge facing African countries is to reduce the incidence and depth of poverty. The Long-Term Perspectives Study's agenda is still valid, but whether it can be implemented on a sustainable basis is uncertain. What instruments can be applied to achieve the objectives? What are the respective roles of the state and the private sector? How can external donors and the international community support the Long-Term Perspectives Study's agenda? And what is the role of the Bank in advancing it?

At present, the outlook is uncertain. Even in countries with sound policy reforms, economic growth is inadequate to make a serious dent on poverty. Most countries are still suffering from a confluence of poverty, malnutrition, high population growth, unemployment, and deteriorating social indicators. For them, the resumption of growth is the first and foremost task.

The scenarios for Africa's growth performance at an aggregate level mask the great variety among subregions as well as among individual countries. Constraints and challenges vary by country, and the real issue is whether the

twenty-six larger economies that appear less vulnerable to natural and man-made disasters can accelerate overall growth.

Promising events in the newly democratic South Africa are too recent to provide an accurate assessment of its impact on the Southern Africa subregion. But if South Africa's leadership continues to follow a path of prudent and rational economic management, it will provide a greater impetus to neighboring countries already pursuing serious economic reforms. The prospects for the Southern African countries look better now than they appeared in the last decade.

The quality of economic policies and institutions in the Eastern Africa subregion has also improved in the past few years. The liberalization and deregulation of economies, convertibility of currency, and enhanced incentives to the agriculture sector have laid the foundation for stronger growth. The gains can be accelerated if the existing reforms are consolidated, pending reforms are implemented, and a more open and participatory approach is adopted in decisionmaking.

The decision to change the parity of the CFA exchange rate has removed one of the major blocks to the revival of the thirteen countries in the zone. But the outcomes from this policy change are likely to vary. While most countries in the zone should not find it difficult to reverse their economic decline, the outlook for others is less certain. Much depends upon the intensity and the tenacity with which they are able to hold the line and put in place complementary measures to stimulate the economy.

A group of countries in the Western Africa region consisting of Ghana, Guinea, Sierra Leone, Mauritania, and The Gambia has also displayed economic performance standards that augur well for the future. Ghana illustrates the importance of sustaining consistency of purpose over the long-term. Although Ghana's performance has not always been timely and aggressive, particularly in pursuing

Ghana illustrates the importance of consistency of purpose sustained over the long-term. Although Ghana's performance has not always been timely and aggressive, particularly in pursuing liberalization and supporting the private sector, the government has stuck to the policies adopted

liberalization and supporting the private sector, the government has stuck to the policies adopted, and in terms of results, this is proving to be more important than spurts of virtue, followed by massive lapses.

The remaining countries in the region are faced with uncertain prospects for a variety of reasons. Nigeria, the most populous country in Africa, demonstrated in the late 1980s that it can generate high rates of growth if it puts its house in order. But political instability in the country since 1992 makes it difficult to guess which path the country will travel.

Nigeria, the most populous country in Africa, demonstrated in the late 1980s that it can generate high rates of growth if it puts its house in order. But political instability in the country since 1992 makes it difficult to guess which path the country will travel

Angola, Zaire, Sudan, Liberia, Somalia, Rwanda, and others are still mired in the quagmire of civil unrest, ethnic strife, and devastated physical infrastructure. It will take some time for these countries to achieve a semblance of order and security and revive the rudiments of institutions.

In spite of such differences in the prospects for various groups of countries, the response to four challenges will affect the prospects of all of Africa:

- How rapidly they are able to contain population growth rates. Current rates of over 3 percent per year are eating away much of the gains in GDP and constraining access to social services and basic amenities. Measures to limit population growth rates would help.

- How to diversify economies from dependence upon single or few commodities while managing the consequences of commodity price fluctuations in world markets. This will smooth income and consumption trends and avoid the volatility in foreign exchange markets.

- How to increase productivity in the agriculture sector so as to achieve food security and regain the lost market share in international trade. The link between a productivity increase across the sector and the incomes of small-holder farm households provides a powerful mechanism for alleviating poverty.

• How to establish economic policies and practices that enable the private sector in these countries to be competitive in regional and world export markets.

In order to address the constraints and the challenges faced by Africa, the Bank's role in the coming decades is to help African member countries advance the implementation of economic reforms, domestic capacity building, including human resource development, and governance improvement, with a redefinition of the role of the state. Determining the relationship in Africa between poverty alleviation and sustainable growth, and economic policy reforms via good governance, capacity building, and structural adjustment programs is a complex but critical task.

The lessons from successful developing countries and Africa's own past reveal an unresolved debate around the respective roles of state and market. The central issue is one of redirecting and redefining the role of the state in development. There is often a gap between the need for the state to act and its ability to do so, given prevailing fiscal difficulties, limited administrative capacity, and poor credibility.

Expanding domestic capacity, including an enabling environment for the private sector, would help to reinforce the Bank's quest for development effectiveness in Africa, and specifically for improving the implementation and results of Bank-assisted projects. The Bank's African portfolio has not met with great success relative to other regions, and various reviews have pointed to the connection between fiscal fragility and weak institutional infrastructure as a dominant cause. The Bank's current African agenda, having evolved gradually through the past decade, places great emphasis on domestic capacity-building and improved governance as the building blocks for enduring changes in Africa's economic policies and institutions.

Africa is a continent endowed with a large untapped potential of natural resources—oil,

Determining the relationship in Africa between poverty alleviation and sustainable growth, and economic policy reforms via good governance, capacity building, and structural adjustment programs is a complex but critical task

If the younger generation in Africa chooses to equip itself to equal and compete with the rest of the developing world . . . the living standards of most of its people will improve and Africa will join the ranks of the emerging regions of the world

minerals, and metals—fertile soils, and a population that is full of energy, vigor, and ingenuity. The recent expansion of its informal sector in response to economic incentives attests to this vitality. Due to the preponderance of small-holder agriculture in most African countries, income and asset distribution is more equitable than in Latin America or South Asia, and this makes the task of achieving shared growth more manageable under a right set of policies. The gap between the best practice technological frontier and the actual practices in Africa can also be transformed into a source of rapid growth.

The future of Africa will be largely determined by Africans themselves. If the younger generation in Africa chooses to equip itself to equal and compete with the rest of the developing world through productivity and technological gains, the living standards of most of its people will improve and Africa will join the ranks of the emerging regions of the world. On the other hand, if failed policies and the tendency to insulate Africa from competition and technological assimilation, protecting and preserving inefficient modes of production and consumption, and blaming the rest of the world for the economic ills continue, Africa will be marginalized. The World Bank and donor community should assist the efforts of those African leaders and countries intent on developing indigenous capacity to manage their economies in an open, participatory, and competitive way and thus help lift 250 million people out of poverty while preserving the environment.

