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Former Vice President and Treasurer of the World Bank - October 16, 1995

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A. CLASSIFICATION

- ☐ Meeting Material
- ☐ Trips
- ☒ Speeches

- ☐ Annual Meetings
- ☐ Corporate Management
- ☐ Communications with Staff

- ☐ Phone Logs
- ☐ Calendar
- ☐ Press Clippings/Photos

- ☐ JDW Transcripts
- ☐ Social Events
- ☒ Other

B. SUBJECT: Eugene Rotberg, former Vice President and Treasurer of the World Bank.

1. speech for the 50th Anniversary of the World Bank
2. paper written in May 1994 entitled, "The Financial Operations of the World Bank"

DATE: 10/16/95

C. VPU

Corporate

- ☒ CTR
- ☐ EXT
- ☐ LEG
- ☐ MPS
- ☐ OED
- ☐ SEC/Board
- ☐ TRE

Regional

- ☐ AFR
- ☐ EAP
- ☐ ECA
- ☐ LAC
- ☐ MNA
- ☐ SAS

Central

- ☐ CFS
- ☐ DEC
- ☐ ESD
- ☐ FPD
- ☐ FPR
- ☐ HRO

Affiliates

- ☐ GEF
- ☐ ICSID
- ☐ IFC
- ☐ Inspection Panel
- ☐ Kennedy Center
- ☐ MIGA

D. EXTERNAL PARTNER

- ☐ IMF
- ☐ UN
- ☐ MDB/Other IO
- ☐ NGO
- ☐ Private Sector

- ☐ Part I
- ☐ Part II
- ☐ Other

E. COMMENTS:

**On the Occasion of the 50th Anniversary of The World Bank:
A Fairy Tale
by Eugene H. Rotberg**

Once upon a time, there was a magician born in the woods of ordinary folk -- well, maybe not ordinary, sort of upper middle class intellectual types. The magician had a potion, but did little with it at first. He was not sure what he was supposed to do, and frankly, his parents did not know what to do with him. No one bothered him. He had few requests for the magic potion and led a normal, if pedestrian, childhood.

One day a visitor in his parents' house whispered something in the magician's ear. By this time he was past adolescence already. The visitor said something like, "Get on with it already." The visitor was sort of like how Martin Luther would have turned out had he gone to Harvard Business School. He had a big influence on the magician.

The magician began to use his magical powers. At first, he brought corn to poor people and barren lands. He trained sowers, harvesters, processors, marketers and gave magical advice. Soon, food became more plentiful -- not only for local farmers, but also for others outside their boundaries. Many asked for the magic potion. Expectations rose, and soon people began to do other things with their lives which were productive and healthful. They built factories and went to work. They began to take control. They even began to compete against those who used to push them around. They had an increased sense of pride -- those the

EUGENE H. ROTBERG was formerly Vice President and Treasurer of the World Bank. He currently is an advisor to governments and international financial institutions.

magician touched -- and many left their fields and entered new worlds.

But the magic potion was not infinite. It had to be allocated. That was the beginning of the problem. Too many wanted the potion which produced such wonderful crops and harvest, and there wasn't enough to go around. Others wanted only the corn (please, not the training nor advice, not the sowers, nor the harvesters, nor the processors). Some wanted it free -- after all, was it not from magic? And, there was frustration over the absence of quicker benefits. Why did it have to take so long to see the results of the magic potion? There also was competition from other magic people who seemed to have an almost infinite supply of real cash money, made available quick and easy, with no questions asked and little advice given about corn, or harvesting, or anything else. Later, when the cash suppliers got in some trouble, the magician would not help them out. The magician wasn't very good at making or keeping friends that way.

But, mostly, the crop growers wanted more of what the magician offered, not less. No one forced them to take the magician's magic potion. They came to respect and love the magician, even though he was a bit of a demanding father figure at times.

But, things did not go smoothly. Some -- not the beneficiaries of the potion -- argued there was too much corn. Who needed all that corn? There was concern that corn would lose its value, and worse, the recipients of the magic potion worked for far less pay than those in the magician's own lands. That made things more difficult in affluent places. And remember, they

were not just planting corn. Others were upset that the corn and the factories diverted streams in the wrong way and turned forests into lands of plantings in the sun, or worse, cities of metal and smoke. But, starvation lessened, the poor had better food, went to school longer, lived longer, fewer children died near birth, and they led fuller lives.

Some, particularly outside the borders of the corn growers, mourned for the lost innocence of the poor, their lost tribal ties, their simple ways. Others were upset over the newly-found independence of once plain-minded folk. They just didn't know their place. Uppity. Imagine, learning about algorithms. They blamed it on the magician.

Some said the magic potion cost too much, and the magician was profiting from his brew; others said, with equal vehemence, the opposite -- the magician was practically giving it away, not charging enough, inducing inefficiency, and worse, making it tough on those who did not have access to the potion because they were rich already. Others said the magician caused human hands and minds to be exploited, and still others said, "If he really is a magician, how come there remains so much sorrow, pain, and poverty?" And some said the magician's potion only made the rich richer. Others said that the potion did more harm than good and it didn't really help the poor. Or, if it did, it would have happened anyway. The poor, though, did not think so. "What do they know," said the critics from far-off lands.

Sometimes the magic potion didn't work -- it created side effects which overwhelmed the cure -- so it went for nought. So the magician, who knew quite well the risks, was always

refining the potion, sustaining it, and maintaining its strength. The critics had a field day. They held the magician to a tough test: infallibility. So when the magician sometimes adjusted the magic brew, learning from experience, the cynics took great pleasure at the admission of mistake. As if that were a great sin. That, too, is what comes from trying to be a do-gooder.

"Anyway," said some critics, "the magician is powerful and rich, how could he possibly want to help the poor, or know how to?" That just didn't fit into the idea of the class struggle. And others said the magician was a traitor to his class. If he were so smart and well-intentioned, why didn't he use the magic in the place of his birth where others like him lived.

So, the magician found himself surrounded by a lot of people who were giving him a hard time. But the users of the magic potion had better food, went to school longer, lived longer, fewer children died near birth, and they led fuller lives. They liked the potion and gave credit where it was due.

Now, it must be said the magician was pretty rich. Nice clothes. Nice place to live. Perks. Lots of travel. He didn't look poor. So, he had a real image problem, which was not helped by the fact that he didn't pay much attention to his parents. You see, 175 of them claimed credit for his birth and upbringing and each, therefore, understandably felt entitled to give all sorts of orders and advice. Understandably inconsistent. The magician, under the circumstances, had to choose between being independent -- sort of going his own way, or going nuts. He just went on his way dispensing the magic potion.

His parents, those upper middle class folk who gave him life, were hard put to explain what their kid did for a living. You know how it is with parents: "So, what does your kid do?" They just couldn't say, "Why he just tries to do good things." It was too embarrassing; it wasn't fashionable to say that sort of thing.

So, the magician lost a lot of support. He was beset left, right and center. Even his parents were shook up. By middle age, he had few friends, except the users, of course, of the magic potion. The magician kept trying to do good things. And starvation lessened, the poor had better food, went to school longer, lived longer, fewer children died near birth, and they led fuller lives. "What do they know," said the critics from far-off lands.

**Address by Eugene H. Rotberg
at the World Bank Strategic Reserve Forum
September 28, 1995**

Many years ago when I was a very young lawyer, I listened to speeches of experts who were then my age now. Their remarks almost uniformly were touched with some arrogance. Consistently, the speaker talked about the good old days -- how he had a tougher time of it, how he (there were no "shes" in those days) and his colleagues broke new ground and made it easier for the current generation sitting in the audience, how the speaker was courageous, having few guidelines, and how single-minded and focused and committed he and his contemporaries were. How "spoiled" was the current generation.

I remember saying to myself that if I grew up, I would be neither paternalistic, nor regale an audience with anecdotes about how tough or uncertain it was in the good old days. I noticed also that the speakers often used archaic language or phrases which gave away the fact they really were not aware of what was going on at the present. So, when Jessica, Debbie and Hans talked to me about speaking here at lunch, I accepted with some misgivings for I certainly did not want to fall into the category I just described -- and the risk is not inconsiderable since the subject is "A Historical Perspective on World Bank Financial Operations." So, with apologies if I am too anecdotal, self-serving, or worse, paternalistic, let me reflect on the past.

I would like to start with what the financial world and the Bank were like in the late 1960s. For the Bank, assuredly, is a proxy for the changes that took place. The World Bank's balance sheet in 1968 was but \$3.5 billion, its outstanding debt about \$2.5 billion -- an accumulated debt after

20 years of operations. In the late 1960s, the World Bank explicitly was restricted by governments as to how much it could borrow. The world was a constrained one. And if the Bank could not borrow in the private markets, it could not lend. Indeed, one of the great misconceptions about the World Bank was and is that it has all this government money. The truth is that even now, with a \$140 billion balance sheet, the total amount of capital paid-in by governments is a little over \$8 billion. Except for \$16 billion of retained earnings, the great bulk of the rest is raised through people like you in this room -- the bond markets. But, I am already getting ahead of myself.

Through the late 1960s, the Bank had little access to markets. It had done but one debt issue in the United Kingdom in 20 years. None in France; but one in Italy; never in Japan. These countries restricted not just the Bank, but also the right of their citizens to lend to borrowers not domiciled in their country, let alone in a currency other than their own. There was no "Euro-market." Indeed, the World Bank was only allowed to borrow \$200 million a year in the United States, and even then only if it bought U.S. government bonds with the proceeds. It did not then and does not now print money. The World Bank, therefore, could lend little.

The structure of pricing issues also was different. In Switzerland, for example, there was a two week period between the pricing for a bond issue and the date of sale; the marketing, therefore, occurred with the price known for a period of two weeks. That is what you call a stable bond market. The underwriting commission in Switzerland at the time was higher than the interest rate. That is why "rich Swiss bankers" was one redundant word.

The World Bank's first long term bond issue in the mid-1940s was at 1-7/8. It took months to sell it. It didn't matter. Interest rates hardly moved. Through the early 1970s, exchange rates were stable, the yen hadn't moved from 360 yen to the dollar for a decade; the DM was about four to the dollar; the Sw fr 3.35 to the dollar and hadn't moved in decades.

Exchange rates were fixed; there was no such thing as floating exchange rates.

There was no such thing as a five-year bond in U.S. dollars. Why would anyone want the uncertainty of only locking in interest rates for five years.

The World Bank spreads in the early 1970s were anywhere between 75 to 150 over Treasuries, depending on the maturity of the bond and whether or not the Bank was then being attacked a lot or just a little as some kind of "do gooder, left wing organization" whose policies were set by the British Labor Party, the Swedish government -- free love and that sort of thing -- and staffed by the Trilateral Commission. The Bank at the same time also was accused of supporting dictatorships of the right indiscriminately and corrupt regimes, and for being a "capitalist tool." I remember once reading 600 faxes from institutional investors saying that they did not invest in institutions owned by foreigners and certainly not one in which the proceeds were for projects outside the U.S.

Such was the world in the late 1960s. When the Bank did a bond issue, virtually all of it was placed in the country whose currency was being offered. If we offered DM, it was all sold to

German nationals, and if in Holland, to the Dutch, and if in dollars, to U.S. institutions and individuals. Citizens from one country did not invest in another country's currency because first, in many places it was illegal, and second, why bother. There was nothing to be made from foreign exchange.

There were no swaps. The liability side of the balance sheets of corporations were fixed in cement.

In Germany, floating rate issues were illegal. They were considered instruments of gambling because, argued the Bundesbank, if one could invest in an interest-rate-sensitive asset whose value would increase with inflation, then there would be little pressure by the body politic to constrain inflationary pressures. Therefore, make floating rates illegal. What a strange idea.

Now all this was in the circumstance of a new Bank President, Bob McNamara, who wanted to increase Bank lending, but he couldn't do it unless we borrowed more, and more flexibly. Fortunately, and quite by coincidence, the world began to open up. German savings increased and accumulated in a variety of places -- cooperative banks, savings banks, insurance companies, and to a lesser extent, pension funds and trust banks -- as did similar pools of financial wealth in Japan. The build-ups were so substantial, beyond that which was needed for internal capital expenditures, that these savings were available for outsiders to tap into. Not coincidentally, when borrowers like the World Bank began to borrow and then convert the DM into other currencies to pay for goods and services, it put some downward pressure on the DM, yen and

Swiss franc which, at that time, were fixed at an arbitrary undervalued rate. Therefore, a country which permitted access to its currency provided some safety valve to stem the quick potential rise in their currency. It wasn't enough, of course, and, as you know, by the early 1970s, the fixed-rate mechanism broke down.

The Bank, therefore, almost uniquely had both access to the international investors who wanted to speculate in the future of a currency and, of course, to the pools of new savings. Better to give the Bank access for fixed rate bonds than for speculative short term investment in the currency market. The Bank began to borrow medium rather than long term; it borrowed at floating rates, would soon institute a policy of borrowing not just in public issues, but private placements from banks, trust banks, insurance companies, with discreet syndicates made up just of those investors, particularly in Germany and in Japan. When the oil price increase occurred in the early 1970s, the Bank executed major borrowings from Iran, Saudi Arabia, Kuwait, etc. both in U.S. dollars and in local currencies. The theory was very simple. The Bank chose to open up access to markets even when it did not have to borrow. It had a policy -- and I suspect still does -- of never borrowing when it had to, always borrowing when it did not need to, always borrowing more than it needed and from sources and in ways that others did not. By the early 1970s the Bank had borrowed more in Dutch guilders than it had in the United States because the guilder market was simply open while the U.S. was still worried about capital constraints.

The Bank's liquidity, because of these policies, went from \$1 billion to over \$20 billion. That

meant that the Bank had to develop a quite sophisticated money management operation to manage its petty cash, which was denominated in 20 currencies. I think it is fair to say that it probably became not just the most sophisticated borrower in the world, but the most sophisticated short term money market manager in the international markets. The U.S. market opened up. The Bank issued debt with perpetual maturity and zero coupons (and tried to do both in one instrument), floating rate notes based on Treasuries, currency linked bonds, continuously offered medium term notes.

