

# The Functions of the IMF & the World Bank

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The International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), also known as the Bretton Woods Institutions (BWIs), were formed in Bretton Woods, New Hampshire in 1944 on the eve of the end of World War II. They were precursors to the United Nations and other multilateral institutions formed after World War II and reflected the new spirit of cooperation between nations, especially in economic matters. As you will learn in this E-Book, the operations of the BWIs have had an important impact on concepts of development and development policy.

The first three parts of this section discuss the events leading up to the Bretton Woods Conference. They will explain how at the founding of the IMF and the IBRD the founders were not directly concerned with "development" as we know it today. They were more concerned about avoiding behavior among nations that led to economic catastrophe and war and they also wanted to prepare for the economic problems they believed would confront them after the end of World War II.

In the fourth section, we will describe the functions of the IMF. You will learn about key concepts relating to that institution, such as "par value" under the fixed exchange rate system, "surveillance" after the collapse of the fixed rate system, "convertibility," and "conditionality." Although these terms may not strike you as important to "development," they are in fact integrally tied to your well being and your country's economic, even cultural, future.

The last section describes the function of the IBRD, which, along with the International Development Association, is known as the World Bank. The World Bank was an "afterthought" at the Bretton Woods Conference. Established initially to assist with the reconstruction of war-torn Europe, the IBRD has become deeply involved in developing countries. Because other portions of the E-Book will cover World Bank activity, this part's section will be limited to a brief discussion of the IBRD and its affiliations with the World Bank Group.

As you read this section, ask yourself whether the functions of both institutions made sense for the period spanning the 1940s to the early 1980s. Of course, the question is

whether the IMF and World Bank are useful in today's world. Part Three of the E-Book will help you think about the last question.

### *A. The Rough Road to Bretton Woods: Looking for Stability and Growth*

Those who attended the Bretton Woods Conference in New Hampshire wanted to establish a monetary system that would prevent the repetition of the chaos during the inter-war period (1918-1939), which was marked by high inflation, restrictions on international trade and payments, speculation in the foreign exchange market, sharp movements in central banks' foreign reserves, wildly fluctuating exchange rate movements, gold shortages, and sharp drops in economic activity (deflation). To accomplish stability and economic growth, the founders of the IMF agreed upon a "gold exchange standard." The reference to gold is important, so let's review a bit of history before we explain the Bretton Woods System in more detail.

#### **1. The Gold-Standard System was Supposed to Operate Automatically and Maintain Economic Stability, but it Failed to Do So.**

The system agreed upon at Bretton Woods was related to the gold standard period between 1870 and 1914. Many hoped the BWIs would restore the perceived order of the gold-standard system, minus the standard's problems. That international monetary system required that each unit of a country's currency represent a certain weight of gold—i.e., central banks were required to keep an "official parity" between the country's currency and gold. Maintaining the official parity required central banks to keep adequate stocks of gold as "reserves."

The objective of the gold-standard system was to encourage countries to maintain sound economic policies. If they failed to do so, gold would flow from one country to another, which could cause deflation in the country losing gold or inflation in the country receiving the gold. For example, if a country was importing more than it was exporting—i.e., running a current account deficit—but not receiving sufficient loans from abroad to pay for all of the imports (the proceeds from exports help pay for some of the imports), the central bank would start losing gold reserves. This was supposed to set off a chain of events that would cause prices to decrease and ultimately result in a reduction of imports and an increase in exports, which, in turn, would reduce the current account deficit. The country experiencing the corresponding current account surplus (for every country with a current account deficit there is a country with a matching current account surplus) would experience the opposite effect.

In theory, the gold-standard system was supposed to operate automatically, requiring little government cooperation between countries or their central banks. In fact, the "rules of the game" did not work as smoothly as expected (for example, prices did not drop easily) and countries frequently violated the rules because they did not want to risk unemployment or inflation. And experience demonstrated that the burdens of adjustment under the standard fell disproportionately on deficit countries, which pursued policies that unnecessarily caused economic pain in order to preserve gold reserves.

## **2. During the Inter-War Period, Countries Pursued Policies that Led to International Economic Chaos and War.**

After World War I, during the inter-war period, it was difficult for the European countries to return to the pre-1914 economic world because of the war debts they owed to each other and to the United States. The Allies had depleted their reserves during the war due to imports of food and wartime supplies. After the war, reserves were further depleted in order to service wartime debts. Because their reserves were low, their currencies were worth less. Consequently, European nations could not maintain the gold standard after the end of World War I. Although several countries returned to the gold standard in the mid-twenties, the system ultimately fell apart permanently in 1931.