Notes

1. *The McNamara Years at the World Bank*, The Johns Hopkins University Press, 1981, Chapter 12.
2. (a) *World Bank Adjustment in Africa: Reforms, Results and the Road Ahead* (Washington, Oxford University Press 1994)

   (b) Ishrat Husain and Rashid Faruqee, *Adjustment in Africa: Lessons from Country Case Studies* (World Bank Regional and Sectoral Studies 1994).
3. World Bank, *World Bank Support for the Environment: A Progress Report*, 1989.
4. World Bank, *Accelerated Development in Sub-Saharan Africa*, 1981.
5. Throughout this analysis, it is assumed that there is a positive relationship between import levels and GDP growth; otherwise, the analysis would be untenable.
6. The SDA program was launched in November 1987 with funding provided by the World Bank, the United Nations Development Program, the African Development Bank, and several bilateral and multilateral agencies. The SDA program focused on setting up poverty monitoring systems (through the collection of household data) and supporting social action programs and social funds to alleviate short-term poverty caused by adjustment. The SDA program was merged in 1992 into a broader effort of alleviating poverty in African countries under the sponsorship of the Special Program of Assistance for Africa.
7. World Bank, *Sub-Saharan Africa: From Crisis to Sustainable Growth*, 1989.
8. See, for instance, Timothy M. Shaw, *Reformism and Revisionism in Africa's Political Economy in the 1990s: the Dialectics of Adjustment*, 1993
9. The concept of governance was further developed and elaborated in other Bank studies and presented in a paper to the Board in 1991 (See *Governance and Development*, World Bank, 1992).
10. More than 80 percent of Africa's poor live in rural areas.
11. Donald Rothchild and Naomi Chazan (eds), *The Precarious Balance: State and Society in Africa*, Westview Press, 1988.
12. See, for example, *Adjustment in Africa: Reform, Results and the Road Ahead*, Op.cit.

Mobilizing Private Savings for Development

IBRD and the Capital Markets

Kenneth G. Lay

By any measure, the International Bank for Reconstruction and Development (IBRD) has been a bargain for its government owners and their taxpayers and an extraordinarily efficient financial intermediary for developing-country borrowers. Since Bretton Woods, the IBRD has committed close to $250 billion in long-term development finance. Of the amounts it has borrowed to fund these loans (see Figure 1), more than three-quarters have been supplied by bond market investors worldwide—by pension funds and insurance companies, banks and endowments, mutual funds and private trusts, corporations and individual brokerage accounts. The IBRD's government stockholders, meanwhile, have transferred only $10.7 billion in capital to the institution in payment for their shares.

Since Bretton Woods, the IBRD has committed close to $250 billion in long-term development finance. . . . (In this period) the IBRD's government stockholders . . . have transferred only $10.7 billion in capital to the institution in payment for their shares

This record continues today, with the IBRD borrowing around $10 billion a year to fund loans and other operations. The low cost of these funds is remarkable. In its most recent fiscal year, the IBRD financed itself in U.S. dollars, Deutsche marks, and Japanese yen at interest rates only a few hundredths of a percentage point higher than the rates at which governments borrow in their own currencies. How so? By paying meticulous attention throughout its history to the soundness of the IBRD's credit and using innovative, sophisticated approaches to achieve the best possible terms for that credit in the financial markets.

Box 1. The Bank as a Financial Intermediary

Like commercial banks, the World Bank performs a credit intermediation function, lending to lesser credits from the proceeds of its higher-quality obligations. However, the features of the IBRD's major loan product are different from those of commercial bank loans. Most commercial bank lending is at floating rates based on LIBOR, adding a margin over their cost of funds that depends on country-specific factors, the most important being the country's creditworthiness. By contrast, IBRD's lending rate is the same for all its borrowers and is based on its average cost of funds—repriced every six months—and a 0.50 percent spread (0.25 percent for timely payers). The volatility of the IBRD's lending rate is ten times lower than LIBOR volatility (as measured by their standard deviation around its 1989–94 average). Some other comparisons of IBRD's financial intermediation are provided below.

IBRD Terms Compared...

...With Commercial Bank Lending Terms

	IBRD loans	Syndicated loans
Grace period	3–5 years	1–3 years
Repayment period	15–20 years	5–7 years
Interest rate variability	quasi-fixed interest rate	floating (LIBOR-based) rate

IBRD Rates Compared...

...With Commercial Bank Rates

	IBRD	Commercial banks
Funding costs		
Short-term	LIBOR –0.25% [a]	LIBID (LIBOR –0.125%)
Long-term	LIBOR –0.20% [b]	LIBOR +0.60% [c]
Lending spreads to developing countries	0.25%–0.50%	0.375%–5.00% [d]

...With Developing-Country Bond Issue Costs

	IBRD	Developing countries
Bond issue costs	U.S. Treasuries +0.20%	U.S. Treasuries +0.90% (AA– borrower) U.S. Treasuries +2.25% (BB+ borrower)
Maturity	Unlimited	Up to 10 years

a. Floating rate equivalent of the cost of a six-month maturity U.S. dollar discount note issued by the IBRD.
b. LIBOR equivalent of the cost of a U.S. dollar global bond of ten-year maturity.
c. LIBOR equivalent of the cost of funding in the fixed income market by a AA-rated commercial bank.
d. The lower bound of this range is based on the syndicated loan spread on a ten-year installment loan to a A1/A+ rated sovereign.

The Credit Foundation

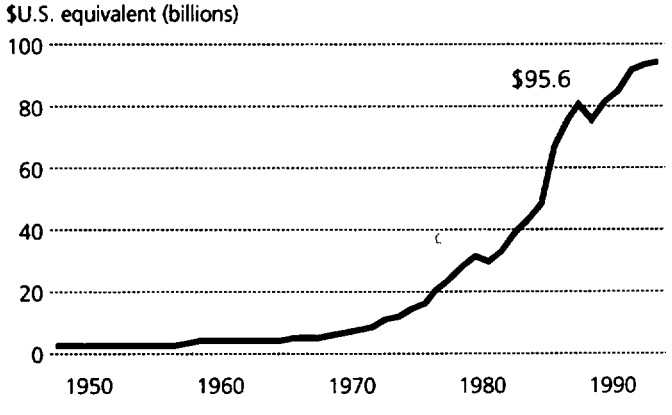
Most banks are credit intermediators, lending to lesser credits from the proceeds of their higher-quality obligations. The difference between a bank's cost of borrowing and its lending rates is one source of profits. Fees that other financiers are willing to pay for the bank's guarantees are another. The World Bank's founders assumed that its loans and guarantees would be made to credits that other banks and investors found so questionable that either these credits lacked access to finance from traditional financial institutions or had it only on prohibitively expensive terms.

How could an institution persuade financial markets to fund a portfolio of assets that most market participants would reject funding directly? The key was the application of the sovereign credit of the IBRD's richer stockholders to the credit of the new institution. The genius of the IBRD's financial structure, however, lay in the way in which it applied the sovereign credit of its rich shareholders and leveraged it, so that a modest cash outlay by stockholders to purchase equity in the IBRD has generated dramatic volumes

The genius of the IBRD's financial structure . . . lay in the way in which it applied the sovereign credit of its rich shareholders and leveraged it, so that a modest cash outlay by stockholders to purchase equity in the IBRD has generated dramatic volumes of development finance from private sources

Figure 1

Total outstanding borrowings* have increased steadily.



*Excludes short-term borrowings and swaps

of development finance from private sources.

