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Financing

Multilateral Finance and Development

by Professor Dr Wolfgang König, Göttingen *

This article presents an outline of major international financial institutions, i.e. the Bretton Woods organisations. The focus of analysis is on the conceptions that have shaped the posture of these institutions on development issues and on their corresponding activities and problems.

Organisations of all kinds are now participating in the expanding system of international economic cooperation. The distinguishing feature of the financial institutions is that their output is more than verbal; for that reason they are often considered, and perhaps have become, the most effective mechanisms for multilateral collaboration. They are receiving and transmitting mechanisms, even though their members have conflicting interests, differing degrees of power, and substantial bilateral financial relations. As far as Third World development is concerned, we might consider these international financial institutions to be not only independent variables, but also mechanisms shaped by the demands of that development.

This paper presents an outline of major international financial institutions, i.e. the Bretton Woods organisations, which are the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) together with the International Finance Corporation (IFC) and the International Development Association (IDA), as well as of regional development banks, as demonstrated by the case of the Inter-American Development Bank (IDB). The focus of analysis is on the conceptions that have shaped the posture of these institutions on development issues, the process of decision-making with respect to the provision of financial assistance to developing countries, the power they acquire and use in the process, and the problems they face by the mid-1970s. Let us first establish our terms of reference.

The case for multilateral monetary cooperation, including temporary balance of payments assistance mitigating the effects of short-run international instability, is not hard to make. Such cooperation may become necessary when, for example, shocks originating somewhere in the world economy are passed on through the international economy, when short-term variations in demand and supply occur, or volatile international move-

ments of short-term capital ensue. The case becomes more complex, however, when we have to deal with long-run changes in the international economy and the specific issues of developing countries. Are these countries to bear the total responsibility for their development, i.e. an increase in productive capacity and transformations in their social and economic structures? If we accept that, in an increasingly interdependent world, regional disparities in the standard of living are to be substantially reduced, the foundations for constructive partnership and cooperation based on the interdependence of interest can be laid — the more so if we also accept that the relatively open developing economies face external barriers to their growth. With this in mind, a coherent set of international policy measures can be formulated and external financial cooperation may help to overcome the rigidity of an economic structure, lead to a more effective mobilisation and use of financial resources, increase the rate of capital formation, accelerate the process of industrialisation, and provide jobs for unemployed manpower.

What are the potentially controversial aspects of such action? The diagnosis of the causes of underdevelopment might result in a decision to concentrate remedial measures on transforming social structure rather than on accelerating the growth of the economy, external financial assistance being considered unnecessary and/or undesirable. In terms of economic efficiency the success of the approach without external cooperation depends, among other things, on the degree of substitutability between domestic and foreign resources, or, expressed differently, on the relative importance of the foreign exchange gap and the savings gap. Politically, it might require the introduction of forced methods of capital formation which are usually considered socialistic. One can, therefore, conclude that, under certain circumstances and for the sake of achieving high growth rates, external financial assistance makes it unnecessary for the state to take

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over the sources of income of the more affluent and obviates the need for social reorganisation. This explains why international financial cooperation is not necessarily based on humanitarian and economic considerations. In reality, a multilateral financial system for development might have to forgo some of its possible advantages to recipient nations, and gain a political dimension in order to mobilise financial resources from ultimate lenders. However, with the prospect of long-term international stability, both sides would probably agree on a minimum condition for external assistance: that the self-help effort of recipients is not impaired.

The principles and objectives of the Bretton Woods system, as embodied in the Articles of Agreement of the IBRD and the IMF, stipulated exchange rate stability, multilateralism, convertibility, access to a pool of international liquidity in the event of temporary balance of payments difficulties, and a high level of international investment with emphasis on the flow of private capital. The Bank as well as the Fund "was bound to be politically controlled"¹ since in their work they would be dealing with politically vulnerable matters such as exchange rate policies and the generalisation of risks inherent in foreign private investment. Under the circumstances, a major breakthrough in international cooperation had been achieved. By their functions, the two institutions were designed to effectively complement each other in restoring and maintaining international economic stability, but because the Bank did not have direct authority over international investment, its scope was relatively limited and its task was easier than that of the Fund which faced the challenge of assuming, through completely new approaches, a central position in the international monetary system.