At one point in the early 1980s, it was probably doing one bond issue or debt issue of some sort once every three days somewhere in the world year after year. That meant that it had to maintain the confidence of a worldwide marketplace. Its earnings soared over a billion dollars; it had a policy, which I hope it still has, of never rescheduling debt. If a country did not pay, it simply stopped disbursing on all loans to that country. Its policy was to build liquidity and reserves. It operated the opposite from a S&L, which as you know in the 1970s and 80s put fixed rate assets on their books and funded them with floating rate liabilities. For the most part, 90% of the Bank's debt was medium to long term fixed rate and it lent essentially at a fixed rate, with periodic adjustments of the rate based on the pooled cost of new debt.

In the early 1980s, the Bank did the first publicized swap. It took three months to arrange it. There may have been one before, but certainly not in connection with a public issue and so heavily publicized. It "invented" the global bond and very substantially expanded its underwriting syndicates in the U.S. and elsewhere. It had a policy of not "bailing out"

commercial banks who had made very foolish loans in Latin America and Asia. It had a policy of not treating investors as adversaries and not playing off underwriters against each other in their zeal to get a mandate and be buried under their own tombstones in their effort to price undercut each other. It wanted investors to be comfortable with the fairness of the pricing. It believed that any debt instrument bought with the World Bank's name on it should fluctuate for one reason and one reason only -- changes in interest rates -- not in a changing perception concerning its creditworthiness and certainly not based on a perception that reflected a doubt about confidence in the Bank's lending operations.

The Bank was then, and I suspect still is, a very tough financial institution. That meant that it had responsibilities as well as obligations. Therefore, when the Bank had to service debt to Iran right through the hostage crisis (because it had borrowed from Iran), it was unthinkable that the Bank would hide behind the restrictions placed by the U.S. government to freeze accounts which would, by definition, prevent an issuer from servicing its debt. The Bank owed interest, and it paid it. Similarly, the Bank expected to be repaid by Iran after the revolution for loans made under the Shah's regime. It consistently received those payments. It expected to receive payments (and did so) from Lebanon despite the civil war in the 1970s. The Bank had, and has, a policy of charging market rates for its loans and not subsidizing those loans. That means that if rates rise and the Bank has to pay more, so too will its borrowers.

The Bank does not play politics. The Bank is supposed to lend to help poor people, build infrastructure, get the money to them and simply make sure that the projects make sense in the

sense that they would, one way or another, serve the poor as intended and increase their standard of living and their prospects for growth.

The Bank's financial policies reflected the fact that it is a closed circle institution, except for the money that it borrows from the private markets. Those funds are then lent and repaid or kept as part of liquidity. No dividends to its shareholders. If the returns on liquidity and loans are insufficient to maintain prudent reserves, the lending rate rises. The Bank could, if it wished, have profits approaching \$2 billion a year. It maintains a somewhat lower level simply because it would be guilting the lily. The money is put back into the business in the form of reserves, the accumulation of which now exceeds \$16 billion.

The Bank, of course, has never sought to change the extremely restrictive ratio of its callable capital to its loans and guarantees -- one to one. From an investor's point of view, an investor should prefer to have callable capital, not paid-in capital. Paid-in capital is put at risk on loans. Callable capital can only be called to pay a bondholder, and it is not available for lending. And, of course, the Bank's basic policy is to make good loans. The reason is very simple. When things get tough in borrowing countries, and they will, and when those countries get in trouble and find difficulty in servicing their debt, those countries may default to commercial banks, they may and will default on their bilateral government loans, they may and will default to the IMF, but they will not and do not, if they have any choice at all, default to the Bank.

I never have had any sense of embarrassment when my banker friends would say, "Gene,

they're not paying us interest on our syndicated loans. We are having to reschedule. Why don't you participate in debt rescheduling -- or at least guarantee that when we make future loans you will stand behind our future loans." Those were both no-nos -- and I assume still are. If the U.S. government or the German government or their central banks want to take steps to protect their banks either through tax policy or opening up their "windows," that is a moral hazard they can take. It is the luxury one has if you can print money. The World Bank does not have such a printing press, and therefore must retain the total confidence of the institutional investor that its policies are not dictated by either politics or some vague notion about the necessity to do its part to maintain the integrity of the banking system. I also have felt that debt forgiveness, certainly for someone not then paying interest or principal, was a theological concept -- "I forgive you my child, bless you" -- not a financial one, as by definition it could have no cash flow effect. You weren't paying before, you weren't paying after. You were just "forgiven." I have never figured out how that accounting concept, which mainly affects the lenders' valuation of its loans, made a defaulting country more creditworthy. Less guilty, I understand, not more creditworthy.

Basically, the World Bank functions as if its enormous callable capital does not exist because, I think, the management knows, and indeed it is the fact, that once one needs to call on the callable capital, although the bondholder always is protected, it, by definition, means the liquidation and dissolution of the institution. That is not a thinkable alternative for the institution. Because all this has been recognized, World Bank bonds now are sold at or about the level of government paper. That is one positive measure of the wisdom of the policies

established by the Bank -- or cynics will say that just shows how the rest of the world has deteriorated.

Right now the Bank's major critics have shifted 180 degrees. It is looked upon as too capitalistic, too mainstream, too market-oriented, too tough, too rigid, too bureaucratic, too risk adverse, and the attacks now come from those who believe small is better, too private sector oriented, and to use an unfashionable term, the liberal and the left. I truly am sorry about that because as one who puts himself precisely in that political category, I know that the Bank simply tries to do the best that it can to help the poorest of the world. That's its job, and that is its fundamental reason for being. Yet it is those very groups who are attached to that constituency which attack the Bank the most. That's a shame given the Bank's responsibility and role and motivation.

I used to be asked, "What can go wrong with the Bank. What should we, the providers of debt, look to as a danger signal." You won't find the answer in the balance sheet or the P&L statement, or even in the pronouncements of its highest officials. What you should be concerned about are fundamental policy changes which would (1) take over the commercial banks' role or subsidize it, or (2) guarantee commercial bank lending, past or future, or (3) indicate the Bank is being politicized under pressure from one or more governments to take care of all nasty situations in the world -- particularly where Parliaments or Congresses do not have the money or the courage to do so -- under circumstances where it would be financially very unwise and imprudent for the Bank to step in. Or, policies which would diminish protection to bondholders

in the form of a reduced callable capital ratio. Or, policies which increase the moral hazard of the Bank by supporting or bailing out imprudent financial or economic policies in the developing world -- cleaning up messes. I also would be somewhat concerned, to a lesser degree, if the Bank's lending were to decline to levels where it made no financial sense for countries to service that debt simply because they were getting very modest amounts on new money.

Ultimately, of course, you all must look to a management -- people -- commitment to those of you in this room -- for you are the only constituency which is not represented inside these buildings, except by the President of the Bank and its Chief Financial Officer -- its Vice President and Treasurer. Just about everyone else represents either other governments or the lending operations of the Bank. These two spokespersons, though, always have supported policies which understand the importance and concerns of the constituency which, in fact, supplies the money necessary to finance the operations of the Bank. You should have total confidence in their integrity and wisdom. And when I say "should," I mean not only that it is necessary that you "should" have it, but that it is, in reality, justified -- and deservedly so.

The Financial Operations of the World Bank

May 1994

Eugene H. Rotberg

This paper focuses on the financing of the International Bank for Reconstruction and Development (the Bank)—the market lending arm of the World Bank group—whose loans are made only to member country governments or under government guarantees. It does not address the Bank's budget, administrative costs, or the financial implications of the various trust funds over which it has control. Nor does this paper describe the financial structure or funding of either the International Development Association (IDA), the so-called "soft loan" window, the International Financial Corporation (IFC), whose operations are conducted solely in the private sector, or the Multilateral Investment Guarantee Agency (MIGA), which provides political risk insurance. The operations of these affiliate institutions which make up the "World Bank Group" are intricately linked to those of the Bank. Their policies and financial resources deserve extensive treatment separately.

This paper is divided into six parts: (1) a brief discussion of the Bank's capital structure and the various "constituencies" affecting its financial policies; (2) the relevance of the Bank's borrowing operations to its lending program; (3) a description of the World Bank's borrowing operations over the last five decades and how their costs are passed on to Bank borrowers; (4) the constraints, political and financial, which have effected the conduct of the Bank's borrowing operations; (5) recent and current initiatives to "leverage" the Bank's financial operations; and (6) prospects for the future.

Constituencies and Capital Structure

The reality is the Bank represents a number of different constituencies whose interests may not be consistent with each other. First, the countries to whom the Bank lends constitute a constituency (and they, too, are made up of various subgroups), each with their own expectations, concerns, and problems. That constituency, understandably, would like long-term Bank loans at low interest costs, with no currency risk and as little conditionality as possible. They would prefer that disbursements be made quickly and that not too many issues are raised about creditworthiness, speed of privatization, fundamental structural reforms, the encouragement of private investment, and, generally, the overall political/economic/physical environment. Many of these countries, unlike as recently

as a decade ago, have access to external bond markets or direct foreign investments. Few, though, have access to the vast sums borrowed in the 1970s and early 1980s from commercial banks. The Bank was formed to service that constituency—to facilitate financial transfers to these client borrowers, to encourage private investment, and to provide quality advice.

A second constituency is made up primarily of industrialized countries who provide most of the Bank's paid-in capital and, more important, provide the callable capital—which, as a practical matter, guarantees the timely payment of interest and principal of Bank obligations.

It may be useful here to describe the Bank's capital structure and, in particular, the unique links between the Bank's shareholders and its creditors. The capitalization of the Bank is not complex, but it is frequently

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misunderstood. Basically, the Bank's equity base is composed of its subscribed capital and its accumulated earnings—its reserves. Its subscribed capital, the largest portion of the Bank's equity base, in turn, is divided into two parts—"paid-in capital" and "callable capital."

Two features of the Bank's subscribed capital are of central importance to its strength as a financial institution. The first is the limit the Bank's capital imposes on its lending. Under the Bank's Articles of Agreement, the Bank's loans (interpreted as its "disbursed and outstanding loans," not its signed loan commitments and guarantees) must not exceed its subscribed capital, "paid-in" and "callable," and its reserves. In contrast to this 1:1 ratio, the risk assets of commercial banks often exceed 15-to-20 times their equity base. Stated another way, the Bank's lending and guarantees are limited by the size of its capital base. Therefore, even if the Bank were to borrow unlimited amounts, it could not, under its Articles of Agreement, disburse those funds on loans beyond its subscribed capital and reserves. In short, the founders of the Bank made a conscious decision to restrict not how much the Bank could borrow, but rather, how much it could lend—and they did so in an extraordinarily conservative way, by restricting Bank outstanding loans and guarantees to its equity base—"dollar for dollar." At the end of FY93, the Bank had about \$104 billion of loans disbursed and outstanding against its subscribed capital—paid-in and callable—of \$166 billion and reserves of about \$14 billion.

The second feature of the Bank's subscribed capital is the distinction between "paid-in capital" and "callable capital." Paid-in capital is that portion of the subscribed capital that is actually paid in by member countries and is usable by the Bank in its general operations. As of June, 1993, paid-in and usable capital represented only about \$7.4 billion, or 4.4 percent, of the World Bank's subscribed capital. It represents the permanent capital "cash" contribution of member governments to the Bank made over its 50-year lifetime.

The Bank's callable capital constitutes the remaining 95.6 percent of the World Bank's subscribed capital. The "callable" capital, unlike the paid-in portion, may never be called or used in Bank operations for disbursements or for administrative expenses. It can only be called for payment to Bank's creditors and can be used only for that purpose. The Bank's Ar-

ticles of Agreement require that it call, to the extent necessary, callable capital only if it is unable to meet its obligations to its creditors in full out of its other assets. In the event of a call on capital, all members must meet the call up to the full amount of the members' subscription. Failure by one or more members to honor their obligations does not relieve any other member from its obligation to meet a call. Moreover, if the amount received on a call is insufficient to meet the Bank's obligations, then it must issue further calls until it has the necessary amount to satisfy its creditors. The callable capital may not be used to make disbursements on loans. That is why the callable capital is, in effect, a guarantee solely for the benefit of the Bank's creditors, who supply the cash resources needed for its lending operations and disbursements on its loans. No call on capital has ever been made by the Bank. Voting power in the Bank is determined by the capital contribution of its member countries. Appendix I sets forth the callable capital liability of the Bank's member countries.

Those member governments, who supply the bulk of callable capital, are understandably concerned that Bank loans be made with care and prudence. They are concerned about the financial integrity of the institution. They do not want their capital called—they tend to be demanding and cautious. Indeed, the industrialized countries, who would have to provide most of the Bank's callable capital, know that the risks of a call of capital relate to the creditworthiness of Bank borrowers since only defaults by the latter to the Bank could jeopardize the Bank's capacity to service its debt to its creditors. They also know, as a practical matter, that they cannot default on their callable capital obligation to the Bank, since their obligation, in effect, is for the benefit of the major institutional investors in those same countries—banks, pension funds, insurance companies—who hold Bank bonds. Indeed, the institutions of the industrialized world who buy Bank obligations look to their own governments, and those of other industrialized countries, to provide a sense of comfort in the form of callable capital. Currently, the callable capital of the 20 industrialized countries who are members of the Development Assistance Committee of the OECD is about \$96 billion, slightly less than the Bank's outstanding debt.

The major industrialized countries, in view of the above, are therefore concerned with the quality of loans, for if these are not made prudently and well, the risks and costs will ultimately be borne by the industrialized countries' taxpayers. These countries, therefore, understandably want loans to be made at market rates, to creditworthy countries, and for projects and reforms which will enable the borrowing countries to service their debt to the Bank. This constituency also wants the Bank to "cover" its costs, build reserves, and generally implement policies which will insure that the callable capital need never be called. That, in turn, means careful attention to the quality and condition of borrowers and the charges levied and risks taken by the Bank.

