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International financial institutions
in the 21st century



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One hundred years after Bretton Woods: A future history of the World Bank Group

Michael Klein

1. The World Bank Group

1.1 The first 50 years

Reconstruction and development. The Bretton Woods conference of 1944 gave rise to a set of global economic institutions - the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD or World Bank) and the General Agreement on Tariffs and Trade (GATT), precursor to the World Trade Organisation (WTO). Their rationale reflected the experience of the Great Depression of the 1930s, when world output collapsed amidst a contraction of trade and competitive devaluations. During the 1950s, in a world of fixed exchange rates with borders gradually opening up to trade and finance, the World Bank funded mostly infrastructure projects for economic development first in Europe, but soon in developing countries.

Poverty and basic needs. When the developed world recovered beyond expectations, attention turned to persistent poverty, particularly in Asia, one of the big battle grounds in the cold war. At the time, trust in public sector solutions to tackle development issues was still high. In addition to infrastructure lending, the 1970s saw rapid growth of World Bank projects in health and education, as well as rural and urban development to meet the basic needs of the world's poor via public sector solutions.

Debt crisis and the end of communism. The debt crisis of the 1980s shifted the focus towards policy-based adjustment lending, particularly in Latin America. Disillusioned with public sector solutions, attention shifted to private sector development, deregulation and open trade combined with orthodox fiscal and monetary discipline under the new "Washington Consensus". Latin America barely emerged from the debt crisis when the Soviet Union and other East European communist states collapsed, and the World Bank started on the uncharted task of helping the affected countries with the change towards a market economy.

Global exchange, global concerns. With the end of the cold war and increasing cross-border flows of trade, capital and information, a new global system started to emerge. The 1980s and 1990s saw an ever broadening scope of concerns for the World Bank in diverse areas such as protection of the environment, good governance including the fight against corruption, private sector development, gender equality combined with broader support for civic society, calls to consider the full spectrum of human rights, and moves towards advocacy of some form of democratic government.

By the 1990s, the World Bank Group had increased lending to over USD 20 billion per annum and grown from a few hundred staff in the 1950s to almost 11,000. Beyond the original IBRD, the World Bank group comprised its private sector arm, the International Finance Corporation (IFC) since 1956, the soft-loan window of the International Development Association (IDA) since 1960,

The views presented in this essay are the author's own and do not reflect positions of organisations that the author is or was affiliated with. The author would like to thank Constantijn Claessens, Pierre Guislain, Ignacio Mas, Doug McKay, Neil Roger, Jeffrey Shafer and Nemat Shafik for helpful comments.

the International Center for the Settlement of Investment Disputes (ICSID) since 1966, and the Multilateral Investment Guarantee Agency (MIGA) since 1988. In parallel, a whole system of regional multilateral development banks had developed including the African Development Bank (AfDB), the Asian Development Bank (ADB), the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IDB), the Islamic Development Bank and a number of smaller ones.

Never were the development bureaucracies bigger, never were they asked to pursue more varied goals and never were they criticised more. Criticism reached a peak at the occasion of the 50th anniversary of Bretton Woods in 1994. Conservatives argued that the World Bank was just crowding out private firms and financial institutions and more generally wasting taxpayers' money. Left-leaning critics accused the institution of ruining the environment, hurting poor people and supporting corrupt elites. More mainstream observers found evidence of waste, an overemphasis on meeting lending targets over getting results on the ground, and a variety of other complaints about bureaucrats resisting needed change.

The fact that the Bank had systematically achieved very respectable real returns on projects where such returns could be measured, seemed to count for little (Table 1). The additional fact that the Bank was exposed to projects of a riskiness that looked more like venture capital than prudent lending did not make its critics pause. The decline of project quality following the worsening world environment in the 1980s was largely blamed on staff. Success ratios of 60 percent, a venture capitalist's dream, attracted only criticism, some of the sharpest from within the institution. It is not at all clear that the World Bank would have been invented at the turn of the 21st century had it not already existed.

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Table 1. Average economic rates of return on World Bank-supported projects (in percent)

Sector	1974-1982	1983-1992
Irrigation and drainage	17	13
Telecommunications	20	19
Transport	18	21
Power	12	11
Water and sanitation	7	9
All World Bank operations	17	15

Source: World Bank (1994).

Yet, many argued that the World Bank Group was still in better shape than many other multilateral organisations. The World Bank, partly due to its exposed position, became a test case in the move to the new 'zero-tolerance' world, in which it was subject to increasing and competing demands from multiple constituencies including the about 180 shareholding governments, electorates in the various countries, non-governmental organisations (NGOs), firms, financial institutions, etc. In fact, in the absence of well-established global institutions for many concerns, it helped mediate, shape and implement conflicting demands, which were ultimately meant to affect policies in countries throughout the world.

1.2 Understanding the transformation

Functions of the World Bank. To understand the evolution of the World Bank Group it is helpful to decompose its basic product conceptually. In essence, the World Bank of the first 50 years produced a single product, the loan. Bundled up in the loan were five main functions - funding, guarantee, subsidy, policy advice and, to some extent, rating agency services. In addition, the World Bank participated to a degree in the lender of last resort system spearheaded by the IMF.

The World Bank of the first 50 years produced a single product, the loan, but bundled up in this were five main functions.

- The pure provision of *funding* was essential in the original Bretton Woods world of capital controls. The World Bank had *de facto* the privileged ability to move funds (loans) out of developed countries into developing ones - and back again (repayments). In principle, the Bank was to provide such funding only as a last resort, when private markets failed to do so.
- *Vis-à-vis* its bondholders the World Bank provided *guarantees* of repayment of the loans backed by callable capital from its shareholders. Normally this guarantee function was bundled with the loan, but for some time the World Bank tried to develop free-standing guarantee instruments to support direct private lending to developing nations.
- World Bank lending - often together with support by the IMF - was also seen by proponents as providing valuable *signals to private investors* about the creditworthiness of a country, thus coordinating investor expectations and preventing panicky and uninformed investor behaviour. In that sense, IMF and World Bank were *de facto* delegated to monitor countries' policy efforts on behalf of the private financial markets (Rodrik, 1995, and Gilbert *et al.*, 1996). The stamp of approval from the Bretton Woods institutions helped countries attract foreign capital, but might also have created a degree of moral hazard. The IMF, sometimes complemented by the World Bank and other international financial institutions (IFIs) also backed its signalling function with liquidity provision as a *lender of last resort*.
- The World Bank Group also passed on *subsidies* to developing countries either funded explicitly from resources provided by donor governments under the IDA scheme, or implicitly as shareholders renounced taxes and dividends and callable capital was not remunerated.
- Finally, World Bank staff and an army of consultants conducted research and provided *advice* on project design and management as well as on economic policies in the course of project work and in parallel.

Synergies and conditionality. Various analysts argued that the provision of all these functions under one umbrella was beneficial. Essentially it was argued that subsidised funds and the facilitation of private investment acted as an incentive for governments to pursue policy or project designs, which were thought to be suitable for economic development on the basis of research by the World Bank. The research was in turn facilitated by the access to data that lending enabled. The whole approach was often called policy conditionality.

Unbundling and new roles. With hindsight we can see how changes in the world at the turn of the century exerted major pressures on the World Bank to unbundle the different functions of the traditional loan. In the following, the essay analyses the emergence of a new set of separate, generally free-standing 'products'. In addition, an in-built tension underlay the role of the World Bank and also the IMF that drove to some extent the evolution of today's world governance mechanisms. Both

Changes in the world at the turn of the century exerted major pressures to unbundle the different functions of the traditional loan.

institutions, sometimes complemented by other IFIs, tried to set conditions for sovereign nations, thereby undermining aspects of sovereignty. This 'contradiction' was gradually resolved by the creation of standards and rules that were accepted world-wide. Once such rules were accepted the peculiar mechanisms of conditionality were no longer necessary. In retrospect, it is also clear that these changes were for the better, given the emergence of the world economy as we know it today, in 2044. In fact, out of the World Bank Group emerged a number of essential features of our current global governance mechanisms, even though few remember their origin.

