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What should the multilateral development banks do?

Willem Buiter and Steven Fries

Abstract

Their name suggests that the multilateral development banks (MDBs) should provide finance for investments in human and physical capital that promote development. The interpretation of this broad mandate, however, has changed significantly over time. One reassessment occurred when the European Bank for Reconstruction and Development was established following the fall of the Berlin Wall and given a mandate to foster the transition to a market economy by investing primarily in private sector projects. Another is ongoing with the strong focus on achieving the international development goals to reduce extreme poverty to one-half its 1990 level by 2015. This paper assesses the role of MDBs in fostering development or transition through the institutional mechanisms that the MDBs possess for the selection, monitoring and enforcement of loans and other financing agreements and through the use of subsidies that they receive from their shareholders and other sources. We conclude that a useful direction for MDB reform is to exploit more effectively the potential complementarities between the public and private sector financing operations. We disagree with the view that the MDBs should become at least in part fiscal agencies for the allocation of grants either for the purpose of international redistribution or for the financing of international public goods.

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Address for correspondence: European Bank for Reconstruction and Development, One Exchange Square, London EC2A 2JN, UK.

Tel: +44 20 7338 6805; Fax: +44 20 7338 6110
E-mail: buiterw@ebrd.com friess@ebrd.com

Willem Buiter is Chief Economist and Special Counsellor to the President, and Steven Fries is Deputy Chief Economist and Director of Policy Studies and Transition Strategy at the EBRD.

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1. INTRODUCTION

Their name suggests that the multilateral development banks (MDBs) should provide finance for investments in human and physical capital that promote development. This is in broad terms the mandate of the World Bank (WB) and the three regional development banks – the African Development Bank (AfDB), Asian Development Bank (AsDB) and Inter-American Development Bank (IADB) – that were established between the late 1940s and the mid 1960s. In their initial decades of operations, these MDBs financed primarily public sector infrastructure projects through the provision of sovereign loans to developing countries. The European Bank for Reconstruction and Development (EBRD) – the fourth major regional bank – was founded in 1991 following the fall of the Berlin Wall and was given a mandate to finance investments, mostly in the private sector, that foster the transition to a market economy in the post-communist countries of central and eastern Europe and the former Soviet Union.[1]

The rapid development of international capital markets in the 1990s and the recent experiences of developing countries and transition economies have prompted many reassessments of the roles of the MDBs. The growth of global private capital flows and the development of domestic financial systems have expanded access to commercial finance by governments and private entities alike. At the same time, most of these countries have achieved significant progress in liberalising markets and trade, stabilising their economies and abandoning state-led strategies of economic development, and creating conditions conducive to private investment.

While there have been episodes of rapid development in East and South Asia, the output growth of many developing countries and transition economies has failed to respond as strongly to these reforms as had been expected or hoped. Overall global poverty has declined, owing mainly to robust growth in China and India. However, in many countries growth and the distribution of its benefits have not managed to reduce poverty and to raise living standards. This experience has led to a re-examination of development strategies and to a focus on institution building and social development as necessary complements to liberalisation, privatisation and macroeconomic stabilisation (see, for example, World Bank, 1998).

At the same time, the objectives of the controlling shareholders of the MDBs have shifted with the introduction of markets and private enterprise in China beginning in the late 1970s and the collapse of the Soviet Union in the early 1990s. In the 1990s, leaders of all countries, including the G-7, agreed on International Development Goals (IDGs) to reduce extreme poverty by 2015 to one-half its level in 1990 and to achieve advances in education and health (including a reduction in gender bias) and in environmentally sustainable development.[2] The goals are very ambitious, but with the commitment and efforts of developing, transition and developed countries and international development agencies they can be achieved. Enhancing the global trading system by redressing the imbalances in trade liberalisation and by lowering

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[1] In addition, the EBRD is unique among the MDBs in having both a political and an economic mandate. The Agreement Establishing the EBRD calls for it to "foster the transition towards open market oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics."

[2] There are several slightly different versions of the International Development Goals, which have been put forward by different bodies. The version referred to here is that adopted in the UN Millennium Declaration issued by the General Assembly in September 2000.

trade barriers faced by developing countries in the export of products for which they possess a comparative advantage in production – particularly agricultural products, textiles and clothing – will be necessary. A successful World Trade Organization round of trade negotiations launched at the November 2001 Doha ministerial meeting and accession to the WTO by Russia and the other post-communist countries that remain outside the trading system would put down important markers for eventual IDG success. At its Summit in July 2000, the G-7 began to monitor progress in achieving these goals at its annual summits.

In addition, the G-7 launched an MDB reform initiative at its Summit in July 2001 that seeks to strengthen the effectiveness of these institutions in fostering development and transition. These reform recommendations reflect in part the analyses and recommendations of three recent special-purpose commissions that assessed the role of the MDBs in fostering development or transition, taking into account the recent developments in international capital markets and in developing countries and transition economies. These commissions span the political spectrum from right of centre to the left, including the middle ground. This paper provides an assessment of these commission reports and their recommendations and sets out our own views on reform of the MDBs.

As a basis for this assessment, our paper provides an analytical framework for examining the role of the MDBs. It focuses on the institutional mechanisms that the MDBs use for the selection, monitoring and enforcement of loans and other financial investments. The analysis emphasises the unique characteristics of these institutions that provide them with a comparative advantage in providing finance that is related to the design and implementation of structural reforms and institution-building programmes adopted by governments. These selection, monitoring and enforcement mechanisms bear some surprising similarities to those of micro-finance banks, which like the MDBs seek to penetrate financial market segments not reached by private finance because of high risk and weak or non-existent institutions for the enforcement of financing agreements. The commitment of governments to the policy reforms and changes in government practices embodied in MDB conditionality and their monitoring and enforcement measures are fundamental to MDB operations.

At the same time, it is important to recognise that, while many of the government policy reforms supported by the MDBs aim at strengthening the process of private investment and innovation, the response to these measures can often be stunted by resistance to change in the private sector itself. In many developing countries and transition economies, businesses are often more focused on seeking rents than on undertaking the innovation and investment that is necessary to exploit new profit opportunities and to expand. The private sector operations of MDBs can help to strengthen the investment response to reforms by mitigating risks associated with government policies (particularly the introduction and implementation of new measures), by demonstrating successful innovations in technologies, skills and business practices, and by strengthening the process of competition through support for market entry and production linkages.

Our analysis and assessment point to several key directions for MDB reform that would strengthen their role in the selection, monitoring and enforcement of financing agreements that are closely associated with the reform of government policies and practices. It is here that, in our view, the MDBs' comparative advantage lies. It is our view that the overriding objective of MDB reform should be to strengthen the existing institutional arrangements and financial instruments to ensure that the MDBs perform well the core tasks for which they were designed. One such improvement would be to exploit more effectively the potential complementarities between MDB public sector operations and those in the private sector.

We disagree with proposals that would involve a significant broadening of the roles of the MDBs beyond their comparative advantage – one derived from their unique institutional arrangements. In particular, the MDBs should not be transformed into primarily fiscal agencies for the provision of grants for development, transition and poverty relief purposes, including the provision of many types of international public goods or the control of cross-border externalities. There may well be need for increased funding of grant-based activities, but the case has not been made that the MDBs should be transformed into the principal vehicles for engaging in such activities. Grants and subsidies (generally conditional) can properly be attached to projects or programmes financed by MDBs, if this is an effective way of correcting for externalities or public good features associated with projects or programmes that respect the MDBs' comparative advantage.

The MDBs are indeed mechanisms for allocating subsidies. The MDBs receive subsidies from their shareholders in the form of subsidised capital and tax exemptions and from their borrowers in the form of their preferred creditor status. Our analysis of the amount of these subsidies and their allocation during the period 1996-2000 suggests the bulk of the subsidies provided by MDB shareholders flows into the net earnings of the MDBs and the accumulation of reserves. This reflects the conservative financial policies of the MDBs, as well as the seniority of their obligations due to their preferred creditor status and their associated preferential treatment in international debt workouts. Shareholders of MDBs have allocated some of their earnings and accumulated reserves to special purposes such as the International Development Agency (IDA) and the Heavily Indebted Poor Countries Initiative (HIPC). The subsidy accorded to the MDBs by their countries of operations in the form of the preferred creditor status is broadly returned to sovereign borrowers in the form of low interest rates. At a first order of magnitude, the subsidies received by the MDBs do not appear to be wasted on inefficient bureaucracies, although there is no room for complacency on this.