A third constituency is the Bank's creditors—primarily the buyers of its obligations. They, too, are concerned about the quality of the Bank's loan portfolio. Fundamentally, they are not interested in "development." They do not have to buy World Bank bonds. They are interested primarily in a safe rate of return. They want the price of bonds they buy to fluctuate for one reason only—interest rate changes—and not because of anxiety about the viability or creditworthiness of the Bank. Their support is crucial since, given the small amount of paid-in capital, they supply the vast proportion of funds needed to support the Bank's lending program. For example, in the mid-1960s, the World Bank paid-in capital and reserves were about equal to its outstanding debt. In contrast, the Bank's outstanding debt is about five times its paid-in capital and reserves, and currently, new paid-in capital subscriptions for recent capital increases are running less than \$500 million a year as compared to annual borrowings in excess of \$11 billion. Multilateral development institutions start off with a lot of paid-in capital that inexorably drops as the institution begins to rely increasingly on private sector funds to finance its operations. Bondholders know this and can be quite demanding. They are a constituency to be reckoned with, and the fact that they are not formally "represented" at the Bank makes them no less important.

There is a fourth constituency—the constituency represented by a vast array of institutions and organizations: Congresses, Parliaments, the press, academia, the corporate sector, labor, NGOs who cover a wide spectrum of interests: health, infrastructure, environ-

ment, poverty alleviation, etc. There are groups on the "left" and "right" who both support and criticize the Bank for tilting in one direction or another and who exercise pressure to affect the Bank's operations. It is not appropriate here to detail the various ways this constituency operates; suffice to note that it is powerful and typically at cross purposes with widely divergent views and agendas. It is a constituency whose power is most often felt in the political arena—most notably when increases in capital are being considered, or when IDA replenishments are voted upon by parliaments and legislatures.

The fifth constituency is Bank staff and management. They are often cast in the role of balancing the demands of the Bank's other constituencies—indeed, the constituencies of the World Bank group—while, at the same time, not allowing their own "map of the world" to unduly affect their recommendations and policies. Among other major responsibilities, they must balance the demands (sometimes articulated, sometimes not) of the often disparate requirements of competing constituencies. It is also their responsibility to cope with the constraints placed upon the Bank group—political, market and legal constraints, and constraints demanded by prudence. Management and staff seek to move the institution to specific articulated development objectives with the support of member governments without doing violence to the fair needs and demands of competing constituencies.

The Relevance of Bank Borrowing Operations

The Bank's capacity to lend is now based almost entirely on its capacity to borrow. At the beginning of its 50th year, the Bank's paid-in and usable capital from its member states amounted to only \$7.4 billion. Its reserves (accumulated net earnings after transfers to IDA) amounted to another \$14 billion. The Bank's outstanding loans, however, as noted above, were about \$104 billion. The gap essentially was financed by borrowings which, at June 30, 1993, stood at about \$99 billion outstanding.

As noted above, in annual cash flow terms, the Bank currently receives a few hundred million a year in the form of paid-in capital for new subscriptions to capital from all of its members. It earns, after all administrative and

operational expenses, about \$1.0 billion from its lending operations and the return on its liquidity. Loan repayments by borrowers to the Bank and retirement of its own debt each run about \$10 billion a year, and offset each other. The net result is that the Bank must borrow about \$10 billion a year to finance disbursements. The Bank also has undisbursed loans of \$55 billion—not yet financed—and a pipeline of loans expected to be approved in the next three years or over \$50 billion. Since paid-in capital in 1988 was negotiated at only 3 percent of total capital contribution (and profits are predictable at about \$1.0 billion a year), most new lending and disbursements on previously committed loans must therefore be financed by borrowings in the world capital markets and—to a lesser, but growing, extent—by loan repayments from its borrowers.

All of this is in stark contrast to the 1960s when the Bank's paid-in capital and reserves were equal to its outstanding debt—a 1:1 ratio as compared to a 1:5 ratio today. Thus, in 1968 the Bank had \$2 billion of paid-in capital. Currently, 26 years later, it has \$7.4 billion of paid-in capital—an increase of \$5.0 billion (see Appendix IIA). Its borrowings, however, rose from \$3.5 billion outstanding to \$99 billion outstanding—a \$95.5 billion increase since 1968. The increase in borrowings between 1968 and 1994 basically provided the finance for over \$225 billion of loan commitments (net of cancellations) in the period. And future lending will require the same scale of borrowing. In the early years, the Bank was such a minor lender that it could finance most of its lending by its paid-in capital, retained earnings, and its loan sales. In later years, the expansion of the Bank would have to rely on borrowed funds given the minor paid-in capital and accretions to its net income.

To give further orders of magnitude, the Bank loan commitments in its first 22 years from 1946 to 1968 were \$11.5 billion as compared to the \$225 billion

over the next 27 years. Indeed, the Bank lending for the period 1970 to 1975 was greater than all of its lending in the previous 25 years. Yet at the beginning of that period, no paid-in capital had been received except for the initial \$2.0 billion contribution to paid-in capital in the late 1940s.

The increase in borrowings can be seen in Tables 1 and 2 and Appendix IIA. The Bank's net borrowings in its first 22 years amounted to only \$3.5 billion, its cumulative loan commitments \$11.5 billion, and its net disbursements \$7.3 billion. Over the next 27 years, its net borrowings were \$96.5 billion, its loan commitments were \$225 billion, and its net disbursements (after loan repayments) were \$53 billion. By 1994, the Bank was borrowing in each quarter amounts in the capital markets that equalled its net borrowings in the first 22 years of its existence.

The leveraged use of the paid-in capital also can be seen over time. Shortly after the

Table 1. IBRD Borrowings in Perspective 1947-89
(\$ million)

	FY47-56 (10 yrs)	FY57-64 (8 yrs)	FY65-68 (4 yrs)	FY69-74 (6 yrs)	FY75-81 (7 yrs)	FY82-89 (8 yrs)
Totals for the Period						
Gross Borrowings	1,014	3,065	2,350	8,645	31,010	76,169
Debt Retired & Sinking Fund	164	1,423	1,318	3,748	12,602	38,406
Net Borrowings	850	1,642	1,032	4,897	18,408	37,763
Add: Loan Sales	272	1,506	365	330	532	911
Net Resources Mobilized	1,122	3,148	1,397	5,227	18,940	38,674
Loan Commitments	2,823	5,210	3,586	12,136	44,590	96,450
Gross Disbursements 1,962	4,016	2,837	6,324	22,918	57,795	
Loan Repayments	162	611	727	4,563	5,810	35,332
Net Disbursements	1,800	3,401	2,110	1,761	17,108	22,463
Annual Averages for the Period						
Gross Borrowings	101	388	587	1,441	4,430	10,156
Debt Retired & Sinking Fund	16	178	328	625	1,800	5,121
Net Borrowings	85	205	258	816	2,630	5,035
Add: Loan Sales	27	188	91	55	76	114
Net Resources Mobilized	112	394	349	871	2,706	5,149
Loan Commitments	282	651	897	2,023	6,370	12,860
Gross Disbursements	196	502	709	1,054	3,274	7,706
Loan Repayments	16	76	269	761	830	4,711
Net Disbursements	180	426	440	293	2,444	2,995

(c) In 1960, paid-in capital represented about 50 percent of disbursed and outstanding loans. By 1994, paid-in capital represented only 7 percent of outstanding loans.

(d) In 1966, paid-in capital from governments represented 60 percent of Bank debt. By 1994 it represented only 7.5 percent of Bank debt.

(e) From 1960 through December 1993, Bank paid-in capital rose by about fivefold—from \$1.4 billion to \$7.4 billion. Outstanding debt, however, rose almost 50 times from \$2.1 billion to almost \$100 billion.

Bank was formed, the United States paid \$635 million in 1947 in the form of paid-in capital for the purchase of its shares. The United States paid in nothing more until 1971 and \$1.3 billion since then, resulting in total U.S. paid-in capital of \$1.9 billion by 1994. All other governments have paid in and released only \$5.5 billion over the 50 year history of the Bank, resulting in \$7.4 billion of paid-in and usable capital in 1994.

How has the Bank leveraged its capital?

- Since 1969, cumulative loan commitments rose from \$11.5 billion to \$225 billion (net of about \$15 billion in cancelled loans).
- Since 1969, gross disbursements increased from \$10 billion to \$137 billion.

The Bank Borrowing Program: A Retrospective Look

1947-1968¹

In the beginning, the late 1940s and early 1950s, the only significant market for borrowing operations was the United States. The Bank tapped that market fairly regularly with an annual borrowing presence between 1950-1955, but not

for more than \$175 million during any one of those years. In those years, the Bank was essentially a "dollar bank" with the active support of the United States authorities. Investors looked to the strength of the U.S. guarantee through its callable capital. Yet, even in that early period, the Bank was concerned about the risks of depending too heavily on any one market and establishing the foundations for becoming a global borrower. Its first issues in 1948 had been purchased by investors from Canada, Latin America, Europe, and Asia. European commercial banks became significant and regular buyers of IBRD dollar bonds in the 1950s for their trust account clients. In 1953 some of these banks were included as managers of the Bank's dollar issues, selling about 30 percent of that issue in Europe. In the early 1950s, several Central Banks became purchasers of dollar issues, setting the stage for the Bank's tapping this particular source later in a special, tailored fashion.

The Bank's first issue denominated in a currency other than the U.S. dollar was a Swiss Franc private placement with the Bank for International Settlements (BIS) in 1948. It was followed in 1950 with another private issue of SF28.5 million with the BIS and three leading Swiss banks. Its first public issue outside the U.S. was a £5 million

Pounds Sterling issue in 1951 sold in London through a syndicate of six merchant banks. In 1952 the Bank sold its first Canadian dollar issue and in 1954 also floated its first Dutch guilder bonds. Between 1947-1956, the Bank borrowed about \$1.0 billion, of which \$835 million (83 percent) was in U.S. dollars; \$80.3 million in Swiss Francs; \$50 million in Canadian dollars; \$28 million in Pounds Sterling and \$21 million in Dutch guilders.

The Bank ended its first decade with borrowings of only \$88 million and \$22 million in 1955 and 1956 respectively. It had yet to make its first deutschmark borrowing, and its first Yen borrowing was still 15 years away.

In the eight years 1957-1964, Bank borrowings amounted to over \$3 billion, or nearly four times the annual average level of gross borrowing in the first de-

Table 2. IBRD Borrowings in Perspective FY90-93 (\$ millions)

	FY90	FY91	FY92	FY93	4-YR Total FY90-93
Gross Borrowings	11,440	10,761	11,612	10,793	44,606
Debt Retirement + Sinking Fund	10,055	7,543	12,567	12,639	42,804
Net Borrowings	1,385	3,218	(955)	(1,846)	1,802
Add: Loan Sales	0	0	0	0	0
Net Resources Mobilized	1,385	3,218	(955)	(1,846)	1,802
Loan Commitments:	15,380	16,592	15,256	17,020	64,248
Gross Disbursements:	14,078	11,581	11,727	13,077	50,463
Loan Repayments:	8,132	9,281	9,819	10,646	37,878
Net Disbursements	5,946	2,300	1,908	2,431	12,585

Annual Average For The Period

Gross Borrowings	11,152
Debt Retirement + Sinking Fund	10,701
Net Borrowings	451
Add: Loan Sales	0
Net Resources Mobilized	451
Loan Commitments:	16,062
Gross Disbursements:	12,616
Loan Repayments:	9,470
Net Disbursements	3,146

cade. But annual borrowings fluctuated, shadowing equally uneven lending levels. They rose from \$22 million in 1956 to \$322 million in 1957 to nearly \$800 million in 1961 before collapsing to around \$100 million in 1963-1964. It was a period at the beginning of which investors became concerned about the rapidly-narrowing margin between outstanding Bank borrowings and the United States' share of callable capital—a margin which in early 1959 had shrunk to \$700 million. In those years, the Bank management "sold" the strength of the Bank almost solely on the basis of the U.S. callable capital. Later, that was broadened to include the value of the callable capital of all OECD countries and OPEC countries and still later, on the financial strength of the institution, its reserves, profitability, liquidity, financial policies, and ultimately the quality of its lending operations.

But in 1958, to avert the prospect of a standstill, the Bank's management proposed the first general capital increase. It was approved by the Board within a year, doubling the Bank's capacity to lend. No capital was paid-in at that time. In the period 1958-1964, the Bank borrowed over \$2.4 billion in U.S. dollars, three times the modest totals borrowed in the first ten years. The Bank also launched its first Belgian franc and deutschmark issues (1959) and an Italian Lire issue (1962) with continued borrowings in Swiss francs and less frequent ones in Dutch guilders. Contrary to its earlier expectations of tapping the London capital market regularly, the Bank only did one other sterling issue—for £10 million—in 1960. It was not to become a major borrower in sterling for over 20 years.

The fall-off of Bank borrowing in the early 1960s marked the end of U.S. market predominance in Bank funding. No long-term dollar borrowings took place in the U.S. market between 1962-1963 for a number of reasons. Most important, the Bank experienced unprecedented difficulty in securing the consent of the U.S. authorities for dollar borrowings. Heavy gold losses, accompanied by a sharp rise in the United States' external short-term liabilities, led its authorities to put much more weight on its external account balance when formulating its economic policies and conducting its economic affairs.

Seen in retrospect, the George Woods

presidency (1965-1968) represented an interlude between the Gene Black and Robert McNamara epochs. The first of these established a foundation for a sound and enduring lending institution. The second reached for heights of operational and financial performance which previously had not even been contemplated. During the period 1965-1968, the Bank borrowed a total of \$2.35 billion—an average of nearly \$600 million annually, or about 50 percent above the previous period. As with the earlier periods, no smooth year-to-year pattern was evident. Borrowings increased sixfold between 1964 and 1965, dropped to half the previous year's level in 1966, increased again by 2.5 times to about \$730 million in 1967, and stayed at that level in 1968. The sharp increase in 1965 coincided with the Bank's annual loan commitments crossing the \$1 billion threshold for the first time. But borrowings again dropped back, not to reach that level again until 1969.

