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A Foresight and Policy Study of the Multilateral Development Banks

Executive Summary 2000:2

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A Foresight and Policy Study of the Multilateral Development Banks

Executive Summary

Prepared for the Ministry for Foreign Affairs, Sweden

by

The Institute of Development Studies
at the University of Sussex

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PREFACE

This report represents the culmination of some twelve weeks of exceedingly intensive work by the research team at the Institute of Development Studies (IDS). The magnitude of the tasks and the complexity of the issues set out in the Terms of Reference posed a daunting research challenge within the time frame allocated to this project. Completion of the work would not have been possible without the strong, consistent and willing support we received from the Ministry for Foreign Affairs of Sweden, from many Executive Directors and their staff in the Multilateral Development banks (MDBs), from the management and staff of the MDBs we visited, and from many experts and academics we interviewed. We wish to express our deep appreciation to all of them.

While we have attempted faithfully to capture and reflect the richness of the assessments and suggestions we received in the conduct of the study, the views expressed in this report are entirely those of its authors. We are also grateful to Catherine Gwin and Barrie Hudson, who provided detailed and most useful comments on the draft report, and to the participants in the seminar “Financing the Multilateral System” held in Stockholm on August 31, 2000 and organized by the Ministry for Foreign Affairs of Sweden.

The IDS MDB team was led by Keith Bezanson and the report was prepared by Francisco Sagasti, Silvia Charpentier and Ricardo Gottschalk, with the assistance of Ursula Casabonne and Fernando Prada. Hans Singer, Stephany Griffith-Jones and Howard White provided advice, comments and suggestions. Jill Clements and Diane Frazer-Smith provided operational and administrative support.

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EXECUTIVE SUMMARY

(i) The present study attempts to provide a broad strategic framework for examination of issues affecting the future of the Multilateral Development Banks (MDBs). It is based on a review of the extensive and growing literature on the subject**,** on research conducted by the members of the IDS team, and on interviews with senior MDB staff members, government officials and policy makers, financial sector experts and researchers.

(ii) The range of membership in the research team reflected multiple, prior experiences with MDBs. Some had held senior policy positions within MDBs; one had been an Executive Director on the Board of Directors of the World Bank; and two had negotiated policies and loans with MDBs on behalf of their countries. These diverse experiences and perspectives proved exceedingly valuable in carrying out this investigation.

(iii) The conduct of this study has been compressed into an exceedingly short period of time, especially considering the magnitude of the task and the diversity of institutions and issues to be covered. The team did hold first-hand discussions in all of the major MDBs and interviewed dozens of senior policy-makers, but time and resource limitations prevented extensive, direct consultations with bilateral users of MDB services and products or with the sub-regional banks that are also a factor in multilateral development co-operation. These represent gaps in this study and an important piece of unfinished business that we would hope might be addressed in follow-up work to this report.

MDBs: Current Pressures and Paradoxes

(iv) This is a time of unprecedented stress on the entire MDB system. At no time since the founding of the World Bank over fifty years ago have multilateral institutions been forced to contend with so many pressures and paradoxes. They are challenged as never before by their poorer member countries to help catalyse successful integration into the global economy and, at the same time, to help alleviate the deep socio-economic fissures that such integration can also cause. New levels of openness and transparency are demanded over the full range of MDB operations, while the institutions remain bound in many instances to protect the confidentiality of privileged relationships with clients. They are asked to exercise regional and global leadership by uniting international development efforts and also to reflect the myriad interests, differing viewpoints, and often-conflicting priorities of a vast array of other actors. They are required to seek out and function effectively in partnerships with governments, decentralised authorities, the private sector, bilateral and other multilateral agencies and NGOs, and to do so at national, trans-national and grass roots levels. They are instructed to decentralise and increase operational strengths "on the ground" while demonstrating increases in parsimony and savings in administrative costs. They are confronted with angry mobs calling for their abolition; with accusations of expansionism ("mission creep"); with pleas for expanded roles in human rights and "good governance;" and with very public reports (such as the Meltzer Report) urging radical changes, greater role differentiation and much higher levels of specialisation.

(v) These are only some of the current pressures and paradoxes being experienced by the MDBs. Recognition of the magnitude of these factors was clearly provided in the World Bank's 1997 launch of its Strategic Compact. The stated goal of the Compact was nothing less than a dramatic transformation of the institution in recognition of the new pressures and to contend with the new paradoxes. Similar recognition and similar efforts at fundamental transformation have since become evident in all of the MDBs.

