CHAPTER 2

PURPOSES AND FINANCING
OF THE IBRD
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The origin, financial structure and organizational set-up of the IBRD have been discussed in Chapter - 1. The aim of this chapter is to elaborately discuss the purpose of the Bank and to determine the extent to which these have been successfully carried out in the prevailing conditions.

PURPOSE OF THE IBRD

1. Assistance in the reconstruction and development of member countries.

2. Promotion of private foreign investment.
   (a) Supplementation of private investment when private capital is not available on reasonable terms.
   (b) Guarantees or participations in loans and other investments made by private investors.

3. Promotion of the long range balanced growth of international trade and maintenance of equilibrium in the balance of payments.
4. Encouragement of loans to useful and urgent projects.

5. Conduct of operations with due regard to the effect of international investment on business conditions in the territories of member countries and to bring about a smooth transference from a war time to a peace time economy.

Now these purposes need to be discussed elaborately.

**Assistance in the Reconstruction and Development of Member Countries**

The idea of loans for reconstruction applied to countries, especially in Western Europe, that had suffered war damage, while the idea of loans for development applied to countries in the underdeveloped category. These reconstruction loans were found to be an important supplement to the resources of the borrowing countries and helped restore their economies at the pre-war level of production.

It was apparent from the very outset that the Bank was ill-prepared to cope with them. The Bank's resources were too limited and the scheduled lending procedure was inappropriate for the task at hand. Consequently, alternate arrangements were made to deal with the reconstruction problem. The most important of these was the Marshall Plan initiated by the United States which extended a huge
amount of money for reconstruction. The Bank became an institution concerned solely with long-term lending for development purposes after 1948. Since then its lending has been mainly for the developed countries. During the 1950s, Bank lending concentrated on economic infrastructure such as electric power, telecommunications, transportation, irrigation and flood control, etc.

As newly independent countries joined the Bank, rapid rates of population growth put increasing pressure on the basic resources of the world. By the early 1960s the requirements of such sectors as agriculture, education and industrialization were recognized by the Bank to be crucial to social and economic progress. In addition, technical assistance was essential for the supplementation of financial assistance. Consequently, greater emphasis began to be laid on technical assistance to help developing countries in formulating effective policies for their development, identifying and preparing projects and establishing appropriate development institutions.

In 1968, the Bank launched its first Five-Year Plan (1969-73) to provide considerable expansion and diversification of its activities, and enable the institution to determine the place of particular projects in the development process. Since then special efforts have been made to assist the poorest and "least developed" member countries. During the plan period, the Bank lending more than
doubled as compared with the previous fiscal five years.

At the same time steps were taken to improve the qualitative impact of the activities of the Bank. In addition to lending in the traditional sectors, the Bank operations greatly increased in the areas of agriculture and education, and more attention was paid to the social aspects of education, and greatly increased in the areas of agriculture and education, and its impact on the environment. Recognizing the rapidly aggravating urban conditions in developing countries, the pattern of lending for urbanization projects was changed from infrastructure to introducing new concepts for relieving urban pressures. The Bank has also started making direct loans for tourism projects.

Now the development involves people. The more comprehensive view of the development process by the Bank has led to an increasingly integrated approach to lending by incorporating into a variety of projects, a variety of activities which embrace many subsectors and often cut across sectoral lines. At the same time, the Bank is concerned that the benefits of its assistance should be distributed more widely, especially among the poorer sections of a country's population.

The Bank endeavours to be innovative and flexible in its approach towards finding solutions when dealing with the special
requirements of a people to be assisted. In the final analysis, development can have no meaning unless it brings a better, fuller and more productive life to mass of the under-privileged in poor countries.

One can observe that the past and present pattern of the Bank lending and its policies have contributed a lot to the economic development of underdeveloped countries. Really speaking, it has been instrumental in increasing the economic growth of underdeveloped and developing economies.

Promotion of Private Foreign Investment

(a) supplementation of Private Investment when Private Capital is not Available on Reasonable Terms: So far as the second objective is concerned, the Bank has been restricted by its articles of Agreement I (ii) that the Bank cannot make loans if these can be obtained from private lenders on reasonable terms. In this way borrowers can go to the Bank when others do not offer reasonable terms.