During the same period, commodity prices had soared due to speculation. However, the market could not maintain the inflated prices of the oversupplied commodities indefinitely. Eventually commodity prices plummeted and the U.S. stock market crashed in 1929. The ensuing Great Depression intensified the demand for gold. Since commodity prices had sharply declined, export income had also declined. In order to protect reserves, countries began to "hoard" gold and reserve currencies such as the dollar. This caused a shortage of gold and dollars.

To make matters worse, country after country began to devalue their currencies (i.e., reduce the currency's value vis-a-vis other currencies) in order to make exports cheaper to foreign buyers. A country's goods become cheaper when it devalues its currency because another country buying these goods can buy more of the exporting nation's money with its own money. Since the goods are to be paid with the exporting country's currency and the price of the goods remains the same as before the devaluation, the goods are cheaper.

The problem was that other countries also began to use this technique to avoid losing buyers for *their* goods. There was really no advantage to these "competitive devaluations." In fact, countries around the world, including the United States, implemented

measures restricting trade and payments in order to reduce imports and protect their domestic economies. All of this led to a severe drop in global economic activity and, in Germany, contributed to the rise of Hitler.

***B. Preoccupation with Avoiding Repetition of the Inter-War Problems Led to the Creation of the IMF and the World Bank***

The founders of the Bretton Woods Institutions were very worried that after World War II the events of the inter-war period would repeat themselves. They sought to prevent this reoccurrence by setting up a system that would provide monetary order as well as facilitate investment in economies where little private capital was expected to flow, namely the European economies. They also hoped economic prosperity—starting with reconstruction of war-ravaged Europe—would promote peaceful relations.

Given the inter-war experience, economic policymakers of the time viewed floating exchange rates—that is, rates mandated by market forces—as destabilizing. They believed floating exchange rates produced speculation and large shifts in the value of the exchange rate. They also wanted to avoid competitive devaluations and the ensuing trade restrictions, which had brought trade to a virtual standstill.

The gold standard provided the stability policymakers wanted to pursue at the end of World War II, but the standard's negative aspects dissuaded the BWIs' founders from adopting it. One of the principal founders, Lord John Maynard Keynes of Britain, was especially critical of the standard. Thus, the founders favored a fixed exchange rate system tied to gold that would promote important domestic goals such as full employment and price stability. They also wanted a system that would allow countries to maintain sound external economic relations (healthy and balanced international trade and foreign investment—balance of payments equilibrium) without having to impose trade restrictions to, say, reduce imports.

***C. Given the Challenges of Fashioning Institutions to Address the Inter-War Problems, the Founders of the BWIs Did Not Address "Development" as We Know It Today***

The Bretton Woods Conference was held in New Hampshire during the summer of 1944. The U.S. Department of State issued invitations to forty-four governments (the Allied countries), which included developing countries such as Brazil and Mexico. The invitations stated the purpose of the conference was to "formulat[e] definite proposals for an International Monetary Fund, and possibly a Bank for Reconstruction and Development."

## **1. The Negotiations Over the Creation of the IMF Focused on Technical Issues Relating to International Monetary Affairs.**

Although the conference's objectives formally mentioned "development," relatively little time was devoted to discussing the plight of "developing countries." Instead, the participants—the United States and the United Kingdom in particular—focused on promoting currency stability, devising a system of international payments, and organizing the economic reconstruction of Europe. Most of the discussions related to figuring out how the IMF would operate, a subject that required much debate and analysis of technical issues relating to international monetary affairs.

For example, although both the U.S. and the U.K. agreed that some sort of mechanism would have to be created to supply countries experiencing balance-of-payments deficits with temporary loans ("liquidity"), the two countries had serious disagreements over how resources would be made available. Keynes, representing a deficit country (the U.K.), wanted to create a system that would provide deficit countries with plenty of credit upon request. He therefore proposed an International Clearing Union (ICU) that would issue a new form of international money called "bancor" and monitor lending from one country to another. Keynes wanted the ICU to issue about \$26 billion worth of the new money.

The United States, represented by Harry Dexter White, objected to Keynes' proposal because it would amount to a huge loan from the United States to the rest of the world. In contrast to the Keynes plan, the White plan reflected the agenda of creditor nations, or more specifically the only expected creditor nation, the United States. The U.S. had the highest level of gold reserves, its infrastructure was not damaged by the war, and neither was its economy. So it was probably going to be the main contributor to the liquidity mechanism.