The onus is on the MDBs, however, to demonstrate that they can use effectively the resources that they receive.[3] To the extent that an MDB can demonstrate both the need for its services and its effective response, its shareholders should allocate it the necessary resources. If effectiveness is demonstrated and the need for an MDB's services is increasing, it should be allowed to build up its capital and to expand. If this is not the case, the shareholders of an MDB should allocate its net earnings (and capital) to other purposes. This does not necessarily require imparting to the MDBs new roles for which they were not designed.

The process of economic development and *a fortiori* the transition process should be time-limited. Of course, even in the case of the transition process, the day that victory can be declared lies some distance away. As one looks further east, the day of graduation recedes steadily further into the future. The development process for the least-developed countries may well take decades rather than years. Nevertheless, the MDBs should have an institutional culture appropriate to a public agency finite time span. Adding additional tasks to extend the life of the MDBs beyond the successful completion of the development and transition processes will not be an effective use of shareholder resources.

[3] The heads of the MDBs, in a joint statement at the UN Financing for Development Conference in March 2002, committed their institutions to better measuring, monitoring and managing for results.

2. WHAT IS DIFFERENT ABOUT THE MDBs?

Two general characteristics distinguish the MDBs from private financial institutions and bilateral donors: (1) their multilateral shareholding structure and preferred creditor status, and (2) a subsidised capital base and access to other subsidies. These features shape the way in which the MDBs select and monitor their loans and investments, create an incentive for compliance with the terms and conditions of their financing agreements, and allocate subsidies as part-financing and non-financing activities.

In broad terms, the African Development Bank, Asian Development Bank, Inter-American Development Bank and World Bank provide loans primarily to governments. They therefore extend a form of budgetary finance, which is largely fungible in that the loans free government resources for alternative uses until they are repaid.[4] In exchange for this finance, the borrowing governments commit to implement reforms such as sectoral adjustment and institution-building programmes and to undertake public investments in human and physical capital. In their operations with low-income developing countries, these four banks provide loans on concessional terms that are effectively a blend of loans and grants. The financing provided by the European Bank for Reconstruction and Development and the International Finance Corporation (an affiliate of the World Bank) is primarily (in the case of the EBRD) or entirely (in the case of the IFC) to the private sector on terms that are intended to reflect fully the risks involved.

The selection of private sector operations by the EBRD and IFC is concentrated on sectors where one or both of two key features are present. The first feature is that the returns to private investment are strongly dependent on government policies and practices, including those affecting infrastructure and financial services, restructuring of large, politically and socially sensitive enterprises, and entrepreneurial activity. MDB support for private sector projects can be instrumental in mitigating risks associated with government policies and practices and in strengthening the investment response to reforms. The second feature is the presence of scope for structuring the terms and conditions of the investment in such a way that it strengthens the functioning of markets, transfers and diffuses new technologies and skills, or improves corporate governance and business practices. Such investments can generate significant economic benefits that are not captured fully by the financial returns to the investment project itself. The potential to generate such externalities may be greater in the context of successful development or transition to a market economy, where the structure of an economy and its organisations and institutions are undergoing significant change.

2.1 CHARACTERISTICS OF THE MDBS AS FINANCIAL INTERMEDIARIES

As a mechanism for allocating finance, the MDBs bear surprising similarities to micro-finance banks, reflecting the fact that both types of institutions provide finance where risks are high and supporting legal and other institutional arrangements are weak. Morduch (1999) and Armendáriz de Aghion and Morduch (2000) argue that the distinguishing features of micro-finance banks are their use of social groups to screen and monitor loans, reliance on non-refinancing threats in the absence of alternative sources of credit to provide repayment incentives, and creation of collateral substitutes such as self-insurance by borrowers against default.

[4] Use of proceeds accounting and reporting is particularly pointless in this case, even though it is invariably part of the paperwork associated with project finance.

Rather than social groups, the MDBs rely on the review by shareholding governments of financing operations that are often associated with reform of government policies and practices. Crucial to the success of these financing operations is the commitment of governments to implement reforms. The MDBs rely on the incentive for compliance in their operations with governments that is created by the repeated interaction with borrowing governments, while in their private sector operations the MDBs rely on enforcement mechanisms similar to those in private financial contracts. Moreover, as a substitute for collateral the MDBs benefit from a so-called preferred creditor status.[5]

2.1.1 Selection and monitoring mechanisms

The shareholders of the institutions include both donor governments and countries of operations.[6] With the exception of the Inter-American Development Bank, the controlling shareholders are donor governments, in particular those of the G-7 countries. This multilateral shareholding structure allows donor governments and countries of operations to agree the criteria for providing multilateral finance before funds are provided and, if appropriate, to change them over time based on experience.

With their multilateral shareholder structure, the MDBs are a unique mechanism for allocating finance. They seek to penetrate segments of financial markets not reached by private finance because of high risks and limited institutional mechanisms for enforcing financing agreements and reform commitments by governments. Instead, they rely on a multilateral mechanism for the design and monitoring of financing agreements. As institutions that are owned by governments and that serve a large number of countries of operations, the staff and shareholders of the MDBs are well placed to acquire extensive knowledge of cross-country reform experiences. These institutions also have a strong incentive to acquire this knowledge to the extent that the design and implementation of reform directly affect the performance of their financing operations. Moreover, Rodrik (1995) among others has argued that, because borrowers are also shareholders of the MDBs, the conditionality and monitoring imposed by MDBs is more politically palatable compared with the alternatives of their being imposed by another sovereign government or by private financial institutions. MDBs therefore have important advantages relative to private financial institutions and bilateral donors in the design and monitoring of reform conditions for financing in developing countries and transition economies.

The MDBs do not have a monopoly of reform design and monitoring, however. There is widespread access to research and information about sound policies and practices on a range of economic issues from academic and policy research institutions and from governments through bilateral technical cooperation programmes. Private financial institutions and credit rating agencies also actively monitor government policies and their impact on economic performance. Nevertheless, the MDBs do have a particular advantage in linking the provision and cost of financing to policy reforms and their implementation. Their conditionality should be informed not only by their own experience and analysis but also by that of independent researchers and governments. The monitoring of policy implementation can also take into consideration assessments of other public and private institutions, but the MDBs must assess carefully the compliance with their own financing agreements.

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[5] The presence of 'negative pledge' clauses in MDB sovereign loans means that conventional collateral is severely restricted if not impossible to find.

[6] In the case of the EBRD, shareholders include in addition to shareholder governments (both donor countries and countries of operations) the European Community and European Investment Bank.

That being said, it is crucial to recognise that the main obstacles to the design and implementation of sound reforms come, not from lack of understanding or external monitoring, but rather from the absence of effective domestic political support, resistance to change from vested interests and weak domestic implementation capacity. For example, infrastructure investment and the pricing of infrastructure services, as well as directed bank credits, are often used as political instruments for redistribution and patronage and their reform frequently encounters strong resistance. Similarly, judiciaries and public administrations can be arbitrary in their enforcement of laws and regulations and in their administration of taxation. Corrupt practices are common. Government expenditures on education and public health are fundamental to development of the skills and the well being of their citizens, but those without access to these public services often also have little effective voice in domestic politics. Reform programmes and investment projects that foster development or transition to a market economy can have important domestic constituencies of support. However, the ability of potential beneficiaries to express effectively their views on government policies and practices can be stifled by the lack of political freedoms.

There is an increased recognition of the important role of domestic politics in the design and implementation of structural reform and institutional development, particularly that of democratic institutions. Dollar and Svennson (1998) find that the underlying institutional and political features of a country can largely predict the success or failure of World Bank structural adjustment loans. In particular, countries with democratically and newly elected governments have a greater probability of success in complying with the policy conditions in structural adjustment loans than do other countries. Similarly, EBRD (2000, Chapter 2) finds that among transition economies progress in structural and institutional reform is positively associated with political liberalisation and with the extent to which governments reflect the outcome of free and fair elections. These and other analyses, such as those of Rodrik (1999) and Sen (1999), suggest that democracy – political contestability and respect for civil liberties – encourages sound economic reforms, particularly those aimed at building institutions that support markets, private enterprise and social protection.