In the context of the Articles of Agreement it can be said that the Bank has been helping in the establishment of reasonable rates of interest and other loan conditions. It may also adjust repayment terms if necessary and can extend the length from, say, twenty-two
years, depending on the merit of each project. But the Bank has also to impose safeguards. In fact, it has been accused of imposing conditions and it has agreed with accusers, but virtually there is no other way of avoiding serious set-backs. For instance, it agreed to finance the modernization of Thailand's government-owned railway system, but on the condition that the government would have to set up an autonomous agency free from governmental interference. In other cases the Bank has refused to consider loan applications until the country has reformed its way and stopped an important spending spree that absorbs considerable amounts of foreign exchange.\footnote{5}

The IBRD has never had a default on a loan. Its standing is excellent in the international banking circles of America and Europe, and it has raised a major portion, i.e. more than half of its loan disbursement from bonds sold in the North America and European markets.\footnote{6} Appendix. 2 provides necessary details. From the point of view of its creditors it has been a success. It has indeed been a "safe bridge" over which private capital can enter the Third World.\footnote{7}

The lending pattern of the Bank has changed little in the past twenty-three years. As already pointed out, the Bank's Charter of Agreement instructs it to promote private investment, and the pattern of the IBRD revels that this has been a strong priority of the Bank
throuhout its hitory. The Western private investor's looking towards the Third World has been restricted by the lack of highways, railroads, electric power and communications, necessary for the profitable operation of a business operations, but are usually not themselves profitable to build, operate and maintain. No businessman expects to pay for these facilities so necessary to his business as it is the job of the public sector. But underdeveloped countries has been slow in providing these facilities.

It has been observed that the Bank has been successful in providing these facilities to underdeveloped and developing member countries. The IBRD lending in the Third World has been primarily directed towards this businessman's dilemma since 1949. Out of $44,708.2 million loaned by the Bank upto June 30, 1998, approximately $19,622.0 million (i.e., about 45% of the total) has been for the development of electric power and transportation. In addition, a few loans have been made to public projects which it considers profitable to private enterprise.

(b) Guarantees or Participation in Loans Made by Private Investors: Direct IBRD's promotion of foreign corporate investment in underdeveloped countries has essentially been limited, because the Articles of Agreement requires that its loans must be guaranteed by government concerned. As has already been pointed out, private
companies have avoided government guarantees because of fears of political interference in business affairs. In the same way, governments have also avoided making such guarantees because of tough nature of possible charges of favouritism.

In addition, a second has been the IBRD's prohibition on equity investment. In this regard also, the efforts of the Bank can be appreciated. The promotion of private interests was initiated in 1956 when the Bank created the International Finance Corporation (IFC), an affiliate body of the Bank. The IFC was designed to make loans only to private enterprises, without governmental guarantee and often with equity investment features.

It is interesting to note here that creation of the IFC as an affiliate of the Bank was not a basic change in political or economic orientation but it was rather an institutional embodiment of one of the Bank's basic priorities. As already pointed out, since the statutory limitation on the Bank precluded the promotion of private investment; thus the IFC was created to fill this gap.

The flow of private investment has sometimes been impeded by the fear among the private investors that their investment may be exposed in a number of countries to expropriate or other arbitrary governmental action not subject to objective and independent judicial review. Hence to safeguard the interests of private
investors and to promote and maintain the flow of international private investors and to promote and maintain the flow of international Centre for settlement of Investment Disputes (ICSID).\textsuperscript{11}

The main purpose of the ICSID is to be available to the parties to certain international investment arrangements by providing them with an assured form on which they may agree, for the settlement of future disputes, as well as any that has already arisen.\textsuperscript{12} The Bank's role in stimulating the flow of private capital was enlarged with the creation of two Bank affiliates — the IFC and the ICSID.\textsuperscript{13}

The Bank's financial as well as technical assistance to development finance companies has helped in launching and expanding large numbers of industrial enterprises. The Bank's objective in promoting development finance companies is to help build strong and effective domestic investment institution which can channel local savings, external capital, local and foreign know-how into productive private enterprises.

In 1980, another Bank's affiliate, namely the international Development Association (IDA), was created. Its organization set-up and staff are identical to that of the IBRD. Its loans are solely for the purpose to develop infrastructure in underdeveloped countries. One of the important objectives of this Association is to private loans to those underdeveloped countries which are allied with South
Asia, especially India which receives about half of the lending resources of the Associateion.

Nevertheless, these countries need more funds to avoid economic collapse. Banking interests understood that "soft loans", i.e. without interest, were necessary to protect their already outstanding loans and to protect any contract which Western business might wish to maintain with such countries.\textsuperscript{14}

The IDA, however, reflects one major revision in policy—a flexible adaptation of the IBRD to the extreme debt servicing problems of some of its more favoured aid recipients.\textsuperscript{15}

Thus, the Bank has been making successful efforts in the promotion of international private investment and seems eventually to have fulfilled its objective. The Bank is primarily a guarantor of private loans, not a large lending institution in its own right.