A changing context for development, finance and the MDBs

(vi) These factors and forces are by no means exclusive to the MDBs, but rather are components of much larger changes to the entire *international development system,* to its foundations and to the context of its efforts. Today's organizations concerned with improving the quality of life and reducing poverty in developing regions, whether primarily local or global in emphasis, are engaged in a new dynamic that pulls simultaneously in two directions: towards collaboration and towards conflict. As never before in its fifty-year history, the *international development system* is now bringing together the state, the private sector and civil society in complex and myriad interactions that will determine the success or failure of future development efforts.

(vii) But MDBs are not only central to the international development system, they are also leading participants in an *international financial system* which has grown explosively during the last three decades. The broad field of *development finance* is located at the cusp of these two systems (the *international development system* and the *international financial system*), and it is here that the uniqueness of the MDBs is defined. While a diversity of institutions is located at this cusp (e.g. bilateral assistance agencies, private foundations and private investors), the *MDBs are uniquely placed, for more than all other organizations, they interact with all entities that straddle the worlds of development and of international finance*.

(viii) Yet while it is conceptually useful to describe the MDBs as a "family" of institutions, they are in practice (and as shown in this report) vastly different organizations. They differ greatly in core capabilities, institutional cultures, governance and accountabilities. There are major obstacles to bringing about improved co-ordination among them, let alone a functional division of labor. To speak more broadly in terms of an "international development family" is to confront an infinitely greater range of differences and obstacles to improved co-ordination.

(ix) Those who seek improved co-ordination among the MDBs and between them and other members of the international development system (and most major donors do seek this) will need to change their own practices if this is to succeed. They will need to move their policy and practice focus away from its dominant pattern of dealing with single organisations and discrete channels of delivery and move to more systemic approaches that visualise the totality of the systems of international development and international finance. Donors have been quick to call for greater development co-ordination, but exceedingly slow in recognising the high transaction costs involved in moving to more co-ordinated country programs. They have similarly been quick in demanding that the MDBs (especially the World Bank) take active leadership in promoting effective partnerships and co-ordinated efforts, but little account seems to have been taken of the considerable increase in administrative and professional resources that this requires.

Multilateral Development Banks: A definition

Multilateral Development Banks are international financial intermediaries whose shareholders include both borrowing developing countries and donor developed countries. They mobilize resources from private capital markets and from official sources to make loans to developing countries on better than market terms; they provide technical assistance and advice for economic and social development; and they also provide a range of complementary services to developing countries and to the international development community.

Their product lines include long-term loans at below market rates of interest, concessional loans at very low rates of interest and long repayment periods, guarantees to enhance private investment, and relatively small amounts of grant financing, mostly for technical assistance, training and capacity building in borrowing countries. Most MDBs fund their long-term loan operations through borrowings in the international capital markets, whereas concessional loans and small grants are funded through contributions by donors (also called replenishments) and from the MDBs net income.

MDBs have a *preferred creditor* status in relation to private lenders, deriving in considerable measure from their low gearing ratios in comparison with private financial institutions. As a result, MDBs enjoy high ratings from bond rating agencies, which allows them to raise funds on favorable terms in the international capital markets. They mostly provide loans directly to governments or to public institutions with government guarantees, even though private sector operations — done directly or through their private sector affiliates— have become increasingly important for some of them. About two dozen international institutions qualify according to this broad definition of an MDB.

(x) *The MDB model is a most useful institutional innovation to assist developing countries.* In spite of many problems and shortcomings, independent analyses have consistently confirmed a reasonably positive track record and the fact that there are no other institutions that provide a comparable range of products and services to member countries. With the possible exception of similar organizations that would benefit from automatic resource mobilization mechanisms (e.g. international taxes), there are no alternative institutional innovations in sight that could provide the combination of financial resource mobilization, capacity building and institutional development, knowledge brokering and the provision of international public goods.

(xi) The *MDBs* have consistently evolved and changed over the past half century, but as already indicated they *are currently experiencing unprecedented transformation.* This involves, *inter alia*:

- The emergence of a fractured global order (which implies a fundamental shift in international power relations, financial globalization, among other changes).

- A more diverse set of borrowing shareholders and clients, necessitating a broadening of their range of products and services.
- A growing number of more active and vocal stakeholders that forcefully press their interests on MDB management and shareholders.
- Expanding and conflicting demands, which are stretching response capacities and may lower the quality of operations.
- Accumulated management and administration problems, often the product of incremental adaptations and operational mistakes.
- An avalanche of criticisms and attacks from both left and right.