The organisations got off to a slow start, but the 1950s saw the activation of multilateral financial policies, more institution building, and task expansion. Because the World Bank's own ability to directly promote private enterprise is limited for statutory reasons, the IFC was established in 1956. It has been described as "unique among inter-governmental organizations in that it is the only such institution operated for the sole purpose of assisting the international spread of private enterprise"². The IDB was created in December 1959, after the considerable insistence of Latin Americans had overcome the negative attitude of the United States towards such a project and when the inter-American system was generally considered to be moving towards collapse. In view of the heavy debt service burden of many countries

IDA was established in 1960. It is held that its concessionary loans not only strengthen the borrower country's economy without adding to the short-term burden of foreign debt service, but also indirectly increase the safety of the conventional loans of foreign investors.

The IMF granted the developing countries facilities for compensatory financing and for stabilising the prices of primary products — amounting in effect to some decontrol of its drawing policies. Then, the extensive debate on the reform of the international monetary system in the 1960s led to a potentially important innovation, the Special Drawing Rights (SDRs), which both made unconditional liquidity available to members for supplementing existing assets, and constituted the first planned international reserves. However, the allocation of the SDRs in accordance with the members' quotas gave rise to considerable criticism by academic circles as well as, in the developing countries, by those who had hoped to see a link with development finance established.

The World Bank Group and IDB strengthened their position with relative ease by expanding and diversifying the scope of their lending and other activities in line with their assessments of changing development priorities. Like the IDB, the Group has shown a growing awareness of social problems in the developing world such as unemployment, income distribution, poverty, and inequality. However, these institutions remain highly dependent on private investors in mobilising resources for development. Furthermore their successful operations in capital markets largely depend on the granting of privileges by the countries concerned, since the scheduling and authorisation of bond issues are usually highly regulated. Other mobilisation techniques employed by the IBRD and IDB (and of course by the IFC), also involve close collaboration with private financial institutions in the developed countries, in the course of which the international organisations are obliged to earn a solid financing reputation.

Beginning in the 1970s, the multilateral financial system has undergone a series of severe tests, which differed in degrees for individual institutions, the IMF facing major problems. The emergence of the US dollar as a vehicle currency, and the international difficulties arising from the persistent US balance of payments deficits, had already been largely instrumental in concentrating rival power in the Group of Ten, thereby leading to the bypassing of the IMF and a weakening of its position in important matters. Then, the suspension of the convertibility of the dollar into gold in 1971 initiated a period of considerable uncertainty which subsequently was enhanced by the booming Euro-currency market with a substantial pool of uncon-

¹ J. Keith Horsefield, *The International Monetary Fund 1945-1965*, Vol. I, Chronicle (IMF, Washington, D.C., 1969), p. 130.

² World Bank, *IDA and IFC, Policies and Operations* (April 1968), p. 95.

trolled world liquidity, the breakdown of the exchange rate system established at Bretton Woods, and increasing inflationary tendencies besetting the industrialized world.

The very existence of the multilateral financial system, however, was critically tested by the energy crisis when oil prices quadrupled and the danger of competitive devaluations and the escalation of restrictions on trade and payments ensued. Established international cooperation habits proved adequate to prevent the worst of this shock; more so, the crisis appeared to give the international institutions the chance for task expansion and to establish themselves as the true center of international financial collaboration. The Fund set up an Oil Facility as a supplementary means of assisting members and established an Interim Committee as a forum for the debate on monetary reform issues. The creation of the Development Committee, a joint body of the World Bank and the Fund, meant a concrete step toward new ways of transferring real resources to developing countries and led to the establishment of a "Third Window" in the IBRD.

Yet, the most intensive reappraisal since World War II of worldwide international economic relationships has produced so far only limited agreement on pressing issues and the additional finance made available by multilateral institutions appears to be small relative to their members' needs in a most disturbed economic condition, and to the magnitude of the "safety net" agreed upon by the Group of Ten. However, significant for the future orientation and work possibilities of these institutions may be a certain aid-weariness of traditional ultimate lenders and the opening of new sources of funds: understandings of the IMF with and borrowings of the IBRD from members of OPEC as well as, in the case of the IDB, the declaration of 12 industrial countries outside the Western Hemisphere to seek membership. All this entails the possibility of significant quantitative and qualitative changes of the institutions' intermediary role in the channelling of resources to developing countries.

