THE EVOLVING ROLE OF THE WORLD BANK

From Reconstruction to Development in Europe and Japan
The Evolving Role of the World Bank

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Caroline Doggart

The World Bank
Washington, DC
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.
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Foreword

The world has changed dramatically over the last 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 series 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 paper 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. These essays 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
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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.

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,"
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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."* 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."

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 worldwide 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

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prerequisites 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

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.

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”
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Response to the U.S. offer was enthusiastic. Even the controversial requirements that would eventually be set aside: 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. 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." For the sake of efficiency and economy, the Bank planned to use expert consultants to deal with specific problems as they arose. In
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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 credit-worthiness. 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.

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,

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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.

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. 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." 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,
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." 77

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." 78 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.

**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.

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
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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.¹⁸ It became clear that the Bank could be no more than a marginal contributor to the emergency reconstruction phase (1945–48).¹⁹ 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).

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
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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." They were sent to listen and played a key role in building good relations between the Bank and member countries.

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 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.

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." 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. 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

Figure 1
The transition from reconstruction to development
Gross annual commitments, $US billions

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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.

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.

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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
The Evolving Role of the World Bank

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Other 50%</th>
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<th>Japan 7%</th>
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<tr>
<td>1952</td>
<td>$1.4 billion</td>
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<td>1960</td>
<td>$5.1 billion</td>
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From Reconstruction to Development in Europe and Japan

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 became 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.

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
The Evolving Role of 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.

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 would need 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 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, 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

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21
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."  

**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."  

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."29 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.

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.

Figures 3

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

External lending to Japan, 1950-1960

<table>
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<tr>
<th>Source</th>
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<td>World Bank</td>
<td>43%</td>
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<tr>
<td>US private banks</td>
<td>15%</td>
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<tr>
<td>US Export/Import Bank</td>
<td>21%</td>
</tr>
<tr>
<td>Others</td>
<td>21%</td>
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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.

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. 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...
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...
The Evolving Role of the World Bank

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, 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
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 creditworthiness 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.
Notes

4. The deflator used was the World Bank Budget Price Index, FY1946–94, Budget and Planning Department.
5. Ibid.
23. Bank Archives: Minutes of Meeting with Japan’s Minister of Finance, September 26, 1965.
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