The IBRD's founders established the concept of "callable capital," which provides "last resort," rich-country credit backing for IBRD's creditors on a contingency basis, only if necessary for it to make good on its borrowings or guarantees. The charter also limits the IBRD's leverage: outstanding loans can be no greater than equity and callable capital. In the third of the key "framework" financial provisions, the IBRD's charter largely eliminated the most volatile bank financial risk—exposure to exchange-rate fluctuations—by requiring that the IBRD lend in the same currencies in which it borrows.

The Bank's policy is succinct: "No loans are made which, in the Bank's opinion, cannot be justified on economic grounds or which would be for countries not deemed creditworthy"

Over the years, the IBRD has built on this basic credit framework with policies designed to reduce the risk that the unpaid portion of its stockholders' subscriptions would ever be called. Key to this effort is a continuing awareness that the IBRD's risk-bearing capacity should carry the institution's principal business: providing loans and guarantees for borrowers. This has meant, of course, disciplined attention to the quality of the loan portfolio, to the thoroughness and productivity of its lending, and to the prospects for its borrowers to repay. The Bank's policy is succinct: "No loans are made which, in the Bank's opinion, cannot be justified on economic grounds or which would be for countries not deemed creditworthy."

But it has also meant putting emphasis on reducing risks, principally the financial risks associated with managing assets and liabilities. To cover itself against disruption in capital market access, the IBRD has continued to carry substantial liquid assets (currently around $20 billion) to meet disbursement obligations, debt service requirements, and administrative expenses for a substantial period without recourse to market borrowing. It has focused its financing on the medium- to long-term sector of the market, producing a portfolio of liabilities with an average maturity roughly equivalent to that of its loan assets. More recently, it has charged interest rates on loans that

reflect its average cost of borrowings (plus a small additional amount to cover the Bank's expenses), which has largely controlled interest rate risk. It has established a conservative policy in provisioning against the risk in its loan portfolio (and currently sets aside 3 percent of the total amount of outstanding loans and callable guarantees for this purpose). Finally, management and stockholders have consistently recognized the need for the institution to operate at a profit sufficient to build and maintain retained earnings as a principal contributor toward prudent levels of equity capital. The IBRD has been profitable every year since 1947 and sets aside reserves to maintain income capacity (currently aiming at a 13 to 14 percent ratio of reserves to loans) while it has waived for promptly paying clients, in each of the last several years, at least half of the 0.5 percent spread it levies on loans.

Its articles, and the policies built around them, made the IBRD one of the premier credits in world financial markets, with triple-A ratings from major rating agencies since 1959. Against this background, the story of the IBRD funding activity in world financial markets is the story of its efforts to obtain for its stockholders—borrowers and nonborrowers alike—the best possible value for this credit.

Building the Franchise: 1946–80

In its early years, despite its strong sponsorship and solid credit foundation, the IBRD did not find it easy to establish a franchise as a borrower. Most of the available money was in the United States, but after the sovereign-bond debt crisis of the 1930s, American investors remained skeptical of the IBRD's viability. This, coupled with the ineligibility of its securities under many state laws for pension funds, insurance companies, and other fiduciaries, meant that the IBRD management faced an uphill struggle.

The Bank mounted a major effort to establish itself in the U.S. investment community. On the legal side, an amendment to the Bretton Woods

The IBRD has been profitable every year since 1947 and sets aside reserves to maintain income capacity (currently aiming at a 13 to 14 percent ratio of reserves to loans)

By 1959, the bond rating agencies were awarding triple-A credit ratings to IBRD bonds

Agreements Act that had authorized U.S. membership in the IBRD exempted IBRD securities from some cumbersome federal regulations. Later, with the help of several U.S. federal agencies, commercial banks that were members of the Federal Reserve System were permitted to purchase Bank bonds up to 10 percent of their capital and surplus. At the state level, things were more complicated. While trust funds, charitable institutions, and educational endowments were eligible investors, certain insurance companies and savings banks required amendments to state laws. New York, for example, passed a law allowing its savings banks to invest in IBRD securities by March 1946. But in November of the same year, the Wisconsin State Banking Commission voted to prohibit the purchase of IBRD securities by any state bank, savings bank, or trust company. Securing state eligibilities took most of the decade, but by the end of the 1950s, the IBRD had established a comprehensive set of investment eligibilities in most of the United States.

At the same time, the IBRD was moving into bond markets. Its first offering was in 1947, a two-tranche affair for $250 million—an immense amount at the time. The Bank organized the syndicate of securities firms and banks that sold the bonds without the customary help of a managing dealer. Staff decided to invite "all responsible merchants of securities to participate in the distribution," and sent invitation telexes to more than 2,600 firms. The Bank received acceptances that produced a syndicate of 1,725 dealers. The bonds were more than six-times oversubscribed and immediately quoted at a premium, although prices showed some sensitivity to the prospects of the Bank's first borrowers—Holland and France.

The deal was also the first opportunity for the rating agencies to assess the Bank. Standard and Poor's Corporation awarded a single-A, Fitch Investors Service a double-A. By 1959, the bond rating agencies were awarding triple-A credit ratings to IBRD bonds, and by the 1980s, IBRD

bonds had become a regular feature in the U.S. market for government-related securities.

The IBRD's international character was evident from the outset. Unusual for the time, the IBRD advertised its first U.S. dollar issue outside the United States and attracted significant interest from non-U.S. investors, an interest that continued during the 1950s. As economic and financial vitality returned to post-war Western Europe, the IBRD began to diversify the currency composition of its liabilities. Its second borrowing, in 1948, was in Swiss francs. In the early 1950s, the IBRD launched issues in pounds sterling, Canadian dollars, Dutch guilders, and more in Swiss francs.

By 1965 the IBRD had become a regular borrower in both German and Swiss markets; indeed, in 1968 it borrowed more in German marks than it did in U.S. dollars. By the "dollar crisis" of the early 1970s and the breakdown of the Bretton Woods exchange-rate regime, it found itself with substantial positions in the portfolios of non-U.S. investors. It had also established a network of relationships with the world's principal investment dealers that was to endure throughout the financially turbulent years that followed.

Even as the IBRD built this market franchise, events were unfolding that would preoccupy its financial managers for almost two decades. Already in the 1960s, as pressure built on the U.S. balance of payments and gold position, there arose official resistance to the IBRD's raising and exporting of dollars from the United States domestic capital market. The IBRD's charter requires the consent of members in whose currencies or markets the institution borrows, and it became more difficult to obtain such agreement from U.S. authorities. This contributed to a fall in U.S. dollar borrowing, as well as an awareness that the IBRD could not take for granted the market access necessary to meet its contractual obligations on loan commitments or debt repayments. This concern took center stage in the 1970s (and persisted into the early 1980s).

The IBRD's international character was evident from the outset. Unusual for the time, the IBRD advertised its first U.S. dollar issue outside the United States and attracted significant interest from non-U.S. investors

The evolution of IBRD finance since 1980 has been a response to two major challenges. The first was volume

In 1969–74, the IBRD borrowed 70 percent more than it had borrowed in the previous eighteen years. These borrowings financed increased lending but built liquid reserves as well. The market access lessons of the 1960s had not been lost, and management found it prudent to have enough on hand to stay out of the markets for extended periods if necessary.