Like money in general, multilateral external finance implies command over resources and therefore power. As far as the financial record is concerned, the outstanding facts are greatly increased flows of multilateral financial assistance, but also a gradual shift from the public to the private sector in the total of external finance of developing countries and substantially increased levels of indebtedness of these nations. The debt problem in particular is not necessarily one of size, but rather of the terms and conditions of financial assistance expressed by the hardening of loan terms and a significant decline in the volume of grants provided.

It appears that more or less informal codes for the conduct of economic policies have assumed a greater importance in the channelling of multilateral financial assistance. On the one hand, this has on occasion caused considerable suspicion about the "true" motives of the institutions. On the other hand, it seems natural that they should seek some assurance that their resources will be effectively used; the evaluation of the recipients' economic performance must, in fact, be considered important in making international financial cooperation for development effective. In doing so, adequate information about the project to be financed and about the recipient's economy as a whole may be essential. Such information is not necessarily contrary to the interest of the recipient but might, under certain conditions, result in a shift to outside the recipient country of the locus of decision making concerning its development policies.

Over the years, the Bank has made lending dependent not only on the financial soundness and efficient management of the project in question but also and increasingly on its being satisfied that the recipient country is making what it believes to be a sufficient self-help effort in promoting its own development. For the latter purpose, IBRD economic missions periodically visit member countries and assess their performance, using as a yardstick such aspects as mobilisation and allocation of available domestic resources, foreign trade and investment policies, patterns of public expenditure, etc. Subsequently policy recommendations are made to the recipients. In its approach to lending the IDB mainly concentrates on projects and usually refrains from separate general evaluations of the economic and social policies of recipient countries.

As far as the IMF is concerned, in the conduct of its growing financial operations, this institution recognised that stand-by arrangements offered a possibility of developing binding codes for the domestic policies of its members. These arrangements became, in fact, its most important single instrument the gradual shaping of which by the Board of Directors is an interesting piece of decision making. Originally, the arrangements were supposed to give the members the right to engage in transactions to the amount of the total credit granted, without further review by the Fund. But the continuously increasing inclusion of terms, the "trigger" clauses, along with the gradually emerging technique of "phasing" — meaning that the full extent of the stand-by could not be drawn in a lump sum but only in instalments, the continuity of which was linked to fulfilment of the performance clauses — gave the Fund in effect the right to cancel these arrangements.

In principle Fund policies have contained a bias against protectionist efforts of developing countries to promote industrialisation, and implied that the full burden of adjustment of balance of payments disequilibria due to factors beyond the control of these countries must be borne by them. Furthermore the ready application of exchange rate devaluation when credit brakes fail is bound to lead to a strengthening of the traditional export-oriented sector. This approach is probably effective if the goal is to strengthen as fast as possible the international reserve position of a country; it has, however, been frequently claimed that this would occur at the expense of some longer-term growth potential.

If their central aim was the stabilisation of the economies of the countries concerned, the standby arrangements may be considered to have largely failed. Generally speaking, these arrangements have long been recognised as an exercise undertaken by member countries to increase their prospects for external finance, since potential lenders of capital tend to consider their conclusion as an acceptable assurance of a proper conduct by the recipients. But what is "proper" conduct? It is not necessarily complete stabilisation — rather, perhaps, the elimination of what are considered the worst types of exchange controls, and „responsible“ financial conduct in general.

Indeed, beginning in the second half of the 1950s, the Fund encouraged a move towards the sim-

plification and elimination of multiple exchange rates which had increasingly become key instruments in the ambitious efforts of major developing countries to achieve a rapid industrialisation of their economies. Alternative measures introduced, mainly import surcharges, advance deposits on imports and export taxes, were declared temporary, but today are still in force and appear to have permanently taken over most of the former functions of multiple rates. Also, experience with the application of the so-called crawling peg, first introduced by Chile at the end of 1962 (and terminated under the Allende administration) suggests that this technique can only be introduced and maintained by the simultaneous application of multiple exchange rates and/or non-tariff restrictions.