Outline of the essay. The essay starts by providing a general sketch of the world in 2044 compared to that in the mid-1990s. Further features of the world of 2044 are later introduced topic by topic. The essay then argues that:

- First, the rise of both private financial markets and the private provision of most economic and social services rendered the *funding and guarantee functions* of the World Bank group largely superfluous.
- Second, most remaining *lender of last resort functions* are in 2044 exercised by pre-funded private standby liquidity schemes, because most lending is private-to-private and currency competition has rendered central banks unable to provide open-ended liquidity support.
- Third, the World Bank's involvement in structural surveillance and in various forms and aspects of public-private partnerships has given rise to a number of voluntary and mandatory *global standards and regulatory rules*, which embody policies that were previously promoted *via* World Bank loans. These rules form the essence of the global governance system of 2044. The World Bank has in particular facilitated better *governance for failed states*.
- Fourth, the *subsidy function* has by 2044 been integrated into the global component of the safety net for the poor. The World Bank helped design effective schemes and continues funding a number of them *via* loans or *via* straight subsidies.
- Fifth, much of the information and advisory work has been taken over by private firms as governments felt obliged to divulge more and more information and became increasingly transparent. The World Bank, in concert with other organisations, has more and more turned into an agency that helps governments diffuse *best practice in the area of economic policy*.
- Sixth, the World Bank is now run as a *foundation* living off an endowment funded from its original paid-in-capital and subsequent contributions. It continues to provide innovative contributions to the fledgling world governance system and particularly to the fight against poverty.

In essence, the World Bank's main over-arching role has been that of an *international catalyst for transition*. From being primarily a lender and guarantor it has evolved to promoter of best practice for policy-makers and better rules and standards for the global governance system. Its efforts remain focused around policies and schemes that help eradicate poverty and create the conditions for sustainable progress. Other multilateral organisations have been shaped by many of the same forces affecting the World Bank. Some, like the AfDB, took on increasing importance when Africa finally started growing. Others, like the EIB, are now largely private as the strong institutional framework of Europe, combined with highly sophisticated capital markets, enabled funding needs to be fulfilled that were previously covered by the EIB.

2. Lending and guarantees

2.1 The world in 2044 - Economic growth, income and poverty

The World Bank has evolved to promoter of best practice for policy-makers and better rules and standards for the global governance system.

Growth at the frontier. As in the 150 years preceding 1994, world productivity growth in the most advanced countries averaged about 1.5 percent per annum between 1994 and 2044. Japan overcame a major crisis at the turn of the century, deregulated its economy and has now reached US levels of labour productivity and a living standard of about USD 54,000 per capita (all figures in 1994 dollars adjusted for purchasing power differences). Labour and product market rigidities plagued the European Union during much of the early decades of the century with the result that Latin America has now caught up with European living standards at about USD 40,000 per capita on average (see Annex).

Conditional convergence. Most Latin American and Asian countries averaged productivity growth rates of about four percent as economies were prudently managed and suitably deregulated (Table 2) (1). Some countries were able to benefit from the ever-increasing potential for technological catch-up, achieving sustained growth rates above ten percent for two decades. But most countries and regions were plagued by recurring crises with the result that world output growth averaged a historically unexciting 3.3 percent (2.3 percent per capita).

Table 2. Per capita income growth in historical perspective (in percent)

	1950-1973	1973-1995	1995-2044
Western Europe	3.9	1.8	1.2
Southern Europe	4.9	1.7	1.2
North America and Oceania	2.4	1.4	1.6
Eastern Europe	3.5	-1.1	3.8
Asia (incl. Japan)	3.8	3.2	3.1
Latin America	2.5	0.5	3.7
Africa	2.0	-0.1	2.0
World	2.9	1.2	2.3

Note: Income figures are in PPP-adjusted terms.

Source: Maddison (1995) for historical numbers.

Africa is by now developing more broadly. Several countries have actually reached per capita incomes above USD 7,000. The greatest difficulties with economic growth have been experienced in the Middle East, where governments remained paralysed and unable to undertake necessary reform while the decline of conventional oil has reduced living standards. As a result of steady advance among the most developed countries on the one hand, and severe long standing disruptions in some economies on the other hand, inequality among countries has actually increased.

Inequality and poverty. While world output almost quintupled in real terms and average per capita output exceeds USD 18,000, about 15 percent of all people live on incomes below USD 3,500 (Indonesia's level in 1994). Serious poverty is still an issue in various pockets of the most advanced

1) Empirical analyses suggest that subject to sound policies backward countries tend to catch up with more advanced countries (Barro, 1991, and Fishlow, 1995).

regions and in parts of South and Central Asia, Africa and the Middle East. Yet, hope for an eventual victory over poverty has never been greater as a result of overall economic performance in the world. Successful global schemes for managing environmental stresses promise a future of sustainable decent living standards for most people still within the current century. By 2094, average African GDP per capita should have reached about USD 14,000 (Portugal's level in 1994), if reforms persist reasonably well and productivity growth increases to a moderate three percent on average - a rate achieved quickly by the early reformers in the late 20th century.

2.2 The evolution of private markets

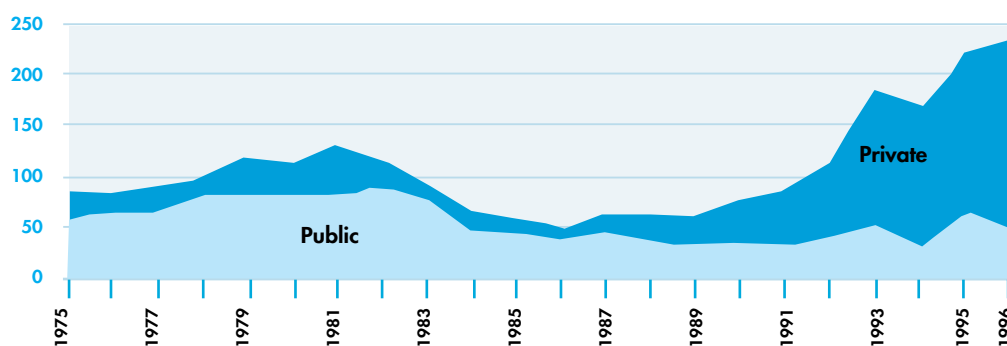
The rise of private capital flows

Diminishing capital controls. Following World War II, global financial flows were limited by pervasive capital controls everywhere. Until 1960, about 80 percent of current account transactions from developed countries were still subject to controls (IMF, 1998a). Significant capital account liberalisation in major OECD economies such as Japan, France and Italy occurred only in the 1980s and to some degree throughout the 1990s. Japan's 'big bang' extended well into the first decade of this century. It took developing countries until almost 2010 to fully liberalise current account transactions. Capital account opening was delayed following the Asian crises of 1997. Yet, *de facto*, borders were becoming more and more permeable for financial flows. Following improvements in financial sector regulation and the unstoppable advance of cheaper and safer telecommunication technologies, capital account controls crumbled in most countries by the middle of the 2010s.

It became apparent that private capital could be counted on to meet the investments needs of promising developing countries.

Private capital flows. Already in the early years of liberalisation of financial flows it became apparent that private financial flows from domestic and foreign saving could be counted on to meet the investment needs of promising developing countries. Following the opening of developed financial markets, the 1970s saw massive private cross-border lending to developing governments (Figure 1). During the 1990s, developing countries had developed large private sectors able to borrow from private sources abroad. While some commentators complained that over 70 percent of such flows went to only 12 countries, on closer inspection it was clear that those 12 countries actually accounted for over 60 percent of world population and the number of countries with access to the capital markets kept increasing as governments improved economic policies (World Bank, 1997a). In particular, the IMF noted that countries in Africa with decent policies saw private capital flows recovering to levels "not much lower" relative to GDP than developing regions outside Africa (IMF, 1998a).

Figure 1. Public and private capital flows to developing countries, 1975-1996 (in 1996 USD billion)



Source: World Debt Tables.

Fiscal crises, privatisation and deregulation

Incentives in tax-funded transfer systems. The capital markets were not the only area where private markets replaced government financing and provision of services. On the back of unexpected productivity growth, and therefore high taxation possibilities, many developed countries expanded the welfare state after World War II, particularly in Western Europe. The share of government expenditure in GDP rose from about nine percent of GDP in 1913 to 28 percent in 1960 and 46 percent by 1996 (Crook, 1997). Most of the increase was due to the ever-increasing cost of transfer payments from previously unfunded pension, social security and unemployment insurance systems. The very security provided by tax-funded schemes, combined with labour and product market rigidities, gradually undermined incentives to work and innovate. When productivity growth declined in the mid-1970s, government funding of the welfare state became increasingly problematic.

Table 3. Average government expenditure in advanced economies as a share of GDP (in percent)

Type of Expenditure	1981	2044
Traditional (military, civil, interest)	11.0	9.0
Economic services	4.4	2.0
Social services (health, education, housing)	14.0	8.0
Pensions and other transfers	12.8	6.0
Total	42.2	25.0

Source for 1981 data: Maddison (1991); unweighted average for 1981 calculated from data for France, Germany, Japan, the Netherlands, the United Kingdom and the United States.