This prospect worried the U.S. negotiators. They wanted to avoid putting too many dollars into foreign hands, mainly because the U.S. Treasury and the U.S. Congress would probably not agree to such an outcome. Consequently, it was important for White to limit the extent to which the United States would be liable for financing the post-war adjustments of other countries. The United States also wanted the international institution to have the power to require deficit countries to adopt policies that would restore balance of payments equilibrium.

These concerns were reflected in White's proposal for an international organization called the Stabilization Fund (SF). To address the liability concern, the SF plan, unlike the

ICU proposal, required members to contribute their own currencies and gold to the Fund. Rather than borrowing directly from other countries (the ICU plan), deficit countries would have to obtain the currencies they needed from a fund established and operated by the SF. Each member country's contribution would reflect their relative economic strength. The U.S. contribution would be limited to just under \$3.5 billion, far less than its liability under Keynes' proposal.

The United States' other main concern—requiring countries to adopt sound economic policies—was reflected in a proposed rule that would require countries to comply with conditions set forth by the SF in exchange for accessing the pool of currencies. This conditionality approach was intended to create longer-term stability by promulgating economic and monetary policies that would help prevent future crises.

It was obvious to everyone the IMF would not be created without the approval of the United States and the United Kingdom. Both countries faced major challenges at home. The U.S. negotiators knew the U.S. Congress would not vote in favor of the ICU plan because elements of the plan were so unfamiliar to them, and because of their perception that the United States, as creditor, would be at a disadvantage.

On the U.K. side, the British Parliament and public were not prepared to accept a plan based on a fixed exchange rate system that would completely deprive the nation of its sovereign right to control its monetary policy in order to protect its domestic economy. They wanted the power to change the exchange rate; they wanted to be able to manage the domestic economy because they feared the sterling was going to be very weak and require the government's protection.

A series of compromises led to the creation of an international organization, the International Monetary Fund, which closely resembled the White plan. Given the U.K.'s concerns, the exchange rate system allowed countries to make a ten percent modification of the exchange rate. A larger change required IMF approval, although if the change was to correct a "fundamental disequilibrium," then the IMF had to approve. In addition, White's proposal to tie lending to economic policy reform was dropped in the compromise. However, White's approach was ultimately vindicated when the IMF adopted the conditionality practice in the 1950's.

## **2. The World Bank Preparatory Work and Negotiations at the Conference Reflected Only a Peripheral Concern for "Development."**

Today the World Bank is at the center of many conversations regarding international finance and development. But at the Bretton Woods Conference, creating the World Bank was an afterthought—and even when the participants did focus on it, "development" was not their primary concern.

Preparations for creating the IMF had been underway for close to five years. There had been preliminary drafts for the World Bank charter, but they had not been subject to extensive discussion. In June 1944, just prior to the Bretton Woods conference, a number of countries met in Atlantic City, U.S.A., to prepare an agenda for the conference. There, the United Kingdom submitted the "boat draft"—the document was drafted on the Queen Mary—which became the basis for discussion at the Bretton Woods conference.

At the conference the main point of contention was whether "development" or reconstruction would be the World Bank's priority. The European nations were particularly interested in World Bank assistance for post-war reconstruction. The Soviet delegation emphasized, for example, that the main purpose of the World Bank was to assist in the reconstruction of infrastructure and the revitalization of European economies destroyed by the war

The delegations from developing countries were more interested in the formation of the World Bank than the IMF. Mexico proposed language for the World Bank's charter that would make development a priority. The proposal, not surprisingly, failed. However, developing nations did succeed in introducing the language found in Art. III, Section 1(a) which states the Bank's facilities would be used with "equitable consideration to projects for development and projects for reconstruction alike."

#### ***D. The IMF's Functions and Structure***

The IMF Articles of Agreement are intended to be a Code of Good Conduct controlling members' monetary policies. Article I, which lists the purposes of the IMF, reflects the founders' view that the IMF's primary function should be to keep the international monetary system running smoothly. Monetary order, in turn, would promote economic growth and fair trade, goals stated in Art. I (ii). The IMF addresses these goals in various ways. Let's begin with a brief discussion of the Bretton Woods fixed exchange rate system, which is related to the gold exchange standard we mentioned earlier.

##### **1. The IMF Charter Originally Established Adjustable Par Values for the Currencies of Member Countries.**

The IMF charter originally set up a system of fixed exchange rates in order to address the problems of the inter-war period. All members declared a "par value" in terms of the dollar, and the value of the dollar was fixed to the price of gold—\$35 an ounce. Member countries held reserves in dollars and gold and they had the right to sell dollars to the U.S. Federal Reserve (a central bank) for gold.

