ESSAYS IN INTERNATIONAL FINANCE

No. 33, March 1959

THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

ALEC CAIRNCROSS

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS AND SOCIOLOGY

PRINCETON UNIVERSITY

Princeton, New Jersey

This is the thirty-third number in the series ESSAYS IN INTERNATIONAL FINANCE *published from time to time by the International Finance Section of the Department of Economics and Sociology in Princeton University.*

The author, Alec Cairncross, is Professor of Applied Economics at the University of Glasgow and Editor of the SCOTTISH JOURNAL OF POLITICAL ECONOMY. *He has served in many other positions; among them are Economic Adviser to the Board of Trade, Economic Adviser to the Organization for European Economic Cooperation, Director of the Economic Development Institute and member of the Radcliffe Committee. The views expressed in this essay are, of course, his own and do not purport to reflect those of any institution with which he is or has been associated.*

The Section sponsors the essays in this series but takes no further responsibility for the opinions expressed in them. The writers are free to develop their topics as they will. Their ideas may or may not be shared by the editorial committee of the Section or the members of the Department.

The submission of manuscripts for this series is welcomed.

LESTER V. CHANDLER, *Acting Director*
International Finance Section

ESSAYS IN INTERNATIONAL FINANCE

No. 33, March 1959

THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

ALEC CAIRNCROSS

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS AND SOCIOLOGY

PRINCETON UNIVERSITY

Princeton, New Jersey

THF INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

I. THE BANK AND THE FUND

OF THE twins of Bretton Woods, the International Bank for Reconstruction and Development enjoyed far less of the limelight at its inception than the International Monetary Fund. At the preliminary conference at Atlantic City in June 1944, attention was concentrated on the Fund and at Bretton Woods the main source of controversy was the Articles of Agreement of the Fund, even when it was intended that similar provisions should apply to the Bank. The quotas on which so much of the discussion centred were worked out first for the Fund and later became the basis for subscriptions to the Bank—to the consternation of members who had sought high quotas in the Fund in order to establish drawing rights but were less anxious to make equal capital subscriptions to the Bank. At Savannah it was again the Fund that was the principal subject of debate; it seems to have been assumed that the same relations between management and executive directors would govern both institutions. The site chosen for the Fund automatically became the site of the Bank, which until 1958 shared the same building in Washington and continues to share the same library.

Yet in the first ten years of its existence it was the Bank rather than the Fund which most readily found a place for itself. The scope of its activities steadily expanded; it was never subject to the frustrations that inevitably beset the Fund when the burden of international reconstruction fell on the United States; its policies took increasingly firm shape; and its influence on world economic development grew progressively.

The membership of the Bank has throughout been identical with that of the Fund; Bank membership is, in fact, open only to members of the Fund. All the 44 countries represented at Bretton Woods subsequently joined the two institutions except the Soviet Union, New Zealand and Liberia. Nearly all other countries of any economic importance outside the Communist bloc (except Switzerland) have been added to the list of members, which now totals 68. Poland withdrew in 1950 and Czechoslovakia was expelled in 1953 for non-fulfilment of its obligations, leaving Yugoslavia the only Communist member. China's membership was continued in favour of Taiwan on an undertaking from the emigré government that it would pay the remaining (and major) part of its subscription as soon as possible, and the Chinese Executive Director retained his position as an appointed member of the Board.

Although the two institutions have led a more separate existence than was perhaps originally intended, they supplement one another and the future of the one is closely tied up with the future of the other. The Bank is concerned primarily with the flow of capital into long-term investment across national boundaries, the Fund with problems of international liquidity and short-term credit. But both institutions share a common interest in helping their members to reconcile economic balance and economic growth, in promoting economic and financial policies that pay regard not only to national but also to international interests, and in maintaining an international framework within which countries can make necessary adjustments in their economies without excessive strain.

II. THE FUNCTIONS OF THE BANK

The purpose of the Bank is implicit in its title. This emphasises an immediate and temporary function: that of assisting the restoration and reconstruction of productive capacity destroyed during the war. It also underlines a continuing and longer-range function: that of contributing to the development of economic resources and the growth of productive power and standards of living, particularly in backward or under-developed countries.

These functions were regarded at Bretton Woods as competitive; so long as the capital at the disposal of the Bank was limited and the claims of reconstruction were pressing, and indeed paramount, there could be no assurance that the Bank would have enough funds to discharge its obligations towards the less-developed countries. In the early years of the Bank there did in fact appear to be some antithesis between its functions. The first loans were made exclusively for the reconstruction of countries in Western Europe and it was only after a large proportion of the Bank's freely usable, paid-in capital had already been committed that any loan agreements were concluded with under-developed countries. But even at that stage the limiting factor in loans to those countries was not the inadequate resources of the Bank so much as the greater care that was needed in examining the projects submitted for financial support, and the delays that prolonged examination entailed. In any event, it was obvious that, sooner or later, reconstruction would come to an end and the needs of economic development would become the enduring preoccupation of the Bank. Marshall Aid hastened the transition and for many years the word "Reconstruction" in the Bank's title has been an anachronism.