Reform of the welfare state. While the break with the welfare state is often associated with the name of Margaret Thatcher, British Prime Minister between 1979 and 1990, the classic example that showed the way was Holland, where starting in 1983 the government slowly reduced benefits and taxes, such that the expenditure-to-GDP ratio dropped by 10 percentage points between 1983 and 1996. In the early 21st century the shift to the new systems started in earnest, albeit accompanied by acrimonious political fights, which in Europe led to the great unemployment and social crisis of 2010, which nearly broke the monetary union and dragged down growth for over a decade. Today government expenditure tends to vary between 20 and 33 percent in most developed countries (Table 3) (2). The accepted norm is that national welfare systems should largely rely on privately funded and defined contribution schemes. Society maintains a residual safety net with strong incentives to seek work.

Privatisation and deregulation. In both developing and developed countries the performance of state-owned firms in the manufacturing and service sectors remained disappointing. When fiscal constraints forced governments to act, a wave of privatisation and deregulation started to sweep all sectors of the economy throughout the world, much of it initiated by Chile, New Zealand, the United Kingdom and the United States in the 1970s and 1980s.

2) Given the assumptions about growth in this essay, the total amount of government expenditure is still higher by a quarter than in 1994. While roughly half of transfers remain in the public sector, half are handled via private insurance and pension schemes.

Competition and innovation. The biggest gains resulted from introducing real competition, which in particular increased incentives to innovate. One could already see that the benefits from innovation for infrastructure firms after the first serious episodes of deregulation swamped simple static efficiency gains (Winston, 1993). Education entered a revolutionary change in the early 21st century, driven on the one hand by demands for greater school choice (OECD, 1994), and by new options to design and deliver educational content as a result of the multimedia and telecommunications revolution, which is finally bearing full fruit. In the face of these pressures, old education systems were often unable to cope and gradually gave way to new entrants. Change was fastest in poor countries where on the one hand the potential return to education was enormous, while existing delivery systems were often dysfunctional. Likewise in health, where delivery has often been private, the new advances in medical know-how, such as a more complete understanding of the human genome, required new forms of delivery and funding for medical services of all kinds. Thus governments allowing experiments and free entry into these sectors have by now been widely imitated.

Today, governments focus on setting basic policy frameworks governing entry into an industry, abuse of market power and regulation of quality.

The role of government. Today, governments focus on setting basic policy frameworks governing entry into an industry, means to counter abuse of market power, and regulation of quality with mandatory standards in sensitive areas covering health, safety, environment and privacy. Basic services are delivered in health and education. In remaining natural monopoly areas such as some large transmission and distribution systems, mainly in water, road and rail transport, public agencies engage in price regulation. A number of road systems are still publicly owned, but more and more road utilities have emerged funded by electronically collected road user fees. As governments have contracted out a whole range of services, sometimes including tax and customs administration, security services, etc., the tasks of remaining civil servants have become more focused and demanding with a consequent rise in their pay and revival of status.

2.3 The vanishing rationale for World Bank funding and guarantees

The changing role of aid

Concerns about crowding out. The liberalisation of financial flows and the privatisation of economic and social services fundamentally challenged the rationale for lending by the World Bank Group. Various observers noted that in the early days of free global capital markets in the late 19th century, private capital moved across borders without anything like the World Bank or any other international financial institution. Available evidence did not suggest that continued lending by the World Bank in the absence of capital controls would catalyse private capital flows beyond the level they would otherwise have reached (Rodrik, 1995). Private investors felt the Bank was taking away their legitimate business. Calls increased for the World Bank and the IFC to withdraw from traditional lending.

The end of the foreign policy rationale. At the same time, the end of the cold war in the late 1980s eroded the foreign policy rationale for supporting lending by the World Bank. When the cold war ended, official aid flows as a percentage of donor countries' GDP declined from 0.35 in 1986 to 0.25 by 1996 (World Bank, 1998). As part of a move towards greater regionalism, regional mul-

3) Regional development banks comprise the African Development Bank, the Andean Development Bank, the Asian Development Bank, the Caribbean Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Inter-American Development Bank, the Islamic Development Bank and the Nordic Development Bank.

tilateral banks (3) grew in importance compared to the World Bank, as their objectives were more directly aligned with the foreign policy goals of their major shareholders.

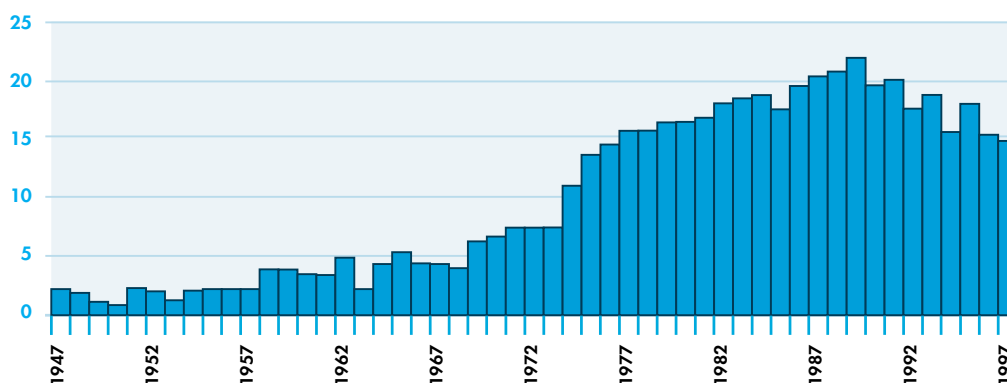
The changing rationale for aid. Finally, the basic justification for standard World Bank loans and development aid more generally was convincingly questioned (World Bank, 1998). Repeatedly, studies showed that good policies mattered most for economic development, not funding *per se*. In the context of good policies, aid could enhance their impact explaining, for example, the World Bank's successes in Japan and East Asia more generally. In the absence of good policy, aid actually often made matters worse as it reinforced and enhanced the command over resources by corrupt elites. Partly in response, late 20th century aid flows shifted from 'development' to humanitarian aid and support of policy reform in transition economies (World Bank, 1997a).

The decline of traditional project lending

Sectoral shifts in lending. With increasing privatisation, the portfolio of the World Bank began to shift to areas of residual public sector involvement. One of the first areas to go was lending to tourism, followed by a decline in industrial and energy lending in the 1980s. During the 1990s, the Bank started to withdraw from infrastructure lending, where private investment boomed, for example, telecommunications and power-generation. During the first two decades of the 21st century, the social sectors, health and education were similarly affected (4).

Overall lending. Aggregate World Bank project lending started declining in the late 1980s (Figure 2). At that time, many governments in developing countries made major efforts to reduce their fiscal deficits. As a result the total amount of public or publicly guaranteed debt fell slightly over the decade of the 1990s. This restricted the market for World Bank loans, which had to be guaranteed by governments. At the same time several other multilateral banks (ADB, IDB) received capital increases and took market share from the World Bank. More importantly, private players were able to lend funds to all creditworthy governments. If the World Bank wanted to follow its official philosophy of remaining a lender of last resort, it had to accept a declining lending volume.

Figure 2. World Bank lending, 1947-1997 (in 1997 USD billion)



Source: World Bank Annual Reports.

4) As early as the mid-1990s, Bank staff was faced with surprising proposals such as the one by the Nicaraguan government to privatise large parts of the primary education system of the country.

Lending rate policy. Already since the 1980s, the World Bank had a policy of not on-lending loans via financial intermediaries to private firms at below market interest rates so as not to crowd out private lenders. In 1998, the Bank set a precedent by charging South Korea a more market-based interest rate as part of special support following the Asian currency crises of 1997. In the first decade of the century this policy was broadened to encompass all lending. During the 2010s it was finally decided to make World Bank loans available at a penalty to the market (5). Consequently, World Bank loans are now only attractive to countries without adequate access to private capital markets, essentially a small and shrinking number of 'failed states'.

Co-financing and guarantees - Supporting private enterprise

Co-financing and guarantees. The World Bank responded to the vanishing rationale for loans with a number of schemes to complement rather than crowd out private financiers, e.g., co-financing and guarantees. The 1980s saw credit guarantees under 'B-loans' and 'ECO' (enhanced co-financing) schemes. However, all World Bank exposure had to be counter-guaranteed by governments thus effectively maintaining government risk exposure.