This period also saw the first German mark borrowings. With the U.S. running external deficits and Germany generating large surpluses, the Bundesbank and German commercial banks became major buyers of Bank securities. The deutschmark became a prominent currency in Bank borrowings, accounting for 13 percent of total borrowings during that period. Though 1965-1968 saw U.S. dollar borrowings of \$1.9 billion (80 percent of the total—the same ratio as in the previous two periods), the bulk of these were sold outside the U.S. domestic market. By 1965, U.S. Treasury and Congressional resistance to Bank borrowings in the U.S. had hardened and the issue was further complicated by calls being made on the U.S. for IDA contributions. In this period the U.S. insisted that the proceeds of Bank borrowings not be disbursed on loans, but be reinvested in U.S. government bonds as part of Bank liquidity. That condition was left in place for many years. 1968 saw the Bank's first borrowing in the Middle East with a \$15 million issue taken up by the Saudi Arabian Monetary Agency. The only other currencies in which the Bank borrowed during this period were Canadian dollars and Swiss francs, which accounted for 3 percent and 4 percent of total borrowings, respectively.

1969-1979

Robert McNamara's first presidential term began the Bank's transformation from a project-

financing bank into a high-profile, multipurpose development bank. Its borrowing role had to adapt correspondingly—a process which brought new challenges and problems.

In the period 1969-1974, the Bank borrowed a total of nearly \$8.65 billion gross and \$4.9 billion net after debt retirement, a six-year total which was 70 percent greater than total net borrowings in the previous 18 years. This level of borrowing was intended not merely to finance expanded lending, but to build the Bank's liquid assets to higher levels than before in order to insure future financial flexibility and lending. These years also saw the emergence of Japan as a major source of funding. In 1970-71, five placements totalling ¥151 billion were placed with the Bank of Japan. The Bank's first public issue of Yen bonds was launched, and \$332 million equivalent in loans outstanding to Japan from the Bank's portfolio were repurchased by the Bank of Japan. Japan's entry as a provider of resources to the Bank was, therefore, quite dramatic—it accounted for a \$600 million increase, in Yen equivalent, in the Bank's loanable resources in just two years.

With the successful expansion of net borrowings between 1969 and 1974 to three times the annual average amounts of the previous period, net annual average borrowings between 1975-1981 tripled yet again, as did gross borrowings. The increase in this seven-year period, with aggregate borrowings of over \$31 billion—more than doubled the total of all borrowings in the previous 28 years. During this period, OPEC became a significant source of resources primarily from direct private placements with official institutions.

In the period 1975-1981, official and market funding from Germany, Japan and Switzerland provided the mainstays of Bank borrowings, accommodating the shortfalls when other sources dried up. Other European markets were much less important, though the Bank returned to the UK and Dutch public markets in 1981 after absences of ten and five years, respectively. As a result, the shares of these three markets and their respective currencies rose sharply during this period. Indeed, in the early 1980s, the Bank's outstanding debt in guilders equalled its outstanding debt in dollars from U.S. domestic bond issues.

1980-Current

By the 1980s, the Bank had borrowed in dollars (both Canadian and U.S.), francs (both

Belgian and French), deutschmark, lire, yen, dinars (both in Kuwait and Libya), pounds (both Lebanese and UK), Dutch guilders, Saudi Arabian riyals, Abu Dhabi dirhams, Swedish kroner, Austrian schillings, Venezuelan bolivares, Norwegian kroner and ECU. It even borrowed from India. The largest amounts of debt had been raised in U.S. dollars, and in Germany, Switzerland and Japan in their respective domestic currencies. OPEC countries held over \$4 billion of World Bank debt purchased directly from the Bank by the early 1980s. The Bank had only \$400 million of floating rate notes and less than \$3.0 billion short-term paper. The rest was fixed-rate, medium/long-term debt.

The Bank issued "perpetual" bonds, zero coupon bonds, discount notes, bonds with deferred rate settings, "tap" facilities, continuously offered securities, synthetic issues based on benchmarks, global bonds, extendables, retractables, warrants, multi-currency option bonds, and a variety of reset interest rate obligations. Virtually every new borrowing technique and product in the world capital markets was brought to the Bank initially by scores of investment bankers or were initiated by the Bank.

By the 1990s, the Bank had issued bonds or notes privately in Japan, Germany, and Switzerland. A range of syndicates was tapping into specific sectors of the savings markets, banking systems, insurance companies, trust banks, and cooperative banks, whose resources were normally untapped by traditional bond issues. The Bank simply could not rely on any one market or one type of borrowing, given the magnitude of its lending program. The Bank became the largest nonresident borrower in Japan, Germany, and Switzerland. By the early 1990s, the Bank had adopted a conscious policy, out of necessity, of diversifying its borrowings by currency, country, savings sector, maturity, and structure in order to tap into the world's accumulation of savings. It had little other choice. It was bringing to market about 100 different issues a year—one every three or four days somewhere in the world. Not until the huge \$1-2 billion "global bond" issuances in the 1990s did the Bank reduce the number of individual issues in the market.

To sum up, the volume of its borrowing between 1980-1994 led to: (a) the Bank actively exploiting its traditional markets with

substantially larger demands, i.e., the U.S., Germany, Japan and Switzerland; (b) revival of regular and large access to the Dutch market and refinancing of its previous borrowings with OPEC; (c) greater recourse to the Euro and global markets for bonds and notes in a much wider range of currencies and the ECU; (d) more regular resort to the UK market; (e) increasing incremental short-term borrowings on the U.S. money market and from central banks; and (f) greater penetration of nontraditional markets (including those of Austria, Belgium, Canada, Denmark, Finland, France, Hong Kong, Italy, Kuwait, Luxembourg, New Zealand, Norway, Portugal, Spain, and Sweden). For a summary of the scope of Bank borrowings, see Appendix IV.

The Bank began to use currency swaps in 1982. It is generally recognized as the first borrower to develop that market. It did so initially because it was beginning to saturate the capital markets in certain currencies. The currency swap over the years had two major benefits for the Bank:

- it allowed the Bank to continue its policy of diversifying its funding sources into a wider variety of currencies; and
- it served to reduce the cost of borrowed funds by providing cost savings compared to direct borrowings in the target currencies.

By 1993, the Bank had about \$20 billion equivalent of currency swaps on its books.

Interest rate swaps also became an important liability management tool for the Bank since first used in 1986 to create floating rate funding in U.S. dollars. By 1993, the Bank had engaged in about \$15 billion equivalent of interest rate swaps. Swaps had to meet certain key thresholds:

- there was no currency risk to the Bank;
- the costs to the World Bank would not be higher than the cost of doing a direct transaction in the targeted currency; and
- the Bank would not take on undue credit risk on the transactions. The Bank's Board ultimately passed resolutions permitting it to take the counterparty credit risk only with designated commercial banks and AAA corporations.

Prior to 1989, the Bank had entered into swaps directly from fixed rates in vehicle cur-

rencies to fixed rates in target currencies. In 1989, the Bank extended the use of interest rate swaps to the management of its currency swap program, giving it the flexibility to swap into floating rates at sub-LIBOR costs and thereby to take advantage of attractive arbitrage in currency swaps without regard to the absolute level of rates. Interest rate swaps could then be used to spread the Bank's rate fixings within the fiscal year, maintaining scope for phasing the borrowing costs over the course of the year independently of specific capital market conditions.

By June, 1993, the Bank's outstanding debt of almost \$100 billion was denominated in 24 different currencies. It was a AAA/aaa borrower, had debt outstanding in all of the world's major capital markets, and was fully diversified as to currency, country, source and maturity. The weighted average cost of its medium- and long-term debt (after adjustment for swaps) was 6.90 percent. Table 3 (following) shows the currency composition as of June 30, 1992 and June 30, 1993.

Constraints: Political and Financial

The relevance of the foregoing material obviously is significant primarily in the context of its impact on Bank borrowers. First, and most important, it provided the resources to support a massively increased lending program. But beyond that, it had other quite important political and financial effects on the Bank borrowers and on the Bank itself.

Under its Articles of Agreement, the Bank was required to obtain the explicit permission of each government in whose currency or market it intended to borrow. If the Bank borrowed dollars in the United States, it required the approval of the U.S. Treasury for each borrowing; if it borrowed dollars in Japan, it required both the approval of the U.S. as well as the Japanese government. If it borrowed in the Euromarket, it required the approval of each country whose currency was used, as well as the approval of each country whose bankers managed the issue.

The Bank is not permitted, under its Articles of Agreement, to take any currency risk with respect to the currencies which it borrows. Therefore, if it borrows German marks (deutschmark), it cannot legally convert those deutschmark (unhedged) into another currency and lend such other currency. That

meant, in effect, that when the Bank borrowed deutschmark, yen, Swiss franc, dollars or any other currency, it either had to hold those currencies as part of its liquidity, or lend them. That, in turn, meant that—to the extent that a currency borrowed was disbursed to finance the lending program—the borrowers of the Bank took the currency risk for that currency. Moreover, until quite recently, the borrowers had no choice what currency would be lent, as in the early years, the Bank rarely could predict what currency it would have access to by government permission, particularly over the 3-8 year period following a loan commitment in which the funds were disbursed. Indeed, in the early years borrowers had differ-

ent "mixes" of currencies depending on what the Bank was borrowing at the time of disbursement. Later, after the establishment of a currency pool, all borrowers took the same currency risk. Basically, the borrowers, one way or another, assumed obligations only in currencies which could be "exported" and which were freely and readily convertible to pay for goods and services all over the world (and not typically in the country whose currency was being used). As a practical matter, that meant that the Bank, acting as a financial intermediary, transferred the stronger convertible currencies of the world—those more likely to revalue against the local currency of the Bank's borrowing countries. The Bank, by

definition, did not have access to the world's weaker or non-convertible currencies.

The Bank, also, one way or another, had to pass on to its borrowers the nominal costs—the interest rate—it was paying for its borrowings. Its paid-in capital could not subsidize its lending rate. Nor would the bondholders support lending to an institution whose charges did not cover the cost of debt service. While this paper cannot describe in detail the various formulae and changes which occurred over the last 50 years in setting the loan charges to its borrowers, the basic principal was (a) borrow as inexpensively as possible, (b) at fixed rates, (c) at medium to long maturities, and charge the borrowers a modest spread over Bank cost.

Over the years, because of the lag be-

**Table 3. Summary Statement of Borrowings
June 30, 1993 and June 30, 1992 (\$ millions)
Medium- and Long-Term Borrowings and Swaps**

	Medium-and long-term borrowings			Swap agreements			Net Currency Obligations	
	Principal Outstanding		Weighted average cost (%)	Currency swap payables/ (receivables)		Weighted average cost/ (return) (%)		
	1993	1992		1993	1992		1993	1992
Australian dollars	498	689	14.01	(503)	(699)	(14.02)	(5)	(10)
Austrian schillings	274	405	7.89	(68)	(167)	(8.44)	206	238
Belgian francs	483	584	8.47	(434)	(518)	(8.75)	49	66
Canadian dollars	1,718	1,255	9.43	(1,584)	(1,110)	(9.31)	134	145
Danish kroner	122	224	9.93	(121)	(222)	(9.93)	1	2
Deutsche mark	9,127	12,893	7.37	10,129	7,722	7.42	...	...
European currency units	2,431	2,731	8.15	(2,120)	(2,513)	(8.18)	311	218
Finnish markkaa	209	358	9.79	(206)	(354)	(9.81)	3	4
French francs	1,337	1,194	9.24	(807)	(608)	(9.10)	530	586
Hong Kong dollars	271	272	9.41	(267)	(270)	(9.42)	4	2
Italian lire	3,310	4,110	11.06	(3,298)	(4,098)	(11.07)	12	12
Japanese yen	34,173	28,775	5.63	721	941	(7.34)	...	...
Kuwaiti dinars	99	103	7.65	...	...	...	99	103
Luxembourg francs	142	186	7.96	(84)	(93)	(8.21)	58	93
Netherlands guilders	3,184	3,374	7.47	584	827	6.75	...	...
New Zealand dollars	175	177	12.65	(174)	(178)	(12.67)	1	-1
Norwegian kroner	34	41	9.55	...	...	...	34	41
Portuguese escudos	195	249	11.59	(194)	(247)	(11.61)	1	2
Pounds sterling	2692	2,711	9.88	(1,381)	(1,088)	(9.38)	1,311	1,623
Spanish pesetas	1,077	1,245	11.82	(1,064)	(1,229)	(11.83)	13	16
Swedish kronor	279	402	10.66	(278)	(394)	(10.67)	1	8
Swiss francs	5,692	6,717	6.23	4,680	5,867	5.41	10,372	12,584
U.S. dollars	25,013	22,962	8.2	4,030	4,046	8.53	...	...
				(3,158)	(2,506)	(7.66)	25,885	24,502
Principal at face value	92,535	91,657	7.32					
Plus net unamortized (discounts) premiums	(47)	25						
Total	92,488	91,682						

tween loan commitments and disbursements, the interest rate formulae underwent a number of changes. One reason was the long period of disbursement, and the fact that the Bank did not do back-to-back financing of its loans (instead only borrowing partially the amounts that it committed). Suffice to note here that since 1980, all new Bank loans have been charged an interest rate on the basis of the costs of a currency pool—a basket of all currencies borrowed and outstanding. Later, pursuant to targeted ratios established by the Bank's Executive Directors in 1989, the pool was reconstituted through swaps and adjusting the mix of new borrowings so that the currency pool on which charges were based was approximately equivalent to 30 percent dollars, 30 percent yen, 30 percent deutschmark and 10 percent other. That currency pool is now almost \$100 billion, and since its nominal cost fluctuates very little (being primarily made up of fixed-rate debt), the Bank's borrowers have a currency risk of one-third dollars/one-third yen/one-third deutschmark and an interest rate risk based upon the average nominal cost of those currencies outstanding in the pool. The recent lending rate, which is reset on the basis of changes in the pool every six months, is 7.43 percent—a spread of 50 basis points over the after-swap cost of the borrowings in the currency pool.