Further diversification of financing sources was imperative, given rapidly rising interest rates and continuing problems over access to markets. The IBRD continued to adapt its fundraising activities to follow the money. In the late 1960s it initiated private placements with the Saudi Arabian Monetary Agency. So began a substantial direct call on OPEC members lasting throughout the 1970s and into the 1980s. In 1970 the IBRD began placing securities in Japan, first with the Bank of Japan. It launched its first yen bond issue in 1971 and drew the equivalent of almost US$600 million from that market between fiscal 1970 and 1972.

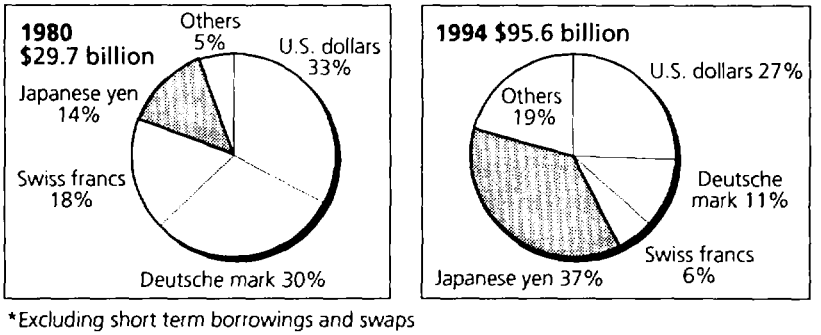
Concerns about Volume

The evolution of IBRD finance since 1980 has been a response to two major challenges. The first was volume. Undisbursed commitments remained from

Figure 2

The currency composition of IBRD's capital market operations* has shifted since 1980

Percentage shares of borrowings outstanding



*Excluding short term borrowings and swaps

the tremendous growth in lending in the 1970s, while the debt crisis brought new requirements for high-volume, fast-disbursing support for structural adjustment. IBRD funding needs went from $5.3 billion in fiscal 1980 to over $10 billion by fiscal 1985. In the first half of the decade, moreover, in Japan, Germany, and Switzerland particularly, IBRD borrowings were large compared to market size. And in all of the major industrial countries important to its finances, authorities concerned over the capacity of their markets followed IBRD borrowing closely. Some continued to place constraints on IBRD borrowing. Because of these factors, there remained anxiety among staff concerning the year-in, year-out capacity of the institution to meet its funding requirements.

Another worry in the early 1980s was the extraordinarily bearish tone of the bond markets arising from the industrial country inflation of the late 1970s. In 1980 and 1981, the IBRD faced the prospect that medium- and long-term fixed-rate dollar financings could not be completed, or if they could, that they would be locked into fixed annual interest payments of 15 percent or more on five-year and longer bond issues. To avoid both, the IBRD began issuing short-term paper in the United States' agency discount notes market, a program that continued throughout the 1980s.

Volume concerns also sustained the IBRD's emphasis on direct borrowing from stockholders' central banks, which have been significant buyers of IBRD bonds throughout the Bank's history. Beginning in 1956, the IBRD began offering securities directly to these investors in periodic, two-year bond issues—in U.S. dollars and Swiss francs—to all central banks and in private placements in their own currencies with the Bundesbank and the Bank of Japan. Finally, in the mid-1980s, with central banks increasingly emphasizing the need for liquidity in their holdings, Bank staff designed and implemented a special "central bank facility" in U.S. dollars, which offered securities with a one-year final maturity, an interest rate reset monthly (at

In all of the major industrial countries important to its finances, authorities concerned over the capacity of their markets followed IBRD borrowing closely

a small spread fixed to one-year U.S. Treasury bills), and an option to sell the securities back to the IBRD on forty-eight hours notice if the buyer urgently needed the funds. Direct borrowing from central banks, however, was no substitute for borrowings in the market. As bond markets liberalized and expanded in the 1980s and 1990s, this direct borrowing declined both in relative and absolute terms as a proportion of total IBRD borrowing.

As the decade progressed, the concerns over volume waned. Projected increases in IBRD commitments failed to materialize, and the borrowing program plateaued at $10 to $13 billion. At the same time, bond markets grew dramatically with the increasing institutionalization of private savings, elimination of exchange controls in industrial countries, and opening of capital markets to foreign participation.

The second challenge of the 1980s, ultimately of greater long-term importance to the Bank's finances, was the increasing volatility of interest and foreign exchange rates

Dealing with Volatility

The second challenge of the 1980s, ultimately of greater long-term importance to the Bank's finances, was the increasing volatility of interest and foreign exchange rates. This stemmed from the collapse of the Bretton Woods system, the oil price shocks, and the rapid growth in structural fiscal deficits. In the United States, this led to the separation of financial instruments into distinct, negotiable packages of risk and return and to the surge of derivative instruments such as financial futures and options. New communications and analysis technology encouraged these trends and prompted governments to liberalize, as pressure built for more efficient cross-border financial activity.

By 1980, the IBRD was only just beginning to respond to these developments. In 1980, concerns over the extreme differences in exchange-rate risk of borrowers (because of the IBRD's essentially unpredictable selection of currencies for disbursement) prompted the IBRD to pool the currencies funding its loans so that all borrowers would share proportionally in the risk. But at the beginning of the 1980s, it

was still making unfunded commitments of long-term fixed-rate loans with several-year lead times before disbursement, a practice that exposed it to excessive interest rate risk. Interest on IBRD fixed-rate loans reached 11.4 percent in 1982.

The IBRD clearly needed major changes in its financial risk management. In 1982, an expansion of the "pooling" concept set out to cover the interest rate risk. The new loan product preserved the currency pooling, but instead of a fixed rate of interest, it carried an interest rate reset semiannually at a spread to the volume-weighted average cost of IBRD borrowings originated during a specified period. This was a virtually complete pass through of both currency and interest-rate risk to IBRD's borrowers. It ensured that all borrowers shared equally in the value of its financial intermediation capacity. And it eliminated the interest-rate risk it faced from unfunded, fixed-rate loan commitments without placing material constraints on the timing or currency composition of its borrowing.

In the early 1980s, in the face of double-digit interest rates in U.S. dollars all along the yield curve, the IBRD made a concerted effort to borrow and lend currencies with the lowest available nominal interest rate: Swiss francs, Deutsche marks, and Japanese yen. Indeed, the IBRD was the largest nonresident borrower in each of these major markets during the early years of the decade. With the revaluation of these currencies against the U.S. dollar after 1985, however, this approach shifted. Responding to its clients' concerns about the susceptibility of their effective funding cost to currency fluctuations, the IBRD moved in 1989 to stabilize the currency composition of its lending by adopting stable ratios of U.S. dollars, yen, and Deutsche marks (and Deutsche mark-related currencies—the Swiss franc and the Dutch guilder).