Political risk insurance. The 1990s saw a move towards targeting guarantees on special policy risks, which private lenders could not bear or manage as well as the World Bank. But private political risk insurance markets developed astonishingly fast. Already by 1998, political risk insurance of about USD one billion per project could be syndicated by half a dozen corporations such as AIG, Lloyds or CITI for maturities up to ten years. The coverages (convertibility, war and civil disturbance, expropriation and breach of contract) were no different from the World Bank's (Table 4). In fact, pricing for reasonable risk was not very different from the World Bank's (40 to 100 basis points for the beneficiary of the policy). That exposed the World Bank to a major adverse selection problem, leaving it with the worst risks.

Table 4. Offering of political risk insurance in 1997

Supplier	Private market	Bilateral risk insurers	MIGA	IBRD
Coverage	W-E-C-B	W-E-C-B	W-E-C	W-E-C-B
Maturity	up to ten years	about 15 years	about 15 years	15 to 20 years
Amount per project	> USD 1 billion	USD 250 million	< USD 50 million	n.a.
Price range in basis points	20 - 1,500	25 - 125	20 - 175	40 - 100

Notes: W = war risk; E = expropriation; C = currency convertibility; B = breach of contract.

Source: West (1998) and Irwin *et al.* (1997).

The cost of risk-bearing to taxpayers. The development of the private political risk insurance markets drove home the point that captive taxpayers are not necessarily better placed to absorb such risks than are global investors that can diversify over many countries. Taxpayer finance might have

Private political risk insurance markets drove home the point that captive taxpayers are not necessarily better placed to absorb such risks than are global investors that can diversify over many countries.

5) The example of US Treasury lending to Mexico in 1995 showed how effective such lending could be, providing the Mexican government with an incentive to regain access to the financial markets as early as possible so as to be able to repay the loan early. Furthermore, the US government made a profit thus validating the implicit trust of its taxpayers.

a rationale if the government truly had a lower cost of capital than private investors. But that is not clear at all. Governments borrow at lower apparent cost than private firms because they have recourse to taxpayers, not because they are better able to manage projects. The taxpayers provide unremunerated credit insurance. If such insurance was remunerated to compensate taxpayers for the risk imposed on them, it is *ex ante* no longer clear that public funding is advantageous (Brealey *et al.*, 1997, and Klein, 1997). The benefits to private parties that somehow participated in loans and/or projects under the World Bank Group umbrella, were ultimately based on the superior ability of the World Bank Group to extract taxpayers' money from defaulting nations *via* its preferred creditor status. In turn, this special position was backed by the taxpayers in the world's most developed countries. None of these taxpayers was ever remunerated for the *de facto* credit insurance they provided. Taking into account the risks borne by these taxpayers, it became doubtful whether policy risk cover of whatever type was actually adding value from a social cost-benefit perspective.

Risk redistribution vs. risk reduction. Of course, participation in lending operations alongside the World Bank Group was attractive to private investors, providing them with added security as they could hope for quiet diplomatic intervention, and in case of default they might find themselves higher up in the queue of claimants than otherwise (6). Today, this is determined by the new world bankruptcy system. In the case of the credit guarantee program, analysis suggested that the benefits from World Bank guarantees broadly equalled the cost of those guarantees to taxpayers, thus mostly shifting risk rather than reducing it (Huizinga, 1997).

Moral hazard. In fact, wherever there was an absence of sound policy, the risk cover provided actually created moral hazard problems. Both in Mexico's 1994 crisis and in the 1997 Asian crises, the culture of explicit or implicit off-balance sheet guarantees, particularly those provided to infrastructure projects, was a major contributing factor (Ruster, 1997). The IBRD had always been wary of these problems, and the amount of credit and policy guarantees it issued actually dropped in the late 1990s from about USD 500 million in 1995 to USD 100 million in 1997. Following the Asian crises of 1997, there was a period of revival. Yet, when convertibility insurance became tradable in the first decade of this century, the IBRD's program collapsed.

Privatisation of MIGA and IFC. MIGA and the IFC initially continued to be attractive to private parties, while in the case of the IBRD one of the investors' first question was "how long will the Bank delay us?". MIGA and the IFC were more focused and did not require government counter-guarantees and were thus easier to deal with. Yet, they too were forced to change. Under the pressure from competing financial institutions both MIGA and the IFC took on more and more risks in countries where investors did not yet dare to tread. Luckily, the relentless process of globalisation provided sufficient incentives for countries to perform. MIGA and the IFC were eventually privatised in the second decade of the century on the example of the Commonwealth Development Corporation, the IFC-equivalent of the UK government, which was already privatised before the end of the 20th century (7).

Sound policy. Throughout this period, World Bank policy work advocated private, competitive solutions more and more. Slowly, the simple basics emerged. Projects are eventually paid for either by

6) Lending alongside the IFC could also provide some tax advantages such as exemption from withholding taxes.

7) Privatisation of the Commonwealth Development Corporation is being prepared for 1998.

taxpayers or consumers. When consumers pay the full cost of projects including the cost of capital, investors will invest. The 'shortage' of private financing for infrastructure finance in the late 20th century was essentially due to governments' unwillingness to raise tariffs to cost-covering levels (Dailami and Klein, 1997). The net effect of all efforts by the World Bank Group to support private sector development was to help in the politics of the transition to market solutions and adequate user fees, but it became more and more doubtful that the World Bank Group had any permanent rationale for financing the private sector. The only areas where public funding mechanisms are still used to support privately provided services in 2044 are those where governments have found it impossible to charge user fees, i.e., in the case of pure public goods, such as maintenance of the legal system.

3. Lender of last resort and rating agency functions

3.1 Incentives behind currency crises

Repeated currency crises. In the process of financial liberalisation world-wide, the IMF, the World Bank Group and other IFIs were repeatedly called upon to fulfil their function as lenders of last resort (8). Following the private lending boom to governments during the 1970s, IFIs, led by the IMF, provided positive new flows to countries in crisis in the 1980s, particularly in Latin America as private net flows became negative. The Mexico crisis of 1994/1995 and again the Asian crises of 1997 briefly interrupted the increase in private flows and IFIs spearheaded efforts to ward off excessive economic and political distress. The biggest of all operations of last resort occurred in the first two decades of the 21st century, when Russia and China experienced severe currency crises just as they emerged on the world stage as new powerhouses.

Moral hazard. The repeated nature of currency crises, even in countries with the appearance of sensible macroeconomic policies, highlighted the importance of underlying incentive policies governing financial and currency systems. Foreign lenders in high-risk environments with high domestic interest rates were continuously tempted to lend to firms that were equally motivated to exploit interest rate arbitrage. The temptation to exploit such apparent arbitrage opportunities was vastly strengthened by the perception of borrowers, short-term lenders particularly, that somebody would ride to their rescue in case of distress, particularly in the case of large borrowers like Russia. Off-balance sheet government guarantees, for example for quasi-private infrastructure projects and widespread *de facto* liability insurance for financial institutions and principally politically powerful groups of companies with connected banks, underpinned the private sector's expectations about a bail-out, thus creating major moral hazard problems (9). These basic lessons had already been learned many years ago during the Chilean crisis of 1982, which in many ways resembled the Asian crises of 1997. The IMF and the various IFIs at times aggravated the problem by creating implicit government guarantees prior to a crisis, and then helping to bail out foreign lenders after the crisis hit. It took until the turn of the century for the first serious consequences to be drawn.

**Internationally agreed
bankruptcy rules govern
defaults, which are mostly
private-to-private.**

8) *Isolated attempts by private financial institutions to substitute for the monitoring and co-ordinating role of the IMF ended in failure, notably a monitoring experiment in Peru in 1976.*

9) *Once distress approaches, the incentives to gamble for financial institutions with barely any capital are tremendous. For the owners of a bank with a true capital-to-asset ratio of two percent, it pays to play roulette on single numbers because they have a one in 35 chance to win, but only a two in 100 chance to lose for a positive net present value, which explains share price appreciations for shaky banks that gamble for resurrection.*

Lender of last resort functions are managed by a combination of fiscal and private schemes.

Weaknesses of surveillance. The Chinese and Russian crises of the early 21st century also finally drove home the point that pre-emptive discipline was very hard to impose *via* government-owned institutions such as the IMF. Unfortunately, the conditionality of the market was often better than none at all, despite serious over-reactions (10). The Bretton Woods institutions had failed to anticipate the 1982 debt crises, the 1994 Mexico crisis and most of the Asian crises of 1997. Where they did anticipate, as in the case of Thailand in 1997, all their private warnings did nothing to prevent the crisis in the face of the political unwillingness of the Thai government. It became clear that public institutions have a hard time to initiate prompt corrective action of even blatant policy mistakes partly because of the fear to unleash problems, for which they would be blamed, partly because of what IMF-internal critics called “clientitis”.