In February 1993, the Bank's Executive Directors approved a pilot program of up to \$3 billion whereby the Bank, as an alternative to the currency pool loans, offers eligible borrowers single-currency floating-rate loans in U.S. dollars, Japanese yen, deutschmark, French francs, pounds sterling, or a combination thereof. Eligible borrowers for such loans are borrowers and project entities which (i) have a need for a single currency loan to match revenues earned in one or more of the offered currencies; (ii) are managed autonomously of their government and are expected by their government to service Bank loans from their own revenues; and (iii) manage the risks associated with the foreign currency composition of their assets and liabilities. The pilot program will be reviewed by January 31, 1995, or earlier if the \$3 billion limit for the pilot program is reached.

One should not assume from what has been said so far that the Bank's borrowing operations were the result of free and open choice of markets, currency, or timing. The

driving force behind the borrowing operations was the need to obtain funds to support an increasingly massive lending program. As seen above, the lending and borrowing in any typical five-year period at least double that of the previous five years. And yet almost no week went by during the McNamara/Clausen/Conable era in which the Bank was not constrained over its choice of what it wanted to do in the marketplace—except in the late 1980s and into the 1990s. And even now, certain of those constraints still exist.

There were a variety of factors at work. First and foremost was the fact that, as noted above, the Bank needed official permission for each borrowing that it executed. Governments consistently limited when and whether the Bank could borrow in their markets based upon their perceived balance of payments condition, budget deficits, and their perceived shortage of capital. Thus, governments curtailed access by the Bank to domestic savings—and often in an unpredictable fashion. In the 1980s, markets were closed to the Bank for months at a time in Germany with uncertain prospects for the future and for as long as two years in the Japanese capital markets in the mid 1970s. Indeed, even domestic government bond issues had been cancelled in those markets because of the unavailability of intermediate to longer term funds because of unstable market conditions—a result of rapidly rising interest rates. The Bank was denied access to the U.S. capital markets in the late 1960s and early 1970s. It had borrowed only once in the UK public markets during the 1970s, and by the 1980s its previous borrowing in Italy was in 1973 and its only borrowing in French francs was in 1972. By 1982 the Bank's access to markets in virtually all non-dollar currencies was limited to a program well below what the Bank was required to borrow. These constraints were due not only to domestic economic conditions, but also because of a perceived weak foreign exchange position of the currency. Governments knew full well that the Bank required that a borrowed currency be immediately and fully convertible which, in turn, would put yet further pressure on currencies whose values the Central Bank was trying to maintain. That condition was systemic, yet unpredictable, throughout the 1960s, 1970s, and into the 1980s.

Access also was denied or constrained by member governments because of disagree-

ment with Bank management on lending to particular sectors in the developing world which were deemed potentially "competitive" with narrower national interests or because of "geopolitical" differences with countries to whom the Bank was lending. It also was a time of "burden sharing" and "linkage," and the Bank not infrequently was used to make the point that a particular country was doing more than its share in terms of its international burdens and other countries were not. The Bank's access, therefore, to markets in certain currencies was explicitly conditioned by access to the markets in other currencies or countries.

The Bank's access to markets was also affected by the increasing competition from other borrowers with ties to OECD governments, such as other sovereign credits, supranational institutions (European Economic Community, European Investment Bank, European Coal and Steel, etc.) and other development banks whose requirements were also increasing. The authorities in OECD countries had close ties with these borrowers and therefore restricted the number and frequency of World Bank issues so as to permit access to the market by a different "client" base.

OPEC central banks and monetary authorities, which had provided substantial funding shortly after the oil price increases, were reluctant to increase their fixed-rate lending to the World Bank, or to other issuers, understandably preferring short or variable rate instruments such as those offered by the IMF or by commercial banks. Worse, even borrowings from OPEC were considered as borrowings from the domestic capital market of the currency used to denominate the transaction and, accordingly, were "counted" against the Bank's access to that market—on the theory that OPEC loans to the Bank in a particular currency substituted for OPEC purchases of government obligations in that same currency.

Further, none of the major industrialized country central banks was prepared to extend to the Bank medium or long-term fixed-rate loans beyond outstanding amounts held by them in the late 1970s. The volatility of their own foreign exchange positions as well as philosophical questions concerning the role of central banks in financing development did not provide the Bank with optimism that dur-

ing times of financial stress it could increase its borrowings from these institutions.

During the 1970s and 1980s, the Bank also was denied access to markets because of displeasure over the Bank's hiring practices and, in particular, the number and level of nationals from a particular country. Access also was restricted because of disagreements on the Bank's mix of structural reform versus project lending. Access was even constrained because of disagreements and opposition to the Bank's allocation of IDA resources. For some countries, they were unable to permit Bank access to its market without setting a precedent whereby other supranational entities also would demand the same access. Fundamentally, the reason for the Bank's diversity in its borrowings was as much because of the necessity to do so as its wisdom from a financial perspective.

There were also constraints on what the Bank might do with the proceeds of any borrowing. These constraints, in various forms, limited the Bank to holding the proceeds of bond issues, sometimes for prolonged periods, other times for shorter periods, in the United States, Germany, Japan and the United Kingdom. This had the effect of limiting what currencies could be disbursed on loans and which held as part of the Bank's liquidity. The sense of uncertainty as to when access would be restricted or denied, and the form that it would take, never caused the Bank to limit or constrain its lending activities or its pipeline of projects. It was assumed that one way or another the Bank would increase rapidly and efficiently its access to markets which were open, or would draw down its liquidity to meet current and future demands. But that latter argument was somewhat circular for the liquidity itself could only be built up by increased borrowings and access.³

There also were constraints on the Bank's borrowings simply based on staff and management assessment of its nominal cost. At times, even when access was available, the nominal costs were too high at fixed interest rates, or resources were only available at very short maturities—with an unpredictable future cost of refinancing the maturing short maturities, as well as uncertainty whether access for refinancing could be assured. Unlike a commercial bank, the Bank had no "deposit" base which could be relied on to maintain funding. Its loans were long-term and its bor-

rowers, at the time, wanted "fixity"—at least in nominal cost terms. That made the Bank essentially a fixed-rate borrower in the bond markets, not a commercial bank-like intermediary. In any event, since the Bank was a "pass through" institution, too much emphasis on shorter-term maturities, for which access generally was more easily available (particularly during a time of very high interest rates) would cause the Bank's lending rate to rise above the 15 percent level. The alternative (taking funds at fixed rates at 12 percent and 13 percent in, say, U.S. dollars) was equally unpalatable. And there was no way of knowing when that condition would change. The early 1980s was a particularly difficult time when the Bank had on its books \$30-40 billion of undisbursed loans and a massive five-year increase in its lending program. Under the circumstances, the Bank had little choice but to borrow whatever currencies it *did* have access to (at what were then considered to be reasonable nominal rates, and what was believed to be a reasonable exchange rate risk for its borrowers).

The Bank soon found that, given the constraints on access, the high nominal costs in certain currencies, and the exchange rate risk of currencies likely to revalue, they could quickly saturate a market for a given currency. That, too, caused the Bank to choose forms of borrowing which it believed, on balance, would be sufficient to support a lending program, but which it had not yet used too often.

In a memorandum sent to Bank senior management in 1982, the environment was described as follows:

Saturation. Quite apart from the official access which must be given to the Bank prior to executing a borrowing operation, the Bank faces increasing problems in bringing issues to market because of the desire to avoid possible saturation. For example, our underwriters had been reluctant to make a firm bid in the last three months for a Eurodollar bond issue because of our recent and frequent entry into that market. Financial journals, reflecting interviews with market participants, have noted the frequency of our issues in Switzerland and Germany and have speculated about the increasing problem in adding to the debt already outstanding. In 1972, the volume of World Bank borrowings in Switzer-

land represented 5 percent of borrowings by all public authorities (including the Confederation, cantons and cities). In 1981, this proportion had increased to 25 percent. In the period FY79-80, IBRD borrowing volume in Switzerland was equivalent to 67 percent of the borrowings of the Swiss Confederation. The size of Bank public issues has been reduced from the 200-250 million level to 100-150 million in Switzerland. In Germany, our placements with savings and cooperative banks which were designed to be privately placed have recently been resold in the public marketplace, thereby putting pressure on our direct public issues.

We are, in every country in which we borrow, the largest nonresident borrower. Last year the Bank was twice as large a borrower in international capital markets as any other single borrower. Our underwriters in Switzerland and Germany have advised us that, given the size of the respective markets and the frequency and variety of instruments used in our operations, we may have to proceed more deliberately in order not to saturate the market. It is in this environment that we are seeking even greater market penetration.

All of this means that the Bank is forced to fill the gap between its requirements and what it can readily borrow in Europe and Japan with borrowings in the U.S. capital market or in pounds sterling. Even in the U.S., however, there are limits to borrowings in the fixed-rate, medium-term sector. In the period 1976-77, the Bank borrowed approximately \$2 billion in each year in the U.S. capital market during a period when interest rate levels were in the 8.5 to 9.5 percent range. At that time, our underwriters suggested it would be advisable to consider borrowing outside the U.S. capital market so as not to run the risk of saturating the market with the paper of a single issuer. The problem in the United States, however, is made more acute because of structural changes in the market. The fixed-rate, medium-term market is shrinking and the prevailing rates are very high in nominal and real terms. Since the Bank in recent years has used the U.S. capital market as a residual source of funds after tapping as much as possible elsewhere, the increase in the overall size of its program means, as a practical matter, that the U.S. market will be required to supply increasing percentages and amounts of the Bank's program.

Shrinking Medium and Long Term Markets. Long-term markets in Europe have always been fragile. They have dried up almost completely in Canada and the UK. In Canada, there has been only one bond issue of a maturity as long as 20 years in the last six months. In the United Kingdom, only 1 percent of the total corporate funding has originated from straight bond issues during the period 1973-1981. In Japan, the average life of public bond issues, once 12 to 15 years, is now typically below ten years. In the U.S., the evidence is quite clear that the long-term bond market has and is undergoing structural changes in its size, vitality and growth.

There are many reasons for the shrinking fixed-rate, long-term market. The most obvious is the reaction of investors to past inflation and inflationary expectations. As a result of inflation, the financial and real returns from holding medium-term fixed-income securities issued in the mid-1970s have been negative through 1981. For example, on five-year notes, the record of inflation through 1981 shows a negative real return of 3.5 percent annually for notes issued in 1977. Even if inflation were to decline to 6 percent in the next two years, the real return on five-year obligations bought commencing in 1978 would still be negative 1.5 percent. The financial losses in the long-term fixed-income bond market have even been larger. The average annual financial return of holding long-term bonds has been approximately negative 200 basis points during a period in which short term money market instruments gained 8 percent. Losses of insurance companies, pension funds and banks remain on their books. Personal savings have shifted from the bond market to money market funds, equities and real estate speculation. These losses have seriously eroded the fixed-rate market and made investors far more conscious of the risks attendant to long-term fixed-rate investments. The \$4 billion of the World Bank bonds issued in the mid-1970s at a price of \$100 are now on the books of institutions at an average price of \$60.

Neither savings and loan companies nor commercial banks, previously significant investors, are now buyers of medium or long-term fixed-rate bonds. The bond market essentially has become a speculative or arbitrage market fueled by great volatility and risk with participants basically looking for quick profit rather than for a long-term investment ve-

hicle.

The explosive growth of money market funds is a vivid example of changes in investment behavior. Virtually nonexistent in 1975, money market funds have grown from \$10 billion in 1978 to \$184 billion at the end of 1981. Similarly, mortgages are now increasing at floating rates, as financial intermediaries seek to avoid capital risk and to balance their short term and variable rate inflows with similar assets. Commercial bank lending, for similar reasons, is almost exclusively at variable rather than fixed rates. The investment behavior of life insurance companies provides another example, as the ratio of bonds to total assets has decreased since 1978 after steadily increasing throughout the decade. In 1980, the net increase of holdings by insurance companies of foreign government and international agency debt was only \$300 million. Most of the shift away from bonds has been directed into real estate and corporate equity and into specialized cash accounts. In pension funds, too, bond investments have declined in proportion to equity investment, reversing the trend established during the 1975-1978 period.

The problem is further exacerbated by projected U.S. federal deficits—estimated to be \$300 billion over the next three years. In the U.S. Treasury sector, the most remarkable change since 1970 is the rapid increase in medium and long-term issues. In 1970, there was no U.S. Treasury issue of longer than five years. The longest cash issue was for 18 months. By 1981, over \$50 billion was borrowed through such instruments. Similarly, in the state and local government sector, all the issues with a maturity longer than a year increased from \$18 billion in 1970 to \$45 billion.

Cost. The last factor which is troublesome is that of cost. During the last four-five years, when the Bank had a borrowing program of \$3 or \$4 billion a year, it did not have to resort to the U.S. market when nominal interest rates were high. Indeed, about one-half of its program was accounted for by rollovers with central banks of outstanding debt. The balance could be met by borrowing in relatively low nominal cost markets. Given, however, the restrictions on access and the erosion of the medium and long-term bond markets, the Bank could well find itself, even assuming that these factors could be over-

come, having to pay the highest ever rates for much of its borrowing, i.e., 15-17 percent. This is solely a function of the size of the borrowing program. Other development banks with borrowing programs of a smaller scale can limit their borrowing largely to low nominal cost markets and thus keep their lending rates down. The Bank's borrowing program could also be lower by 2-3 percent if it were half its present size and if it did not have to borrow in the United States and the United Kingdom.