Thus, the system has been referred to as a gold exchange standard. The founders believed this system would impose monetary discipline on member countries. For example, if the central bank, say, of Brazil, decided to unduly expand its money supply, it would start losing its reserves and become unable to maintain its fixed exchange rate—the currency's par value. In theory, the United States would also be constrained because an expansion of its money supply would result in central banks holding more dollars, which they could present to the Federal Reserve for gold.

As explained in Part Three, Section IV of the E-Book, the Bretton Woods fixed exchange rate system worked reasonably well through the 1960s—even though its rules were occasionally violated. The system, however, placed great strains on countries as they tried to defend the par values. The late 1960s witnessed considerable financial and economic turbulence, which resulted in the collapse of the fixed exchange rate system in the early 1970s. Today the IMF charter implicitly endorses a system of floating exchange rates—rates governed primarily by market forces of supply and demand.

## **2. The IMF's "Lending" Facilities Help Member Countries Make Adjustments to Restore Balance of Payments Equilibrium.**

The inter-war experience taught the IMF's founders that countries would be unwilling to maintain fixed exchange rates and a free trade regime at the expense of domestic unemployment. So the founders built flexibility into the system in various ways.

As we noted above, one important aspect of flexibility involves establishing a pool of currencies member countries can use to help them with adjustments they have to make to restore balance of payments equilibrium. In order to fulfill this function, the IMF must obtain resources. The primary method for gaining resources is through the member's quota subscriptions, although the IMF Articles allow the IMF to borrow in order to fulfill the balance of payments needs of its members.

Each member's quota subscription is determined by the size of the member's economy and the importance of its currency worldwide—the bigger and more powerful the

country's economy, the bigger the quota. Generally, a member is required to pay up to 25% of its subscription in Special Drawing Rights (SDRs), an international reserve asset created by the IMF, or in currencies accepted by the IMF; 75% of its quota subscription can be paid in its own currency.

Quotas relate importantly to other aspects of the IMF. For example, quotas determine a member country's voting power. Instead of conducting its business based on a one-vote-per-country rule, the IMF uses a formula that gives a wealthy member country with a large quota (e.g., the United States) more voting power and influence than a small, poor country. (Actually, the Fund usually operates by consensus, avoiding formal voting procedures.) Quotas also determine the allocation of SDRs and each member country's access to the IMF's financial resources.

Although the IMF's assistance is usually referred to as "lending" or "loans," a member country actually "purchases" SDRs or other currencies from the Fund in exchange for its own currency and agrees to "repurchase" (buy back) its own currency at a later date. Because the member is charged for this transaction, the purchase or "drawing" looks like a loan, which is what we will call the transaction for the sake of simplicity.

The loans from the Fund's General Resources Account can be used for any purpose relating to general balance-of-payments support, such as restoring reserves in the country's central bank or selling the acquired currency in the foreign exchange markets to stabilize exchange rates. Member countries have automatic access to a portion of the Fund's resources, called the "reserve tranche."

Member countries seeking an IMF loan beyond the reserve tranche must convince the Fund they have a balance of payments need. As the amount of the loan increases beyond the reserve tranche (technically, moving into the "first credit" followed by "upper credit" tranches), the IMF imposes conditions on the use of the funds—known around the world as "conditionality."

Conditionality refers to the explicit commitment by the member country to implement remedial measures in return for IMF assistance. Conditions may range from general commitments to cooperate with the IMF with respect to establishing domestic economic policy to presenting the Fund with specific measures the country intends to implement at specific points in time. Those measures typically have related to the domestic money supply, budget deficits, international reserves, external debt, exchange rates, and

interest rates. However, as you learn in other sections of the E-Book, the IMF's conditionality has spread into other areas.

Drawings in the upper credit tranches typically are associated with 12-18 month "stand-by arrangements" (similar to pre-approved lines of credit) or "extended arrangements" under the Extended Fund Facility, which provide assistance for longer periods of time (3-4 years) and for larger amounts than stand-by arrangements in order to address structural problems in the economy. Upper credit tranche drawings are usually made in installments and released only after economic performance targets have been met. The country's specific plans are set forth in a "Letter of Intent" presented to the IMF. Although formally the member country formulates and "presents" the Letter of Intent to the Fund, practically speaking the Fund wields a great deal of influence regarding the content of the Letter.