Where there is significant domestic support for structural reforms and institution building, conditional loans (or other forms of conditional finance, from equity investments to grants) provided by the MDBs can help reinforce the reforms in several ways. First, conditional finance is a means through which reforming governments can publicly commit to policy measures and thereby send a signal to the private sector that a reform programme is credible. Second, conditional loans can help finance the costs of reforms and adjustments to them, helping to consolidate political support for reforms (Stern, 2001). Third, private sector MDB financing operations can help stimulate the response of investors to market reforms through the demonstration effects of successful projects arising from the introduction of market-based business practices, skills and innovation, and the strengthening of market competition and production linkages. Private investment projects with these characteristics can generate significant positive externalities beyond the projects themselves.

The last point is sometimes overlooked, because a common assumption is that, provided market incentives are in place, entrepreneurs and investors will respond to profit opportunities created by structural reforms and institutional development. However, it must be recognised that in many developing countries and transition economies, businesses are often more focused on seeking rents than on undertaking the innovation and investment that is necessary to exploit newly created profit opportunities and to expand. This focus is often an individually rational adaptation to the business environments in which they operate. However, with the implementation of structural and institutional reforms aimed at fostering innovation and investment in the private sector, many businesses may be resistant to change and to the loss of rents through the liberalisation of markets and trade, the reduction of subsidies (both budgetary and off-budget), and the elimination of monopolies and cartels. In these circumstances, the private sector operations of MDBs can help to demonstrate sound business practices and successful approaches to innovation and investment, helping to foster the productivity gains that are required for sustained growth in a well-functioning market economy.

The MDBs are therefore financing mechanisms designed for selecting and monitoring loans (and other forms of financing) whose performance depends significantly on the reform of government policies and practices. The higher are the financial risks associated with these reforms, the greater is the relative strength of the MDBs in providing finance and in mitigating risk compared with both private financial institutions and bilateral donors. These loans and investments can be to governments for general budgetary support or to private entities where the returns to investment are significantly influenced by government policies and practices. In addition, MDBs can support private sector investment projects that create significant positive externalities that strengthen the process of private investment, innovation and competition. These two approaches can be strongly complementary.

2.1.2 Enforcement mechanisms

A basic mechanism for fostering compliance with the terms and conditions of MDB loans to the public sector involves the dynamic incentives that arise from the repeated interaction between borrowing governments and the MDBs. The potential for repeated loans, together with the credible threat to cut off future lending when terms and conditions are not met, can be exploited to help ensure borrower compliance. In addition, other financial sanctions can be used, including accelerating existing loans, discontinuing tranched loan disbursements or imposing financial penalties such as step-ups in interest rates.

The incentive mechanism arising from repeated interactions is more effective when borrowers have potential investment opportunities with positive net present values and limited access to alternative sources of financing. These conditions prevail in many low-income developing countries and those transition economies that remain in the early and intermediate stages of reform. Bolton and Scharfstein (1990) provide a general treatment of this issue in the context of the financing of investments by firms where the managers of firms can act against the interests of creditors and investors, although the analysis can be readily applied to government expenditure and borrowing. It must be emphasised, however, that the threat to cut off future lending must be credible in order for the enforcement mechanism to be effective. This condition has not always been met in the relationship between borrowing governments and MDBs. There are many examples of the continuation of MDB (and IMF) loans even though there has been inadequate compliance with loan terms and conditions.

In addition, as with all finite repeated games, the incentive to comply with the terms and conditions of MDB loans can diminish as the end of the lending relationship nears. If the lending relationship has a known finite horizon and there is no prospect of a transition to a new financing relationship, the borrowing government would have an incentive to renege on the loan terms and conditions in the final period. Anticipating this, an MDB would not lend in the final period, giving the borrowing government an incentive to default in the penultimate period and so forth until the entire mechanism unravels. However, the prospect of graduation from MDB financing to market-based financing and the terms and conditions that this form of financing requires can help to reinforce the incentives created by the repeated interaction of the MDBs and their borrowing governments. To the extent that private international capital markets grant access to governments based on the types of reforms embodied in MDB loan conditions, the prospect of graduation to market-based financing can transform a finite repeated game into an infinite horizon one.

In their private sector operations, the MDBs apply the principles of sound banking in structuring and pricing their financing operations (that is, economic and financial sustainability). To ensure that sound banking principles are satisfied, MDBs take security interests in the assets of investment projects and impose conditions related to financial transparency and corporate governance arrangements. Moreover, the MDBs are active in protecting their interests as creditors or equity investors in private companies, both in their countries of operations under the local laws and court systems and through international courts or arbitration procedures. MDBs are not immune to violations of creditor or minority shareholder rights, but the active pursuit of their interests in the local legal system can have a strong demonstration effect, particularly where these rights are not always respected and enforced. Actions that serve to meet the conditions of sound banking may therefore also have important development or transition impacts.

The MDBs therefore use a range of devices to foster compliance with the terms and conditions of their financing operations. They include repeated interactions with governments to encourage compliance with reform conditions and repayment terms in their public sector operations, as well as the vigorous pursuit of their rights as investors in private sector operations through local and international legal systems. They can also be complemented with other financial sanctions, such as the discontinuation of tranched loan disbursements or the acceleration of existing loans. These two forms of financial sanctions can be rather blunt instruments and they have not always been used effectively by the MDBs (or the IMF). A more graduated response could involve step-ups in interest rates that in the first instance impose financial costs in the event of non-compliance with loan terms. Use of a range of enforcement mechanisms (appropriately sequenced) could help to strengthen the effectiveness of the MDBs in fostering compliance with financing conditions.

2.1.3 Collateral substitutes and the MDBs preferred creditor status

While sovereign borrowers typically do not pledge their domestic assets as security for international loans, the preferred creditor status of MDBs serves to safeguard the quality of their financing and to protect their paid-in and accumulated reserves and their unpaid capital. Preferred creditor status is bestowed by convention rather than by treaty or law. It is mutually agreed by the shareholders of the MDBs, and exempts the claims of MDBs on entities in their countries of operations against restrictions on the convertibility of local currencies for the purpose of meeting obligations to the MDBs. This means in principle that the obligations to MDBs by both sovereign borrowers and private entities have a priority claim on the international reserves of the central bank of a country of operations. Moreover, when a sovereign borrower cannot meet its international financial obligations, the debt claims of the MDBs are treated as senior to those of bilateral and commercial creditors.

These conventions mean that the MDBs have a senior claim to the balance of external payments net of interest payments on external debt and, in the case of sovereign loans, a senior claim on primary fiscal balances (general government balance net of interest payments on government debt).[7] MDB operations with private sector borrowers benefit only from a senior claim to the foreign exchange reserves of the central bank. The seniority of MDB

[7] In addition to these conventions in international finance, some MDBs as a condition for their sovereign loans typically impose a so-called negative pledge clause that commits the government not to pledge state assets as security for any international loans or obligations.

claims on the private sector is determined by the contractual terms of their financing. Because of this status, the MDBs are able to provide financing operations in circumstances that are unattractive to private providers of finance in terms of the balance between expected return and risk.

2.2 SUBSIDIES RECEIVED BY THE MDBS AND THEIR ALLOCATION

In addition to serving as a mechanism for allocating, monitoring and enforcing financing agreements, the MDBs also receive subsidies from their shareholders and from other sources. These subsidies come in several forms and, in principle, they can be allocated to clients (borrowers) through the provision of finance and non-lending services, consumed by the institutions in the form of organisational inefficiencies, or retained for the shareholders through the accumulation of reserves.

2.2.1 Sources of subsidies provided to the MDBs

The first element of subsidy arises from the fact that the MDBs have neither paid dividends nor made any share repurchases. If this state of affairs were to persist indefinitely (and is expected to do so) some part of the opportunity cost of the shareholders' paid-in capital and accumulated reserves (the equity of the MDBs) can be viewed as a subsidy to the MDBs. The exact magnitude of the subsidy represented by the shareholders' equity depends on the nature and magnitude of the shareholders' ultimate claim on this equity. When (or if) at some point in the future the development process, or the transition from plan to market, will have been completed, the MDBs will, presumably, be wound up, and the equity plus accumulated reserves will be returned to the shareholders.