Under the present system, the Bank increasingly will find itself in the position of having to lock in borrowing costs for 2, 5, or 10 years at, say, 15-16 percent and pass on those costs to its borrowers for the entire life of the loan—even assuming that such funds were available. The Bank's liquidity does not provide it with sufficient protection since an absence from the markets for a period as short as, say, six months—given the Bank's substantial negative cash flow—will cause the Bank to lose almost half of its liquid resources. Thus, the need to "lock in" medium- and long-term high-cost borrowings occurs because the Bank must borrow to meet its cash requirements—it no longer can wait for markets to "stabilize." It does not have available to it short or variable rate resources and a lending rate system to permit it to intermediate those funds which either (a) cost less (when short term rates are less costly than medium- or long-term rates) or (b) cost the same for a shorter period of time.

That memorandum formed the basis for a major Bank program in the short-term and variable rate markets and for expansion in the swap market.

In addition to the foregoing, all during the 1970s and early 1980s, Bank management was confronted with overcoming indifference or hostility to the Bank on the part of the major institutional holders of bonds. As a result, even when access was available and costs reasonable, the Bank, in the late 1960s and early 1970s, was faced with establishing its credibility, both in a political and financial context. There were investors who did not like the fact that the Bank lent to countries who were not paragons of democracy and who were ruled by military dictatorships or juntas of the left or right. There were those who did not wish to lend to the Bank because the Bank would on-lend those funds to countries who

produced goods potentially in competition with industrialized states. And there were those who thought that Bank lending was simply putting good money after bad. There was resistance to Bank lending which addressed core problems of poverty, health, education, etc. on the grounds that these did not have explicit, visible cash flows and that lending to the Bank would simply support yet another "do good" institution with highly uncertain and suspect results.

There were those institutions who thought that their resources should be used domestically in their own communities for roads, schools, infrastructure, and the private sector. For some, the Bank was too complicated to explain to their supervisory boards. For others, they simply did not wish to lend to the poor or to "foreigners." There was concern about the quality of the Bank loan portfolio and the creditworthiness of its borrowers, particularly during the height of the commercial bank debt crisis.

There also was uncertainty about the commitment of callable capital. There was concern that too high a percentage of the Bank's callable capital was accounted for by countries to whom the Bank was lending—countries whose callable capital bondholders could not rely on should those same countries default on their obligations to the Bank. There was concern that the Bank's capital would not be increased and that, over time, would diminish the ability of the Bank to continue to lend which, in turn, would result in a negative transfer of resources between the Bank and the developing world. Since the Bank had always been a positive net transferor of resources, because of its increasing lending program, the prospect of a diminishment or levelling off of that lending, it was believed, could increase the probability that a given country might default on its obligations to the Bank. After all, it was argued, it is one matter to repay \$100 million in principal where there is a pipeline of loans far in excess of that amount yet to be disbursed; it is quite another to expect interest and principal to be repaid if the industrialized countries choose to restrict the lending capacity to that country by not providing increased callable capital. Recall, the Bank could not lend beyond its subscribed capital and reserves.

There also was concern by some institutions that the Bank was a U.S. controlled and

dominated institution over whom other countries had little impact or influence, while other institutions in the United States believed that the Bank was essentially a "foreign" dominated institution over which the United States had little influence!

Each of these attitudes had to be confronted, then answered—all in the context of uncertain access, high cost, saturation of market, and a massive and expanding lending program. While space constraints do not permit in this paper a description how each of these issues was confronted, suffice to note that Bank management went into each market and to virtually each investor where it had access and "sold" the Bank. It did so, for the most part, by pointing to the safety of an investment from a financial perspective, based not only on the Bank's callable capital, but also on the financial strength of the institution, its overall financial policies, the quality of its asset and liability management, its profitability, reserve policies, liquidity. But most important, it emphasized the quality of the Bank's lending operations—the quality of its loan economists, engineers, project specialists, macroeconomists, and the dedication and care which they applied in making, evaluating and supervising the entire lending process. Bank staff emphasized the importance of structural adjustment reform and a wide range of policies which were designed to insure the quality and integrity of the loans being made and their usefulness in facilitating economic growth. Virtually all of this was done not by the lending staff of the Bank, but by the staff conducting the Bank's financial operations.

Over a period of perhaps five years, incrementally, attitudes began to change toward the Bank. Underwriters and financial institutions throughout the world gave great support to the Bank, even during difficult market periods. Resistance to investing in Bank bonds diminished, new markets opened, access became freer, and the environment became conducive to what we now call a global financial economy. Governments, as a practical matter, began to lose control over their capacity to constrain the flow of savings and currencies across their borders—first involuntarily, then voluntarily—for a whole range of reasons which have been written about elsewhere. The Bank was a major beneficiary. The opening up of markets and the freer attitude of governments toward cross border investments,

particularly in the 1980s, had an effect whose implications went well beyond finance. The Bank, by diversifying its funding, no longer was hostage to any one country for political reasons. (IDA would always remain hostage to political pressures.) The Bank could not so easily be pressured since in earlier, much tougher times it had established its reputation in many different kinds of markets. It turned out it had established so many bases and techniques of borrowing and had achieved a level of independence which, in a very real sense, almost immunized it from inappropriate political pressures. It had privatized in the best sense of the word—not by changing its share ownership, but by increasing the importance and diversity of its creditor base. And that creditor base was guaranteed, for the most part, by a shareholder base domiciled in the same country as the creditors. Moreover, the Bank's liquidity had risen to levels high enough by the mid-to-late 1980s that it could wait out investor or government constraints on access to markets. Soon governments came to realize that the risks and pain of denying Bank access to funding, after loan commitments had been entered into, would be borne not by the Bank or its management, but by their own taxpayers should capital need to be called. Better to let the Bank borrow.

By the late 1980s/early 1990s, the environment was such that in some markets, the Bank's paper became a "prestige" symbol for institutional holdings. In addition, the Bank was exempted from various reserve requirements normally applicable to the risk positions of financial institutions. Institutions could no longer afford not to have Bank obligations on their books. Profits approached and then exceeded a billion dollars per year. Nonpayment on Bank loans were nonexistent, or trivial. Most important, it was clear the Bank was a preferred creditor. It did not participate in debt reschedulings and would not acquiesce in the debt rescheduling of interest and/or principal so endemic in the late 1980s. Nor did the Bank participate in schemes to bail out commercial banks. This, too, raised the credit standing of the Bank since it attested to the commitment of senior management to maintain the financial integrity of the institution. Moreover, it was not lost on investors that the undisbursed loans of the Bank of \$50 billion was a powerful incentive for Bank borrowers to meet their debt service obligations on loans

already disbursed. For a default on one loan would trigger a cessation of disbursements on all loans not yet disbursed to the country.

There were other, more subtle changes in the environment. In some countries, once the Bank was given access to the market, it was assumed—either because of the rarity of such event or the identification of the Bank by the government as worthy of access—that it was tantamount to a government imprimatur that the Bank was a safe investment. Institutions also began to see the Bank, correctly, as facilitating trade and privatization, opposed to subsidies, insistent on macroeconomic reform, structural reform adjustments, realistic exchange rates, etc. All of these were recognized as consistent with their own best interests in a world coming closer together in trade and politics. In short, the Bank, at some magic point (and it is hard to identify even in retrospect exactly when it occurred) had more flexibility than it needed—after so many years of having to overcome an adverse political and financial environment. But that “point” was not clearly seen at the time.

There is also little doubt that the Bank financial staff was on autopilot. Habits were hard to break. It was easier to have scores of bond issues in each of the markets in Switzerland, Japan and Germany, for example, than to have yet another hassle with the U.S. Treasury over access to markets and burden-sharing. And when the United States became more accommodating, Bank management rationalized, in the best sense of the word, that it was “better” not to borrow and disburse dollars. It took the position that it was best for its borrowers that they take on obligations in deutschmarks, yen and Swiss francs. The Bank management described it this way:

The Bank does not take a currency risk on its borrowings... The Bank, however, acts as if it took the currency risk. That is it calculates the implicit revaluation potential of a currency borrowed against the interest differential of other major currencies... One of the principal reasons why the Bank borrowed almost exclusively in deutschmark, yen, and Swiss franc in recent years (referring to the period FY78-81) is that it was our belief that the dollar, given the interest rate differentials vis-a-vis these currencies, was undervalued. This does not mean that the dollar would not devalue at all. Rather we did not believe the dollar would devalue by as much as the interest rate differential implied.

Basically, amongst the currencies available to U.S., we seek the longest maturities at the lowest interest rates in those currencies that are projected to be at the lowest long-term overall cost i.e. after considering the potential exchange rate risk. Although the exchange rate risk... is not assumed by the Bank... we make decisions in choosing among currencies to borrow as if the Bank did, in fact, take the exchange risk... The fact is, at times we would rather borrow Swiss francs at 4 percent than U.S. dollars at 10 percent... we believe the Bank, as a cooperative institution, might be better served by having liabilities at 4 percent rather than at 10 percent. A nominal interest rate differential of 6 percent over 15 years, we believe was greater than the revaluation potential, say, of the Swiss franc against the dollar. Perhaps we will turn out to be wrong. But it should be stressed that our decisions are not made either arbitrarily or randomly... As for the future, as interest rate differentials change amongst currencies, so will our mix of borrowed currencies change also... It may be that the short-term currency appreciation of a particular currency, say, over one year, might, at least in our analysis, exceed the current long-term interest rate differential between two currencies. In that case, we would consider the prospective availability and nominal costs of each and the long-term exchange rate risk before deciding whether to borrow and disburse in one currency or the other.

It turned out that not only did the deutschmark, yen, and Swiss franc *not* revalue, they *devalued*—unexpectedly producing not only interest rate savings, but extraordinary exchange rate gains through February, 1985. While some public calls were made by senior financial staff and consideration given to capturing or locking-in the revaluation gains, for a variety of reasons nothing was done. The gains were lost, and when those currencies revalued against the U.S. dollar, the currency losses substantially exceeded the savings in interest over what would have been the notional rate in U.S. dollars (but, of course, it would have been notional only since the Bank could not have financed the lending program in the first place in U.S. dollars given the constraints described above).

On looking back, it is difficult even now to know precisely why Bank management did not press harder for a total restructuring of the liabilities of the Bank and/or its borrowers when the U.S. dollar was strong in 1985 and the Bank's borrowing constituencies had substantial unre-

alized gains. My sense, looking backward, was that there were a variety of reasons, some articulated, others subliminal:

- the financial complex was not really sure that the exchange rate gains would not continue to grow;
- financial engineering and swaps were in their infancy, and Bank staff were not certain of the costs of hedging so complex a product as the multi-currency pool;
- management believed, based on its experience, that the currencies being disbursed were in the best interests of the borrowers;
- to the extent that hedges were possible, the borrowing countries did not wish to bear the costs out of their current budgets;
- the Bank was not in the business of providing financial technical assistance, a rather arcane subject at the time (as distinguished from macroeconomic advice), particularly since the matter dealt with a condition for which the Bank and its industrialized member governments were responsible;
- major shareholders were concerned that a Bank recommendation, even for hedging purposes, could be construed as the Bank taking a view on the future movement of exchange rates—and therefore a “speculative” activity;
- the cost of protection, should the Bank absorb it, would be substantial—a sort of insurance policy which would involve a major restructuring of the Bank’s entire balance sheet;
- it would have involved the Bank financial staff interfacing directly with borrowing countries in financial technical assistance programs, and the turf and budget battles in the Bank at the time were such that few resources would be made available for such activity; and
- the pressing preoccupation at the time was what to do about commercial bank debt and how to reduce the overhang of unpaid principal and interest facing the Bank’s borrowers.

In short, there was simply no drive/incen-tive—or informed experience—on the part of the financial staff, the senior management of

the Bank, or the countries themselves to en-gage in hedging operations or change the structure of the Bank’s balance sheet. Nor was there an expectation of the future volatility of exchange rates which was to ensue. Indeed, to this day, Bank borrowers, Bank loan offi-cers, and many in senior management do not place a high priority on technical financial assistance for developing countries. Funda-mentally, there is a sense that macroeconomic advice and structural reform measures are more “important,” and therefore need and de-serve more attention than the handling and hedging of foreign exchange risk on external liabilities—a minor part of the borrowing country’s economy.

As noted earlier, by the late 1980s/early 1990s, the Bank took the step of recreating the currency pool on which the charges for loans were based to assure that all borrowers would end up with approximately one-third yen, one-third deutschmark, and one-third dollars. That did not avoid the exchange rate risk. It simply made it uniform, certain and predictable for all borrowers, irrespective of their trade currencies or the composition of their foreign exchange assets.

Recent Innovations

By the late 1980s/early 1990s, the Bank be-gan to take advantage of its credit standing in the markets, the flow of savings across bor-ders, and its virtually unrestricted and free access to markets. It did so by the institution of the global bond in a variety of different currencies. The effect was to permit a bond to be offered for purchase by investors in all major markets irrespective of the currency of issue; the issue was free of any “seasoning” requirements and U.S. tax-related holding im-pediments; clearance and settlement was per-mitted in both Euroclear and Cedel as well as in domestic clearing systems; the issues were of very large size (one billion dollars or more) and had global primary market sponsorship; the placements were worldwide and the obli-gations were available as collateral for repur-chase agreements, etc. These bonds were the primary cause of an even further narrowing of the spread between World Bank bonds and government obligations to about 15 basis points, on average, in virtually every market.

Table 4 following gives an idea of the in-creased value of the World Bank bonds by measuring their spreads against U.S. Treasury

obligations and other AAA financial institutions. It is indeed a remarkable record. It can be attributed to the necessities fostered in the 1970s and 1980s, the imaginative steps taken in the late 1980s and early 1990s to capture the demands of a global marketplace, and perhaps most important, to the recognition of the quality of the Bank's advice and lending operations and the underlying policies underpinning those operations by the marketplace. The Bank could raise in one bond issue amounts which previously took 10-20 issues narrowly focused in specific markets and sectors of a market.