In addition to drawings from the General Resources Account, the Fund has established a number of other lending "facilities" designed for specific problems, such as the Enhanced Structural Adjustment Facility (concessional loans for poor countries experiencing protracted balance of payments problems - now called the Poverty Reduction and Growth Facility), the Compensatory and Contingency Financing Facility (shortfall in export earnings or rise in costs of cereal imports), and the Supplemental Reserve Facility (exceptional balance of payments difficulties because of sudden and disruptive loss of market confidence).

Except for the Supplemental Reserve Facility, the IMF uses quotas to determine how much a member country may borrow under a facility. The Fund's Executive Board reviews the access limits periodically, taking into account payment problems of its members, the need to safeguard IMF resources, and developments in the Fund's liquidity.

### **3. Today the IMF Engages in Surveillance Over the Exchange Rates of Member Countries.**

After the collapse of the Bretton Woods System based on fixed exchange rates, the IMF's charter was amended to allow member countries to choose their own exchange rate systems. However, under Article IV of the charter, members agreed to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. Moreover, Article IV gives the IMF broad powers of surveillance over exchange rate policies of members, and gives it the authority to adopt principles that will guide members with respect to those policies.

IMF surveillance takes on two forms. First, bilateral surveillance is carried out in part through annual consultations with member countries, known as "Article IV consultations." During these meetings with member country officials, IMF staff members analyze the country's economic developments and policies. In addition to the traditional economic variables we mentioned above in connection with conditionality, the Fund recently has begun to look at social, environmental, industrial, labor market, and governance issues that influence economic management of the country.

Second, the IMF supplements its Article IV consultations with multilateral surveillance, which focuses on economic and policy spillovers between countries. The IMF examines both regionally-designed policies, such as those of the European Monetary Union or the Central African Monetary and Economic Union, and national policies that have regional consequences. The IMF then relays its feedback on these regional issues to individual member nations through Article IV consultations. Multilateral surveillance is discussed in greater depth in Part Four of the E-book.

#### **4. The IMF has Encouraged Members to Make Their Domestic Currencies "Convertible" —i.e., Freely Exchangeable for Foreign Currencies.**

According to its charter, the IMF's principal purpose is to facilitate the expansion and balanced growth of trade. This is done in part by establishing a multilateral system of payments for current account—e.g. trade—transactions. Convertibility is important for international trade. Under the Bretton Woods System, the convertible dollar was the key currency. Trade was conducted in dollars; importers and exporters typically held dollar accounts for their business transactions.

By accepting the obligations of Article VIII of the IMF's charter, member countries agree not to impose restrictions on payments and transfers relating to the current account, and they also agree to refrain from engaging in discriminatory currency arrangements or multiple currency arrangements without the approval of the IMF. Although historically member countries were slow to accept Article VIII obligations, 165 of the IMF's 184 member countries now adhere to these rules.

#### **5. The Fund has Several Ways of Assuring Compliance With its Rules and Policies.**

Although it is frequently stated that the IMF has no real authority to force members to comply with IMF rules and policies, in truth the Fund commands considerable leverage over member countries.

Technically, letters of intent, stand-by arrangements and other IMF loans are not contracts or any other type of legal obligation. Thus, a failure to abide by a letter of intent or standby-arrangement is not a breach of contract that would enable the IMF or anybody else to sue the country.

Still, there are many other ways the IMF can apply pressure on countries to comply. First, conditionality enables the IMF to withhold funds if a member country does not comply with the conditions of the loan. Second, members know that by violating the rules and policies of the IMF they may be shut out of the international capital markets. Third, the Fund can prohibit a member country from using the General Resources Account. Fourth, the IMF can kick the country out of the organization (as it did with Czechoslovakia in 1954). Finally, through collaboration and consultation with member countries, the Fund tries to persuade and cajole countries into complying with rules and policies. You should know, though, that in many cases the IMF has ignored violations.

#### **6. The IMF Provides Countries with Assistance Regarding Technical Issues.**

Another function of the IMF is to provide technical assistance. The IMF began to give countries technical assistance in 1964 when ex-colonies wanted help in setting up their own central banks and ministries of finance.

The IMF provides assistance in the areas of fiscal policy, monetary policy, banking, institution-building, financial legislation, and statistics (which helps IMF surveillance). When the IMF is providing assistance in areas not directly related to economics, it still links the assistance to economics. For instance, the IMF provides technical assistance in the area of law—financial legislation, but the emphasis is on enacting laws that support a free market.

#### **7. The structure of the IMF.**

There are two primary organs within the IMF: the Board of Governors and the Executive Board. Each member country has one representative, typically its finance minister or the head of its central bank, on the Board of Governors, which meets once annually. Members of the Board of Governors also serve on two important committees. The International Monetary and Financial Committee considers key monetary system policies. The Development Committee—a joint committee with the World Bank—advises the Board on policies and matters concerning developing countries.