If the shareholders expect (demand) to receive back, at that time, an amount equal to their original capital contribution plus profits on this capital, accrued at something like the normal rate of return on capital, there will not have been any shareholder equity subsidy. If the shareholders only expect (demand) back, when the MBD is wound up, the *nominal* value of their original capital contributions – a policy of "keeping the (nominal) value of capital intact" – the subsidy provided by shareholders to the MDB is measured by the opportunity cost of having provided these funds for a period of time. In this case, the MDB effectively receives from its shareholders a nominal interest-free loan for the duration of its institutional life.[8] Thus, a policy of "keeping the value of the MDB's capital intact" does not imply the absence of a subsidy from the shareholders. With equity of, say, €5 billion and a nominal interest rate of 5 per cent per annum, a policy of keeping the Euro value of the capital intact implies an annual subsidy of €250 million. The present value of this subsidy, for an expected remaining institutional life span of, say, 20 years, with a constant annual Euro interest rate of 5 per cent, is just over €3 billion. If the shareholders do not expect (demand) anything back, the equity

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[8] Let E_0 be the nominal equity value today of an MDB, i the annual nominal rate of interest and N the number of years until the institution is wound up. The annual value of the subsidy to the MDB is iE_0 and the net present value of the subsidy is $E_0\left[1-\left(\frac{1}{1+i}\right)^N\right]=iE_0\sum_{j=1}^{N}\left(\frac{1}{1+i}\right)^j$.

Therefore, if an MDB has an equity value today of €5 billion, the annual nominal interest rate is a constant 5.0% and the expected duration of the institution is a further 20 years, the annual subsidy is €250 million and the net present value of the stream of annual subsides over 20 years is €3.02 billion.

subsidy is not just the rate of return foregone, but the foregone repayment of principal as well – the entire current capital contribution can be treated as a grant.[9]

In the latter two cases there is a subsidy from the shareholders to the MDB, where a subsidy is defined as the excess of incremental opportunity cost over price. A subsidy is present whenever the shareholders expect (demand) to receive when the MDB is wound up an amount less than paid-in capital plus accumulated profits on this capital accrued at the incremental opportunity cost of capital to the MDB.[10] To a first approximation, this opportunity cost can be measured by the risk-free nominal interest rate. The position of the shareholders on their ultimate claim to the MDBs' equity is not clear, but we take as our benchmark a middle case of the shareholders demanding and expecting to receive the nominal value of their paid-in capital when the MDBs are wound up.[11] The incremental opportunity cost to the MDB shareholders can be measured by the shareholders' marginal cost of borrowing, that is the risk-free market rate of interest.[12]

The second element of subsidy is the "commitment fee" foregone by the shareholders on the callable capital of the MDBs, that is, the subscribed capital that has not (yet) been paid in. The shareholders guarantee that additional capital will be available (up to the limit of the subscribed capital) should specific contingencies arise. This guarantee is valuable to the MDB and serves as a guarantee of MDB borrowing in international capital markets. As with commercial banks, the bulk of funds mobilised by the MDBs are borrowed. The average ratio

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[9] If the shareholders demand and expect the MDB to keep the *real* value of its capital intact, the subsidy granted by the shareholders to the MDB is equal to the present value of a loan with a zero real rate of interest. Let E_0 be the nominal equity value today of an MDB, *r* the annual real rate of interest (assumed constant for simplicity), P_j the general price level in period *j* and *N* the number of years until the institution is wound up. The nominal annual value of the subsidy to the MDB is $rE_0 \frac{P_{j+1}}{P_j}$ and the net present value of the subsidy is (assuming constant real interest rates and inflation rates) $E_0\left[1-\left(\frac{1}{1+r}\right)^N\right] = rE_0 \sum_{j=1}^{N}\left(\frac{1}{1+r}\right)^j$.

Therefore if an MDB has an equity value today of €5 billion, if the annual real interest rate is a constant 2.5% and the expected duration of the institution is a further 20 years, the net present value of the stream of annual subsides over 20 years is approximately €1.948 billion.

[10] Note that, as long as the risk-free nominal interest rate is positive, the present value of the subsidy in the case where the nominal value of the capital is kept constant will, as the horizon, *N,* increases, tend to the present value of the subsidy when the shareholders expect to get nothing back when the MDB is wound up.

[11] By insisting on sound banking principles for all its projects, the EBRD could be interpreted as falling into the category in which there is no subsidy at all because shareholders expect back their paid-in capital plus a nominal return over the life of the institution. Other interpretations are possible, however. For example, there is some ambiguity as to what constitutes an appropriate use of the EBRD's capital once an adequate level of reserves has been accumulated (set at 10% of subscribed capital). The other MDBs, except for the International Finance Corporation (the private sector financing group of the World Bank), do not apply a sound banking test for their financing operations. For programme lending, sound banking is not even well defined.

[12] If MDB shareholders have market power in borrowing, their marginal cost of funds could be less than the market rate of interest.

of paid-in capital and accumulated reserves to total assets is about 9 per cent over the period 1996-2000. With this structure of capital and guaranteed liabilities, the marginal cost of MDB borrowed funds approaches that of their most creditor-worthy shareholders even though their portfolio of assets is of lower credit quality.[13] This involves a cost to MDB shareholders. However, neither is a charge made for the guarantee nor has the guarantee been invoked up until now.

Third, the preferred creditor status is granted to MDBs at no cost. This status provides the MDBs with a senior claim to the reserves of the central bank and, in the case of sovereign borrowings, a senior claim on any primary government surpluses. This too can be viewed as a subsidy provided by the countries of operations that can in principle be returned to them in the form of both lower interest rates on loans and more stable access to finance. The subsidy could also be used to foster development and transition in other ways.

The fourth element of subsidy arises from the fact that the employees of MDBs (like those of other international organisations) are largely exempt from income tax on their MDB salaries and that the MDBs are exempt from indirect taxes on the goods and services that they procure. While this limits transfers from those governments that provide resources to the MDBs to the governments that would receive the taxes, it also reduces the operating costs of the MDBs. If the incidence of these taxes falls on employees and providers of goods and services, and if the MDBs pay net of tax market wages and prices, the operational costs of the MDBs are reduced by the amount of tax that would be due on their salary payments and expenditures on goods and services.

Fifth, the MDBs are able to mobilise grants, such as technical cooperation funds, from donor governments. Donors provide these funds as explicit grants for the MDBs to administer and allocate among competing projects.[14] The subsidies allocated by the MDBs are not lump sum in nature. They affect behaviour through channels other than income effects alone and in fact are often designed to alter behaviour by changing monetary incentives so as to mitigate a distortion, counteract a market failure or government failure, internalise externalities or directly address poverty. We assume that these grants are allocated in such as way that the financial benefits do not accrue largely to the MDBs themselves.[15]

2.2.2 Estimated subsidies received by the MDBs

The main source of potential subsidy to the MDBs is the opportunity cost of the paid-in capital and accumulated reserves.[16] At the beginning of 2000, this capital and reserves amounted to US$ 61 billion (Table 1). This amount excludes the capital of the concessional lending arms of the MDBs. The opportunity cost to the MDB shareholders of providing these funds is their cost of borrowing in international markets. Using an unweighted average interest rate on German and US treasury bills with a maturity of one year in 2000, the estimated opportunity cost would be about US$ 3.1 billion. Table 1 reports the details of these

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[13] The MDBs typically borrow funds on international capital markets at interest rates significantly below those at which international commercial banks borrow (LIBOR), but marginally above the risk-free interest rates at which their most creditworthy shareholders raise funds.

[14] Since funds are fungible, the designated use of proceeds (so-called official use of proceeds of grants) need not bear a close resemblance to the ultimate incidence of these subsidies.

[15] Buiter and Schankerman (2002) provide an analysis of the use of technical cooperation funds in support of MDB investment operations.

[16] Note that we assume here that the MDBs' shareholders expect and demand that the MDBs will maintain intact the nominal value of their equity.

calculations for all years from 1996 to 2000. Over the past five years, the estimated subsidies imparted to the MDBs by their shareholders through the opportunity cost of their paid-in capital (excluding the capital of the concessional lending arms of the MDBs) and accumulated reserves has totalled US$ 12.6 billion using an unweighted average of German and US interest rates.