The 1980s saw the market's view of the IBRD not only unimpaired, but strengthened. The Bank continued its unbroken record of profitability . . . and it continued retaining a significant portion of profits to bolster its equity position

Market Standing

The 1980s saw the market's view of the IBRD not only unimpaired, but strengthened. The Bank continued its unbroken record of profitability (throughout the decade, the

IBRD earned US$8.7 billion), and it continued retaining a significant portion of profits to bolster its equity position. A general capital increase in 1988 and steps to minimize the effect of foreign exchange fluctuations on IBRD reserves further strengthened its capital. Finally, IBRD's major borrowers validated its preferred creditor status by continuing to service IBRD loans throughout the debt crisis, even while they suspended payments to commercial-bank creditors. These circumstances put to rest any doubts rating agencies and other market analysts may have had about the soundness of the institution or of its stockholder support. Throughout the transition in its lending-currency policies, Bank staff managed funding strategy against a basic objective: to achieve the best possible sustainable value for IBRD credit in the market.

IBRD's major borrowers validated its preferred creditor status by continuing to service IBRD loans throughout the debt crisis, even while they suspended payments to commercial-bank creditors

The Pursuit of Value

In its early years, the IBRD's financial innovation was most obvious in its pioneering efforts to open new markets to its securities, and its creative approaches to negotiating coupon and price, underwriting commissions, and other fees. In other respects, though, the IBRD largely adhered to market conventions established by investors, dealers, and governments. The reasons are obvious. The IBRD still had relatively small financing needs, major efforts were required to market its credit and establish the fundamentals of a market franchise, and there was an overriding preoccupation with access. A substantial component of the fixed-income market, particularly outside the United States, remained the province of the individual investor, whose disinclination to trade the holdings in his portfolio matched his extreme sensitivity to credit. And during most of this time, the markets were remarkably stable. Exchange rates were fixed and even a one-eighth percentage-point change in government-bond yields was a major market move.

In the 1980s, things changed. Institutionalization of savings accelerated in every market. As

the decade progressed, volatile markets, a large volume need, assured access, and a firmly established credit left the IBRD largely free to push for value. And it left its financial staff free to question the conventional wisdom that there is a "right" price for a given credit rating, that it is not possible for one triple-A borrower to get better value for its rating than another. To do so came to mean focusing on the structure and imperfections of markets, and playing a leading role in effecting change. As events developed, financial markets rewarded the IBRD for its innovations.

Pioneering New Products

After 1980 the Bank's borrowing program evolved along two distinct lines. First, by initiating currency swaps and using these and other over-the-counter financial derivatives, the IBRD was able to diversify its borrowings into twenty-three currencies while converting the resulting obligations into fixed-rate liabilities in the currencies it preferred. These transactions were extraordinarily cost-effective compared to direct borrowings in the preferred currencies. Because of inefficiencies in world bond markets, investors in one currency tended to price IBRD securities differently (relative to those of other issuers) than investors in others. In some cases, this phenomenon was the result of relative supply and demand. In the early 1980s, for example, the IBRD was a heavy user of the Swiss franc bond market, and its securities commanded lower prices than similar instruments offered by other triple-A issuers. In the U.S. dollar market, the reverse was true. This created the opportunity for the IBRD's first swapped funding transaction, in which it borrowed U.S. dollars while another triple-A credit (IBM) borrowed Swiss francs. The two exchanged the proceeds and, in effect, agreed to service each other's debt at an agreed-upon exchange rate. This left the Bank with a Swiss franc liability (which it preferred) at a lower cost than it could achieve borrowing Swiss francs directly, while IBM effectively converted earlier liabilities in these currencies into dollars in accord with their own liability strategy.

By initiating currency swaps and using these and other over-the-counter financial derivatives, the IBRD was able to diversify its borrowings into twenty-three currencies while converting the resulting obligations into fixed-rate liabilities in the currencies it preferred

Similar situations arose as governments began liberalizing capital markets. Because of the Bank's global status and reputation as a responsible market user, some governments began liberalization by giving it and similar borrowers preferred access to their markets. Some accorded tax treatment that made IBRD securities relatively more attractive to investors. The funding-cost advantage could be quite dramatic (a full percentage point or more) and currency swaps permitted the IBRD to deliver these relative cost advantages into liabilities in the currencies it required.

By the early 1990s, the IBRD and other borrowers found that investors would be willing to pay a price for customized instruments, resulting in a more attractive cost of funds to them than conventional borrowing

The IBRD began to experiment with other ways to take advantage of market inefficiencies. In the 1980s, the same exchange-rate and interest-rate volatility that affected IBRD loans led to a virtual explosion in sophisticated bond-investment strategies among investors. By the early 1990s, the IBRD and other borrowers found that investors would be willing to pay a price for customized instruments, resulting in a more attractive cost of funds to them than conventional borrowing (after factoring in the cost of the financial derivatives used to produce the cash-flow characteristics of a conventional bond issue). But as financial markets have liberalized, these "structured financings" are substituting for currency-swapped issues, eliminating the preferred capital market access or tax treatment that was a major source of the IBRD's comparative borrowing-cost advantage in those operations.

Even as the IBRD continued elaborating derivative-based tools to profit from market inefficiency, it was active developing other techniques to benefit from promoting market efficiency. This required significant improvements in the design and marketing of conventional bond issues in the major currencies.

From the 1950s to the first half of the 1980s, the technical conventions of IBRD's bond issues—Eurodollar bonds issued in U.S. dollars in markets outside the United States and, less frequently, so-called "Yankee" issues in the United States domestic market—and their method of distribution had little to distinguish them

from those of other issuers. Low transaction costs, non-U.S. investors' greater familiarity with the IBRD, and the smaller universe of competing products made the Euromarket more competitive than the United States as a source of dollar funds. Meanwhile, in yen and Deutsche marks, Euromarket borrowing was either tightly controlled by government authorities or, in the case of marks, prohibited, and the IBRD made heavy, but conventional, use of the Japanese and German domestic markets. As staff began to focus on evolving investor behavior, it became evident that departing from these conventions could gain the IBRD competitive advantage.

The U.S. Market

The IBRD's first significant product-design innovations in the bond market in the 1980s began in U.S. dollars. By 1985, Bank management was becoming uncomfortable with the extent to which the institution relied on non-U.S. investors for its dollar funding. In April 1986, therefore, IBRD staff settled on a new approach to offering medium- and long-term bonds in the United States. The IBRD launched a direct investor-relations campaign in the United States around its new program, known as "COLTS" (Continuously Offered Longer-Term Securities), for the continuous issuance of longer-term dollar bonds in individual transactions as small as $25,000, with maturities from three to thirty years or longer. Modeled after the "medium-term note" programs of the major auto finance companies (but novel in its extended maturities and streamlined, lower-cost clearing and settlement procedures), the IBRD's always-available product served as the centerpiece for direct conversations with major investors. While Eurobonds continued to be the mainstay of IBRD's fundraising in dollars, the IBRD was back again with a serious presence in the United States.