The IMF's day-to-day operations are managed by the Executive Board, which consists of twenty-four Executive Directors, eight of whom represent individual countries (China, France, Germany, Japan, Russia, Saudi Arabia, the United Kingdom, and the United States). The remaining sixteen Executive Directors represent constituencies—groups of similarly situated (for example, geographically or linguistically) member nations. The Executive Board meets three days each week, and more often as needed. Each Director has a weighted number of votes tied to the constituency's combined IMF quota. In practice, however, decisions rarely are made by formal vote, but by general consensus.

Additionally, IMF staff is subdivided into a number of regional and functional departments. Five regional departments cover operations for the entire world. Functional departments include Finance, Fiscal Affairs, the IMF institute, which trains national finance officers, and various administrative departments (Legal, Policy Development, Research, External Relations, etc.). In 2001, the Executive Board also established the Independent Evaluation Office, which operates independently to evaluate the efficacy of IMF operations and policies.

### ***E. The Functions and Structure of the World Bank Group***

The World Bank consists of the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA), the latter created in 1960. Both institutions make loans to governments (or to public or private entities that have a government guarantee) for projects and programs related to "development," that is, loans designed to promote economic and social progress in member countries. The IDA, however, provides concessional loans (interest free and long term) to the very poor countries (measured by per capita gross national product) that cannot afford IBRD loans. Unlike the IBRD, which raises its funds on the international capital markets, the IDA's funding comes from donations from the world's rich countries.

Three other entities are associated with, but legally and financially independent of, the IBRD and the IDA: The International Finance Corporation (IFC), the International Center for Settlement of Investment Disputes (ICSID), and the Multilateral Investment Guarantee Agency (MIGA). Collectively, these five entities are known as the World Bank Group.

Below we will describe the activities of the IBRD. We will then briefly explain the work of the IFC, ICSID, and MIGA.

**1. Although the IMF and the IBRD Seem Like Very Similar Institutions, Formally They Differ in Fundamental Ways.**

The IBRD and the IMF are similar in several ways and they frequently coordinate their activities. Still, their operations differ in important ways.

**a. Both are multilateral institutions whose charters call for weighted voting; both also focus on economic matters in member countries.**

Like the IMF, the IBRD is a multilateral institution, meaning that it is owned by the governments of member countries. Only countries that are members of the IMF can become members of the IBRD. In fact, virtually every country in the world is a member of both institutions.

The IBRD is also like the IMF to the extent that richer countries own a greater share of the IBRD and have more voting power than the poorer countries. When a country joins the IBRD, the number of shares (representing ownership) it receives will reflect its quota in the IMF, which in turn reflects the country's relative economic strength. Like the IMF, the IBRD's charter calls for weighted voting—i.e., not a one-vote-per-country rule but rather a voting system giving the richer countries (e.g., the United States) more votes and influence than poorer countries (although decisions typically have been taken on a consensus basis).

Both institutions focus on economic matters. The IMF traditionally engaged in short-term balance-of-payments lending to help establish policies that would stabilize overheated economies (e.g., correct a distorted exchange rate). The Bank, by contrast, traditionally funded longer-term projects designed to promote economic growth (e.g., irrigation project to increase commodity exports). Starting with the debt crisis of the 1980s and continuing through the financial crises of the 1990s, both institutions have more closely coordinated their lending and their use of conditionality to promote fundamental and often painful market reforms in developing countries and former socialist economies. Consequently, the Bank now engages in "adjustment lending" aimed at helping countries modify their economic policies and structures—a focus that differs from project lending. The IMF's activities have also come to resemble the Bank's to the extent that the Fund (i) now concerns itself with structural issues as well as balance-of-payments problems and (ii) no longer restricts itself to short-term lending.

**b. The IBRD, however, is an investment bank that intermediates between investors, who buy the Bank's bonds, and developing countries, which borrow from the Bank.**

Although the IMF administers a pool of currencies from which it makes loans to member countries, it likes to think of itself primarily as an institution that oversees an orderly international monetary system, as called for in its charter. By contrast, the IBRD is an investment bank whose primary function is to engage in multilateral development financing. It lends to creditworthy countries whose per capital income falls below a stipulated floor.