(xii) These factors create great pressures of a discontinuous nature and must be expected to produce a climate of uncertainties both about the future of the institutions themselves and within the individual institutions themselves. By contrast, however, there are some reasonable certainties at least in the foreseeable future of development finance. These would include:

- *Developing country financing demands will continue to be very large*. There is no prospect of achieving reasonable rates of growth to reduce poverty without major increases in investment. Domestic savings for much of the world are simply insufficient to finance investment levels that would lead to sustainable poverty reduction.
- *Private financing has grown significantly, but not in a way that suits most developing countries* (high concentration of foreign direct and portfolio investment, volatility, limited and uncertain developing country access to capital markets).
- *Official Development Assistance is stagnating*. Fiscal constraints have given way to political constraints in key donor countries. Although encouraging, newcomers to the concessional finance scene will not significantly change this situation. There is certainly need for a renewed national security argument to support ODA in the post Cold War era, but there are few signs that would suggest early dividends from such arguments.
- *New forms of development finance* (e.g. Clean Development Mechanism, international taxes) could become important in the medium-run and *private foundations* may expand their assistance to developing countries in a highly focused and selective way. Such new forms, however, are both too uncertain and too limited to be depended upon to spur development in poor countries.
- Therefore, *MDBs will continue to be needed to provide finance and a range of complementary services and products to developing countries for many years to come.*

The MDB system

(xiii) Of the two dozen institutions that are classified as MDBs, a relatively small number (i.e. the World Bank Group and the four regional development banks) are regarded as major players in international development finance. However, several sub-regional banks are growing in importance for their developing country members (e.g. Andean Finance Corporation, Arab Fund for Economic and Social Development).

(xiv) The percentage of total net resource flows to developing countries accounted for by the major MDBs has varied between 5 and 20 percent during the last thirty years and is now at about 7 percent. The peak occurred in the mid-1980s, as the MDBs stepped in to compensate for the abrupt fall in private flows due to the debt crisis. While the MDB share in total net resource flows to developing countries appears relatively small, its impact is much greater, primarily because it mobilizes complementary domestic and international resources, and involves policy dialogue, conditionality and technical assistance —which spill over beyond specific loan operations.

(xv) The historical nature of institutional relations between MDBs has been complex and contradictory, involving a combination of cooperation, rivalry and competition, particularly in the field. While there have been a number of formal inter-institutional co-operation agreements, including cases where specific divisions of labour have been agreed, there has also been (and continues to be) competition for bankable projects, particularly in the smaller countries where the number of such projects may be limited.

(xvi) The traditional MDB constituencies have been —in addition to member governments — groups and individuals concerned with Cold War containment, private businesses seeking procurement and/or contracts in public works, and groups concerned with improving the quality of life for the poor. The end of the Cold War has eliminated much of the national security constituency; and the transition to policy based lending, privatization and competitive bidding for public works has diminished the relative importance of MDBs to private firms. Apart from shareholders, therefore, the constituency trend for MDBs is towards just one of its traditional constituencies: those with a professional or personal interest in development.

(xvii) MDBs are owned by and must respond to the expressed interests of their member-governments. But here, too, important changes are occurring. The perceptions of many shareholders — as well as those of management — are being influenced increasingly by domestic constituencies, particularly in the non-borrowing countries, and by a growing multiplicity of stakeholders. Each group of stakeholders tends to express its views and requirements in a variety of ways, in different manners and through a diversity of channels, generating a cacophony of demands that must be paid attention to and sorted out, seeking to balance conflicting interests. However, in spite of the growing differentiation of stakeholders, the member-governments as shareholders remain pre-eminent in shaping the future of the MDBs and in determining their main accountabilities.

(xviii) In parallel with a host of reforms pressed on United Nations bodies by member governments, during the last decade shareholders have also sought to introduce major institutional reforms in the MDBs. However, there are indications of a growing "reform fatigue" in United Nations agencies and in the MDBs. The issues involved here are quite complex, but both anecdotal evidence and research suggest the emergence of genuine concerns about whether the reforms are owned within the organisations and accepted by many of the country members. Concerns are also voiced about whether the costs of "downsizing" and "rightsizing" —and of decentralisation and of "streamlining" administrative structures — will result in new and excessive costs being passed on to borrowers.

(xix) The importance of MDBs declines for borrowing countries that succeed in increasing their living standards, improving their economies and gaining direct access to private capital markets. At the same time, this transition usually means that such countries move from a relationship involving a positive net financial transfer with MDBs to one that is negative over many years as loans obtained earlier are repaid. Economic growth and poverty reduction, however, are far from being entirely synonymous, and for developing countries unable to grow and reduce poverty in a sustained manner, negative net transfers pose serious problems. This has led to the argument that MDB portfolios should grow steadily to maintain positive net transfers: meeting shareholder expectations with respect to poverty reduction is seen as inconsistent with negative net disbursements. An alternative perspective would view the net transfer situation of the MDB system as a whole and region by region. As the portfolio of one MDB matures and moves into lower positive transfers or into negative net transfers with a group of countries, other MDBs would move to a positive net transfer situation to compensate for it. For example, as the World Bank has reduced its positive net transfers globally and to the various regions, the regional development banks have increased theirs. This may also bear on at least some of the sub-regional MDBs. For example, the Andean Finance Corporation (CAF) is currently in a larger positive net transfer situation with Andean region countries than either the Inter-American Development Bank or the World Bank.