As the COLTS program matured, it became increasingly evident that the structure of the fixed-income market created unnecessary obstacles that made it difficult for issuers such

The IBRD's first significant product-design innovations in the bond market in the 1980s began in U.S. dollars. . . . In April 1986 . . . [it launched a] new program, known as "COLTS" (Continuously Offered Longer-Term Securities), for the continuous issuance of longer-term dollar bonds in individual transactions as small as $25,000, with maturities from three to thirty years or longer

Increasingly, sophisticated institutional investors were buying high-grade bonds and pursuing investment strategies that relied on active trading of their bond portfolios on the basis of views about interest, exchange rates, or the potential for changes in the relative value of securities from different issuers

as the IBRD to achieve the best possible terms for bond offerings. Increasingly, sophisticated institutional investors were buying high-grade bonds and pursuing investment strategies that relied on active trading of their bond portfolios on the basis of views about interest, or exchange rates, or the potential for changes in the relative value of securities from different issuers. In the U.S. dollar market, the dramatic increase of U.S. dollar holdings in Europe, the Middle East, and Japan was solidifying a global investor base for U.S. dollar bonds, and the trend toward active portfolio management was creating a notable homogeneity in the bond characteristics these investors valued.

Yet the mechanisms for distributing bonds to these investors were unresponsive to change. Bonds on identical financial terms were offered in different forms in domestic and international markets for U.S. dollar bonds. Underwriting conventions and costs differed widely for the same services. The organization of investment dealers' businesses and friction in cross-border clearing and settlement prevented the free movement of bonds from one market to another. In 1988, for example, two nearly identical IBRD bond issues, sold within weeks of each other in New York and London, traded at yields one-half a percentage point apart. Yet there was virtually no attempt by London dealers to satisfy European demand for this paper out of the supply trading in New York. All of this, of course, meant that the IBRD had no effective way to ensure that any single bond issue would be offered to all potential buyers or that holders and traders could benefit from the full range of worldwide demand for IBRD bonds.

Global Bonds

In an eighteen-month period in 1988 and 1989, the Bank set about to remedy this situation, developing a new method of distributing and trading securities that came to be known as "global bonds." The product design was based on extensive interviews with institutional investors (staff met with 125 portfolio managers in sixteen countries) to ensure that the new approach would respond

to their requirements. Bringing the transaction to fruition required detailed technical and legal work with major clearing and settlement systems, both international and domestic, to address deficiencies that surfaced during product development. Finally, a successful outcome depended on the agreement of major investment dealers to sponsor the transaction as underwriters (despite the profound skepticism of many) and to alter their internal business arrangements to ensure that the new bonds would receive equal attention from their salespeople and traders in London, New York, and Tokyo.

With the sponsorship of a syndicate of the leading global firms, the IBRD brought the first "global bond" (for $1.5 billion and a ten-year maturity) to market in September 1989. Its reliable primary market pricing, liquid secondary market, and easier cross-market custody, clearing, and settlement proved to have great appeal for investors, leading to significant improvement in the performance of IBRD bonds relative to those of comparable borrowers (see Figure 3). A single, global price for IBRD paper emerged, with the securities now trading at yield levels lower than any other dollar borrower except the U.S. Treasury.

IBRD's financing activity in other major currencies (yen, Deutsche marks, and Swiss francs) focused on the same issues, but at a different pace and against a more difficult background. In these markets, the IBRD experimented with different approaches to improving the relative value of its bonds, approaches that had to adapt to rapid structural changes.

The Japanese Market

In Japan, IBRD borrowing grew in a heavily intermediated, highly regulated market, dominated by immense financial institutions operating in clearly differentiated market segments and with specifically-defined roles in financing Japan's postwar expansion. IBRD borrowing in Japan, therefore, continued to involve large-scale loans from relatively fixed bank syndicates almost throughout the 1980s, despite

With the sponsorship of a syndicate of the leading global firms, the IBRD brought the first "global bond" (for $1.5 billion and a ten-year maturity) to market in September 1989

The success of the U.S. dollar global bond in 1989 focused attention on the benefits of worldwide distribution and trading of large bond issues, including those in yen

the cost inefficiency relative to securities market alternatives.

At the same time, however, a yen bond market was beginning to grow. As early as 1971 the IBRD and the Asian Development Bank (ADB)—at the invitation of Japanese authorities—began offering securities in Japan through Japanese securities companies in what came to be known as the "samurai" bond market. In the early 1980s, the government cautiously began permitting these dealers to underwrite and distribute IBRD and ADB bonds in London in the "Euroyen" market.

As market liberalization began to pick up speed, the IBRD proved innovative once again. In 1987, it issued "daimyo" bonds that sought (unsuccessfully) to adapt samurai issuing conventions to permit active distribution and trading in the London market. But the IBRD helped bring down the high transaction costs associated with borrowing in yen. It achieved reductions in fees charged by the commissioned banks that participated in Japanese domestic bond issues and ultimately benefitted from their complete elimination from globally-distributed yen issues. It led efforts by borrowers to renegotiate underwriting and sales commissions to bring greater consistency to international practice, and it began negotiating direct transactions with major Japanese institutional investors to lower the cost of bond-market operations in Tokyo still further.

As these developments unfolded, it grew apparent that the evolving Japanese capital market would be fully able to supply the IBRD's needs without recourse to the (more expensive) syndicated loans characteristic of the formative period of the IBRD's yen-borrowing program. By the end of the 1980s, the IBRD was satisfying a growing share of its borrowing needs through bond issues, both daimyo and Euroyen, rather than from syndicated loans. At the same time, extremely low Japanese interest rates in 1986 and 1987 allowed the IBRD to prepay important amounts of its outstanding yen loans.

Meanwhile, the success of the U.S. dollar global bond in 1989

illustrated the benefits of worldwide distribution and trading of large bond issues, including those in yen. Japanese authorities and market participants had, from the second dollar global bond, arranged modifications to certain Japanese domestic market conventions to permit IBRD global issues to be sold in the primary market in Tokyo, and it proved possible to extend these modifications to yen.

IBRD's first global bond in yen came to the market in March 1992 after the removal of two key regulatory obstacles. The issue was the first in yen to be offered simultaneously in the Japanese domestic market and internationally, and it was also the first domestic yen issue without a Japanese bank in the traditional commissioned bank role. That ten-year deal (for 250 billion yen) was soon established as the most liquid yen instrument in the bond market after the benchmark. Japanese government issue. By 1994, yen global bonds (supplemented by occasional structured financings in that currency) were the predominant vehicle for IBRD funding in yen.

The European Market

In Europe as well, IBRD financing kept pace with capital market liberalization. Throughout the 1980s, the IBRD was a major factor in key European markets, particularly in Germany, Holland, and Switzerland, where nominal interest rates remained low relative to those on U.S. dollars and on other European currencies. Indeed, from fiscal 1980 to fiscal 1985, the IBRD completed 18 percent of its annual borrowing program in Swiss francs and another 19 percent in Deutsche marks, making it far and away the largest nonresident borrower in Germany and the largest single borrower of any description in Switzerland.

Throughout the 1980s, the IBRD was a major factor in key European markets, particularly in Germany, Holland, and Switzerland, where nominal interest rates remained low relative to those on U.S. dollars and on other European currencies

But these massive demands took their toll, particularly in Switzerland, where—by the mid-1980s—the IBRD began to encounter significant investor resistance to further purchases of IBRD Swiss franc bonds. The Bank's response was to pull back from direct operations and focus on converting liabilities in other currencies into Swiss francs through the swap

markets. This approach had its intended effect. By 1991, the Swiss market was receptive again, and the stage was set for the IBRD to improve the relative value of its Swiss franc paper by developing larger, more widely-distributed benchmark issues designed to stimulate lower-cost secondary-market trading.