3.2 Creditor co-ordination and market-based disciplines

Towards an international bankruptcy system. In the early decades of the century, a system was put in place that imposed a significant cost on lenders who wanted to benefit from any form of support by a lender of last resort. Essentially, lenders would have to pay for their sins, for example by agreeing to roll over debt at or below original interest rates or accept a discount on the value of their loans. To some degree the new rules institutionalised principles applied under the Brady bond schemes for highly indebted countries in the late 1980s. The new system resembled a bit proposals for international standards for bankruptcy mechanisms as proposed, for example, by the late Jeffrey Sachs in the late 20th century. It was this new system that made the Russian and Chinese rescues just about manageable, because it reduced moral hazard by foreign lenders, while political moral hazard remained very large.

Private-to-private capital market finance. Today in 2044, internationally agreed bankruptcy rules elaborated under the auspices of the IMF, with participation of the World Bank and the Bank for International Settlements, govern defaults, which are mostly private-to-private. Sovereign lending hardly exists anymore and public debt policies tend to be quite conservative. In addition, deposit banking is no longer important. Securitised capital market transactions dominate. Private rating agencies provide market intelligence as governments and private borrowers in most countries have realised that increased transparency helps improve their access to capital markets and financial terms. Deposit insurance is restricted to well defined high-quality banks, so-called narrow banks, and is pre-funded.

Pre-funded liquidity and deposit insurance schemes. To the extent that governments maintain lender of last resort functions they are managed by a combination of fiscal and private schemes, such as the ones developed under Argentina’s currency board system in the 1990s. The fiscal authorities run conservative policies, thus maintaining room to borrow, and standby lines of credit with highly rated financial institutions are pre-arranged for the case of a panic. The IMF, in concert with international development banks, occasionally still provides lender of last resort functions to newly emerging economies, which make the transition from failed state to successful developing nation.

Market-based rules and disciplines. The key moral hazard issue of today arises from the reliance of basic pension and social security schemes on volatile investment in securities markets. Pre-funded portfolio insurance schemes go a certain way towards handling the issue. In addition, prudential

10) Crook (1991) and Collier and Gunning (1997) discuss problems with applying conditionality.

regulations covering financial institutions benefiting from access to some type of lender (or subsidiser) of last resort were progressively tightened. Today, most financial institutions, particularly those directly supporting payment arrangements, often find it in their interest to maintain 15 to 25 per cent equity reflecting the capital structure that one used to find in banking systems without clear lenders of last resort, such as Hong Kong in the late 20th century. Investors of all types are providing a significant level of co-insurance, as it is now recognised that co-insurance by investors in financial institutions, and even depositors in narrow banks, improves monitoring incentives without enhancing the risk of systemic failure (Baer and Klingebiel, 1995). To some extent managers and shareholders of financial institutions are liable for failure with their personal wealth (11).

3.3 Currency competition

Currency competition. Central banks did not voluntarily decide to abandon their traditional lender of last resort role. Overtaken by events, they had no choice. Today, monetary authorities are simply small players in a very large world market. Uncontrollable, secure and low cost electronic transaction systems allow buyers and sellers anywhere to settle even micro-transactions in any currency under any jurisdiction. Many of the concerns about currency crises have been transformed by now. People are able to store value in numerous assets until close to the time of a purchase transaction. They can then choose from several hundred assets what they offer as means of payment, including some highly rated debt of private companies. At the time of transaction the current value of the 'money' offered as means of payment is electronically checked and the transaction concluded (12).

Such currency competition implies not only that issuers of money have lost their monopoly and their special power. It also means that political borders are no longer contiguous with transactions conducted in particular currencies. Investors in a particular country can thus hedge their position much better against 'currency' risk. The world has finally left behind the awkward currency system, where sudden changes in the value of a single asset (national currency) issued by a monopoly (central bank) can lead to the breakdown of whole economies. Lender of last resort services for borrowers in distress can be fulfilled by any issuer of means of payments who believes - based on an assessment of underlying solvency issues - that extra liquidity is good business. On the other hand, the expectation of excessive money issue by a money issuer trying to perform the function of lender of last resort can lead to pre-emptive 'capital flight' into another currency, a fate experienced already to some extent by several Asian countries during the crises of the late 20th century. Moral hazard is thus not much of a problem anymore.

Structural surveillance. In the transition to the new lender of last resort and bankruptcy regimes the World Bank played a subordinate role to the IMF. In addition to allowing its balance sheet to be used, relevant Bank staff was more and more seconded to support rescue operations. However, the World Bank benefited from its enhanced role in policy surveillance. In the late 20th century it became clear that macroeconomic monitoring by the IMF was not enough for effective surveillance. Structural policies and developments, particularly in the financial markets, also needed attention.

11) New Zealand reintroduced aspects of unlimited liability for bank owners in the 1990s. The history of free banking in Scotland shows how uninsured banks advertised with the personal wealth of their owners (Caprio and Vittas, 1997).

12) In 19th century North America, clerks at shops had books providing guidance on what money issued by what bank they could accept and how to discount it.

Around the turn of the century, the World Bank became responsible for structural surveillance complementing the IMF's macroeconomic surveillance under its Articles IV and VIII. While originally seen mostly as part of the lender of last resort system, the new systematic attention by the World Bank to structural policies - as opposed to its otherwise often *ad hoc* attention in the context of loans - and its promotion of public-private partnerships paved the way for the Bank's major contributions to the establishment of a new world system of governance, a topic to which we now turn.

4. Public-private relations: Emerging governance systems

4.1 Standards, property rights and enforcement mechanisms

Focus on policy framework. As discussed above, intricate schemes to impose risks on taxpayers, even when there is no public good to be produced, do not matter much for progress. What does are policies that create appropriate market structures facilitating competition, and regulatory frameworks dealing with market power abuse and standards affecting health, safety, environment and privacy. The World Bank had for some time worked on improving such policies. As the connection of policy work with traditional project loans withered away, the Bank focused more on developing rules and standards in various emerging global fora.

Environmental standards and policies. One of the most prominent examples is provided by the World Bank Group's work on the environment. In a way environmental work started out as standard-setting before it was translated to some degree into lending activity. Today's World Environment Organisation owes much of its success to early World Bank work on standard setting, and, particularly, implementation of the 1997 Kyoto environment conference. The emission permit trading scheme that the Bank, together with the Environmental Defence Fund, helped promote is now seen as a key mechanism for creating a sustainable path to growth. Initially, there was a wide variety of economic instruments used to implement environmental goals, including command and control schemes, 'green' taxes and tradable permits. However, in time it became clear that all such systems required the same detailed monitoring and penalty features, but that tradable permits provided better incentives to minimise waste and to monitor obligations. A series of new types of tradable property rights has enabled the world to cope with a number of market failures, for example via fishery and water rights, trade in ecological sinks and markets for bio-diversity (13).

Reputational mechanisms. The transparency brought about by ubiquitous information technology has created many ways for voluntary standards to be monitored and gain wider acceptance. For example, labour standard SA 8000 is one of the early examples dating back to the previous century. It was devised in late 1997 by the New York-based Council on Economic Priorities covering areas such as trade union rights, child labour, health and safety and fair pay. It was initially subscribed to by multinationals such as Toys 'R' Us, Avon and Otto Versand, who hoped to gain competitive advantage by subscribing to it (Control Risks Group, 1998). Today, governments and corporations have no place to hide.

13) By the mid-1990s, tradable water rights had been introduced, for example in the south-western United States, Chile and Peru. Fishery rights in countries such as Iceland and Canada, as well as emission trading for sulfur dioxide in the United States, were deemed a success. Schemes to 'harvest' bio-diversity instead of destroying it were promoted by coalitions of multinationals and NGOs (Lacasse, 1992, Hahn, 1993, and Thobani, 1997).

A host of accreditation and monitoring bodies, often private, certify behaviour to various constituencies, be they socially conscious consumers or relevant voters. Interest in maintaining reputation has often turned out to be an effective mechanism for upholding rules. The bond markets are now very effective at instilling fear in those governments that are seen to generate social problems, and thus trigger investor withdrawals. The World Bank Group has been instrumental in promoting better rules in a wide variety of areas including methods of popular participation, corporate governance, corruption and labour standards. While the World Bank has in various cases helped establish new rules and agencies to supervise them, it has itself not become a standard or regulatory agency, but continues to catalyse new approaches.