Members of the IBRD pay only a small portion of the value of their shares, which collectively constitutes "paid-in capital;" the remainder is referred to as "callable capital." Unlike the IMF, which funds its loans primarily from quota subscriptions from its members, the IBRD primarily funds its lending by selling bonds to individuals and private institutions in the world's capital markets. Because of its strong standing in the markets, the IBRD can borrow at relatively inexpensive rates and pass along the savings to borrowing members.

## **2. The IBRD's Lending Stresses Market-Based Economic Development and Poverty Reduction.**

The main purposes of the IBRD are to promote economic development and reduce poverty. It tries to pursue these purposes by providing loans, guarantees and technical assistance for projects and programs in member countries. Here we will limit our explanation to the IBRD's lending activities.

### **a. The IBRD initially focused on project lending, concentrating on investment in physical capital in developing countries.**

Initially, the IBRD stressed reconstruction over development, providing loans to war-torn European countries. With the advent of the Marshall Plan, which provided significant U.S. aid to reconstruct Europe, the IBRD switched from reconstruction lending to "project lending" in developing countries. Many of these countries had just achieved independence during the decolonization period (1955-1965) and governments were eager to start down the same road industrialized countries had taken to achieve economic prosperity. Policymakers in both the developed and developing world thus promoted a development strategy encouraging massive investments in developing countries in order help them "take off" economically through a modern industrialized sector. The resultant economic growth was supposed to "trickle down" to the poorest segments of society.

Thus, the IBRD's lending concentrated on developing a country's infrastructure, such as building electric power plants and implementing transportation projects. Electric

power would encourage the creation of factories, which in turn would create non-agricultural jobs and increase the standard of living. Improved transportation would not only benefit industry, but agriculture as well by making it easier to transport commodities to the markets.

Interestingly, the IBRD was formed in part to promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors. However, most of the lending during this period was to government entities, which were better able to handle large projects than the relatively small private sectors in decolonized countries. This contributed to state-led development in many part of the world.

**b. In the 1960s and 1970s the IBRD began to focus on investing in human capital.**

Starting in the early 1960s and culminating in the 1970s under the helm of Robert McNamara, the IBRD shifted its focus somewhat from investment primarily in physical capital to investment in "human capital." This coincided with a growing realization that development policies stressing rapid industrialization had failed to produce benefits for most of the poor. In fact, some economists argued that the benefits of such policies were "trickling up" rather than down.

Consequently, under McNamara's presidency the IBRD's (and the IDA's) lending stressed poverty alleviation in an effort to promote distributional equity along with economic growth. Lending focused on improving agriculture, rural development, small-scale enterprises, urban development, waste-disposal facilities, health care, family-planning assistance, nutrition, education, and housing. The IBRD's lending goal was to meet people's basic needs.

Today, the IBRD (and IDA) continues to invest in human capital. For instance, new commitments by the IBRD and IDA in fiscal year 2006 for human and social development and protection projects totaled \$5.585 billion, constituting twenty-four percent of all new World Bank lending. The remaining loan commitments were devoted to thirteen other sectors, ranging from water supply and sanitation to finance.

**c. The debt crisis of the 1980s prompted the IBRD to make market-based adjustment loans.**

Most IBRD development activities fall under the category of "investment lending" for projects or programs. The Bank also provides "adjustment lending" designed to support fundamental changes in economic and financial policies of member countries.

This type of lending emerged with the onset of the debt crisis of the 1980s. The IBRD typically approved "Structural Adjustment Loans" and "Sector Adjustment Loans" aimed at liberalizing domestic and foreign trade and privatizing public enterprises. These were market-based measures policymakers felt were necessary to reform inefficient, state-dominated economies—which developed prior to the debt crisis thanks in part to World Bank support. More recently, the IBRD approved billions of dollars in adjustment loans to Indonesia, Korea, and Thailand to help those countries restructure their financial and corporate sectors in the wake of the Asian financial crisis.

### **3. In the 1990s the Bank Tried to Improve its Responsiveness While Stressing Poverty Alleviation and Corruption Reduction.**

In the 1990s the World Bank, a relatively large institution with its headquarters in Washington, D.C., came under criticism from many quarters. Critics claim it is a top-down, unresponsive institution that is out of touch with grassroots development realities in member countries. In response, the Bank has formed an Inspection Panel to monitor the Bank's compliance with its own policies—a topic covered in Part Two, Section III of the E-Book. It has also embarked upon a reform program called the Strategic Compact. The program's objectives include improving the effectiveness of its lending and nonlending services; improving its responsiveness to client needs; diversifying its products and services; and reducing overhead while decentralizing its activities.