(xx) Currently and for the foreseeable future, MDBs will be pressed to perform a triple role:

- Financial resource mobilization;
- Capacity building, institutional development and knowledge brokering;
- Provision of global and regional public goods.

An adequate capital and financing structure is fundamental if MDBs are to fulfill satisfactorily this triple role. Yet as pressures mount on MDBs to respond to increasing demands for global and regional public goods they must be careful to maintain their resource mobilization capabilities that have made them one of the most successful institutional innovations of the 20th century. *This requires simultaneously the maintaining of the political support of shareholders* and *consistently achieving good financial ratios* (especially in relation to risk-bearing capital). Both of these are necessary if capital markets and donor countries are to continue to view MDBs as viable financial intermediaries.

Managing Risk and Vulnerabilities

(xxi) Sources of risk and vulnerability are different in regular, concessional and private operations.

- For regular lending windows, there are three interrelated sources of risk: (i) *political*, which refers to the relevance of MDBs to their shareholders and the support they receive from them; (ii) *market*, which refers to the ability to raise funds in capital markets at low cost; and (iii) *portfolio*, which refers to the concentration and quality of the loans, as well as to the impact of global financial shocks and contagion effects.
- For concessional lending windows, there are two sources of risk: (i) *political*, which refers to the support of donor countries; and (ii) *portfolio*, which refers to the ability of borrowers to pay the loans back.
- For private sector lending there are two sources of risk: (i) *market*, which refers to the ability to raise funds in capital markets on appropriate terms; and (ii) *portfolio*, which refers to the performance of their investment projects and of their equity holdings in private firms.

These risks cannot be managed effectively without the maintenance of strong financial positions and the bolstering of risk-bearing capacity. In more concrete terms, this requires a solid capital base and robust operating and net income levels, which would allow for increases in equity (paid-in capital plus reserves). Other options are often suggested, including measures to reduce the cost of borrowing, assuming higher risks in managing liquidity, loan securitization, and improved management of administrative expenses. These could help, but only in relatively modest ways. The irreducible keys to effective risk management in MDBs lie in the combination of a strong capital base and solid and sustainable operating and net income levels.

(xxii) Given these factors, it is not surprising that the growing and conflicting pressures faced by MDBs find clear expression in the *management of their income*. Achieving an appropriate balance between the three main functions of MDBs involves difficult decisions on the size and the allocation of operating and net income. First, there is the need to use net income to *increase reserves and strengthen their financial position and risk-bearing capacity*. Second, a shift to more complex operations and engagements with stakeholders requires more and better trained staff, as well as a larger presence in the field, both of which *increase administrative expenses* and reduce the margin for net income. Third, a portion of net income is needed to make *transfers to concessional loan windows* and to *provide grants* for public goods and special operations such as emergency relief (which also increase administrative costs). Finally, some MDBs will face new challenges as a result of *the assignment of significant amounts of net income to cover part of the costs of their participation in the Highly Indebted Poor Country* (HIPC) initiative.

Income from loans can be raised either by increasing the lending volume or by increasing loan charges. Without adequate safeguards, both measures could lead to a deterioration of the loan portfolio. Increasing the lending volume could prove imprudent while increasing the charges could make MDB lending non-competitive (in countries with access to capital markets and especially when transaction costs to borrowers are factored in). In addition, i*ncome from the management of liquid assets* can be raised by increasing the resources at the disposal of the MDB for short-term investment in capital markets, and by assuming higher market risks. However, this source of income is rather volatile and subject to capital market swings, which makes it unreliable so that it cannot be counted upon at a time of international financial crisis, when it would be most needed.

The Enhanced HIPC Initiative

(xxiii) The enhanced HIPC initiative aims to provide broad, deep and fast debt relief for the poorest countries. However, even though efforts are being made to link debt relief with sustainable poverty reduction programs in recipient countries, doubts are emerging about the quality and sustainability of post-HIPC growth and poverty reduction efforts. *The cost of HIPC is estimated at US $28.2 billion in 1999 net present value terms, about 40 percent (roughly US 11 billion) of which corresponds to multilateral creditor*s. This has important financial implications for some MDBs (especially IDA: US $5.7 billion; African Development Bank: US$ 2.2 billion; Central American Bank for Economic Integration: US$ 390 million; Arab Bank for Economic Development in Africa: US$ 180 million). As of mid-2000 pledges to the MDB HIPC Trust Fund added to about US$ 2.4 billion, less than a quarter of the required amount.