The functions of the Bank can be not inadequately summarised by describing it as an international development bank. It is in the first place an *international* institution: a specialized agency of the United Nations operating as a co-operative venture in long-term foreign lending. It is, secondly, a *development* bank: not perhaps the exact counterpart at the international level of those development banks which it has done so much to encourage at the national level, since these have been devoted exclusively to industrial financing and have been privately owned; but, like them, engaged in promoting development by supplying long-term capital, and following an older tradition of development banks in financing a variety of large projects of special importance to the economies of member countries. Moreover, just as many development banks found themselves obliged to enter other fields of activity as they took a more comprehensive view of all that development implied, so the Bank, starting out as a lender on long-term, has been forced to take an increasingly wide view of its responsibilities.

As an international institution, the prime task of the Bank is to stimulate and support foreign investment. So far as this involves the use of the Bank's own resources, it must be able to mobilize capital from a variety of capital-exporting countries and lend the capital so mobilized to a variety of capital-importing countries. The wider the range of borrowers and lenders, the more truly international will the Bank become. It has in fact relied heavily on the United States for its funds and has found employment for those funds chiefly in the under-developed countries. But it is by no means simply a vehicle for channelling American investment towards the under-developed countries. It has raised a growing proportion of its funds outside the United States and it has always been willing to make loans to countries that would not normally be regarded as backward, or even under-developed. Every country aspires to economic development and nearly every country has a pressing need for extra capital. Developed countries, though generally lenders, particularly on long-term, very often import capital and may have good reasons for trying to borrow through an international institution. Similarly, under-developed countries, although normally importers of capital, at least on long-term, may at times be in a position to lend to the Bank or accelerate repayment of their loans from it. The Bank's international role, therefore, need not consist in raising capital in developed countries in order to lend it to under-developed countries.

It may borrow from either group and lend to either group. It may even finance projects in countries from which it is currently borrowing; and it has in fact done so. For example, in a recent issue by private placement, the Bank found buyers for its bonds in no less than nine countries to which it had made loans during the year 1957-58. In May 1957 the Dutch Herstelbank borrowed $15 million from the Bank, although public issues of guilder bonds had been made in 1954, and again in 1955, by the Bank, and the Netherlands is a steady buyer of the Bank's dollar bonds.

As a development bank, the Bank is first and foremost a lender on long-term. From its standing as a lender, it has acquired authority in the exercise of other functions. It has built up a special expertise in the peculiar blend of engineering, economics and administrative skill necessary for the appraisal and supervision of large projects of construction. It has also a unique experience in the formulation of comprehensive programmes of economic development. This experience leads member countries to turn to the Bank not only for finance, but also for advice and guidance; while the Bank, in devising techniques by which it could put its experience at the service of member countries has come to think of itself as a consultant quite as much as a financial institution.

The functions of the Bank extend, therefore, well beyond the series of loan transactions in which it engages. Not only does it, like other development banks, maintain a continuing relationship with borrowers throughout the life of each loan. It insists that the loans cannot be treated as isolated transactions and that the projects which they finance must be examined in relation to the rest of the development effort of the borrower. It constantly emphasises the value of a development programme into which the major projects are fitted. It aims also at identifying the economic and financial policies most conducive to development and the strategic factors upon which governments should be encouraged to operate. Thus the Bank has found itself involved in working out, if not a theory, at least a philosophy of development. This is not a philosophy which the Bank has ever articulated in any detail. But there are passages in its Annual Reports that recur to the same general themes: the limited value of additional finance if other, institutional factors are not propitious; the importance of good management both in the planning of individual projects and in the conduct of a nation's affairs; the need to encourage initiative, enterprise and the will to develop, and to avoid policies which, through weakness, vacillation or impatience, prevent the emergence of attitudes and institutions favourable to development.

III. THE BANK AS BORROWER

At Bretton Woods it was envisaged that the Bank would operate mainly by guaranteeing loans by private investors rather than through direct loans from its own capital. It was thought that the immediate needs of post-war reconstruction would be met by UNRRA, and that thereafter an adequate amount of long-term capital might be raised with the Bank's guarantee, the Bank pledging the collective credit of its members in security. The Articles of Agreement call upon the Bank "to promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors." It is only when private capital is not available on reasonable terms that it is required "to supplement private investment by providing on suitable conditions finance for productive purposes out of its own capital, funds raised by it and its other resources."