Arbitration. At the same time more formal enforcement mechanisms have been strengthened. The World Bank's ICSID has become part of the World Arbitration System, which in conjunction with the International Court of Justice has, *inter alia*, replaced the old system of over 1,200 bilateral investment treaties that existed at the turn of the century. Building on previous arbitration conventions, the new system provides an effective mechanism to obtain enforceable judgements, not only in cases of breach of private contracts, but also for complaints about non-adherence to environmental norms and human rights. Signatories, which include most countries of the world, tend to live up to their undertaking to enforce the system's judgements, as they perceive clear benefits from playing by the rules and creating a favourable investment climate. The new arbitration and monitoring systems have taken a major burden off the back of the WTO, which was in danger of being abused to enforce all sorts of norms by applying trade sanctions. New global norms and standards combined with agreed arbitration and enforcement principles instead have placed the spotlight on the real issue, i.e., the quality of local enforcement mechanisms.

The real problem was to find ways to improve the governance system so that it would stop erratically taxing economic activity officially or via corruption.

Competition among jurisdictions. The world is, of course, still a far cry from a single global government. But that is to the best. While it has been possible to tackle the key global problems such as climate change sufficiently to prevent disaster, competition among polities persists. Competition among jurisdictions has given us some of the most promising policy reforms, for example those of Chile in the 1970s and 1980s. Chile, like Vietnam, introduced key reforms precisely when the countries were abandoned by the world community and had to make necessity the mother of invention. The world today operates much in the spirit of the 1992 European Union project. Differing jurisdictions allow firms and financial organisations to conduct business on the basis of licenses issued in any other jurisdiction that subscribes to the new global standards and rules. Going back further in history to the origins of our fast-advancing world economy, it was competition among jurisdictions in medieval Europe that brought about the "European Miracle" (Jones, 1981), while the technologically more advanced China languished as mandarins suppressed merchants (Landes, 1998).

4.2 Governance for failed states

Economic recipes. While the global governance system has arguably improved, a number of states continue to languish in a Hobbesian state of affairs. Such 'failed states', mainly in Africa, became more of a pre-occupation of the Bank in the late 20th century. It had become reasonably clear by then that the basic economic policies to be recommended for such states were quite simple: peace, stable macroeconomic policy (low inflation and sensible, predictable taxation) and open borders

without policy distortions. Countries able to put such policies in place easily grew at three percent per capita. Uganda demonstrated the power of such simple measures when it grew at rates of about eight percent per annum in the 1990s (five percent per capita). Botswana and Mauritius had previously tied themselves to basic sound policies and quickly became middle income countries.

The real issue: governance. The real problem was not the basic technocratic policy prescription but ways to improve the governance system to the point that it would adopt the basic policies and stop erratically taxing economic activity officially or *via* corruption (Olson, 1996). Obviously, success had to do with the ability of governments to commit themselves to a basic set of sound policies. Commitment required that governments tie their hands credibly so as to resist the temptation by influential players to rip off the country.

Commitment devices. Very slowly the lesson began to sink in that tying one's hand behind one's back can help enormously as long as sensible minimal governance can be established. In many ways Hong Kong was the master example implementing economic policy making *via* institutions operating at arms-length from patronage and electoral processes that may undermine sound solutions (14). Argentina and Estonia successfully demonstrated the benefits of tying macroeconomic policy to simple rules under a currency board system.

Most of the troubled states in Africa, Central Asia, Indochina, the Middle East and parts of Latin America that have found a way out of their predicament proceeded along the Ugandan route by sticking to simple macroeconomic disciplines using cash-budget rules (15) that were so successful in reigning in Bolivia's fiscal deficit in 1985. Some adopted currency board schemes that became popular again after loopholes in the West-African CFA system were closed and tight constraints on policy-makers imposed. All opened their borders to trade and abolished price controls and entry restrictions.

Concessions. Citizens could recognise a good policy when they saw one. Old, simplistic notions of nationalism versus colonialism, private versus public ownership, etc., gradually became irrelevant to debate. The most dramatic policy experiments became possible as would-be-millionaires among government officials and warlords saw that they could actually live better by renouncing corruption and predation. The key obstacle proved to be the removal of the incumbents' fear of losing out to their various real and imagined opponents in the process of tying their own hands. It thus became essential to 'import' good government by delegating key policy-functions to agencies with no axe to grind in the country. Hong Kong, the world's first 99-year BOT (built-operate-transfer) country, provided the basic model, albeit complemented by a basic democratic mechanism to establish legitimacy. The World Bank Group became one of a group of agencies which provided technocratic insulation to policy-making processes that were judged to be better made at arms-length from the political process (see the Box on the next page).

14) Blinder (1997) argues the case for independent economic institutions even for advanced democratic economies.

15) Under the simple cash-budget rule, a government can only spend money when it has cash. Borrowing is forbidden.

The Easy Mining Concession

The first experiment in 2005 began with the attempt by the ruler of a war-torn African state to attract business to the country. Parts of the country were not under government control and dominated by warlords, but the ruler tried to bring business to these areas too. He was able to find some interest in the Easy Mining company, a far flung mining and services conglomerate.

In thinking through the practicalities, it became clear that the mining operation required protection by a private security firm. At the same time, in the territory of the warlords several NGOs continued to participate in humanitarian relief operations. On the one hand, Easy Mining feared that the NGOs might monitor its operations and potentially create problems to its reputation. On the other hand, it started seeing an opportunity in working constructively with NGOs to demonstrate credibly that it was implementing acceptable business principles.

Easy Mining approached a well-known IFI with a reputation as a keen promoter of partnership ideas with business and civic organisations. After many meetings, an entirely new solution emerged. The whole operation would not be restricted to mining, but aim at economic development for the whole region in which Easy Mining was planning to operate.

To establish the legitimacy of the arrangements, the principle of the concession was put to a vote among the affected inhabitants. The vote supported the establishment of a 69-year concession of a vast track of territory to a venture between a special subsidiary of the IFI and a coalition of local and foreign NGOs currently operating in the territory. The warlords were provided with a royalty-type interest in the success of the concession. Concession administration was contracted out to a multinational service company, which was to run the concession as a country with the ability to raise taxes. A private security company was hired to ensure protection. It was to operate under rules of engagement similar to those that had been developed by Shell Nigeria in consultation with Pax Christi and Amnesty International in the 1990s. A complex revenue-sharing agreement existed between all the parties involved.

By now we know the result. While not as spectacular as Hong Kong's rise, the concession territory soon became the envy of its neighbours. Peace and stable property rights allowed a variety of businesses to flourish. With success came immigration pressure from other countries. After some incidents, when security personnel expelled illegal immigrants with dubious methods, agreements with neighbouring countries were negotiated, which either expanded the concession territory in exchange for a share of extra royalties, or introduced tighter and better regulated border controls. Several concessions have since been formed. Many delivered their promise, only a few failed. At the same time several governments saw the wisdom of introducing simple standard policies and Africa's turnaround began in earnest.

This story is, of course, fiction. Yet, the elements are mostly real. Africa has experienced a mining boom in recent years, with companies often using security firms or mercenaries to protect people and sites. While Easy Mining is a figment of the imagination, the World Bank does promote innovative public-private partnerships, including ones that would promote community development in the area of operation of foreign investors (World Bank, 1997b).

5. Safety nets for the poor

5.1 Incentive issues

Shame brought by success. Economic growth remains a necessary means to eradicate poverty on a large scale and was essential to success in the Asian miracle of the late 20th century, which overturned many dire predictions made in the 1950s and 1960s about widespread misery among the masses of Asia. During the last three decades of the 20th century, and for the first time in 300 years, the income of the average person in developing countries grew faster than those in developed ones (Maddison, 1995). Yet, as most of the world found its way towards decent living standards, the inadequacies and injustices of trickle-down solutions became ever more intolerable (16).

Aid became like export credit, with multilateral institutions wooing politicians with examples of how many contracts went to firms in their states.

Hidden interests behind aid. Much of aid, particularly at the bilateral level, was originally given on the background of foreign policy interests. As foreign policy concerns subsided after the end of the cold war, a key constituency for aid were firms in relatively well-developed countries that sought funding for projects in developing ones. Aid became relatively more like export credit, with international institutions such as the World Bank, for example, wooing members of the US Congress with examples of how many contracts went to firms in their states. Much of aid was thus given to fund the construction of projects. Whether projects delivered services after completion was *de facto* of lesser concern. Furthermore, much aid flowed through governments with the result that corruption and inefficiency raised costs and lowered performance.