Whereas debt reduction can be achieved at the stroke of a pen, making use of the opportunities it creates for economic and social development requires time, financial resources and the capacity to design and implement development programs. Donors, including MDBs, are agreed that the preparation of Poverty Reduction Strategy Papers (PRSPs) is key to linking debt reduction to development. Thus, PRSPs are prerequisite to obtaining debt relief under the HIPC initiative. The intent for PRSPs is that they should be carefully designed with significant involvement of all segments of society, should be "owned" by developing countries, should be analytically sound and practical, and should provide a framework for all donors to work together. This is the current theory linking HIPC to development effectiveness.

In practice, however, (and in addition to a large potential funding gap) several major problems are emerging that threaten the initiative and that hold serious implications for MDBs. First, PRSPs are viewed by many as dominated by the World Bank and the IMF. Secondly, there are great time pressures: countries want to benefit from debt relief as soon as possible and the financial institutions want to be seen as taking swift action. Thirdly, there is considerable concern in at least some MDBs that the PRSPs may tend to substitute direct social expenditures for investments in the economic infrastructure essential to private investment, employment creation and economic growth. Fourthly (and related to the third point) is a worry that PRSPs may push several MDBs (and the IMF) away from their core competencies in macroeconomic stabilization and support to essential economic infrastructure and through "mission creep" into areas of development in which they have neither experience nor competence. The longer term implications of HIPC and PRSP for at least several of the MDBs are considerable. In addition, PRSPs may end up being a casualty of hasty implementation and the Achilles heel of the HIPC process.

Towards a framework for strategic choices

(xxiv) In order better to examine the roles that the MDB family of institutions could play at the fast-changing intersection of the development and international finance systems two extreme situations have been visualized (see Section 5.1). The first scenario is exceedingly negative, in which the world economy moves perilously close to global deflation and which carries, of course, severe implications for developing countries. The second scenario posits the continuation of a robust world economy with only minor fluctuations around a high-growth trend. An examination of the requirements, consequences, demands and implications of both these extreme scenarios (and for any intermediate ones) suggests that, for the foreseeable future, there *is a clear need for the multilateral development banks and for the important role that they play*. While there are other institutions that also work at the intersection between the development and the international financial systems, none can furnish the combination of products and services that the MDB family of institutions is capable of providing to its member countries.

(xxv) *This does not imply, however, a "business as usual" approach. To maintain their relevance to a growing diversity of stakeholders, and to their shareholders in particular, MDBs will need to articulate multiple strategies to respond to disparate, conflicting and shifting demands.* Such strategies, in the first instance, must be directed at maintaining and increasing political support from <u>all</u> their shareholders (i.e. not only from the most powerful ones). In turn, this implies having the capacity to respond to the continuously changing demands of a more diverse set of shareholders. Without ensuring that they can adequately respond to the shifting needs, demands and perceptions of its shareholders, it is unlikely that the MDBs will be able to respond with consistency and coherence to the explosion of new demands coming from other sources. Included here are international organizations, bilateral development agencies, financial markets, private firms and corporations, academic and policy-making institutions, non-governmental organizations and MDB staff.

Each multilateral development bank has a different set of constituencies to which it is accountable. However, what may be described as the different "personalities" of the MDBs should not prevent visualizing them in an integral manner, as a set of organizations that share common characteristics, play similar roles and conform broadly to the same institutional model. Approaching the family of MDBs as a whole will require a shift in perspective on the part of member governments and MDB management. The dominant practice of focussing on the World Bank, and occasionally on one or another regional development bank, will need to move to *more systemic approaches* that visualize the totality of these institutions as they relate to their shareholders and other stakeholders. *The challenge is to transform a more or less disparate family of institutions into a more efficient network and eventually into an effective MDB system.*

(xxvi) Such systemic approaches will be essential to ensuring future effectiveness of the *delicate balance between (a) financial resource mobilization; (b) capacity building, institutional development and knowledge brokering; and (c) providing regional and global public goods*. It is increasingly clear that MDBs should not be involved in each of these functions to the same degree, but that the MDB system as a whole (including the sub-regional institutions) needs to ensure adequate coverage of all of them.