Table 1. Selected income statement and balance sheet items of the MDBs, 1996-2000
(in US$ billions)

	1996	1997	1998	1999	2000	1996-2000
Balance sheet items						
Total assets	268.0	290.8	361.1	402.9	411.0	…
Operational investments	166.0	166.1	178.6	199.5	205.1	…
Other assets	102.0	124.7	182.5	203.4	205.9	…
Total liabilities	211.9	233.4	302.2	341.5	346.9	…
Total equity	56.2	57.4	58.9	61.4	64.2	…
Paid-in capital	26.9	28.9	30.4	30.0	29.8	…
Accumulated reserves	33.3	32.7	33.3	35.9	38.4	…
Other capital items	-4.0	-4.2	-4.7	-4.4	-4.0	…
Income statement items						
Net interest revenue	3.4	3.4	3.6	4.0	4.6	19.0
Other operating revenue	1.3	1.6	1.3	1.4	1.4	7.0
Other income	0.0	0.0	0.4	0.3	0.5	1.2
Loan loss provisions	0.5	0.7	1.5	1.0	0.4	4.1
Total administrative costs	1.6	1.5	1.7	1.7	1.9	8.3
Operating profit	2.6	2.8	2.2	3.0	4.1	14.7
Estimated subsidies to MDBs						
Opportunity cost of shareholder equity	2.4	2.4	2.4	2.3	3.1	12.6
Income tax exemption of MDB salary payments	0.3	0.3	0.3	0.4	0.4	1.7
Memorandum items:						
US one-year treasury bill rate (in per cent)	5.2	5.3	4.8	4.8	5.8	…
German one-year treasury bill rate (in per cent)	3.3	3.3	3.4	2.9	4.3	…

Sources: African Development Bank, *Annual Reports*, Asian Development Bank, *Annual Reports*, European Bank for Reconstruction and Development, *Annual Reports*, Inter-American Development Bank, *Annual Reports*, International Monetary Fund, *International Financial Statistics*, and World Bank, *Annual Reports*.

Note: These MDB accounts include neither the concessional lending agencies of the MDBs (African Development Fund, Asian Development Fund, Fund for Special Operations (IADB) and International Development Agency) nor the Multilateral Investment Guarantee Agency, the activities of which consist primarily of off-balance-sheet items.

In addition to the normal operations of the MDBs, four of the institutions have special agencies for the allocation of concessional lending – the African Development Fund, Asian Development Fund, Fund for Special Operations (IADB) and the International Development Agency (World Bank). These agencies in 2000 had a combined capital of about US$ 140 billion, total concessional loans of US$ 110 billion (net of provisions) and other net assets of US$ 30 billion. However, the loans of these development agencies are recorded at their face value rather than in terms of their net present value. The grant element of these loans is estimated at about 50 per cent of the total loan value. This assumes an average loan with a 30-year maturity, 10 years grace period, 0.75 concessional interest rate and a market interest rate of 5.5 per cent. Therefore, the estimated value of shareholder equity in these development agencies, allowing for the estimated grant element of their outstanding loans, is about US$ 75 billion. The annual subsidy from the adjusted value of shareholder capital of the MDB development agencies in 2000, using an unweighted average of German and US interest rates, is US$ 3.8 billion.

A second source of subsidy to the MDBs is the exemption of most of their salary payments from income tax. On average across the MDBs, salaries have accounted for about 70 per cent of total administrative costs over the period 1996-2000. The balance of administrative expenses is for the procurement of goods and services and capital depreciation. We make no allowance for the potential subsidy associated with the exemptions of MDBs from indirect taxes. However, this value would be small relative to the opportunity cost of shareholder equity and the income tax exemption. Assuming that MDB employees would pay an average income tax of about 30 per cent if they were so liable and that the incidence of this tax rests with employees, this tax exemption resulted in a subsidy to the MDBs of about US$ 1.7 billion over the period 1996-2000. Taken together, the subsidies associated with the opportunity cost of shareholders equity (excluding the capital of the concessional lending arms of the MDBs) and the exemption from income tax of MDB salary payments resulted in estimated total subsidy of US$ 14.3 billion over the period 1996-2000.

We assume that the value of the subsidies provided to the MDB from the two other sources – the foregone commitment fee on the callable capital of MDBs and the preferred creditor status – are also limited. It would appear that the value of the subsidy associated with the callable capital is small given the current financial policies of the MDBs and their preferred creditor status. This guarantee has not been invoked. We also maintain that the value subsidy associated with the preferred creditor status is largely returned to borrowers in the form of low interest rates. The next section provides evidence to support this view.

2.2.3 Loan pricing and allocation of MDB subsidies

MDB loans to borrowing governments are priced well below the interest rates at which these governments can access funding in international capital markets. The cost of MDB sovereign loans (including fees) range from about 60 basis points above LIBOR for the World Bank and AfDB to about 115 basis points for the AsDB and IADB and 170 basis points for the EBRD. In comparison, the interest rate spread on the JP Morgan emerging market bond index in 2000 averaged about 700 basis points. The governments of emerging market economies included in this index are the more credit-worthy governments of developing countries and transition economies. In their private sector operations the MDBs are required to provide financing on fully differentiated terms that reflect an assessment of the risks involved and the appropriate pricing of that risk.

While MDB loans to governments are less costly on average than borrowing by emerging markets in the international bond market, it does not necessarily mean that the terms of MDB loans to government borrowers are subsidised. A subsidy is provided if and only if the MDBs make funds available at a price below the incremental cost to the MDBs of these funds. A fundamental difference between international bonds and MDB loans is the preferred creditor status of the MDBs and the seniority they are accorded in international debt workouts. Therefore, the expected default rates on MDB loans is substantially lower and the expected recovery rates significantly higher than are those on international bonds and other forms of private international finance. Since there is no private market equivalent to an MDB loan to a government borrower, we must consider the extent to which MDB financing operations are subsidised by examining the flow of transfers to the MDBs from their shareholders and the resource flows from the MDBs to the various stakeholders in the institutions.

Over the period 1996-2000, the net income from the MDBs normal operations averaged US$ 2.9 billion per annum. This compares with an estimated average annual subsidy of US$ 2.8 billion from the opportunity cost of the shareholders equity and the income tax exemption of MDB salary payments. Therefore it would appear that the bulk of the subsidies provided to the MDBs are retained by MDB shareholders in the form of accumulated earnings and that MDB are not providing finance or non-lending services on subsidised terms in their normal operations.

It is important to recognise, however, that the accumulated reserves of the MDBs increased by less than their earnings over this period, with the difference being allocated to special funds, including those for the IDA and debt reduction under the HIPC programme. Moreover, the MDBs transfer significant resources to low-income countries though the concessional financing operations of their affiliated development agencies. Given the estimated capital structure of these funds in 2000, the annual subsidy that could be transferred to eligible borrowers though concessional loan terms is US$ 3.8 billion.

Since the estimated average annual subsidy to MDBs over the period 1996-2000 is less than the average net income of the MDBs, the MDBs did not receive from shareholders a net subsidy over the period. It is nevertheless possible that borrowers from the MDBs provided a net resource transfer to the institutions themselves (or *vice versa*).

Regarding the potential transfer of resources between the recipients of MDB finance and the institutions themselves, a comparison of the cost structure of MDBs with that of private financial institutions can indicate whether the MDBs are using their preferred creditor status to fund organisational slack. As a benchmark, the average ratio of total administrative costs to total assets for commercial banks in OECD countries is about 2.5 per cent (see Demirgüç-Kunt and Huzinga, 1998). The comparable ratio for the MDBs is about 0.5 per cent. There are, however, important differences between MDBs and commercial banks in terms of their operational activities and cost structures. The MDBs fund themselves in wholesale money markets rather than with deposits, which are expensive to attract (although they may be subsidised by deposit insurance). In addition, about half of the total assets of MDBs are invested by their treasuries in relatively liquid, low-risk securities. Their effective management costs are less than that of a loan portfolio of comparable value. The liquid assets of a commercial bank are typically about 10 to 15 per cent of total assets. The MDBs are therefore perhaps more similar in their activities and cost structure to a wholesale commercial bank, such as JP Morgan (before its merger with Chase Manhattan in 2000), for which the ratio of administrative costs to total assets was 2.2 per cent in 1999.