Africa of the late 20th century provides the clearest examples. Aid-funded telephone lines in Africa cost much more than double their cost in developed countries. Donor-supported utilities in many countries performed miserably. Port charges in Abidjan (USD 200 per container) were higher than those in Antwerp (USD 120 per container). Only 37 percent of non-salary funds released in Uganda for primary schools actually reached them (Collier and Gunning, 1997).

Incentives to perform. Proponents of aid could point out that aid-funded projects did still better than many unsupervised government programs. However, evidence became more compelling that it should be possible to do better by providing sound incentives to private providers of services, and by keeping funds out of the hands of rapacious officials. In Ghana, for example, “the average public clinic had 2.2 times the number of staff and a 25 percent lower probability of having drugs than a private facility. In Kenya public clinics had 10 times more staff and 20 times the number of days without antibiotics as the private facilities. In both the resulting lower quality of public facilities reduced their usage (Collier and Gunning, 1997, p. 25)”.

5.2 Performance-based subsidies

The key to the beginning of a solution lay in recognising that under traditional aid projects subsidies went to inputs rather than being based on ultimate performance. By the late 20th century, World Bank social sector projects shifted their emphasis from brick-and-mortar projects to sound policy and service performance. Programs such as education for girls received prominence. Some moderate success was achieved with using NGOs as more effective delivery channels for aid. By

16) Already, in the mid-1990s, the UN estimated that the basic needs of the poor for water, food and healthcare could be met with only USD 40 billion annually, i.e., only about 0.13 percent of world output (United Nations Development Program, 1997).

World Bank social sector projects shifted their emphasis from brick-and-mortar projects to sound policy and service performance.

now it has become common to provide performance-based subsidies. Essentially there are two main types, both of which were explored in World Bank projects around the turn of the century.

Performance contracts. For some services like basic health and education, performance contracts have been granted to private firms including NGOs. Under these contracts the private provider undertakes to deliver services and is paid as a function of agreed performance measures - often directly by the donors. Such measures range from the number of vaccinations performed to the quality of test results for elementary school students. Monitoring of results has always been imperfect and, as always, what gets mostly monitored is what gets done to the detriment of unforeseen or non-measurable side effects. Yet, advances in measurement techniques prompted by the performance contracts have reduced such concerns. Many measurement improvements were actually proposed by competing bidders when trying to obtain performance contracts. In any case, there was never much choice. Under any approach to poverty alleviation donors needed to assess the effectiveness of their interventions.

Reputational interests by major contractors have also limited reckless neglect of undesirable side effects, particularly after some early scandals. The payments to the contractors are sometimes grants, but sometimes also loans obtained by the government. Competitive bidding of the contracts has resulted in major cost reductions as evidenced, for example, early on in the case of competitively bid contracts to provide remote areas of Chile with telecommunications services.

Targeted income subsidies. The second type of performance-based subsidy is applied wherever user fees can sensibly be levied, be it in water and power systems, more specialised healthcare and much of education. Essentially, subsidies are targeted to poor individuals. For example, they may take the form of vouchers for healthcare and education or subsidies to the bills of customers of monopoly utilities, such as water distribution systems. An early example is found in the Chilean water subsidy system of the 1980s. Here the municipality maintained lists of poor citizens and paid up to 85 percent of their bill once they had paid their portion. This provided firms with proper incentives to provide services without distorting prices and relying on cross-subsidies.

Policy improvements. In essence, the now widespread performance-based subsidy schemes enhance the purchasing power of the poor to levels that allow provision of a targeted service. In a number of cases even generous amounts of subsidy have not been able to motivate private investors to initially provide services. This was due to inadequate policy environments that prevented the private party from operating and/or actually obtaining revenues and keeping profits. Such policy barriers to provision for the poor became much more obvious with the introduction of the performance-based schemes. Policy conditionality was then established as a condition for obtaining funds for subsidy schemes (17).

5.3 Economics and politics of targeting

Rationing and segmentation. Initially, there was a certain amount of apprehension about introducing means tested subsidy schemes.

17) A key policy issue is the supply response from businesses benefiting from some form of subsidy scheme. When supply is fixed, subsidies simply raise the price to producers and possibly redistribute the supply towards those previously too poor to afford much. The poor benefit most when increased demand is translated into increased supply rather than increased rents for producers.

- First, some critics argued that distinguishing between the deserving and undeserving poor smacked of paternalism. While this kind of criticism has always been raised in the history of charity, it remains unavoidable to ration the limited supply of gifts by something other than price.
- Second, it was feared that the administrative costs of targeting might offset the benefits. Indeed, in areas where poverty was endemic, basic services were provided free to all under the first type of performance contract. However, with the advent of smart cards, monitoring of beneficiaries has by now become relatively cheap in many cases.
- Third, some felt that more choice in competitive markets like health and education might increase social segmentation. Yet, effects have been limited. Segmentation has always happened anyway, as people move to areas they feel comfortable in, and, more importantly, the quality of service seems to have had the determining influence on the choice of school and hospital.

Constituencies for subsidies. Extensive targeting of funds to the truly poor has obvious ethical attractions, yet it has consistently been difficult to raise funds for subsidies without appeal to other motives of the donor community such as the export support mentioned above. Yet, three factors in particular have helped sustain and even increase support for subsidies:

- The new performance-based subsidies have maintained the export support motive as companies in developed countries have been prominent providers of services that have been rendered profitable by the new form of subsidies. The policy dialogue tied to the provision of performance-based subsidies has actually opened new fields for private enterprise.
- Improvements in targeting have spurred charitable giving and support for tax-funded aid, while a general improvement in living standards in rich countries has gradually raised the amount of donations to combat poverty. Today, private charitable donations to developing countries exceed USD 30 billion, enough to fund basic needs projects for all the world's poor (18). There is thus an adequate constituency for widespread targeting, particularly as more and more people see themselves as citizens of earth and not only of their home nation.
- Finally, innovative matching grant schemes pioneered by the World Bank have also contributed to alleviate free rider issues, and the decline in tax levels has nudged levels of charitable giving up in most countries.

Competition among donor agencies has increased. This is just as normal and healthy as competition among firms.

The donor market. Competition among donor agencies has increased. It has become clearer that competition among donors is just as normal and healthy as competition among firms. Donors simply deliver a service to somebody else than the person who pays. In a way, competition among donors is like competition among flower-by-wire agencies who, for payment, deliver a service to somebody other than the person paying. Efforts at donor co-ordination have focused on the one area where there is a natural monopoly of sorts, namely in systems that identify deserving beneficiaries and, more importantly, in systems that establish whether beneficiaries have already received

18) Output in the advanced countries with incomes above USD 20,000 exceeds USD 125 trillion in 2044. The absolute number of truly poor has shrunk by at least 25 percent over the last 50 years. As a result, in terms of 1995 purchasing power, it is now possible to meet the poor's basic needs with just about USD 30 billion, or about 0.024 percent of rich countries' output. Traditionally, people in rich countries have given between one-half and two percent of GDP to charity (Kaplan, 1996, and Klein, 1986). Of this up to five percent has gone to 'remote' causes such as humanitarian aid abroad. By 2044, five percent of 0.5 percent amounts to over USD 30 billion.

help by some other donor. Again, smart-card technology that became widespread even in remote areas of Africa in the early 21st century in the form of pre-paid cards for electricity meters, has made possible a cost-effective solution for identifying the beneficiaries of aid.

All in all, there is reason to hope that poverty may largely be wiped out by the end of the century. World-wide inequality is not likely to decline much, while growth rates continue to diverge strongly within and among countries. But, yet again like in the case of Chile in the 1980s and 1990s, it seems possible to reduce poverty drastically through targeted performance-based subsidy schemes (Ferreira and Litchfield, 1997).

6. Learning

6.1 Information, research, advisory and training services

Towards transparency. The original synergy between the World Bank's lending activities, the access to information it obtained, and the ability to give relatively apolitical advice provided some rationale for its mode of operation. By now governments and other institutions alike have realised the benefit of transparency and make more and more detailed information available. Advisory relationships consequently rely less on political acceptability than professional competence.

Private solutions. As in the case of loans, pressure from private providers not to crowd them out of good business has reduced the Bank's role in information provision, monitoring and advice. Rating agencies, consulting companies, research institutes and training and education companies have taken the place of World Bank activity to a large degree. The Bank's special information and advisory advantage mainly persists in 'failed states'.