In the early years of its establishment, the Bank was criticised on the ground that it supplanted private foreign investment as it was in a position to supply larger funds than individual investment institutions. But this is not true because the object of the Bank, as provided by the Articles of Agreement, is to supplement and not to supplant private foreign investment. The Bank grants a loan to a country only when it finds that the country concerned could not be
able to get one on favourable terms. Moreover, a considerable portion of finance provided by the Bank has come from private investors. Nearly 50% of $2262 million which was available for lending during the first 8 years of its financial operations had come from private sources.

Effective coordination among multilateral and bilateral donors16 of assistance, and between donors and recipient countries, is an important element in the development effort. It can help to assure that donors are supporting consistent development goals, and the financial and technical aid from different sources is applied efficiently to priority requirements. It can also facilitate better planning and execution by the developing countries and so enable them to use assistance more productively.

The Bank has taken the lead in forming groups to coordinate the flow of financial and technical assistance to individual developing countries. Aid coordination groups provide a forum, in which a country may regularly inform donor governments of its problems and in which donor government can exchange information about their respective programmes and activities in the recipient country. They help to maintain a flow of aid to recipient country. They help to maintain a flow of aid to recipient countries to coordinate the flow of external
finance and technical assistance from different sources, and to facilitate its efficient changing with a view to meeting recipients priority needs. They also provide opportunities for mitigating the problems associated with aid tying and suppliers credits. By December 1993, the Bank was the chairman of 16 aid coordination groups of assist the developing countries.17

Promotion of the Long Range Balanced Growth of International Trade

The third objective of the Bank is designed to promote the long-range balanced growth of international trade and maintenance of equilibrium in the balance of payments of member countries for this function the Bank applies several means. First, the Bank examines the overall economy of the borrower and makes sure that the project in question fits well into a broad pattern that will eventually lead to self-sustained growth. Incidentally, a number of economic surveys conducted by the Bank indicate how this is done, and also provide a wealth of information on economic development.

Secondly, the Economic Development Institute run by it, trains the people of different countries. Thirdly, it requires the borrower to find enough local capital to meet local expenditures for labour and materials.18 Fourthly, the Bank tries to help develop the multilateral
trade and investment, mainly by permitting the borrower to spend the proceeds of a loan in any country. This method of the Bank is entirely in contrast to the procedure of Export-Import Bank of Washington, which requires that loans must be spent in purchasing US products or services.¹⁹

Lastly, the Bank has been helping to create an international stake in the regular servicing of loans. All members provide the Bank with capital and also agree to share losses. Each member of the Bank is liable for its proportionate share of losses up to the size of its subscription.

**Encouragement of Loans to Useful and Urgent Projects**

The fourth objective of the Bank dictates that it will encourage its loans for useful and urgent projects in underdeveloped countries. It has been helping to promote sustained high level international lending by asking the member countries to submit sound projects and by demonstrating to investors that the Bank is worthy of their confidence. With respect to projects, it has laid principal emphasis upon basic public service facilities. Thus, its development loans have been ranked, by category, as transportation, communications, electric power, agriculture, industry and general development, etc. These are the fundamentals of any sound economy.
However, the concept of the development has now changed. The Bank places greater emphasis on technical assistance and on more social projects such as education, population, agriculture in which credit-worthless in not guaranteed.

**Conduct of Operations**

The IBRD is required by its Articles of Agreement to do what it could to smooth out business — cycle fluctuations. The purpose of the Bank — ! (V) to conduct its operations with due regard to the effect of international investment on business conditions in the territories of its members.

It is sometimes argued that long-term lending should be used as a counter-cyclical device. Professor Kindleberger has rightly observed that "foreign lending expanded in depression and contracted in prosperity." This would have two effects: first, to assist in stabilizing business conditions in the lending country, and secondly, to stabilize its balance of payments.

As the Bank operations show, this objective of the Bank does not seem to have been fulfilled as is clear from the statements of the Bank Authorities who maintain that the Bank's primary task must be economic development, and any major attention to cyclical timing would come into conflict with this objective. Further, Mr. Condliffe
observes, "One of the primary purposes of the Bank was to break the log jams of investment. It was not to act as an international agency of planned investment, or as an instrument of international lending to counteract depression and to maintain equilibrium at full employment."\(^{21}\)

However, on the contrary, the Bank is a really practical institution in the world. It has been taking pains to emphasize its role as a catalyst of private enterprise and private investment and thereby to win the confidence of Banks, insurance companies and other institutional investors."\(^{22}\)

**FINANCE OF THE IBRD**

There are the channels through which the Bank can advance loans.

1. Direct loans from its own funds.

2. Advancement of loans out of the amount raised in money markets.

3. Guarantee of loans in full or in part made by investment agencies.

In theory, the Bank is a "lender of the last resort". As a general principal, the Bank is to intervene only when a prospective borrower,
though fully qualified, is unable to arrange a loan elsewhere on reasonable terms. This is in keeping with the principal that the Bank supplements and not supplants the existing credit facilities.