In short, by the 1990s the Bank had reached the point where there was no political or financial constraint on its ability to fund virtually any size lending program and provide tremendous financial technical assistance to its borrowers on both asset and liability management. Indeed, as events in the early 1990s showed, the financial capacity of the Bank far outstripped the demands of its creditworthy borrowers for Bank loans.

The Bank had become such a confident borrower that in recent years it has retired debt before maturity in order to lower costs of the pool of outstanding indebtedness on which its lending rate is based. For the first time in its history, the Bank has become a negative net borrower—that is, despite borrowing programs in excess of \$10 billion annually, it chose to retire over \$12 billion in both 1992 and 1993. The effect of this policy decision has been to reduce the Bank's liquidity and, of course, its loan charges. But the underlying unspoken premise underpinning the early retirement of debt is a sense that the Bank can escalate its borrowings whenever it wishes to, free of restraint. Just as important, it reflects the rather flat level of loan commitments and flat net disbursements (gross disbursements minus loan repayments) in recent years. The reasons for that condition will be subject to considerable public comment and will only be briefly alluded to at the end of this paper.

Leveraging the Bank: Some Initiatives

Before concluding, it may be useful to comment on certain initiatives developed both internally and externally at the Bank, but not implemented, whose purpose was to find alternative ways, apart from borrowing, to encourage private sector flows to the developing world.

Table 4. New U.S. Dollar Bond Issues: IBRD and AAA Financials Spreads Over U.S. Treasuries

Offer Date/Market ¹		IBRD Spread:		AAA ² Financials	Relative Spread: IBRD minus AAA Financials	
		5-Year	10-Year		5-Year	10-Year
		Maturities	Maturities			
June 18, 1980	E	56	...	...	N/A	...
June 24, 1981	E	85	...	...	N/A	...
August 12, 1981	E	114	...	109	5	...
September 23, 1981	E	67	...	116	-49	...
October 22, 1981	D	111	144	121	-10	23
December 8, 1981	D	157	...	129	28	...
December 9, 1981	D	...	171	129	...	42
April 27, 1982	E	76	...	116	-40	...
May 26, 1982	D	...	126	103	...	23
July 20, 1982	E	152	...	109	43	...
July 29, 1982	D	155	...	109	46	...
August 18, 1982	D	133	125	95	38	30
September 7, 1982	E	100	...	92	8	...
January 14, 1983	E	88	68	97	-9	-29
February 24, 1983	D	55	62	46	9	16
May 6, 1983	D	46	46	56	-10	-10
July 21, 1983	E	37	...	48	-11	...
August 24, 1983	E	...	53	55	...	-2
September 23, 1983	E	52	...	33	19	...
January 17, 1984	E	32	...	34	-2	...
February 7, 1984	E	...	49	38	...	11
April 17, 1984	D	55	...	39	...	16
August 17, 1984	E	...	19 3/	34	...	-15
October 26, 1984	E	...	55	38	...	17
December 5, 1984	D	...	66	36	...	30
January 10, 1985	D	65	...	45	20	...
July 2, 1985	E	...	23	38	...	-15
January 9, 1987	E	46	...	50	-4	...
February 18, 1987	E	...	46	45	...	1
April 6, 1987	E	29	...	59	...	-30
July 17, 1987	D	...	51	54	...	-3
September 14, 1987	D	...	68	61	...	7
June 9, 1988	E	39	...	57	-18	...
October 27, 1988	E	...	36	51	...	-15
January 9, 1989	E	...	28	54	...	-26
September 19, 1989	G	...	44	61	...	-17
September 12, 1990	G	38	...	63	-25	...
February 20, 1991	G	...	47	94	...	-47
September 20, 1991	G	26	...	58	-32	...
January 9, 1992	G	...	20	55	...	-35
July 8, 1992	G	12	...	43	-31	...

1/ E: Euro Dollar Issue; D: Domestic Issue; G: Global Issue.

2/ Source: Salomon Brothers; last day of month until 1986; last day of week thereafter. These represent an index of 5- to 10-year bond issues.

3/ First issue following repeal of withholding tax on foreign investors; Euro investors subsequently realized IBRD bearer bonds were exempt from withholding tax in any event.

Guarantees

The first of these was the use of guarantees. At Bretton Woods, the original conception was that the World Bank, given its unique capital structure, would be less a lender and more a guarantor to catalyze private capital flows. But that concept disappeared quite quickly, and the Bank essentially became a project lender in the 1950s and financed itself, as described earlier, in the bond markets. Nonetheless, from time to time, and particularly in the 1980s and again, more recently, initiatives were floated that the Bank should guarantee third parties as an alternative to financing itself in the world capital markets. These suggestions ranged from (a) the use of the Bank's guarantee power directly to support a generic bond issue of a developing country, or (b) a guarantee of the interest and/or principal of a new commercial bank loan—or an old one—as a precursor for new commercial bank lending.

These initiatives were considered and, for the most part, rejected, particularly during the negotiations in connection with the international debt crisis of the late 1970s/early 1980s. The “guarantees” concept later took on a more subtle form in that initiatives were broached whereby a default on, say, a commercial bank loan, would be treated as equivalent to a default on a World Bank loan and would therefore trigger a panoply of World Bank penalties—specifically, no new loans from the Bank and a cessation of disbursements on old loans—even though there had been no default to the World Bank itself.

Initiatives also were raised for joint/parallel financing arrangements in which any payment made which was insufficient to meet the full interest and principal due to the private sector would be considered a shortfall to be shared pro rata between the parties, even if the Bank were paid in full. Since, by definition, this would result in a shortfall to the Bank, it would thereby create only a partial payment to the Bank—a default, which, in turn, would trigger the full panoply of Bank sanctions. With few exceptions, until recently there was a considerable reluctance for Bank management to accept these types of initiatives for a variety of reasons:

- There was little leverage in the proposals since guarantees counted against the Bank's callable capital from the first date that the guarantee could be called. This meant that

the Bank might as well make and disburse a loan as guarantee someone else's for purposes of its capital constraint.

- The Bank staff was not of a mind to give blank checks or guarantees to either the LDCs or commercial banks for lending on unknown or uncertain projects in which the Bank itself was uninvolved in the supervision of the project and/or providing structural adjustment advice. And, the staff argued in the 1980s, if it were so involved, it did not need the commercial banks' participation. And, if it were required (because the size of the proposed loan was too large for the Bank), there was no feasible way to distinguish among banks, projects, countries, etc.
- Bank management also was concerned about the political implications of being tarred with a brush of “bailing out” commercial banks for old loans, or in a highly selective and arbitrary fashion, guaranteeing new ones for certain banks in certain countries on an ad hoc basis, to “encourage” banks to keep on lending. If member governments thought commercial bank lending to LDCs should be guaranteed, that was a political choice (and an unlikely one given upcoming elections in the U.S.) that national governments should take—not the Bank.
- The institutional holders of Bank bonds were not particularly enamoured of the idea that their funds might be put at risk to support the lending of commercial banks. It had been enough of a hassle to convince these institutions to support lending directly to the developing world with the panoply of World Bank protections. They were not in the mood, at the time, to provide resources to the Bank if its strength might be diluted by a commercial banking sector which, it was believed, did not make loans with the same discipline as did the Bank.
- There was also a sense that the Bank should not be reduced to an institution which would use its capital structure to provide financial incentives to third parties in the commercial banking sector. Inevitably it was believed that would diminish or make irrelevant what many considered the Bank's greatest asset—the quality of its economic advice.

- There was considerable concern that the Bank might lose its preferred creditor status, or might be drawn into debt rescheduling negotiations, particularly under proposals whereby the Bank would be forced to take sanctions against a borrower even though the borrower was current and meticulous with respect to its debt servicing to the Bank.

In short, Bank management did not wish to use its guarantee power and/or expand joint or parallel financing in a way which would tie the Bank's fortunes to the myriad relationships between the developing world and commercial banks.

These attitudes caused a good deal of hostility, to say the least, between the commercial banking sector and the World Bank. In reality, it was really not a crisis for the LDCs (they had simply stopped paying their commercial bank debtors), but a crisis for the financial integrity of many of the world's banking institutions. The World Bank for its part took the view that Central Banks had the responsibility, along with depositary insuring agencies, to take care of bank depositors and the integrity of commercial banks. That was not the role of the World Bank, which was financed, not by depositors, but by bondholders, whose continuing and growing support would be needed to make new loans. Indeed, the World Bank was not even permitted to borrow from the U.S. Government, the Federal Reserve Bank, or from any U.S. Government entity, under its Articles of Agreement. The bottom line was that Bank management felt that they could not take the risk that Bank bondholders might be damaged in the same way as were commercial bank shareholders, but in the latter case, so long as there were depositors, the commercial banks could continue their operations—and they have, despite the international debt crisis. But if Bank bondholders were damaged because of calls on the guarantees, that could irreparably damage the quality of the Bank and, in the extreme, if guarantees were issued and called in amounts even approaching the defaulted LDC principal or interest due to commercial banks, that could prompt a call on the Bank's capital—which would be tantamount to the winding up and bankruptcy of the institution itself.

Moreover, there was, and is, a good deal of confusion between the impact of guaran-

tees, the various forms of cross-default clauses, and loan sales (in which the Bank remained lender of record) on the 1:1 ratio and on the Bank's preferred creditor status. Moreover, the environment in which these subjects were first raised—the international debt crisis—conditioned the discussion of these subjects, and positions once hardened have been difficult to change. Nonetheless, on selected cases, the Bank has engaged in a variety of credit enhancement measures and has guaranteed from time to time the later maturities of commercial bank loans for specific projects. But these, for the most part, if not exclusively, have involved a careful World Bank appraisal of the quality of the project and the creditworthiness of the borrower.

These partial guarantees have been used to supplement World Bank direct lending. In addition, there have been some initiatives whereby the Bank would "take out" a private lender, which would provide the lower cost, LIBOR-based funding during a construction period on an infrastructure project. This is attractive to borrowers because it provides a less expensive initial cost and also offers the commercial bank an assurance that it would be made whole at the end of the construction period.

There remains, however, lingering resistance to these kinds of operations, particularly to the extent that they are not counted by management and staff, and indeed the outside world, against a targeted lending program. As a result, there still remains internal resistance to taking initiatives where the catalytic effect may be obvious, but not on the "books" of the Bank. That is part of the Bank culture which surely can be addressed.

Recently, the Bank has been considering government "performance guarantees," whereby the Bank would guarantee the interest and/or principal of a third party private sector loan only if the borrower in question failed to meet or keep its commitments with respect to specific contractual obligations, such as tariffs, the maintenance of a particular regulatory structure, charges, etc. But these fundamental obligations on the borrower (a) would be World Bank designated, (b) would involve risks which the Bank would have assumed directly through its lending, (c) would be incorporated into a World Bank loan, and (d) if the guarantee were triggered, the Bank would claim against the borrower. Again,

these guarantees are not a guarantee of the commercial success of a particular project, but are only guarantees of articulated, quantifiable practices by the borrowers. The Bank might provide such guarantees to compliment what IFC and MIGA are able to do on their own. While there is significant interest in this initiative in the financial community and among private investors, it remains to be seen the extent to which these kinds of operations will be implemented and in what magnitude. There also are formidable internal "bureaucratic" issues to be resolved if the program is to develop beyond ad hoc or "one off" transactions.

There is little doubt, however, that guarantees have some significant advantages over making straight loans—even single currency ones. The primary advantage is that guarantees can be "fine-tuned" and addressed to a specific issue which might be troublesome to private sector investment. The use of guarantees in a targeted fashion can therefore have a significant catalytic effect (probably with less risk than a full-fledged loan), particularly in bringing in external finance. Moreover, if used wisely, the use (or disuse) of guarantees can encourage governments to make selected reforms as a condition to bringing in needed private investment. Thus, the Bank is prepared to offer a guarantee for the benefit of the private sector which would assure that the government, or a parastatal, would institute necessary reforms, say, fair charges for electric power or reduction of state employment in that sector, as a condition for private investment. Indeed, there are many cases where governments might acquiesce to such reforms simply because the private sector would not bring in capital or expertise otherwise.

In any event, guarantees will have little impact on the one-to-one callable capital constraint, or the timing of the next capital increase, as they must be counted against the capital constraint from the first date that the third party has the right to call on the Bank for payment. Nonetheless, there is likely to be some argument that a guarantee should be "counted" against callable capital in probabilistic or actuarial terms rather than on a 1:1 basis from the first date of a potential call. The impact and propriety of such leveraging will, yet again, be a matter of controversy within the Bank. To put it mildly. The heart of the issue is that the Bank's Articles do not

permit a calculation of the "probability" of arrears in assessing Bank exposure for purposes of calculating its 1:1 ratio against loans. And loans are not treated differently or separately from guarantees in the Bank's Articles of Agreement.

Changing the 1:1 Ratio

As noted above, the Bank's Articles of Agreement limit the Bank's outstanding loans (disbursed) and guarantees to the total of its subscribed capital and reserves. From time to time, most notably as early as the Brandt Commission Report, and as an alternative to a capital increase, there has been talk about changing that ratio so that governments would not have to provide more callable capital—but the Bank could make more loans. Such a change, it has been argued, would permit the Bank to disburse and/or guarantee two, or perhaps three or more times its subscribed capital and reserves without further capital increases.

That initiative, too, has not been implemented for a variety of reasons. Since each Bank prospectus used in offering its obligations explicitly tells the bondholder that the Bank's risks (its loans and guarantees) are covered on a one-to-one basis, there would arise the likelihood—indeed, the certainty—that a bondholder would bring suit against the Bank for a false and misleading prospectus—having bought the bonds on that assumption. The Bank, of course, in response would argue that the small print in the prospectus notes generally that its Articles can be changed by vote of its shareholders—without reference to this particular section. No one was prepared to take on the possibility of a lawsuit and to assure that the Bank would win it, particularly since the staff of the Bank, in hundreds of articles and speeches, emphasized the 1:1 protection to the Bank's proposed creditors. And even should the investors lose in their claims against the Bank, it was suggested, that would not be an event which would encourage them to finance, each year, \$10-15 billion of new obligations—under a diminished statutory protection.