This explains why the bulk of the Bank's subscribed capital—four-fifths—takes the form of a guaranty fund, to be drawn upon when necessary to meet obligations arising out of loans and guarantees. Only the remaining fifth of the subscriptions from member countries is payable in cash; and of this fifth only one-tenth, or 2 per cent of the total capital, must be paid in gold and dollars. Even this 2 per cent was at first subject to a concession—to meet Russian objections at Bretton Woods—in favour of countries occupied during the war; it was the failure of Czechoslovakia to pay the balance of her 2 per cent dollar subscription that led to her expulsion.

The expectation that the Bank would operate by guaranteeing loans raised by its members from private investors came to nothing. From the Bank's point of view there would have been serious inconvenience if loans issued by different countries, all bearing its guarantee, had been sold in the market at different rates. This not unlikely contingency would have been damaging to the Bank's credit; and it was largely in an effort to establish that credit on a firm basis that it was decided to issue Bank obligations rather than guarantee those of member governments.

The decision to follow the path of direct lending involved the Bank in a long struggle to extend the market for its bonds, to gain access not only to the American but to other capital markets as well, and to obtain fuller and more unrestricted use of member countries' subscriptions. It took some years before the Bank could claim with assurance that its lending would not be limited by the funds at its command and that it could undertake to lend to any country as much as that country, in its judgment, could hope to repay.

By the middle of 1948, for example, the Bank had lent almost $500 million in United States dollars, for periods ranging up to thirty years, to France, the Netherlands, Luxembourg and Denmark. On the other hand, the member countries other than the United States had paid in less than $100 million in gold and United States dollars so that the Bank had to find the whole of the balance out of the United States subscription of $635 million or from loans floated in the United States market, largely against the security of the uncalled portion of the United States subscription. The marketing of Bank loans in the United States, however, presented difficulties since there were initially only a few states where institutional investors could legally invest in the Bank's securities and it required a prolonged campaign, first to obtain legislative approval for such investment and then to interest the leading institutions in the Bank's offerings of bonds.

The first bond issues, one for $100 million and one for $150 million, were made in order to test the market in July 1947, and were heavily over-subscribed. Apart from a re-financing issue in 1950, no further issues were made in America until 1951, but there has been at least one issue in every subsequent financial year except 1954-55 and 1955-56. The chief buyers have been pension and trust funds, which hold nearly half the total in the United States, and insurance companies and savings banks which together hold most of the other half. As one might suppose, these have proved firm holders, and the price of Bank bonds has been well maintained in relation to the price of United States government obligations.

TABLE I

BORROWING OPERATIONS OF THE WORLD BANK, 1946-58
($ MILLION)

United States	*Funded debt outstanding*	*Net increase in funded debt*	*Funded debt held outside the United States*	*Net increase in funded debt held outside the United States*
June 30 1948	254	—	—	—
1949	254	—	—	—
1950	261	7	—	—
1951	325	64	64[1]	—
1952	500	175	100	36
1953	556	56	155	55
1954	777	221	279	124
1955	852	75	374	95
1956	850	−2	380	6
1957	1034	183	480	100
1958	1658	625	730	250

Source: *Annual Reports* of I.B.R.D.

[1] Cumulative to June 30, 1951.

In seeking to broaden the market for its bonds, the Bank did not look exclusively to action in the United States. It obtained listings on various stock exchanges and found buyers for some of its dollar obligations outside the United States, chiefly among the central banks of member countries. By the middle of 1957, about $280 million of United States dollar bonds, or one-third of the outstanding total, was held outside the United States and in the ensuing year three dollar issues totalling $250 million were placed privately with the Deutsche Bundesbank. The Bank made its first issue of bonds denominated in other currencies when it placed a small issue of Swiss franc bonds in 1948 with the Bank for International Settlements, an issue which the B.I.S. readily disposed of to Swiss banks. This was followed in 1951 and later years with public issues made in succession in the United Kingdom, Switzerland and the Netherlands. The Bank also floated two issues in Canada and brought Canadian and European participants into one of the early syndicates through which its bonds were offered to the public.

The record has been one of diminishing dependence on the United States as a source of finance and of increasing dependence on Western Europe. Although it was not until 1951 that the Bank was able to make public offerings of its bonds outside the United States, bonds to the value of nearly $700 million (including dollar bonds) were purchased by non-American holders over the next seven years, and by the middle of 1958 they held about half the total funded debt of the Bank. The experience of recent years suggests that this proportion is likely to be maintained.