It is possible to make two conservative adjustments to the administrative cost ratios of the MDBs to account for their relatively large treasury operations and for the tax exemption for MDB salary payments. An allowance can be made for the relatively large treasury operations of the MDBs by using total operational loans rather than total assets in calculating the operating cost ratios. In this case the operating cost ratio of the MDBs would almost double to

0.9 per cent. A similarly conservative correction to administrative expenses would be to allow for an average rate of income tax of 30 per cent, recognising that salaries account for about 70 per cent of total administrative costs. Taking both adjustments into account would therefore increase the operating cost ratio to 1.1 per cent, still below that of JP Morgan.

These comparisons are not meant to be overly precise, but rather to indicate in broad terms where the subsidies provided to the MDBs are allocated. At a first order of magnitude, therefore, it would appear that the MDBs are not wasting their subsidies on inefficient bureaucracies, if commercial bank costs are taken as a benchmark. However, there is no room for complacency because there is considerable organisational inefficiency in the average private commercial bank (see, for example, Berger and Humphrey, 1997). The MDBs should seek to be on their efficient frontier in producing the bundling of financing and reform conditions in which they have a comparative advantage.

This analysis of the potential receipt and allocation subsidies of the MDBs suggests that on average the pricing of MDB loans to governments is set at terms such that on balance they limit the flow of subsidies from their shareholders to borrowing governments and to their private sector operations. Rather, the bulk of the potential subsidies provided by shareholders appears to have accumulated in the reserves of the institutions and therefore in the value of equity. Shareholders have allocated some of these earnings and accumulated reserves to special purposes such as the IDA and the HIPC initiative. At the same time, the cost structures of the MDBs do not appear excessive if commercial banks are used as a benchmark, although there may still be scope for efficiency gains. Therefore the scope for net subsidies to be provided by borrowers to the MDBs themselves appears to be limited. There is nevertheless cross-subsidisation among sovereign borrowers, with relatively low-risk government borrowers paying the same interest rate as higher risk borrowers.

2.3 PROVISION OF INTERNATIONAL PUBLIC GOODS BY MDBS

Global and regional public goods and cross-border externalities have come to the fore as advances in technology and international trade have made these issues more important (see, for example, Kanbur and others, 1999). A pure international public good is one whose benefits are globally or regionally non-rival and non-excludable. Non-rivalry means that one country benefiting does not preclude another from doing so, in other words additional countries or regions can benefit at zero incremental costs. Non-excludability means that no country can in fact exclude another from benefiting or that it is prohibitively expensive to do so. Most international public goods are not pure public goods. Examples of impure international public goods include non-country-specific investments in basic scientific research on treatments for infectious diseases (HIV/AIDS, malaria, tuberculosis), production methods for tropical agriculture, and economic policies that promote economic development or foster transition to market economy. Cross-border externalities occur when actions of one country have consequences for another and these consequences have not been priced properly. Examples of negative international externalities include water use in countries that share the same water sources, atmospheric pollution, contributions to global warming and the hole in the ozone layer, the international spread of diseases, and contagion from financial instability. Examples of positive international externalities include good governance in one country that promotes political stability in neighbouring countries.

In principle, the production of (impure) international public goods should be organised to ensure both productive efficiency and provision at marginal cost (free in the case of pure public goods) and they should be funded at least in part through subsidies. For example, the production of scientific research should be undertaken in those institutions that have the necessary skills base and physical capital and it should be funded if appropriate through government subsidies. The control of cross-border externalities requires negotiations to agree upon the problem and to coordinate actions to overcome the externalities and to monitor these actions. It may also involve the payment of compensation for costs incurred by any party as a result of the agreement that would otherwise induce them to break ranks and leave the agreement. For example, as part of a cross-border agreement on water conservation, there may be need for financial support to the agricultural sector to enable it to adapt to a restricted and/or more expensive supply of water and to introduce water conservation techniques.

There are some international public goods and externalities that are central to the operations of the MDBs. They include the analysis and dissemination of sound government policies and regulatory practices and investment projects that help to protect the environment while promoting private sector development. As discussed above, these public goods are produced as part of the core financing activities of the institutions and their provision can be financed out of the subsidies received by the MDBs. Their broad dissemination can be achieved at a low marginal cost. However, there are many other global and regional public goods and cross-border externalities that the MDBs are not well placed to produce or to fund. Other international organisations, including specialised UN agencies, may be more effective in organising the production of public goods or the control of cross-border externalities. Moreover, to the extent that subsidies are required to address these issues, it will be necessary to mobilise sustainable fiscal resources from donor governments to meet these requirements.

3. RECOMMENDATIONS ON WHAT THE MDBs SHOULD DO

As part of the ongoing review of the international financial architecture, there have been several recent assessments of the role of the MDBs. This section of the paper summarises three such studies, which span the spectrum of political opinion. One assessment is from right of centre (Report of the International Financial Institutions Advisory Commission, 2000) and another from left of centre (Report to the Swedish Ministry of Foreign Affairs by the Institute of Development Studies at the University of Sussex, 2000), while a third occupies the middle ground (Commission on the Role of MDBs in Emerging Markets, 2001). These assessments differ somewhat in their coverage both of the MDBs themselves (the International Financial Institutions Advisory Commission report excludes the EBRD) and types of countries of operations (the Commission on the Role of MDBs in Emerging Markets report excludes low-income developing countries), although their assessments can be compared in broad terms. Table 2 summarises the key recommendations of each report.

The review of these recommendations is organised by key dimensions of the reform proposals: priorities and instruments for public sector operations, conditionality, pricing and graduation, private sector operations, and institutional innovations. Each dimension is considered in turn.

3.1 PRIORITIES AND INSTRUMENTS FOR PUBLIC SECTOR OPERATIONS

Each report shares the view that MDBs should make loans or grants for public investments and expenditures with high economic returns and social benefits. Health, education and social sector programmes receive specific mention. There is also an emphasis on institution-building programmes, including judicial reform and banking regulation. Two of the three studies also recommend that the MDBs continue to participate in macroeconomic stabilisation and structural adjustment programmes, together with the IMF and donor governments. However, the Report of the International Financial Institutions Advisory Commission rules out this role, arguing that it is the responsibility of the IMF (and donor governments). The reports also differ on the extent to which they emphasise policy-based lending versus the promotion of international regulatory standards and the provision of other international public goods. The Commission on the Role of MDBs in Emerging Markets emphasises the former, while the International Financial Institutions Advisory Commission stresses the latter. The Swedish Ministry of Foreign Affairs report argues that the MDBs cannot and should not provide international public goods on their own, but that they should engage in strategic partnerships with other regional and international organisations and explore new forms of resource mobilisation for this purpose.

Two of the three reports call for continued use of MDB loans as an instrument for financing programmes and projects that conform with their priorities for public sector operations. However, the International Financial Institutions Advisory Commission argues that for operations with poor countries that do not benefit from access to international capital markets, only grants should be used and they should be provided from the income earned on the paid-in capital and accumulated reserves of the MDBs.

Table 2. Summary of recent MDB reform recommendations by special commissions

	Swedish Ministry of Foreign Affairs/Institute of Development Studies, Sussex (2000)	Commission on the Role of MDBs in Emerging Markets (2001)	International Financial Institutions Advisory Commission (2000)
Coverage of reports and recommendations	All MDBs and all borrowing countries	All MDBs, but only middle income countries with access to international capital markets.	All MDBs except the EBRD and all borrowing countries
Operational priorities and instruments	To strengthen financial resource mobilisation, the MDBs should develop a wider range of products suited to different clients' needs, ranging from large emergency loans for middle income countries to small, capacity building loans for poor countries. MDBs should focus on enhancing other financial flows (both official and private), on helping to increase domestic resource mobilisation and on exploring new forms of mobilising financial resources for poor countries. MDBs should secure the technical and management capacity to engage in costly and lengthy institution-building operations (such as social safety nets and governance). MDBs cannot and should not on their own provide public goods, which require sufficient grant finance to ensure their sustainable provision.	MDBs should encourage public investments with high social returns (investments in health, education, rural infrastructure, banking regulation and judicial reform). Provide contingency financing to help countries cope with the insecurities created by volatile capital markets in a way that is consistent with a medium-term development framework.	In poor countries without capital market access, grants should replace loans and guarantees for physical infrastructure and social-service projects. MDBs should focus on the provision of global or regional public goods and technical assistance and should fund these from income from paid-in capital and retained earnings. MDBs should be precluded from emergency lending, which is the responsibility of the IMF.