Moreover, even though the Bank was "sold" on the basis of factors other than the underpinning of its callable capital, it did not follow that if that underpinning were removed or weakened, the remaining financial structure would be sufficient to attract the huge resources needed from the market each year.

And, it was not just a question of the "cost" of such resources. It was not likely the volumes could be achieved, at any realistic cost, if the Bank were, unilaterally, to reduce the protection it offered to its bondholders.

Further, there was no need to change the one-to-one ratio. The Bank had, and still has, "headroom." Indeed, as of this writing, the Bank's disbursed and outstanding loans and guarantees are less than 60 percent of its current statutory upper limit. And current projections of disbursements on existing commitments as well as those on future commitments yet to be made are such that the Bank probably will not need another infusion of capital until around 1997. And if it is not forthcoming even then, the Bank would be able to sustain a lending level at or about current levels *ad infinitum*. (This is not to say that that is a positive development since it means, in effect, given loan repayments from borrowers, that the Bank, over time, would no longer be a net transferor of resources to the developing world. That, in turn, could have adverse consequences to its borrowers and therefore to its credit standing. But that, too, is another subject which goes well beyond the scope of this paper.)

Moreover, the maintenance of the one-to-one capital to loan and guarantee ratio was deemed proof of government support from the industrialized countries. Indeed, as pointed out earlier, government support in the form of actual paid-in capital to the Bank (as distinguished from IDA) is *de minimis*—it having been reduced from 20 percent paid-in capital (80 percent callable) in the early years to 3 percent paid-in (97 percent callable) for the 1988 general capital increase. Under those circumstances, changing the 1:1 ratio would be deemed evidence by the markets of a lack of political support for the institution and its role—and an irrational one at that. Indeed, Bank management had shown that the institution could conduct its financial affairs, the handling of its financial assets and liabilities, its lending, and its economic advice in an extremely prudent fashion. Moreover, the Bank's borrowers themselves had, even under periods of tremendous stress—particularly in the 1980s—met their obligations to the Bank almost without exception in a timely and meticulous fashion. There was, and is, therefore, little, if any, risk that an increase in callable capital to support an increase in its lending

program would jeopardize or add to the risks taken by major shareholders through their callable capital commitment.

Despite all of the foregoing, it is likely that a future capital increase will not be easy to come by, and as the time approaches for a capital increase, the prospects for changing the ratio or having a less "restrictive" interpretation of its use of guarantees will again reappear. At that time, the use of guarantees may be seen as giving the Bank, in the short run, more effective capacity than straight disbursements. That would put the Bank in a game of "Russian Roulette." Of course, if the 1:1 ratio were breached because of the extensive use of guarantees, all disbursements to borrowers on perfectly serviced Bank loans, even if no guarantees were actually called, would have to cease to assure compliance with the Bank's Articles. In a real sense, therefore, it would be the developing world which would bear the risk of too aggressive off-balance-sheet financial engineering.

The World Bank "Bank"

Mention should also be made of a proposal to establish an affiliate to the Bank—a World Bank bank—which would be capitalized by an investment by the Bank, IFC, and, perhaps, private banks as a deposit-taking institution. The deposits would not be backed by the callable capital of the Bank, but rather by the Central Bank wherever the affiliate was domiciled, or possibly several central banks and/or lines of credit from the World Bank itself.

It was designed to raise funds exclusively in the shorter-term markets and thereby tap into the pools of savings in that market. The idea was to do joint and parallel financing with other commercial banks on World Bank appraised projects with appropriate cross-default clauses. It was, in short, a financing/legal vehicle whose structure was designed to insulate the World Bank's credit and creditors while encouraging increased commercial bank lending without affecting the World Bank's callable capital. (It makes little sense to provide scarce callable capital to attract short-term deposits.) The affiliate also would have the capacity to lend and guarantee to the private sector, and in amounts greater than the IFC could handle. This paper is not the place to describe the detail and rationale for the proposal. A very significant amount of work was done on the concept in the 1980s.

Ultimately, the Bank's Board of Executive Directors decided not to go forward with the proposal, mostly because it could have jeopardized the difficult and tenuous negotiations concerning a capital increase, since the affiliate could have provided an alternative way of financing development without the need for a capital increase. I believe its use today would be somewhat different from what was envisioned in the 1980s. But it still could have particular attraction as a vehicle to "marry" the operations of the IFC to those of the Bank, and to systematize the use of guarantees or credit enhancement in a manner which could avoid many of the policy issues referred to earlier.

The Bank still has immense credibility, access, and leverage with governments to implement fundamental reforms which IFC does not possess. That subject—how the Bank group's financial, macroeconomic, and appraisal skills might be mobilized, through such an affiliate, to attract private sector venture capital and loans (as distinguished from blank check commercial bank loans) beyond the financial and legal capacity of IFC or MIGA—is a subject well beyond the scope of this paper, but whose importance is fundamental to the future role of the Bank. At its core, it relates to how the Bank group's financial strength and flexibility might be leveraged—without damaging the good will and support of its creditors and shareholders. This brings us to the final section of this paper, which focuses on how the Bank's financial structure might be made more flexible to achieve its objectives through less dramatic, but quite important measures.

Prospects for the Future

There is no doubt that the Bank's financial policies, its access to markets and its credit standing are such that, after 50 years, there are now few constraints on its ability to deliver, both in quantity and quality, a financial product which meets the needs of its borrowers. Nonetheless, net disbursements on Bank loans have fallen significantly since 1990 (admittedly an aberration year). More importantly, loan commitments in the four years FY90-FY93 have shown only modest increases, with the prospect that in the next year or two, loan commitments may barely average that of the previous four years (see Table 2 and Appendices IIB and IIC). Indeed, these

currently might be at the lowest levels since the late 1980s. This phenomenon will be dissected and disaggregated by region, country, and type of loan, and there will undoubtedly be academic, political and editorial comment. Bank management will defend itself and will lay out the following reasons for the lack of substantial growth of its lending operations:

- Certain borrowers are not creditworthy for market-based loans, particularly in Eastern Europe and Africa. The Bank will argue persuasively that it cannot provide financial support to borrowers whose political, economic, and financial condition is such that loan commitments would involve excessive credit risk if financed by the private capital markets.
- For some borrowers there is no need for Bank loans. They either have access to capital markets, commercial bank loans, or private equity investment.
- There is greater government budgetary discipline in many countries which reduces the amount of external debt that a responsible government is willing to take on.
- There has been a shift to the private sector, even for infrastructure—a result of widespread privatization—which makes Bank lending, at least in its traditional format, not responsive.
- There is a reduction of subsidies, and, therefore, a decreased reliance on parastatal infrastructural projects.
- Some countries are unable or unwilling to meet the Bank's demanding conditionality and its economic structural adjustment reform requirements.
- There are increased red tape and bureaucratic constraints in borrowing countries arising from the pluralistic nature of emerging democracies which make difficult final clearances of loan commitments.
- There is less pressure on Bank staff to meet annual loan targets.
- Finally—and perhaps not so readily admitted—the Bank's financial product is simply not flexible or suitable enough for many borrowers who have alternative ways—less risky and less complex—to finance their needs.

In this connection, the cancellation rate of loans already committed is no longer in-

significant and is a proxy of sorts, perhaps precursor is the better word, of future lending and disbursements. Bank borrowers have now cancelled over \$21 billion of loans committed but not yet disbursed, of which \$3 billion were cancelled in FY93 alone and more are being cancelled at an even higher rate this current fiscal year. Some of these cancellations simply represent "dead wood" projects which, though approved, could not meet the preconditions for their implementation. These are being taken off the Bank books. Others are being cancelled for a variety of reasons set forth above.

It is difficult for the outside world to know the importance of each of the foregoing reasons for the levelling-off in loan demand—which reasons are overstated, and which really account for the levelling of demand. Undoubtedly it will vary from country to country and from region to region. The outside world will say, unfairly, the Bank is not doing its job. It will not escape notice that the Bank net disbursements (gross disbursements less loan repayments) in the last several years are averaging less than half the levels of the early-to-mid 1980s. The Bank will, yet again, have to defend itself and will have an image problem. Certainly the matter will not be resolved by endless speeches on the so-called dilemma of addressing poverty elimination versus economic growth, or yet another unnecessary reorganization or attitude survey. Nor will it be useful to debate whether the Bank's most important "product" is its economic advice or the actual resources it transfers—or whether one can be done without the other. What is clear is that the Bank has the expertise, motivation, idealism and the delivery systems to increase its lending and disbursements, and with it, the delivery of sound economic advice.

I would suggest that, at the least, the Bank must create a more flexible financial product. The latest initiative—to permit borrowers, under quite narrow conditions and for modest amounts—to choose a floating-rate loan in designated currencies, is not enough. Many borrowers have complained to the Bank that they are unable to pass on the currency risk to their sub-borrowers because of the risks, the complexity of the formula, and the difficulty of hedging that risk. Other Bank borrowers have simply taken on the fixed-rate

currency basket and passed on a LIBOR-based, dollar-denominated cost to their sub-borrowers—an expensive choice. Inexorably, this makes Bank loans unattractive for governments. Indeed, some borrowers have already indicated that the Bank should expand the use of its guarantee power or credit enhancement, solely because the Bank's financial product is so awkward. Rather than cope with this awkwardness, borrowers would prefer some form of credit enhancement whereby they would borrow the currency and achieve the fixity of rates it wants. It would, indeed, be unfortunate if the Bank were reduced to guaranteeing loans because its financial products were too rigid. Assuredly, that would reduce the Bank's leverage in providing and insisting on structural reform and economic initiatives.

The borrowers should be allowed to choose (a) the currency among at least a half dozen, (b) its rate fixity, and (c) a maturity range and amortization schedule more closely aligned to what they need. There is little doubt that the Bank has the financial capacity and expertise to develop a system to match the currency, maturity and interest rate risk implied by such flexibility. And the Bank can borrow and pass on its costs, plus a profit margin, well below what the borrowers are paying currently for fixed-rate funding in the capital markets.

While this kind of initiative may not yet be on the front burner, there is little doubt that unless the Bank changes its financial product, it will soon find, given the access of borrowers to alternative ways of financing, that it will become a side show for many borrowers. The Bank, however, does have a somewhat "paternalistic" attitude toward these matters, and probably is concerned that its borrowers will choose the "wrong" currency. They are likely to ask for short term, interest sensitive charges, rather than the more costly fixed-rate obligations. Bank lending staff, in any event, should better understand the financial terms and conditions of loan agreements, educate its borrowers who are not already fully aware, and pressure senior management for a more flexible product. The Bank also should address the subject of counterparty risk on swaps (a subject related to the above) who bears the cost, and in what manner, so that borrowers might be able to insure against both the interest rate and currency risk.

In Conclusion

The Bank is the strongest financial institution in the world. It has the flexibility to change the products it delivers. The quality of its macroeconomic advice has no parallel in the world, and it is respected by the constituencies which it serves. Most important, the motivation of Bank management and staff is to do the right thing. That does not mean they are infallible; it does mean, though, that they want to make a difference, in the best sense of that word, in the conditions of those who live in poverty or under conditions of diminished potential. It is rare in the modern world that an institution of this sort exists, staffed by such committed people with highly sophisticated expertise and relatively few political

constraints. The Bank's leadership must use the Bank to make a difference, and truly there are fewer constraints now to the execution of its role than in recent decades.

While I am quite aware that reorganizations, management structures and budgets are important subjects, they cannot preoccupy the management and its Board of Executive Directors. The Bank group has many options—some complex, structural, and difficult (like setting up an affiliate institution), others less complicated—which it can implement to deliver a product. This product, both financial and advisory, could take advantage of the expertise and motivation of the Bank's management and staff. It remains for management to lead.³

End Notes

¹ The author expresses his indebtedness to Percy Mistry, whose paper, "The World Bank's Role as a Borrower," is used almost verbatim in this section describing the years 1947-1980.

² This paper does not address the issues surrounding the Bank's liquidity policy and the management of its liquid cash resources. The Bank's liquidity—its cash resources at any given time—represents the partial funding of its future cash flow requirements. Unlike a commercial bank, which disburses quite quickly after making a loan and whose funding is based on a deposit base, Bank commitments are disbursed, typically, over a three-to-seven year period and funded in the fixed rate markets. As a result, the buildup of the Bank's liquidity reflected its need to make disbursements on loans already committed (those undisbursed loans now are in excess of \$50 billion) and, of course, its projection of new loan commitments over the next several years, which ultimately also will have to be disbursed. A variety of formulae and financial policies were developed to set that liquidity in a prudent manner. The Bank's liquidity rose from less than a billion dollars in the late 1960s to over \$22 billion by the late 1980s and into the 1990s. Moreover, just as important, the liquidity was managed with a great deal of care and sophistication, and, indeed, the techniques used to manage Bank liquidity were just as complex and innovative as were its borrowing operations. The cost of the borrowing operations, of course, were passed on to the Bank's borrowers. The return on liquidity, however, went straight to the bottom line of the Bank's profit and loss statement and effected its capacity to build reserves, and therefore lower its lending rate or other charges to its borrowers. The holding of liquidity, even though "committed" to future disbursements, gave the Bank the flexibility to stay out of markets during unstable conditions and also permitted a further degree of political independence when market access was at times restricted. A full description of these important matters would require a paper as detailed as this one and is well beyond the scope of this paper.

³ My thanks to the staff of the Bank and the Brookings Institution (The History of the World Bank project) who supplied the tables used in the text and appendices. My appreciation also is offered to those in the Bank and outside who have offered their suggestions on the text. The recollections, analysis, and conclusions, however, are mine, and any errors of fact or interpretation or balance are mine alone, for which I take sole responsibility.