IBRD funding activities in Deutsche marks underwent an even more basic transformation in the 1980s and early 1990s. At the beginning of this period, the IBRD raised a substantial share of its total financing requirements through direct Deutsche mark borrowings, using diversified instruments targeted toward retail investors. As more attractive funding opportunities emerged in Swiss francs and Dutch guilders (together with the introduction of currency swaps), direct Deutsche mark issues diminished over the 1980s.

International interest in Deutsche marks and the capacity of the Deutsche mark market were boosted by the liberalization of capital flows and the deregulation and globalization of securities markets that swept the major industrial countries

In part, this was related to changes in the regulatory environment—for example, successive changes in the withholding tax regime applicable to Deutsche mark bonds. This development and the increasing trend to asset diversification by investors seeking to protect themselves against (or take advantage of) the much more pronounced volatility of exchange and interest rates led the IBRD to reshape its approach to Deutsche mark offerings repeatedly. At the beginning of the 1990s, there were new opportunities through the issuance of innovative instruments (for instance, bonds with embedded currency options and warrants, which the IBRD converted to conventional liabilities by purchasing derivatives with offsetting cash flows) to reduce its borrowing cost. There were early precursors of the IBRD's structured financings in various currencies that developed rapidly in the ensuing few years.

Meanwhile, the Deutsche mark became the anchor of the European exchange rate mechanism. International interest in Deutsche marks and the capacity of the Deutsche mark market were boosted by the liberalization of capital flows and the deregulation and globalization of securities markets that swept major industrial countries. At the same time, the financial

requirements associated with German reunification pushed German authorities to liberalize still further and to remove most of the remaining obstacles to participation by foreign borrowers and intermediaries in an international Deutsche mark bond market.

These changes put the IBRD in a position, after considerable development work, to launch the first global Deutsche mark bond—a product focused on broadening distribution, improving liquidity, and reducing transaction costs. This effort brought together the IBRD's long-standing franchise in the German market, built on a thirty-year history of Deutsche mark borrowing, with a product that had come of age in the world's other two major financial markets.

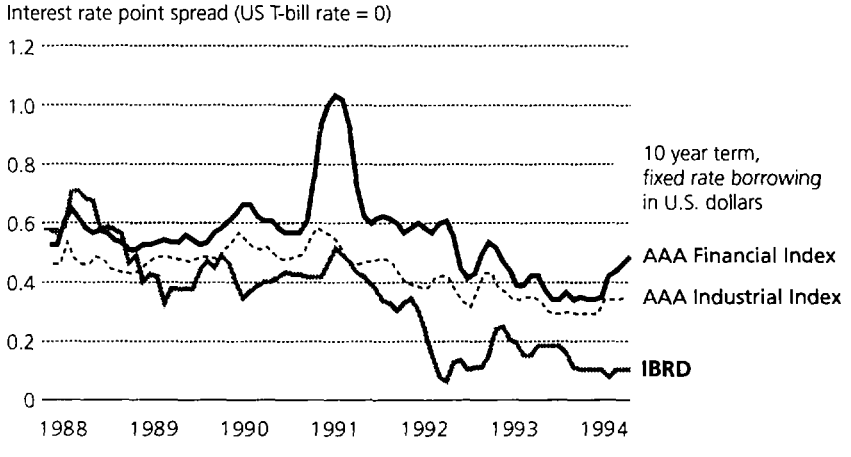
Of Things to Come

As of the summer of 1994, almost fifty years of attention to its credit and market franchise and a record of value-oriented innovation have left the Bank with the most powerful financial intermediation capacity in its history, capable of delivering to developing

As of the summer of 1994, almost fifty years of attention to its credit and market franchise and a record of value-oriented innovation have left the Bank . . . capable of delivering to developing countries large-volume funding at costs less than one-half a percentage point higher than the funding costs of the largest industrial countries in their own currencies

Figure 3

The IBRD has earned favorable terms for its borrowing



The new financial tools available have created opportunities for the IBRD to deliver its financial intermediation capacity in a manner more adaptable to the needs of individual clients and transactions

countries large-volume funding at costs less than one-half a percentage point higher than the funding costs of the largest industrial countries in their own currencies (see Figure 3). Market evolution has equipped the IBRD with the tools to manage interest rate and currency volatility and the knowledge to use them.

At the same time, however, there is growing interest in the IBRD offering a diversified array of financial products rather than the pooled loan that served so well during the past twelve years. The pooled loan has made a major contribution to the IBRD's evolution—giving it breathing room, in effect, to permit it and the markets to adapt to post-Bretton Woods volatility and the unbundling of financial risk and return. But it is increasingly apparent that the new financial tools available have created opportunities for the IBRD to deliver its financial intermediation capacity in a manner more adaptable to the needs of individual clients and transactions. The IBRD has started down this road with a pilot program that offers LIBOR-based single-currency loans at the same low spreads available in the fixed-rate product.

As the IBRD enters its second half-century, it will seek new tools and a globally diversified financing program so that it can offer its borrowers the benefits of its powerful intermediation capacity and great flexibility in terms.

The author wishes to acknowledge the substantial contribution of Ms. Eriko Ishikawa, financial counselor in the Bank's External Affairs Department, for material she supplied on the Bank's finances prior to 1980. Ms. Ishikawa drew extensively on two other sources for accounts of events in this earlier period: Mason and Asher, The World Bank Since Bretton Woods, *(Brookings Institution, 1973) and Eugene H. Rotberg, "The Financial Operations of the World Bank," in* Bretton Woods: Looking to the Future *(Bretton Woods Commission, 1994).*

Distributors of World Bank Publications

ARGENTINA
Carlos Hirsch, SRL
Galeria Guemes
Florida 165, 4th Floor-Ofc. 453/465
1333 Buenos Aires

Oficina del Libro Internacional
Alberti 40
1082 Buenos Aires

AUSTRALIA, PAPUA NEW GUINEA, FIJI, SOLOMON ISLANDS, VANUATU, AND WESTERN SAMOA
D.A. Information Services
648 Whitehorse Road
Mitcham 3132
Victoria

AUSTRIA
Gerold and Co.
Graben 31
A-1011 Wien

BANGLADESH
Micro Industries Development Assistance Society (MIDAS)
House 5, Road 16
Dhanmondi R/Area
Dhaka 1209

BELGIUM
Jean De Lannoy
Av. du Roi 202
1060 Brussels

BRAZIL
Publicacoes Tecnicas Internacionais Ltda.
Rua Peixoto Gomide, 209
01409 Sao Paulo, SP

CANADA
Le Diffuseur
151A Boul. de Mortagne
Boucherville, Québec
J4B 5E6

Renouf Publishing Co.
1294 Algoma Road
Ottawa, Ontario K1B 3W8

CHINA
China Financial & Economic Publishing House
8, Da Fo Si Dong Jie
Beijing

COLOMBIA
Infoenlace Ltda.
Apartado Aereo 34270
Bogota D.E.