Conditionality	The MDBs need to change the way they relate to borrowers, eschewing unilaterally adopted country assistance strategies and engaging in more participatory processes such as the Comprehensive Development Framework and Poverty Reduction and Growth Strategy Papers.	Conditionality should be simplified and focused on equity as well as growth issues. Once conditions are agreed, disbursements should be halted if governments fail to honour commitments. Policy conditions under discussion should normally be open to public debate and once conditions are agreed and a loan approved, the relevant documents should be made public.	Lending for institutional reform in poor countries without capital market access should be conditional on specific institutional and policy changes. Failure to meet standards would trigger a mandatory start on repayment of principal and elimination of any interest rate subsidy.
Pricing and graduation	Formal graduation should be eschewed, rather the MDBs should differentiate their financing aimed at specific borrower segments and price them according to their characteristics. MDBs should charge for non-lending services to middle income countries.	MDB graduation should be voluntary but coupled with incentives (pricing and conditions). Loan pricing should increase with a country's per capita income. MDBs should develop systematic policies for pricing their advisory services.	All resource transfers to countries that enjoy capital market access or with a per capita income in excess of US$ 4,000 should be phased out over 5 years.
Private sector operations		Expand private sector operations, in all cases in a manner that catalyses, rather than substitutes for, private finance.	Private sector operations should be limited to the provision of technical assistance and the dissemination of best practice. Investments, guarantees and lending to the private sector should be halted.
Institutional innovations	There should be a clearer division of labour among the MDBs and coordination among their activities should be enhanced, for example through memoranda of understanding.	New MDBs with narrow regional focus in which the borrowers are also the controlling shareholders could be created. They could be modelled on the Andean Development Bank.	The World Bank should be renamed the World Development Agency; as should the regional banks (except the EBRD). All country and regional programmes in Asia and Latin America should be devolved to the relevant regional development bank.

3.2 CONDITIONALITY

Two of the three reports emphasise the need to strengthen MDB conditionality by halting disbursements on loans if their terms and conditions are not met and one of them – the International Financial Institutions Advisory Commission – proposes that compliance failures should trigger a mandatory start on repayment of principal and elimination of any interest rate subsidy. The other study, for the Swedish Ministry of Foreign Affairs, stresses that the MDBs should change the way they relate to borrowers, eschewing unilaterally adopted country assistance strategies and engaging in more participatory processes. These recommendations are not mutually exclusive, but they do aim at different objectives. The first seeks to strengthen the incentive for borrowing countries to comply with the conditions and terms of MDB loans, while the second aims to strengthen domestic political backing for MDB-funded programmes.

In addition, the Commission on the Role of MDBs in Emerging Markets emphasises the need for transparency and public debate while the policy conditions are under discussion and, once loans are approved, for the public disclosure of relevant documents. These proposals also aim to increase domestic political support for MDB-funded programmes.

3.3 PRICING AND GRADUATION

Two of the three studies recommend differentiated pricing according to the nature of the impact of programmes or projects on development or transition and the level of development of the borrowing countries. Combined with this approach to pricing is a market-oriented approach to country graduation from MDB loan operations. The aim is to create an incentive for countries to move voluntarily towards reliance on private international capital markets for their external financing needs and away from MDB loans. The combination of pricing at or near market terms on a risk-adjusted basis and demanding loan conditions is expected both to create this incentive and to expand access to private capital. The Commission on the Role of MDBs in Emerging Markets also proposes that MDBs charge for their advisory services.

The International Financial Institutions Advisory Commission recommends a different approach. It proposes that all financing operations to countries that benefit from access to international capital markets or that have a per capita income in excess of US$ 4,000 be phased out over five years. Those low-income countries that remain clients of the MDBs would receive resource transfers in the form of grants and technical assistance subject to conditionality. If the conditions for the grant are not adhered to, the grant would be converted into a loan to create a financial incentive for compliance.

3.4 PRIVATE SECTOR OPERATIONS

The Commission on the Role of MDBs in Emerging Markets and the International Financial Institutions Advisory Commission make fundamentally opposing recommendations regarding MDB operations in the private sector. The former recommends that MDBs expand their private sector operations in a manner that catalyses rather than substitutes for private finance, recognising the role that such operations can perform in expanding opportunities for private finance. This potential is also recognised in the Institute for Development Studies report, which stresses the need for MDBs to enhance other financial flows including private capital. However, the International Financial Institutions Advisory Commission sees little potential for MDB private sector operations to catalyse market financing and to expand private investment opportunities and recommends that such investment operations by the IFC be halted. This commission report does not cover the EBRD.

3.5 INSTITUTIONAL INNOVATIONS

The proposed institutional reforms vary widely and in interesting directions. The Commission on the Role of MDBs in Emerging Markets considers a new model for development finance in which the controlling owners of the institutions are also the borrowing members, forming a so-called borrowers club.[17] This structure has the potential to create greater borrower participation and ownership in the design of programmes and projects, and effective peer review of compliance with loan terms and conditions. Moreover, with high paid-in capital and conservative financial policies, such an institution could enjoy borrowing costs below that of its member countries, creating a further incentive for members to meet their repayment obligations**.** One multilateral institution that is organised in this way is the Andean Development Bank, which has achieved considerable operational and financial success. However, a borrowers club would have an incentive to transfer the paid-in capital and accumulated reserves to borrowers through lax financial policies or other means and any individual borrowers would have an incentive to free ride on any financial responsibility shown by other borrowers.

The institutional reform proposals of the International Financial Institutions Advisory Commission lead in an altogether different direction. This commission calls for the transformation of the World Bank and three of the four regional development banks (the commission does not cover the EBRD) into grant-making development agencies. In effect, these institutions would become fiscal agents of their controlling shareholders, allocating grants from the income generated by their paid-in capital and accumulated reserves on the basis of policy and public investment commitments of governments of low-income countries. This approach seeks to target the subsidies received by the MDBs from their shareholders to the poorest countries, while leveraging policy changes that promote sustainable growth.

The Institute for Development Studies focuses on the need to eliminate duplication and overlaps among the existing institutional arrangements. The proposed instruments for achieving this are memoranda of understanding between the World Bank and the regional development banks. This approach aims at increasing the efficiency of the existing institutional arrangements.

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[17] The IADB is the only one of the major MDBs where borrowing countries also constitute a majority of the shareholders. Among the smaller regional MDBs, the Andean Development Bank (CAF), discussed below, is an example of a multilateral bank dominated by the borrowers.

4. ASSESSMENT OF THE RECOMMENDATIONS

The MDBs are unique mechanisms for the selection and monitoring of loans and other forms of financing that are closely associated with reform of government policies and practices, including those aimed at creating a sound environment for business investment. To be effective in fulfilling their mandates to promote development and foster transition to a market economy, the MDBs must be catalysts for those government policies that promote sustainable growth. As argued by Stern (2001), this requires a strong focus on innovation and investment in the private sector. This sector accounts for about three-quarters of economic activity in a typical market economy and it is the processes of private innovation and investment that generate the productivity gains that lift living standards over time. To be successful, however, the private sector requires much from government in terms of sound institutions to support investment and finance, development of human capital, and social protection to facilitate adjustment to inevitable economic change. Successful development and transition will therefore include measures to enhance effective participation in productive economic activity by the poorest and most marginalised citizens. This emphasis on promoting development and fostering transition through innovation and investment in the private sector, and on government policies and practices that are required to unlock this potential, shapes our assessment of the MDB reform proposals.

4.1 PRIORITIES AND INSTRUMENTS FOR PUBLIC SECTOR OPERATIONS

We see the primary role of the MDBs as the provision of financing operations that are closely associated with reform of government institutions, policies and practices. Financing operations in the public sector should be in the form of loans to the extent that governments have the capacity to sustain the resulting debt burdens. The setting of loan terms that reflect the risk involved – recognising the preferred creditor status of the MDBs – would help confine the selection of MDB financing operations to those circumstances where governments are committed to reform. Notwithstanding the low rates on MDB sovereign loans, borrowing governments have an incentive to limit the amount of borrowing from the MDBs because *ceteris paribus* the greater the amount of this "senior" debt the more expensive will be the terms and conditions required by any new commercial lenders. Moreover, the conditionality associated with MDB loans helps to ensure that seniority accorded to the MDB loans does not result in a reduction in the value of outstanding claims on borrowing countries.