There has always been a *fundamental tension between the financing and development roles of the MDBs. This has been exacerbated during the last decade by an increasing emphasis on the public goods function*. In some MDBs (e.g, the Asian Development Bank, the Central American Bank for Economic Integration and, to a lesser extent the World Bank), tensions between financial market mediation (i.e. the financing role), on one hand, and the development and public goods roles, on the other, are at their highest level in years. The impacts of recent financial crises in Asia, Russia and Latin America, of increased volatility in financial markets, and of new demands on the MDBs have combined to create increased pressures for tradeoffs between pursuing one function at the expense of the others. The significant decline in real terms of ODA, for example, has resulted in greater demands on MDBs from both developed and developing member states for increased resource allocations to poverty reduction programs and to public goods. However essential this may be, for *the MDB system as a whole* financial resource mobilization must be considered as "*primus inter pares*" of the functions assigned to these institutions. Providing loans to borrowing member countries is an essential condition for the existence of an MDB, and neither of their other two main functions could be performed without preserving their lending capacity, which in turn requires safeguarding their financial integrity.

(xxvii) This will also require that much sharper differentiation be made between categories of countries and the kinds of MDB engagement that make sense for each of these categories. The current distinction between concessional and non-concessional borrowers is inadequate to meet the needs of the increasingly complex, conflicting and expanding demands on MDB resources. It is also inadequate to distinguish between countries that are eligible for non-concessional loans and those that are not, simply on the basis of rather crude assessment of whether they have access to private capital markets. In addition to the extent of poverty and the degree of access to private capital, issues such as the extent of and commitment to policy reforms, the impact that MDB lending on the sustainability of the reform process, the importance of maintaining policy dialogue, and the need to provide support in the event of a major international financial crisis, should figure among the criteria to determine the categories of MDB borrowers and the types of engagement that make sense.

(xxviii) If the MDBs are to cover their three main functions adequately and maintain shareholder support, they will *need to expand the product line*.

With regard to *financial resource mobilization,* this will require the MDBs to:

- Develop a broader range of products suited to different client needs and priced accordingly (all the way from large, emergency, fast-disbursing loans for middle and high income developing countries, to small, capacity building, slow disbursing loans for poor countries).
- Eschew formal graduation policies, and instead differentiate products aimed at specific segments of borrowers, pricing them according to their characteristics.
- Focus on enhancing other financial flows, both official (co-financing, donor coordination) and private (comfort, guarantees), and on helping to

increase domestic resource mobilization (financial sector reforms, public expenditure reviews).
- Explore new forms of mobilizing financial resources for poor countries (trust funds to cover recurrent expenditures, export promotion, debt reduction on an exceptional basis).

With regard to *capacity building, institutional development and knowledge brokering* MDB institutions will need to:

- Ensure the availability of the technical and management capacity to engage in more costly and lengthy operations (social sectors, governance, safety nets, and continuous policy dialogue). Some of the MDBs currently simply do not have these capabilities or do not have them in sufficient quantity and quality.
- Build and renew their intellectual capacity to engage in policy dialogue with stakeholders, embracing intellectual diversity and a greater willingness to learn from others.
- Focus on spreading best practices and on building policy-making capacities in borrowing countries.
- Give greater and special emphasis to technological innovation and scientific research capabilities (bridge the knowledge divide).
- Explore the possibility of charging for non-lending (i.e. technical assistance, information, policy dialogue) services to middle and high-income developing countries.

With regard to the *provision of regional and global public goods* the MDB family of institutions will need to:

- Engage with other regional, international and global organizations in strategic partnerships. The evidence from current practice is that MDBs cannot and should not on their own continue to attempt to provide public goods.
- Ensure they can count on sufficient grant-making resources to cover the cost of contributing to the sustainable provision of public goods.
- Develop jointly with strategic partners rapid-response capacities to help member countries cope with shocks. In addition to the sudden and unforeseen requirements resulting from natural disasters and health epidemics, the benefits of increased economic openness and integration into the global economy also entail increased exposure to volatility.
- Explore new forms of resource mobilization for this purpose (predictable and assured funding, international taxes, international fiscal transfers).

(xxix) The rapid expansion of demand on the MDBs to play a much greater role in the provision of regional and global public goods needs to be further examined in order to arrive at the right balance between this function and direct support to the development of a borrowing country. There are tradeoffs that will need to be addressed, but there are also issues of the comparative advantage of MDBs versus other institutions in the provision of certain public goods. The MDBs should not be placed in the position as last resort provider of global public goods.