Insofar as the Bank did intervene, its lending capacity was limited to the amount of total subscription (plus the amount held as reserves and surplus). Since only 20% of subscription was paid in, the Bank's ability to lend on this basis is not great. It was never intended, however, to confine the Bank's lending operations to this amount. The Bank is also empowered to lend on the basis of proceeds from the sale of its own bonds and to promote private lending though its guarantee of loans.

An examination of three conditions for lending operations would be helpful in revealing the role of the Bank in the field of international investment.

**Direct Loans from the Bank's Own Fund**

The Bank is empowered to lend its own funds consisting of the paid-in subscriptions of members plus any reserves and surplus that might be accumulated. Of this paid-in capital, 2% (now 1%) represented by gold could be used for any purpose, but the remaining 18% (now 9%) represented by the member's own currency. Thus, this provision gives member countries control over the lending currencies
supplied by them, though members retain no control over subsequent withdrawals.

The 1% portion of the subscription of all members which is payable in gold or the U.S. portion paid in national currency but converted by the subscribing members into US dollars which is freely available for lending, amounted to about $343 million on December 31, 1993. On the same date, member countries had paid in about $2,180 million as subscriptions in their own currencies to the Bank's capital. The total of these subscriptions that the Bank had been able to use in its lending operations, including amounts allocated to future disbursements, came to about $1,845 million up to December 31, 1993.23

The Bank's net income, which is derived mainly from interest, commitment charges on loans and earnings from investments, rose from $5.3 million in fiscal year 1948 to $219.8 in 1993\16 and $238.4 million in 1998.

**Direct Loans from Borrowed by the Bank**

The Bank is empowered to float its own bonds (commonly known as "World Bank Bonds") and to lend the proceeds. As a conditions for the sale of its bonds, however, the Bank is to obtain the approval of the country in whose market they are offered. In the
case of loans denominated in a currency other than the one circulating in the country in which bonds are marketed, permission by currency country is also required. According to the Articles of Agreement the Bank can borrow funds (or guarantee loans) "only with the approval of the member in whose currency the loan is denominated, and only if those members agree that the proceeds may be exchanged, for the currency of any other member without restriction." Without such approval, it is though that the technical possibility exists that a particular member country might fail to honour claims for goods and services arising out of the credit operations of the Bank. If approval is obtained, however, the currency raised by the Bank would be certainly freely convertible with neither the lending country nor the currency country thereafter retaining control over withdrawals.

The Bank has obtained the principal part of its lending resources from borrowings. Up to December 31, 1993, the Bank had sold its own obligations in various currencies in an aggregate principal amount equivalent to $15,736 million, of which approximately $9,056 million was then outstanding.

Guarantees of Loans

Prospective borrowers, as already pointed out, unable to obtain funds elsewhere on reasonable terms, can apply to the Bank for
loans. The Bank, if so disposed, could then extend a loan from its own funds, or it could refer the applicant back to the private capital market, but in doing so the Bank might agree to guarantee in whole or in part the loan occurring through private investment channels. The Bank, however, is to guarantee such a loan only after obtaining the approval of the country in whose market the funds are floated. Such an approval is deemed necessary for the protection of the balance-of-payments positions of the lender and currency countries respectively, but once it is obtained the individual country has no further control over either convertibility of a currency or the rate and manner of withdrawals.

It was believed initially that the guarantee of private loans would comprise the major portion of the Bank's business. Appreciating the guarantee function of the Bank, Lord J.M. Keynes stated before the Bretton Woods Conference, "Without some supporting guarantee, therefore, loans which are greatly in the interests of the whole world, and indeed essential for recovery, it may prove impossible to float." It soon became apparent, however, that the guarantee operations accounted for relatively little — only five per cent of the loans advanced by the Bank. Basically, the Bank's management relied upon outright lending from funds secured through the sale of bonds, rather than upon the guarantee function.
NOTES AND REFERENCES


3 For a detailed discussion refer to Chapter 3.


7 Steve Weissman, (ed.), *The Trojan Horse*, 1994, p. 52.

8 Steve Weissman, *op. cit.*, p. 53.

9 Vide Table 4.1, Chapter 4.


11 The convention on the Settlement of Investment Disputes between States and Nationals of other States was opened for signature on March 18, 1965 ot all members of the Bank. By April 1, 1991 the 66 states had signed the convention, and out of these 60 have

12 Ibid.


14 Steve Weissman, *op. cit.*, p. 54.

15 Ibid.

16 In this section, the term "Donor" means a government or intergovernmental organization which provides technical and/or financial assistance by way of grants or loans.


19 For a detailed discussion refer to Chapter 3.


25 IBRD, The Articles of Agreement, IV, Sec 1.