It remains true, however, that the Bank is heavily dependent on United States finance. The need to have recourse to the United States for half its current borrowings may do no more than reflect the concentration of industrial and financial potential in that country but must at the same time take from the international character of the Bank's operations. Moreover, apart from the United States there are still very few other capital markets to which it is possible to turn: European holders of Bank bonds are largely confined to Germany, a comparatively recent supplier of funds, Switzerland, a non-member of the Bank, and, to a much smaller extent, the United Kingdom, the Netherlands and Belgium.

How successful the Bank will be in the future in broadening the sources of its funds must depend not only on the success of capital-rich countries in generating a favourable balance of payments but also on their willingness to open their capital markets to foreign borrowers, on their desire to direct the flow of capital to suit their own national interests or colonial and commonwealth responsibilities, and on the rates of interest at which bond issues can be made. The establishment of the Common Market in Europe, for example, may operate to reduce the access of the Bank to European capital; and the pressures on the British capital market may also rule out a revival of British investment through the Bank.

Almost from the beginning, the Bank found it possible to arrange for participation in its loans by institutional investors and to make sales to them from its own portfolio, with or without its guarantee. When sales are made without the Bank's guarantee, as has been the invariable practice in recent years, the Bank passes on to the borrower all savings in interest up to 1 per cent, the commission payable to the Bank; but the rise in interest rates has made it impossible to sell maturities appreciably, if at all, below the full rate (including commission) already payable. The Bank is under no obligation to seek authority from the borrower before selling a portion of his loan—a circumstance that was cited by the Colonial Development Corporation in 1950 as an obstacle to the conclusion of a loan agreement with the Bank.

Participations and sales have been by no means confined to American investors and a growing proportion of the funds—in recent years well over half—has come from Europe. The total amount realized to the middle of 1958 came to $420 million or about one-ninth of the loans made by the Bank up to that time. Sometimes participations are arranged simultaneously with the loan agreement, at other times they represent subsequent sales from the Bank's portfolio: in 1957-58 the two were roughly equal. The Bank normally takes the longer maturities, leaving it to the participating institutions to take the short- and medium-term tranches. This is apparent from the fact that of the $420 million, no less than $173 million had already been repaid, whereas only $219 million had been repaid directly to the Bank on its much larger portfolio.

These sales from the Bank's portfolio economize the call on its own resources and extend the total market for loans raised by the borrowing countries. A similar effect is obtained by joint operations with the investment market in the United States. On a number of occasions, the Bank has made a loan to a member government to finance a programme of development while the government concerned made a public offering (or placement) of its bonds concurrently through investment banking firms in order to obtain supplementary finance for the same programme. These joint operations, which have enabled countries like South Africa and Belgium to offer their bonds in the United States market, usually involve the Bank in taking the longer maturities, just as in the case of direct participations. The total raised from the market in this way up to June 30, 1958, was $140 million.

In view of the limited access that the Bank had to the nominally very large capital subscriptions by its members, it was natural that it should lay increasing stress on the desirability of removing restrictions on the use of the 18 per cent payable in members' own currencies. This 18 per cent may be lent by the Bank only with the consent of the member country concerned. In the early years the Bank recognised that few of its members had capital to spare for foreign lending and that, even if they had, they would have difficulty in lending convertible currencies. At the same time, since it was one of the main purposes of the Bank to internationalize foreign lending, it could not rest content with a situation in which nearly all its funds came from a single member.

Progress was made gradually and in a variety of ways. Some countries have been persuaded to announce that their 18 per cent can be used to finance purchases made from them; one important member, Great Britain, agreed in 1953 to the use of £60 million for loans to the sterling countries of the Commonwealth and has since agreed to release the remaining £20 million over a series of years; others have agreed to partial convertibility (for example, to the use of their 18 per cent within the area of the European Payments Union) or to release, step by step, over a period of years; only a few have accepted complete convertibility, releasing their 18 per cent for purchases in any part of the world.

The position in 1958 is that, out of the 18 per cent subscriptions of its members, the Bank has been able to make use of only $1176 million, half of which is made up of the United States subscription. As recently as 1954, other member countries had released less than $150 million, but this total has grown to some $600 million in the past four years. Even now, a sum equivalent to about $500 million has not yet been made available for lending, although part of this total could be used, subject to conditions laid down by the members concerned.

The funds available to the Bank at June 30, 1958, and the increase in those funds over the preceding three years are shown in Table II.

Thus the principal sources of funds have been, in roughly equal measure, members' subscriptions and bond issues. The contribution made by net income from loans is small but growing and has doubled in the past five years. Participations and sales have averaged about $75 million in the past few years, and have furnished a rising proportion of total funds. Repayment of loans, although extremely small, must eventually become a much more important source of funds; a situation in which repayments are under $30 million a year while loans over the