(xxx) The division of labor between the MDBs and other development agencies as well as between the MDBs themselves has been a rather vexing question that has persistently dogged these institutions. First, there is the *division of labor between MDBs and private sources of capital*. The argument has recently been re-stated (see the Meltzer Report) that MDB loans produce market distortions by "crowding out" private investment. There is no credible economic analysis in support of this contention. To the contrary, the assessment provided by major rating agencies and by private investors tends to suggest that MDB loans send signals of market confidence and are inclined, therefore, to "crowd in" private investment. In addition, even in sectors that attract private financing, loan maturities, conditions for private investment (tax breaks, fiscal incentives) and differences between private and social rates of return may continue to require MDB participation through loans or guarantees.

Second, there is the *division of labor between the MDBs, bilateral agencies, and United Nations and regional organizations in mobilizing concessional financing*, especially for social sectors. This is an area of very rapid change that is moving in paradoxical directions. On the one hand, in the areas of "soft interventions", which involve primarily setting norms, establishing standards, and providing policy advice, a larger role is emerging for institutions other than the MDBs, including private entities, foundations and non-governmental organizations. This recognizes that the margins for independent action and for agility in policy and in practice are greater for a range of international actors than for the MDBs which must respond first to their complex inter-governmental constituency. On the other hand, the MDBs themselves are at the same time moving increasingly into "soft interventions" (e.g. micro credit, vaccination, gender, participatory programs, governance, environmental conservation). There is perhaps no more dramatic example of this than the direct involvement of the International Monetary Fund (IMF) in "participatory approaches" to the preparation of Poverty reduction Strategy Papers (PRSPs) and the renaming of the ESAF as the Poverty Reduction and Growth Facility. This paradox of "mission creep into soft interventions" by the MDBs and the emerging larger role in the same areas for other organizations is contributing to an increasingly unclear division of labor. In response to this, the MDBs have begun to articulate strategic alliances with such organizations to design and implement projects. For MDBs (and IDA in particular), such steps are imperative if they are to continue to be the preferred channel for concessional resources.

Third, there is the *division of labor between the MDBs themselves*. There have been frequent calls for a clearer definition of responsibilities between the World Bank and the regional development banks and, to a lesser extent, between the regional and the sub-regional development banks. Mutual suspicion and different institutional personalities have prevented more effective co-ordination in the MDB system. Asymmetric power relations between members of the MDB family have often heightened suspicions and conspired to achieve smooth working relationships. Although discussions concerning the Comprehensive Development Framework (CDF) and specific cooperation agreements (e.g. the recent Memorandum of Understanding between the African Development Band and the World Bank), it is necessary to intensify coordination efforts in order to reduce operational overlaps and improve efficiency (harmonization of procedures, pooling of staff, joint missions, exchange of information, sharing of knowledge management systems, common strategies in selected sectors).

(xxxi) The various *MDBs are in quite different situations with respect to their capital and replenishment needs to support their regular lending operations.* What is clear over the medium to longer term, however, is that if the MDB system as a whole (or for that matter its individual members) wishes to maintain positive net transfers with its borrowers in the long run, further capital increases and increases in the size of replenishments will be necessary.

At approximately current levels of lending (which came down sharply after the Asian crisis) the World Bank does not appear to need a capital increase for several years. The Inter-American Development Bank is in a comfortable position and may not need a capital increase for a long time, and the European Bank for Reconstruction and Development —which started operations a decade ago, is in the same situation. The African Development Bank increased its capital recently. Its projections and the quite limited number of countries currently eligible for Bank lending indicate that a further capital increase will not likely be required for at least the next 3-4 years. The Asian Development Bank was seriously affected by the East Asian financial crisis of 1997-1998, and appears to be the regional development bank most in need of a capital increase (its capital is less than half of that of the Inter-American Development Bank, even though it has a larger constituency to serve). The situation is less clear with sub-regional development banks, although it appears that the European Investment Bank, the Islamic Bank, the Arab Fund and the Andean Finance Corporation are well capitalized for several years to come at their current operation levels. The Caribbean Development Bank and the Central American Bank for Economic Integration appear to be experiencing difficulties that may require capital increases.

All *MDBs face restrictions regarding their soft loan windows, to the extent of generating doubts about the future prospects for concessional lending*. It appears probable that the best that can be expected is that the total volume of Official Development Assistance, both through multilateral and bilateral channels, will remain at current levels in nominal terms, which implies a decline in real terms. Given low rates of economic growth and of domestic savings in many poor countries, this gives rise to legitimate doubts about the prospects for the poverty reduction objectives agreed for 2015 and for the central role that MDBs are being asked to play in that connection. The current HIPC initiative bears directly on this.