COSTA RICA, BELIZE, GUATE-MALA, HONDURAS, NICARAGUA, PANAMA
Chispas Bookstore
75 Meters al Norte del Hotel Balmoral en calle 7
San Jose

COTE D'IVOIRE
Centre d'Edition et de Diffusion Africaines (CEDA)
04 B.P. 541
Abidjan 04 Plateau

CYPRUS
Center of Applied Research
Cyprus College
6, Diogenes Street, Engomi
P.O. Box 2006
Nicosia

CZECH REPUBLIC
National Information Center
P.O. Box 668
CS-113 57 Prague 1

DENMARK
SamfundsLitteratur
Rosenoerns Allé 11
DK-1970 Frederiksberg C

EGYPT, ARAB REPUBLIC OF
Al Ahram
Al Galaa Street
Cairo

The Middle East Observer
41, Sherif Street
Cairo

FINLAND
Akateeminen Kirjakauppa
P.O. Box 23
FIN-00371 Helsinki

FRANCE
World Bank Publications
66, avenue d'Iéna
75116 Paris

GERMANY
UNO-Verlag
Poppelsdorfer Allee 55
53115 Bonn

GREECE
Papasotiriou S.A.
35, Stournara Str.
106 82 Athens

HONG KONG, MACAO
Asia 2000 Ltd.
46-48 Wyndham Street
Winning Centre
7th Floor
Central Hong Kong

HUNGARY
Foundation for Market Economy
Dombovari Ut 17-19
H-1117 Budapest

INDIA
Allied Publishers Private Ltd.
751 Mount Road
Madras - 600 002

INDONESIA
Pt. Indira Limited
Jalan Borobudur 20
P.O. Box 181
Jakarta 10320

IRAN
Kowkab Publishers
P.O. Box 19575-511
Tehran

IRELAND
Government Supplies Agency
4-5 Harcourt Road
Dublin 2

ISRAEL
Yozmot Literature Ltd.
P.O. Box 56055
Tel Aviv 61560

R.O.Y. International
P.O. Box 13056
Tel Aviv 61130

Palestinian Authority/Middle East
Index Information Services
P.O.B. 19502 Jerusalem

ITALY
Licosa Commissionaria Sansoni SPA
Via Duca Di Calabria, 1/1
Casella Postale 552
50125 Firenze

JAMAICA
Ian Randle Publishers Ltd.
206 Old Hope Road
Kingston 6

JAPAN
Eastern Book Service
Hongo 3-Chome, Bunkyo-ku 113
Tokyo

KENYA
Africa Book Service (E.A.) Ltd.
Quaran House, Mfangano St.
P.O. Box 45245
Nairobi

KOREA, REPUBLIC OF
Daejon Trading Co. Ltd.
P.O. Box 34
Yeoeida
Seoul

MALAYSIA
University of Malaya Cooperative Bookshop, Limited
P.O. Box 1127, Jalan Pantai Baru
59700 Kuala Lumpur

MEXICO
INFOTEC
Apartado Postal 22-860
14060 Tlalpan, Mexico D.F.

NETHERLANDS
De Lindeboom/InOr-Publikaties
P.O. Box 202
7480 AE Haaksbergen

NEW ZEALAND
EBSCO NZ Ltd.
Private Mail Bag 99914
New Market
Auckland

NIGERIA
University Press Limited
Three Crowns Building Jericho
Private Mail Bag 5095
Ibadan

NORWAY
Narvesen Information Center
Book Department
P.O. Box 6125 Etterstad
N-0602 Oslo 6

PAKISTAN
Mirza Book Agency
65, Shahrah-e-Quaid-e-Azam
P.O. Box No. 729
Lahore 54000

Oxford University Press
5 Bangalore Town
Sharae Faisal
P.O. Box 13033
Karachi-75350

PERU
Editorial Desarrollo SA
Apartado 3824
Lima 1

PHILIPPINES
International Book Center
Suite 720, Cityland 10
Condominium Tower 2
Ayala Avenue, H.V. dela Costa Extension
Makati, Metro Manila

POLAND
International Publishing Service
Ul. Piekna 31/37
00-577 Warszawa

PORTUGAL
Livraria Portugal
Rua Do Carmo 70-74
1200 Lisbon

SAUDI ARABIA, QATAR
Jarir Book Store
P.O. Box 3196
Riyadh 11471

SINGAPORE, TAIWAN
Gower Asia Pacific Pte Ltd.
Golden Wheel Building
41, Kallang Pudding, #04-03
Singapore 1334

SLOVAK REPUBLIC
Slovart G.T.G. Ltd.
Krupinska 4
P.O. Box 152
852 99 Bratislava 5

SOUTH AFRICA, BOTSWANA
Oxford University Press Southern Africa
P.O. Box 1141
Cape Town 8000

SPAIN
Mundi-Prensa Libros, S.A.
Castello 37
28001 Madrid

Librería Internacional AEDOS
Consell de Cent, 391
08009 Barcelona

SRI LANKA & THE MALDIVES
Lake House Bookshop
P.O. Box 244
100, Sir Chittampalam A. Gardiner Mawatha
Colombo 2

SWEDEN
Fritzes Customer Service
Regeringsgatan 12
S-106 47 Stockholm

Wennergren-Williams AB
P.O. Box 1305
S-171 25 Solna

SWITZERLAND
Librairie Payot
Case postale 3212
CH 1002 Lausanne

Van Diermen Editions Techniques
P.O. Box 465
CH 1211 Geneva 19

TANZANIA
Oxford University Press
Maktaba Street
P.O. Box 5299
Dar es-Salaam

THAILAND
Central Books Distribution Co. Ltd.
306 Silom Road
Bangkok

TRINIDAD & TOBAGO, JAMAICA
Systematics Studies Unit
#9 Watts Street
Curepe
Trinidad, West Indies

UGANDA
Gustro Ltd.
1st Floor, Room 4, Geogiadis Chambers
P.O. Box 9997
Plot (69) Kampala Road
Kampala

UNITED KINGDOM
Microinfo Ltd.
P.O. Box 3
Alton, Hampshire GU34 2PG
England

ZAMBIA
University Bookshop
Great East Road Campus
P.O. Box 32379
Lusaka

ZIMBABWE
Longman Zimbabwe (Pte.) Ltd.
Tourle Road, Ardbennie
P.O. Box ST 125

THE WORLD BANK
A partner in strengthening economies
and expanding markets
to improve the quality of life
for people everywhere,
especially the poorest

The World Bank

Headquarters
1818 H Street, N.W.
Washington, D.C. 20433, U.S.A.

Telephone: (202) 477-1234
Facsimile: (202) 477-6391
Telex: MCI 64145 WORLDBANK
MCI 248423 WORLDBANK
Cable Address: INTBAFRAD,
WASHINGTONDC

European Office
55 avenue d'Iéna
75116 Paris, France

Telephone: (1) 40.69.30.00
Facsimile: (1) 40.69.30.66
Telex: 640651

Tokyo Office
Kokusai Building
1-1 Marunouchi 3-chome
Chiyoda-ku, Tokyo 100, Japan

Telephone: (3) 3214-5001
Facsimile: (3) 3214-3657
Telex: 26838

ISBN 0-8213-3234-1

13234
9 780821 332344