Among the many complex and interdependent questions posed in principle by developing country and IMF exchange and other non-tariff policies, we may single out the following two groups which have not been thoroughly studied: (1) types of disequilibria, the degree of joint responsibility of surplus and deficit countries, and the relative advantage of adjusting as compared to financing imbalances; and (2) the relative effectiveness of the existing adjustment instruments, and their bearing on development policies, including the removal of structural imbalances and export diversification, and the possibilities of developing alternative devices.

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There is no agreed standpoint from which to view institution building and task expansion in the multilateral financing of development in developing countries. In the final instance, the political dimension of the financial system may rule out a non-normative perspective. Thus in reviewing the effectiveness of the system, answers to the following questions will remain controversial: have appropriate institutional mechanisms been created at the multilateral level for dealing with the development needs of the developing countries? If so, in which ways have these institutions actually responded to the opportunity to pursue development policies? Have they, in the process, achieved a legitimate authoritative position in the development field?

To be sure, the questions themselves involve the problem of the degree of objectivity it is possible to achieve in identifying the causes of underdevelopment in developing countries and in prescribing remedial action. But for practical purposes, we might simply ask how responsive the institutions are to changing development priorities.

The differing degrees of responsiveness of the Fund and of the development finance institutions are largely to be explained by the purposes for which they were established. The IMF was not founded with the development problem in mind. Nevertheless, from the mid-1950s it seized opportunities for task expansion in developing countries by ways often considered controversial in both form and substance.

By contrast, the development finance institutions seem to have responded to the functional challenge of Third World development by constantly developing new techniques and increasingly financing projects that for long were thought unbankable. Problem areas are the volume, terms and conditions of their financial resources made available as well as the orientation of development policies of developing countries themselves in making external finance effective. As for the latter, a decline in the ratio of investment out of domestic resources which occurred in a number of recipient countries has given rise to serious concern.

In the context, the impact of external financial resources on developing countries' self-help effort may be a crucial question. Because a statistical basis is lacking it is not possible to prove or disprove the worst of all possible cases, namely that contrary to the usual assumption (that they significantly and effectively raise the rate of capital formation in developing countries), multilateral financial resources have in fact reduced domestic savings, largely supplemented consumption, and tended to lower the output-capital ratio. It would

only be possible to substantiate this thesis if it could be shown, *inter alia*, that the resources had been devoted to low priority, marginal projects; that, despite the scarcity of resources, one project tended to lead to another in a given sector and/or country; that preference was given to the financing of large projects (possibly because the administrative costs and effort involved are smaller per dollar loaned); that publicly guaranteed resources were channelled into less directly productive activities (possibly because government ownership of directly productive activities is not promoted); and that the availability of the resources reduced the tax effort and geared public expenditure more to consumption. If this were so, a country might be well advised to do without the external financial resources, but then the maintenance of a given growth rate would require some restriction of current consumption, and probably some social reorganisation.

The possibility that external financial resources directly permit a higher level of current consumption in recipient countries, and their need to introduce changes in their socio-economic development policies, would lead to examine membership in the multilateral financial system in relation to the degree to which development options are available to respective members. Decisions by recipients on development options always have a socio-political content, and are therefore of interest to the ultimate lenders, but not necessarily to the multilateral financial institutions as such. These institutions are expected to refrain from interference in the domestic politics of their members. However, their judgement on the economic performance of the recipients may take socio-political developments into account, and in turn the decision of the institutions may have an extra-economic influence in the recipient country³.

The future role of the multilateral financial system in Third World development will ultimately be the result of changes in the priorities, and the degree of consensus, of the major powers. In fact, it remains to be seen to which extent the institutions are given the chance to remain or become more independent variables vis-à-vis these powers the structure of which is under change with the possibility of an increase in conflicting interests among them. Their independence may be strengthened if there is a shift in the emphasis of the multilateral financial system from integration to cooperative relations — a prospect that would enhance the international character of the system itself and increase the development options of its members.

³ IBRD, World Bank and IDA, Questions and Answers (September 1971), pp. 7, 13.