If the HIPC debt cancellation initiative is not fully and timely funded, it could conceivably reduce the total amount of concessional resources available for the poorest countries, primarily because reflows to MDB soft loan windows would be significantly lowered. Donors facing high HIPC costs for their bilateral programs may have a difficult time contributing both to the HIPC Trust Fund and to subsequent replenishments of the concessional funds. Lower reflows and stagnant replenishments imply reductions in the level of future soft window loans. This is crucial for those HIPCs whose sustainable level of borrowing after debt relief can be achieved only at grant or IDA rates. There is genuine and legitimate concern in the MDBs that unless the HIPC initiative is adequately funded on a timely basis and unless donors contribute additional resources for future soft-loan window replenishments, the net effect of the initiative for many of the poorest countries may be negative over the medium and long term.

(xxxii) *Changes are required in the way MDBs, and in particular the World Bank, relate to borrowers*. MDBs have accumulated a broad base of knowledge about development policies and strategies, and could thus become "knowledge institutions," ready to learn and adapt on the basis of experience. The considerable unevenness between MDBs, however, has made it difficult to achieve this across the MDB family. Even though other MDBs have tried to build their own research and policy advice capacities, the World Bank continues to be dominant as the main purveyor of development ideas. In addition and although its policy prescriptions change significantly over time, a "the Bank can never be wrong" mentality still prevails in much of the institution's thoughts and actions. This impairs the World Bank's ability to learn and creates an accountability deficit. By contrast, some sub-regional MDBs appear overly deferential to borrowing country governments, which could undermine sound policy advice and conditions established by regional development banks and the World Bank for access to financial resources.

The Comprehensive Development Framework (CDF) and the Poverty Reduction Strategy Papers (PRSP) could be used to engage borrowers in a more meaningful dialogue with the MDBs and with other development assistance agencies. However imperfect their application may be, especially when viewed from the ground up, they are preferable to country assistance strategies unilaterally designed by MDB staff. Nevertheless, for these instruments to play a positive role MDBs must be prepared to accept strategies and policies different from those they espouse and collaborate with other institutions and organizations, particularly to integrate institutional considerations into the design of CDFs and PRSPs. Greater interaction with borrowing country members requires staff time, intensive consultations and possibly a more substantive field presence. It also raises the costs of MDB operations. Again, there is great unevenness across the MDBs with regard to such capabilities and this, in turn, adds further support to the importance of systemic approaches.

(xxxiii) If the MDBs are to meet the multiple challenges outlined above and to play the increasingly complex roles expected of them, *it will be necessary to increase operating and net income*. This is the only way to cover administrative costs, increase reserves, make transfers to their soft-loan windows and provide grants to finance public goods. Decisions on the management of operating and net income should be based on strategic views of the roles MDBs will play in the future. The costs of increasing operating and net income should be equitably distributed among shareholders, seeking to balance increases in callable and paid-in capital, increases in loan charges, charges for non-lending services, and pressures on staff to reduce administration costs.

Much greater flexibility in budget procedures and multi-annual budgets are also essential to improve the administration of MDBs, allowing them to make a more efficient use of resources. This would require a major shift from the public agency style of budget management of MDBs, which involves a fair degree of Board micro-management, to a style of budget management more in tune with modern resource allocation and use practices (decentralization, cost centers, performance indicators, outcomes and results accountability).

Concluding remarks

(xxxiv) *Shareholders and senior MDB staff should react with a sense of urgency to the challenges implied by the major transformations that are now under way in the international context*. In particular, there is an important role for concerned small non-borrowing shareholders in support of the MDBs. Many of these participate in several MDBs, which gives them a broad perspective on the operations of these institutions as a whole. They should help articulate a shared perspective of the future of MDBs, acknowledging their limitations and shortcomings, but forcefully mobilizing support for their continued existence and gradual expansion.

(xxvi) In addition to paying attention to the World Bank and the regional development banks, *it is necessary to pay greater attention to the smaller sub-regional banks*. They often play an important role when viewed from the perspective of the borrowing countries, and should intensify and improve their interactions with other members of the MDB family. Also, the absence of sub-regional institutions in a region as large and diverse as Asia is quite striking and merits further examination.

(xxvii) Under attack from both conservative and radical positions, the MDBs need champions among their smaller non-borrowing shareholders. Their motivations are less suspect than those of big developed country shareholders and of borrowing member countries, they understand well the strengths and weaknesses of MDBs, and they are well poised to exert leadership in a renewal of a somewhat disparate family of rather unique and most useful institutions.

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The study's purpose is to provide a broad strategic framework of key issues affecting the future of the Multilateral Development Banks. Some of the key issues addressed by the study are:

- Key functions for the MDBs as a system in a globalized world
- The need for new products and differentiated pricing
- Division of labour in the international system
- Financing needs of the MDBs

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