Inaugurated in the fall of 1996, the Bank opened another front in its war against poverty: the Heavily Indebted Poor Countries (HIPC) Debt Initiative. Developed along with the IMF in response to worldwide activism, the Initiative's purpose is to enable poor (mainly African) countries pursuing market-based policies to reduce their debt to multilateral, Paris Club (a group of creditor countries), and other official bilateral and commercial creditors. The objective is to reach "sustainable levels" of debt—i.e., debt that can be paid via export earnings, aid, and capital inflows in the context of a growing, poverty-reducing economy. Uganda became the first beneficiary with a debt-service relief package in April 1998 of \$650 million. Part IV of the E-book addresses HIPC in more detail.

The World Bank's anti-corruption campaign began in 1997 in Eastern Europe and Central Asia as it became apparent that corruption was undermining the transition to a market economy and exacerbating social ills, such as poverty. The Bank's efforts began with diagnostic tools, such as public scorecards and large scale surveys of private citizens and public officials, designed to increase dialog on corruption issues and to expose areas

where reform is most needed. Today, diagnostic tools are complemented with analytic work, technical assistance, training programs, and lending instruments that are all designed to encourage transparency and accountability.

In recent years, the Bank has taken an increasingly aggressive approach to its anticorruption efforts, recognizing that corruption continues to sabotage developmental and social programs. The Bank focuses on five key elements in fighting corruption: 1) increasing political accountability; 2) strengthening civil society participation; 3) creating a competitive private sector; 4) developing institutional restraints on power, including a strong, independent judiciary; and 5) improving public sector management. The Bank follows a three-prong strategy for addressing these core issues: working at the country level to build transparent institutions and to design appropriate anti-corruption programs; partnering on a global level with other public and private organizations on joint anti-corruption initiatives; and, internally, minimizing corruption and fraud and increasing transparency in the Bank's lending and operations. These issues likely will remain one of the hottest topics in the World Bank until widespread corruption is effectively circumscribed.

#### **4. The IFC, MIGA and ICSID Help Mobilize the Private Sector.**

The International Finance Corporation (IFC), formed in 1956, promotes private sector investment in poor countries that would otherwise not easily attract private investment. It does this by providing long-term market-priced loans and equity financing for private sector projects. The IFC's participation in a project acts as a seal of approval, encouraging other private investors to become involved.

Established in 1988, the Multilateral Investment Guarantee Agency (MIGA) is the most recent addition to the World Bank Group. MIGA is an investment insurance agency that encourages foreign direct investment in developing nations. It does this by providing guarantees against political (noncommercial) risks. In this way, investors are more willing to invest in countries that may not be politically stable.

The International Center for Settlement of Investment Disputes (ICSID) was established by treaty in 1966 in order to provide a forum for arbitration or mediation of disputes between foreign investors and their host countries. Its purpose is to promote increased flows of international investment by providing a forum outside the host state for settlement of investment disputes. Parties cannot be forced to use ICSID conciliation and arbitration services. But once they have consented to arbitration under the ICSID

Convention, neither can withdraw unilaterally.

The work of the World Bank Group is intended to facilitate foreign private investment in one form or another. Such investment is frequently critical to the economies of host countries. However, many people and organizations believe the benefits of investment fail to benefit the society as whole. In fact, many believe foreign investment frequently increases the gap between the poor and the rich. Keep these views in mind as you read the rest of the E-Book.

## **5. The Structure of the IBRD and Other World Bank Group Organizations.**

Similar to the IMF, the IBRD is comprised of a Board of Governors and a Board of Executive Directors. All member countries have one representative on the Board of Governors, typically the minister of finance or minister of development. They meet annually and are the Banks' ultimate policy-makers.

The Board of Executive Directors, like that of the IMF, has twenty-four members who meet once or twice weekly: eight Executive Directors represent individual nations; the remainder represents groups of similarly situated nations. Each Executive Director also serves on one or more committees (Audit, Budget, Development Effectiveness, Personnel, and Governance and Executive Directors' Administrative Matters), and, together, the Board oversees all IBRD business, including lending and borrowing decisions, policies, and country assistance strategies. The Executive Board is chaired by its President, traditionally nominated by, and a national of, the Bank's largest shareholder (the United States). Voting power is based on the pro rata size of each nation's shareholding within the Bank.

The other World Bank Group organizations, discussed in the preceding section, have a parallel structure. Individuals who serve as Executive Directors for the IBRD typically serve as the Executive Directors in all other World Bank Group institutions, managing their day-to-day operations.

*Charles McClellan, a UICIFD staff member, contributed to the 2007 update.*