The extent to which the MDBs should move beyond their core business of providing finance that is closely associated with structural reforms and institution building depends on judgements about the cost-effectiveness of the MDBs and the existence of alternative institutional mechanisms. On lending for macroeconomic stabilisation programmes, the IMF has a clear comparative advantage in the design and monitoring of this form of policy-based lending. These programmes should be designed to attract and sustain private capital flows necessary to fund any internal and external imbalances and, if necessary, bilateral support. The participation of MDBs in short-term stabilisation essentially indicates that the domestic adjustment is insufficient to restore confidence and access to market finance. While the MDBs can provide financing for longer-term development goals that complement stabilisation programmes, these institutions do not have a comparative advantage (or competence) in providing short-term adjustment financing.

On the provision of global or regional public goods and control of cross-border externalities, the MDBs should focus on those issues that are closely related to their core business. This includes work on the dissemination of knowledge on reform experiences across countries, including standards and practices for institutions that support markets and private enterprise that are central to the process of innovation and investment in the private sector. More generally, however, the sustained provision of international public goods and the control of cross-border externalities require both specialised skills to provide the public goods and institutional arrangements that can finance and allocate subsidies. This is not the primary purpose for which the MDBs have been designed. Proposals aimed at expanding the role of MDB financing in this area without identifying commensurate sustainable funding sources could compromise the financial viability of the institutions. It could also result in a loss of focus and deterioration in the effectiveness of the MDBs' core activities.

MDB grants, including those embodied in concessional loans, should be used primarily where subsidies are the most appropriate financing instrument from the point of view of economic efficiency, such as the use of grants for the financing of international public goods or controlling cross-border externalities. Grants can also be used for purposes of international redistribution, particularly in low-income developing countries and transition economies. However, the impact of any grants that could be feasibly conveyed by the MDBs is likely to be dwarfed both by the impact of sound government policies and practices in the developing and accession countries, particularly on innovation and investment in the private sector, and by the benefits of improved market access for developing countries and accession countries to the markets of the industrial countries. The maximum subsidy that can be conveyed from the opportunity cost of the paid-in capital and accumulated reserves of the MDBs is about US$ 3 billion per annum, with a further US$ 4 billion per annum from that of the estimated value of shareholder capital in their development agencies. There are an estimated 1.2 billion people living in extreme poverty (less than US$ 365 per year) in developing and transition economies. Assuming that such grants could be targeted at those living in extreme poverty at no cost (which they cannot), these transfers would add about US$ 5 to their annual incomes (approximately equivalent to a 2 per cent one-time increase in their total annual income). Much larger impacts on living standards can be achieved through sustained high rates of growth in which most people participate and benefit from.

4.2 CONDITIONALITY

To be effective in fulfilling their mandates, the MDBs must be effective in their support of reform of government policies and state practices. Reform conditions in MDB loans should be focused on economic and social priorities, capable of being achieved, amenable to monitoring and transparent to the public. Once conditions are agreed, disbursements should be halted if a government fails to honour its commitments. This is central to the ability of the MDBs to signal credible commitments to policy change and to create an incentive for compliance with these conditions. If financing conditions are not met, financial penalties should also be applied on fully or partially disbursed loans, such as step-ups in interest rates. This includes the conversion of grants into loans.

4.3 PRICING AND GRADUATION

The aim of MDB operations should be to promote access by governments and private entities to sustainable sources of commercial finance. This means that MDB instruments for middle income countries should be designed to limit the subsidy element of loans and price at or near terms that reflect on average the risks, given their preferred creditor status and seniority in debt workouts. A combination of risk-related pricing with demanding loan conditions should give borrowers an incentive to make the transition to market-based finance. It would also allow recourse to MDB financing in periods of volatility in private financial markets. Arbitrary cut-off dates that are not necessarily linked to sustainable market access lack a clear economic rationale and would be counter-productive.

4.4 PRIVATE SECTOR OPERATIONS

While innovation and investment in the private sector are the key to sustained growth and rising living standards, it must be recognised that response of the private sector to policy changes is not automatic. In fact, there is often strong resistance to change in the private sector and considerable need to adapt organisations and production processes to new market conditions. The private sector operations of the MDBs can play an effective role in mitigating certain policy-related risks and demonstrating successful investment responses to policy changes, including support for restructuring and innovation in existing enterprises and for entrepreneurship and SMEs – which are often a source of much innovation and growth. MDB investments in private financial institutions and infrastructure enterprises can also help strengthen the response to regulatory reforms in these sectors where the government must play a strong role in creating sound regulatory frameworks. However, MDB private sector operations must serve to mobilise private investment through co-financing and demonstration effects, rather than substitute for market sources finance.

4.5 INSTITUTIONAL INNOVATIONS

The MDBs are unique institutions, but not perfect ones. They are particularly well suited for the provision of finance that is closely associated with reform of government policies and practices and careful consideration should be given to how this selection, monitoring and enforcement mechanism could be strengthened. There is considerable scope for strengthening the focus and effectiveness of the existing institutions, including the elimination of overlaps among the various institutions and the strengthening of their internal governance mechanisms. It is not clear that the transformation of the MDBs into so-called borrowers clubs would strengthen their effectiveness. With the globalisation of economic activity, there is also the need for effective institutional arrangements to provide or to finance for international public goods and to control cross-border externalities. However, the MDBs in their current form are not well suited for this purpose apart from those issues that are closely related to their core operational areas and competencies.

5. CONCLUSION

If we were asked with which of the special-purpose commission reports is our assessment most closely aligned, our answer would be that of the Commission on the Role of MDBs in Emerging Markets. The recommendations of this report reflect a careful assessment of the strengths and weaknesses of the MDBs as institutional mechanisms for the selection, monitoring and enforcement of loans that are closely associated with reform of government policies and practices. It advances a number of concrete reform proposals to improve the way these institutions function and explores the potential for institutional innovation. There are nevertheless elements in each the reports with which we agree and disagree. This is a sign of healthy and constructive debate on an important issue.

One recommendation with which we disagree is that MDBs should be transformed into fiscal agents for allocation of grants. There may be a need for such fiscal agencies, but it is far from clear that the MDBs should be transformed into them. As long as the risks in providing finance to developing countries and transition economies remain high and the institutional mechanisms for enforcing financing agreements and reform commitments by governments remain limited, the MDBs should retain their unique role in providing finance to their counties of operations. Nevertheless, this should not be an indefinite task and, with progress in development and transition, their roles should evolve and eventually recede and come to an end.

There are, however, three issues of current importance that the special-purpose commissions have left largely unexamined, but that are central to the effectiveness of the MDBs. One such issue is the preferred creditor status of the MDBs and the extent to which it is a desirable feature of the institutional arrangements of the MDBs. This characteristic has been taken for granted or overlooked in many assessments. However, it is fundamental both to the financial viability of the MDBs and to the nature of their financing operations. As with all financial contracts, their design can have important selection and incentive effects. It is our view that the combination of MDB loan seniority with reform conditionality (effectively applied and enforced) is in the interests of both borrowing governments and other claimants on the MDBs' countries of operations.

A second issue centres on the role of the MDBs in the private sector. It is surprising that much of the analyses of the commissions and most of their recommendations focus on the public sector operations of the institutions. This is of course the main area of activity for the MDBs. However, the experience of developing countries and transition economies has shown that the process of adjustment and adaptation in the private sector to reforms of government policies and practices is neither automatic nor assured. While there can be strong resistance to change in the private sector, MDB private sector operations can demonstrate successful ways to adapt, as well as sound business practices. There are of course potentially strong complementarities between the public sector and private sector operations of the MDBs.

A third issue relates to the allocation of subsidies received by the MDBs. Based on the experience of the past five years, the bulk of the subsides received by the institutions from their shareholders has been accumulated in reserves, thereby allowing the institutions to expand their operations. This expansion may well be desirable given the scale of the challenges faced by developing countries and transition economies. The challenge for the MDBs is to demonstrate clearly that they have the capacity to use these resources effectively and that this expansion is justified. This requires assessments both of the effectiveness of their operations in terms of fostering development or transition and of the availability of finance from alternative sources, including commercial lending.

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