6.2 Learning systems

Government failure. Yet, even today governments find it hard to learn as well as firms do from best practice in other countries. Civil servants grow up within a particular government and do not naturally find exposure to other countries and environments as happens in multinational firms that rotate staff. The eternal incentives of unavoidable bureaucratic budgeting processes make sensible, discretionary *ad hoc* decisions about study trips, seminar attendance and other learning activities, etc., problematic. Some bureaucrats do not want to fund such 'unnecessary' luxuries, while others are all too keen to go on low-pressure 'boondoggles'.

Market test. There remained, therefore, a role for the World Bank to create learning opportunities for public officials. At the same time more and more governments recognised the importance of ideas and good advice as opposed to 'simply money'. Chile, Malaysia and also Peru were early World Bank customers that were willing to pay a share of the cost of advice (19). In 1997, the World Bank also introduced the first training courses that were heavily funded from participants' contributions and thus for the first time subject to a reasonable market test.

The global public sector learning system. By now we have a system of international learning and benchmarking for public officials, which combines automaticity to cope with bad bureaucratic incen-

19) Early fee-based advisory services of this type were provided more and more by the mid-1990s under special memoranda of understanding with individual countries.

Governments find it hard to learn from best practice in other countries. There remains, therefore, a role for the World Bank to create learning opportunities for public officials.

tives and a measure of market test to maintain the providers' incentives for quality products, including those of World Bank officials involved in the process. Today's institutions also retain elements of the old OECD, which *de facto* provided relatively low cost standardisation of cross-country information and learning, and a type of mid-career academy for officials, who either worked at the OECD for some years, or in the embassies that countries maintained there. As a result, a small core of staff with pay dependent on course attendance and other measures of results works with a large rotating complement of country officials from all over the world to digest experience and spread best practice information. Core staff is located in a few centres in the major time zones of the world. Learning events may take place at these centres or through video conferences of various types.

Policy games. As incentives to provide more intuitive and useful learning events improved, the World Bank, partly under the auspices of its training arm, EDI, developed the powerful games that today are essential support for policy-makers. Much learning was previously text-bookish, dry, overly diplomatic and often not forward looking. In fact, many meetings and conferences did little justice to the quality of participants, materials and speakers available. Policy games, however, became intuitive and fun ways of exploring possible courses of action based on serious analysis fed into the process (20). By now it is clear that it is worth making as many mistakes as possible in policy games before trying out strategies in real life - an obvious point among US military strategists and tacticians, but not yet among economic policy-makers by the end of the 20th century.

7. Foundation

Tool for change. While the World Bank tackled a large variety of topics, it ultimately maintained a focus on improving policies, whether by using conditionality as provider of funds or by providing intellectual and organisational support for new policy or learning initiatives. Sometimes the focus slipped and the World Bank started to compete unnecessarily with private firms or other organisations. Yet, usually, external pressures brought back the essential focus on policy. The World Bank turned out to be a useful tool or forum to help bring about a new global governance system. Given that the system was - and still is - evolving, it was at times not easy, or even sensible, to ascribe a particular role to the World Bank, because there was no fixed system within which such roles could be defined for any length of time.

Disorderly bureaucrats. What made the World Bank effective in this endeavour, paradoxically, was its lack of bureaucracy. While often accused of bureaucratic behaviour, it was in fact a rather free-wheeling and at times undisciplined organisation, the "most under-managed he had ever seen" in the words of its President Lewis Preston (1991-1995) (Wolf, 1994). The IMF was a true bureaucracy marching effectively to the tune of its management. The Bank, although it had its share of bureaucratic rigidities, in a sense resembled more a science park full of policy entrepreneurs.

Sources of funds. In the late 1990s the Bank was led by James Wolfensohn, a policy-entrepreneur rather than a conservative guardian of focused basic rules (Stevenson, 1997). He managed to set the Bank on a course that made it the *Thermo-electron* of public agencies. *Thermo-electron* was an exceptionally successful company in the 1990s that acquired notoriety for its ability to spin off a multitude of successful subsidiaries. Wolfensohn started looking at the Bank as a foundation. From

20) By 1998, several large corporations were experimenting with games as methods for exploring strategic issues. Consulting companies, such as Booz, Allen & Hamilton, who had closely worked with the US military provided assistance.

that perspective the Bank had an endowment, its paid-in capital and retained earnings, on which it earned money that could be used for a variety of purposes. Today, the Bank no longer invests its capital in highly liquid and safe government paper. Rather it behaves like a foundation or pension fund investing in a variety of instruments including bonds and equities. This has allowed it to earn funds to maintain the real value of its capital and still earn about six percent in real terms, about one percent higher than the average real returns of a diversified portfolio in the financial markets due to its exemption from today's corporate tax rates of about 20 percent. As it has not had a capital increase for 50 years it earns today roughly USD 1.8 billion per year in 1995 prices after increasing reserves to maintain the real value of its capital.

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Uses of funds. Its income is spent on a variety of initiatives. Usually funds are allocated either as seed capital or as matching funds. For example, standard-setting bodies supported by the World Bank may obtain fees from certification activities. World Bank supported learning activities are usually 90 percent funded by user fees or annual appropriations (as in the case of the OECD today). World Bank contributions to performance-based subsidies are generally made on a matching basis complementing both public and private contributions via multiple specialised windows. When governments borrow from the World Bank, because they lack access to the private financial markets, the World Bank uses its considerable scope for borrowing in addition to its paid-in capital. It earns good money on the loans, which are now routinely priced at a penalty to the market. By the same token the subsidies are thus completely unbundled from the loan product and deployed in a targeted fashion.

Staff and offshoots. The World Bank maintains only a small core staff, although it also pays for key staff seconded more permanently to its offshoots. Including the latter it maintains a payroll of about 500 regular staff compared to almost 11,000 staff and long-term consultants at the end of the last century. It achieved reductions in staff via natural attrition, by drastically restricting indefinite employment contracts, and by encouraging entrepreneurial staff to form spin-offs where they had some upside earnings potential as long as they could attract matching funds in agreed proportions. In addition, many staff joined the organisations that became ever more important in the emerging new world governance system (21).

JMK-Foundation. One of the enduring legacies of the Bretton Woods system is the Annual Meeting of the IMF and World Bank, which continues to be a preferred event for economic policy-makers to exchange views and to mingle with private companies and NGOs. In Abidjan, this year's venue, a motion is on the table in honour of the 100th anniversary of Bretton Woods to rename the World Bank in the spirit of the father of Bretton Woods, John Maynard Keynes. As he said the "Fund (IMF) is a bank and the Bank is a fund". The World Bank is to be named the John Maynard Keynes Foundation, a more modest and becoming name in view of its role, its achievements, and the changing role it plays in a world that has changed the World Bank's very nature almost beyond recognition - a rare case of an international bureaucracy that was able to adjust dynamically, actively help shape the emerging global system, and work itself largely out of business in line with its mandate.

21) An example of this were the staff members who left the World Bank to head up regulatory agencies when many countries privatised infrastructure services in the 1990s.

Annex

World output and population in 1995 and 2044

Area	GDP (as a percentage of world total)		Growth of GDP/capita (in percent)	Population (as a percentage of world total)		GDP/ capita (in USD)	
	1995	2044		1995-2044	1995	2044	1995
North America	22.9	10.5	1.5	5.1	3.5	26,436	54,831
Europe	21.5	7.9	1.2	5.4	3.5	23,114	41,469
Japan	8.1	3.6	1.8	2.2	1.3	21,677	51,956
Oceania	1.1	1.2	2.8	0.5	0.4	12,804	49,545
East Asia	18.5	34.8	4.0	31.1	26.6	3,479	23,773
South Asia	5.3	8.2	3.0	23.0	25.8	1,351	5,751
Latin America	9.0	16.7	3.7	8.4	8.2	6,255	37,102
Sub-Saharan Africa	2.4	3.5	2.0	10.3	17.9	1,365	3,602
Middle East and North Africa	5.7	6.6	2.0	5.5	7.4	6,124	16,160
Eastern Europe and FSU	5.5	7.0	3.0	8.5	5.4	3,791	23,575
World	USD 33.6 trillion	USD 170.8 trillion	2.3 percent per annum	5,744 million	9,388 million	USD 5,857	USD 18,195

Notes: Regional GDP is given as a percentage of total world GDP, GDPs are in PPP-adjusted dollars, and regional population is given as a percentage of total world population. FSU is the former Soviet Union.

Source: Bulato *et al.* (1990) for population growth estimates, and IMF (1998b) for baseline GDP growth.

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